NEW YORK MORTGAGE TRUST INC
Form S-3/A
April 09, 2012

As filed with the Securities and Exchange Commission on April 9, 2012

Registration No. 333-179314

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Pre-Effective Amendment No. 1 to

Form S-3
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

New York Mortgage Trust, Inc.
(Exact name of registrant as specified in its charter)

Maryland	47-0934168
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification number)

52 Vanderbilt Avenue, Suite 403
New York, New York 10017
(212) 792-0107
(Address, Including Zip Code, and Telephone Number, including Area Code, of Registrant's Principal Executive Offices)

Steven R. Mumma
Chief Executive Officer
New York Mortgage Trust, Inc.
52 Vanderbilt Avenue, Suite 403
New York, New York 10017
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(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to public: From time to time after the effective date of this registration statement.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, please check the following box. x

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Securities and Exchange Commission pursuant to Rule 462(e) under the Securities Act, check the following box. o

If this form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box. o

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities, and we are not soliciting offers to buy these securities, in any state where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED APRIL 9, 2012

PROSPECTUS

$250,000,000

Common Stock
Preferred Stock
Debt Securities

We may offer and sell, from time to time, in one or more offerings, up to an aggregate of $250,000,000 of the common stock, preferred stock and debt securities described in this prospectus. We may offer and sell these securities to or through one or more underwriters, dealers and agents, or directly to purchasers, on a continuous or delayed basis.

The specific terms of any securities to be offered, and the specific manner in which they may be offered, will be described in one or more supplements to this prospectus. This prospectus may not be used to consummate sales of any of these securities unless it is accompanied by a prospectus supplement. Before investing, you should carefully read this prospectus and any related prospectus supplement.

Our shares of common stock are listed on the Nasdaq Capital Market under the symbol “NYMT.” The last reported sale price of our common stock on the Nasdaq Capital Market on April 5, 2012, was $6.66 per share.

To preserve our qualification as a real estate investment trust, or REIT, for federal income tax purposes, we impose certain restrictions on the ownership and transfer of our capital stock. See “Description of Common Stock — Restrictions on Ownership and Transfer” and “Description of Preferred Stock — Restrictions on Ownership and Transfer; Change of Control Provisions.”

Investing in our securities involves substantial risks. You should carefully read and consider the information under “Risk Factors” on page 3 of this prospectus and any prospectus supplement before making a decision to purchase these securities.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is , 2012.

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You should rely only on the information contained in this prospectus and the accompanying prospectus supplement or incorporated by reference in these documents. No dealer, salesperson or other person is authorized to give any information or to represent anything not contained or incorporated by reference in this prospectus or the accompanying prospectus supplement. If anyone provides you with different, inconsistent or unauthorized information or representations, you must not rely on them. This prospectus and the accompanying prospectus supplement are an offer to sell only the securities offered by these documents, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus or any prospectus supplement is current only as of the date on the front of those documents.

ABOUT THIS PROSPECTUS

This prospectus is part of a shelf registration statement that we filed with the Securities and Exchange Commission, or the SEC. Under this shelf registration statement, we may offer and sell any combination of our common stock, preferred stock and debt securities in one or more offerings. This prospectus provides you with a general description of the securities we may offer. Each time we offer to sell securities under this shelf registration statement, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may add, update or change information contained in this prospectus. Before you buy any of our securities, it is important for you to consider the information contained in this prospectus and any prospectus supplement together with additional information described under the headings “Incorporation By Reference Of Information Filed With The SEC” and “Where You Can Find More Information.”

The SEC allows us to incorporate by reference information that we file with them, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to be a part of this prospectus, and information that we file later with the SEC will automatically update and supersede this information. You should rely only on the information incorporated by reference or set forth in this prospectus or any prospectus supplement. We have not authorized anyone to provide you with information different from that contained in this prospectus. No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus. You must not rely on any unauthorized information or representation. This prospectus is an offer to sell only the securities offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. You should assume that the information in this prospectus or any prospectus supplement is accurate only as of the date of the document incorporated by reference. Our business, financial condition, results of operations and prospects may have changed since that date.

In this prospectus, we refer to New York Mortgage Trust, Inc., together with its consolidated subsidiaries, as “we,” “us,” “Company,” or “our,” unless we specifically state otherwise or the context indicates otherwise. In addition, the following defines certain of the commonly used terms in this prospectus: “RMBS” refers to residential adjustable-rate, hybrid adjustable-rate, fixed-rate, interest only and inverse interest only, and principal only mortgage-backed securities; “Agency RMBS” refers to RMBS representing interests in or obligations backed by pools of residential mortgage loans issued or guaranteed by a federally chartered corporation, such as the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”), or an agency of the U.S. government, such as the Government National Mortgage Association (“Ginnie Mae”); “IOs” refers collectively to interest only and inverse interest only mortgage-backed securities that represent the right to the interest component of the cash flow from a pool of mortgage loans; “POs” refers to mortgage-backed securities that represent the right to the principal component of the cash flow from a pool of mortgage loans; “ARMs” refers to adjustable-rate residential mortgage loans; “prime ARM loans” refers to prime credit quality residential ARM loans (“prime ARM loans”) held in securitization trusts; and “CMBS” refers to commercial mortgage-backed securities comprised of commercial mortgage pass-through securities, as well as IO or PO securities that represent the right to a specific component of the cash flow from a pool of commercial mortgage loans.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING INFORMATION

When used in this prospectus and in any accompanying prospectus supplement, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as “believe,” “expect,” “anticipate,” “estimate,” “plan,” “continue,” “intend,” “should,” “would,” “could “objective,” “will,” “may” or similar expressions, are intended to identify “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act, and, as such, may involve known and unknown risks, uncertainties and assumptions.

Forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. The following factors are examples of those that could cause actual results to vary from our forward-looking statements: changes in interest rates and the market value of our securities; the impact of the downgrade of the long-term credit ratings of the U.S., Fannie Mae, Freddie Mac, and Ginnie Mae; market volatility; changes in the prepayment rates on the mortgage loans underlying our investment securities; increased rates of default and/or decreased recovery rates on our assets; our ability to borrow to finance our assets; changes in government regulations affecting our business; our ability to maintain our qualification as a real estate investment trust for federal tax purposes; our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended; and risks associated with investing in real estate assets, including changes in business conditions and the general economy. These and other risks, uncertainties and factors, including the risk factors described in Item 1A of our most recent Annual Report on Form 10-K, as updated by our subsequent filings under the Exchange Act, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements speak only as of the date on which they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

OUR COMPANY

We are a real estate investment trust, or REIT, in the business of acquiring, investing in, financing and managing primarily mortgage-related and, to a lesser extent, financial assets. Our objective is to manage a portfolio of investments that will deliver stable distributions to our stockholders over diverse economic conditions. We intend to achieve this objective through a combination of net interest margin and net realized capital gains from our investment portfolio. Our portfolio includes investments sourced from distressed markets over recent years that create the potential for capital appreciation, as well as more traditional types of mortgage-related investments, such as Agency RMBS consisting of adjustable-rate and hybrid adjustable-rate RMBS, which we sometimes refer to as Agency ARMs, and Agency RMBS comprised of IOs, which we sometimes refer to as Agency IOs, that generate interest income.

We commenced operations as a vertically integrated mortgage origination and portfolio investment manager in 2004 upon the completion of our initial public offering. Facing increasingly difficult operating conditions, we elected to exit the mortgage origination business in 2007 to preserve our capital and focus on our existing mortgage securities portfolio. In January 2008, concurrent with the private placement of $20 million of our preferred stock to JMP Group Inc. and certain of its affiliates, we engaged Harvest Capital Strategies LLC (“HCS”) (formerly known as JMP Asset Management LLC), an affiliate of JMP Group Inc., to serve as our investment advisor for the purpose of helping us increase our capital base and source certain types of alternative investments or nontraditional mortgage related investments that could provide significant net realized capital gains.

Since 2009, we have endeavored to build a diversified investment portfolio that includes elements of interest rate and credit risk, as we believe a portfolio diversified among interest rate and credit risks is best suited to delivering stable cash flows over various economic cycles. In 2009 and 2010, we invested in several alternative assets, including a collateralized loan obligation, RMBS backed by prime jumbo and Alternative A-paper, or non-Agency RMBS, individual loans and distressed residential single family mortgage loans. In 2011, we refined our investment strategy from one focused on a broad range of alternative assets sponsored by HCS to an investment strategy focused on residential and multi-family loans and securities. In connection with this focus, we entered into separate investment management agreements with The Midway Group, L.P. and RiverBanc, LLC to provide investment management services with respect to certain of our investment strategies, including our investments in Agency IOs and CMBS backed by commercial mortgage loans on multi-family properties, which we sometimes refer to as multi-family CMBS. In connection with the refinement of our investment focus away from the alternative assets sourced by HCS, we ended our advisory relationship with HCS on December 31, 2011.

Under our investment strategy, our targeted assets currently include:

- Agency ARMs and Agency IOs; and
- multi-family CMBS.

Subject to maintaining our qualification as a REIT, we also may opportunistically acquire and manage various other types of mortgage-related and financial assets that we believe will compensate us appropriately for the risks associated with them, including, without limitation, non-Agency RMBS (which may include IOs and POs), collateralized mortgage obligations, residential mortgage loans and certain commercial real estate-related debt investments.

We have elected to be taxed as a REIT and have complied, and intend to continue to comply, with the provisions of the Internal Revenue Code of 1986, as amended, or Internal Revenue Code, with respect thereto. Accordingly, we do not expect to be subject to federal income tax on our REIT taxable income that we currently distribute to our stockholders if certain asset, income and ownership tests and recordkeeping requirements are fulfilled. Even if we maintain our qualification as a REIT, we expect to be subject to some federal, state and local taxes on our income generated in our taxable REIT subsidiaries, or TRSs.

Corporate Offices

We are a Maryland corporation that was formed in 2003. Our principal executive offices are located at 52 Vanderbilt Avenue, Suite 403, New York, New York 10017, and our telephone number is (212) 792-0107. Our website is www.nymtrust.com. Our website and the information contained at or connected to our website do not constitute a part of this prospectus or any accompanying prospectus supplement.

RISK FACTORS

Investing in our securities involves substantial risks, including the risk that you might lose your entire investment. Before making an investment decision, you should carefully read and consider the information set forth under the heading “Risk Factors” in our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q (which information is incorporated by reference in this prospectus), as well as the other information contained or incorporated by reference in this prospectus or in any prospectus supplement hereto. See “Where You Can Find More Information” below. Any one of the risks discussed could cause actual results to differ materially from expectations and could adversely affect our business, financial condition and results of operations. Additional risks and uncertainties not presently known to us or not identified, may also materially and adversely affect our business, financial condition and results of operations.

USE OF PROCEEDS

Unless otherwise indicated in an accompanying prospectus supplement, we intend to use the net proceeds from the sale of securities offered by this prospectus and the accompanying prospectus supplement to acquire our target assets and for general corporate purposes, including the repayment of indebtedness.

DESCRIPTION OF THE SECURITIES WE MAY OFFER

This prospectus contains a summary description of the common stock, preferred stock and debt securities that we may offer from time to time. As further described in this prospectus, these summary descriptions are not meant to be complete descriptions of each security. The particular terms of any security will be described in the accompanying prospectus supplement and other offering material. The accompanying prospectus supplement may update, change or add to the terms and conditions of the securities as described in this prospectus.

DESCRIPTION OF COMMON STOCK

The following summary description of our common stock does not purport to be complete and is subject to and qualified in its entirety by reference to Maryland law, our charter and our bylaws, copies of which are filed as exhibits to the registration statement of which this prospectus is a part. See “Where You Can Find More Information.”

General

Our charter provides that we may issue up to 400,000,000 shares of common stock, par value $0.01 per share. As of March 31, 2012, 14,175,494 shares of common stock were issued and outstanding. Under Maryland law, our stockholders are not generally liable for our debts or obligations. Our charter authorizes our board of directors to amend our charter to increase or decrease the aggregate number of shares of capital stock of any class or series that we have the authority to issue, without stockholder approval.

Voting Rights of Common Stock

Subject to the provisions of our charter regarding restrictions on the transfer and ownership of shares of common stock, each outstanding share of common stock entitles the holder to one vote on all matters submitted to a vote of stockholders, including the election of directors, and, except as provided with respect to any other class or series of shares of our stock, the holders of our common stock possess the exclusive voting power. There is no cumulative voting in the election of directors, which means that the holders of a majority of our outstanding shares of common stock can elect all of the directors then standing for election. Under Maryland law, a Maryland corporation generally cannot dissolve, amend its charter, merge, sell all or substantially all of its assets, or engage in a share exchange or engage in similar transactions outside the ordinary course of business unless approved by the affirmative vote of stockholders holding at least two-thirds of the shares entitled to vote on the matter, unless a lesser percentage (but not less than a majority of all the votes entitled to be cast on the matter) is set forth in the corporation’s charter. Our charter provides for approval by a majority of all the votes entitled to be cast on the matter for the matters described in the preceding sentence.

Dividends, Liquidation and Other Rights

All of our outstanding shares of common stock are duly authorized, fully paid and nonassessable. Holders of our shares of common stock are entitled to receive dividends when authorized by our board of directors and declared by us out of assets legally available for the payment of dividends. They also are entitled to share ratably in our assets legally available for distribution to our stockholders in the event of our liquidation, dissolution or winding up, after payment of or adequate provision for all of our known debts and liabilities. These rights are subject to the preferential rights of any other class or series of our stock and to the provisions of our charter regarding restrictions on transfer and ownership of our stock.

Holders of our shares of common stock have no appraisal, preference, conversion, exchange, sinking fund or redemption rights and have no preemptive rights to subscribe for any of our securities. Subject to the restrictions on transfer of capital stock contained in our charter and to the ability of the board of directors to create shares of common stock with differing voting rights, all shares of common stock have equal dividend, liquidation and other rights.

Power to Issue Additional Shares of Common Stock and Preferred Stock

Our charter also authorizes our board of directors to amend our charter to increase or decrease the aggregate number of shares of capital stock of any class or series that we have the authority to issue, to classify and reclassify any unissued shares of our common stock and preferred stock into any other classes or series of classes of our stock, to establish the number of shares in each class or series and to set the terms, preferences, conversion and other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each such class or series. We believe that the power of our board of directors to take these actions provides us with increased flexibility in structuring possible future financings and acquisitions and in meeting other needs which might arise. The additional classes or series, as well as our common stock, are available for issuance without further action by our stockholders, unless stockholder action is required by applicable law or the rules of any stock exchange or automated quotation system on which our securities may be listed or traded. Although our board of directors has no intention at the present time of doing so, it could authorize us to issue a class or series that could, depending upon the terms of such class or series, delay, defer or prevent a transaction or a change in control of us that might involve a premium price for holders of our common stock that our common stockholders or otherwise believe to be in their best interest.

Restrictions on Ownership and Transfer

In order to qualify as a REIT under the Internal Revenue Code, our shares of stock must be beneficially owned by 100 or more persons during at least 335 days of a taxable year of 12 months or during a proportionate part of a shorter taxable year. Also, no more than 50% of the value of our outstanding shares of capital stock may be owned, directly or constructively, by five or fewer individuals (as defined in the Internal Revenue Code to include certain entities) during the last half of any taxable year. In addition, if certain "disqualified organizations" hold our stock, although the law on the matter is unclear, a tax might be imposed on us if a portion of our assets is treated as a taxable mortgage pool. In addition, a tax will be imposed on us if certain disqualified organizations hold our stock and we hold a residual interest in a real estate mortgage investment conduit, or REMIC.

To help us to qualify as a REIT, our charter, subject to certain exceptions, contains restrictions on the number of shares of our capital stock that a person may own and prohibits certain entities from owning our stock. Our charter was amended in June 2009 to reduce the aggregate stock ownership limit and common stock ownership limit from 9.9% to 5%. As amended, our charter provides that generally no person may own, or be deemed to own by virtue of the attribution provisions of the Internal Revenue Code, either (i) more than 5% in value of the aggregate of our outstanding shares of capital stock or (ii) more than 5% in value or in number of shares, whichever is more restrictive, of the aggregate of our outstanding common stock. However, to the extent that any person's "beneficial ownership" or "constructive ownership" of our stock immediately prior to the effectiveness of the June 2009 charter amendment exceeded the 5% ownership limit described in the preceding sentence, the ownership limit is not effective for such person until that person's ownership percentage falls below the 5% ownership limit; provided, however, that until such time as the person's ownership percentage falls below the 5% ownership limit, any further acquisition of our capital stock by such person will be in violation of the ownership limits established by our charter. Our board of directors is permitted under our charter to increase or decrease the common stock ownership limit and the aggregate stock ownership limit from time to time, and to waive these ownership limits on a case by case basis so long as the waiver will not allow five or fewer individuals to beneficially own more than 49.9% in value of our outstanding capital stock or otherwise cause us to fail to comply with applicable REIT ownership requirements under the Internal Revenue Code. Our charter prohibits the following "disqualified organizations" from owning our stock: the United States; any state or political subdivision of the United States; any foreign government; any international organization; any agency or instrumentality of any of the foregoing; any other tax-exempt organization, other than a farmer's cooperative described in Section 521 of the Internal Revenue Code, that is exempt from both income taxation and from taxation under the unrelated business taxable income provisions of the Internal Revenue Code and any rural electrical or telephone cooperative.

Our charter also prohibits any person from (a) beneficially or constructively owning shares of our capital stock that would result in our being "closely held" under Section 856(h) of the Internal Revenue Code, and (b) transferring shares of our capital stock if such transfer would result in our capital stock being beneficially owned by fewer than 100 persons. Any person who acquires or attempts or intends to acquire beneficial ownership of shares of our capital stock that will or may violate any of the foregoing restrictions on transferability and ownership will be required to give notice immediately to us and provide us with such other information as we may request in order to determine the effect of such transfer on our status as a REIT. The foregoing restrictions on transferability and ownership will not apply if our board of directors determines that it is no longer in our best interests to attempt to qualify, or to continue to qualify, as a REIT.

Our board of directors, in its sole discretion, may exempt a person from the above ownership limits and any of the restrictions described in the first sentence of the paragraph directly above. However, the board of directors may not grant an exemption to any person unless the board of directors obtains such representations, covenants and undertakings as the board of directors may deem appropriate in order to determine that granting the exemption would not result in our losing our status as a REIT. As a condition of granting the exemption, our board of directors may require a ruling from the Internal Revenue Service, or IRS, or an opinion of counsel, in either case in form and substance satisfactory to the board of directors, in its sole discretion, in order to determine or ensure our status as a REIT. Our board of directors has granted exemptions from the ownership limits from time to time in the past, including the grant of a waiver to allow Joseph A. Jolson, an affiliate of HCS and JMP Group Inc., to own up to 25% of the aggregate value of our outstanding stock.

Any transfer that results in our shares of stock being owned by fewer than 100 persons will be void. However, if any transfer of our shares of stock occurs which, if effective, would result in any person beneficially or constructively owning shares of stock in excess or in violation of the above transfer or ownership limitations, known as a prohibited owner, then that number of shares of stock, the beneficial or constructive ownership of which otherwise would cause such person to violate the transfer or ownership limitations (rounded up to the nearest whole share), will be automatically transferred to a charitable trust for the exclusive benefit of a charitable beneficiary, and the prohibited owner will not acquire any rights in such shares. This automatic transfer will be considered effective as of the close of business on the business day before the violative transfer. If the transfer to the charitable trust would not be effective for any reason to prevent the violation of the above transfer or ownership limitations, then the transfer of that number of shares of stock that otherwise would cause any person to violate the above limitations will be void. Shares of stock held in the charitable trust will continue to constitute issued and outstanding shares of our stock. The prohibited owner will not benefit economically from ownership of any shares of stock held in the charitable trust, will have no rights to dividends or other distributions and will not possess any rights to vote or other rights attributable to the shares of stock held in the charitable trust. The trustee of the charitable trust will be designated by us and must be unaffiliated with us or any prohibited owner and will have all voting rights and rights to dividends or other distributions with respect to shares of stock held in the charitable trust, and these rights will be exercised for the exclusive benefit of the trust's charitable beneficiary. Any dividend or other distribution paid before our discovery that shares of stock have been transferred to the trustee will be paid by the recipient of such dividend or distribution to the trustee upon demand, and any dividend or other distribution authorized but unpaid will be paid when due to the trustee. Any dividend or distribution so paid to the trustee will be held in trust for the trust's charitable beneficiary. Subject to Maryland law, effective as of the date that such shares of stock have been transferred to the trustee, the trustee, in its sole discretion, will have the authority to:

- rescind as void any vote cast by a prohibited owner prior to our discovery that such shares have been transferred to the trustee; and

- recast such vote in accordance with the desires of the trustee acting for the benefit of the trust's beneficiary.

However, if we have already taken irreversible corporate action, then the trustee will not have the authority to rescind and recast such vote.

Within 20 days of receiving notice from us that shares of stock have been transferred to the charitable trust, and unless we buy the shares first as described below, the trustee will sell the shares of stock held in the charitable trust to a person, designated by the trustee, whose ownership of the shares will not violate the ownership limitations in our charter. Upon the sale, the interest of the charitable beneficiary in the shares sold will terminate and the trustee will distribute the net proceeds of the sale to the prohibited owner and to the charitable beneficiary. The prohibited owner will receive the lesser of:

- the price paid by the prohibited owner for the shares or, if the prohibited owner did not give value for the shares in connection with the event causing the shares to be held in the charitable trust (for example, in the case of a gift or devise), the market price of the shares on the day of the event causing the shares to be held in the charitable trust; and

- the price per share received by the trustee from the sale or other disposition of the shares held in the charitable trust (less any commission and other expenses of a sale).

The trustee may reduce the amount payable to the prohibited owner by the amount of dividends and distributions paid to the prohibited owner that are owed by the prohibited owner to the trustee. Any net sale proceeds in excess of the amount payable to the prohibited owner will be paid immediately to the charitable beneficiary. If, before our discovery that shares of stock have been transferred to the charitable trust, such shares are sold by a prohibited owner, then:

- such shares will be deemed to have been sold on behalf of the charitable trust; and
- to the extent that the prohibited owner received an amount for such shares that exceeds the amount that the prohibited owner was entitled to receive as described above, the excess must be paid to the trustee upon demand.

In addition, shares of stock held in the charitable trust will be deemed to have been offered for sale to us, or our designee, at a price per share equal to the lesser of:

- the price per share in the transaction that resulted in such transfer to the charitable trust (or, in the case of a gift or devise, the market price at the time of the gift or devise); and
- the market price on the date we, or our designee, accept such offer.

We may reduce the amount payable to the prohibited owner by the amount of dividends and distributions paid to the prohibited owner that are owed by the prohibited owner to the trustee. We may pay the amount of such reduction to the trustee for the benefit of the charitable beneficiary. We will have the right to accept the offer until the trustee has sold the shares of stock held in the charitable trust. Upon such a sale to us, the interest of the charitable beneficiary in the shares sold will terminate and the trustee will distribute the net proceeds of the sale to the prohibited owner and any dividends or other distributions held by the trustee will be paid to the charitable beneficiary.

All certificates representing shares of our capital stock will bear a legend referring to the restrictions described above.

Every holder of more than 5% (or such lower percentage as required by the Internal Revenue Code or the regulations promulgated thereunder) in value of all classes or series of our capital stock, including shares of common stock, within 30 days after the end of each taxable year, will be required to give written notice to us stating the name and address of such holder, the number of shares of each class and series of shares of our stock that the holder beneficially owns and a description of the manner in which the shares are held. Each holder shall provide to us such additional information as we may request in order to determine the effect, if any, of the holder's beneficial ownership on our status as a REIT and to ensure compliance with our ownership limitations. In addition, each stockholder shall upon demand be required to provide to us such information as we may request, in good faith, in order to determine our status as a REIT and to comply with the requirements of any taxing authority or governmental authority or to determine such compliance.

Our ownership limitations could delay, defer or prevent a transaction or a change in control of us that might involve a premium price for holders of our common stock or might otherwise be in the best interest of our stockholders.

Transfer Agent and Registrar

The transfer agent and registrar for our shares of common stock is American Stock Transfer & Trust Company, LLC.

DESCRIPTION OF PREFERRED STOCK

The following summary description of our preferred stock does not purport to be complete and is subject to and qualified in its entirety by reference to Maryland law, our charter and our bylaws, copies of which are filed as exhibits to the registration statement of which this prospectus is a part. See "Where You Can Find More Information."

General

Our charter authorizes our board of directors to issue 200,000,000 shares of preferred stock, par value $0.01 per share, in one or more series and with rights, preferences, privileges and restrictions that our board of directors may fix or designate without any further vote or action by our stockholders.

Our charter authorizes our board of directors to reclassify any unissued shares of common stock into preferred stock, to classify any unissued shares of preferred stock and to reclassify any previously classified but unissued shares of any series of preferred stock previously authorized by our board of directors. Prior to issuance of shares of each class or series of preferred stock, our board of directors is required by Maryland law and our charter to fix, subject to our charter restrictions on transfer and ownership, the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each class or series. Thus, our board could authorize the issuance of shares of preferred stock with terms and conditions that could have the effect of delaying, deferring or preventing a transaction or a change of control that might involve a premium price for you or otherwise be in your best interest.

Terms

When we issue preferred stock, it will be fully paid and non-assessable. The preferred stock will not have any preemptive rights.

Articles supplementary that will become part of our charter will reflect the specific terms of any new series of preferred stock offered. A prospectus supplement will describe these specific terms, including:

- the title and stated value;
- the number of shares, liquidation preference and offering price;
- the dividend rate, dividend periods and payment dates;
- the date on which dividends begin to accrue or accumulate;
- any auction and remarketing procedures;
- any retirement or sinking fund requirement;
- the price and the terms and conditions of any redemption right;
- any listing on any securities exchange;
- the price and the terms and conditions of any conversion or exchange right;
- any voting rights;

- the relative ranking and preferences as to dividends, liquidation, dissolution or winding up;

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- any limitations on issuing any series of preferred stock ranking senior to or on a parity with the series of preferred stock as to dividends, liquidation, dissolution or winding up;
- any limitations on direct or beneficial ownership and restrictions on transfer; and
- any other specific terms, preferences, rights, limitations or restrictions.

Restrictions on Ownership and Transfer; Change of Control Provisions

As discussed above under “Description of Common Stock — Restrictions on Ownership and Transfer,” our charter contains restrictions on ownership and transfers of our capital stock. In addition, the articles supplementary designating the terms of each series of preferred stock may also contain additional provisions restricting the ownership and transfer of the preferred stock. The prospectus supplement will specify any additional ownership limitation relating to a series of preferred stock.

For a discussion of provisions in our charter that may have the effect of delaying, deferring or preventing a change of control, see “Certain Provisions of Maryland Law and of our Charter and Bylaws.”

Transfer Agent

The prospectus supplement will identify the transfer agent and registrar for the preferred stock.

DESCRIPTION OF DEBT SECURITIES

General

The debt securities offered by this prospectus will be our direct unsecured general obligations. This prospectus describes certain general terms of the debt securities offered through this prospectus. In the following discussion, we refer to any of our direct unsecured general obligations as the "Debt Securities." When we offer to sell a particular series of Debt Securities, we will describe the specific terms of that series in a prospectus supplement or any free writing prospectus. The Debt Securities will be issued under an open-ended Indenture (for Debt Securities) between us and a trustee to be selected by us at or about the time we offer our Debt Securities. The open-ended Indenture (for Debt Securities) is incorporated by reference into the registration statement of which this prospectus is a part and is filed as an exhibit to the registration statement. In this prospectus we refer to the Indenture (for Debt Securities) as the Debt Securities Indenture. We refer to the trustee under any Debt Securities Indenture as the "Debt Securities Trustee."

The prospectus supplement or any free writing prospectus applicable to a particular series of Debt Securities may state that a particular series of Debt Securities will be our subordinated obligations. The form of Debt Securities Indenture referred to above includes optional provisions (designated by brackets ("[ ]")) that we would expect to appear in a separate indenture for subordinated debt securities in the event we issue subordinated debt securities. In the following discussion, we refer to any of our subordinated obligations as the "Subordinated Debt Securities." Unless the applicable prospectus supplement or any free writing prospectus provides otherwise, we will use a separate Debt Securities Indenture for any Subordinated Debt Securities that we may issue. Our Debt Securities Indenture will be qualified under the Trust Indenture Act of 1939, as amended, or the Trust Indenture Act, and you should refer to the Trust Indenture Act for the provisions that apply to the Debt Securities.

We have summarized selected provisions of the Debt Securities Indenture below. Each Debt Securities Indenture will be independent of any other Debt Securities Indenture unless otherwise stated in a prospectus supplement or any free writing prospectus. The summary that follows is not complete and the summary is qualified in its entirety by reference to the provisions of the applicable Debt Securities Indenture. You should consult the applicable Debt Securities, Debt Securities Indenture, any supplemental indentures, officers' certificates and other related documents for more complete information on the Debt Securities. These documents appear as exhibits to, or are incorporated by reference into, the registration statement of which this prospectus is a part, or will appear as exhibits to other documents that we will file with the SEC, which will be incorporated by reference into this prospectus. In the summary below, we have included references to applicable section numbers of the Debt Securities Indenture so that you can easily locate these provisions.

Ranking

Our Debt Securities that are not designated Subordinated Debt Securities will be effectively subordinated to all secured indebtedness that we have outstanding from time to time to the extent of the value of the collateral securing such secured indebtedness. Our Debt Securities that are designated Subordinated Debt Securities will be subordinate to all outstanding secured indebtedness as well as Debt Securities that are not designated Subordinated Debt Securities. We incur indebtedness from time to time to finance many of our assets pursuant to repurchase agreements and certain other structured finance instruments, such as the trust preferred securities issued by our subsidiary, Hypotheca Capital, LLC, or Hypotheca, pursuant to which we guarantee the payment of notes by Hypotheca that back the trust preferred securities issued by it. This indebtedness is deemed to be secured indebtedness. As a result, we have a significant amount of secured indebtedness at any given time in relation to our total assets. The Debt Securities Indenture does not limit the amount of secured indebtedness that we may issue or incur.

Our ability to meet our financial obligations with respect to any future Debt Securities, and cash needs generally, is dependent on our operating cash flow, our ability to access various sources of short- and long-term liquidity, including repurchase agreements, financing and the capital markets. Holders of our Debt Securities will effectively have a junior position to claims of our creditors, including trade creditors, debt holders, secured creditors, taxing authorities and guarantee holders.

Provisions of a Particular Series

The Debt Securities may from time to time be issued in one or more series. You should consult the prospectus supplement or free writing prospectus relating to any particular series of Debt Securities for the following information:

- the title of the Debt Securities;
- any limit on the aggregate principal amount of the Debt Securities of the series of which they are a part;
- the date(s), or method for determining the date(s), on which the principal of the Debt Securities will be payable;
- the rate, including the method of determination, if applicable, at which the Debt Securities will bear interest, if any, and:
- the date from which the interest will accrue;
- the dates on which we will pay interest;
- to whom the interest is payable, if other than the registered holder;
- our ability, if any, to defer interest payments and any related restrictions during any interest deferral period; and
- the record date for any interest payable on any interest payment date;
- the place where:
- the principal of, premium, if any, and interest on the Debt Securities will be payable;
- you may register the transfer of the Debt Securities;
- you may exchange the Debt Securities; and
- you may serve notices and demands upon us regarding the Debt Securities;
- the security registrar for the Debt Securities and whether the principal of the Debt Securities is payable without presentment or surrender of them;
- the terms and conditions upon which we may elect to redeem any Debt Securities, including any replacement capital or similar covenants limiting our ability to redeem any Subordinated Debt Securities;
- the denominations in which we may issue Debt Securities, if other than $1,000 and integral multiples of $1,000;
- the terms and conditions upon which the Debt Securities must be redeemed or purchased due to our obligations pursuant to any sinking fund or other mandatory redemption or tender provisions, or at the holder's option, including any applicable exceptions to notice requirements;
- the currency, if other than United States currency, in which payments on the Debt Securities will be payable;

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- the terms according to which elections can be made by us or the holder regarding payments on the Debt Securities in currency other than the currency in which the Debt Securities are stated to be payable;
- if any Debt Securities are denominated in a currency other than U.S. dollars or in a composite currency, the obligations or instruments that will be considered eligible obligations with respect to such Debt Securities and any additional provisions for the reimbursement of the Company's indebtedness with respect to such Debt Securities after the satisfaction or discharge thereof;
- if payments are to be made on the Debt Securities in securities or other property, the type and amount of the securities and other property or the method by which the amount shall be determined;
- the manner in which we will determine any amounts payable on the Debt Securities that are to be determined with reference to an index or other fact or event ascertainable outside of the applicable indenture;
- if other than the entire principal amount, the portion of the principal amount of the Debt Securities payable upon declaration of acceleration of their maturity;
- any addition to the events of default applicable to any Debt Securities and any addition to our covenants for the benefit of the holders of the Debt Securities;
- the terms applicable to any rights to convert Debt Securities into or exchange them for other of our securities or those of any other entity;
- whether we are issuing Debt Securities as global securities, and if so:
- the terms and conditions upon which the global securities may be exchanged for certificated Debt Securities;
- the depositary for the global securities; and
- the form of legend to be set forth on the global securities;
- whether we are issuing the Debt Securities as bearer certificates;
- any limitations on transfer or exchange of Debt Securities or the right to obtain registration of their transfer, and the terms and amount of any service charge required for registration of transfer or exchange;
- any exceptions to the provisions governing payments due on legal holidays, or any variations in the definition of business day with respect to the Debt Securities;
- any collateral security, assurance, guarantee or other credit enhancement applicable to the Debt Securities;
- any other terms of the Debt Securities not in conflict with the provisions of the applicable Debt Securities Indenture; and
- the material federal income tax consequences applicable to the Debt Securities.

For more information, see Section 3.01 of the applicable Debt Securities Indenture.

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Debt Securities may be sold at a substantial discount below their principal amount. You should consult the applicable prospectus supplement or free writing prospectus for a description of certain material federal income tax considerations that may apply to Debt Securities sold at an original issue discount or denominated in a currency other than U.S. dollars.

Unless the applicable prospectus supplement or free writing prospectus states otherwise, the covenants contained in the applicable indenture will not afford holders of Debt Securities protection in the event we have a change in control or are involved in a highly-leveraged transaction.

Subordination

The applicable prospectus supplement or free writing prospectus may provide that a series of Debt Securities will be Subordinated Debt Securities, subordinate and junior in right of payment to all of our Senior Indebtedness, as defined below. If so, we will issue these securities under a separate Debt Securities Indenture for Subordinated Debt Securities. For more information, see Article XV of the form of Debt Securities Indenture.

Unless the applicable prospectus supplement or free writing prospectus states otherwise, in the event:

- there occur certain acts of bankruptcy, insolvency, liquidation, dissolution or other winding up of our company;
- any Senior Indebtedness is not paid when due;
- any applicable grace period with respect to other defaults with respect to any Senior Indebtedness has ended, the default has not been cured or waived and the maturity of such Senior Indebtedness has been accelerated because of the default; or
- the maturity of the Subordinated Debt Securities of any series has been accelerated because of a default and Senior Indebtedness is then outstanding;

then no payment of principal of, including redemption and sinking fund payments, or any premium or interest on, the Subordinated Debt Securities may be made until all amounts due to holders of Senior Indebtedness have been paid in full.

Upon any distribution of our assets to creditors upon any dissolution, winding up, liquidation or reorganization, whether voluntary or involuntary or in bankruptcy, insolvency, receivership or other proceedings, all principal of, and any premium and interest due or to become due on, all outstanding Senior Indebtedness must be paid in full before the holders of the Subordinated Debt Securities are entitled to payment. For more information, see Section 15.02 of the applicable Debt Securities Indenture. The rights of the holders of the Subordinated Debt Securities will be subrogated to the rights of the holders of Senior Indebtedness to receive payments or distributions applicable to Senior Indebtedness until all amounts owing on the Subordinated Debt Securities are paid in full. For more information, see Section 15.04 of the applicable Debt Securities Indenture.

Unless the applicable prospectus supplement or free writing prospectus states otherwise, the term “Senior Indebtedness” means all:

- obligations (other than non-recourse obligations and the indebtedness issued under the applicable Subordinated Debt Securities Indenture) of, or guaranteed or assumed by, us:
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for borrowed money (including both senior and subordinated indebtedness for borrowed money, but excluding the Subordinated Debt Securities); or

- for the payment of money relating to any lease that is capitalized on our consolidated balance sheet in accordance with generally accepted accounting principles;

- indebtedness evidenced by bonds, debentures, notes or other similar instruments;
- obligations with respect to letters of credit, bankers' acceptances or similar facilities issued for our account;
- obligations issued or assumed as the deferred purchase price of property or services (excluding trade accounts payable or accrued liabilities arising in the ordinary course);
- obligations for claims, as defined in section 101(5) of the United States Bankruptcy Code of 1978, as amended, in respect of derivative products such as interest and foreign exchange rate contracts, commodity contracts and similar arrangements; and
- obligations of another person for which we have guaranteed or assumed direct or indirect responsibility or liability.

In the case of any such indebtedness or obligations, Senior Indebtedness includes amendments, renewals, extensions, modifications and refundings, whether existing as of the date of the Subordinated Debt Securities Indenture or subsequently incurred by us.

The Subordinated Debt Securities Indenture does not limit the aggregate amount of Senior Indebtedness we may issue.

Form, Exchange and Transfer

Unless the applicable prospectus supplement or free writing prospectus states otherwise, we will issue Debt Securities only in fully registered form without coupons and in denominations of $1,000 and integral multiples of that amount. For more information, see Sections 2.01 and 3.02 of the applicable Debt Securities Indenture.

Holders may present Debt Securities for exchange or for registration of transfer, duly endorsed or accompanied by a duly executed instrument of transfer, at the office of the security registrar or at the office of any transfer agent we may designate. Exchanges and transfers are subject to the terms of the applicable indenture and applicable limitations for global securities. We may designate ourselves the security registrar.

No charge will be made for any registration of transfer or exchange of Debt Securities, but we may require payment of a sum sufficient to cover any tax or other governmental charge that the holder must pay in connection with the transaction. Any transfer or exchange will become effective upon the security registrar or transfer agent, as the case may be, being satisfied with the documents of title and identity of the person making the request. For more information, see Section 3.05 of the applicable Debt Securities Indenture.

The applicable prospectus supplement or free writing prospectus will state the name of any transfer agent, in addition to the security registrar initially designated by us, for any Debt Securities. We may at any time designate additional transfer agents or withdraw the designation of any transfer agent or make a change in the office through which any transfer agent acts. We must, however, maintain a transfer agent in each place of payment for the Debt Securities of each series. For more information, see Section 6.02 of the applicable Debt Securities Indenture.

We will not be required to issue, register the transfer of, or exchange any:

- Debt Securities or any tranche of any Debt Securities during a period beginning at the opening of business 15 days before the day of mailing of a notice of redemption of any Debt Securities called for redemption and ending at the close of business on the day of mailing; or
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Debt Securities selected for redemption except the unredeemed portion of any Debt Securities being partially redeemed.

For more information, see Section 3.05 of the applicable Debt Securities Indenture.

Payment and Paying Agents

Unless the applicable prospectus supplement or free writing prospectus states otherwise, we will pay interest on a Debt Security on any interest payment date to the person in whose name the Debt Security is registered at the close of business on the regular record date for the interest payment. For more information, see Section 3.07 of the applicable Debt Securities Indenture.

Unless the applicable prospectus supplement or free writing prospectus provides otherwise, we will pay principal and any premium and interest on Debt Securities at the office of the paying agent whom we will designate for this purpose. Unless the applicable prospectus supplement or free writing prospectus states otherwise, the corporate trust office of the Debt Securities Trustee in New York City will be designated as our sole paying agent for payments with respect to Debt Securities of each series. Any other paying agents initially designated by us for the Debt Securities of a particular series will be named in the applicable prospectus supplement or free writing prospectus. We may at any time add or delete paying agents or change the office through which any paying agent acts. We must, however, maintain a paying agent in each place of payment for the Debt Securities of a particular series. For more information, see Section 6.02 of the applicable Debt Securities Indenture.

All money we pay to a paying agent for the payment of the principal and any premium or interest on any Debt Security that remains unclaimed at the end of two years after payment is due will be repaid to us. After that date, the holder of that Debt Security shall be deemed an unsecured general creditor and may look only to us for these payments. For more information, see Section 6.03 of the applicable Debt Securities Indenture.

Redemption

You should consult the applicable prospectus supplement or free writing prospectus for any terms regarding optional or mandatory redemption of Debt Securities. Except for any provisions in the applicable prospectus supplement or free writing prospectus regarding Debt Securities redeemable at the holder’s option, Debt Securities may be redeemed only upon notice by mail not less than 30 nor more than 60 days prior to the redemption date. Further, if less than all of the Debt Securities of a series, or any tranche of a series, are to be redeemed, the Debt Securities to be redeemed will be selected by the Debt Securities Trustee by the method provided for the particular series. In the absence of a selection provision, the Debt Securities Trustee will select a fair and appropriate method of selection. For more information, see Sections 4.02, 4.03 and 4.04 of the applicable Debt Securities Indenture.

A notice of redemption we provide may state:

- that redemption is conditioned upon receipt by the paying agent on or before the redemption date of money sufficient to pay the principal of and any premium and interest on the Debt Securities; and

- that if the money has not been received, the notice will be ineffective and we will not be required to redeem the Debt Securities.

For more information, see Section 4.04 of the applicable Debt Securities Indenture.

Consolidation, Merger and Sale of Assets

We may not consolidate with or merge into any other corporation, nor may we transfer or lease substantially all of our assets and property to any other person, unless:

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the corporation formed by the consolidation or into which we are merged, or the person that acquires by conveyance or transfer, or that leases, substantially all of our property and assets:

- is organized and validly existing under the laws of any domestic jurisdiction; and

- expressly assumes by supplemental indenture our obligations on the Debt Securities and under the applicable indentures;
- immediately after giving effect to the transaction, no event of default, and no event that (after notice or lapse of time or both) would become an event of default, has occurred and is continuing; and
- we have delivered to the Debt Securities Trustee an officer's certificate and opinion of counsel as provided in the applicable indentures.

For more information, see Section 11.01 of the applicable Debt Securities Indenture.

Events of Default

Unless the applicable prospectus supplement or free writing prospectus states otherwise, "event of default" under the applicable indenture with respect to Debt Securities of any series means any of the following:

- failure to pay any interest due on any Debt Security of that series within 30 days after it becomes due;
- failure to pay principal or premium, if any, when due on any Debt Security of that series;
- failure to make any required sinking fund payment when due on any Debt Securities of that series;
- breach of or failure to perform any other covenant or warranty in the applicable indenture with respect to Debt Securities of that series for 60 days (subject to extension under certain circumstances for another 120 days) after we receive notice from the Debt Securities Trustee, or we and the Debt Securities Trustee receive notice from the holders of at least 33% in principal amount of the Debt Securities of that series outstanding under the applicable indenture according to the provisions of the applicable indenture;
- certain events of bankruptcy, insolvency or reorganization; and
- any other event of default set forth in the applicable prospectus supplement or free writing prospectus.

For more information, see Section 8.01 of the applicable Debt Securities Indenture.

An event of default with respect to a particular series of Debt Securities does not necessarily constitute an event of default with respect to the Debt Securities of any other series issued under the applicable indenture.

If an event of default with respect to a particular series of Debt Securities occurs and is continuing, either the Debt Securities Trustee or the holders of at least 33% in principal amount of the outstanding Debt Securities of that series may declare the principal amount of all of the Debt Securities of that series to be due and payable immediately. If the Debt Securities of that series are discount Debt Securities or similar Debt Securities, only the portion of the principal amount as specified in the applicable prospectus supplement or free writing prospectus may be immediately due and payable. If an event of default occurs and is continuing with respect to all series of Debt Securities issued under a Debt Securities Indenture, including all events of default relating to bankruptcy, insolvency or reorganization, the Debt Securities Trustee or the holders of at least 33% in principal amount of the outstanding Debt Securities of all series issued under that Debt Securities Indenture, considered together, may declare an acceleration of the principal amount of all series of Debt Securities issued under that Debt Securities Indenture. There is no automatic acceleration, even in the event of our bankruptcy or insolvency.

The applicable prospectus supplement or free writing prospectus may provide, with respect to a series of Debt Securities to which a credit enhancement is applicable, that the provider of the credit enhancement may, if a default has occurred and is continuing with respect to the series, have all or any part of the rights with respect to remedies that would otherwise have been exercisable by the holder of that series.

At any time after a declaration of acceleration with respect to the Debt Securities of a particular series, and before a judgment or decree for payment of the money due has been obtained, the event of default giving rise to the declaration of acceleration will, without further action, be deemed to have been waived, and the declaration and its consequences will be deemed to have been rescinded and annulled, if:

- we have paid or deposited with the Debt Securities Trustee a sum sufficient to pay:
    - all overdue interest on all Debt Securities of the particular series;
- the principal of and any premium on any Debt Securities of that series that have become due otherwise than by the declaration of acceleration and any interest at the rate prescribed in the Debt Securities;
- interest upon overdue interest at the rate prescribed in the Debt Securities, to the extent payment is lawful; and
- all amounts due to the Debt Securities Trustee under the applicable indenture; and
- any other event of default with respect to the Debt Securities of the particular series, other than the failure to pay the principal of the Debt Securities of that series that has become due solely by the declaration of acceleration, has been cured or waived as provided in the applicable indenture.

For more information, see Section 8.02 of the applicable Debt Securities Indenture.

The applicable Debt Securities Indenture includes provisions as to the duties of the Debt Securities Trustee in case an event of default occurs and is continuing. Consistent with these provisions, the Debt Securities Trustee will be under no obligation to exercise any of its rights or powers at the request or direction of any of the holders unless those holders have offered to the Debt Securities Trustee reasonable security or indemnity against the costs, expenses and liabilities that may be incurred by it in compliance with such request or direction. For more information, see Section 9.03 of the applicable Debt Securities Indenture. Subject to these provisions for indemnification, the holders of a majority in principal amount of the outstanding Debt Securities of any series may direct the time, method and place of conducting any proceeding for any remedy available to the Debt Securities Trustee, or exercising any trust or power conferred on the Debt Securities Trustee, with respect to the Debt Securities of that series. For more information, see Section 8.12 of the applicable Debt Securities Indenture.

No holder of Debt Securities may institute any proceeding regarding the applicable indenture, or for the appointment of a receiver or a trustee, or for any other remedy under the applicable indenture unless:

- the holder has previously given to the Debt Securities Trustee written notice of a continuing event of default of that particular series;
- the holders of at least a majority in principal amount of the outstanding Debt Securities of all series with respect to which an event of default has occurred and is continuing have made a written request to the Debt Securities Trustee, and have offered reasonable indemnity to the Debt Securities Trustee, to institute the proceeding as trustee; and
- the Debt Securities Trustee has failed to institute the proceeding, and has not received from the holders of a majority in principal amount of the outstanding Debt Securities of that series a direction inconsistent with the request, within 60 days after notice, request and offer of reasonable indemnity.

For more information, see Section 8.07 of the applicable Debt Securities Indenture.

The preceding limitations do not apply, however, to a suit instituted by a holder of a Debt Security for the enforcement of payment of the principal of or any premium or interest on the Debt Securities on or after the applicable due date stated in the Debt Securities. For more information, see Section 8.08 of the applicable Debt Securities Indenture.

We must furnish annually to the Debt Securities Trustee a statement by an appropriate officer as to that officer's knowledge of our compliance with all conditions and covenants under each of the indentures for Debt Securities. Our compliance is to be determined without regard to any grace period or notice requirement under the respective indenture. For more information, see Sections 6.05 and 6.06 of the applicable Debt Securities Indenture.

Modification and Waiver

We and the Debt Securities Trustee, without the consent of the holders of the Debt Securities, may enter into one or more supplemental indentures for any of the following purposes:

- to evidence the assumption by any permitted successor of our covenants in the applicable indenture and the Debt Securities;
- to add one or more covenants or other provisions for the benefit of the holders of outstanding Debt Securities or to surrender any right or power conferred upon us by the applicable indenture;
- to add any additional events of default;
- to change or eliminate any provision of the applicable indenture or add any new provision to it, but if this action would adversely affect the interests of the holders of any particular series of Debt Securities in any material respect, the action will not become effective with respect to that series while any Debt Securities of that series remain outstanding under the applicable indenture;
- to provide collateral security for the Debt Securities;
- to establish the form or terms of Debt Securities according to the provisions of the applicable indenture;
- to provide for the authentication and delivery of bearer securities (and coupons representing any interest thereon) and for procedures for the registration, exchange and replacement of such bearer securities and for the giving of notice to, and the solicitation of the vote or consent of, the holders of such bearer securities, and for all related incidental matters;
- to evidence the acceptance of appointment of a successor Debt Securities Trustee under the applicable indenture with respect to one or more series of the Debt Securities and to add to or change any of the provisions of the applicable indenture as necessary to provide for trust administration under the applicable indenture by more than one trustee;
- to provide for the procedures required to permit the use of a non-certificated system of registration for any series of Debt Securities;
- to change any place where:
- the principal of and any premium and interest on any Debt Securities are payable;
- any Debt Securities may be surrendered for registration of transfer or exchange; or
- notices and demands to or upon us regarding Debt Securities and the applicable indentures may be served; or

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- to cure any ambiguity or inconsistency, but only by means of changes or additions that will not adversely affect the interests of the holders of Debt Securities of any series in any material respect.

For more information, see Section 12.01 of the applicable Debt Securities Indenture.

The holders of at least a majority in aggregate principal amount of the outstanding Debt Securities of any series may waive:

- compliance by us with certain provisions of the applicable indenture (see Section 6.06 of the applicable Debt Securities Indenture); and

- any past default under the applicable indenture, except a default in the payment of principal, premium or interest and certain covenants and provisions of the applicable indenture that cannot be modified or amended without consent of the holder of each outstanding Debt Security of the series affected (see Section 8.13 of the applicable Debt Securities Indenture).

The Trust Indenture Act of 1939 may be amended after the date of the applicable indenture to require changes to the indenture. In this event, the indenture will be deemed to have been amended so as to effect the changes, and we and the Debt Securities Trustee may, without the consent of any holders, enter into one or more supplemental indentures to evidence or effect the amendment. For more information, see Section 12.01 of the applicable Debt Securities Indenture.

Except as provided in this section, the consent of the holders of a majority in aggregate principal amount of the outstanding Debt Securities of all series issued pursuant to a Debt Securities Indenture, considered as one class, is required to change in any manner the applicable indenture pursuant to one or more supplemental indentures. If there are Debt Securities of more than one series outstanding under a Debt Securities Indenture and less than all of such series are directly affected by a proposed supplemental indenture, however, only the consent of the holders of a majority in aggregate principal amount of the outstanding Debt Securities of all series directly affected, considered as one class, will be required. Furthermore, if the Debt Securities of any series have been issued in more than one tranche and if the proposed supplemental indenture directly affects the rights of the holders of one or more, but not all, tranches, only the consent of the holders of a majority in aggregate principal amount of the outstanding Debt Securities of all tranches directly affected, considered as one class, will be required. In addition, an amendment or modification:

- may not, without the consent of the holder of each outstanding Debt Security affected:

- change the maturity of the principal of, or any installment of principal of or interest on, any Debt Securities;

- reduce the principal amount or the rate of interest, or the amount of any installment of interest, or change the method of calculating the rate of interest;

- reduce any premium payable upon the redemption of the Debt Securities;

- reduce the amount of the principal of any Debt Security originally issued at a discount from the stated principal amount that would be due and payable upon a declaration of acceleration of maturity;

- change the currency or other property in which a Debt Security or premium or interest on a Debt Security is payable; or

- impair the right to institute suit for the enforcement of any payment on or after the stated maturity, or in the case of redemption, on or after the redemption date, of any Debt Securities;

- may not reduce the percentage of principal amount requirement for consent of the holders for any supplemental indenture, or for any waiver of compliance with any provision of or any default under the applicable indenture, or reduce the requirements for quorum or voting, without the consent of the holder of each outstanding Debt Security of each series or tranche affected; and

- may not modify provisions of the applicable indenture relating to supplemental indentures, waivers of certain covenants and waivers of past defaults with respect to the Debt Securities of any series, or any tranche of a series, without the consent of the holder of each outstanding Debt Security affected.

A supplemental indenture will be deemed not to affect the rights under the applicable indenture of the holders of any series or tranche of the Debt Securities if the supplemental indenture:

- changes or eliminates any covenant or other provision of the applicable indenture expressly included solely for the benefit of one or more other particular series of Debt Securities or tranches thereof; or

- modifies the rights of the holders of Debt Securities of any other series or tranches with respect to any covenant or other provision.

For more information, see Section 12.02 of the applicable Debt Securities Indenture.

If we solicit from holders of the Debt Securities any type of action, we may at our option by board resolution fix in advance a record date for the determination of the holders entitled to vote on the action. We shall have no obligation, however, to do so. If we fix a record date, the action may be taken before or after the record date, but only the holders of record at the close of business on the record date shall be deemed to be holders for the purposes of determining whether holders of the requisite proportion of the outstanding Debt Securities have authorized the action. For that purpose, the outstanding Debt Securities shall be computed as of the record date. Any holder action shall bind every future holder of the same security and the holder of every security issued upon the registration of transfer of or in exchange for or in lieu of the security in respect of anything done or permitted by the Debt Securities Trustee or us in reliance on that action, whether or not notation of the action is made upon the security. For more information, see Section 1.04 of the applicable Debt Securities Indenture.

Defeasance

Unless the applicable prospectus supplement or free writing prospectus provides otherwise, any Debt Security, or portion of the principal amount of a Debt Security, will be deemed to have been paid for purposes of the applicable indenture, and, at our election, our entire indebtedness in respect of the Debt Security, or portion thereof, will be deemed to have been satisfied and discharged, if we have irrevocably deposited with the Debt Securities Trustee or any paying agent other than us, in trust money, certain eligible obligations, as defined in the applicable indenture, or a combination of the two, sufficient to pay principal of and any premium and interest due and to become due on the Debt Security or portion thereof, and other required documentation. Included among the documentation we are required to deliver to be deemed to have our indebtedness deemed satisfied and discharged with respect to a Debt Security pursuant to the preceding sentence is an opinion of counsel to the effect that, as a result of a change in law occurring after the date of the applicable Debt Security Indenture, the holders of such Debt Security, or portions thereof, will not recognize income, gain or loss for United States federal income tax purposes as a result of the satisfaction and discharge of our indebtedness in respect thereof and will be subject to United States federal income tax on the same amounts, at the same times and in the same manner as if such satisfaction and discharge had not been effected. For more information, see Section 7.01 of the applicable Debt Securities Indenture. For this purpose, unless the applicable prospectus supplement or free writing prospectus provides otherwise, eligible obligations include direct obligations of, or obligations unconditionally guaranteed by, the United States, entitled to the benefit of full faith and credit of the United States, and certificates, depositary receipts or other instruments that evidence a direct ownership interest in those obligations or in any specific interest or principal payments due in respect of those obligations.

Resignation, Removal of Debt Securities Trustee; Appointment of Successor

The Debt Securities Trustee may resign at any time by giving written notice to us or may be removed at any time by an action of the holders of a majority in principal amount of outstanding Debt Securities delivered to the Debt Securities Trustee and us. No resignation or removal of the Debt Securities Trustee and no appointment of a successor trustee will become effective until a successor trustee accepts appointment in accordance with the requirements of the applicable indenture. So long as no event of default or event that would become an event of default (after notice or lapse of time or both) has occurred and is continuing, and except with respect to a Debt Securities Trustee appointed by an action of the holders, if we have delivered to the Debt Securities Trustee a resolution of our board of directors appointing a successor trustee and the successor trustee has accepted the appointment in accordance with the terms of the applicable indenture, the Debt Securities Trustee will be deemed to have resigned and the successor trustee will be deemed to have been appointed as trustee in accordance with the applicable indenture. For more information, see Section 9.10 of the applicable Debt Securities Indenture.

Notices

We will give notices to holders of Debt Securities by mail to their addresses as they appear in the Debt Security Register. For more information, see Section 1.06 of the applicable Debt Securities Indenture.

Title

The Debt Securities Trustee and its agents, and we and our agents, may treat the person in whose name a Debt Security is registered as the absolute owner of that Debt Security, whether or not that Debt Security may be overdue, for the purpose of making payment and for all other purposes. For more information, see Section 3.08 of the applicable Debt Securities Indenture.

Governing Law

The Debt Securities Indentures and the Debt Securities, including any Subordinated Debt Securities Indentures and Subordinated Debt Securities, will be governed by, and construed in accordance with, the law of the State of New York. For more information, see Section 1.12 of the applicable Debt Securities Indenture.

GLOBAL SECURITIES

We may issue some or all of our securities of any series as global securities. We will register each global security in the name of a depositary identified in the applicable prospectus supplement. The global securities will be deposited with a depositary or nominee or custodian for the depositary and will bear a legend regarding restrictions on exchanges and registration of transfer as discussed below and any other matters to be provided pursuant to the indenture.

As long as the depositary or its nominee is the registered holder of a global security, that person will be considered the sole owner and holder of the global security and the securities represented by it for all purposes under the securities and the indenture. Except in limited circumstances, owners of a beneficial interest in a global security:

- will not be entitled to have the global security or any securities represented by it registered in their names;
- will not receive or be entitled to receive physical delivery of certificated securities in exchange for the global security; and
- will not be considered to be the owners or holders of the global security or any securities represented by it for any purposes under the securities or the indenture.

We will make all payments of principal and any premium and interest on a global security to the depositary or its nominee as the holder of the global security. The laws of some jurisdictions require that certain purchasers of securities take physical delivery of securities in definitive form. These laws may impair the ability to transfer beneficial interests in a global security.

Ownership of beneficial interests in a global security will be limited to institutions having accounts with the depositary or its nominee, called “participants” for purposes of this discussion, and to persons that hold beneficial interests through participants. When a global security is issued, the depositary will credit on its book-entry, registration and transfer system the principal amounts of securities represented by the global security to the accounts of its participants. Ownership of beneficial interests in a global security will be shown only on, and the transfer of those ownership interests will be effected only through, records maintained by:

- the depositary, with respect to participants’ interests; or
- any participant, with respect to interests of persons held by the participants on their behalf.

Payments by participants to owners of beneficial interests held through the participants will be the responsibility of the participants. The depositary may from time to time adopt various policies and procedures governing payments, transfers, exchanges and other matters relating to beneficial interests in a global security. None of the following will have any responsibility or liability for any aspect of the depositary’s or any participant’s records relating to, or for payments made on account of, beneficial interests in a global security, or for maintaining, supervising or reviewing any records relating to those beneficial interests:

- us or our affiliates;
- the trustee under any indenture; or
- any agent of any of the above.

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CERTAIN PROVISIONS OF MARYLAND LAW
AND OUR CHARTER AND BYLAWS

The following description of certain provisions of Maryland law and of our charter and bylaws is only a summary. For a complete description, we refer you to the applicable Maryland law, our charter and our bylaws. Our charter and bylaws are filed as exhibits to this registration statement. See "Where You Can Find More Information."

Number of Directors; Vacancies

Our charter and bylaws provide that the number of our directors may only be increased or decreased by a vote of a majority of the members of our board of directors. Our board of directors is currently comprised of six directors. Our charter provides that any vacancy, including a vacancy created by an increase in the number of directors, may be filled only by a majority of the remaining directors, even if the remaining directors do not constitute a quorum.

Removal of Directors

Our charter provides that a director may be removed at any time upon the affirmative vote of at least two-thirds of the votes entitled to be cast generally in the election of directors. Absent removal of all of our directors, this provision, when coupled with the provision in our bylaws authorizing our board of directors to fill vacant directorships, may preclude stockholders from removing incumbent directors and filling the vacancies created by such removal with their own nominees.

Amendment to the Charter

Generally, our charter may be amended only by the affirmative vote of the holders of not less than a majority of all of the votes entitled to be cast on the matter. However, provisions in our charter related to (1) removal of directors, (2) the power of our board of directors to classify and cause us to issue additional shares of common and preferred stock and, (3) except as set forth in the sentence immediately below, the restrictions on transfer and ownership, may only be amended by the affirmative vote of the holders of two-thirds of all of the votes entitled to be cast on the matter. In addition, our board of directors may from time to time increase or decrease the common stock ownership limit and the aggregate stock ownership limit without stockholder approval.

Dissolution

Our dissolution must be approved by the affirmative vote of the holders of not less than a majority of all of the votes entitled to be cast on the matter.

Business Combinations

Maryland law prohibits "business combinations" between us and an interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder becomes an interested stockholder. These business combinations include a merger, consolidation, share exchange, or, in circumstances specified in the statute, an asset transfer or issuance or reclassification of equity securities. Maryland law defines an interested stockholder as:

- any person or entity who beneficially owns 10% or more of the voting power of our stock; or
- an affiliate or associate of ours who, at any time within the two year period prior to the date in question, was the beneficial owner of 10% or more of the voting power of our then outstanding voting stock.

A person is not an interested stockholder if our board of directors approves in advance the transaction by which the person otherwise would have become an interested stockholder. However, in approving a transaction, our board of directors may provide that its approval is subject to compliance, at or after the time of approval, with any terms and conditions determined by our board of directors.

After the five-year prohibition, any business combination between us and an interested stockholder generally must be recommended by our board of directors and approved by the affirmative vote of at least:

- 80% of the votes entitled to be cast by holders of our then outstanding shares of voting stock; and
- two-thirds of the votes entitled to be cast by holders of our voting stock other than stock held by the interested stockholder with whom or with whose affiliate the business combination is to be effected or stock held by an affiliate or associate of the interested stockholder.

These super-majority vote requirements do not apply if our common stockholders receive a minimum price, as defined under Maryland law, for their shares in the form of cash or other consideration in the same form as previously paid by the interested stockholder for its stock.

The statute permits various exemptions from its provisions, including business combinations that are approved by our board of directors before the time that the interested stockholder becomes an interested stockholder.

As permitted by the Maryland General Corporation Law, our board of directors has adopted a resolution that the business combination provisions of the Maryland General Corporation Law will not apply to us.

Control Share Acquisitions

Maryland law provides that "control shares" of a Maryland corporation acquired in a "control share acquisition" have no voting rights unless approved by a vote of two-thirds of the votes entitled to be cast on the matter. Shares owned by the acquiror or by officers or directors who are our employees are excluded from the shares entitled to vote on the matter. "Control shares" are voting shares that, if aggregated with all other shares currently owned by the acquiring person, or in respect of which the acquiring person is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquiring person to exercise voting power in electing directors within one of the following ranges of voting power:

- one-tenth or more but less than one-third;
- one-third or more but less than a majority; or
- a majority or more of all voting power.

Control shares do not include shares the acquiring person is then entitled to vote as a result of having previously obtained stockholder approval. A "control share acquisition" means the acquisition of issued and outstanding control shares, subject to certain exceptions.

A person who has made or proposes to make a control share acquisition may compel our board of directors to call a special meeting of stockholders to be held within 50 days of demand to consider the voting rights of the shares. The right to compel the calling of a special meeting is subject to the satisfaction of certain conditions, including an undertaking to pay the expenses of the meeting. If no request for a meeting is made, we may present the question at any stockholders meeting.

If voting rights are not approved at the stockholders meeting or if the acquiring person does not deliver an acquiring person statement required by Maryland law, then, subject to certain conditions and limitations, we may redeem any or all of the control shares, except those for which voting rights have previously been approved, for fair value. Fair value is determined, without regard to the absence of voting rights for the control shares, as of the date of the last control share acquisition by the acquiror or of any meeting of stockholders at which the voting rights of the shares were considered and not approved. If voting rights for control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares entitled to vote, all other stockholders may exercise appraisal rights. The fair value of the shares for purposes of these appraisal rights may not be less than the highest price per share paid by the acquiror in the control share acquisition. The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange if we are a party to the transaction, nor does it apply to acquisitions approved by or exempted by our charter or bylaws.

Our bylaws contain a provision exempting any and all acquisitions of our shares of stock from the control shares provisions of Maryland law. Nothing prevents our board of directors from amending or repealing this provision in the future.

Limitation of Liability and Indemnification

Maryland law permits a corporation to include in its charter a provision limiting the liability of its directors and officers to the corporation and its stockholders for money damages, except for liability resulting from:

- actual receipt of an improper benefit or profit in money, property or services; or
- a final judgment based upon a finding of active and deliberate dishonesty by the director or officer that was material to the cause of action adjudicated.

Our charter contains such a provision which eliminates such liability to the maximum extent permitted by Maryland law.

Our charter authorizes us to obligate ourselves, and our bylaws obligate us, to the maximum extent permitted by Maryland law, to indemnify, and to pay or reimburse reasonable expenses in advance of final disposition of a final proceeding to, any of our present or former directors or officers or any individual who, while a director or officer and at our request, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or any other enterprise as a director, officer, partner or trustee. The indemnification covers any claim or liability arising from such status against the person.

Maryland law requires a corporation (unless its charter provides otherwise, which our charter does not) to indemnify a director or officer who has been successful in the defense of any proceeding to which he is made a party by reason of his service in that capacity.

Maryland law permits us to indemnify our present and former directors and officers against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in any proceeding to which they may be made a party by reason of their service in those or other capacities unless it is established that:

- the act or omission of the director or officer was material to the matter giving rise to the proceeding and (i) was committed in bad faith or (ii) was the result of active and deliberate dishonesty;
- the director or officer actually received an improper personal benefit of money, property or services; or
- in the case of a criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful.

However, Maryland law prohibits us from indemnifying our present and former directors and officers for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that personal benefit was improperly received unless in either case a court orders indemnification and then only for expenses. Maryland law permits a corporation to advance reasonable expenses to a director or officer upon the corporation’s receipt of:

- a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification; and

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- a written undertaking by him or her, or on his or her behalf, to repay the amount paid or reimbursed by us if it is ultimately determined that the standard of conduct is not met.

Our charter and bylaws also permit us to indemnify and advance expenses to any person who served a predecessor of ours in any capacity described above and to any of our or our predecessors' employees or agents.

In addition, indemnification could reduce the legal remedies available to us and our stockholders against our officers and directors. The Securities and Exchange Commission takes the position that indemnification against liabilities arising under the Securities Act of 1933 is against public policy and unenforceable. Indemnification of our directors and officers may not be allowed for liabilities arising from or out of a violation of state or federal securities laws, unless one or more of the following conditions are met:

- there has been a adjudication on the merits in favor of the director or officer on each count involving alleged securities law violations;

- all claims against the director or officer have been dismissed with prejudice on the merits by a court of competent jurisdiction; or

- a court of competent jurisdiction approves a settlement of the claims against the director or officer and finds that indemnification with respect to the settlement and the related costs should be allowed after being advised of the position of the Securities and Exchange Commission and of the published position of any state securities regulatory authority in which the securities were offered as to indemnification for violations of securities laws.

Meetings of Stockholders

Special meetings of stockholders may be called only by our board of directors, the chairman of our board of directors, our chief executive officer, our president or our secretary upon the written request of the holders of common stock entitled to cast not less than a majority of all votes entitled to be cast at such meeting. Only matters set forth in the notice of the special meeting may be considered and acted upon at such a meeting.

Advance Notice of Director Nominations and New Business

Our bylaws provide that, with respect to an annual meeting of stockholders, nominations of individuals for election to our board of directors and the proposal of business to be considered by stockholders at the annual meeting may be made only:

- pursuant to our notice of the meeting;

- by or at the direction of our board of directors; or

- by a stockholder who was a stockholder of record both at the time of the giving of notice by the stockholder and at the time of the meeting, who is entitled to vote at the meeting and has complied with the advance notice procedures set forth in our bylaws.

With respect to special meetings of stockholders, only the business specified in our notice of meeting may be brought before the meeting of stockholders and nominations of individuals for election to our board of directors may be made only:

- pursuant to our notice of the meeting;

- by our board of directors; or

- provided that our board of directors has determined that directors shall be elected at such meeting, by a stockholder who was a stockholder of record both at the time of the provision of notice and at the time of the meeting who is entitled to vote at the meeting and has complied with the advance notice provisions set forth in our bylaws.

The purpose of requiring stockholders to give advance notice of nominations and other proposals is to afford our board of directors the opportunity to consider the qualifications of the proposed nominees or the advisability of the other proposals and, to the extent considered necessary by our board of directors, to inform stockholders and make recommendations regarding the nominations or other proposals. The advance notice procedures also permit a more orderly procedure for conducting our stockholder meetings. Although our bylaws do not give our board of directors the power to disapprove timely stockholder nominations and proposals, they may have the effect of precluding a contest for the election of directors or proposals for other action if the proper procedures are not followed, and of discouraging or deterring a third party from conducting a solicitation of proxies to elect its own slate of directors to our board of directors or to approve its own proposal.

Possible Anti-Takeover Effect of Certain Provisions of Maryland Law and of Our Charter and Bylaws

Subtitle 8 of Title 3 of the Maryland General Corporation Law permits a Maryland corporation with a class of equity securities registered under the Securities Exchange Act of 1934, as amended, and at least three independent directors to elect to be subject, by provision in its charter or bylaws or a resolution of its board of directors and notwithstanding any contrary provision in its charter or bylaws, to any or all of five of the following provisions:

- a classified board of directors, meaning that the directors may be divided into up to three classes with only one class standing for election in any year,
- a director may be removed only by a two-thirds vote of the stockholders,
- a requirement that the number of directors be fixed only by vote of the directors,
- a requirement that a vacancy on the board of directors be filled only by the remaining directors and for the new director to serve the remainder of the full term of the class of directors in which the vacancy occurred, and
- a requirement that stockholder-called special meetings of stockholders may only be called by stockholders holding a majority of the outstanding stock.

Through provisions in our charter and bylaws unrelated to Subtitle 8, we already (a) require a two-thirds vote for the removal of any director from our board, (b) vest in our board of directors the exclusive power to fix the number of directorships, (c) require vacancies on the board of directors to be filled only by the remaining directors and (d) require that stockholder-called special meetings of stockholders may only be called by stockholders holding a majority of our outstanding stock. Further, although we do not currently have a classified board of directors, Subtitle 8 permits our board of directors, without stockholder approval and regardless of what is provided in our charter or bylaws, to implement takeover defenses that we may not yet have, such as dividing the members of our board of directors into up to three classes with only one class standing for election in any year.

The business combination and control share acquisition provisions of Maryland law (if the applicable provisions in our bylaws are rescinded), the provisions of our charter on the removal of directors, the ownership limitations required to protect our REIT status, the board of directors' ability to increase the aggregate number of shares of capital stock and issue shares of preferred stock with differing terms and conditions, and the advance notice provisions of our bylaws could have the effect of delaying, deterring or preventing a transaction or a change in control that might involve a premium price for you or might otherwise be in your best interest.

MATERIAL FEDERAL INCOME TAX CONSIDERATIONS

This section summarizes the federal income tax issues that you, as a holder of our securities, may consider relevant. Hunton & Williams LLP has acted as our tax counsel, has reviewed this summary, and is of the opinion that the discussion contained herein is accurate in all material respects. Because this section is a summary, it does not address all aspects of taxation that may be relevant to particular holders of our securities in light of their personal investment or tax circumstances, or to certain types of holders that are subject to special treatment under the federal income tax laws, such as insurance companies, tax-exempt organizations, financial institutions or broker-dealers, and non-U.S. individuals and foreign corporations (except to the extent discussed in “Taxation of Non-U.S. Stockholders” below).

The statements in this section and the opinion of Hunton & Williams LLP are based on the current federal income tax laws governing qualification as a REIT. We cannot assure you that new laws, interpretations of law, or court decisions, any of which may take effect retroactively, will not cause any statement in this section to be inaccurate.

We urge you to consult your own tax advisor regarding the specific tax consequences to you of the purchase, ownership and sale of our securities and of our election to be taxed as a REIT. Specifically, you should consult your own tax advisor regarding the federal, state, local, foreign, and other tax consequences of such purchase, ownership, sale and election, and regarding potential changes in applicable tax laws.

Taxation of Our Company

We elected to be taxed as a REIT under the federal income tax laws commencing with our short taxable year ended on December 31, 2004. We believe that we are organized and we operate in such a manner so as to qualify for taxation as a REIT under the federal income tax laws, and we intend to continue to operate in such a manner, but no assurance can be given that we will operate in a manner so as to remain qualified as a REIT. This section discusses the laws governing the federal income tax treatment of a REIT. These laws are highly technical and complex.

In connection with this prospectus, Hunton & Williams LLP is rendering an opinion that we qualified to be taxed as a REIT for our taxable years ended December 31, 2004 through December 31, 2011, and our organization and current and proposed method of operation will enable us to continue to meet the requirements for qualification and taxation as a REIT for our taxable year ending December 31, 2012 and subsequent taxable years. Investors should be aware that Hunton & Williams LLP’s opinion is based upon customary assumptions, is conditioned upon certain representations made by us as to factual matters, including representations regarding the nature of our assets and the conduct of our business, and is not binding upon the IRS or any court and speaks as of the date issued. In addition, Hunton & Williams LLP’s opinion is based on existing federal income tax law governing qualification as a REIT, which is subject to change either prospectively or retroactively. Moreover, our qualification and taxation as a REIT depend upon our ability to meet on a continuing basis, through actual annual operating results, certain qualification tests set forth in the federal tax laws. Those qualification tests involve the percentage of income that we earn from specified sources, the percentage of our assets that falls within specified categories, the diversity of our stock ownership, and the percentage of our earnings that we distribute. Hunton & Williams LLP will not review our compliance with those tests on a continuing basis. Accordingly, no assurance can be given that our actual results of operations for any particular taxable year will satisfy such requirements. For a discussion of the tax consequences of our failure to qualify as a REIT, see “— Failure to Qualify”.

As a REIT, we generally will not be subject to federal income tax on the REIT taxable income that we distribute to our stockholders, but taxable income generated by Hypotheca and New York Mortgage Funding, LLC, or NYMF, our TRSs, will be subject to regular corporate income tax. The benefit of that tax treatment is that it avoids the double taxation, or taxation at both the corporate and stockholder levels, that generally applies to distributions by a corporation to its stockholders. However, we will be subject to federal tax in the following circumstances:

- We will pay federal income tax on taxable income, including net capital gain, that we do not distribute to stockholders during, or within a specified time period after, the calendar year in which the income is earned.

- We may be subject to the "alternative minimum tax" on any items of tax preference that we do not distribute or allocate to stockholders.

- We will pay income tax at the highest corporate rate on:

- net income from the sale or other disposition of property acquired through foreclosure, or foreclosure property, that we hold primarily for sale to customers in the ordinary course of business, and

- other non-qualifying income from foreclosure property.

- We will pay a 100% tax on our net income from sales or other dispositions of property, other than foreclosure property, that we hold primarily for sale to customers in the ordinary course of business.

- If we fail to satisfy the 75% gross income test or the 95% gross income test, as described below under "— Gross Income Tests," and nonetheless continue to qualify as a REIT because we meet other requirements, we will pay a 100% tax on:

- the greater of (i) the amount by which we fail the 75% gross income test or (ii) the amount by which 95% of our gross income exceeds the amount of our income qualifying under the 95% gross income test, multiplied by

- a fraction intended to reflect our profitability.

- In the event of a more than de minimis failure of any of the asset tests, as described below under "— Asset Tests," as long as the failure was due to reasonable cause and not to willful neglect, we file a description of the assets that caused such failure with the IRS, and we dispose of the assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure, we will pay a tax equal to the greater of $50,000 or 35% of the net income from the nonqualifying assets during the period in which we failed to satisfy any of the asset tests.

- If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests or the asset tests, as long as such failure was due to reasonable cause and not to willful neglect, we will be required to pay a penalty of $50,000 for each such failure.

- If we fail to distribute during a calendar year at least the sum of:

- 85% of our REIT ordinary income for the year,

- 95% of our REIT capital gain net income for the year, and

- any undistributed taxable income required to be distributed from earlier periods,

we will pay a 4% nondeductible excise tax on the excess of the required distribution over the amount we actually distributed.

- We may elect to retain and pay income tax on our net long-term capital gain. In that case, a U.S. stockholder would be taxed on its proportionate share of our undistributed long-term capital gain (to the extent that we make a timely designation of such gain to the stockholder) and would receive a credit or refund for its proportionate share of the tax we paid.

- We will be subject to a 100% excise tax on transactions between us and a TRS that are not conducted on an arm's-length basis.

- If we acquire any asset from a C corporation, or a corporation that generally is subject to full corporate-level tax, in a merger or other transaction in which we acquire a basis in the asset that is determined by reference either to the C corporation's basis in the asset or to another asset, we will pay tax at the highest regular corporate rate applicable if we recognize gain on the sale or disposition of the asset during the 10-year period after we acquire the asset. The amount of gain on which we will pay tax is the lesser of:

  - the amount of gain that we recognize at the time of the sale or disposition, and
  - the amount of gain that we would have recognized if we had sold the asset at the time we acquired it.

- If we own a residual interest in a real estate mortgage investment conduit, or REMIC, we will be taxable at the highest corporate rate on the portion of any excess inclusion income that we derive from the REMIC residual interests equal to the percentage of our stock that is held by "disqualified organizations." Although the law is not entirely clear, the IRS has taken the position that similar rules may apply if we own an equity interest in a taxable mortgage pool. To the extent that we own a REMIC residual interest or an equity interest in a taxable mortgage pool through a TRS, we will not be subject to this tax. For a discussion of "excess inclusion income," see "Requirements for Qualification — Organizational Requirements — Taxable Mortgage Pools." A "disqualified organization" includes:

  - the United States;
  - any state or political subdivision of the United States;
  - any foreign government;
  - any international organization;
  - any agency or instrumentality of any of the foregoing;

- any other tax-exempt organization, other than a farmer's cooperative described in section 521 of the Internal Revenue Code, that is exempt both from income taxation and from taxation under the unrelated business taxable income provisions of the Internal Revenue Code; and

  - any rural electrical or telephone cooperative.

For this reason, our charter prohibits disqualified organizations from owning our stock.

Requirements for Qualification

Organizational Requirements

A REIT is a corporation, trust, or association that meets each of the following requirements:

(1) It is managed by one or more trustees or directors.

(2) Its beneficial ownership is evidenced by transferable shares, or by transferable certificates of beneficial interest.

(3) It would be taxable as a domestic corporation, but for the REIT provisions of the federal income tax laws.

(4) It is neither a financial institution nor an insurance company subject to special provisions of the federal income tax laws.

(5) At least 100 persons are beneficial owners of its shares or ownership certificates.

(6) Not more than 50% in value of its outstanding shares or ownership certificates is owned, directly or indirectly, by five or fewer individuals, which the federal income tax laws define to include certain entities, during the last half of any taxable year.

(7) It elects to be a REIT, or has made such election for a previous taxable year, and satisfies all relevant filing and other administrative requirements established by the IRS that must be met to elect and maintain REIT status.

(8) It meets certain other qualification tests, described below, regarding the nature of its income and assets and the distribution of its income.

We must meet requirements 1 through 4 during our entire taxable year and must meet requirement 5 during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months. Requirements 5 and 6 applied to us beginning with our 2005 taxable year. If we comply with all the requirements for ascertaining the ownership of our outstanding stock in a taxable year and have no reason to know that we violated requirement 6, we will be deemed to have satisfied requirement 6 for that taxable year. For purposes of determining share ownership under requirement 6, an “individual” generally includes a supplemental unemployment compensation benefits plan, a private foundation, or a portion of a trust permanently set aside or used exclusively for charitable purposes. An “individual,” however, generally does not include a trust that is a qualified employee pension or profit sharing trust under the federal income tax laws, and beneficiaries of such a trust will be treated as holding our stock in proportion to their actuarial interests in the trust for purposes of requirement 6.

We believe that we have issued sufficient stock with sufficient diversity of ownership to satisfy requirements 5 and 6. In addition, our charter restricts the ownership and transfer of our stock so that we should continue to satisfy these requirements. The provisions of our charter restricting the ownership and transfer of our capital stock are described in “Description of Common Stock — Restrictions on Ownership and Transfer.”

Qualified REIT Subsidiaries. A corporation that is a “qualified REIT subsidiary” is not treated as a corporation separate from its parent REIT. All assets, liabilities, and items of income, deduction, and credit of a “qualified REIT subsidiary” are treated as assets, liabilities, and items of income, deduction, and credit of the REIT. A “qualified REIT subsidiary” is a corporation all of the capital stock of which is owned by the REIT and that has not elected to be a TRS. Thus, in applying the requirements described herein, any “qualified REIT subsidiary” that we own will be ignored, and all assets, liabilities, and items of income, deduction, and credit of such subsidiary will be treated as our assets, liabilities, and items of income, deduction, and credit.

Other Disregarded Entities and Partnerships. An unincorporated domestic entity, such as a partnership or limited liability company, that has a single owner, generally is not treated as an entity separate from its parent for federal income tax purposes. An unincorporated domestic entity with two or more owners generally is treated as a partnership for federal income tax purposes. In the case of a REIT that is a partner in a partnership that has other partners, the REIT is treated as owning its proportionate share of the assets of the partnership and as earning its allocable share of the gross income of the partnership for purposes of the applicable REIT qualification tests. For purposes of the 10% value test (described in “— Asset Tests”), our proportionate share is based on our proportionate interest in the equity interests and certain debt securities issued by the partnership. For all of the other asset and income tests, our proportionate share is based on our proportionate interest in the capital interests in the partnership. Thus, our proportionate share of the assets, liabilities, and items of income of any partnership, joint venture, or limited liability company that is treated as a partnership for federal income tax purposes in which we acquire an interest, directly or indirectly, will be treated as our assets and gross income for purposes of applying the various REIT qualification requirements.

Taxable REIT Subsidiaries. A REIT is permitted to own up to 100% of the stock of one or more “taxable REIT subsidiaries,” or TRSs. A TRS is a fully taxable corporation that may earn income that would not be qualifying income if earned directly by the parent REIT. The subsidiary and the REIT must jointly elect to treat the subsidiary as a TRS. A corporation of which a TRS directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a TRS. Overall, no more than 25% of the value of a REIT’s assets may consist of stock or securities of one or more TRSs.

A TRS will pay income tax at regular corporate rates on any income that it earns. In addition, the TRS rules limit the deductibility of interest paid or accrued by a TRS to its parent REIT to assure that the TRS is subject to an appropriate level of corporate taxation. Further, the rules impose a 100% excise tax on transactions between a TRS and its parent REIT or the REIT’s tenants that are not conducted on an arm’s-length basis. We have elected to treat Hypotheca, its wholly owned subsidiary, The New York Mortgage Company, Inc., and NYMF as TRSs. Our TRSs are subject to corporate income tax on their taxable income. We believe that all transactions between us and our TRSs have been and will be conducted on an arm’s-length basis.

Taxable Mortgage Pools. An entity, or a portion of an entity, may be classified as a taxable mortgage pool, or TMP, under the Internal Revenue Code if:

- substantially all of its assets consist of debt obligations or interests in debt obligations;
- more than 50% of those debt obligations are real estate mortgage loans or interests in real estate mortgage loans as of specified testing dates;
- the entity has issued debt obligations that have two or more maturities; and
- the payments required to be made by the entity on its debt obligations “bear a relationship” to the payments to be received by the entity on the debt obligations that it holds as assets.

Under U.S. Treasury regulations, if less than 80% of the assets of an entity (or a portion of an entity) consist of debt obligations, these debt obligations are considered not to comprise “substantially all” of its assets, and therefore the entity would not be treated as a TMP.

We may make investments or enter into financing and securitization transactions that give rise to our being considered to be, or to own an interest in, one or more TMPs. Where an entity, or a portion of an entity, is classified as a TMP, it is generally treated as a taxable corporation for federal income tax purposes. However, special rules apply to a REIT, a portion of a REIT, or a qualified REIT subsidiary, that is a TMP. The portion of the REIT’s assets, held directly or through a qualified REIT subsidiary, that qualifies as a TMP is treated as a qualified REIT subsidiary that is not subject to corporate income tax, and the TMP classification does not affect the tax status of the REIT. Rather, the consequences of the TMP classification would generally, except as described below, be limited to the REIT’s stockholders. The Treasury Department has yet to issue regulations governing the tax treatment of the stockholders of a REIT that owns an interest in a TMP.

If a REIT is a TMP, or if a REIT owns a qualified REIT subsidiary that is a TMP, then a portion of the REIT's income will be treated as "excess inclusion income" and a portion of the dividends the REIT pays to its stockholders will be considered to be excess inclusion income. A stockholder's share of excess inclusion income: (1) would not be allowed to be offset by any net operating losses otherwise available to the stockholder; (2) would be subject to tax as unrelated business taxable income in the hands of most types of stockholders that are otherwise generally exempt from federal income tax; and (3) would result in the application of federal income tax withholding at the maximum rate (30%) (and any otherwise available rate reductions under income tax treaties would not apply) to the extent allocable to most types of foreign stockholders. IRS guidance indicates that our excess inclusion income will be allocated among our stockholders in proportion to our dividends paid. However, the manner in which excess inclusion income would be allocated to dividends attributable to a tax year that are not paid until a subsequent tax year or to dividends attributable to a portion of a tax year when no excess inclusion income-generating assets were held or how such income is to be reported to stockholders is not clear under current law. Although the law is unclear, the IRS has taken the position that a REIT is taxable at the highest corporate tax rate on the portion of any excess inclusion income that it derives from an equity interest in a TMP equal to the percentage of its stock that is held in record name by "disqualified organizations." To the extent that our stock owned by "disqualified organizations" is held in street name by a broker-dealer or other nominee, the broker-dealer or nominee would be liable for a tax at the highest corporate rate on the portion of our excess inclusion income allocable to the stock held on behalf of the disqualified organizations. See "— Taxation of Our Company" for a discussion of "disqualified organizations." A regulated investment company or other pass-through entity owning our stock will be subject to tax at the highest corporate tax rate on any excess inclusion income allocated to their record name owners that are disqualified organizations. Tax-exempt investors, foreign investors, taxpayers with net operating losses, regulated investment companies, pass-through entities and broker-dealers and other nominees should carefully consider the tax consequences described above and are urged to consult their tax advisors in connection with their decision to invest in or hold our stock.

If we were to own less than 100% of the ownership interests in an entity that is classified as a TMP, the foregoing rules would not apply. Rather, the entity would be treated as a corporation for federal income tax purposes, and its income would be subject to corporate income tax. In addition, this characterization would alter our REIT income and asset test calculations and could adversely affect our compliance with those requirements. We currently do not own, and currently do not intend to own some, but less than all, of the ownership interests in an entity that is or will become a taxable mortgage pool, and we intend to monitor the structure of any taxable mortgage pools in which we have an interest to ensure that they will not adversely affect our status as a REIT.

Gross Income Tests

We must satisfy two gross income tests annually to maintain our qualification as a REIT. First, at least 75% of our gross income for each taxable year must consist of defined types of income that we derive, directly or indirectly, from investments relating to real property or mortgage loans on real property or qualified temporary investment income. Qualifying income for purposes of the 75% gross income test generally includes:

- rents from real property;
- interest on debt secured by a mortgage on real property, or on interests in real property;
- dividends or other distributions on, and gain from the sale of, shares in other REITs;
- gain from the sale of real estate assets;
- amounts, such as commitment fees, received in consideration for entering into an agreement to make a loan secured by real property, unless such amounts are determined by income and profits;

- income derived from a REMIC in proportion to the real estate assets held by the REMIC, unless at least 95% of the REMIC's assets are real estate assets, in which case all of the income derived from the REMIC; and

- income derived from the temporary investment of new capital that is attributable to the issuance of our stock or a public offering of our debt with a maturity date of at least five years and that we receive during the one-year period beginning on the date on which we received such new capital.

Second, in general, at least 95% of our gross income for each taxable year must consist of income that is qualifying income for purposes of the 75% gross income test, other types of interest and dividends, gain from the sale or disposition of stock or securities or any combination of these. Gross income from our sale of property that we hold primarily for sale to customers in the ordinary course of business is excluded from both the numerator and the denominator in both income tests. Income and gain from "hedging transactions," as defined in "— Hedging Transactions," that we entered into on or before July 30, 2008 to hedge indebtedness incurred or to be incurred to acquire or carry real estate assets and that are clearly and timely identified as such are excluded from both the numerator and the denominator for purposes of the 95% gross income test (but are non qualifying income for purposes of the 75% gross income test). Income and gain from hedging transactions entered into after July 30, 2008 are excluded from both the numerator and the denominator for purposes of both the 75% and 95% gross income tests. In addition, certain foreign currency gains will be excluded from gross income for purposes of one or both of the gross income tests. See "— Foreign Currency Gain." We will monitor the amount of our nonqualifying income and we will manage our portfolio to comply at all times with the gross income tests. The following paragraphs discuss the specific application of the gross income tests to us.

Interest. The term "interest," as defined for purposes of both gross income tests, generally excludes any amount that is based in whole or in part on the income or profits of any person. However, interest generally includes the following:

- an amount that is based on a fixed percentage or percentages of receipts or sales; and
- an amount that is based on the income or profits of a debtor, as long as the debtor derives substantially all of its income from the real property securing the debt from leasing substantially all of its interest in the property, and only to the extent that the amounts received by the debtor would be qualifying "rents from real property" if received directly by a REIT.

If a loan contains a provision that entitles a REIT to a percentage of the borrower's gain upon the sale of the real property securing the loan or a percentage of the appreciation in the property's value as of a specific date, income attributable to that loan provision will be treated as gain from the sale of the property securing the loan, which generally is qualifying income for purposes of both gross income tests.

Interest on debt secured by a mortgage on real property or on interests in real property, including, for this purpose, discount points, prepayment penalties, loan assumption fees, and late payment charges that are not compensation for services, generally is qualifying income for purposes of the 75% gross income test. In general, under applicable Treasury Regulations, if a loan is secured by real property and other property and the highest principal amount of the loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan determined as of (1) the date we agreed to acquire or originate the loan or (2) as discussed further below, in the event of a "significant modification," the date we modified the loan, then a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test, but will be qualifying income for purposes of the 95% gross income test. Although the law is not entirely clear, a portion of the loan will likely be a non-qualifying asset for purposes of the 75% asset test. The non-qualifying portion of such a loan would be subject to, among other requirements, the 10% value test. See "— Asset Tests" below.

We invest primarily in Agency RMBS, prime ARM loans held in securitization trusts and CMBS. Other than income from embedded derivative instruments as described below, all of the income on our Agency RMBS is qualifying income for purposes of the 95% gross income test. The Agency RMBS are treated either as interests in a grantor trust or as interests in a REMIC for federal income tax purposes. In the case of Agency RMBS and CMBS treated as interests in grantor trusts, we are treated as owning an undivided beneficial ownership interest in the mortgage loans held by the grantor trust. The interest on such mortgage loans and the prime ARM loans held in securitization trusts is qualifying income for purposes of the 75% gross income test to the extent that the obligation is secured by real property, as discussed above. In the case of Agency RMBS and CMBS treated as interests in a REMIC, income derived from REMIC interests will generally be treated as qualifying income for purposes of the 75% gross income test. If less than 95% of the assets of the REMIC are real estate assets, however, then only a proportionate part of our interest in the REMIC and income derived from the interest will qualify for purposes of the 75% gross income test. In addition, some REMIC securitizations include imbedded interest swap or cap contracts or other derivative instruments that potentially could produce non-qualifying income for the holders of the related REMIC securities. We believe that substantially all of our income from Agency RMBS, prime ARM loans held in securitization trusts and CMBS is qualifying income for the 75% and 95% gross income tests.

Certain of the terms of our mortgage loans held by our securitization trusts may in the future be modified to avoid foreclosure actions and for other reasons. Under the Code, if the terms of a loan are modified in a manner constituting a "significant modification," such modification triggers a deemed exchange of the original loan for the modified loan. IRS Revenue Procedure 2011-16 provides a safe harbor pursuant to which we will not be required to redetermine the fair market value of the real property securing a loan for purposes of the gross income and asset tests in connection with a loan modification that is: (1) occasioned by a borrower default; or (2) made at a time when we reasonably believe that the modification to the loan will substantially reduce a significant risk of default on the original loan. No assurance can be provided that all of our loan modifications have or will qualify for the safe harbor in Revenue Procedure 2011-16. To the extent we significantly modify loans in a manner that does not qualify for that safe harbor, we will be required to redetermine the value of the real property securing the loan at the time it was significantly modified. In determining the value of the real property securing such a loan, we generally will not obtain third-party appraisals, but rather will rely on internal valuations. No assurance can be provided that the IRS will not successfully challenge our internal valuations. If the terms of our mortgage loans are significantly modified in a manner that does not qualify for the safe harbor in Revenue Procedure 2011-16 and the fair market value of the real property securing such loans has decreased significantly, we could fail the 75% gross income test, the 75% asset test and/or the 10% value test.

We may acquire distressed mortgage loans. Revenue Procedure 2011-16 provides that that the IRS will treat distressed mortgage loans acquired by a REIT that are secured by real property and other property as producing in part non-qualifying income for the 75% gross income test. Specifically, Revenue Procedure 2011-16 indicates that interest income on such a distressed mortgage loan will be treated as qualifying income based on the ratio of: (1) the fair market value of the real property securing the debt determined as of the date the REIT committed to acquire the loan; and (2) the face amount of the loan (and not the purchase price or current value of the loan). The face amount of a distressed mortgage loan will typically exceed the fair market value of the real property securing the mortgage loan on the date the REIT commits to acquire the loan. We will invest in distressed mortgage loans in a manner that is consistent with maintaining our qualification as a REIT.

We have entered into sale and repurchase agreements under which we nominally sold certain of our mortgage assets to a counterparty and simultaneously entered into an agreement to repurchase the sold assets. Based on positions the IRS has taken in analogous situations, we believe that we will be treated for purposes of the REIT gross income and asset tests (see "—Asset Tests" below) as the owner of the mortgage assets that are the subject of any such agreement notwithstanding that we transferred record ownership of the assets to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the mortgage assets during the term of the sale and repurchase agreement, in which case our ability to qualify as a REIT could be adversely affected.

The interest, original issue discount, and market discount income that we receive from our mortgage loans and mortgage-backed securities generally will be qualifying income for purposes of both gross income tests. However, as discussed above, if the fair market value of the real estate securing any of our loans is less than the principal amount of the loan, a portion of the income from that loan will be qualifying income for purposes of the 95% gross income test but not the 75% gross income test.

We have invested in Agency RMBS through TBA contracts and have recognized gain or loss upon the disposition of our investment in TBA contracts. The law is unclear regarding whether gains from dispositions of TBA contracts will be treated as gains from the sale of real property (including interests in real property and interests in mortgages on real property) or other qualifying income for purposes of the 75% gross income test. Until we receive a favorable private letter ruling from the IRS or we receive an opinion of counsel to the effect that income and gain from the disposition of TBA contracts should be treated as qualifying income for purposes of the 75% gross income test, we will either invest and dispose of TBA contracts through a TRS or we will limit our gains from dispositions of TBA contracts and any non-qualifying income to no more than 25% of our gross income for each calendar year. Accordingly, our ability to dispose of TBA contracts through dollar roll transactions or otherwise, could be limited. Moreover, even if we are advised by counsel that income and gains from dispositions of TBA contracts should be treated as qualifying income, it is possible that the IRS could successfully take the position that such income is not qualifying income. In the event that such income were determined not to be qualifying for the 75% gross income test, we could be subject to a penalty tax or we could fail to qualify as a REIT if such income and any non-qualifying income exceeds 25% of our gross income. See "— Failure to Qualify."

Dividends. Our share of any dividends received from any corporation (including Hypotheca, NYMF and any other TRS, but excluding any REIT) in which we own an equity interest will qualify for purposes of the 95% gross income test but not for purposes of the 75% gross income test. Our share of any dividends received from any other REIT in which we own an equity interest will be qualifying income for purposes of both gross income tests.

Fee Income. Fee income generally is qualifying income for purposes of both the 75% and 95% gross income tests if it is received in consideration for entering into an agreement to make a loan secured by real property and the fees are not determined by income and profits. Other fees generally are not qualifying income for purposes of either gross income test. Any fees earned by a TRS are not included for purposes of the gross income tests.

Foreign Currency Gain. Certain foreign currency gains are excluded from gross income for purposes of one or both of the gross income tests. “Real estate foreign exchange gain” is excluded from gross income for purposes of the 75% gross income test. Real estate foreign exchange gain generally includes foreign currency gain attributable to any item of income or gain that is qualifying income for purposes of the 75% gross income test, foreign currency gain attributable to the acquisition or ownership of (or becoming or being the obligor under) obligations secured by mortgages on real property or on interest in real property and certain foreign currency gain attributable to certain “qualified business units” of a REIT. “Passive foreign exchange gain” is excluded from gross income for purposes of the 95% gross income test. Passive foreign exchange gain generally includes real estate foreign exchange gain as described above, and also includes foreign currency gain attributable to any item of income or gain that is qualifying income for purposes of the 95% gross income test and foreign currency gain attributable to the acquisition or ownership of (or becoming or being the obligor under) obligations secured by mortgages on real property or on interest in real property. Because passive foreign exchange gain includes real estate foreign exchange gain, real estate foreign exchange gain is excluded from gross income for purposes of both the 75% and 95% gross income test. These exclusions for real estate foreign exchange gain and passive foreign exchange gain do not apply to foreign currency gain derived from dealing, or engaging in substantial and regular trading, in securities. Such gain is treated as nonqualifying income for purposes of both the 75% and 95% gross income tests.

Rents from Real Property. As a result of foreclosures on mortgage loans held by our securitization trusts, we hold a small portfolio of residential real property. We do not intend to acquire any real property with the proceeds of this offering, but we may acquire real property or an interest therein in the future. Rents we receive with respect to real property or an interest therein will qualify as “rents from real property” in satisfying the gross income requirements for a REIT described above only if the following conditions are met:

- First, the amount of rent must not be based in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from rents from real property solely by reason of being based on fixed percentages of receipts or sales.

- Second, rents we receive from a “related party tenant” will not qualify as rents from real property in satisfying the gross income tests unless the tenant is a TRS, at least 90% of the property is leased to unrelated tenants and the rent paid by the TRS is substantially comparable to the rent paid by the unrelated tenants for comparable space and the rent is not attributable to a modification of a lease with a controlled TRS (i.e., a TRS in which we own directly or indirectly more than 50% of the voting power or value of the stock). A tenant is a related party tenant if the REIT, or an actual or constructive owner of 10% or more of the REIT, actually or constructively owns 10% or more of the tenant.

- Third, if rent attributable to personal property, leased in connection with a lease of real property, is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as rents from real property.

- Fourth, we generally must not operate or manage our real property or furnish or render noncustomary services to our tenants, other than through an “independent contractor” who is adequately compensated and from whom we do not derive revenue. However, we may provide services directly to tenants if the services are “usually or customarily rendered” in connection with the rental of space for occupancy only and are not considered to be provided for the tenants’ convenience. In addition, we may provide a minimal amount of “noncustomary” services to the tenants of a property, other than through an independent contractor, as long as our income from the services does not exceed 1% of our income from the related property. Furthermore, we may own up to 100% of the stock of a TRS, which may provide customary and noncustomary services to tenants without tainting its rental income from the related properties.

Hedging Transactions. From time to time, we enter into hedging transactions with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps, and floors, options to purchase these items, and futures and forward contracts. Income and gain from "hedging transactions" entered into on or before July 30, 2008 is excluded from gross income for purposes of the 95% gross income test (but is treated as nonqualifying income for purposes of the 75% gross income test). Income and gain from hedging transactions entered into after July 30, 2008 are excluded from gross income for purposes of both the 75% and 95% gross income tests. A "hedging transaction" includes any transaction entered into in the normal course of our trade or business primarily to manage the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, to acquire or carry real estate assets. A "hedging transaction" also includes any transaction entered into after July 30, 2008 primarily to manage risk of currency fluctuations with respect to any item of income or gain that is qualifying income for purposes of the 75% or 95% gross income test (or any property which generates such income or gain). We are required to clearly identify any such hedging transaction before the close of the day on which it was acquired, originated, or entered into and satisfy certain other identification requirements. To the extent that we hedge or for other purposes, or to the extent that a portion of our mortgage loans is not secured by "real estate assets" (as described below under "— Asset Tests") or in other situations, the income from those transactions is not likely to be treated as qualifying income for purposes of the gross income tests. We have structured and intend to continue to structure any hedging transactions in a manner that does not jeopardize our status as a REIT.

Prohibited Transactions. A REIT will incur a 100% tax on the net income (including foreign currency gain) derived from any sale or other disposition of property, other than foreclosure property, that the REIT holds primarily for sale to customers in the ordinary course of a trade or business. We believe that none of our assets will be held primarily for sale to customers and that a sale of any of our assets will not be in the ordinary course of our business. Whether a REIT holds an asset "primarily for sale to customers in the ordinary course of a trade or business" depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. Nevertheless, we will attempt to comply with the terms of safe-harbor provisions in the federal income tax laws prescribing when an asset sale will not be characterized as a prohibited transaction. We cannot assure you, however, that we can comply with the safe-harbor provisions or that we will avoid owning property that may be characterized as property that we hold "primarily for sale to customers in the ordinary course of a trade or business."

Foreclosure Property. We will be subject to tax at the maximum corporate rate on any income (including foreign currency gain) from foreclosure property, other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. However, gross income from foreclosure property will qualify under the 75% and 95% gross income tests. Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

- that is acquired by a REIT as the result of the REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;
- for which the related loan or lease was acquired by the REIT at a time when the default was not imminent or anticipated; and
- for which the REIT makes a proper election to treat the property as foreclosure property.

However, a REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor. Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property, or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

- on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test, or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;
- on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or
- which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT, other than through an independent contractor from whom the REIT itself does not derive or receive any income.

Although we have not made any foreclosure property elections, we may do so in the future.

Failure to Satisfy Gross Income Tests. If we fail to satisfy one or both of the gross income tests for any taxable year, we nevertheless may qualify as a REIT for that year if we qualify for relief under certain provisions of the federal income tax laws. Those relief provisions generally will be available if:

- our failure to meet such tests was due to reasonable cause and not due to willful neglect; and
- following such failure for any taxable year, a schedule of the sources of our income is filed with the IRS.

We cannot predict, however, whether in all circumstances we would qualify for the relief provisions. In addition, as discussed above in "— Taxation of Our Company," even if the relief provisions apply, we would incur a 100% tax on the gross income attributable to the greater of (i) the amount by which we fail the 75% gross income test or (ii) the amount by which 95% of our gross income exceeds the amount of our income qualifying under the 95% gross income test, multiplied by a fraction intended to reflect our profitability.

Asset Tests

To qualify as a REIT, we also must satisfy the following asset tests at the end of each quarter of each taxable year. First, at least 75% of the value of our total assets must consist of:

- cash or cash items, including certain receivables;
- government securities;
- interests in real property, including leaseholds and options to acquire real property and leaseholds;
- interests in mortgage loans secured by real property;
- stock in other REITs;

- investments in stock or debt instruments during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt with at least a five-year term; and

- regular or residual interests in a REMIC. However, if less than 95% of the assets of a REMIC consists of assets that are qualifying real estate-related assets under the federal income tax laws, determined as if we held such assets, we will be treated as holding directly our proportionate share of the assets of such REMIC.

Second, of our investments not included in the 75% asset class, the value of our interest in any one issuer's securities may not exceed 5% of the value of our total assets, or the 5% asset test.

Third, of our investments not included in the 75% asset class, we may not own more than 10% of the voting power or value of any one issuer's outstanding securities, or the 10% vote or value test.

Fourth, no more than 25% of the value of our total assets may consist of the securities of one or more TRSs.

Fifth, no more than 25% of the value of our total assets may consist of the securities of TRSs and other non-TRS taxable subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test, or the 25% securities test.

For purposes of the 5% asset test, the 10% vote or value test and the 25% securities test, the term "securities" does not include stock in another REIT, equity or debt securities of a qualified REIT subsidiary or TRS, mortgage loans or mortgage-backed securities that constitute real estate assets, or equity interests in a partnership. For purposes of the 10% value test, the term "securities" does not include:

- "Straight debt" securities, which is defined as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the debt is not convertible, directly or indirectly, into stock, and (ii) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors. "Straight debt" securities do not include any securities issued by a partnership or a corporation in which we or any controlled TRS (i.e., a TRS in which we own directly or indirectly more than 50% of the voting power or value of the stock) hold non-"straight debt" securities that have an aggregate value of more than 1% of the issuer's outstanding securities. However, "straight debt" securities include debt subject to the following contingencies:

- a contingency relating to the time of payment of interest or principal, as long as either (i) there is no change to the effective yield of the debt obligation, other than a change to the annual yield that does not exceed the greater of 0.25% or 5% of the annual yield, or (ii) neither the aggregate issue price nor the aggregate face amount of the issuer's debt obligations held by us exceeds $1 million and no more than 12 months of unaccrued interest on the debt obligations can be required to be prepaid; and

- a contingency relating to the time or amount of payment upon a default or prepayment of a debt obligation, as long as the contingency is consistent with customary commercial practice.

- Any loan to an individual or an estate.

- Any "section 467 rental agreement," other than an agreement with a related party tenant.

- Any obligation to pay "rents from real property."

- Certain securities issued by governmental entities.

- Any security issued by a REIT.

- Any debt instrument of an entity treated as a partnership for federal income tax purposes to the extent of our interest as a partner in the partnership.

- Any debt instrument of an entity treated as a partnership for federal income tax purposes not described in the preceding bullet points if at least 75% of the partnership's gross income, excluding income from prohibited transactions, is qualifying income for purposes of the 75% gross income test described above in "— Requirements for Qualification — Gross Income Tests."

The asset tests described above are based on our gross assets.

We invest primarily in Agency RMBS consisting of pass-through certificates and IOs, as well as prime ARM loans held in securitization trusts and multi-family CMBS. We believe that these assets qualify as real estate assets or as government securities.

As discussed above under "— Gross Income Tests," we, through our securitization trusts, own mortgage loans and we may invest in distressed mortgage loans. In general, under the applicable Treasury Regulations, if a loan is secured by real property and other property and the highest principal amount of the loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan as of: (1) the date we agreed to acquire or originate the loan; or (2) in the event of a significant modification, the date we modified the loan, then a portion of the interest income from such a loan will not be qualifying income for purposes of the 75% gross income test, but will be qualifying income for purposes of the 95% gross income test. Although the law is not entirely clear, a portion of the loan will also likely be a non-qualifying asset for purposes of the 75% asset test. The non-qualifying portion of such a loan would be subject to, among other requirements, the 10% vote or value test. IRS Revenue Procedure 2011-16 provides a safe harbor under which the IRS has stated that it will not challenge a REIT's treatment of a loan as being, in part, a qualifying real estate asset in an amount equal to the lesser of: (i) the fair market value of the real property securing the loan determined as of the date the REIT committed to acquire the loan; or (ii) the fair market value of the loan on the date of the relevant quarterly REIT asset testing date. Under the safe harbor, when the current value of a distressed mortgage loan exceeds the fair market value of the real property that secures the loan, determined as of the date we committed to acquire or originate the loan, the excess will be treated as a non-qualifying asset. Accordingly, an increasing portion of a distressed mortgage loan will be treated as a non-qualifying asset as the value of the distressed mortgage loan increases. To the extent we invest in distressed mortgage loans, we will do so in a manner consistent with maintaining our qualification as a REIT.

We have entered into sale and repurchase agreements under which we nominally sold certain of our Agency RMBS to a counterparty and simultaneously entered into an agreement to repurchase the sold assets in exchange for a purchase price that reflects a financing charge. Based on positions the IRS has taken in analogous situations, we believe that we are treated for REIT asset and income test purposes as the owner of the Agency RMBS that are the subject of such agreements notwithstanding that such agreements may transfer record ownership of the assets to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the Agency RMBS during the term of the sale and repurchase agreement, in which case we could fail to qualify as a REIT.

We have invested in TBA contracts and have recognized gain and loss upon the disposition of our investment in TBA contracts. The law is unclear with respect to the qualification of TBA contracts as real estate assets or Government securities for purposes of the 75% asset test. Until we receive a favorable private letter ruling from the IRS or we receive an opinion from counsel to the effect that TBA contracts should be treated as qualifying assets for purposes of the 75% asset test, we will either invest and dispose of TBA contracts through a TRS or we will limit our investment in TBA contracts and any non-qualifying assets to no more than 25% of our assets at the end of any calendar quarter and will limit our investments in TBA contracts with a single counterparty to no more than 5% of our assets at the end of any calendar quarter. Accordingly, our ability to purchase Agency RMBS through TBA contracts could be limited. Moreover, even if we are advised by counsel that TBA contracts should be treated as qualifying assets, it is possible that the IRS could successfully take the position that such assets are not qualifying assets. In the event that such assets were determined not to be qualifying for the 75% asset test, we could be subject to a penalty tax or we could fail to qualify as a REIT if the value of our TBA contracts and any non-qualifying assets exceeds 25% of our total assets at the end of any calendar quarter or if the value of our investments in TBA contracts with a single counterparty exceeds 5% of our assets at the end of any calendar quarter. See "—Failure to Qualify."

We will monitor the status of our assets for purposes of the various asset tests and will seek to manage our portfolio to comply at all times with such tests. There can be no assurance, however, that we will be successful in this effort. In this regard, to determine our compliance with these requirements, we will need to value our investment in our assets to ensure compliance with the asset tests. Although we will seek to be prudent in making these estimates, there can be no assurances that the IRS might not disagree with these determinations and assert that a lower value is applicable. If we fail to satisfy the asset tests at the end of a calendar quarter, we will not lose our REIT status if:

- we satisfied the asset tests at the end of the preceding calendar quarter; and
- the discrepancy between the value of our assets and the asset test requirements arose from changes in the market values of our assets and was not wholly or partly caused by the acquisition of one or more non-qualifying assets.

If we did not satisfy the condition described in the second item, above, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

If we violate the 5% asset test or the 10% vote or value test described above at the end of any calendar quarter, we will not lose our REIT status so long as (i) the failure is de minimis (up to the lesser of 1% of our assets or $10 million) and (ii) we dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure. In the event of a more than de minimis failure of any of the asset tests, as long as the failure was due to reasonable cause and not to willful neglect, we will not lose our REIT status if we (i) dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure (ii) file a description of the assets that caused such failure with the IRS, and (iii) pay a tax equal to the greater of $50,000 or 35% of the net income from the nonqualifying assets during the period in which we failed to satisfy the asset tests.

We currently believe that our assets satisfy the foregoing asset test requirements. However, no independent appraisals have been or will be obtained to support our conclusions as to the value of our assets and securities, or in many cases, the real estate collateral for the mortgage loans we hold through our securitization trusts that support our Agency RMBS. Moreover, the values of some assets may not be susceptible to a precise determination. As a result, there can be no assurance that the IRS will not contend that our ownership of securities and other assets violates one or more of the asset tests applicable to REITs.

Distribution Requirements

Each taxable year, we must distribute dividends, other than capital gain dividends and deemed distributions of retained capital gain, to our stockholders in an aggregate amount at least equal to:

- the sum of
- 90% of our “REIT taxable income,” computed without regard to the dividends paid deduction and our net capital gain or loss, and
- 90% of our after-tax net income, if any, from foreclosure property, minus
- the sum of certain items of non-cash income.

We must pay such distributions in the taxable year to which they relate, or in the following taxable year if we declare the distribution before we timely file our federal income tax return for the year and pay the distribution on or before the first regular dividend payment date after such declaration.

In order for distributions to be counted as satisfying the annual distribution requirements for REITs, and to provide us with a REIT-level tax deduction, the distributions must not be “preferential dividends.” A dividend is not a preferential dividend if the distribution is (i) pro-rata among all outstanding shares of stock within a particular class, and (ii) in accordance with the preferences among different classes of stock as set forth in our organizational documents.

We will pay federal income tax on taxable income, including net capital gain, that we do not distribute to stockholders. Furthermore, if we fail to distribute during a calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

- 85% of our REIT ordinary income for such year,
- 95% of our REIT capital gain income for such year, and
- any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% nondeductible excise tax described above. We intend to continue to make timely distributions sufficient to satisfy the annual distribution requirements and to avoid corporate income tax and the 4% nondeductible excise tax.

It is possible that, from time to time, we may experience timing differences between the actual receipt of income and actual payment of deductible expenses and the inclusion of that income and deduction of such expenses in arriving at our REIT taxable income. Possible examples of those timing differences include the following:

- Because we may deduct capital losses only to the extent of our capital gains, we may have taxable income that exceeds our economic income.
- We will recognize taxable income in advance of the related cash flow if any of our mortgage loans or mortgage-backed securities are deemed to have original issue discount. We generally must accrue original issue discount based on a constant yield method that takes into account projected prepayments but that defers taking into account credit losses until they are actually incurred.
- We may acquire investments that will be treated as having "market discount" for federal income tax purposes, because the investments will be debt instruments that we acquire for an amount less than their principal amount. Under the federal income tax rules applicable to market discount and our elections under those rules, we are required to recognize market discount as ordinary income as it accrues. The recognition of market discount results in an acceleration of the recognition of taxable income to periods prior to the receipt of the related economic income. Further, to the extent that such an investment does not fully amortize according to its terms, we may never receive the economic income attributable to previously recognized market discount.
- We may recognize taxable income without receiving a corresponding cash distribution if we foreclose on or make a significant modification to a loan, to the extent that the fair market value of the underlying property or the principal amount of the modified loan, as applicable, exceeds our basis in the original loan.
- We may recognize phantom taxable income from any residual interests in REMICs or retained ownership interests in mortgage loans subject to collateralized mortgage obligation debt.

Although several types of non-cash income are excluded in determining the annual distribution requirement, we will incur corporate income tax and the 4% nondeductible excise tax with respect to those non-cash income items if we do not distribute those items on a current basis. As a result of the foregoing, we may have less cash than is necessary to distribute all of our taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or issue additional common or preferred stock.

We may satisfy the 90% distribution test with taxable distributions of our stock or debt securities. The IRS has issued private letter rulings to other REITs treating certain distributions that are paid partly in cash and partly in stock as dividends that would satisfy the REIT annual distribution requirement and qualify for the dividends paid deduction for federal income tax purposes. Those rulings may be relied upon only by taxpayers whom they were issued, but we could request a similar ruling from the IRS. In addition, the IRS previously issued a revenue procedure authorizing publicly traded REITs to make elective cash/stock dividends, but that revenue procedure does not apply to our 2012 and future taxable years. Accordingly, it is unclear whether and to what extent we will be able to make taxable dividends payable in cash and stock. We have no current intention to make a taxable dividend payable in our stock.

Under certain circumstances, we may be able to correct a failure to meet the distribution requirement for a year by paying "deficiency dividends" to our stockholders in a later year. We may include such deficiency dividends in our deduction for dividends paid for the earlier year. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

Recordkeeping Requirements

We must maintain certain records in order to qualify as a REIT. In addition, to avoid a monetary penalty, we must request on an annual basis information from our stockholders designed to disclose the actual ownership of our outstanding stock. We intend to comply with these requirements.

Failure to Qualify

If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and the asset tests, we could avoid disqualification if our failure is due to reasonable cause and not to willful neglect and we pay a penalty of $50,000 for each such failure. In addition, there are relief provisions for a failure of the gross income tests and asset tests, as described in "— Gross Income Tests" and "— Asset Tests."

If we fail to qualify as a REIT in any taxable year, and no relief provision applies, we would be subject to federal income tax and any applicable alternative minimum tax on our taxable income at regular corporate rates. In calculating our taxable income in a year in which we fail to qualify as a REIT, we would not be able to deduct amounts paid out to stockholders. In fact, we would not be required to distribute any amounts to stockholders in that year. In such event, to the extent of our current and accumulated earnings and profits, all distributions to stockholders would be taxable as ordinary income. Subject to certain limitations of the federal income tax laws, corporate stockholders might be eligible for the dividends received deduction and domestic non-corporate stockholders might be eligible for the reduced federal income tax rate of 15% on such dividends (through 2012). Unless we qualified for relief under specific statutory provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT. We cannot predict whether in all circumstances we would qualify for such statutory relief.

Taxation of Taxable U.S. Stockholders

The term "U.S. stockholder" means a holder of our capital stock that, for U. S. federal income tax purposes, is:

- a citizen or resident of the United States;
- a corporation or partnership (including an entity treated as a corporation or partnership for U.S. federal income tax purposes) created or organized under the laws of the United States or of a political subdivision of the United States;

- an estate whose income is subject to U.S. federal income taxation regardless of its source; or

- any trust if (i) a U.S. court is able to exercise primary supervision over the administration of such trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or (ii) it has a valid election in place to be treated as a U.S. person.

As long as we qualify as a REIT, a taxable U.S. stockholder must take into account as ordinary income distributions made out of our current or accumulated earnings and profits that we do not designate as capital gain dividends or retained long-term capital gain. For purposes of determining whether a distribution is made out of our current or accumulated earnings and profits, our earnings and profits will be allocated first to our preferred stock dividends and then to our common stock dividends. A U.S. stockholder will not qualify for the dividends received deduction generally available to corporations. In addition, dividends paid to a U.S. stockholder generally will not qualify for the 15% tax rate for "qualified dividend income."

Legislation enacted in 2003, 2006 and 2010 reduced the maximum tax rate for qualified dividend income received by taxpayers taxed at individual rates to 15% for tax years 2003 through 2012. Because we are not generally subject to federal income tax on the portion of our REIT taxable income distributed to our stockholders (see "— Taxation of Our Company" above), our dividends generally will not be eligible for the 15% rate on qualified dividend income. As a result, our ordinary REIT dividends will be taxed at the higher tax rate applicable to ordinary income, which is a maximum rate of 35% through 2012. Qualified dividend income generally includes dividends paid by domestic C corporations and certain qualified foreign corporations to most U.S. noncorporate stockholders. Because we are not generally subject to federal income tax on the portion of our REIT taxable income distributed to our stockholders, our dividends generally will not be eligible for the 15% rate on qualified dividend income. As a result, our ordinary REIT dividends will continue to be taxed at the higher tax rate applicable to ordinary income. Currently, the highest marginal individual income tax rate on ordinary income is 35%. However, the 15% tax rate for qualified dividend income will apply to our ordinary REIT dividends, if any, that are (i) attributable to dividends received by us from non-REIT corporations, such as our TRSs, and (ii) attributable to income upon which we have paid corporate income tax (e.g., to the extent that we distribute less than 100% of our taxable income). In general, to qualify for the reduced tax rate on qualified dividend income, a stockholder must hold our capital stock for more than 60 days during the 120-day period beginning on the date that is 60 days before the date on which our stock becomes ex-dividend.

If we declare a distribution in October, November, or December of any year that is payable to a U.S. stockholder of record on a specified date in any such month, such distribution shall be treated as both paid by us and received by the U.S. stockholder on December 31 of such year, provided that we actually pay the distribution during January of the following calendar year.

A U.S. stockholder generally will recognize distributions that we designate as capital gain dividends as long-term capital gain without regard to the period for which the U.S. stockholder has held its capital stock. We generally will designate our capital gain dividends as either 15% or 25% rate distributions. See "— Capital Gains and Losses." A corporate U.S. stockholder, however, may be required to treat up to 20% of certain capital gain dividends as a preference item.

We may elect to retain and pay income tax on the net long-term capital gain that we recognize in a taxable year. In that case, a U.S. stockholder would be taxed on its proportionate share of our undistributed long-term capital gain. The U.S. stockholder would receive a credit or refund for its proportionate share of the tax we paid. The U.S. stockholder would increase the basis in its capital stock by the amount of its proportionate share of our undistributed long-term capital gain, minus its share of the tax we paid.

A U.S. stockholder will not incur tax on a distribution in excess of our current and accumulated earnings and profits if the distribution does not exceed the adjusted basis of the U.S. stockholder's capital stock. Instead, the distribution will reduce the adjusted basis of such capital stock. A U.S. stockholder will recognize a distribution in excess of both our current and accumulated earnings and profits and the U.S. stockholder's adjusted basis in his or her capital stock as long-term capital gain, or short-term capital gain if the capital stock has been held for one year or less, assuming the capital stock is a capital asset in the hands of the U.S. stockholder.

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Stockholders may not include in their individual income tax returns any of our net operating losses or capital losses. Instead, these losses are generally carried over by us for potential offset against our future income. Taxable distributions from us and gain from the disposition of the capital stock will not be treated as passive activity income and, therefore, stockholders generally will not be able to apply any "passive activity losses," such as losses from certain types of limited partnerships in which the stockholder is a limited partner, against such income. In addition, taxable distributions from us and gain from the disposition of our capital stock generally will be treated as investment income for purposes of the investment interest limitations. We will notify stockholders after the close of our taxable year as to the portions of the distributions attributable to that year that constitute ordinary income, return of capital, and capital gain.

For taxable years beginning after December 31, 2012, certain U.S. stockholders who are individuals, estates or trusts and whose income exceeds certain thresholds will be required to pay a 3.8% Medicare tax. The Medicare tax will apply to, among other things, dividends and other income derived from certain trades or businesses and net gains from the sale or other disposition of property, such as our capital stock, subject to certain exceptions. Our dividends and any gain from the disposition of our capital stock generally will be the type of gain that is subject to the Medicare tax.

Our excess inclusion income generally will be allocated among our stockholders to the extent that it exceeds our REIT taxable income in a particular year. A stockholder's share of excess inclusion income would not be allowed to be offset by any net operating losses otherwise available to the stockholder.

Taxation of U.S. Stockholders on the Disposition of Capital Stock

In general, a U.S. stockholder who is not a dealer in securities must treat any gain or loss realized upon a taxable disposition of our capital stock as long-term capital gain or loss if the U.S. stockholder has held the capital stock for more than one year and otherwise as short-term capital gain or loss. However, a U.S. stockholder must treat any loss upon a sale or exchange of capital stock held by such stockholder for six-months or less as a long-term capital loss to the extent of capital gain dividends and any other actual or deemed distributions from us that such U.S. stockholder treats as long-term capital gain. All or a portion of any loss that a U.S. stockholder realizes upon a taxable disposition of the capital stock may be disallowed if the U.S. stockholder purchases substantially identical capital stock within 30 days before or after the disposition.

Redemption of Preferred Stock

In general, a redemption of any preferred stock will be treated under Section 302 of the Internal Revenue Code as a distribution that is taxable at ordinary income tax rates as a dividend (to the extent of our current or accumulated earnings and profits), unless the redemption satisfies certain tests set forth in Section 302(b) of the Internal Revenue Code enabling the redemption to be treated as a sale of the preferred stock (in which case the redemption will be treated in the same manner as a sale described in "— Taxation of U.S. Stockholders on the Disposition of Capital Stock" above). The redemption will satisfy such tests and be treated as a sale of the preferred stock if the redemption:

- is "substantially disproportionate" with respect to the U.S. stockholder's interest in our stock;
- results in a "complete termination" of the U.S. stockholder's interest in all classes of our stock; or
- is "not essentially equivalent to a dividend" with respect to the U.S. stockholder, all within the meaning of Section 302(b) of the Internal Revenue Code.

In determining whether any of these tests have been met, stock considered to be owned by the U.S. stockholder by reason of certain constructive ownership rules set forth in the Internal Revenue Code, as well as stock actually owned, generally must be taken into account. Because the determination as to whether any of the three alternative tests of Section 302(b) of the Internal Revenue Code described above will be satisfied with respect to any particular U.S. stockholder of the preferred stock depends upon the facts and circumstances at the time that the determination must be made, prospective investors are advised to consult their own tax advisors to determine such tax treatment.

If a redemption of preferred stock does not meet any of the three tests described above, the redemption proceeds will be treated as a distribution, as described in "— Taxation of Taxable U.S. Stockholders" above. In that case, a U.S. stockholder's adjusted tax basis in the redeemed preferred stock will be transferred to such U.S. stockholder's remaining stock holdings in our company. If the U.S. stockholder does not retain any of our stock, such basis could be transferred to a related person that holds our stock or it may be lost.

Under proposed Treasury regulations, if any portion of the amount received by a U.S. stockholder on a redemption of any class of our preferred stock is treated as a distribution with respect to our stock but not as a taxable dividend, then such portion will be allocated to all stock of the redeemed class held by the redeemed holder just before the redemption on a pro-rata, share-by-share, basis. The amount applied to each share will first reduce the redeemed holder's basis in that share and any excess after the basis is reduced to zero will result in taxable gain. If the redeemed holder has different bases in its shares, then the amount allocated could reduce some of the basis in certain shares while reducing all the basis and giving rise to taxable gain in others. Thus the redeemed holder could have gain even if such holder's basis in all its shares of the redeemed class exceeded such portion.

The proposed Treasury regulations permit the transfer of basis in the redeemed preferred stock to the redeemed holder's remaining, unredeemed shares of preferred stock of the same class (if any), but not to any other class of stock held (directly or indirectly) by the redeemed holder. Instead, any unrecovered basis in the redeemed shares of preferred stock would be treated as a deferred loss to be recognized when certain conditions are satisfied. The proposed Treasury regulations would be effective for transactions that occur after the date the regulations are published as final Treasury regulations. There can, however, be no assurance as to whether, when and in what particular for such proposed Treasury regulations will ultimately be finalized.

Capital Gains and Losses

A taxpayer generally must hold a capital asset for more than one year for gain or loss derived from its sale or exchange to be treated as long-term capital gain or loss. The highest marginal individual income tax rate currently is 35% (which rate applies for the period through December 31, 2012 absent further Congressional action). The maximum tax rate on long-term capital gain applicable to non-corporate taxpayers is 15% through December 31, 2012. The maximum tax rate on long-term capital gain from the sale or exchange of "section 1250 property," or depreciable real property, is 25% to the extent that such gain would have been treated as ordinary income if the property were "section 1245 property." With respect to distributions that we designate as capital gain dividends and any retained capital gain that we are deemed to distribute, we generally may designate whether such a distribution is taxable to our non-corporate stockholders at a 15% or 25% rate. Thus, the tax rate differential between capital gain and ordinary income for non-corporate taxpayers may be significant. In addition, the characterization of income as capital gain or ordinary income may affect the deductibility of capital losses. A non-corporate taxpayer may deduct capital losses not offset by capital gains against its ordinary income only up to a maximum annual amount of $3,000 ($1,500 for married individuals filing separate returns). A non-corporate taxpayer may carry forward unused capital losses indefinitely. A corporate taxpayer must pay tax on its net capital gain at ordinary corporate rates. A corporate taxpayer may deduct capital losses only to the extent of capital gains, with unused losses being carried back three years and forward five years.

Information Reporting Requirements and Backup Withholding

We will report to our stockholders and to the IRS the amount of dividends we pay during each calendar year, and the amount of tax we withhold, if any. Under the backup withholding rules, a stockholder may be subject to backup withholding at a rate of 28% with respect to distributions unless the holder:

- is a corporation or comes within certain other exempt categories and, when required, demonstrates this fact; or

- provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with the applicable requirements of the backup withholding rules.

A stockholder who does not provide us with its correct taxpayer identification number also may be subject to penalties imposed by the IRS, Any amount paid as backup withholding will be creditable against the stockholder's income tax liability. U.S. stockholders that hold their capital stock through foreign accounts or intermediaries will be subject to U.S. withholding tax at a rate of 30% on dividends, for taxable years beginning after December 31, 2013, and proceeds of sale of our capital stock, for taxable years beginning after December 14, 2014, if certain disclosure requirements related to U.S. accounts are not satisfied. In addition, we may be required to withhold a portion of capital gain distributions to any stockholders who fail to certify their non-foreign status to us. For a discussion of the backup withholding rules as applied to non-U.S. stockholders, see "— Taxation of Non-U.S. Stockholders."

A U.S. withholding tax at a 30% rate will be imposed on dividends, for taxable years beginning after December 31, 2013, and proceeds of sale in respect of our capital stock, for taxable years beginning after December 31, 2014, received by certain non-U.S. stockholders if certain disclosure requirements related to U.S. accounts or ownership are not satisfied. If payment of withholding taxes is required, non-U.S. stockholders that are otherwise eligible for an exemption from, or reduction of, U.S. withholding taxes with respect of such dividends and proceeds will be required to seek a refund from the IRS to obtain the benefit or such exemption or reduction. We will not pay any additional amounts in respect of any amounts withheld.

Taxation of Non-U.S. Stockholders

The rules governing U.S. federal income taxation of nonresident alien individuals, foreign corporations, foreign partnerships, and other foreign stockholders are complex. This section is only a summary of such rules. We urge non-U.S. stockholders to consult their own tax advisors to determine the impact of federal, foreign, state, and local income tax laws on ownership of our stock, including any reporting requirements.

A non-U.S. stockholder that receives a distribution that is not attributable to gain from our sale or exchange of U.S. real property interests, as defined below, and that we do not designate as a capital gain dividend or retained capital gain will recognize ordinary income to the extent that we pay the distribution out of our current or accumulated earnings and profits. A withholding tax equal to 30% of the gross amount of the distribution ordinarily will apply unless an applicable tax treaty reduces or eliminates the tax. However, if a distribution is treated as effectively connected with the non-U.S. stockholder's conduct of a U.S. trade or business, the non-U.S. stockholder generally will be subject to federal income tax on the distribution at graduated rates, in the same manner as U.S. stockholders are taxed on distributions and also may be subject to the 30% branch profits tax in the case of a corporate non-U.S. stockholder. We plan to withhold U.S. income tax at the rate of 30% on the gross amount of any ordinary dividend paid to a non-U.S. stockholder unless either:

- a lower treaty rate applies and the non-U.S. stockholder files an IRS Form W-8BEN evidencing eligibility for that reduced rate with us, or

- the non-U.S. stockholder files an IRS Form W-8ECI with us claiming that the distribution is effectively connected income.

However, reduced treaty rates are not available to the extent that the income allocated to the foreign stockholder is excess inclusion income. Our excess inclusion income generally will be allocated among our stockholders to the extent that it exceeds our REIT taxable income in a particular year.

A non-U.S. stockholder will not incur U.S. tax on a distribution in excess of our current and accumulated earnings and profits if the excess portion of the distribution does not exceed the adjusted basis of its capital stock. Instead, the excess portion of the distribution will reduce the adjusted basis of that capital stock. A non-U.S. stockholder will be subject to tax on a distribution that exceeds both out current and accumulated earnings and profits and the adjusted basis of the capital stock, if the non-U.S. stockholder otherwise would be subject to tax on gain from the sale or disposition of its capital stock, as described below. Because we generally cannot determine at the time we make a distribution whether or not the distribution will exceed our current and accumulated earnings and profits, we normally will withhold tax on the entire amount of any distribution at the same rate as we would withhold on a dividend. However, by filing a U.S. tax return, a non-U.S. stockholder may obtain a refund of amounts that we withhold of we later determine that a distribution in fact exceeded our current and accumulated earnings and profits.

We must withhold 10% of any distribution that exceeds our current and accumulated earnings and profits. Consequently, although we intend to withhold at a rate of 30% on the entire amount of any distribution, to the extent that we do not do so, we will withhold at a rate of 10% on any portion of a distribution not subject to withholding at a rate of 30%.

Non-U.S. stockholders will be subject to U.S. withholding tax at a rate of 30% on dividends, for taxable years beginning after December 31, 2013, and proceeds of sale in respect of our capital stock, for taxable years beginning after December 31, 2014, if certain disclosure requirements related to U.S. accounts or ownership are not satisfied. If payment of withholding taxes is required, non-U.S. stockholders that are otherwise eligible for an exemption from, or reduction of, U.S. withholding taxes with respect to such dividends and proceeds will be required to seek a refund from the IRS to obtain the benefit or such exemption or reduction. We will not pay any additional amounts in respect of any amounts withheld.

For any year in which we qualify as a REIT, a non-U.S. stockholder could incur tax on distributions that are attributable to gain from our sale or exchange of "U.S. real property interests" under special provisions of the federal income tax laws known as FIRPTA. The term "U.S. real property interests" includes interests in real property and shares in corporations at least 50% of whose assets consist of interests in real property. We do not expect to make significant distributions that are attributable to gain from our sale or exchange of U.S. real property interests. Moreover, any distributions with respect to a particular class of our capital stock that are attributable to our sale of real property will not be subject to FIRPTA, but instead will be treated as ordinary dividends as long as (1) our shares of that class of capital stock are "regularly traded" on an established securities market in the United States and (2) the non-U.S. stockholder did not own more than 5% of that class of our capital stock at any time during the one-year period ending on the date of the distribution. If, however, we were to make a distribution with respect to a particular class of our capital stock that is attributable to gain from our sale or exchange of U.S. real property interests and a non-U.S. stockholder were subject to FIRPTA on that distribution, the non-U.S. stockholder would be taxed on the distribution as if such amount were effectively connected with a U.S. business of the non-U.S. Holder. A non-U.S. stockholder thus would be taxed on such a distribution at the normal capital gains rates applicable to U.S. stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of a nonresident alien individual. A non-U.S. corporate stockholder not entitled to treaty relief or exemption also could be subject to the 30% branch profits tax on such a distribution. We must withhold 35% of any distribution that we could designate as a capital gain dividend. A non-U.S. stockholder would receive a credit against its U.S. federal income tax liability for any amount we withhold.

A non-U.S. stockholder should not incur a tax under FIRPTA on gains from the disposition of our capital stock because we are not and do not expect to be a U.S. real property holding corporation, or a corporation the fair market value of whose U.S. real property interests equals or exceeds 50% of the fair market value of its stock. In addition, even if we were to become a U.S. real property holding corporation, a non-U.S. stockholder would not incur tax under FIRPTA with respect to gain realized upon a disposition of our capital stock as long as at all times non-U.S. persons hold, directly or indirectly, less than 50% in value of our outstanding stock. Moreover, even if we are treated as a U.S. real property holding corporation, a non-U.S. stockholder that owned, actually or constructively, 5% or less of a class of our capital stock at all times during a specified testing period would not incur tax under FIRPTA on gain from the disposition of our capital stock if that class of our capital stock held is "regularly traded" on an established securities market. However, a non-U.S. stockholder generally will incur tax on gain not subject to FIRPTA if:

- the gain is effectively connected with the non-U.S. stockholder's U.S. trade or business, in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to such gain, or

- the non-U.S. stockholder is a nonresident alien individual who was present in the U.S. for 183 days or more during the taxable year and has a "tax home" in the United States, in which case the non-U.S. stockholder will incur a tax of

30% on his or her capital gains.

Taxable REIT Subsidiaries

As described above, we may own up to 100% of the stock of one or more TRSs. A TRS is a fully taxable corporation that may earn income that would not be qualifying income if earned directly by us. A corporation will not qualify as a TRS if it directly or indirectly operates or manages any hotels or health care facilities or provides rights to any brand name under which any hotel or health care facility is operated.

We and our corporate subsidiary must elect for the subsidiary to be treated as a TRS. A corporation of which a qualifying TRS directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a TRS. Overall, no more than 20% of the value of our assets may consist of securities of one or more TRSs, and no more than 25% of the value of our assets may consist of the securities of TRSs and other non-TRS taxable subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test.

The TRS rules limit the deductibility of interest paid or accrued by a TRS to us to assure that the TRS is subject to an appropriate level of corporate taxation. Further, the rules impose a 100% excise tax on transactions between a TRS and us or our tenants that are not conducted on an arm’s-length basis.

We have elected to treat Hypotheca, its wholly owned subsidiary, The New York Mortgage Company, Inc., and NYMF as TRSs. Hypotheca and NYMF are subject to corporate income tax on their taxable income. We believe that all transactions between us and each of Hypotheca, NYMF and any other TRS that we form or acquire (including sales of loans from Hypotheca or NYMF to us or a qualified REIT subsidiary) have been and will be conducted on an arm’s-length basis.

Sunset of Reduced Tax Rate Provisions

Several of the tax considerations described herein are subject to a sunset provision. The sunset provisions generally provide that for taxable years beginning after December 31, 2012, certain provisions that are currently in the Internal Revenue Code will revert back to a prior version of those provisions. These provisions include provisions related to the reduced maximum income tax rate for long term capital gains of 15% (rather than 20%) for taxpayers taxed at individual rates, the application of the 15% tax rate to qualified dividend income, and certain other tax rate provisions described herein. The impact of this reversion is not discussed herein. Consequently, you should consult your tax advisor regarding the effect of sunset provisions on an investment in our securities.

State, Local and Foreign Taxes

We and/or our securityholders may be subject to taxation by various states, localities or foreign jurisdictions, including those in which we or a securityholder transacts business, owns property or resides. We may own properties located in numerous jurisdictions and may be required to file tax returns in some or all of those jurisdictions. The state, local and foreign tax treatment may differ from the federal income tax treatment described above. Consequently, you should consult your tax advisor regarding the effect of state, local and foreign income and other tax laws upon an investment in our securities.

PLAN OF DISTRIBUTION

We may sell the securities offered by this prospectus from time to time in one or more transactions, including without limitation:

- through underwriters or dealers;
- directly to purchasers;
- in a rights offering;
- in "at the market" offerings, within the meaning of Rule 415(a)(4) of the Securities Act to or through a market maker or into an existing trading market on an exchange or otherwise;
- through agents;
- through a combination of any of these methods; or
- through any other method permitted by applicable law and described in a prospectus supplement.

The prospectus supplement with respect to any offering of securities will include the following information:

- the terms of the offering;
- the names of any underwriters or agents;
- the name or names of any managing underwriter or underwriters;
- the purchase price or initial public offering price of the securities;
- the net proceeds from the sale of the securities;
- any delayed delivery arrangements;
- any underwriting discounts, commissions and other items constituting underwriters' compensation;
- any discounts or concessions allowed or reallowed or paid to dealers;
- any commissions paid to agents; and
- any securities exchange on which the securities may be listed.

Sale through Underwriters or Dealers

If underwriters are used in the sale, the underwriters may resell the securities from time to time in one or more transactions, including negotiated transactions, at a fixed public offering price or at varying prices determined at the time of sale. Underwriters may offer securities to the public either through underwriting syndicates represented by one or more managing underwriters or directly by one or more firms acting as underwriters. Unless we inform you otherwise in the applicable prospectus supplement, the obligations of the underwriters to purchase the securities will be subject to certain conditions, and the underwriters will be obligated to purchase all of the offered securities if they purchase any of them. The underwriters may change from time to time any initial public offering price and any discounts or concessions allowed or reallowed or paid to dealers.

We will describe the name or names of any underwriters, dealers or agents and the purchase price of the securities in a prospectus supplement relating to the securities.

In connection with the sale of the securities, underwriters may receive compensation from us or from purchasers of the securities, for whom they may act as agents, in the form of discounts, concessions or commissions. Underwriters may sell the securities to or through dealers, and these dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agents, which is not expected to exceed that customary in the types of transactions involved. Underwriters, dealers and agents that participate in the distribution of the securities may be deemed to be underwriters, and any discounts or commissions they receive from us, and any profit on the resale of the securities they realize may be deemed to be underwriting discounts and commissions, under the Securities Act. The prospectus supplement will identify any underwriter or agent and will describe any compensation they receive from us.

Underwriters could make sales in privately negotiated transactions and/or any other method permitted by law, including sales deemed to be an “at-the-market” offering, sales made directly on the Nasdaq Capital Market, the existing trading market for our common stock, or such other exchange or automated quotation system on which our securities trade, or sales made to or through a market maker other than on an exchange. The name of any such underwriter or agent involved in the offer and sale of our securities, the amounts underwritten, and the nature of its obligations to take our securities will be described in the applicable prospectus supplement.

Unless otherwise specified in the prospectus supplement, each series of the securities will be a new issue with no established trading market, other than our common stock, which is currently listed on the Nasdaq Capital Market. We currently intend to list any shares of common stock sold pursuant to this prospectus on the Nasdaq Capital Market. We may elect to list any series of preferred stock on an exchange, but are not obligated to do so. It is possible that one or more underwriters may make a market in a series of the securities, but underwriters will not be obligated to do so and may discontinue any market making at any time without notice. Therefore, we can give no assurance about the liquidity of or the trading market for any of the securities.

Under agreements we may enter into, we may indemnify underwriters, dealers, and agents who participate in the distribution of the securities against certain liabilities, including liabilities under the Securities Act, or contribute with respect to payments that the underwriters, dealers or agents may be required to make. Unless otherwise set forth in the accompanying prospectus supplement, the obligations of any underwriters to purchase any of the securities will be subject to certain conditions precedent.

In compliance with the guidelines of the Financial Industry Regulatory Authority, Inc., or FINRA, the maximum aggregate discounts, commissions, agency fees or other items constituting underwriting compensation to be received by any FINRA member or independent broker-dealer will not exceed 8% of the aggregate offering price of the securities offered pursuant to this prospectus and any applicable prospectus supplement.

To facilitate the offering of securities, certain persons participating in the offering may engage in transactions that stabilize, maintain or otherwise affect the price of the securities. This may include over-allotments or short sales of the securities, which involve the sale by persons participating in the offering of more securities than we sold to them. In these circumstances, these persons would cover such over-allotments or short positions by making purchases in the open market or by exercising their over-allotment option, if any. In addition, these persons may stabilize or maintain the price of the securities by bidding for or purchasing securities in the open market or by imposing penalty bids, whereby selling concessions allowed to dealers participating in the offering may be reclaimed if securities sold by them are repurchased in connection with stabilization transactions. The effect of these transactions may be to stabilize or maintain the market price of the securities at a level above that which might otherwise prevail in the open market. These transactions may be discontinued at any time.

From time to time, we or our affiliates may engage in transactions with these underwriters, dealers and agents in the ordinary course of business. Underwriters have from time to time in the past provided, and may from time to time in the future provide, investment banking services to us for which they have in the past received, and may in the future receive, customary fees.

If indicated in the prospectus supplement, we may authorize underwriters or other persons acting as our agents to solicit offers by institutions to purchase securities from us pursuant to contracts providing for payment and delivery on a future date. Institutions with which we may make these delayed delivery contracts include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions and others. The obligations of any purchaser under any such delayed delivery contract will be subject to the condition that the purchase of the securities shall not at the time of delivery be prohibited under the laws of the jurisdiction to which the purchaser is subject. The underwriters and other agents will not have any responsibility with regard to the validity or performance of these delayed delivery contracts.

Direct Sales and Sales through Agents

We may sell the securities directly. In this case, no underwriters or agents would be involved. We may also sell the securities through agents designated by us from time to time. In the applicable prospectus supplement, we will name any agent involved in the offer or sale of the offered securities, and we will describe any commissions payable to the agent. Unless we inform you otherwise in the applicable prospectus supplement, any agent will agree to use its reasonable best efforts to solicit purchases for the period of its appointment.

We may sell the securities directly to institutional investors or others who may be deemed to be underwriters within the meaning of the Securities Act with respect to any sale of those securities. We will describe the terms of any sales of these securities in the applicable prospectus supplement.

Remarketing Arrangements

Securities may also be offered and sold, if so indicated in the applicable prospectus supplement, in connection with a remarketing upon their purchase, in accordance with a redemption or repayment pursuant to their terms, or otherwise, by one or more remarketing firms, acting as principals for their own accounts or as agents for us. Any remarketing firm will be identified and the terms of its agreements, if any, with us and its compensation will be described in the applicable prospectus supplement.

Delayed Delivery Contracts

If we so indicate in the applicable prospectus supplement, we may authorize agents, underwriters or dealers to solicit offers from certain types of institutions to purchase securities from us at the public offering price under delayed delivery contracts. These contracts would provide for payment and delivery on a specified date in the future. The contracts would be subject only to those conditions described in the applicable prospectus supplement. The applicable prospectus supplement will describe the commission payable for solicitation of those contracts.

General Information

We may have agreements with the underwriters, dealers, agents and remarketing firms to indemnify them against certain civil liabilities, including liabilities under the Securities Act, or to contribute with respect to payments that the underwriters, dealers, agents or remarketing firms may be required to make. Underwriters, dealers, agents and remarketing firms may be customers of, engage in transactions with or perform services for us in the ordinary course of their businesses.

CERTAIN LEGAL MATTERS

The legality of any securities offered by this prospectus will be passed upon for us by Hunton & Williams LLP. Certain legal matters will be passed upon for the underwriters or agents, if any, by the counsel named in the prospectus supplement. In addition, we have based the description of federal income tax consequences in "Federal Income Tax Consequences of Our Status as a REIT" upon the opinion of Hunton & Williams LLP.

EXPERTS

The consolidated financial statements incorporated by reference in this prospectus and elsewhere in the registration statement have been so incorporated by reference in the reliance upon the report of Grant Thornton LLP, independent registered public accountants, upon the authority of said firm as experts in giving said reports.

WHERE YOU CAN FIND MORE INFORMATION

We are required to file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any documents filed by us at the SEC's public reference room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at (800) SEC-0330 for further information about the public reference room. Our filings with the SEC are also available to the public through the SEC's Internet site at www.sec.gov. We have filed with the SEC a registration statement on Form S-3 relating to the securities covered by this prospectus. This prospectus is part of the registration statement and does not contain all the information in the registration statement. Wherever a reference is made in this prospectus to a contract or other documents of ours, the reference is only a summary and you should refer to the exhibits that are a part of the registration statement for a copy of the contract or other document. You may review a copy of the registration statement at the SEC's public reference room in Washington, D.C., as well as through the SEC's Internet site at http://www.sec.gov.

Our Internet address is http://www.nymtrust.com. We make available free of charge, on or through the "Financial Information—SEC Filings" section of our website, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Also posted on our website, and available in print upon request to our Investor Relations Department, are the charters for our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee, and our Code of Business Conduct and Ethics, which governs our directors, officers and employees. Information on our website is not part of this prospectus.

INCORPORATION BY REFERENCE OF INFORMATION FILED WITH THE SEC

The SEC allows us to "incorporate by reference" into this prospectus the information we file with the SEC, which means that we can disclose important business, financial and other information to you by referring you to other documents separately filed with the SEC. The information incorporated by reference is considered to be part of this prospectus from the date we file that document. Any reports filed by us with the SEC after the date of this prospectus and before the date that the offering of the securities by means of this prospectus is terminated will automatically update and, where applicable, supersede any information contained in this prospectus or incorporated by reference in this prospectus.

We incorporate by reference the following documents or information filed with the SEC and any subsequent filings we make with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act, after the date of the initial registration statement and prior to completion of the offering of the securities described in this prospectus (other than, in each case, documents or information deemed to have been furnished and not filed in accordance with SEC rules):

- our Annual Report on Form 10-K for the fiscal year ended December 31, 2011;

- our Current Report on Form 8-K filed on January 5, 2012;
- our Current Report on Form 8-K filed on January 19, 2012;
- our Current Report on Form 8-K filed on January 20, 2012;
- our Current Report on Form 8-K filed on February 1, 2012;
- our Current Report on Form 8-K filed on March 16, 2012;
- our Current Report on Form 8-K filed on March 19, 2012;
- our Current Report on Form 8-K filed on March 30, 2012;
- our definitive proxy statement on Schedule 14A filed on April 4, 2012; and
- the description of our capital stock in our Registration Statement on Form 8-A filed on June 3, 2008.

We will provide copies of all documents incorporated into this prospectus by reference, without charge, upon oral request to our Corporate Secretary at the number listed below or in writing by first class mail to the address listed below. Requests for such documents incorporated by reference should be directed to New York Mortgage Trust, Inc., c/o Secretary, 52 Vanderbilt Avenue, Suite 403, New York, New York 10017 or by calling our Corporate Secretary at (212) 792-0107.

Common Stock
Preferred Stock
Debt Securities

PROSPECTUS

Part II

INFORMATION NOT REQUIRED IN PROSPECTUS

ITEM 14. OTHER EXPENSES OF ISSUANCE AND DISTRIBUTION

The following sets forth the expenses in connection with the issuance and distribution of the securities being registered other than underwriting discounts and commissions. All such expenses will be borne by New York Mortgage Trust, Inc. All amounts set forth below are estimates, except for the SEC registration fee and FINRA filing fee.

		Amount to be paid
SEC registration fee	$	28,650
FINRA filing fee		25,500
Printing expenses (1)		5,000
Legal fees and expenses (1)		50,000
Accountants' fees and expenses (1)		33,000
Miscellaneous (including trustee and transfer agent fees) (1)		7,850
Total	$	150,000

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(1) Does not include expenses of preparing any accompanying prospectus supplements, listing fees, subsequent transfer agent fees, trustee fees and other expenses related to offerings of the securities from time to time.

ITEM 15. INDEMNIFICATION OF OFFICERS AND DIRECTORS

Maryland law permits a Maryland corporation to include in its charter a provision limiting the liability of its directors and officers to the corporation and its stockholders for money damages except for liability resulting from (a) actual receipt of an improper benefit or profit in money, property or services or (b) active and deliberate dishonesty established by a final judgment as being material to the cause of action. Our charter contains such a provision which eliminates directors' and officers' liability to the maximum extent permitted by Maryland law.

Our charter authorizes us, to the maximum extent permitted by Maryland law, to obligate us to indemnify any present or former director or officer or any individual who, while a director or officer of us and at the request of us, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise as a director, officer, partner or trustee, from and against any claim or liability to which that individual may become subject or which that individual may incur by reason of his or her status as a present or former director or officer of us and to pay or reimburse his or her reasonable expenses in advance of final disposition of a proceeding. Our bylaws obligate us, to the maximum extent permitted by Maryland law, to indemnify any present or former director or officer or any individual who, while a director or officer of us and at the request of us, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise as a director, officer, partner or trustee and who is made a party to the proceeding by reason of his service in that capacity from and against any claim or liability to which that individual may become subject or which that individual may incur by reason of his or her status as a present or former director or officer of us and to pay or reimburse his or her reasonable expenses in advance of final disposition of a proceeding. The charter and bylaws also permit us to indemnify and advance expenses to any individual who served a predecessor of us in any of the capacities described above and any employee or agent of us or a predecessor of us.

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Maryland law requires a corporation (unless its charter provides otherwise, which our charter does not) to indemnify a director or officer who has been successful in the defense of any proceeding to which he is made a party by reason of his service in that capacity. Maryland law permits a corporation to indemnify its present and former directors and officers, among others, against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceeding to which they may be made a party by reason of their service in those or other capacities unless it is established that (a) the act or omission of the director or officer was material to the matter giving rise to the proceeding and (i) was committed in bad faith or (ii) was the result of active and deliberate dishonesty, (b) the director or officer actually received an improper personal benefit in money, property or services or (c) in the case of any criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful. However, under Maryland law, a Maryland corporation may not indemnify for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that personal benefit was improperly received, unless in either case a court orders indemnification and then only for expenses. In addition, Maryland law permits a corporation to advance reasonable expenses to a director or officer upon the corporation's receipt of (a) a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification by the corporation and (b) a written undertaking by him or her or on his or her behalf to repay the amount paid or reimbursed by the corporation if it is ultimately determined that the standard of conduct was not met.

ITEM 16. EXHIBITS

Exhibit No.	
	Reductions in the reimbursement provided to our customers by Medicare or Medicaid could negatively impact the demand and price for our services, impair our ability to collect for our services from customers and could have a material adverse effect on our rehabilitation revenues and growth prospects.

Although reductions or changes in reimbursement from governmental or third party payors and regulatory changes affecting our business represent one of the most significant challenges to our business, our operations are also affected by coverage rules and determinations. Medicare providers like us can be negatively affected by the adoption of coverage policies, either at the national or local level, that determine whether an item or service is covered and under what clinical circumstances it is considered to be reasonable, necessary, and appropriate. Current CMS coverage rules require inpatient rehabilitation services to be ordered by a qualified rehabilitation physician and be coordinated by an interdisciplinary team. The interdisciplinary team must meet weekly to review patient status and make any needed adjustments to the individualized plan of care. Qualified personnel must provide required rehabilitation nursing, physical therapy, occupational therapy, speech language pathology, social services, psychological services, and prosthetic and orthotic services. CMS has also noted that it is considering specific standards governing the use of group therapies. For individual claims, Medicare contractors make coverage determinations regarding medical necessity which can represent more restrictive interpretations of the CMS coverage rules. We cannot predict how future CMS coverage rule interpretations or any new local coverage determinations will affect us.

Home health and hospice division

General regulations. The home health and hospice division is subject to various federal and state regulations. Many states require the entity through which home health or hospice services are provided to obtain a license or certification from one or more state agencies. In addition, a substantial majority of our home health

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and hospice agencies achieved and/or maintain certification through the Medicare deeming authority of one of the three private accreditation bodies: the Joint Commission, the Accreditation Commission for Health Care, and the Community Health Accreditation Program. The therapists and other healthcare professionals employed by the home health and hospice division are required to be individually licensed or certified pursuant to applicable state and federal laws. We have processes in place to ensure that our home health and hospice providers and the therapists and other healthcare professionals that we employ are licensed or certified in accordance with applicable federal and state laws. In addition, we require our therapists and other employees to participate in continuing education programs. The failure to obtain, maintain or renew required licenses or certifications by our home health and hospice agencies or the therapists or other healthcare professionals employed by those agencies could cause a material adverse effect on the home health and hospice division s results of operations.

As noted above, the home health and hospice division also is subject to federal and state laws that govern financial and other arrangements between healthcare providers. These laws prohibit, among other things, certain direct and indirect payments for the referral of patients, certain referrals by physicians if they or their immediate family members have a financial relationship with the home health or hospice agency, or fee-splitting arrangements between healthcare providers that are designed to induce or encourage the referral of patients to, or the recommendation of, a particular provider for medical products and services. Such laws include the Anti-Kickback Statute, the Stark Law and the FCA. In addition, some states restrict certain business relationships between physicians and ancillary service providers and some states prohibit business corporations from providing, or holding themselves out as a provider of, medical care. Possible sanctions for violation of any of these restrictions or prohibitions include loss of licensure or eligibility to participate in Medicare, Medicaid and other reimbursement programs, as well as civil and criminal penalties. These laws vary considerably from state to state.

Overview of home health and hospice division reimbursement

Medicare

Home health. To be eligible to receive Medicare payments for home health services, a patient must be homebound (cannot leave home without considerable or taxing effort), require periodic skilled nursing or physical or speech therapy services, and receive treatment under a plan of care established and periodically reviewed by a physician based upon a face-to-face encounter between the patient and the physician.

We receive a standard prospective payment for home health services provided over a base 60-day period, or episode, of care. There is no limit to the number of episodes a patient may receive as long as he or she remains Medicare eligible. The base episode payment is a flat rate subject to adjustment based upon differences in the expected needs of each patient. The adjustment is determined by each patient s categorization into one of 153 payment groups, known as home health resource groups, and the cost of care for patients in each group relative to the average patient. Payment is further adjusted for differences in local prices using the hospital wage index. The payment also is subject to retroactive adjustment in certain circumstances, including: (1) an outlier adjustment if the patient s care was unusually costly; (2) a utilization adjustment if the number of visits to the patient was less than five; (3) a partial payment adjustment if the patient transferred to another provider during an episode; (4) an adjustment based upon the level of required therapy services; and (5) an adjustment based upon the number of episodes of care, with episodes three and higher receiving an increased rate.

On November 4, 2011, CMS issued final regulations regarding Medicare payment rates for home health agencies effective January 1, 2012. These final regulations implement a net market basket increase of 1.4% consisting of: (1) a 2.4% market basket inflation increase, less (2) a 1.0% adjustment mandated by the ACA. In addition, CMS implemented a 3.79% reduction in case mix. CMS projected the impact of these changes would result in a 2.31% decrease in payments to home health agencies.

On November 2, 2012, CMS issued final regulations regarding Medicare payment rates for home health agencies effective January 1, 2013. These final regulations implement a net market basket increase of 1.3%

consisting of: (1) a 2.3% market basket inflation increase, less (2) a 1.0% adjustment mandated by the ACA. In addition, CMS implemented a 1.32% reduction in case mix. CMS has projected the impact of these changes will result in a 0.01% decrease in payments to home health agencies.

Hospice. To be eligible to receive hospice care under the Medicare program, a patient must have a terminal illness, as certified by two physicians, with a life expectancy of six months or less. The patient must affirmatively elect hospice treatment to the exclusion of other Medicare benefits related to his or her condition.

We receive payment for our hospice services under Medicare through a prospective payment system that pays an established payment rate for each day that we provide hospice services to a Medicare eligible patient. The rates we receive from Medicare are subject to annual adjustments for inflation and vary based upon the geographic location of the services provided. The rate also varies depending upon which of four established levels of care we provide to the Medicare patient: (1) routine home care, which is the default level paid for each day a patient is in the hospice program and does not receive one of the higher levels of care; (2) general inpatient care, which is paid when a patient needs inpatient services for pain or symptom management for a brief period; (3) continuous home care, which is home care provided during a crisis period when the patient requires intensive monitoring and nursing care; and (4) respite care, which allows a patient to receive inpatient care for a short period to provide relief for the patient s family and other care givers from the demands of providing care for up to five consecutive days.

The Medicare payments we receive for hospice care are subject to two caps. First, there is the 80-20 Rule providing that if the number of inpatient care days furnished to Medicare patients exceeds 20% of the total days of hospice care (measured during a 12-month period ending October 31 of each year) provided to Medicare patients, the excess is only eligible for the routine home care rate. Second, there is a cap based upon an overall average payment per Medicare beneficiary. Any payments exceeding the cap must be refunded to Medicare.

On July 24, 2012, CMS issued final regulations regarding Medicare payment rates for hospice providers effective October 1, 2012. These final regulations implement a net market basket increase of 1.6% consisting of: (1) a 2.6% market basket inflation increase, less (2) offsets to the standard payment conversion factor mandated by the ACA of: (a) a 0.7% adjustment to account for the effect of a productivity adjustment, and (b) 0.3% as required by statute. CMS has projected the impact of these changes will result in a 0.9% increase in payments to hospice providers.

Beginning April 1, 2013, the Budget Control Act of 2011 (as amended by the Taxpayer Relief Act) will automatically reduce federal spending by approximately $1.2 trillion split evenly between domestic and defense spending. Payments to Medicare providers are subject to these automatic spending reductions, subject to a 2% cap. At this time, we believe that the automatic 2% reduction on each claim submitted to Medicare will begin on April 1, 2013. Reductions to Medicare and Medicaid reimbursement resulting from the Budget Control Act of 2011 could have a material adverse effect on our business, financial position, results of operations and liquidity.

Medicaid Medicaid reimburses home health and hospice providers for care provided to certain low income patients. Reimbursement varies from state to state and is based upon a number of different systems including cost-based, prospective payment and negotiated rate systems. Rates are subject to multiple adjustments in different circumstances and are subject to statutory and regulatory changes and interpretations and rulings by individual state agencies.

Non-government payments The home health and hospice division seeks to maximize the number of its non-government payment patients, including those covered under private insurance and managed care health plans. Non-government payment patients typically have financial resources (including insurance coverages) to pay for their services and do not rely upon government programs for support. We negotiate contracts with purchasers of group healthcare services, including private employers, commercial insurers and managed care companies. Most payor organizations attempt to obtain discounts from established charges. We focus on demonstrating to these payors how our services can provide them and their customers with the most viable pricing arrangements in circumstances where they may otherwise be faced with funding treatments at higher rates at other healthcare providers. The importance of obtaining contracts with commercial insurers, managed care health plans and other private payors varies among markets, depending on such factors as the number of commercial payors and their relative market strength.

MASTER LEASE AGREEMENTS

At December 31, 2012, we leased from Ventas and its affiliates 38 TC hospitals and 159 nursing and rehabilitation centers under four master lease agreements (as amended, the Master Lease Agreements). We have also entered into an additional lease agreement with Ventas for ten TC hospitals that will be effective on May 1, 2013 (the 2013 Lease Agreement). The material terms and conditions of the 2013 Lease Agreement are substantially similar to the Master Lease Agreements, except as otherwise described below.

Term and Renewals

Each Master Lease Agreement includes land, buildings, structures and other improvements on the land, easements and similar appurtenances to the land and improvements, and permanently affixed equipment, machinery and other fixtures relating to the operation of the leased properties. There are several bundles of leased properties under each Master Lease Agreement, with each bundle containing approximately six to 20 leased nursing and rehabilitation centers and TC hospitals.

The Master Lease Agreements initially provided that we could renew all or none of the facilities within each bundle up to a maximum of three separate five year renewal terms by providing written notice between 12 and 18 months prior to the expiration of the lease term for such bundle.

Under the Master Lease Agreements, we had 73 nursing and rehabilitation centers and 16 TC hospitals within ten separate bundles eligible for renewal prior to an April 30, 2012 lease renewal notice date. We renewed three of these renewal bundles, containing 19 nursing and rehabilitation centers and six TC hospitals (collectively, the Renewal Facilities) for an additional five years.

The Renewal Facilities contain 2,178 licensed nursing and rehabilitation center beds and 616 licensed hospital beds and generated revenues of approximately $443 million for the year ended December 31, 2012. The current annual rent for the Renewal Facilities approximates $47 million.

We did not renew seven renewal bundles containing 54 nursing and rehabilitation centers (the Expiring Facilities). The Expiring Facilities contain 6,140 licensed nursing and rehabilitation center beds and generated revenues of approximately $475 million for the year ended December 31, 2012. The current annual rent for these facilities approximates $57 million. We have also entered into an agreement with Ventas to provide Ventas with more flexibility to accelerate the transfer of the Expiring Facilities. We will continue to operate the Expiring Facilities and include the Expiring Facilities in our results from continuing operations through the expiration of the lease term. When we terminate our operations of the Expiring Facilities, these facilities will be reclassified to discontinued operations.

We believe that the divesture of the Expiring Facilities will not have a material impact on our financial position, results of operations or liquidity.

On May 24, 2012, we entered into the 2013 Lease Agreement covering the ten TC hospitals that were otherwise scheduled to expire on April 30, 2013. The 2013 Lease Agreement will be effective on May 1, 2013 and will have a term of ten years with three five-year renewal options. The annual rent for the 2013 Lease Agreement will be $28 million and is subject to annual increases based on the increase in the Consumer Price

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Index (subject to an annual 4% cap). The current annual rent for these ten TC hospitals approximates $22 million. These ten TC hospitals contain 1,066 licensed hospital beds and generated revenues of approximately $283 million for the year ended December 31, 2012.

The following chart sets forth the current lease renewals under the existing Master Lease Agreements:

			Facility renewals		
Renewal Group	**Expiration date**	**Renewal date**	**Nursing and rehabilitation centers**	**TC hospitals**	**Renewal bundles**
Group 1	April 30, 2015	October 31, 2013 April 29, 2014	86	22	10
Group 2	April 30, 2018	October 31, 2016 April 29, 2017	7	1	1
Group 3	April 30, 2018	October 31, 2016 April 29, 2017	12	5	2

Renewal Group 1

In 2009, we entered into agreements with Ventas to renew all of the Group 1 facilities (12,101 licensed beds) for an additional five years. The current term for the Group 1 facilities expires on April 30, 2015. The current annual rent for the Group 1 facilities approximates $136 million. At our option, the Group 1 facilities may be extended for up to two five-year renewal terms beyond the current renewal term at the greater of: (1) the then existing rental rate plus the then existing escalation amount per annum or (2) the then fair market value rental rate. Upon any such renewal, the fair market value rental rate is determined through an appraisal procedure described in the Master Lease Agreements.

Renewal Group 2

The Group 2 facilities contain seven nursing and rehabilitation centers (766 licensed beds) and one TC hospital (109 licensed beds). The current annual rent for the Group 2 facilities approximate $15 million. As noted above, the Group 2 facilities are grouped into one renewal bundle. At our option, the Group 2 facilities may be extended for one five-year renewal term beyond the current term at the greater of: (1) the then existing rental rate plus the then existing escalation amount per annum or (2) the then fair market value rental rate. Upon any such renewal, the fair market value rental rate is determined through an appraisal procedure described in the Master Lease Agreements.

Renewal Group 3

The Group 3 facilities contain 12 nursing and rehabilitation centers (1,412 licensed beds) and five TC hospitals (507 licensed beds). The current annual rent for the Group 3 facilities approximate $32 million. As noted above, the Group 3 facilities are grouped into two separate renewal bundles. At our option, the Group 3 facilities may be extended for up to two five-year renewal terms beyond the current term at the greater of: (1) the then existing rental rate plus the then existing escalation amount per annum or (2) the then fair market value rental rate. Upon any such renewal, the fair market value rental rate is determined through an appraisal procedure described in the Master Lease Agreements.

Conditions to effectiveness of renewals

We may not extend the Master Lease Agreements beyond any previously exercised renewal term if, at the time we seek such extension and at the time such extension takes effect: (1) an event of default has occurred and is continuing or (2) a Medicare/Medicaid event of default (as described below) and/or a licensed bed event of default (as described below) has occurred and is continuing with respect to three or more leased properties subject to a particular Master Lease Agreement. The renewal term of each Master Lease Agreement is subject to termination upon default by us (subject to certain exceptions) and certain other conditions described in the Master Lease Agreements.

Rent appraisal process and our right to revoke such renewals

Under the Master Lease Agreements, if we provide Ventas with notice that we intend to renew one or more renewal bundles, Ventas may then initiate an appraisal process to establish a new fair market rental (as defined in the Master Lease Agreements) (FMR) for any or all of these bundles.

Under the appraisal process, an independent appraiser determines the FMR for each renewal bundle and each property within such renewal bundle. Once FMR is determined, the appraiser sends to both parties simultaneously the aggregate FMR for such renewal bundle and the FMR for each property within the bundle. Ventas, in its sole discretion, then determines whether: (1) to accept the appraised FMR for the renewal bundle in the aggregate or (2) make no changes to the current base rent and contingent annual rent escalator for the renewal bundle. If Ventas selects the new FMR for a renewal bundle, then the new FMR would become effective at the start of the renewal term unless we elect to revoke our renewal by the applicable deadline set forth in the Master Lease Agreements.

The determination of FMR requires certain levels of subjectivity and judgment related to the many variables that may be considered under the circumstances. As a result, it is important for investors to consider the possibility of a wide range of outcomes with respect to the appraisal process.

Rental Amounts and Escalators

Each Master Lease Agreement is commonly known as a triple-net lease or an absolute-net lease. Accordingly, in addition to rent, we are required to pay the following: (1) all insurance required in connection with the leased properties and the business conducted on the leased properties, (2) certain taxes levied on or with respect to the leased properties (other than taxes on the income of Ventas) and (3) all utilities and other services necessary or appropriate for the leased properties and the business conducted on the leased properties.

We paid rents to Ventas (including amounts classified as discontinued operations) approximating $260 million for the year ended December 31, 2012, $253 million for the year ended December 31, 2011 and $246 million for the year ended December 31, 2010.

Each Master Lease Agreement provides for rent escalations each May 1 if the patient revenues for the leased properties meet certain criteria as measured using the preceding calendar year revenues as compared to the base period. All annual rent escalators are payable in cash. The contingent annual rent escalator is 2.7% for Master Lease Agreements Nos. 1, 3 and 4. The contingent annual rent escalator for Master Lease Agreement No. 2 is based upon the Consumer Price Index with a floor of 2.25% and a ceiling of 4%. In 2012, the contingent annual rent escalator for Master Lease Agreement No. 2 was 2.87%.

Unlike the Master Lease Agreements, beginning the second full year of the lease term, the 2013 Lease Agreement provides for rent escalations each May 1 that equal the percentage increase, if any, in the Consumer Price Index, subject to a ceiling of 4%.

Use of the Leased Property

The Master Lease Agreements require that we utilize the leased properties solely for the provision of healthcare services and related uses and as Ventas may otherwise consent. We are responsible for maintaining or causing to be maintained all licenses, certificates and permits necessary for the leased properties to comply with various healthcare and other regulations. We also are obligated to operate continuously each leased property as a provider of healthcare services.

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Events of Default

Under each Master Lease Agreement, an Event of Default will be deemed to occur if, among other things:

we fail to pay rent or other amounts within five days after notice,

we fail to comply with covenants, which failure continues for 30 days or, so long as diligent efforts to cure such failure are being made, such longer period (not over 180 days) as is necessary to cure such failure,

certain bankruptcy or insolvency events occur, including filing a petition of bankruptcy or a petition for reorganization under the bankruptcy code,

an event of default arises from our failure to pay principal or interest on any indebtedness exceeding $50 million,

the maturity of any indebtedness exceeding $50 million is accelerated,

we cease to operate any leased property as a provider of healthcare services for a period of 30 days,

a default occurs under any guaranty of any lease or the indemnity agreements with Ventas,

we or our subtenant lose any required healthcare license, permit or approval or fail to comply with any legal requirements as determined by a final unappealable determination,

we fail to maintain insurance,

we create or allow to remain certain liens,

we breach any material representation or warranty,

a reduction occurs in the number of licensed beds in a facility, generally in excess of 10% (or less than 10% if we have voluntarily banked licensed beds) of the number of licensed beds in the applicable facility on the commencement date (a licensed bed event of default),

Medicare or Medicaid certification with respect to a participating facility is revoked and re-certification does not occur for 120 days (plus an additional 60 days in certain circumstances) (a Medicare/Medicaid event of default), we become subject to regulatory sanctions as determined by a final unappealable determination and fail to cure such regulatory sanctions within the specified cure period for any facility,

we fail to cure a breach of any permitted encumbrance within the applicable cure period and, as a result, a real property interest or other beneficial property right of Ventas is at material risk of being terminated, or

we fail to cure the breach of any of the obligations of Ventas as lessee under any existing ground lease within the applicable cure period and, if such breach is a non-monetary, non-material breach, such existing ground lease is at material risk of being terminated.

Remedies for an Event of Default

Except as noted below, upon an Event of Default under one of the Master Lease Agreements, Ventas may, at its option, exercise the following remedies:

(1) after not less than ten days notice to us, terminate the Master Lease Agreement to which such Event of Default relates, repossess any leased property, relet any leased property to a third party and require that we pay to Ventas, as liquidated damages, the net present value of the rent for the balance of the term, discounted at the prime rate,

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(2) without terminating the Master Lease Agreement to which such Event of Default relates, repossess the leased property and relet the leased property with us remaining liable under such Master Lease Agreement for all obligations to be performed by us thereunder, including the difference, if any, between the rent under such Master Lease Agreement and the rent payable as a result of the reletting of the leased property, and

(3) seek any and all other rights and remedies available under law or in equity.

In addition to the remedies noted above, under the Master Lease Agreements, in the case of a facility-specific event of default, Ventas may terminate a Master Lease Agreement as to the leased property to which the Event of Default relates, and may, but need not, terminate the entire Master Lease Agreement. Each of the Master Lease Agreements includes special rules relative to Medicare/Medicaid events of default and a licensed bed event of default. In the event a Medicare/Medicaid event of default and/or a licensed bed event of default occurs and is continuing: (1) with respect to not more than two properties at the same time under a Master Lease Agreement that covers 41 or more properties and (2) with respect to not more than one property at the same time under a Master Lease Agreement that covers 21 to and including 40 properties, Ventas may not exercise termination or dispossession remedies against any property other than the property or properties to which the event of default relates. Thus, in the event Medicare/Medicaid events of default and licensed bed events of default would occur and be continuing: (1) with respect to one property under a Master Lease Agreement that covers less than 20 properties, (2) with respect to two or more properties at the same time under a Master Lease Agreement that covers 21 to and including 40 properties, or (3) with respect to three or more properties at the same time under a Master Lease Agreement that covers 41 or more properties, then Ventas would be entitled to exercise all rights and remedies available to it under the Master Lease Agreements.

Assignment and Subletting

Except as noted below, the Master Lease Agreements provide that we may not assign, sublease or otherwise transfer any leased property or any portion of a leased property as a whole (or in substantial part), including by virtue of a change of control, without the consent of Ventas, which may not be unreasonably withheld if the proposed assignee: (1) is a creditworthy entity with sufficient financial stability to satisfy its obligations under the related Master Lease Agreement, (2) has not less than four years experience in operating healthcare facilities for the purpose of the applicable facility s primary intended use, (3) has a favorable business and operational reputation and character, and (4) has all licenses, permits, approvals and authorizations to operate the facility and agrees to comply with the use restrictions in the related Master Lease Agreement. The obligation of Ventas to consent to a subletting or assignment is subject to the reasonable approval rights of any mortgagee and/or the lenders under its credit agreement. We may sublease up to 20% of each leased property for restaurants, gift shops and other stores or services customarily found in hospitals or nursing and rehabilitation centers without the consent of Ventas, subject, however, to there being no material alteration in the character of the leased property or in the nature of the business conducted on such leased property.

In addition, each Master Lease Agreement allows us to assign or sublease (1) without the consent of Ventas, 10% of the nursing and rehabilitation center facilities in each Master Lease Agreement and (2) with Ventas consent (which consent will not be unreasonably withheld, delayed or conditioned), two hospitals in each Master Lease Agreement, if either: (a) the applicable regulatory authorities have threatened to revoke our Medicaid or Medicare certification or an authorization necessary to operate such leased property or (b) we cannot profitably operate such leased property. Any such proposed assignee/sublessee must satisfy the requirements listed above and it must have all licenses, permits, approvals and other authorizations required to operate the leased properties in accordance with the applicable permitted use. With respect to any assignment or sublease made under this provision, Ventas agrees to execute a nondisturbance and attornment agreement with such proposed assignee or subtenant. Upon any assignment or subletting, we will not be released from our obligations under the applicable Master Lease Agreement.

Subject to certain exclusions, we must pay to Ventas 80% of any consideration received by us on account of an assignment and 80% (50% in the case of existing subleases) of sublease rent payments (approximately equal to revenue net of specified allowed expenses attributable to a sublease, and specifically defined in the Master Lease Agreements), provided that Ventas s right to such payments will be subordinate to that of our lenders.

Ventas will have the right to approve the purchaser at a foreclosure of one or more of our leasehold mortgages by our lenders. Such approval will not be unreasonably withheld so long as such purchaser is creditworthy, reputable and has four years experience in operating healthcare facilities. Any dispute regarding whether Ventas has unreasonably withheld its consent to such purchaser will be subject to expedited arbitration.

2013 Lease Agreement

As noted above, we entered into the 2013 Lease Agreement covering the ten TC hospitals that were otherwise scheduled to expire on April 30, 2013. The terms of the 2013 Lease Agreement are substantially similar to the terms of the Master Lease Agreements, except that we may not: (1) develop any additional TC hospitals within a ten-mile radius of each of the ten TC hospitals subject to the 2013 Lease Agreement or (2) increase the number of licensed beds at TC hospitals that are within the restricted areas and not leased to us by Ventas under the 2013 Lease Agreement. We are not restricted, however, from acquiring operating TC hospitals within (or outside of) the restricted area. The 2013 Lease Agreement also excludes for these ten TC hospitals certain change of control transactions from the assignment restrictions that are otherwise applicable to us in the Master Lease Agreements. The 2013 Lease Agreement does not modify the above-described assignment restrictions applicable under the Master Lease Agreements, which remain in effect.

ADDITIONAL INFORMATION

Employees

As of December 31, 2012, we had approximately 50,900 full-time and 27,100 part-time and per diem employees. We had approximately 3,000 unionized employees at 35 of our facilities as of December 31, 2012.

The market for qualified nurses, therapists and other healthcare professionals is highly competitive. We, like other healthcare providers, have experienced difficulties in attracting and retaining qualified personnel such as nurses, certified nurse s assistants, nurse s aides, therapists and other providers of healthcare services. Our hospitals and nursing and rehabilitation centers are particularly dependent on nurses for patient care. Our rehabilitation division continues to seek qualified therapists to fill open positions. The difficulty we have experienced in hiring and retaining qualified personnel has increased our average wage rates and may force us to increase our use of contract personnel. We expect to continue to experience increases in our labor costs primarily due to higher wages and greater benefits required to attract and retain qualified healthcare personnel. Salaries, wages and benefits were approximately 59% of our consolidated revenues for the year ended December 31, 2012. Our ability to manage labor costs will significantly affect our future operating results.

Professional and General Liability Insurance

Our healthcare operations are insured for professional and general liability risks by our wholly owned limited purpose insurance subsidiary, Cornerstone Insurance Company (Cornerstone). Cornerstone covers losses up to specified limits per occurrence. On a per claim basis, coverage for losses in excess of those covered by Cornerstone are maintained through unaffiliated commercial reinsurance carriers. Cornerstone insures all claims in all states up to a per occurrence limit without the benefit of any aggregate stop loss limit, thereby increasing our financial risk.

We believe that our insurance is adequate in amount and coverage. There can be no assurance that in the future such insurance will be available at a reasonable price or that we will be able to maintain adequate levels of professional and general liability insurance coverage.

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Where You Can Find More Information

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the SEC) under the Exchange Act.

Our filings with the SEC are available to the public free of charge on the SEC website at *http://www.sec.gov*, which contains reports, proxy and information statements and other information. You also may read or obtain copies of this information in person or by mail from the SEC s Public Reference Room, 100 F Street, NE, Room 1580, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the Public Reference Room.

Our filings with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments thereto, are available free of charge on our website, through a link to the SEC s website, as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. Our website is *www.kindredhealthcare.com*. Information made available on our website is not a part of this document.

Item 1A. ***Risk Factors***

Certain statements made in this Annual Report on Form 10-K and the documents we incorporate by reference in this Annual Report on Form 10-K include forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. All statements regarding our expected future financial position, results of operations, cash flows, financing plans, business strategy, budgets, capital expenditures, competitive positions, growth opportunities, plans and objectives of management and statements containing the words such as anticipate, approximate, believe, plan, estimate, expect, project, could, intend, may and other similar expressions, are forward-looking statements.

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

the impact of healthcare reform, which will initiate significant changes to the United States healthcare system, including potential material changes to the delivery of healthcare services and the reimbursement paid for such services by the government or other third party payors, including reforms resulting from the ACA or future deficit reduction measures adopted at the federal or state level. Healthcare reform is affecting each of our businesses in some manner. Potential future efforts in the U.S. Congress to repeal, amend, modify or retract funding for various aspects of the ACA create additional uncertainty about the ultimate impact of the ACA on us and the healthcare industry. Due to the substantial regulatory changes that will need to be implemented by CMS and others, and the numerous processes required to implement these reforms, we cannot predict which healthcare initiatives will be implemented at the federal or state level, the timing of any such reforms, or the effect such reforms or any other future legislation or regulation will have on our business, financial position, results of operations and liquidity,

the impact of the 2012 CMS Rule which, among other things, will reduce Medicare reimbursement to our TC hospitals in 2013 and beyond by imposing a budget neutrality adjustment and modifying the short-stay outlier rules,

the impact of the 2011 CMS Rules which significantly reduced Medicare reimbursement to our nursing and rehabilitation centers and changed payments for the provision of group therapy services effective October 1, 2011,

the impact of the Budget Control Act of 2011 (as amended by the Taxpayer Relief Act) which will automatically reduce federal spending by approximately $1.2 trillion split evenly between domestic and defense spending. At this time, we believe that the automatic 2% reduction on each claim submitted to Medicare will begin on April 1, 2013,

the impact of the Taxpayer Relief Act which, among other things, reduces Medicare payments by 50% for subsequent procedures when multiple therapy services are provided on the same day. At this time, we believe that the new rules related to multiple therapy services will reduce our Medicare revenues by $25 million to $30 million on an annual basis,

changes in the reimbursement rates or the methods or timing of payment from third party payors, including commercial payors and the Medicare and Medicaid programs, changes arising from and related to the Medicare prospective payment system for LTAC hospitals, including potential changes in the Medicare payment rules, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, and changes in Medicare and Medicaid reimbursement for our TC hospitals, nursing and rehabilitation centers, IRFs and home health and hospice operations, and the expiration of the Medicare Part B therapy cap exception process,

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

the ability of our hospitals to adjust to potential LTAC certification and medical necessity reviews,

the impact of our significantly increased levels of indebtedness as a result of the RehabCare Merger on our funding costs, operating flexibility and ability to fund ongoing operations, development capital expenditures or other strategic acquisitions with additional borrowings,

our ability to successfully pursue our development activities, including through acquisitions, and successfully integrate new operations, including the realization of anticipated revenues, economies of scale, cost savings and productivity gains associated with such operations, as and when planned, including the potential impact of unanticipated issues, expenses and liabilities associated with those activities,

the failure of our facilities to meet applicable licensure and certification requirements,

the further consolidation and cost containment efforts of managed care organizations and other third party payors,

our ability to meet our rental and debt service obligations,

our ability to operate pursuant to the terms of our debt obligations, and comply with our covenants thereunder, and our ability to operate pursuant to our Master Lease Agreements with Ventas,

the condition of the financial markets, including volatility and weakness in the equity, capital and credit markets, which could limit the availability and terms of debt and equity financing sources to fund the requirements of our businesses, or which could negatively impact our investment portfolio, national and regional economic, financial, business and political conditions, including their effect on the availability and cost of labor, credit, materials and other services,

our ability to control costs, particularly labor and employee benefit costs,

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

our ability to attract and retain key executives and other healthcare personnel,

the increase in the costs of defending and insuring against alleged professional liability and other claims and our ability to predict the estimated costs related to such claims, including the impact of differences in actuarial assumptions and estimates compared to eventual outcomes, our ability to successfully reduce (by divestiture of operations or otherwise) our exposure to professional liability and other claims,

our ability to successfully dispose of unprofitable facilities,

events or circumstances which could result in the impairment of an asset or other charges, such as the impact of the Medicare reimbursement regulations that resulted in us recording significant impairment charges in 2012 and 2011,

changes in generally accepted accounting principles or practices, and changes in tax accounting or tax laws (or authoritative interpretations relating to any of these matters), and

our ability to maintain an effective system of internal control over financial reporting.

Many of these factors are beyond our control. We caution investors that any forward-looking statements made by us are not guarantees of future performance. We disclaim any obligation to update any such factors or to announce publicly the results of any revisions to any of the forward-looking statements to reflect future events or developments.

You should consider carefully all the risks described below, together with all of the information included in this Annual Report on Form 10-K, in evaluating our Company and our common stock. To facilitate your consideration of all of the risks described below, these risks are organized under headings and subheadings for your convenience. If any of the risks described in this Annual Report on Form 10-K were to occur, it could have a material adverse effect on our business, financial position, results of operations, liquidity and stock price.

Risk Factors Relating to Reimbursement and Regulation of Our Business

Healthcare reform has initiated significant changes to the United States healthcare system.

Various healthcare reform provisions became law upon enactment of the ACA. The reforms contained in the ACA have impacted each of our businesses in some manner. Several of the reforms are very significant and could ultimately change the nature of our services, the methods of payment for our services and the underlying regulatory environment. The reforms include the possible modifications to the conditions of qualification for payment, bundling payments to cover both acute and post-acute care and the imposition of enrollment limitations on new providers. The ACA also provides for: (1) reductions to the annual market basket payment updates for LTAC hospitals, IRFs, home health agencies and hospice providers, which could result in lower reimbursement than in the preceding year; (2) additional annual productivity adjustment reductions to the annual market basket payment update as determined by CMS for LTAC hospitals, IRFs, and nursing and rehabilitation centers (beginning in federal fiscal year 2012), home health agencies (beginning in federal fiscal year 2015) and hospice providers (beginning in federal fiscal year 2013); (3) new transparency, reporting and certification requirements for skilled nursing facilities, including disclosures regarding organizational structure, officers, directors, trustees, managing employees and financial, clinical and other related data; (4) a quality reporting system for hospitals (including LTAC hospitals and IRFs) beginning in federal fiscal year 2014; and (5) reductions in Medicare payments to hospitals (including LTAC hospitals and IRFs) beginning in federal fiscal year 2014 for failure to meet certain quality reporting standards or to comply with standards in new value based purchasing demonstration project programs.

In addition, a primary goal of healthcare reform is to reduce costs, which includes reductions in the reimbursement paid to us and other healthcare providers. Moreover, healthcare reform could negatively impact insurance companies, other third party payors, our customers, as well as other healthcare providers, which may in turn negatively impact our business. As such, healthcare reforms and changes resulting from the ACA, as well as other similar healthcare reforms, could have a material adverse effect on our business, financial position, results of operations and liquidity.

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Changes in the reimbursement rates or methods or timing of payment from third party payors, including the Medicare and Medicaid programs, or the implementation of other measures to reduce reimbursement for our services and products could result in a substantial reduction in our revenues and operating margins.

We depend on reimbursement from third party payors, including the Medicare and Medicaid programs, for substantially all of our revenues. For the year ended December 31, 2012, we derived approximately 56% of our total revenues (before eliminations) from the Medicare and Medicaid programs and the balance from other third party payors, such as commercial insurance companies, health maintenance organizations, preferred provider organizations and contracted providers. The Medicare and Medicaid programs are highly regulated and subject to frequent and substantial changes. See Part I Item 1 Business Governmental Regulation.

Congress continues to discuss deficit reduction measures, leading to a high degree of uncertainty regarding potential reforms to governmental healthcare programs, including Medicare and Medicaid. These discussions, along with other continuing efforts to reform governmental healthcare programs, both as part of the ACA and otherwise, could result in major changes in the healthcare delivery and reimbursement system on a national and state level. Potential reforms include changes directly impacting the government and private reimbursement systems for each of our businesses. Reforms or other changes to the payment systems, including modifications to the conditions of qualification for payment, the imposition of enrollment limitations on new providers, or bundling payments to cover acute and post-acute care or services provided to dually eligible Medicare and Medicaid patients may be proposed or could be adopted by Congress or CMS in the future.

Beginning April 1, 2013, the Budget Control Act of 2011 (as amended by the Taxpayer Relief Act) will automatically reduce federal spending by approximately $1.2 trillion split evenly between domestic and defense spending. Payments to Medicare providers are subject to these automatic spending reductions, subject to a 2% cap. At this time, we believe that the automatic 2% reduction on each claim submitted to Medicare will begin on April 1, 2013. Reductions to Medicare and Medicaid reimbursement resulting from the Budget Control Act of 2011 could have a material adverse effect on our business, financial position, results of operations and liquidity.

The Taxpayer Relief Act also reduces Medicare payments by 50% for subsequent procedures when multiple therapy services are provided on the same day and creates a new federal Commission on Long-Term Care that has six months in which to provide recommendations on the establishment, implementation and financing of a comprehensive, coordinated and high-quality system that ensures the availability of long-term care services. We believe that the new rules related to multiple therapy services will reduce our Medicare revenues by $25 million to $30 million on an annual basis.

On August 1, 2012, CMS issued the 2012 CMS Rule which, among other things, will reduce Medicare reimbursement to our TC hospitals in 2013 and beyond by imposing a budget neutrality adjustment and modifying the short-stay outlier rules. Effective December 29, 2012, the 2012 CMS Rule: (1) began a three-year phase-in of a 3.75% budget neutrality adjustment which will reduce LTAC hospital rates by 1.3% in 2013; and (2) restored a payment reduction that will limit payments for very short-stay outliers that will reduce our TC hospital payments by approximately 0.5%. The 2012 CMS Rule also: (1) provides for a one-year extension of the existing moratorium on the 25 Percent Rule pending the results of an ongoing research initiative to re-define the role of LTAC hospitals in the Medicare program, and (2) allows for the expiration of the current moratorium on the development or expansion of LTAC hospitals on December 29, 2012.

In aggregate, based upon our review of the 2012 CMS Rule, we expect that LTAC Medicare payment rates will decline slightly in 2013 compared to current rates. The 2012 CMS Rule does not include the impact of a 2% sequestration payment reduction mandated by Congress that is now expected to apply to each claim submitted to Medicare beginning April 1, 2013.

On July 29, 2011, CMS issued the 2011 CMS Rules which, among other things, significantly reduced Medicare payments to nursing centers and changed the reimbursement for the provision of group rehabilitation

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therapy services to Medicare beneficiaries beginning October 1, 2011. CMS projected the impact of these changes will result in an 11.1% decrease in payments to skilled nursing centers. In addition to these rate changes, the 2011 CMS Rules introduced additional changes to RUG calculations along with adding additional patient assessments. Under the 2011 CMS Rules, group therapy is defined as therapy sessions with four patients who are performing similar therapy activities. In addition, for purposes of assigning patients to RUGs IV payment categories, the minutes of group therapy are divided by four with 25% of the minutes being allocated to each patient. The 2011 CMS Rules also clarify the circumstances for reporting breaks in care of three or more days of therapy and also implement a new change of therapy assessment that is designed to allocate the patient to the RUG level that represents the treatment provided in the last seven days. Both changes are likely to produce alterations in the RUG scores billed for the patient along with generating additional patient assessments. We believe that the 2011 CMS Rules on an annual basis have reduced our revenues by approximately $100 million to $110 million in our nursing center business and have negatively impacted our rehabilitation therapy business by approximately $40 million to $50 million.

In February 2012, Congress passed the Job Creation Act which provides for reductions in reimbursement of Medicare bad debts at our hospitals and nursing and rehabilitation centers. For the hospitals, the current bad debt reimbursement rate of 70% for all bad debts will be lowered to 65% effective for cost reporting periods beginning on or after October 1, 2012. For the nursing and rehabilitation centers, the Job Creation Act provides for a phase-in of the reduction in the rate of reimbursement for bad debts of patients that are dually eligible for Medicare and Medicaid. The rate of reimbursement for bad debts for these dually eligible patients will be reduced from 100% to 88%, then 76% and then 65% for cost reporting periods beginning on or after October 1, 2012, October 1, 2013, and October 1, 2014, respectively. The rate of reimbursement for bad debts for patients not dually eligible for both Medicare and Medicaid will be reduced from 70% to 65%, effective with cost reporting periods beginning on or after October 1, 2012. Approximately 90% of our Medicare bad debt reimbursements incurred at our nursing and rehabilitation centers are associated with patients that are dually eligible.

Moreover, weak economic conditions also could adversely affect the budgets of individual states and of the federal government. This could result in attempts to reduce or eliminate payments for federal and state healthcare programs, including Medicare and Medicaid, and could result in an increase in taxes and assessments on our activities. In addition, private third party payors are continuing their efforts to control healthcare costs through direct contracts with healthcare providers, increased utilization review and greater enrollment in managed care programs and preferred provider organizations. These private payors increasingly are demanding discounted fee structures and are requesting that healthcare providers assume more financial risk.

Though we cannot predict what reform proposals will be adopted or finally implemented, healthcare reform and regulations may have a material adverse effect on our business, financial position, results of operations and liquidity through, among other things, decreasing funds available for our services or increasing operating costs. We could be affected adversely by the continuing efforts of governmental and private third party payors to contain healthcare costs. We cannot assure you that reimbursement payments under governmental and private third party payor programs, including Medicare supplemental insurance policies, will remain at levels comparable to present levels or will be sufficient to cover the costs allocable to patients eligible for reimbursement pursuant to these programs. Future changes in third party payor reimbursement rates or methods, including the Medicare and Medicaid programs, or the implementation of other measures to reduce reimbursement for our services and products could result in a material reduction in our revenues. Our operating margins continue to be under pressure because of reduced Medicare reimbursement, deterioration in pricing flexibility, changes in payor mix, changes in length of stay and growth in operating expenses in excess of increases in payments by third party payors. In addition, as a result of competitive pressures, our ability to maintain operating margins through price increases to private patients or commercial payors remains limited. These results could have a material adverse effect on our business, financial position, results of operations and liquidity.

Expiration of the moratorium imposed on certain federal regulations otherwise applicable to LTAC hospitals, including HIHs and satellite hospitals, could have an adverse effect on our future revenues and profitability.

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

On May 1, 2007, CMS issued the 2007 Final Rule which expanded the 25 Percent Rule to all LTAC hospitals, regardless of whether they are co-located with another hospital. Under the 2007 Final Rule, all LTAC hospitals were to be paid LTAC PPS rates for admissions from a single referral source up to 25% of aggregate Medicare admissions. Patients reaching high cost outlier status in the short-term hospital were not to be counted when computing the 25% limit. Admissions beyond the 25% threshold are to be paid at a lower amount based upon IPPS rates.

The SCHIP Extension Act initially placed a three-year moratorium on the expansion of the 25 Percent Rule to freestanding hospitals. The ACA extended the moratorium on the expansion of the 25 Percent Rule to freestanding LTAC hospitals from three years to five years. Following the ACA, the moratorium on the expansion of the 25 Percent Rule to freestanding LTAC hospitals was set to expire for cost reporting periods beginning on or after July 1, 2012. However, the 2012 CMS Rule further extended the moratorium to all freestanding LTAC hospitals with cost report periods beginning on or after October 1, 2012 and before October 1, 2013. This created a potential gap period that will not affect any of our freestanding TC hospitals.

In addition, the ACA extended to five years the period during which: (1) HIHs may admit up to 50% of their patients from their co-located hospitals and still be paid according to LTAC PPS; and (2) LTAC hospitals that are co-located with an urban single hospital or a MSA Dominant hospital may admit up to 75% of their patients from such urban single or MSA Dominant hospital and still be paid according to LTAC PPS. The 2012 CMS Rule further extended these periods to all LTAC hospitals with cost report periods beginning on or after October 1, 2012 and before October 1, 2013.

Since these rules are complex and are based upon the volume of Medicare admissions and the source of those admissions, we cannot predict with any certainty the impact on our future revenues or operations from these regulations. If the 25 Percent Rule is ultimately applied as currently written, it could have a material adverse effect on our business, financial position, results of operations and liquidity when the moratorium expires.

Future cost containment initiatives undertaken by third party payors may limit our revenues and profitability.

Initiatives undertaken by major insurers and managed care companies to contain healthcare costs or to respond to healthcare reform could affect the profitability of our services. These payors attempt to control healthcare costs by contracting with providers of healthcare to obtain services on a discounted basis. We believe that this trend will continue and intensify and may further limit reimbursements for healthcare services. If insurers or managed care companies from whom we receive substantial payments reduce the amounts they pay for services or limit access to our services, our profit margins may decline, or we may lose patients if we choose not to renew our contracts with these insurers at lower rates. These results could have a material adverse effect on our business, financial position, results of operations and liquidity.

Further consolidation of managed care organizations and other third party payors may adversely affect our profits.

Managed care organizations and other third party payors have continued to consolidate in order to enhance their ability to influence the delivery and cost structure of healthcare services. Consequently, the healthcare needs of a large percentage of the United States population are increasingly served by a smaller number of managed care organizations. These organizations generally enter into service agreements with a limited number of providers for needed services. In addition, third party payors, including managed care payors, increasingly are demanding discounted fee structures. To the extent that these organizations terminate us as a preferred provider, engage our competitors as a preferred or exclusive provider or demand discounted fee structures, our business, financial position, results of operations and liquidity could be materially and adversely affected.

We conduct business in a heavily regulated industry, and changes in regulations, the enforcement of these regulations or violations of regulations may result in increased costs or sanctions that reduce our revenues and profitability.

In the ordinary course of our business, we are subject regularly to inquiries and audits by federal and state agencies that oversee applicable healthcare program participation and payment regulations. We also are subject to government investigations. We believe that the regulatory environment surrounding most segments of the healthcare industry will remain intense.

The extensive federal, state and local regulations affecting the healthcare industry include, but are not limited to, regulations relating to licensure, conduct of operations, ownership of facilities, addition of facilities, allowable costs, services and prices for services, facility staffing requirements, qualifications and licensure of staff, environmental and occupational health and safety, and the confidentiality and security of health-related information. In particular, various laws, including the anti-kickback, anti-fraud and abuse amendments codified under the Social Security Act, prohibit certain business practices and relationships that might affect the provision and cost of healthcare services reimbursable under Medicare and Medicaid, including the payment or receipt of remuneration for the referral of patients whose care will be paid by Medicare or other governmental programs. Sanctions for violating the anti-kickback, anti-fraud and abuse amendments under the Social Security Act include criminal penalties, civil sanctions, fines and possible exclusion from government programs such as Medicare and Medicaid. See Part I Item 1 Business Governmental Regulation.

Federal and state governments continue to pursue intensive enforcement policies resulting in a significant number of inspections, audits, citations of regulatory deficiencies and other regulatory sanctions including demands for refund of overpayments, terminations from the Medicare and Medicaid programs, bans on Medicare and Medicaid payments for new admissions and civil monetary penalties or criminal penalties. RAC audits and other audits evaluating the medical necessity of services provided are expected to further intensify the regulatory environment surrounding the healthcare industry as third party firms engaged by CMS commence extensive reviews of claims data and medical and other records to identify improper payments to healthcare providers under the Medicare program. If we fail to comply with the extensive laws, regulations and prohibitions applicable to our businesses, we could become ineligible to receive government program reimbursement, suffer civil or criminal penalties or be required to make significant changes to our operations. In addition, we could be forced to expend considerable resources responding to investigations, audits or other enforcement actions related to these laws, regulations or prohibitions. Furthermore, should we lose the licenses for one or more of our facilities as a result of regulatory action or otherwise, we could be in default under our Master Lease Agreements, our Credit Facilities and indenture governing the Notes. Failure of our staff to satisfy applicable licensure requirements, or of our hospitals, IRFs, nursing and rehabilitation centers, our rehabilitation operations, and home health and hospice operations, to satisfy applicable licensure and certification requirements could have a material adverse effect on our business, financial position, results of operations and liquidity.

We are unable to predict the future course of federal, state and local regulation or legislation, including Medicare and Medicaid statutes and regulations, or the intensity of federal and state enforcement actions.

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Changes in the regulatory framework, including those associated with healthcare reform, and sanctions from various enforcement actions could have a material adverse effect on our business, financial position, results of operations and liquidity.

We face and are currently subject to reviews, audits and investigations under our contracts with federal and state government agencies and other payors, and these reviews, audits and investigations could have adverse findings that may negatively impact our business.

As a result of our participation in the Medicare and Medicaid programs, we face and are currently subject to various governmental reviews, audits and investigations to verify our compliance with these programs and applicable laws and regulations. An increasing level of governmental and private resources is being devoted to the investigation of allegations of fraud and abuse in the Medicare and Medicaid programs, and federal and state regulatory authorities are taking an increasingly strict view of the requirements imposed on healthcare providers by the Social Security Act, the Medicare and Medicaid programs and other applicable laws. We are routinely subject to audits under various government programs, including the RAC program, in which third party firms engaged by CMS conduct extensive reviews of claims data and medical and other records to identify potential improper payments to healthcare providers under the Medicare program. In addition, we, like other nursing center operators, are subject to ongoing investigations by the OIG into the billing of rehabilitation services provided to Medicare patients and general compliance with conditions of participation with Medicare and Medicaid. Private pay sources also often reserve the right to conduct audits. Our costs to respond to and defend reviews, audits and investigations are significant and are likely to increase in the current enforcement environment. In the past, some of these audits and investigations have required us to refund or retroactively adjust amounts that have been paid under the relevant program or from other payors. We may be subject to similar obligations in the future. Moreover, an adverse review, audit or investigation also could result in other adverse consequences, particularly if the underlying conduct is found to be systemic. These consequences include:

- state or federal agencies imposing fines, penalties and other sanctions on us;
- loss of our right to participate in the Medicare or Medicaid programs or one or more third party payor networks; or
- damage to our reputation in various markets, which could adversely affect our ability to attract patients, residents and employees.

If they were to occur, these consequences could have a material adverse effect on our business, financial position, results of operations and liquidity.

We are subject to extensive and complex federal and state government laws and regulations which govern and restrict our relationships with physicians and other referral sources.

The Anti-Kickback Statute, the Stark Law, the FCA and similar state laws materially restrict our relationships with physicians and other referral sources. We have a variety of financial relationships with physicians and others who either refer or influence the referral of patients to our healthcare facilities, and these laws govern those relationships. The OIG has enacted safe harbor regulations that outline practices deemed protected from prosecution under the Anti-Kickback Statute. While we endeavor to comply with the safe harbors, most of our current arrangements, including with physicians and other referral sources, may not qualify for safe harbor protection. Failure to qualify for a safe harbor does not mean the arrangement necessarily violates the Anti-Kickback Statute, but may subject the arrangement to greater scrutiny. However, we cannot offer assurance that practices outside of a safe harbor will not be found to violate the Anti-Kickback Statute. Allegations of violations of the Anti-Kickback Statute may be brought under federal civil monetary penalty laws, which require a lower burden of proof than other fraud and abuse laws, including the Anti-Kickback Statute.

Our financial relationships with referring physicians and their immediate family members must comply with the Stark Law by meeting an exception. We attempt to structure our relationships to meet an exception to the

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Stark Law, but the regulations implementing the exceptions are detailed and complex, and we cannot provide assurance that every relationship complies fully with the Stark Law. Unlike the Anti-Kickback Statute, failure to meet an exception under the Stark Law results in a violation of the Stark Law, even if such violation is technical in nature.

Additionally, if we violate the Anti-Kickback Statute or the Stark Law, or if we improperly bill for our services, we may be found to violate the FCA, either under a suit brought by the government or by a private person under a *qui tam,* or whistleblower, lawsuit.

If we fail to comply with the Anti-Kickback Statute, the Stark Law, the FCA or other applicable laws and regulations, we could be subjected to liabilities, including civil penalties (including the loss of our licenses to operate one or more facilities or healthcare activities), exclusion of one or more facilities or healthcare activities from participation in the Medicare, Medicaid and other federal and state healthcare programs and, for violations of certain laws and regulations, and criminal penalties.

We do not always have the benefit of significant regulatory or judicial interpretation of these laws and regulations. In the future, different interpretations or enforcement of these laws and regulations could subject our current or past practices to allegations of impropriety or illegality or could require us to make changes in our facilities, equipment, personnel, services, capital expenditure programs and operating expenses. A determination that we have violated these laws, or the public announcement that we are being investigated for possible violations of these laws, could have a material adverse effect on our business, financial position, results of operations and liquidity, and our business reputation could suffer significantly. In addition, other legislation or regulations at the federal or state level may be adopted that adversely affect our business.

If our TC hospitals fail to maintain their certification as LTAC hospitals, our profitability would decline.

If our TC hospitals, satellite TC facilities or HIHs fail to meet or maintain the standards for certification as LTAC hospitals, such as average minimum length of patient stay, they will receive payments under the prospective payment system applicable to general acute care hospitals rather than payment under the system applicable to LTAC hospitals. Payments at rates applicable to general acute care hospitals would result in our TC hospitals receiving less Medicare reimbursement than they currently receive for patient services and our profitability would decline. In addition, implementation of additional LTAC hospital certification criteria and medical necessity reviews may limit the population of patients eligible for our services or change the basis upon which we are paid, which could have a material adverse effect on our business, financial position, results of operations and liquidity.

Implementation of additional patient or facility criteria for LTAC hospitals that limit the population of patients eligible for our hospital services or change the basis upon which we are paid could adversely affect our revenues and profitability.

CMS has, for a number of years, considered the development of facility and patient certification criteria for LTAC hospitals, potentially as an alternative to the current payment system under LTAC PPS. In 2004, MedPAC recommended to Congress the adoption by CMS of new facility staffing and services criteria and patient clinical characteristics and treatment requirements for LTAC hospitals in order to ensure that only appropriate patients are admitted to these facilities. Since the MedPAC recommendation, CMS has initiated studies to examine such recommendations and those studies are ongoing.

The LTAC Legislation was introduced into the United States Senate during a prior Congressional session. The LTAC Legislation would have implemented new patient and facility criteria for LTAC hospitals. The LTAC Legislation provided for patient criteria to ensure that LTAC hospital patients are physician screened for appropriateness prior to admission and throughout their stay. In addition, facility criteria would have established

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common requirements for the programmatic, personnel and clinical operations of a LTAC hospital. The LTAC Legislation further provided that at least 70% of patients must be medically complex in order for a hospital to maintain its Medicare certification as a LTAC hospital. While the LTAC Legislation was not enacted during a prior Congressional session, nor has it been reintroduced during the current session of Congress, the Company believes that similar legislation establishing patient and facility criteria for LTAC hospitals could be introduced in the future. However, there can be no assurances that the LTAC Legislation or any other legislation establishing patient and facility criteria for LTAC hospitals will be enacted in the future.

Implementation of additional criteria imposed by CMS or Congress that may limit the population of patients eligible for our hospital services or change the basis upon which we are paid could have a material adverse effect on our business, financial position, results of operations and liquidity.

Healthcare reform and other regulations could adversely affect the liquidity of our customers, which could have an adverse effect on their ability to make timely payments to us for our products and services.

The ACA and other laws and regulations that limit or restrict Medicare and Medicaid payments to our customers could adversely impact the liquidity of our customers, resulting in their inability to pay us, or to timely pay us, for our products and services. In addition, if our customers fail to comply with applicable laws and regulations they could be subject to possible sanctions, including loss of licensure or eligibility to participate in reimbursement programs, as well as civil and criminal penalties. These developments could have a material adverse effect on our business, financial position, results of operations and liquidity.

If we do not manage admissions in the IRFs that we operate or manage in compliance with a 60% threshold, reimbursement for services rendered by us in these facilities will be based upon less favorable rates.

IRFs are subject to a requirement that 60% or more of the patients admitted to the facilities have one or more of 13 specific conditions in order to qualify for IRF-PPS. If that compliance threshold is not maintained, the IRF will be reimbursed at the lower prospective payment system applicable to acute care hospitals. That may lead to reduced revenue in the IRFs that we operate or manage and also may lead customers of IRFs to attempt to renegotiate the terms of their contracts or terminate their contracts, in either case adversely affecting the projected revenues and profitability we expect.

If we are found to have violated laws protecting the confidentiality of patient health information, we could be subject to civil or criminal penalties, which could increase our liabilities and harm our reputation or our business.

There are a number of federal and state laws protecting the confidentiality of certain patient health information, including patient records, and restricting the use and disclosure of that protected information. In particular, the privacy rules under HIPAA protect medical records and other personal health information by limiting their use and disclosure, giving individuals the right to access, amend and seek accounting of their own health information and limiting most uses and disclosures of health information to the minimum amount reasonably necessary to accomplish the intended purpose. If we are found to be in violation of the privacy or security rules under HIPAA or other federal or state laws protecting the confidentiality of patient health information, we could be subject to sanctions and civil or criminal penalties, which could increase our liabilities, harm our reputation and have a material adverse effect on our business, financial position, results of operations and liquidity.

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Risk Factors Relating to Our Indebtedness

Our indebtedness could adversely affect our cash flow and prevent us from fulfilling our obligations.

We have a substantial amount of indebtedness. As of December 31, 2012, we had total indebtedness of approximately $1.6 billion in addition to availability of approximately $420 million under the ABL Facility (subject to a borrowing base and after giving effect to approximately $9 million of letters of credit outstanding on December 31, 2012). Our substantial amount of indebtedness could have important consequences. For example it could:

- make it more difficult for us to satisfy our obligations with respect to our indebtedness;
- increase our vulnerability to general adverse economic and industry conditions;
- expose us to fluctuations in the interest rate environment because the interest rates under the Credit Facilities are variable;
- require us to dedicate a substantial portion of our cash flow from operations to make payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures, acquisitions and other general corporate purposes;
- limit our ability to borrow additional funds for working capital, capital expenditures, acquisitions and other general purposes;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate, which may place us at a competitive disadvantage compared to our competitors that have less debt; and
- restrict us from pursuing business opportunities.

Our indebtedness may restrict our current and future operations, which could adversely affect our ability to respond to changes in our business and manage our operations.

The terms of the Credit Facilities and the indenture governing the Notes include a number of restrictive covenants that impose significant operating and financial restrictions on us and our restricted subsidiaries, including restrictions on our and our restricted subsidiaries ability to, among other things:

- incur additional indebtedness;
- create liens;
- consolidate or merge;

- sell assets, including capital stock of our subsidiaries;
- engage in transactions with our affiliates;
- create restrictions on the payment of dividends or other amounts to us from our restricted subsidiaries;
- pay dividends on our capital stock or redeem, repurchase or retire our capital stock or indebtedness; and
- make investments, loans, advances and acquisitions.

The terms of the Credit Facilities also include certain additional restrictive covenants that impose significant operating and financial restrictions on us and our restricted subsidiaries, including restrictions on our and our restricted subsidiaries ability to, among other things:

- change the date on which our fiscal years or quarters end;
- engage in business other than relating to owning, operating or managing healthcare facilities;

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- enter into sale and lease-back transactions;
- modify certain agreements;
- make or incur capital expenditures; and
- hold cash and temporary cash investments outside of collateral accounts.

In addition, the Credit Facilities require us to comply with financial covenants, including a maximum leverage ratio and a minimum fixed charge coverage ratio.

Our ability to comply with these agreements may be affected by events beyond our control, including prevailing economic, financial and industry conditions. These covenants could have an adverse effect on our business by limiting our ability to take advantage of financing, merger and acquisition or other corporate opportunities. The breach of any of these covenants or restrictions could result in a default under the Credit Facilities or the indenture governing the Notes.

Our failure to comply with the agreements relating to our outstanding indebtedness, including as a result of events beyond our control, could result in an event of default that could materially and adversely affect our business, financial condition, results of operations and liquidity.

If there were an event of default under any of the agreements relating to our outstanding indebtedness, including the Credit Facilities and the indenture governing the Notes, we may not be able to incur additional indebtedness under the Credit Facilities and the holders of the defaulted debt could cause all amounts outstanding with respect to that debt to be due and payable immediately. We cannot assure you that our assets or cash flow would be sufficient to fully repay borrowings under our outstanding debt instruments if accelerated upon an event of default, which could have a material adverse effect on our ability to continue to operate as a going concern. Further, if we are unable to repay, refinance or restructure our secured debt, the holders of such debt could proceed against the collateral securing that indebtedness. In addition, any event of default or declaration of acceleration under one debt instrument also could result in an event of default under one or more of our other debt instruments or under the Master Lease Agreements. Moreover, counterparties to some of our contracts material to our business may have the right to amend or terminate those contracts if we have an event of default or a declaration of acceleration under certain of our indebtedness, which could adversely affect our business, financial condition, results of operations and liquidity.

We, including our subsidiaries, have the ability to incur substantially more indebtedness, including senior secured indebtedness, which could further increase the risks associated with our leverage.

Subject to the restrictions in the Credit Facilities and the indenture governing the Notes, we, including our subsidiaries, have the ability to incur significant additional indebtedness. As of December 31, 2012:

- we had $1.1 billion of senior secured indebtedness under the Credit Facilities;
- we had $550 million of senior unsecured indebtedness under the Notes;
- we had approximately $420 million available for borrowing under the ABL Facility (subject to a borrowing base and after giving effect to approximately $9 million of letters of credit outstanding on December 31, 2012) which, if borrowed, would be senior secured indebtedness; and

subject to our compliance with certain covenants and other conditions, we have the option to incur certain additional secured indebtedness and/or additional unsecured indebtedness which would rank *pari passu* with the Notes.

Although the terms of the Credit Facilities and the indenture governing the Notes include restrictions on the incurrence of additional indebtedness, these restrictions are subject to a number of important exceptions, and indebtedness incurred in compliance with these restrictions could be substantial. If we incur significant additional indebtedness, the related risks that we face could increase.

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We may not be able to generate sufficient cash to pay rents related to our leased properties and service all of our indebtedness and may be forced to take other actions to satisfy our obligations under our indebtedness, which may not be successful.

A substantial portion of our cash flows from operations is dedicated to the payment of rents related to our leased properties, as well as principal and interest obligations on our outstanding indebtedness. Our ability to generate cash depends on many factors beyond our control, and any failure to meet our debt service obligations could harm our business, financial condition and results of operations. Our ability to make payments on and to refinance our indebtedness and to fund working capital needs and planned capital expenditures will depend on our ability to generate cash in the future. This, to a certain extent, is subject to general economic, financial, competitive, business, legislative, regulatory and other factors that are beyond our control.

If our business does not generate sufficient cash flow from operations or if future borrowings are not available to us in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs, we may need to refinance all or a portion of our indebtedness on or before the maturity thereof, sell assets, reduce or delay capital investments or seek to raise additional capital, any of which could have a material adverse effect on our operations. In addition, we may not be able to effect any of these actions, if necessary, on commercially reasonable terms or at all. The terms of existing or future debt instruments may limit or prevent us from taking any of these actions. Our ability to restructure or refinance our indebtedness will depend on the condition of the capital markets and our financial condition at such time. Any refinancing of our debt could be at higher interest rates and may require us to comply with more onerous covenants, which could further restrict our business operations. In addition, any failure to make scheduled payments of interest and principal on our outstanding indebtedness would likely result in a reduction of our credit rating, which could harm our ability to incur additional indebtedness on commercially reasonable terms or at all. Our inability to generate sufficient cash flow to satisfy our debt service obligations, or to refinance or restructure our obligations on commercially reasonable terms or at all, would have an adverse effect, which could be material, on our business, financial condition, results of operations and liquidity.

In addition, our Master Lease Agreements and/or our outstanding indebtedness:

- require us to dedicate a substantial portion of our cash flow to payments on our rent and interest obligations, thereby reducing the availability of cash flow to fund working capital, capital expenditures and other general corporate activities;
- require us to pledge as collateral substantially all of our assets;
- require us to maintain a certain defined fixed coverage ratio above a specified level and a certain defined total indebtedness ratio below a specified level, thereby reducing our financial flexibility;
- require us to limit the amount of capital expenditures we can incur in any fiscal year and also limit the aggregate amount we can expend on acquisitions; and
- restrict our ability to discontinue the operation of any leased property despite its level of profitability and otherwise restrict our operational flexibility.

These provisions:

- could have a material adverse effect on our ability to withstand competitive pressures or adverse economic conditions (including adverse regulatory changes);

could adversely affect our ability to make material acquisitions, obtain future financing or take advantage of business opportunities that may arise; and

could increase our vulnerability to a downturn in general economic conditions or in our business.

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Our failure to pay rent or otherwise comply with the provisions of any of our Master Lease Agreements could materially adversely affect our business, financial position, results of operations and liquidity.

We lease 38 of our TC hospitals and 159 of our nursing and rehabilitation centers from Ventas under our Master Lease Agreements. Our failure to pay the rent or otherwise comply with the provisions of any of our Master Lease Agreements would result in an Event of Default under such Master Lease Agreement and also could result in a default under the Credit Facilities and, if repayment of the borrowings under the Credit Facilities were accelerated, also under the indenture governing the Notes. Upon an Event of Default, remedies available to Ventas include, without limitation, terminating such Master Lease Agreement, repossessing and reletting the leased properties and requiring us to remain liable for all obligations under such Master Lease Agreement, including the difference between the rent under such Master Lease Agreement and the rent payable as a result of reletting the leased properties, or requiring us to pay the net present value of the rent due for the balance of the term of such Master Lease Agreement. The exercise of such remedies would have a material adverse effect on our business, financial position, results of operations and liquidity.

For additional information on the Master Lease Agreements, see Part I Item 1 Business Master Lease Agreements.

Repayment of our indebtedness is dependent on cash flow generated by our subsidiaries.

Our subsidiaries own a significant portion of our assets and conduct a significant portion of our operations. Accordingly, repayment of our indebtedness is dependent, to a significant extent, on the generation of cash flow by our subsidiaries and their ability to make such cash available to us, by dividend, debt repayment or otherwise. Certain of our subsidiaries may not be able to, or may not be permitted to, make distributions to enable us to make payments in respect of our indebtedness. Each subsidiary is a distinct legal entity and, under certain circumstances, legal and contractual restrictions may limit our ability to obtain cash from our subsidiaries. In the event that we do not receive distributions from our subsidiaries, we may be unable to make required principal and interest payments on our outstanding indebtedness.

An increase in interest rates would increase the cost of servicing our debt and could reduce our profitability.

Borrowings under the Credit Facilities bear interest at variable rates. Interest rate changes will not affect our obligation for any debt incurred under the Credit Facilities, but could affect the amount of our interest payments, and accordingly, our future earnings and cash flows, assuming other factors are held constant. Pursuant to the terms of the Credit Facilities, we have entered into an interest rate swap that fixes a portion of our interest rate interest payments in order to reduce interest rate volatility; however, any interest rate swaps we enter into do not fully mitigate our interest rate risk. As a result, an increase in interest rates, whether because of an increase in market interest rates or an increase in our own cost of borrowing, would increase the cost of servicing our debt and could materially reduce our profitability. For example, a change of one-eighth percent in the interest rates for the Credit Facilities would increase or decrease annual interest expense by approximately $1 million.

Risks Factors Relating to Our Capital and Liquidity

The condition of the financial markets, including volatility and weakness in the equity, capital and credit markets, could limit the availability and terms of debt and equity financing sources to fund the capital and liquidity requirements of our businesses.

Financial markets experienced significant disruptions over the past few years. These disruptions have impacted liquidity in the debt markets, making financing terms for borrowers less attractive and, in certain cases, significantly reducing the availability of certain types of debt financing. Despite the instability over the past few years within the financial markets nationally and globally, we have not experienced any individual lender limitations to extend credit under our Credit Facilities. However, the obligations of each of the lending institutions in the ABL Facility are separate and the availability of future borrowings under the ABL Facility could be impacted by further volatility and disruptions in the financial credit markets or other events. We cannot assure you that a prolonged downturn in the credit markets or other circumstances will not impact our ability to access or to refinance the Credit Facilities. Our inability to access or refinance the Credit Facilities would have a material adverse effect on our business, financial position, results of operations and liquidity.

The Credit Facilities are collateralized by substantially all of our assets including certain owned real property and is guaranteed by substantially all of our subsidiaries. The terms of the Credit Facilities and the indenture governing the Notes include financial covenants and certain other provisions that limit acquisitions and annual capital expenditures. We were in compliance with the terms of the Credit Facilities and the indenture governing the Notes at December 31, 2012. However, a downturn in operating earnings or events beyond our control could impair our ability to comply with the covenants contained within the Credit Facilities and the indenture governing the Notes. If we anticipated a potential financial or other covenant violation, however, we would seek relief from our lenders for the Credit Facilities and the holders of the Notes, which likely would include costs to us, and such relief may not be on terms as favorable as those in the Credit Facilities or the Notes, as applicable. Under these circumstances, there is also the potential that our lenders under the Credit Facilities or the holders of the Notes would not grant relief to us. A default due to the violation of a financial or other covenant contained within the Credit Facilities, the indenture governing the Notes or the occurrence of an Event of Default under the Master Lease Agreements could require us to immediately repay all amounts then outstanding under the Credit Facilities and the Notes.

If we have future capital needs that cannot be funded from operating cash flows, any future issuances of equity securities may dilute the value of our common stock and any additional issuances of debt may increase our leverage.

Though we anticipate that the cash amounts generated internally, together with amounts available under the Credit Facilities, will be sufficient to implement our business plan for the foreseeable future, we may need additional capital if a substantial acquisition or other growth opportunity becomes available or if unexpected events occur or opportunities arise. We cannot assure you that additional capital will be available, or available on terms favorable to us. If capital is not available, we may not be able to fund internal or external business expansion or respond to competitive pressures or other market conditions. If available, we may obtain additional capital through the public or private sale of debt or equity securities. However, our ability to access the public debt or equity capital markets, on terms favorable to us or at all, may be limited by further disruptions in these markets or other events. If we sell equity securities, the transaction could be dilutive to our existing shareholders. Furthermore, these securities could have rights, preferences and privileges more favorable than those of our common stock. If we incur additional debt, our leverage may increase and could have a material adverse effect on our business, financial position, results of operations and liquidity.

Disruptions in the financial markets could negatively impact our investment portfolio.

We hold a substantial investment portfolio in our limited purpose insurance subsidiary. Investments held in our limited purpose insurance subsidiary consist principally of cash and cash equivalents, debt securities, equities and certificates of deposit that are held to satisfy the payment of claims and expenses related to professional liability and workers compensation risks. Our investment policy governing insurance subsidiary investments precludes the investment portfolio managers from selling any security at a loss without prior authorization from us. The investment managers also limit the exposure to any one issue, issuer or type of investment. We intend, and have the ability, to hold insurance subsidiary investments for a long duration without the necessity of selling securities to fund the underwriting needs of our insurance subsidiary. This ability to hold securities allows sufficient time for recovery of temporary declines in the market value of equity securities and the par value of debt securities as of their stated maturity date. We cannot assure you, however, that we will recover declines in the market value of our investments. There is a continuing risk that declines in fair value may occur and additional material realized losses from sales or other-than-temporary impairments may be recorded in the future. Furthermore, we cannot assure you that declines in the market value of our investments will not require us to further capitalize our limited purpose insurance subsidiary or otherwise have a material adverse effect on our business, financial position, results of operations and liquidity.

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Our stock price is volatile and fluctuations in our operating results, quarterly earnings and other factors may result in declines in the price of our common stock.

Equity markets are prone to, and in the last few years have experienced, significant price and volume fluctuations. Volatility over the past few years has had a significant impact on the market price of securities issued by many companies, including us and other companies in the healthcare industry. If we are unable to operate our businesses as profitably as we have in the past or as our stockholders expect us to in the future, the market price of our common stock will likely decline as stockholders could sell shares of our common stock when it becomes apparent that the market expectations may not be realized. In addition to our operating results, many economic and other factors beyond our control could have an adverse effect on the price of our common stock, including:

- regulatory and reimbursement changes;
- quarterly variations in operating results;
- general economic conditions;
- changes in financial estimates and recommendations by securities analysts;
- operating and stock price performance of other companies that investors may deem comparable;
- press releases or negative publicity relating to our competitors or us or relating to trends in healthcare;
- adverse outcomes from litigation and government or regulatory investigations;
- sales of stock by insiders;
- changes in our credit ratings;
- natural disasters, terrorist attacks and pandemics; and
- limitations on our ability to repurchase our common stock.

Market volatility and declines in the price of our common stock could have a material adverse effect on our ability to obtain capital or complete acquisitions through the public or private sale or issuance of our equity securities.

In addition, security holders often institute class action litigation following periods of volatility in the price of a company s securities. If the market value of our common stock experiences adverse fluctuations and we become a party to this type of litigation, regardless of the outcome, we could incur substantial legal costs and our management s attention could be diverted from the operation of our business, causing our business to decline.

Risk Factors Relating to Our Operations

Acquisitions, investments and strategic alliances that we have made or may make in the future may use significant resources, may be unsuccessful and could expose us to unforeseen liabilities.

We intend to continue to selectively pursue strategic acquisitions of, investments in, and strategic alliances with, hospitals, IRFs, nursing centers, rehabilitation operations, and home health and hospice operations, particularly where an acquisition may assist us in scaling our operations more rapidly and efficiently than internal growth. Acquisitions may involve significant cash expenditures, debt incurrence, additional operating losses, amortization of certain intangible assets of acquired companies, dilutive issuances of equity securities and expenses that could have a material adverse effect on our business, financial position, results of operations and liquidity.

Acquisitions, investments and strategic alliances involve numerous risks. These risks include:

limitations on our ability to identify acquisitions that meet our target criteria and limitations on our ability to complete such acquisitions on reasonable terms and valuations;

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- limitations on our ability to access equity or capital to fund acquisitions, including difficulty in obtaining financing for acquisitions at a reasonable cost, or that such financing will not contain restrictive covenants that limit our operating flexibility or ability to access additional capital when needed;

- entry into markets or businesses in which we may have limited or no experience;

- difficulties integrating acquired operations, personnel and information systems, and in realizing projected efficiencies and cost savings, particularly in the case of significant acquisitions;

- diversion of management s time from existing operations;

- potential loss of key employees or customers of acquired companies;

- inaccurate assessment of assets and liabilities and exposure to undisclosed or unforeseen liabilities of acquired companies, including liabilities for failure to comply with healthcare laws;

- inability to operate acquired facilities profitably or succeed in achieving improvements in their financial performance; and

- impairment of acquired goodwill and intangible assets.

We continue to seek acquisitions and other strategic opportunities for each of our businesses that may negatively impact our business, financial position, results of operations and liquidity.

We continue to seek acquisitions and other strategic opportunities for each of our businesses, particularly where an acquisition or strategic opportunity may assist us in scaling our operations more rapidly and efficiently than internal growth. Accordingly, we are often engaged in evaluating potential transactions and other strategic alternatives, some of which may be significant in size, and we engage in preliminary discussions that may result in one or more transactions. Although there is uncertainty that any of our discussions will result in definitive agreements or the timing of announcement or completion of any transaction, our business, short-term and long-term financial position, results of operations and liquidity may be impacted if we announce or complete any such transaction or if we incur substantial costs or other losses in connection with such transaction, whether or not it is completed. Moreover, although we intend to enter into transactions that enhance long-term shareholder value, our ability to achieve this objective would be subject to integration risks, the ability to retain and attract key personnel, the ability to realize synergies and other risks, all of which would be more material with transactions of significant size.

In addition to acquisitions, we also may pursue strategic opportunities involving the construction of new hospitals or nursing and rehabilitation centers. The construction of new facilities involves numerous risks, including construction delays, cost over-runs, and the satisfaction of zoning and other regulatory requirements. We may be unable to operate newly constructed facilities profitably and such facilities may involve significant cash expenditures, debt incurrence, additional operating losses, and expenses that could have a material adverse effect on our business, financial position, results of operations and liquidity.

We operate 14 of our facilities through joint ventures with unrelated parties. We are the majority owner of each of those joint ventures. We may enter into additional joint ventures with unrelated parties in the future to acquire, own or operate hospitals, IRFs, nursing and rehabilitation centers and/or home health and hospice services. We will typically seek to be the majority owner of any such new joint ventures. While, as the majority owner, we typically control the day-to-day activities of these joint ventures, the joint venture agreements with our partners often include provisions reserving certain major actions for super-majority approval. Such actions may include entering into a new business activity or ceasing an existing activity, taking on substantial debt, admitting new partners, and terminating the venture. In addition, the joint venture agreements may restrict our ability to derive cash from the joint venture and affect our ability to transfer our interest in the joint venture. We may be required to provide additional capital to a joint venture if our partner defaults on its capital obligations.

Certain events or circumstances could result in the impairment of our assets or other charges, including, without limitation, impairments of goodwill and identifiable intangible assets that result in material charges to earnings.

We review the carrying value of certain long-lived assets, finite lived intangible assets and indefinite-lived intangible assets with respect to any events or circumstances that indicate an impairment or an adjustment to the amortization period may be necessary, such as when the market value of our common stock is below book equity value. On an ongoing basis, we also evaluate, based upon the fair value of our reporting units, whether the carrying value of our goodwill is impaired. If circumstances suggest that the recorded amounts of any of these assets cannot be recovered based upon estimated future cash flows, the carrying values of such assets are reduced to fair value. If the carrying value of any of these assets is impaired, we may incur a material charge to earnings.

During 2012, we determined that pretax impairment charges aggregating $111 million were necessary, which included $108 million of goodwill and $3 million of property and equipment. These charges were directly related to the Taxpayer Relief Act and the 2011 CMS Rules which significantly reduced Medicare payments to our skilled nursing rehabilitation services operating segment and our nursing and rehabilitation centers.

In the fourth quarter 2011, we incurred an aggregate pretax impairment charge of $54 million, of which $11 million was reclassified to discontinued operations in 2012, on the value of the certificates of need intangible assets of certain hospitals and co-located nursing and rehabilitation centers in Massachusetts. See note 1 of the notes to consolidated financial statements.

During 2011, we also determined that pretax impairment charges aggregating $75 million were necessary, which included $52 million of goodwill and $23 million of property and equipment. These charges were directly related to the 2011 CMS Rules which significantly reduced Medicare payments to our nursing and rehabilitation centers and changed the reimbursement for group rehabilitation therapy services.

Future adverse changes in the operating environment and related key assumptions used to determine the fair value of our reporting units and indefinite-lived intangible assets or continued declines in the value of our common stock may result in future impairment charges for a portion or all of these assets. Moreover, the value of our goodwill and indefinite-lived intangible assets could be negatively impacted by potential healthcare reforms. Any such impairment charges could have a material adverse effect on our business, financial position and results of operations.

We could experience significant increases to our operating costs due to shortages of qualified nurses, therapists and other healthcare professionals or union activity.

The market for qualified nurses, therapists and other healthcare professionals is highly competitive. We, like other healthcare providers, have experienced difficulties in attracting and retaining qualified personnel such as nurses, certified nurse s assistants, nurse s aides, therapists and other providers of healthcare services. Our hospitals, nursing and rehabilitation centers and home health and hospice operations are particularly dependent on nurses for patient care. Our rehabilitation division continues to seek qualified therapists to fill open positions. The difficulty we have experienced in hiring and retaining qualified personnel has increased our average wage rates and may force us to increase our use of contract personnel.

In addition, healthcare providers are experiencing a high level of union activity across the country. At December 31, 2012, approximately 3,000 of the employees at 35 of our facilities were unionized. Though we cannot predict the degree to which we will be affected by future union activity, there are continuing legislative proposals that could result in increased union activity. We could experience an increase in labor and other costs from such union activity. Furthermore, we could experience a disruption of our operations if our employees were to engage in a strike or other work stoppage.

We expect to continue to experience increases in our labor costs primarily due to higher wages and greater benefits required to attract and retain qualified healthcare personnel. Salaries, wages and benefits were approximately 59% of our consolidated revenues for the year ended December 31, 2012. Our ability to manage labor costs will significantly affect our future operating results.

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We could experience significant legal actions, fines and increases in our operating costs if we fail to comply with state minimum staffing requirements.

Various states in which we operate hospitals and nursing and rehabilitation centers have established minimum staffing requirements or may establish minimum staffing requirements in the future. Staffing requirements in some states are not contingent upon any additional appropriation of state funds in any budget act or other statute. Our ability to satisfy such staffing requirements will, among other things, depend upon our ability to attract and retain qualified healthcare professionals.

While we seek to comply with all applicable staffing requirements, the regulations in this area are complex and we may experience compliance issues from time to time. Failure to comply with such minimum staffing requirements may result in one or more facilities failing to meet the conditions of participation under relevant federal and state healthcare programs and the imposition of fines or other sanctions. Private litigation involving these matters also has become more common, and certain of our facilities are the subject of litigation involving claims brought in 2010 that we did not meet relevant staffing requirements from time to time since 2006.

Moreover, a portion of the staffing costs we incur is funded by states through Medicaid program appropriations or otherwise. If states do not appropriate sufficient additional funds to pay for any additional operating costs resulting from such minimum staffing requirements, our profitability may be materially adversely affected.

If we lose our key management personnel, we may not be able to successfully manage our business and achieve our objectives.

Our future success depends in large part upon the leadership and performance of our executive management team and key employees and our ability to retain and motivate these individuals. Competition for these individuals is intense and there can be no assurance that we will retain our key officers and employees or that we can attract or retain other highly qualified individuals in the future. If we lose the services of one or more of our key officers or employees, or if one or more of them decides to join a competitor or otherwise compete directly or indirectly with us, we may not be able to successfully manage our business, achieve our business objectives or replace them with similarly qualified personnel. If we lose key personnel, we may be unable to replace them with personnel of comparable experience, reputation in the industry or skills. The loss of any of our key officers or employees could have a material adverse effect on our business, financial position, results of operations and liquidity.

If we fail to attract patients and compete effectively with other healthcare providers or if our referral sources fail to view us as an attractive post-acute healthcare provider, our revenues and profitability may decline.

The post-acute healthcare services industry is highly competitive. Our hospitals face competition from healthcare providers that provide services comparable to those offered by our hospitals. Many competing hospitals are larger and more established than our hospitals. We may experience increased competition from existing hospitals, as well as hospitals converted, in whole or in part, to specialized care facilities. Our nursing and rehabilitation centers compete on a local and regional basis with other nursing centers and post-acute healthcare providers. Some of our competitors operate newer facilities and may offer services not provided by us or are operated by entities having greater financial and other resources than us. Our rehabilitation and home health and hospice divisions compete with national, regional and local service providers within our markets. Several of these competitors may have greater financial and other resources than us, may be more established in the markets in which we compete and may be willing to provide services at lower prices. We cannot assure you that increased competition in the future will not adversely affect our business, financial position, results of operations and liquidity.

In addition, we rely significantly on appropriate referrals from physicians, hospitals and other healthcare providers in the communities in which we deliver our services to attract appropriate patients and residents. Our referral sources are not obligated to refer business to us and may refer business to other healthcare providers. We believe many of our referral sources refer patients and residents to us as a result of the quality of our patient services and our efforts to establish and build a relationship with them. If any of our facilities fail to achieve or maintain a reputation for providing high quality care, or are perceived to provide a lower quality of care than comparable facilities within the same geographic area, or customers of our rehabilitation therapy, home health and hospice services perceive that they could receive higher quality services from other providers, our ability to attract and retain patients and customers could be adversely affected. We believe that the perception of our quality of care by potential residents or patients or their families seeking our services is influenced by a variety of factors, including physician and other healthcare professional referrals, community information and referral services, newspapers and other print and electronic media, results of patient surveys, recommendations from family and friends, and published quality care statistics compiled by CMS or other industry data. If we lose, or fail to maintain, existing relationships with our referral resources, fail to develop new relationships or if we are perceived by our referral sources for any reason as not providing high quality patient care, our patient volumes and the quality of our patient mix could suffer and our revenue and profitability could decline.

Significant legal actions could subject us to increased operating costs and substantial uninsured liabilities, which could materially and adversely affect our business, financial position, results of operations and liquidity.

We incur significant costs to investigate and defend against a variety of claims, including professional liability, wage and hour, and minimum staffing claims, among others, particularly in our hospital and nursing and rehabilitation center operations. In addition to large compensatory claims, plaintiffs attorneys increasingly are seeking, and have sometimes been successful in obtaining, significant fines and punitive damages and attorneys fees. Furthermore, there are continuing efforts to limit the ability of healthcare providers to utilize arbitration as a process to resolve these claims. As a result of these factors, our defense costs and potential liability exposure are significant, unpredictable, and likely to increase.

We also are subject to lawsuits under the FCA and comparable state laws for submitting fraudulent bills for services to the Medicare and Medicaid programs. These lawsuits, which may be initiated by whistleblowers, can involve significant monetary damages, fines, attorneys fees and the award of bounties to private *qui tam* plaintiffs who successfully bring these suits and to the government programs. We also are subject to payment obligations under contracts we enter into with our rehabilitation division customers to indemnify them against claim denials associated with our services.

While we are able to insure against certain of these costs and liabilities, such as our professional liability risks described below, we are not able to do so in many other cases. In the absence of insurance proceeds, we must fund these costs and liabilities from operating cash flows, which can reduce our operating margins and our funds available for investment in our business, and otherwise limit our operating and financial flexibility.

We insure a substantial portion of our professional liability risks primarily through our limited purpose insurance subsidiary. Provisions for loss for our professional liability risks are based upon management s best available information including actuarially determined estimates. The allowance for professional liability risks includes an estimate of the expected cost to settle reported claims and an amount, based upon past experiences, for losses incurred but not reported. These liabilities are necessarily based upon estimates and, while management believes that the provision for loss is adequate, the ultimate liability may be in excess of, or less than, the amounts recorded. Changes in the number of professional liability claims and the cost to settle these claims significantly impact the allowance for professional liability risks. A relatively small variance between our estimated and actual number of claims or average cost per claim could have a material impact, either favorable or unfavorable, on the adequacy of the allowance for professional liability risks. Differences between the ultimate claims costs and our historical provisions for loss and actuarial assumptions and estimates could have a material adverse effect on our business, financial position, results of operations and liquidity.

Our limited purpose insurance subsidiary covers losses up to specified limits per occurrence. On a per claim basis, coverage for losses in excess of those insured by the limited purpose insurance subsidiary are maintained through unaffiliated commercial reinsurance carriers. Our limited purpose insurance subsidiary insures all claims in all states up to a per occurrence limit without the benefit of any aggregate stop loss limit, thereby increasing our financial risk. We maintain professional and general liability insurance in amounts and coverage that management believes are sufficient for our operations. However, our insurance may not cover all claims against us or the full extent of our liability nor continue to be available at a reasonable cost. Moreover, the cost of reinsurance coverage maintained with unaffiliated commercial insurance carriers is costly and may continue to increase. There can be no assurances that in the future reinsurance will be available at a reasonable price or that we will be able to maintain adequate levels of professional and general liability insurance coverage. If we are unable to maintain adequate insurance coverage or are required to pay punitive damages that are uninsured, we may be exposed to substantial liabilities.

Federal and state employment-related laws and regulations could increase our cost of doing business and subject us to significant back pay awards, fines and lawsuits.

Our operations are subject to a variety of federal and state employment-related laws and regulations, including, but not limited to, the U.S. Fair Labor Standards Act which governs such matters as minimum wages, overtime pay, compensable time, recordkeeping and other working conditions, the Americans with Disabilities Act and similar state laws that provide civil rights protections to individuals with disabilities in the context of employment, public accommodations and other areas, the National Labor Relations Act, regulations of the Equal Employment Opportunity Commission, regulations of the Office of Civil Rights, regulations of state attorneys general, federal and state wage and hour laws, family leave mandates and a variety of similar laws enacted by the federal and state governments that govern these and other employment-related matters. Because labor represents such a large portion of our operating costs, compliance with these evolving federal and state laws and regulations could substantially increase our cost of doing business while failure to do so could subject us to significant back pay awards, fines and lawsuits. We are currently subject to employee-related claims, lawsuits (including class action lawsuits) and administrative proceedings in connection with our operations, including, but not limited to, those related to wrongful discharge, discrimination or violations of equal employment or federal and state wage and hour laws. These claims, lawsuits and proceedings are in various stages of adjudication or investigation and involve a wide variety of claims and potential outcomes. In addition, federal proposals to introduce a system of mandated health insurance and flexible work time and other similar initiatives could, if implemented, adversely affect our operations. Our failure to comply with federal and state employment-related laws and regulations could have a material adverse effect on our business, financial position, results of operations and liquidity.

Failure to maintain the security and functionality of our information systems could adversely affect our business, financial position, results of operation and liquidity.

We are dependent on the proper function and availability of our information systems and related software programs. Though we have taken steps to protect the safety and security of our information systems and the patient health information and other data maintained within those systems, there can be no assurance that our safety and security measures and disaster recovery plan will prevent damage, interruption or breach of our information systems and operations.

As a result of our acquisition activities, we have acquired additional information systems. We have been taking steps to reduce the number of systems we operate, have upgraded and expanded our information systems capabilities, and are gradually migrating to fewer information systems. Our information systems require an ongoing commitment of significant resources to maintain, protect and enhance existing systems and develop new systems to keep pace with continuing changes in technology, evolving industry and regulatory standards, and changing customer preferences.

In addition, certain software supporting our business and information systems are licensed to us by independent software developers. Our inability, or the inability of these developers, to continue to maintain and upgrade our information systems and software could disrupt or reduce the efficiency of our operations. In addition, costs and potential problems and interruptions associated with the implementation of new or upgraded systems and technology or with maintenance or adequate support of existing systems also could disrupt or reduce the efficiency of our operations.

Failure to maintain the security and functionality of our information systems and related software could expose us to a number of adverse consequences, the vast majority of which are not insurable, including but not limited to disruptions in our operations, regulatory and other civil and criminal penalties, breach of patient information, loss of customers, disputes with payors and increased operating expense, which either individually or in the aggregate could have a material adverse effect on our business, financial position, results of operations and liquidity.

We have limited operational and strategic flexibility since we lease a substantial number of our facilities.

We lease a substantial number of our facilities from Ventas and other third parties. Under our leases, we generally are required to operate continuously our leased properties as a provider of healthcare services. In addition, these leases generally limit or restrict our ability to assign the lease to another party. Our failure to comply with these lease provisions would result in an event of default under the leases and subject us to material damages, including potential defaults under the Credit Facilities and the indenture governing the Notes. Given these restrictions, we may be forced to continue operating unprofitable facilities to avoid defaults under our leases. See Part I Item 1 Business Master Lease Agreements.

Possible changes in the acuity of residents and patients, as well as payor mix and payment methodologies, may significantly affect our profitability.

The sources and amount of our revenues are determined by a number of factors, including the occupancy rates of our facilities, length of stay, the payor mix of residents and patients, rates of reimbursement among payors and patient acuity. Changes in patient acuity as well as payor mix among private pay, Medicare and Medicaid may significantly affect our profitability. In particular, any significant decrease in our population of high acuity patients or any significant increase in our Medicaid population could have a material adverse effect on our business, financial position, results of operations and liquidity, especially if state Medicaid programs continue to limit, or more aggressively seek limits on, reimbursement rates.

We may be unable to reduce costs to offset completely any decreases in our revenues.

Reduced levels of occupancy in our facilities and reductions in reimbursements from Medicare, Medicaid or other payors would adversely impact our revenues and liquidity. We may be unable to put in place corresponding reductions in costs in response to declines in census or other revenue shortfalls. The inability to timely adjust our operations to address a decrease in our revenues could have a material adverse effect on our business, financial position, results of operations and liquidity.

We are exposed to the credit risk of our payors and customers which in the future may cause us to make larger allowances for doubtful accounts or incur bad debt write-offs.

Due to weak economic conditions, recent Medicare reimbursement reductions and other factors, commercial payors and customers may default on their payments to us and individual patients may default on co-payments and deductibles for which they are responsible under the terms of either commercial insurance programs or Medicare. Although we review the credit risk of our commercial payors and customers regularly, such risks may arise from events or circumstances that are difficult to anticipate or control, such as a general economic downturn. If our payors or customers default on their payments to us in the future, we may have to record higher provisions for allowances for doubtful accounts or incur bad debt write-offs, both of which could have a material adverse effect on our business, financial position, results of operations and liquidity.

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Delays in collection of our accounts receivable could adversely affect our business, financial position, results of operations and liquidity.

Prompt billing and collection are important factors in our liquidity. Billing and collection of our accounts receivable are subject to the complex regulations that govern Medicare and Medicaid reimbursement and rules imposed by non-government payors. Our inability, or the inability of our customers, to bill and collect on a timely basis pursuant to these regulations and rules could subject us to payment delays that could negatively impact our business, financial position, results of operations and liquidity. In addition, we may experience delays in reimbursement as a result of the failure to receive prompt approvals related to change of ownership applications for acquired or other facilities or from delays caused by our or other third parties information system failures. Significant delays in billing and/or collections may adversely affect the borrowing base under the ABL Facility, potentially limiting the availability of funds under the ABL Facility.

Terrorist attacks, pandemics or natural disasters could negatively impact our business, financial position, results of operations and liquidity.

Terrorist attacks, pandemics, or acts of nature, such as floods, fires, hurricanes, tornadoes or earthquakes, may cause damage or disruption to us, our employees and our facilities, which could have an adverse impact on our residents and patients. In order to provide care for our residents and patients, we are dependent upon consistent and reliable delivery of food, pharmaceuticals, power and other products to our facilities and the availability of employees to provide services at our facilities. If the delivery of goods or the ability of employees to reach our facilities were interrupted due to a natural disaster, pandemic or a terrorist attack, it could have a significant negative impact on our business. Furthermore, the impact, or impending threat, of a natural disaster has in the past and may in the future require that we evacuate one or more facilities, which would be costly and would involve substantial risks to our operations and potentially to our residents and patients. The impact of natural disasters, pandemics and terrorist attacks is inherently uncertain. Such events could severely damage or destroy one or more of our facilities, harm our business, reputation and financial performance or otherwise have a material adverse effect on our business, financial position, results of operations and liquidity.

Climate change poses both regulatory and physical risks that could adversely impact our business, financial position, results of operations and liquidity.

Climate change could have a potential economic impact on us and climate change mitigation programs and regulations could increase our costs. Energy costs could be higher as a result of climate change regulations. Our costs could increase if utility companies pass on their costs, such as those associated with carbon taxes, emission cap and trade programs, or renewable portfolio standards. In addition, climate change may increase the frequency or intensity of natural disasters. As such, we cannot assure you that climate change will not adversely impact our business, financial position, results of operations and liquidity.

The inability or failure of management in the future to conclude that we maintain effective internal control over financial reporting, or the inability of our independent registered public accounting firm to issue a report of our internal control over financial reporting, could have a material adverse effect on our business, financial position, results of operations and liquidity.

We report annually on the effectiveness of our internal control over financial reporting, and our independent registered public accounting firm also must audit the effectiveness of our internal control over financial reporting on an annual basis. If we fail to have, or management or our independent registered public accounting firm is unable to conclude that we maintain, effective internal controls and procedures for financial reporting, we could be unable to provide timely and reliable financial information which could have a material adverse effect on our business, financial position, results of operations and liquidity. Different interpretations of accounting principles or changes in generally accepted accounting principles could have a material adverse effect on our business, financial position, results of operations and liquidity.

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Generally accepted accounting principles are complex, continually evolving and changing and may be subject to varied interpretation by third parties, including the SEC. Such varied interpretations could result from differing views related to specific facts and circumstances. Differences in interpretation of generally accepted accounting principles or changes in generally accepted accounting principles could have a material adverse effect on our business, financial position, results of operations and liquidity.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

For information concerning the hospitals and nursing and rehabilitation centers operated by us, see Part I Item 1 Business Hospital Division Hospital Facilities, Part I Item 1 Business Nursing Center Division Nursing and Rehabilitation Center Facilities, and Part I Item 1 Business Master Lease Agreements. We believe that our facilities are adequate for our future needs in such locations. All borrowings under the Credit Facilities are secured by a first priority lien and second priority lien on all eligible real property, which is held in fee.

Our corporate headquarters is located in a 287,000 square foot building in Louisville, Kentucky.

We are subject to various federal, state and local laws and regulations governing the use, discharge and disposal of hazardous materials, including medical waste products. Compliance with these laws and regulations is not expected to have a material adverse effect on us. It is possible, however, that environmental issues may arise in the future which we cannot predict.

Item 3. ***Legal Proceedings***

We are a party to various legal actions (some of which are not insured), and regulatory and other governmental audits and investigations in the ordinary course of our business. We cannot predict the ultimate outcome of pending litigation and regulatory and other governmental audits and investigations. These matters could potentially subject us to sanctions, damages, recoupments, fines and other penalties. The DOJ, CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to our businesses in the future that may, either individually or in the aggregate, have a material adverse effect on our business, financial position, results of operations and liquidity. See Part I Item 1A Risk Factors Risk Factors Relating to Our Operations We could experience significant legal actions, fines and increases in our operating costs if we fail to comply with state minimum staffing requirements, Significant legal actions could subject us to increased operating costs and substantial uninsured liabilities, which could materially and adversely affect our business, financial position, results of operations and liquidity, and Federal and state employment-related laws and regulations could increase our cost of doing business and subject us to significant back pay awards, fines and lawsuits, and note 19 of the notes to consolidated financial statements for a description of our other pending legal proceedings.

Item 4. ***Mine Safety Disclosures***

Not applicable.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

MARKET PRICE FOR COMMON STOCK

AND DIVIDEND HISTORY

Our common stock is quoted on the New York Stock Exchange (the NYSE) under the ticker symbol KND. The prices in the table below, for the calendar quarters indicated, represent the high and low sale prices for our common stock as reported on the NYSE.

	Sales price of common stock	
2012	**High**	**Low**
First quarter	$ 13.62	$ 8.63
Second quarter	$ 10.87	$ 7.60
Third quarter	$ 12.76	$ 8.80
Fourth quarter	$ 12.13	$ 9.68

2011	**High**	**Low**
First quarter	$ 26.27	$ 17.85
Second quarter	$ 28.99	$ 20.53
Third quarter	$ 23.69	$ 8.62
Fourth quarter	$ 13.12	$ 7.67

Our Credit Facilities and the indenture governing the Notes contain covenants that limit, among other things, our ability to pay dividends. Any determination to pay dividends in the future will be dependent upon our results of operations, financial position, contractual restrictions, restrictions imposed by applicable laws and other factors deemed relevant by our Board of Directors. We have not paid, and do not currently anticipate that we will pay in the foreseeable future, any cash dividends on our common stock, although our Board of Directors has the right to do so in the future. Accordingly, investors must currently rely on sales of their common stock after price appreciation which may never occur, as the only way to realize any future gains on their investment. Investors seeking cash dividends in the immediate future should not purchase our common stock.

As of January 31, 2013, there were 1,677 holders of record of our common stock.

See Part III Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, for disclosures regarding our equity compensation plans.

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PERFORMANCE GRAPH

The following graph summarizes the cumulative total return to shareholders of our common stock from December 31, 2007 to December 31, 2012, compared to the cumulative total return on the Standard & Poor s 500 Stock Index (the S&P Composite Index) and the Standard & Poor s 1500 Health Care Index (the S&P 1500 Health Care Index). The graph assumes an investment of $100 in each of our common stock, the S&P Composite Index, and the S&P 1500 Health Care Index on December 31, 2007, and also assumes the reinvestment of all cash dividends.

COMPARISON OF CUMULATIVE TOTAL RETURN

	12/31/07	12/31/08	12/31/09	12/31/10	12/30/11	12/31/12
Kindred Healthcare, Inc.	$ 100.00	$ 52.12	$ 73.90	$ 73.54	$ 47.12	$ 43.31
S&P Composite Index	100.00	63.01	79.69	91.71	93.62	108.59
S&P 1500 Health Care Index	100.00	76.27	92.13	96.96	108.44	128.34

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ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total number of shares (or units) purchased (1)	Average price paid per share (or unit) (2)	Total number of shares (or units) purchased as part of publicly announced plans or programs	Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs (1)
Month #1 (October 1 October 31)	1,016	$ 10.34		$
Month #2 (November 1 November 30)	916	10.21		
Month #3 (December 1 December 31)	3,157	10.89		
Total	5,089	$ 10.66		$

(1) These amounts represent shares of our common stock, par value $0.25 per share, withheld to offset tax withholding obligations that occurred upon the vesting and release of restricted shares previously granted under our stock-based compensation plans for our employees (the Withheld Shares). For each employee, the total tax withholding obligation is divided by the closing price of our common stock on the NYSE on the applicable vesting date to determine the total number of Withheld Shares required to satisfy such withholding obligation.

(2) The average price per share for each period was calculated by dividing the sum of the aggregate value of the Withheld Shares by the total number of Withheld Shares.

Item 6. ***Selected Financial Data***

On June 1, 2011, we completed the RehabCare Merger, and the operating results of RehabCare have been included as part of our selected financial data since June 1, 2011. For more information about the RehabCare Merger, see Part I Item 1 Business General RehabCare Merger and note 2 of the notes to consolidated financial statements.

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The results of operations for the historical periods included in the following table are not necessarily indicative of the results to be expected for future periods. In addition, see Part I Item 1A Risk Factors for a discussion of risk factors that could impact our future results of operations, including the RehabCare Merger.

	Year ended December 31,				
(In thousands, except per share amounts)	2012	2011	2010	2009	2008
Statement of Operations Data:					
Revenues	$ 6,181,291	$ 5,503,928	$ 4,346,984	$ 4,255,726	$ 4,081,421
Salaries, wages and benefits	3,672,475	3,243,603	2,497,293	2,473,444	2,366,581
Supplies	432,008	399,819	340,802	331,591	315,952
Rent	428,979	398,045	356,352	347,205	337,533
Other operating expenses	1,233,134	1,160,293	945,676	882,777	850,741
Other income	(10,812)	(11,191)	(11,422)	(11,512)	(17,407)
Impairment charges	110,856	118,202			
Depreciation and amortization	201,068	165,227	121,374	125,562	119,884
Interest expense	107,896	80,919	7,090	7,880	15,373
Investment income	(1,054)	(1,031)	(1,245)	(4,413)	(7,096)
	6,174,550	5,553,886	4,255,920	4,152,534	3,981,561
Income (loss) from continuing operations before income taxes	6,741	(49,958)	91,064	103,192	99,860
Provision (benefit) for income taxes	39,112	(1,905)	34,173	39,679	38,628
Income (loss) from continuing operations	(32,371)	(48,053)	56,891	63,513	61,232
Discontinued operations, net of income taxes:					
Income (loss) from operations	(2,208)	(5,666)	53	30	(4,171)
Loss on divestiture of operations	(4,745)		(453)	(23,432)	(20,776)
Loss from discontinued operations	(6,953)	(5,666)	(400)	(23,402)	(24,947)
Net income (loss)	(39,324)	(53,719)	56,491	40,111	36,285
(Earnings) loss attributable to noncontrolling interests	(1,043)	238			
Income (loss) attributable to Kindred	$ (40,367)	$ (53,481)	$ 56,491	$ 40,111	$ 36,285
Amounts attributable to Kindred stockholders:					
Income (loss) from continuing operations	$ (33,414)	$ (47,815)	$ 56,891	$ 63,513	$ 61,232
Loss from discontinued operations	(6,953)	(5,666)	(400)	(23,402)	(24,947)
Net income (loss)	$ (40,367)	$ (53,481)	$ 56,491	$ 40,111	$ 36,285
Earnings (loss) per common share:					
Basic:					
Income (loss) from continuing operations	$ (0.65)	$ (1.04)	$ 1.44	$ 1.63	$ 1.58
Discontinued operations:					
Income (loss) from operations	(0.04)	(0.12)			(0.11)
Loss on divestiture of operations	(0.09)		(0.01)	(0.60)	(0.53)
Net income (loss)	$ (0.78)	$ (1.16)	$ 1.43	$ 1.03	$ 0.94
Diluted:					

Income (loss) from continuing operations	$ (0.65)	$ (1.04)	$ 1.44	$ 1.62	$ 1.56
Discontinued operations:					
Income (loss) from operations	(0.04)	(0.12)			(0.11)
Loss on divestiture of operations	(0.09)		(0.01)	(0.60)	(0.53)
Net income (loss)	$ (0.78)	$ (1.16)	$ 1.43	$ 1.02	$ 0.92
Shares used in computing earnings (loss) per common share:					
Basic	51,659	46,280	38,738	38,339	37,830
Diluted	51,659	46,280	38,954	38,502	38,397
Financial Position:					
Working capital	$ 438,435	$ 384,359	$ 214,654	$ 241,032	$ 403,917
Total assets	4,237,946	4,138,493	2,337,415	2,022,224	2,181,761
Long-term debt	1,648,706	1,531,882	365,556	147,647	349,433
Equity	1,292,844	1,320,541	1,031,759	966,594	914,975

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

You should read the following discussion together with the selected financial data in Item 6 and our consolidated financial statements and the notes thereto included in this Annual Report on Form 10-K. All financial and operating data presented in Items 6 and 7 reflect the continuing operations of our business for all periods presented unless otherwise indicated.

Overview

We are a healthcare services company that through our subsidiaries operates TC hospitals, IRFs, nursing and rehabilitation centers, assisted living facilities, a contract rehabilitation services business and a home health and hospice business across the United States. At December 31, 2012, our hospital division operated 116 TC hospitals (8,382 licensed beds) and six IRFs (259 licensed beds) in 26 states. Our nursing center division operated 223 nursing and rehabilitation centers (27,142 licensed beds) and six assisted living facilities (341 licensed beds) in 27 states. Our rehabilitation division provided rehabilitation services primarily in hospitals and long-term care settings. Our home health and hospice division provided home health, hospice and private duty services from 101 locations in ten states.

In recent years, we have completed several strategic divestitures to improve our future operating results. For accounting purposes, the operating results of these businesses and the losses or impairments associated with these transactions have been classified as discontinued operations in the accompanying consolidated statement of operations for all periods presented. Assets not sold at December 31, 2012 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying consolidated balance sheet. See note 4 of the notes to consolidated financial statements.

The operating results of acquired businesses have been included in our accompanying consolidated financial statements from the respective acquisition dates.

RehabCare Merger

On June 1, 2011, we completed the RehabCare Merger. Upon consummation of the RehabCare Merger, each issued and outstanding share of RehabCare common stock was converted into the right to receive the Merger Consideration. We issued approximately 12 million shares of our common stock in connection with the RehabCare Merger. The purchase price totaled $963 million and was comprised of $662 million in cash and $301 million of our common stock at fair value. We also assumed $356 million of long-term debt in the RehabCare Merger, of which $345 million was refinanced on June 1, 2011. The operating results of RehabCare have been included in our accompanying consolidated financial statements since June 1, 2011.

At the RehabCare Merger date, we acquired 32 TC hospitals, five IRFs, approximately 1,200 rehabilitation therapy sites of service and 102 hospital-based inpatient rehabilitation units. The RehabCare Merger expanded our service offerings, positioned us for future growth and provided opportunities for significant operating synergies.

In connection with the RehabCare Merger, we entered into the Credit Facilities and the Notes. In 2011, we used proceeds from the Credit Facilities and the Notes to pay the Merger Consideration, repay all amounts outstanding under our and RehabCare s previous credit facilities and to pay transaction costs. The amounts outstanding under our and RehabCare s former credit facilities that were repaid at the RehabCare Merger closing were $390 million and $345 million, respectively. The Credit Facilities also included an option to increase the credit capacity in an aggregate amount between the two facilities by $200 million. We executed this option to increase the credit capacity by $200 million in October 2012. See note 11 of the notes to consolidated financial statements. In connection with the Credit Facilities and the Notes, we paid $46 million of lender fees related to debt issuance that were capitalized as deferred financing costs during 2011 and paid $13 million of other financing costs that were charged to interest expense during 2011.

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All obligations under the Credit Facilities are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of our existing and future direct and indirect domestic 100% owned subsidiaries, as well as certain non-100% owned domestic subsidiaries as we may determine from time to time in our sole discretion. The Notes are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of our domestic 100% owned subsidiaries.

The agreements governing the Credit Facilities and the indenture governing the Notes include a number of restrictive covenants that, among other things and subject to certain exceptions and baskets, impose operating and financial restrictions on us and certain of our subsidiaries. Our ability to pay dividends is limited to certain restricted payment baskets, which may expand based upon accumulated earnings. In addition, we are required to comply with a minimum fixed charge coverage ratio and a maximum total leverage ratio under the Credit Facilities. These financing agreements governing the Credit Facilities and the indenture governing the Notes also contain customary affirmative covenants and events of default. See Liquidity for additional information on the Credit Facilities and the Notes.

IntegraCare Acquisition

On August 31, 2012, we completed the IntegraCare Acquisition, which was financed through operating cash flows and proceeds from our ABL Facility. The IntegraCare Acquisition included 47 home health and hospice locations across Texas.

Professional Acquisition

On September 1, 2011, we completed the Professional Acquisition, which was financed through operating cash flows and proceeds from our ABL Facility. The Professional Acquisition included 27 home health and hospice locations in northern California, Arizona, Nevada and Utah.

Vista Acquisition

On November 1, 2010, we completed the Vista Acquisition, which was financed through operating cash flows and proceeds from our former revolving credit facility. The Vista Acquisition included four freestanding hospitals and one HIH with a total of 250 beds, all of which are located in southern California. We did not acquire the working capital of Vista or assume any of its liabilities. All of the Vista hospitals were leased at the time of the acquisition.

Critical Accounting Policies

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

We believe the following critical accounting policies, among others, affect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue recognition

We have agreements with third party payors that provide for payments to each of our operating divisions. These payment arrangements may be based upon prospective rates, reimbursable costs, established charges, discounted charges or per diem payments. Net patient service revenue is recorded at the estimated net realizable

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amounts from Medicare, Medicaid, Medicare Advantage, other third party payors and individual patients for services rendered. Retroactive adjustments that are likely to result from future examinations by third party payors are accrued on an estimated basis in the period the related services are rendered and adjusted as necessary in future periods based upon new information or final settlements.

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

	Year ended December 31,		
	2012	2011	2010
Medicare	$ 2,602,488	$ 2,389,331	$ 1,876,599
Medicaid	1,067,863	1,062,518	1,054,669
Medicare Advantage	463,912	413,793	344,334
Other	2,388,345	1,956,623	1,376,976
	6,522,608	5,822,265	4,652,578
Eliminations	(341,317)	(318,337)	(305,594)
	$ 6,181,291	$ 5,503,928	$ 4,346,984

Collectibility of accounts receivable

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

In evaluating the collectibility of accounts receivable, we consider a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with third party payors and general industry conditions. Actual collections of accounts receivable in subsequent periods may require changes in the estimated provision for loss. Changes in these estimates are charged or credited to the results of operations in the period of the change. Based upon improved cash collections in our rehabilitation division, we recognized a change in estimate that reduced the provision for doubtful accounts by $8 million in the fourth quarter of 2012.

The provision for doubtful accounts totaled $24 million for 2012, $35 million for 2011 and $24 million for 2010.

Allowances for insurance risks

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

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

Provisions for loss for professional liability risks retained by our limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 1% to 5% depending upon the policy year. The discount rate was 1% for the 2010 through 2012 policy years and 2% to 5% for all prior policy years. The discount rates are based upon the risk free interest rate for the respective year.

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Amounts equal to the discounted loss provision are funded annually. We do not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. The allowance for professional liability risks aggregated $291 million at December 31, 2012 and $264 million at December 31, 2011. If we did not discount any of the allowances for professional liability risks, these balances would have approximated $293 million at December 31, 2012 and $267 million at December 31, 2011.

As a result of deterioration in professional liability and workers compensation underwriting results of our limited purpose insurance subsidiary in 2011, we made a capital contribution of $9 million in 2012 to our limited purpose insurance subsidiary. Conversely, as a result of improved professional liability underwriting results of our limited purpose insurance subsidiary in 2010 and 2009, we received distributions of $3 million in 2011 and $22 million in 2010 from our limited purpose insurance subsidiary. These transactions were completed in accordance with applicable regulations. Neither the capital contribution nor the distributions had any impact on earnings.

Changes in the number of professional liability claims and the cost to settle these claims significantly impact the allowance for professional liability risks. A relatively small variance between our estimated and actual number of claims or average cost per claim could have a material impact, either favorable or unfavorable, on the adequacy of the allowance for professional liability risks. For example, a 1% variance in the allowance for professional liability risks at December 31, 2012 would impact our operating income by approximately $3 million.

The provision for professional liability risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial reinsurance carriers, aggregated $77 million for 2012, $63 million for 2011 and $55 million for 2010. The increase in 2012 was primarily attributable to an increase in frequency and severity of claims. Changes in estimates for prior year professional liability costs reduced professional liability costs by approximately $6 million, $13 million and $20 million in 2012, 2011 and 2010, respectively.

With respect to our discontinued operations, we recorded favorable pretax adjustments of $2 million in 2012, $3 million in 2011 and $5 million in 2010 resulting from changes in estimates for professional liability reserves related to prior years.

Provisions for loss for workers compensation risks retained by our limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually. The allowance for workers compensation risks aggregated $193 million at December 31, 2012 and $171 million at December 31, 2011. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $59 million for 2012, $58 million for 2011 and $42 million for 2010. The increase in workers compensation costs in each of these years was primarily attributable to an increase in claims resulting from the growth in the number of employees, primarily from the RehabCare Merger.

See notes 4 and 8 of the notes to consolidated financial statements.

Accounting for income taxes

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

The effective income tax rate for 2012 was negatively impacted by $92 million, representing the portion of a $108 million pretax asset impairment charge in our skilled nursing rehabilitation services reporting unit that is not deductible for income tax purposes. Our effective income tax rate was 3.8% in 2011 and 37.5% in 2010. The change in the effective income tax rate in 2011 was primarily attributable to certain impairment charges and transaction costs that are not deductible for income tax purposes. We recorded favorable income tax adjustments related to the resolution of state income tax contingencies from prior years that reduced the provision for income taxes by approximately $0.2 million in 2012 and approximately $3 million in each of 2011 and 2010.

There are significant uncertainties with respect to capital loss carryforwards that could affect materially the realization of certain deferred tax assets. Accordingly, we have recognized deferred tax assets to the extent it is more likely than not they will be realized and a valuation allowance is provided for deferred tax assets to the extent that it is uncertain that the deferred tax asset will be realized. We recognized net deferred tax assets totaling $3 million at December 31, 2012 and net deferred tax liabilities totaling $0.2 million at December 31, 2011.

We identified deferred income tax assets for state income tax NOLs of $53 million and $42 million at December 31, 2012 and 2011, respectively, and a corresponding deferred income tax valuation allowance of $48 million and $38 million at December 31, 2012 and 2011, respectively, for that portion of the net deferred income tax assets that we will likely not realize in the future. We had deferred tax assets for federal income tax NOLs of $8 million and $7 million at December 31, 2012 and 2011, respectively, with no deferred income tax valuation allowances at December 31, 2012 or 2011. The federal income tax NOLs expire in various amounts through 2033.

We are subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties. While we believe our tax positions are appropriate, we cannot assure you that the various authorities engaged in the examination of our income tax returns will not challenge our positions.

We record accrued interest and penalties associated with uncertain tax positions as income tax expense in the consolidated statement of operations. Accrued interest related to uncertain tax provisions totaled $0.1 million as of December 31, 2012 and 2011.

To the extent the unrecognized income tax benefits become realized or the related accrued interest is no longer necessary, our provision for income taxes would be favorably impacted by $1 million.

The federal statute of limitations remains open for tax years 2009 through 2011. During 2011, we resolved federal income tax audits for the 2007 through 2009 tax years. We are currently under examination by the Internal Revenue Service (the IRS) for the 2010 through 2012 tax years. We have been accepted into the IRS s Compliance Assurance Process (CAP) for the 2012 and 2013 tax years. CAP is an enhanced, real-time review of a company s tax positions and compliance. We expect participation in CAP to improve the timeliness of our federal tax examinations.

State jurisdictions generally have statutes of limitations for tax returns ranging from three to five years. The state impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification to the states. We currently have various state income tax returns under examination.

During 2010, we received approval from the IRS for an accounting method change for income tax purposes that resulted in a non-recurring reduction in income tax payments of approximately $25 million. In connection with the RehabCare Merger, the accounting method change was extended in 2012 for the 2011 tax year to certain entities and resulted in a non-recurring reduction in income tax payments of approximately $8 million during 2012. Our earnings were not impacted by these transactions.

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Valuation of long-lived assets, goodwill and intangible assets

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

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

Our intangible assets with finite lives are amortized in accordance with the authoritative guidance for goodwill and other intangible assets using the straight-line method over their estimated useful lives ranging from two to 20 years. As a result of the RehabCare Merger, we acquired finite lived intangible assets consisting of customer relationships ($189 million), a trade name ($17 million) and non-compete agreements ($3 million) with estimated useful lives ranging from two to 15 years.

In connection with the preparation of our operating results for the fourth quarter of 2012, we determined that the impact of regulatory changes related to our skilled nursing rehabilitation services reporting unit was a triggering event in the fourth quarter of 2012, simultaneously with our annual impairment test. The regulatory changes included a new pre-payment manual medical review process for certain Medicare Part B services exceeding $3,700 which became effective October 1, 2012 and new rules which will become effective April 1, 2013 under the Taxpayer Relief Act that reduce Medicare Part B payments by 50% for subsequent procedures when multiple therapy services are provided on the same day. We tested the recoverability of our skilled nursing rehabilitation services reporting unit goodwill, other intangible assets and long-lived assets. We recorded a pretax impairment charge aggregating $108 million ($102 million net of income taxes) (which represented the entire skilled nursing rehabilitation services reporting unit goodwill) in the fourth quarter of 2012 to reflect the amount by which the carrying value of goodwill exceeded the estimated fair value. We determined that other intangible assets and long-lived assets in the skilled nursing rehabilitation services reporting unit were not impaired.

On July 29, 2011, CMS issued the 2011 CMS Rules. In connection with the preparation of our operating results for the third quarter of 2011, we determined that the impact of the 2011 CMS Rules was a triggering event in the third quarter of 2011 and accordingly tested the recoverability of our nursing and rehabilitation centers reporting unit goodwill, intangible assets and property and equipment asset groups impacted by the reduced Medicare payments. We recorded pretax impairment charges aggregating $27 million ($16 million net of income taxes) in the third quarter of 2011. The charges included $6 million of goodwill (which represented the entire nursing and rehabilitation centers reporting unit goodwill) and $21 million of property and equipment. In addition, we recorded pretax impairment charges aggregating $2 million ($1 million net of income taxes) and $3 million ($2 million net of income taxes) in the fourth quarter of 2011 and for the year ended December 31, 2012, respectively, of property and equipment expenditures in the same nursing and rehabilitation center asset groups. These impairment charges reflected the amount by which the carrying value of certain assets exceeded their estimated fair value.

During the fourth quarter of 2011, the estimated negative impact from changes in the reimbursement of group rehabilitation therapy services to Medicare beneficiaries implemented by the 2011 CMS Rules on October 1, 2011 was greater than expected, and as a result, we lowered our cash flow expectations for our skilled nursing rehabilitation services reporting unit, causing the carrying value of goodwill of this reporting unit to exceed its estimated fair value in testing the recoverability of goodwill. As a result, we recorded a pretax impairment charge of $46 million ($43 million net of income taxes) in the fourth quarter of 2011. We also reviewed the other intangible assets and long-lived assets related to the skilled nursing rehabilitation services reporting unit and determined there were no impairments of these assets.

None of the previously discussed impairment charges impacted our cash flows or liquidity.

In accordance with the authoritative guidance for goodwill and other intangible assets, we are required to perform an impairment test for goodwill and indefinite-lived intangible assets at least annually or more frequently if adverse events or changes in circumstances indicate that the asset may be impaired. We perform our annual goodwill impairment test at the end of each fiscal year for each of our reporting units. A reporting unit is either an operating segment or one level below the operating segment, referred to as a component. When the components within our operating segments have similar economic characteristics, we aggregate the components of our operating segments into one reporting unit. Accordingly, we have determined that our reporting units are hospitals, nursing and rehabilitation centers, skilled nursing rehabilitation services, hospital rehabilitation services, home health and hospice. The carrying value of goodwill for each of our reporting units at December 31, 2012 and December 31, 2011 follows (in thousands):

	December 31, 2012	December 31, 2011
Hospitals	$ 747,065	$ 745,411
Nursing and rehabilitation centers		
Rehabilitation division:		
Skilled nursing rehabilitation services		107,026
Hospital rehabilitation services	168,019	167,753
	168,019	274,779
Home health	99,317	49,254
Hospice	26,865	15,211
	$ 1,041,266	$ 1,084,655

As a result of the RehabCare Merger, goodwill was assigned to our hospital reporting unit ($534 million), skilled nursing rehabilitation services reporting unit ($151 million) and hospital rehabilitation services reporting unit ($168 million).

The goodwill impairment test involves a two-step process. The first step is a comparison of each reporting unit s fair value to its carrying value. If the carrying value of the reporting unit is greater than its fair value, there is an indication that impairment may exist and the second step must be performed to measure the amount of impairment loss, if any. Based upon the results of the step one impairment test for goodwill for hospitals, hospital rehabilitation services, home health and hospice reporting units for the years ended December 31, 2012 and December 31, 2011, no goodwill impairment charges were recorded in connection with our annual impairment test. Based upon the results of the step one impairment test for goodwill for all of our reporting units for the year ended December 31, 2010, no impairment charges were recorded.

Since quoted market prices for our reporting units are not available, we apply judgment in determining the fair value of these reporting units for purposes of performing the goodwill impairment test. We rely on widely accepted valuation techniques, including discounted cash flow and market multiple analyses approaches, which capture both the future income potential of the reporting unit and the market behaviors and actions of market participants in the industry that includes the reporting unit. These types of analyses require us to make assumptions and estimates regarding future cash flows, industry-specific economic factors and the profitability of future business strategies. The discounted cash flow approach uses a projection of estimated operating results and cash flows that are discounted using a weighted average cost of capital. Under the discounted cash flow approach, the projection uses management s best estimates of economic and market conditions over the projected

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period for each reporting unit including growth rates in the number of admissions, patient days, reimbursement rates, operating costs, rent expense and capital expenditures. Other significant estimates and assumptions include terminal value growth rates, changes in working capital requirements and weighted average cost of capital. The market multiple analysis estimates fair value by applying cash flow multiples to the reporting unit s operating results. The multiples are derived from comparable publicly traded companies with similar operating and investment characteristics to the reporting units.

Other than the impairment of goodwill for our skilled nursing rehabilitation services reporting unit, we have determined that there was no other goodwill or other intangible asset impairments as of December 31, 2012. Although, adverse changes in the operating environment and related key assumptions used to determine the fair value of our reporting units and indefinite-lived intangible assets or declines in the value of our common stock may result in future impairment charges for a portion or all of these assets. Specifically, if the rate of growth of government and commercial revenues earned by our reporting units were to be less than projected or if healthcare reforms were to negatively impact our business, an impairment charge of a portion or all of these assets may be required. An impairment charge could have a material adverse effect on our business, financial position and results of operations, but would not be expected to have an impact on our cash flows or liquidity.

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

At December 31, 2011, the carrying value of our certificates of need intangible assets exceeded its fair value as a result of declining earnings and cash flows related to five hospitals and two co-located nursing and rehabilitation centers in Massachusetts, all of which were acquired in 2006. The declining earnings and cash flows were attributable to a difficult LTAC operating environment in Massachusetts in which we were unable to achieve consistent operating results, as well as automatic future Medicare reimbursement reductions triggered in December 2011 by the Budget Control Act of 2011. In addition, we decided in the fourth quarter of 2011 to close one of the five hospitals. The pretax impairment charge related to the certificates of need totaled $54 million ($33 million net of income taxes), of which $11 million ($7 million net of income taxes) was reclassified to discontinued operations in 2012. We reviewed the other long-lived assets related to these five hospitals and two co-located nursing and rehabilitation centers and determined there was no impairment. Based upon the results of the annual impairment test for indefinite-lived intangible assets other than certificates of need intangible assets discussed above for the years ended December 31, 2012, 2011 and 2010, no impairment charges were recorded.

As a result of the RehabCare Merger, we acquired indefinite-lived intangible assets consisting of trade names ($115 million), Medicare certifications ($76 million) and certificates of need ($8 million).

Recently Issued Accounting Requirements

In July 2012, the Financial Accounting Standards Board (the FASB) issued authoritative guidance related to testing indefinite-lived intangible assets for impairment. The main provisions of the guidance state that an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If an entity determines it is not more likely than not that the fair value of an indefinite-lived intangible is less than its carrying amount, then performing the one-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the indefinite-lived

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intangible asset impairment test. The guidance is effective for all interim and annual reporting periods beginning after September 15, 2012. The adoption of the guidance did not have a material impact on our business, financial position, results of operations or liquidity.

In September 2011, the FASB issued authoritative guidance related to testing goodwill for impairment. The main provisions of the guidance state that an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step goodwill impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform Step 1 of the goodwill impairment test. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on our business, financial position, results of operations or liquidity.

In July 2011, the FASB issued authoritative guidance related to the presentation and disclosure of patient service revenue, provision for bad debts, and the allowance for doubtful accounts for certain healthcare entities. The provisions of the guidance require healthcare entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not assess a patient s ability to pay, to present the provision for bad debts related to those revenues as a deduction from patient service revenue (net of contractual allowances and discounts), as opposed to an operating expense. All other entities would continue to present the provision for bad debts as an operating expense. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have an impact on our business, financial position, results of operations or liquidity.

In June 2011, the FASB issued authoritative guidance related to the presentation of other comprehensive income. The provisions of the guidance state that an entity has the option to present total comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The statement(s) should be presented with equal prominence to the other primary financial statements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on our business, financial position, results of operations or liquidity.

In December 2011, the FASB amended its authoritative guidance issued in June 2011 related to the presentation of other comprehensive income. The provisions indefinitely defer the requirement to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented, for both interim and annual financial statements. All other requirements of the June 2011 update were not impacted by the amendment which remains effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on our business, financial position, results of operations or liquidity.

In February 2013, the FASB amended its authoritative guidance issued in December 2011 related to the deferral of the requirement to present reclassification adjustments out of accumulated other comprehensive income in both the statement in which net income is presented and the statement in which other comprehensive income is presented. The amended provisions require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under United States generally accepted accounting principles to be reclassified to net income in its entirety in the same reporting period. For all other amounts, an entity is required to cross-reference to other disclosures that provide additional details about these amounts. All other requirements of the original June 2011 update were not impacted by the amendment which remains effective for all interim and annual reporting periods beginning after December 15, 2012. The adoption of the guidance will not have a material impact on our business, financial position, results of operations or liquidity.

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In May 2011, the FASB issued authoritative guidance related to fair value measurements. The provisions of the guidance result in applying common fair value measurement and disclosure requirements in both United States generally accepted accounting principles and International Financial Reporting Standards. The amendments primarily changed the wording used to describe many of the requirements in generally accepted accounting principles for measuring and disclosing information about fair value measurements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on our business, financial position, results of operations or liquidity.

Impact of Medicare and Medicaid Reimbursement

We depend on reimbursement from third party payors, including the Medicare and Medicaid programs, for a substantial portion of our revenues. For the year ended December 31, 2012, we derived approximately 56% of our total revenues (before eliminations) from the Medicare and Medicaid programs and the balance from other third party payors, such as commercial insurance companies, health maintenance organizations, preferred provider organizations and contracted providers.

The Medicare and Medicaid programs are highly regulated and subject to frequent and substantial changes. See Part I Item 1 Business Governmental Regulation for an overview of the reimbursement systems impacting our businesses and Part I Item 1A Risk Factors.

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Results of Operations Continuing Operations

For the years ended December 31, 2012, 2011 and 2010

A summary of our operating data follows (dollars in thousands):

	Year ended December 31,		
	2012	**2011**	**2010**
Revenues:			
Hospital division	$ 2,927,495	$ 2,531,448	$ 1,959,738
Nursing center division	2,148,140	2,254,099	2,187,885
Rehabilitation division:			
Skilled nursing rehabilitation services	1,010,101	775,158	403,755
Hospital rehabilitation services	293,532	200,824	83,678
	1,303,633	975,982	487,433
Home health and hospice division	143,340	60,736	17,522
	6,522,608	5,822,265	4,652,578
Eliminations:			
Skilled nursing rehabilitation services	(223,519)	(229,677)	(224,624)
Hospital rehabilitation services	(110,510)	(83,917)	(78,926)
Home health and hospice	(7,288)	(4,743)	(2,044)
	(341,317)	(318,337)	(305,594)
	$ 6,181,291	$ 5,503,928	$ 4,346,984
Income (loss) from continuing operations:			
Operating income (loss):			
Hospital division	$ 600,649	$ 488,201	$ 360,369
Nursing center division	273,142	338,265	303,418
Rehabilitation division:			
Skilled nursing rehabilitation services	80,663	65,916	33,703
Hospital rehabilitation services	69,745	43,731	18,969
	150,408	109,647	52,672
Home health and hospice division	13,708	3,103	(66)
Corporate:			
Overhead	(179,063)	(174,800)	(133,961)
Insurance subsidiary	(2,127)	(2,306)	(3,153)
	(181,190)	(177,106)	(137,114)
Impairment charges	(110,856)	(118,202)	
Transaction costs	(2,231)	(50,706)	(4,644)
Operating income	743,630	593,202	574,635
Rent	(428,979)	(398,045)	(356,352)
Depreciation and amortization	(201,068)	(165,227)	(121,374)
Interest, net	(106,842)	(79,888)	(5,845)
Income (loss) before income taxes	6,741	(49,958)	91,064

Provision (benefit) for income taxes		39,112		(1,905)		34,173
	$	(32,371)	$	(48,053)	$	56,891

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A summary of our consolidating statement of operations follows (in thousands):

	Year ended December 31, 2012									
			Rehabilitation division							
	Hospital division (a,b)	Nursing center division (a,c)	Skilled nursing services (a)	Hospital services (a)	Total	Home health and hospice division (a)	Corporate (a)	Transaction-related costs	Eliminations	Consolidated
Revenues	$ 2,927,495	$ 2,148,140	$ 1,010,101	$ 293,532	$ 1,303,633	$ 143,340	$	$	$ (341,317)	$ 6,181,291
Salaries, wages and benefits	1,291,835	1,048,079	899,315	206,614	1,105,929	105,303	121,848	(450)	(69)	3,672,475
Supplies	314,230	107,766	3,093	163	3,256	5,953	803			432,008
Rent	217,341	200,679	5,250	140	5,390	3,140	2,429			428,979
Other operating expenses	720,781	719,153	27,030	17,010	44,040	18,376	69,351	2,681	(341,248)	1,233,134
Other income							(10,812)			(10,812)
Impairment charges	753	2,204	107,899		107,899					110,856
Depreciation and amortization	91,776	53,548	11,061	9,309	20,370	4,442	30,932			201,068
Interest expense	1,016	88	156		156		106,636			107,896
Investment income	(79)	(98)	(2)		(2)		(875)			(1,054)
	2,637,653	2,131,419	1,053,802	233,236	1,287,038	137,214	320,312	2,231	(341,317)	6,174,550
Income (loss) from continuing operations before income taxes	$ 289,842	$ 16,721	$ (43,701)	$ 60,296	$ 16,595	$ 6,126	$ (320,312)	$ (2,231)	$	6,741
Provision for income taxes										39,112
Loss from continuing operations										$ (32,371)
Capital expenditures, excluding acquisitions (including discontinued operations):										
Routine	$ 38,272	$ 20,764	$ 2,274	$ 348	$ 2,622	$ 1,616	$ 51,901	$	$	$ 115,175
Development	42,265	8,057								50,322
	$ 80,537	$ 28,821	$ 2,274	$ 348	$ 2,622	$ 1,616	$ 51,901	$	$	$ 165,497

	Year ended December 31, 2011									
			Rehabilitation division							
	Hospital division (d)	Nursing center division	Skilled nursing services	Hospital services	Total	Home health and hospice division	Corporate	Transaction-related costs	Eliminations	Consolidated
Revenues	$ 2,531,448	$ 2,254,099	$ 775,158	$ 200,824	$ 975,982	$ 60,736	$	$	$ (318,337)	$ 5,503,928
Salaries, wages and benefits	1,152,274	1,085,476	679,177	144,147	823,324	45,378	120,478	16,769	(96)	3,243,603
Supplies	281,433	112,095	2,826	189	3,015	2,438	838			399,819
Rent	188,120	198,556	6,275	228	6,503	1,366	1,681	1,819		398,045
Other operating expenses	609,540	718,263	27,239	12,757	39,996	9,817	66,981	33,937	(318,241)	1,160,293
Other income							(11,191)			(11,191)
Impairment charges	46,348	25,855	45,999		45,999					118,202
Depreciation and amortization	74,543	50,040	7,191	5,637	12,828	1,449	26,367			165,227
Interest expense	500	102				1	66,514	13,802		80,919
Investment income	(7)	(86)	(3)	(1)	(4)	(1)	(933)			(1,031)
	2,352,751	2,190,301	768,704	162,957	931,661	60,448	270,735	66,327	(318,337)	5,553,886
Income (loss) from continuing operations before income taxes	$ 178,697	$ 63,798	$ 6,454	$ 37,867	$ 44,321	$ 288	$ (270,735)	$ (66,327)	$	(49,958)
Income tax benefit										(1,905)
Loss from continuing operations										$ (48,053)
Capital expenditures, excluding acquisitions (including discontinued operations):										
Routine	$ 46,393	$ 34,304	$ 1,700	$ 238	$ 1,938	$ 164	$ 50,104	$	$	$ 132,903
Development	67,321	19,167				1,167				87,655
	$ 113,714	$ 53,471	$ 1,700	$ 238	$ 1,938	$ 1,331	$ 50,104	$	$	$ 220,558

(a) Includes employee severance costs of $3.4 million in salaries, wages and benefits (hospital division $0.7 million, nursing center division $1.9 million, rehabilitation division $0.4 million, home health and hospice division $0.2 million and corporate $0.2 million) and contract cancellation costs of $0.9 million (corporate) in other operating expenses incurred in connection with restructuring activities.

(b) Includes severance costs of $2.5 million in salaries, wages and benefits, restructuring costs of $2.0 million in other operating expenses and lease cancellation charges of $1.6 million in rent incurred in connection with the closing a regional office, the closing of two TC hospitals and the cancellation of a sub-acute unit project, and $5.0 million for employment-related lawsuits in other operating expenses.

(c) Includes employee retention costs of $2.2 million in salaries, wages and benefits incurred in connection with the decision to allow the leases to expire for 54 nursing and rehabilitation centers leased from Ventas.

(d) Includes loss on divestiture of a hospital of $1.5 million in other operating expenses.

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Consolidating statement of operations follows (in thousands) (Continued):

	Year ended December 31, 2010									
			Rehabilitation division							
	Hospital division (a)	Nursing center division (a)	Skilled nursing services	Hospital services	Total	Home health and hospice division	Corporate (a)	Transaction-related costs	Eliminations	Consolidated
Revenues	$ 1,959,738	$ 2,187,885	$ 403,755	$ 83,678	$ 487,433	$ 17,522	$	$	$ (305,594)	$ 4,346,984
Salaries, wages and benefits	885,948	1,080,344	356,171	62,173	418,344	12,880	99,480	357	(60)	2,497,293
Supplies	226,762	110,266	2,003	106	2,109	1,108	557			340,802
Rent	151,966	198,105	5,644	106	5,750	386	145			356,352
Other operating expenses	486,659	693,857	11,878	2,430	14,308	3,600	48,499	4,287	(305,534)	945,676
Other income							(11,422)			(11,422)
Depreciation and amortization	51,461	45,471	2,169	306	2,475	234	21,733			121,374
Interest expense	5	131					6,954			7,090
Investment income	(3)	(70)	(5)	(1)	(6)		(1,166)			(1,245)
	1,802,798	2,128,104	377,860	65,120	442,980	18,208	164,780	4,644	(305,594)	4,255,920
Income (loss) from continuing operations before income taxes	$ 156,940	$ 59,781	$ 25,895	$ 18,558	$ 44,453	$ (686)	$ (164,780)	$ (4,644)	$	91,064
Provision for income taxes										34,173
Income from continuing operations										$ 56,891
Capital expenditures, excluding acquisitions (including discontinued operations):										
Routine	$ 36,967	$ 37,024	$ 2,356	$ 293	$ 2,649	$ 66	$ 32,190	$	$	$ 108,896
Development	41,140	26,701								67,841
	$ 78,107	$ 63,725	$ 2,356	$ 293	$ 2,649	$ 66	$ 32,190	$	$	$ 176,737

(a) Includes $2.9 million in aggregate of severance and retirement costs in salaries, wages and benefits (hospital division $1.1 million, nursing center division $0.5 million and corporate $1.3 million).

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Operating data:

	Year ended December 31, 2012	2011	2010
Hospital division data:			
End of period data:			
Number of hospitals:			
Transitional care	116	118	88
Inpatient rehabilitation	6	5	
	122	123	88
Number of licensed beds:			
Transitional care	8,382	8,431	6,777
Inpatient rehabilitation	259	183	
	8,641	8,614	6,777
Revenue mix %:			
Medicare	62	60	56
Medicaid	6	8	9
Medicare Advantage	10	10	10
Commercial insurance and other	22	22	25
Admissions:			
Medicare	46,413	39,724	28,777
Medicaid	4,024	4,535	4,002
Medicare Advantage	7,263	5,625	4,224
Commercial insurance and other	11,316	9,985	8,222
	69,016	59,869	45,225
Admissions mix %:			
Medicare	67	66	64
Medicaid	6	8	9
Medicare Advantage	11	9	9
Commercial insurance and other	16	17	18
Patient days:			
Medicare	1,157,136	1,008,115	771,950
Medicaid	178,647	184,215	182,837
Medicare Advantage	205,242	168,883	134,024
Commercial insurance and other	342,717	309,338	283,552
	1,883,742	1,670,551	1,372,363
Average length of stay:			
Medicare	24.9	25.4	26.8
Medicaid	44.4	40.6	45.7
Medicare Advantage	28.3	30.0	31.7
Commercial insurance and other	30.3	31.0	34.5
Weighted average	27.3	27.9	30.3
Revenues per admission:			
Medicare	$ 38,866	$ 38,592	$ 38,323
Medicaid	45,720	42,604	42,597
Medicare Advantage	41,746	44,654	46,011

Commercial insurance and other	56,243	55,485	59,851
Weighted average	42,418	42,283	43,333
Revenues per patient day:			
Medicare	$ 1,559	$ 1,521	$ 1,429
Medicaid	1,030	1,049	932
Medicare Advantage	1,477	1,487	1,450
Commercial insurance and other	1,857	1,791	1,735
Weighted average	1,554	1,515	1,428
Medicare case mix index (discharged patients only)	1.16	1.18	1.20
Average daily census	5,147	4,577	3,760
Occupancy %	65.0	65.0	65.1
Annualized employee turnover %	20.1	20.3	22.0

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Operating data (Continued):

	Year ended December 31, 2012	2011	2010
Nursing center division data:			
End of period data:			
Number of facilities:			
Nursing and rehabilitation centers:			
Owned or leased	219	220	222
Managed	4	4	4
Assisted living facilities	6	6	7
	229	230	233
Number of licensed beds:			
Nursing and rehabilitation centers:			
Owned or leased	26,657	26,663	26,957
Managed	485	485	485
Assisted living facilities	341	413	463
	27,483	27,561	27,905
Revenue mix %:			
Medicare	33	36	35
Medicaid	41	38	40
Medicare Advantage	7	7	7
Private and other	19	19	18
Patient days (a):			
Medicare	1,296,948	1,408,673	1,423,106
Medicaid	4,879,997	4,965,997	5,182,145
Medicare Advantage	382,369	383,424	365,722
Private and other	1,677,802	1,738,517	1,704,241
	8,237,116	8,496,611	8,675,214
Patient day mix % (a):			
Medicare	16	17	16
Medicaid	59	58	60
Medicare Advantage	5	5	4
Private and other	20	20	20
Revenues per patient day (a):			
Medicare Part A	$ 490	$ 531	$ 485
Total Medicare (including Part B)	542	578	533
Medicaid	179	174	170
Medicaid (net of provider taxes) (b)	158	156	154
Medicare Advantage	407	415	409
Private and other	249	240	233
Weighted average	261	265	252
Average daily census (a)	22,506	23,278	23,768
Admissions (a)	78,932	80,794	76,451
Occupancy % (a)	83.2	85.9	87.4
Medicare average length of stay (a)	32.0	32.8	34.0
Annualized employee turnover %	39.6	39.2	39.6

(a) Excludes managed facilities.
(b) Provider taxes are recorded in other operating expenses for all periods presented.

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Operating data (Continued):

	Year ended December 31,		
	2012	**2011**	**2010**
Rehabilitation division data:			
SRS:			
Revenue mix %:			
Company-operated	22	30	56
Non-affiliated	78	70	44
Sites of service (at end of period)	1,726	1,774	635
Revenue per site	$ 584,468	$ 592,848	$ 686,480
Therapist productivity %	80.4	80.4	82.0
HRS:			
Revenue mix %:			
Company-operated	38	42	94
Non-affiliated	62	58	6
Sites of service (at end of period):			
Inpatient rehabilitation units	105	102	1
LTAC hospitals	123	115	91
Sub-acute units	21	25	7
Outpatient units	119	115	12
Other	5	8	4
	373	365	115
Revenue per site	$ 799,454	$ 783,412	$ 777,690
Annualized employee turnover % (SRS and HRS combined)	16.9	16.5	14.4
Home health and hospice division:			
Locations (at end of period)	101	51	15
Annualized employee turnover %	29.5	32.4	36.4

The Year in Review

As we entered 2012, we were challenged by over $150 million of annualized Medicare reimbursement reductions that became effective on October 1, 2011. These changes, which significantly impacted both our nursing center division and the rehabilitation division, required us to make significant changes in our operations.

In the first quarter of 2012, we put in place a comprehensive plan to realize approximately $125 million in cost savings for the full year. The plan was predicated on the realization of approximately $70 million of annualized synergies from the RehabCare Merger and approximately $55 million of structural cost reductions across the enterprise. Structural cost reductions focused on areas such as executive compensation, district and regional operating resources, employee benefits and corporate support center services. These cost-saving objectives were substantially realized in 2012, resulting in our achievement of our core operating performance that we outlined for investors at the beginning of the year.

While our primary efforts in 2012 related to the stabilization of the enterprise following major Medicare reimbursement reductions, we also reported meaningful accomplishments in the continued growth of our businesses.

First, we continued to aggressively grow our home health and hospice business, adding approximately $75 million in annualized revenues through a series of acquisitions (most notably the IntegraCare Acquisition). Annualized revenues in this business have reached $200 million and we expect additional growth in this business over the next several years.

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Second, we furthered the successful integration of RehabCare by completing key initiatives in the areas of clinical and operational information systems integration, human resources, process management and sales and marketing. These critical milestones were the basis upon which we realized $70 million of post-transaction synergies in a relatively short period.

Third, we continued to reposition our business mix to provide higher levels of profitability and an enhanced capital structure in the future. Early in 2012, we announced that we would not renew the leases for 54 nursing and rehabilitation centers that are non-strategic and, in aggregate, provided very little profit to the Company. The exit from these facilities is expected to be completed in 2013. We also continued to acquire real estate when appropriate to further improve our balance sheet and provide additional collateral for future borrowings.

As further discussed in the detailed review of our business segment results, our underlying operations in 2012 reflected solid execution of our business strategy and improved financial and operational flexibility to manage our enterprise in a period of significant change and unpredictability.

In 2013, we will face additional Medicare reimbursement challenges which could reduce our aggregate revenues by over $100 million. We will remain focused on managing these challenges while also continuing to implement our long-term growth initiatives.

Despite the significant reimbursement pressures in our industry, we continue to focus on five key business strategies:

- Providing quality, clinical-based care while efficiently managing our costs;
- Expanding our presence in the home health and hospice business;
- Accelerating our Integrated Care Market strategy;
- Repositioning assets and management time to higher margin growth businesses; and
- Participating and investing in the development of new integrated care delivery and payment models.

Hospital division

Revenues increased 16% in 2012 to $2.9 billion and 29% in 2011 to $2.5 billion. Revenue growth in 2012 was primarily a result of the RehabCare Merger and, to a lesser extent, favorable reimbursement rates and an increase in same-facility admissions. Revenue growth in 2011 was primarily a result of the RehabCare Merger, the Vista Acquisition, growth in admissions, ongoing development of new hospitals and increases in Medicare reimbursement rates. Same-facility revenues were up 4% in both 2012 and 2011. Revenues associated with the RehabCare Merger were $672 million in 2012 and $365 million in 2011. Revenues associated with the Vista Acquisition were $164 million, $155 million and $24 million in 2012, 2011 and 2010, respectively.

On a same-facility basis, aggregate admissions increased 1% in 2012 and 3% in 2011. Medicare same-facility admissions were relatively unchanged in 2012 and increased 2% in 2011, while non-government same-facility admissions increased 7% in 2012 and 3% in 2011.

Hospital operating margins were 20.5% in 2012 compared to 19.3% in 2011 and 18.4% in 2010. The increase in operating margins in 2012 and 2011 was primarily attributable to higher reimbursement rates, cost efficiencies associated with volume growth and cost synergies associated with the RehabCare Merger. Operating income associated with the RehabCare Merger was $149 million in 2012 and $83 million in 2011. Operating income associated with the Vista Acquisition was $44 million, $37 million and $4 million in 2012, 2011 and 2010, respectively.

Average hourly wage rates were flat in 2012 and rose 2% in 2011 compared to the previous year. Employee benefit costs increased 13% in 2012 compared to 2011 and increased 33% in 2011 compared to 2010, both primarily attributable to the RehabCare Merger.

Professional liability costs were $38 million, $31 million and $27 million for 2012, 2011 and 2010, respectively. The increase in 2012 was primarily attributable to an increase in frequency and severity of claims.

Nursing center division

Revenues declined 5% in 2012 and increased 3% in 2011. The decline in revenues in 2012 was primarily a result of the 2011 CMS Rules and a decline in admissions. Revenue growth in 2011 was primarily attributable to growth in admissions and reimbursement rate increases that reflected inflationary adjustments and higher patient acuity levels. Same-facility admissions declined 3% in 2012 and increased 5% in 2011 compared to prior periods, while same-facility patient days declined 3% in 2012 and 2% in 2011 compared to prior periods as a result of declines in admissions in 2012 and Medicare average length of stay in both 2012 and 2011.

Nursing center operating margins were 12.7% in 2012 compared to 15.0% in 2011 and 13.9% in 2010. The decrease in operating margins in 2012 was primarily attributable to the 2011 CMS Rules. The increase in operating margins in 2011 was primarily attributable to higher reimbursement rates, increases in Medicare and managed care payor mix, and operating efficiencies associated with the growth in admissions.

Average hourly wage rates were flat in 2012 and rose 2% in 2011 compared to the previous year. Employee benefit costs decreased 3% in 2012 compared to 2011 and increased 3% in 2011 compared to 2010.

Professional liability costs were $36 million, $30 million and $27 million for 2012, 2011 and 2010, respectively. The increase in 2012 was primarily attributable to an increase in frequency and severity of claims. These costs are expected to rise further in 2013.

Rehabilitation division

Skilled nursing rehabilitation services

Revenues increased 30% in 2012 to $1.0 billion and 92% in 2011 to $775 million. Revenue growth in both 2012 and 2011 was primarily attributable to the RehabCare Merger, and to a lesser extent, growth in the volume of services provided to existing customers. Revenues associated with the RehabCare Merger were $557 million in 2012 and $315 million in 2011. Revenues derived from non-affiliated customers aggregated $787 million in 2012, $545 million in 2011 and $179 million in 2010.

Operating margins were 8.0% in 2012 compared to 8.5% in 2011 and 8.3% in 2010. The decrease in operating margins in 2012 was primarily as a result of the 2011 CMS Rules. Based upon improved cash collections, we recognized a change in estimate that reduced the provision for doubtful accounts by $8 million in 2012. New Medicare Part B therapy rules for certain services exceeding a threshold of $3,700 became subject to a pre-payment manual medical review process effective October 1, 2012 and reduced operating income by approximately $7 million in 2012. The increase in operating margins in 2011 was primarily attributable to the RehabCare Merger and increased operating efficiencies. Operating income associated with the RehabCare Merger was $34 million in 2012 and $29 million in 2011.

Hospital rehabilitation services

Revenues increased 46% in 2012 to $294 million and 140% in 2011 to $201 million. Revenue growth in both periods was primarily attributable to the RehabCare Merger, and to a lesser extent, growth in new customers and the volume of services provided to existing customers. Revenues associated with the RehabCare Merger were $177 million in 2012 and $109 million in 2011. Revenues derived from non-affiliated customers aggregated $183 million in 2012, $117 million in 2011 and $5 million in 2010.

Operating margins were 23.8% in 2012 compared to 21.8% in 2011 and 22.7% in 2010. The increase in the 2012 operating margin was primarily attributable to improved operating efficiencies. The decline in the 2011 operating margin was primarily attributable to start-up costs associated with new contracts. Operating income associated with the RehabCare Merger was $36 million in 2012 and $26 million in 2011.

Home health and hospice division

Revenues increased 136% in 2012 to $143 million and 247% in 2011 to $61 million. Revenue growth in both periods was primarily attributable to seven acquisitions completed over the last three years. Operating margins were 9.6% in 2012 and 5.1% in 2011 compared to negative margins in 2010. Operating margins in 2012 increased as a result of operating efficiencies associated with increased scale from recent acquisitions. Operating margins in 2011 and 2010 were negatively impacted by start-up and overhead costs in connection with establishing and developing this business segment.

Corporate overhead

Operating income for our operating divisions excludes allocations of corporate overhead. These costs aggregated $179 million in 2012, $175 million in 2011 and $134 million in 2010. The increase in 2011 was primarily attributable to the RehabCare Merger. As a percentage of consolidated revenues, corporate overhead totaled 2.9% in 2012, 3.2% in 2011 and 3.1% in 2010.

We recorded approximately $11 million in each of 2012, 2011 and 2010 in other income related to an information systems service agreement with PharMerica Corporation (PharMerica), which was established on July 31, 2007 upon the completion of the spin-off of our former institutional pharmacy business and the immediate combination with the former institutional pharmacy business of AmerisourceBergen Corporation. PharMerica terminated the information systems service agreement in early 2013.

Transaction costs

Operating results for 2012, 2011 and 2010 included transaction costs totaling $2 million, $51 million and $5 million, respectively. The transaction costs for 2011 were primarily related to the RehabCare Merger.

Capital costs

Rent expense increased 8% to $429 million in 2012 and 12% to $398 million in 2011. The increase in rent expense in both periods resulted primarily from the RehabCare Merger, contractual inflation and contingent rent increases.

Depreciation and amortization expense was $201 million in 2012, $165 million in 2011 and $121 million in 2010. The increase in both periods was primarily the result of the RehabCare Merger, our ongoing capital expenditure program and our hospital development projects.

Interest expense aggregated $108 million in 2012 compared to $81 million in 2011 and $7 million in 2010. The increase in both 2012 and 2011 was attributable to increased borrowings in 2011 necessary to finance the RehabCare Merger and higher interest rates compared to the prior year. Interest expense for 2011 included $14 million of financing costs related to the RehabCare Merger.

Investment income related primarily to our insurance subsidiary investments totaled $1 million in each of 2012, 2011 and 2010. Investment income in 2011 and 2010 was negatively impacted by pretax other-than-temporary impairments of investments of approximately $0.2 million and $1 million, respectively, held in our insurance subsidiary investment portfolio.

Income taxes

The provision (benefit) for income taxes is based upon our annual reported income or loss for each respective accounting period and includes the effect of certain non-taxable and non-deductible items. The effective income tax rate for 2012 was negatively impacted by $92 million, representing the portion of a $108 million pretax asset impairment charge in our skilled nursing rehabilitation services reporting unit that is not deductible for income tax purposes. Our effective income tax rate was 3.8% in 2011 and 37.5% in 2010. The change in the effective income tax rate for 2011 was primarily attributable to certain impairment charges and transaction costs that are not deductible for income tax purposes. We recorded favorable income tax adjustments related to the resolution of state income tax contingencies from prior years that reduced the provision for income taxes by approximately $0.2 million in 2012 and approximately $3 million in each of 2011 and 2010.

Consolidated results

Income from continuing operations before income taxes was $7 million in 2012 compared to loss from continuing operations before income taxes of $50 million in 2011 and income from continuing operations before income taxes of $91 million in 2010. Loss from continuing operations was $33 million in 2012 and $48 million in 2011 compared to income from continuing operations of $57 million in 2010. Operating results in 2012 included severance costs, lease cancellation charges and restructuring costs related to the closing of a regional office, the closing of two TC hospitals, the cancellation of a sub-acute unit project, employment-related lawsuits, employee retention costs incurred in connection with the decision to allow the leases to expire for 54 nursing and rehabilitation centers leased from Ventas, employee severance costs and contract cancellation costs incurred in connection with restructuring activities, asset impairment charges and transaction-related costs totaling $128 million ($114 million net of income taxes). Operating results in 2011 included asset impairment charges, transaction-related costs and a loss on a hospital divestiture totaling $186 million ($134 million net of income taxes). Operating results in 2010 included transaction-related costs and severance and retirement costs totaling $8 million ($5 million net of income taxes). See notes 1, 2 and 3 of the notes to consolidated financial statements.

Results of Operations Discontinued Operations

Loss from discontinued operations was $2 million in 2012 and $6 million in 2011 compared to breakeven results in 2010. Discontinued operations included favorable pretax adjustments of $2 million ($1 million net of income taxes) in 2012, $3 million ($2 million net of income taxes) in 2011 and $5 million ($3 million net of income taxes) in 2010 resulting from changes in estimates for professional liability reserves related to prior years.

We recorded a pretax loss on divestiture of operations of $8 million ($5 million net of income taxes) during 2012 and $0.7 million ($0.4 million net of income taxes) during 2010.

See notes 4 and 8 of the notes to consolidated financial statements.

Liquidity

Operating cash flows

Cash flows provided by operations (including discontinued operations) aggregated $263 million for 2012, $154 million for 2011 and $210 million for 2010. During each year, we maintained sufficient liquidity to finance our routine capital expenditures, our ongoing development programs, and acquisitions (excluding the RehabCare Merger).

Fluctuations in operating cash flows during the past three years were primarily attributable to changes in accounts receivable collections, the timing of income tax payments and the payment of lease cancellation, transaction, severance and financing payments. Operating cash flows for 2012 were negatively impacted by $12 million ($9 million net of income taxes) of lease cancellation, severance, financing and transaction payments. Operating cash flows for 2011 were negatively impacted by $104 million ($84 million net of income taxes) of transaction, severance and financing payments, primarily related to the RehabCare Merger. Transaction, severance and retirement payments (unrelated to the RehabCare Merger) for 2010 were $6 million ($4 million net of income taxes). During 2011, lower accounts receivable collections were primarily a result of temporary

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billing delays caused by information systems conversions related to the RehabCare Merger and fiscal intermediary processing delays related to the 2011 CMS Rules. Income tax payments were favorably impacted by favorable income tax legislation related to the depreciation of property and equipment in 2011, and in 2010 by the realized losses on sales of discontinued operations and a tax accounting method change approved by the IRS in 2010. Excluding lease cancellation, transaction, severance, retirement and financing payments, our operating cash flows in each of the last three years exceeded our routine and development capital spending.

We utilize our ABL Facility to meet working capital needs and finance our acquisition and development activities. As a result, we typically carry minimal amounts of cash on our consolidated balance sheet. Based upon our expected operating cash flows and the availability of borrowings under our ABL Facility ($420 million at December 31, 2012), management believes that we have the necessary financial resources to satisfy our expected short-term and long-term liquidity needs.

Credit facilities and notes

In connection with the RehabCare Merger, we entered into the Credit Facilities and the Notes. In 2011, we used proceeds from the Credit Facilities and the Notes to pay the Merger Consideration, repay all amounts outstanding under our and RehabCare s previous credit facilities and to pay transaction costs. The amounts outstanding under our and RehabCare s former credit facilities that were repaid at the RehabCare Merger closing were $390 million and $345 million, respectively.

The Credit Facilities also included an option to increase the credit capacity in an aggregate amount between the two facilities by $200 million. In October 2012, we executed this option by completing modifications to increase by $100 million our Term Loan Facility and expand by $100 million the borrowing capacity under our ABL Facility. The additional Term Loan Facility borrowings were issued at 97.5% and the net proceeds were used to pay down a portion of the outstanding balance under the ABL Facility. The aggregate amount outstanding under the Term Loan Facility at December 31, 2012 approximated $790 million. In connection with the $100 million expansion of the borrowing capacity under our ABL Facility, we also modified the accounts receivable borrowing base which will allow us to more easily access the full amount of the available credit. As of December 31, 2012, our unused credit capacity totaled $420 million under the ABL Facility. The other terms of the Term Loan Facility and the ABL Facility were unchanged.

In connection with the Credit Facilities and the Notes, we paid $46 million of lender fees related to debt issuance that were capitalized as deferred financing costs during 2011 and paid $13 million of other financing costs that were charged to interest expense during 2011.

All obligations under the Credit Facilities are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of our existing and future direct and indirect domestic 100% owned subsidiaries, as well as certain non-100% owned domestic subsidiaries as we may determine from time to time in our sole discretion. The Notes are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of our domestic 100% owned subsidiaries.

The agreements governing the Credit Facilities and the indenture governing the Notes include a number of restrictive covenants that, among other things and subject to certain exceptions and baskets, impose operating and financial restrictions on us and certain of our subsidiaries. Our ability to pay dividends is limited to certain restricted payment baskets, which may expand based upon accumulated earnings. In addition, we are required to comply with a minimum fixed charge coverage ratio and a maximum total leverage ratio under the Credit Facilities. These financing agreements governing the Credit Facilities and the indenture governing the Notes also contain customary affirmative covenants and events of default. We were in compliance with the terms of the Credit Facilities and the indenture governing the Notes at December 31, 2012.

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ABL Facility

The ABL Facility has a five-year tenor and is secured by a first priority lien on eligible accounts receivable, cash, deposit accounts, and certain other assets and property and proceeds from the foregoing (the First Priority ABL Collateral). The ABL Facility has a second priority lien on substantially all of our other assets and properties. As of December 31, 2012, we had $321 million outstanding under the ABL Facility. In addition, $9 million of letters of credit were issued under the ABL Facility as of December 31, 2012.

Borrowings under the ABL Facility bear interest at a rate per annum equal to the applicable margin plus, at our option, either: (1) the London Interbank Offered Rate (LIBOR) determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. At December 31, 2012, the applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. The applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

Term Loan Facility

The Term Loan Facility has a tenor of seven years and is secured by a first priority lien on substantially all of our assets and properties other than the First Priority ABL Collateral and a second priority lien on the First Priority ABL Collateral. The Term Loan Facility net proceeds at the RehabCare Merger totaled $693 million, net of a $7 million original issue discount that will be amortized over the tenor of the Term Loan Facility.

Borrowings under the Term Loan Facility bear interest at a rate per annum equal to an applicable margin plus, at our option, either: (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings.

Notes

In connection with the RehabCare Merger, we completed a private placement of the Notes. The Notes bear interest at an annual rate equal to 8.25% and are senior unsecured obligations of us and the subsidiary guarantors, ranking *pari passu* with all of their respective existing and future senior unsubordinated indebtedness. The indenture contains certain restrictive covenants that will, among other things, limit our and certain of our subsidiaries ability to incur, assume or guarantee additional indebtedness; pay dividends; make distributions or redeem or repurchase stock; restrict dividends, loans or asset transfers from our subsidiaries; sell or otherwise dispose of assets; and enter into transactions with affiliates. These covenants are subject to a number of limitations and exceptions. The indenture also contains customary events of default.

Pursuant to a registration rights agreement, we filed with the SEC a registration statement related to an offer to exchange the Notes for an issue of SEC-registered notes with substantially identical terms. The exchange offer commenced on October 13, 2011 and was completed on November 10, 2011.

Interest rate swaps

In December 2011, we entered into two interest rate swap agreements to hedge our floating interest rate on an aggregate of $225 million of outstanding Term Loan Facility debt. The interest rate swaps have an effective date of January 9, 2012, and expire on January 11, 2016. We are required to make payments based upon a fixed interest rate of 1.8925% calculated on the notional amount of $225 million. In exchange, we will receive interest

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on $225 million at a variable interest rate that is based upon the three-month LIBOR rate, subject to a minimum rate of 1.5%. We determined the interest rate swaps continue to be effective cash flow hedges at December 31, 2012. The fair value of the interest rate swaps recorded in other accrued liabilities was $3 million and $1 million at December 31, 2012 and December 31, 2011, respectively.

Other financing activities

As a result of deterioration in professional liability and workers compensation underwriting results of our limited purpose insurance subsidiary in 2011, we made a capital contribution of $9 million in 2012 to our limited purpose insurance subsidiary. Conversely, as a result of improved professional liability underwriting results of our limited purpose insurance subsidiary in 2010 and 2009, we received distributions of $3 million in 2011 and $22 million in 2010 from our limited purpose insurance subsidiary. These transactions were completed in accordance with applicable regulations. Neither the capital contribution nor the distributions had any impact on earnings.

Debt and lease obligations

Future payments of principal and interest due under long-term debt agreements and lease obligations as of December 31, 2012 follows (in thousands):

	Payments due by period								
						Non-cancelable operating leases			
Year	**Term Loan Facility (a)**	**Notes**	**ABL Facility (b)**	**Capital lease obligations**	**Other long-term debt**	**Ventas (c)**	**Other**	**Subtotal**	**Total**
2013	$ 50,747	$ 45,375	$ 10,795	$ 615	$ 534	$ 230,905	$ 121,701	$ 352,606	$ 460,672
2014	50,321	45,375	10,795	2	524	218,620	115,513	334,133	441,150
2015	49,894	45,375	10,795		4,002	125,771	101,827	227,598	337,664
2016	48,725	45,375	325,225		128	79,391	94,864	174,255	593,708
2017	48,160	45,375			10	80,683	67,946	148,629	242,174
Thereafter	766,096	614,533				167,039	304,467	471,506	1,852,135
	$ 1,013,943	$ 841,408	$ 357,610	$ 617	$ 5,198	$ 902,409	$ 806,318	$ 1,708,727	$ 3,927,503

(a) The amount of the Term Loan Facility in the accompanying consolidated balance sheet at December 31, 2012 is net of an unamortized original issue discount of approximately $8 million. The fixed interest rate related to the interest rate swap agreements was applied on $225 million of the Term Loan Facility. The Term Loan Facility interest is based upon the weighted average interest rate of 5.3% for the portion of debt not subject to the interest rate swap agreements and 5.6% for the $225 million of debt subject to the interest rate swap agreements, both as of December 31, 2012.

(b) The ABL Facility interest is based upon the weighted average interest rate of 3.3% as of December 31, 2012.

(c) See Part I Item 1 Business Master Lease Agreements Rental Amounts and Escalators.

As of December 31, 2012, we had approximately $1 million of total gross unrecognized tax benefits and $0.1 million of accrued interest related to uncertain tax positions. Because future cash outflows related to these unrecognized tax benefits are uncertain, they are excluded from the table above.

As of December 31, 2012, we had approximately $291 million of allowances for professional liability risks and approximately $193 million of allowances for workers compensation risks that are excluded from the table above.

Capital Resources

Capital expenditures and acquisitions

Excluding the RehabCare Merger and acquisitions, routine capital expenditures (expenditures necessary to maintain existing facilities that generally do not increase capacity or add services) totaled $115 million in 2012, $133 million in 2011 and $109 million in 2010. Hospital development capital expenditures (primarily new and replacement facility construction) totaled $43 million in 2012, $68 million in 2011 and $41 million in 2010. Nursing

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and rehabilitation center development capital expenditures (primarily the addition of transitional care services for higher acuity patients and new facility construction) totaled $8 million in 2012, $19 million in 2011 and $27 million in 2010. These capital expenditures were financed primarily through internally generated funds. At December 31, 2012, the estimated cost to complete and equip construction in progress approximated $11 million. We believe that our capital expenditure program is adequate to improve and equip our existing facilities. The reduction in our nursing and rehabilitation center capacity in 2013, primarily related to exiting from the Expiring Facilities, will result in reduced levels of aggregate routine capital spending in 2014.

Expenditures for acquisitions totaled $178 million in 2012, $715 million in 2011 and $280 million in 2010. To the extent that the expenditures for acquisitions other than the RehabCare Merger were not financed through the use of operating cash flows, we utilized our ABL Facility to finance these transactions. For the RehabCare Merger, we utilized our common stock, the ABL Facility, the Term Loan Facility and the Notes to finance the transaction.

The more significant acquisitions in the past three years included the IntegraCare Acquisition in August 2012 ($71 million), the Professional Acquisition in September 2011 ($51 million), the RehabCare Merger in June 2011 ($662 million in cash and $301 million in our common stock), the Vista Acquisition in November 2010 ($179 million), the purchase of three nursing and rehabilitation centers in September 2010 ($38 million) and the acquisition of previously leased real estate in the last three years ($142 million).

Other Information

Effects of inflation and changing prices

We derive a substantial portion of our revenues from the Medicare and Medicaid programs. We have been, and could be in the future, materially adversely affected by the continuing efforts of governmental and private third party payors to contain healthcare costs.

We cannot assure you that reimbursement payments under governmental and private third party payor programs, including Medicare supplemental insurance policies, will remain at levels comparable to present levels or will be sufficient to cover the costs allocable to patients eligible for reimbursement pursuant to these programs. Medicare reimbursement in LTAC hospitals, IRFs and nursing and rehabilitation centers is subject to fixed payments under the Medicare prospective payment systems. In accordance with Medicare laws, CMS makes annual adjustments to Medicare payment rates in many prospective payment systems under what is commonly known as a market basket update. Each year, MedPAC makes payment policy recommendations to Congress for a variety of Medicare payment systems. Congress is not obligated to adopt MedPAC recommendations, and, based upon outcomes in previous years, there can be no assurance that Congress will adopt MedPAC s recommendations in a given year. Medicaid reimbursement rates in many states in which we operate nursing and rehabilitation centers also are based upon fixed payment systems. Generally, these rates are adjusted for inflation. However, these adjustments may not reflect the actual increase in the costs of providing healthcare services. In addition, Medicaid reimbursement can be impacted negatively by state budgetary pressures, which may lead to reduced reimbursement or delays in receiving payments. Moreover, we cannot assure you that the facilities operated by us, or the provision of goods and services offered by us, will meet the requirements for participation in such programs.

As previously discussed, the 2011 CMS Rules have significantly reduced Medicare revenues in our nursing and rehabilitation center and rehabilitation therapy businesses. We believe that the 2011 CMS Rules on an annual basis have reduced our revenues by approximately $100 million to $110 million in our nursing center business and have negatively impacted our rehabilitation therapy business by approximately $40 million to $50 million.

The reforms contained in the ACA also have affected each of our businesses in some manner and are directed in large part at increased quality and cost reductions. Several of the reforms are very significant and could ultimately change the nature of our services, the methods of payment for our services and the underlying regulatory environment. These reforms include the possible modifications to the conditions of qualification for payment, bundling of payments to cover both acute and post-acute care and the imposition of enrollment limitations on new providers.

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The ACA also provides for: (1) reductions to the annual market basket payment updates for LTAC hospitals, IRFs, home health agencies and hospice providers which could result in lower reimbursement than in the preceding year; (2) additional annual productivity adjustment reductions to the annual market basket payment update as determined by CMS for LTAC hospitals, IRFs, and nursing and rehabilitation centers (beginning in federal fiscal year 2012), home health agencies (beginning in federal fiscal year 2015) and hospice providers (beginning in federal fiscal year 2013); (3) new transparency, reporting and certification requirements for skilled nursing facilities, including disclosures regarding organizational structure, officers, directors, trustees, managing employees and financial, clinical and other related data; (4) a quality reporting system for hospitals (including LTAC hospitals and IRFs) beginning in federal fiscal year 2014; and (5) reductions in Medicare payments to hospitals (including LTAC hospitals and IRFs) beginning in federal fiscal year 2014 for failure to meet certain quality reporting standards or to comply with standards in new value based purchasing demonstration project programs.

The Budget Control Act of 2011, enacted on August 2, 2011, increased the United States debt ceiling in connection with deficit reductions over the next ten years. Under the Budget Control Act of 2011, $1.2 trillion in domestic and defense spending reductions were automatically set to begin February 1, 2013, split evenly between domestic and defense spending. Payments to Medicare providers are subject to these automatic spending reductions, subject to a 2% cap. As discussed below, the Taxpayer Relief Act subsequently delayed by two months the automatic budget sequestration cuts established by the Budget Control Act of 2011. At this time, we believe that the automatic 2% reduction on each claim submitted to Medicare will begin on April 1, 2013. Reductions to Medicare and Medicaid reimbursement resulting from the Budget Control Act of 2011 could have a material adverse effect on our business, financial position, results of operations and liquidity.

The Taxpayer Relief Act was enacted on January 2, 2013. As noted above, this Act delayed by two months the automatic budget sequestration cuts established by the Budget Control Act of 2011. The Taxpayer Relief Act also: (1) reduces Medicare payments by 50% for subsequent procedures when multiple therapy services are provided on the same day; (2) extends the Medicare Part B outpatient therapy cap exception process to December 31, 2013; (3) suspends until December 31, 2013 the SGR reduction applicable to the MPFS for certain services provided under Medicare Part B; (4) increases the statute of limitations to recover Medicare overpayments from three years to five years; and (5) creates a new federal Commission on Long-Term Care that has six months in which to provide recommendations on the establishment, implementation and financing of a comprehensive, coordinated and high-quality system that ensures the availability of long-term care services. We believe that the new rules related to multiple therapy services will reduce our Medicare revenues by $25 million to $30 million on an annual basis.

Congress, MedPAC, and CMS will continue to address reimbursement rates for a variety of healthcare settings. We cannot predict the adjustments to Medicare payment rates that Congress or CMS may make in the future. Any downward adjustment to rates for the types of services we provide could have a material adverse effect on our business, financial position, results of operations and liquidity.

Congress continues to discuss additional deficit reduction measures, leading to a high degree of uncertainty regarding potential reforms to governmental healthcare programs, including Medicare and Medicaid. These discussions, along with other continuing efforts to reform governmental healthcare programs, could result in major changes in healthcare delivery and reimbursement systems on a national and state level, including changes directly impacting the government and private reimbursement systems for each of our businesses. Healthcare reform, future healthcare legislation or other changes in the administration or interpretation of governmental healthcare programs, whether resulting from deficit reduction measures or otherwise, could have a material adverse effect on our business, financial position, results of operations and liquidity.

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

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See Part I Item 1 Business Governmental Regulation for a detailed discussion of Medicare and Medicaid reimbursement regulations. Also see Part I Item 1A Risk Factors.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

The following table provides information about our financial instruments as of December 31, 2012 that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted average interest rates by expected maturity date.

Interest Rate Sensitivity

Principal (Notional) Amount by Expected Maturity

Average Interest Rate

(Dollars in thousands)

	Expected maturities							Fair value
	2013	2014	2015	2016	2017	Thereafter	Total	12/31/12
Liabilities:								
Long-term debt, including amounts due within one year:								
Fixed rate:								
Notes	$	$	$	$	$	$ 550,000	$ 550,000	$ 535,150
Other	102	109	116	123	10		460	457(a)
	$ 102	$ 109	$ 116	$ 123	$ 10	$ 550,000	$ 550,460	$ 535,607
Average interest rate	6.0%	6.0%	6.0%	6.0%	6.0%	8.3%		
Variable rate:								
ABL Facility (b)	$	$	$	$ 320,700	$	$	$ 320,700	$ 320,700
Term Loan Facility (c,d)	8,000	8,000	8,000	8,000	8,000	749,500	789,500	770,157
Other (e)	233	232	3,720				4,185	4,185
	$ 8,233	$ 8,232	$ 11,720	$ 328,700	$ 8,000	$ 749,500	$ 1,114,385	$ 1,095,042

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

(b) Interest on borrowings under our ABL Facility is payable, at our option, at a rate per annum equal to the applicable margin plus, at our option, either: (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of: (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. At December 31, 2012, the applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. The applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

(c) Interest on borrowings under the Term Loan Facility is payable at a rate per annum equal to an applicable margin plus, at our option, either: (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings. The expected maturities for the Term Loan Facility exclude the original issue discount of approximately $8 million.

(d) In December 2011, we entered into two interest rate swap agreements to hedge our floating interest rate on an aggregate of $225 million of outstanding Term Loan Facility debt. The interest rate swaps have an effective date of January 9, 2012, and expire on January 11, 2016. We are required to make payments based upon a fixed interest rate of 1.8925% calculated on the notional amount of $225 million. In exchange, we will receive interest on $225 million at a variable interest rate that is based upon the three-month LIBOR rate, subject to a minimum rate of 1.5%.

(e) Interest based upon LIBOR plus 4%.

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Item 8. ***Financial Statements and Supplementary Data***

The information required by this Item 8 is included in appendix pages F-2 through F-62 of this Annual Report on Form 10-K and incorporated herein by reference.

Item 9. ***Changes in and Disagreements With Accountants on Accounting and Financial Disclosure***

None.

Item 9A. ***Controls and Procedures***

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

We have carried out an evaluation under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2012, the disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, are effective.

There has been no change in our internal control over financial reporting during the quarter ended December 31, 2012, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management s Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

(1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

(2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

(3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based upon our assessment, management has concluded that the Company maintained effective internal control over financial reporting as of December 31, 2012, based upon the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*.

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The effectiveness of the Company s internal control over financial reporting as of December 31, 2012 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm as stated in their report which appears herein.

Item 9B. ***Other Information***

Not applicable.

PART III

Item 10. ***Directors, Executive Officers and Corporate Governance***

EXECUTIVE OFFICERS OF THE REGISTRANT

Set forth below are the names, ages (as of January 1, 2013) and present and past positions of our current executive officers:

Name	Age	Position
Paul J. Diaz	51	Chief Executive Officer
Benjamin A. Breier	41	President and Chief Operating Officer
Richard A. Lechleiter	54	Executive Vice President and Chief Financial Officer
Lane M. Bowen	62	Executive Vice President and President, Nursing Center Division
Jeffrey P. Winter	56	Executive Vice President and President, Hospital Division
Patricia M. Henry	59	President, RehabCare
Richard E. Chapman	64	Executive Vice President and Chief Administrative and Information Officer
William M. Altman	53	Executive Vice President for Strategy, Policy and Integrated Care
Joseph L. Landenwich	48	Co-General Counsel and Corporate Secretary
Gregory C. Miller	43	Chief Development Officer
M. Suzanne Riedman	61	General Counsel and Chief Diversity Officer

Paul J. Diaz has served as one of our directors since May 2002 and as our Chief Executive Officer since January 2004. Mr. Diaz served as our President from January 2002 until May 2012 and as our Chief Operating Officer from January 2002 to December 2003.

Benjamin A. Breier has served as our President since May 2012 and as our Chief Operating Officer since August 2010. He served as our Executive Vice President and President, Hospital Division from March 2008 until August 2010, and as President, Rehabilitation Division from August 2005 to March 2008.

Richard A. Lechleiter, a certified public accountant, has served as our Executive Vice President and Chief Financial Officer since February 2005. He served as Senior Vice President and Chief Financial Officer from February 2002 to February 2005.

Lane M. Bowen has served as our Executive Vice President since February 2005 and as President, Nursing Center Division since October 2002.

Jeffrey P. Winter has served as our Executive Vice President and President, Hospital Division, since November 2010. Prior to joining us, he served as Chief Administrative Officer of Providence Health and Services, California Region. Prior to joining Providence in 2009, Mr. Winter was with Catholic Healthcare West for ten years, most recently as President of Group Operations.

Patricia M. Henry has served as our President, RehabCare since December 2011. She served as Executive Vice President, Skilled Rehabilitation Services Operations, RehabCare from June 2011 to December 2011. Prior to joining us, Ms. Henry served as Executive Vice President, Operations of RehabCare Group, Inc. from October 2006 to June 2011.

Richard E. Chapman has served as our Executive Vice President and Chief Administrative and Information Officer since February 2005. He served as Chief Administrative and Information Officer and Senior Vice President from January 2001 to February 2005.

William M. Altman, an attorney, has served as our Executive Vice President for Strategy, Policy and Integrated Care since May 2012. He served as our Senior Vice President, Strategy and Public Policy from January 2008 to May 2012 and as Senior Vice President, Compliance and Government Programs from April 2002 to December 2007.

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Joseph L. Landenwich, an attorney and certified public accountant, has served as our Co-General Counsel and Corporate Secretary since May 2012. He served as our Senior Vice President of Corporate Legal Affairs and Corporate Secretary from December 2003 to May 2012. Mr. Landenwich served as Vice President of Corporate Legal Affairs and Corporate Secretary from November 1999 to December 2003.

Gregory C. Miller has served as our Chief Development Officer since February 2011. He served as Senior Vice President, Corporate Development and Financial Planning from January 2005 to February 2011. He served as our Vice President, Corporate Development and Financial Planning from January 2004 to January 2005.

M. Suzanne Riedman, an attorney, has served as our General Counsel since August 1999 and as our Chief Diversity Officer since December 2010. She also held the title of Senior Vice President from August 1999 to February 2011.

The information required by this Item, other than the information set forth above under Executive Officers of the Registrant, is omitted because we are filing a definitive proxy statement, which will include the required information under the sections entitled Proposal to Elect Directors, Certain Information Concerning the Board of Directors, Section 16(a) Beneficial Ownership Reporting Compliance, Code of Ethics and Related Person Transactions, pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K. The required information contained in our proxy statement is incorporated herein by reference.

Item 11. ***Executive Compensation***

The information required by this Item is omitted because we are filing a definitive proxy statement, which will include the required information under the section titled Compensation of Directors and Executive Officers, pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K. The required information contained in our proxy statement is incorporated herein by reference.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this Item is omitted because we are filing a definitive proxy statement, which will include the required information under the section titled Securities Authorized for Issuance under Equity Compensation Plans and Security Ownership of Certain Beneficial Owners and Management, pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K. The required information contained in our proxy statement is incorporated herein by reference.

Item 13. ***Certain Relationships and Related Transactions, and Director Independence***

The information required by this Item is omitted because we are filing a definitive proxy statement, which will include the required information under the sections titled Certain Matters Concerning the Board of Directors and Code of Ethics and Related Person Transactions, pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K. The required information contained in our proxy statement is incorporated herein by reference.

Item 14. ***Principal Accounting Fees and Services***

The information required by this Item is omitted because we are filing a definitive proxy statement, which will include the required information under the section titled Proposal to Ratify the Appointment of PricewaterhouseCoopers LLP as our Independent Registered Public Accounting Firm for Fiscal Year 2013, pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K. The required information contained in our proxy statement is incorporated herein by reference.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules***

(a)(1) and (a)(2) Index to Consolidated Financial Statements and Financial Statement Schedules:

(a) All other schedules have been omitted because the required information is not present or not present in material amounts.

(a)(3) Index to Exhibits:

Exhibit number	Description of document
2.1*	Fourth Amended Joint Plan of Reorganization of Vencor, Inc. and Affiliated Debtors under Chapter 11 of the Bankruptcy Code. Exhibit 2.1 to the Current Report on Form 8-K of the Company dated March 19, 2001 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.2	Order Confirming the Fourth Amended Joint Plan of Reorganization of Vencor, Inc. and Affiliated Debtors under Chapter 11 of the Bankruptcy Code, as entered by the United States Bankruptcy Court for the District of Delaware on March 16, 2001. Exhibit 2.2 to the Current Report on Form 8-K of the Company dated March 19, 2001 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.3*	Master Transaction Agreement, dated as of October 25, 2006, by and among AmerisourceBergen Corporation, PharMerica, Inc., Kindred Healthcare, Inc., Kindred Healthcare Operating, Inc., Kindred Pharmacy Services, Inc., Safari Holding Corporation, Hippo Merger Corporation and Rhino Merger Corporation. Exhibit 10.1 to the Company s Current Report on Form 8-K dated October 25, 2006 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.4	Amendment No. 1 To Master Transaction Agreement, dated as of June 4, 2007, among AmerisourceBergen Corporation, PharMerica, Inc., Kindred Healthcare, Inc., Kindred Healthcare Operating, Inc., Kindred Pharmacy Services, Inc., Safari Holding Corporation, Hippo Merger Corporation and Rhino Merger Corporation. Exhibit 10.1 to the Company s Current Report on Form 8-K dated June 4, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.5*	Amendment No. 2 To Master Transaction Agreement, dated as of July 31, 2007, among AmerisourceBergen Corporation, PharMerica Long-Term Care, Inc. (formerly named PharMerica, Inc.), Kindred Healthcare, Inc., Kindred Healthcare Operating, Inc., Kindred Pharmacy Services, Inc., PharMerica Corporation (formerly named Safari Holding Corporation), Hippo Merger Corporation and Rhino Merger Corporation. Exhibit 2.1 to the Company s Form 10-Q for the quarterly period ended September 30, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.6*	Asset Purchase Agreement, dated as of August 23, 2010, by and among (i) (a) KND Development 52, L.L.C., KND Development 53, L.L.C., KND Development 54, L.L.C., and KND Development 55, L.L.C., (ii) Kindred Healthcare Operating, Inc., (iii) (a) Vista Healthcare Holdings, LLC, (b) Vista Healthcare, LLC, (c) Vista Hospital of South Bay, LP, (d) South Bay Community Hospital, Inc., (e) Rancho Cucamonga Community Hospital, LLC, (f) Vista Specialty Hospital of Southern California, LP, (g) Perris Valley Community Hospital, LLC, and (h) Vista Hospital of South Bay, LLC, (iv) (a) Ara Tavitian, M.D., (b) J. Vartan Hovsepian, (c) Marc Ferrell, (d) Marc Furstman, (e) Vista Hospital Management Group, Inc., (f) the Ara Tavitian 2010 GRAT, (g) Vista Partnership Holding, LLC, and (v) Tavitian Holdings, LLC. Exhibit 2.1 to the Company s Current Report on Form 8-K dated August 23, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.7	Amendment No. 1 to the Asset Purchase Agreement, entered into as of October 21, 2010, by and among (i) (a) KND Development 52, L.L.C., KND Development 53, L.L.C., KND Development 54, L.L.C., and KND Development 55, L.L.C., (ii) Kindred Healthcare Operating, Inc., (iii) (a) Vista Healthcare Holdings, LLC, (b) Vista Healthcare, LLC, (c) Vista Hospital of South Bay, LP, (d) South Bay Community Hospital, Inc., (e) Rancho Cucamonga Community Hospital, LLC, (f) Vista Specialty Hospital of Southern California, LP, (g) Perris Valley Community Hospital, LLC, and (h) Vista Hospital of South Bay, LLC, (iv) (a) Ara Tavitian, M.D., (b) J. Vartan Hovsepian, (c) Marc Ferrell, (d) Marc Furstman, (e) Vista Hospital Management Group, Inc., (f) the Ara Tavitian 2010 GRAT, (g) Vista Partnership Holding, LLC, and (v) Tavitian Holdings, LLC. Exhibit 2.1 to the Company s Current Report on Form 8-K dated October 21, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference.

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Exhibit number	Description of document
2.8*	Amendment No. 2 to the Asset Purchase Agreement, entered into as of October 30, 2010, by and among (i) (a) KND Development 52, L.L.C., KND Development 53, L.L.C., KND Development 54, L.L.C., and KND Development 55, L.L.C., (ii) Kindred Healthcare Operating, Inc., (iii) (a) Vista Healthcare Holdings, LLC, (b) Vista Healthcare, LLC, (c) Vista Hospital of South Bay, LP, (d) South Bay Community Hospital, Inc., (e) Rancho Cucamonga Community Hospital, LLC, (f) Vista Specialty Hospital of Southern California, LP, (g) Perris Valley Community Hospital, LLC, and (h) Vista Hospital of South Bay, LLC, (iv) (a) Ara Tavitian, M.D., (b) J. Vartan Hovsepian, (c) Marc Ferrell, (d) Marc Furstman, (e) Vista Hospital Management Group, Inc., (f) the Ara Tavitian 2010 GRAT, (g) Vista Partnership Holding, LLC, and (v) Tavitian Holdings, LLC. Exhibit 2.1 to the Company s Current Report on Form 8-K dated October 30, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.9*	Agreement and Plan of Merger, dated as of February 7, 2011, among Kindred Healthcare, Inc., Kindred Healthcare Development, Inc. and RehabCare Group, Inc. Exhibit 2.1 to the Company s Current Report on Form 8-K dated February 7, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
2.10	Amendment to Agreement and Plan of Merger, dated May 12, 2011, among Kindred Healthcare, Inc., Kindred Healthcare Development, Inc. and RehabCare Group, Inc. Exhibit 2.1 to the Company s Current Report on Form 8-K dated May 12, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
3.1	Amended and Restated Certificate of Incorporation of the Company. Exhibit 4.1 to the Company s Registration Statement on Form S-3 filed August 31, 2001 (Comm. File No. 333-68838) is hereby incorporated by reference.
3.2	Certificate of Amendment of Amended and Restated Certificate of Incorporation. Exhibit 3.1 to the Company s Form 10-Q for the quarterly period ended March 31, 2002 (Comm. File No. 001-14057) is hereby incorporated by reference.
3.3	Amended and Restated Bylaws of the Company. Exhibit 3.1 to the Company s Current Report on Form 8-K dated March 20, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
4.1	Articles IV, IX, X and XII of the Restated Certificate of Incorporation of the Company are included in Exhibit 3.1.
4.2*	Indenture (including form of Note), dated as of June 1, 2011, between Kindred Escrow Corp. and Wells Fargo Bank, National Association, as trustee. Exhibit 4.1 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
4.3	Supplemental Indenture, dated as of June 1, 2011, among Kindred Healthcare, Inc., the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as trustee. Exhibit 4.2 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
4.4	Second Supplemental Indenture, dated as of September 28, 2011, among Kindred Healthcare, Inc., the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as trustee. Exhibit 4.1 to the Company s Current Report on Form 8-K dated September 28, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
4.5	Third Supplemental Indenture, dated as of June 13, 2012, among Kindred Healthcare, Inc., the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as trustee.
4.6	Fourth Supplemental Indenture, dated as of September 28, 2012, among Kindred Healthcare, Inc., the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as trustee.

Exhibit number	Description of document
4.7*	Registration Rights Agreement, dated as of June 1, 2011, between Kindred Escrow Corp. and J.P. Morgan Securities LLC. Exhibit 4.3 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
4.8	Joinder Agreement to Registration Rights Agreement, dated as of June 1, 2011, among Kindred Healthcare, Inc. and the Subsidiary Guarantors party thereto. Exhibit 4.4 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
4.9	Second Joinder Agreement to the Registration Rights Agreement, dated as of September 28, 2011, among the Subsidiary Guarantors party thereto. Exhibit 4.2 to the Company s Current Report on Form 8-K dated September 28, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.1*	ABL Credit Agreement, dated as of June 1, 2011, among Kindred Healthcare, Inc., the Lenders party thereto, JPMorgan Chase Bank, N.A. as Administrative Agent and Collateral Agent and the arrangers and agents party thereto. Exhibit 10.1 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.2	Amendment No. 1 to the ABL Credit Agreement dated as of October 4, 2012, by and among the Company, JPMorgan Chase Bank, N.A., as Administrative Agent and Collateral Agent, each Incremental Lender and each of the other Lenders and Credit Parties thereto. Exhibit 10.1 to the Company s Current Report on Form 8-K dated October 4, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.3*	Term Loan Credit Agreement, dated as of June 1, 2011, among Kindred Healthcare, Inc., the Lenders party thereto, JPMorgan Chase Bank, N.A. as Administrative Agent and Collateral Agent and the arrangers and other agents party thereto. Exhibit 10.2 to the Company s Current Report on Form 8-K dated June 1, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.4	Incremental Amendment No. 1 to the Term Loan Credit Agreement dated as of October 4, 2012, by and among the Company, JPMorgan Chase Bank, N.A., as Administrative Agent and Collateral Agent, each Incremental Term Lender and each of the other Credit Parties thereto. Exhibit 10.2 to the Company s Current Report on Form 8-K dated October 4, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.5	Form of Indemnification Agreement between the Company and certain of its officers and employees. Exhibit 10.31 to the Ventas, Inc. Form 10-K for the year ended December 31, 1995 (Comm. File No. 001-10989) is hereby incorporated by reference.
10.6	Form of Indemnification Agreement between the Company and each member of its Board of Directors. Exhibit 10.21 to the Company s Form 10-K for the year ended December 31, 2001 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.7**	Kindred Deferred Compensation Plan, Third Amendment and Restatement effective as of January 1, 2009. Exhibit 10.4 to the Company s Form 10-Q for the quarterly period ended September 30, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.8**	Amendment No. 1 to the Third Amendment and Restatement of the Kindred Deferred Compensation Plan, effective as of December 21, 2011. Exhibit 10.9 to the Company s Form 10-K for the year ended December 31, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.9**	Amendment No. 2 to the Third Amendment and Restatement of the Kindred Deferred Compensation Plan, effective as of January 1, 2013.

Exhibit number	Description of document
10.10**	Amended and Restated Kindred Healthcare, Inc. Long-Term Incentive Plan. Exhibit 10.5 to the Company s Form 10-Q for the quarterly period ended March 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.11**	Amended and Restated Kindred Healthcare, Inc. Short-Term Incentive Plan. Exhibit 10.3 to the Company s Form 10-Q for the quarterly period ended September 30, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.12**	Agreement dated as of March 20, 2009 by and between Kindred Healthcare, Inc. and Edward L. Kuntz. Exhibit 10.1 to the Company s Current Report on Form 8-K dated March 20, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.13**	Employment Agreement dated as of May 17, 2012 by and between Kindred Healthcare Operating, Inc. and Paul J. Diaz. Exhibit 10.4 to the Company s Form 10-Q for the quarterly period ended June 30, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.14**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and Paul J. Diaz. Exhibit 10.1 to the Company s Current Report on Form 8-K dated November 13, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.15**	Employment Agreement dated as of December 18, 2008 by and between Kindred Healthcare Operating, Inc. and Richard E. Chapman. Exhibit 10.21 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.16**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and Richard E. Chapman. Exhibit 10.21 to the Company s Form 10-K for the year ended December 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.17**	Employment Agreement dated as of December 18, 2008 by and between Kindred Healthcare Operating, Inc. and M. Suzanne Riedman. Exhibit 10.25 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.18**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and M. Suzanne Riedman. Exhibit 10.25 to the Company s Form 10-K for the year ended December 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.19**	Employment Agreement dated as of December 18, 2008 by and between Kindred Healthcare Operating, Inc. and Richard A. Lechleiter. Exhibit 10.5 to the Company s Current Report on Form 8-K dated December 18, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.20**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and Richard A. Lechleiter. Exhibit 10.2 to the Company s Current Report on Form 8-K dated November 13, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.21**	Employment Agreement dated as of May 17, 2012 by and between Kindred Healthcare Operating, Inc. and William M. Altman. Exhibit 10.6 to the Company s Form 10-Q for the quarterly period ended June 30, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.22**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and William M. Altman. Exhibit 10.29 to the Company s Form 10-K for the year ended December 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.

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Exhibit number	Description of document
10.23**	Employment Agreement dated as of December 18, 2008 by and between Kindred Healthcare Operating, Inc. and Lane M. Bowen. Exhibit 10.9 to the Company s Current Report on Form 8-K dated December 18, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.24**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and Lane M. Bowen. Exhibit 10.4 to the Company s Current Report on Form 8-K dated November 13, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.25**	Employment Agreement dated as of May 17, 2012 by and between Kindred Healthcare Operating, Inc. and Joseph L. Landenwich. Exhibit 10.8 to the Company s Form 10-Q for the quarterly period ended June 30, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.26**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and Joseph L. Landenwich. Exhibit 10.33 to the Company s Form 10-K for the year ended December 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.27**	Employment Agreement dated as of September 20, 2012 by and between Kindred Healthcare Operating, Inc. and Benjamin A. Breier. Exhibit 10.1 to the Company s Current Report on Form 8-K dated September 20, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.28**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and Benjamin A. Breier. Exhibit 10.35 to the Company s Form 10-K for the year ended December 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.29**	Employment Agreement dated as of May 17, 2012 by and between Kindred Healthcare Operating, Inc. and Gregory C. Miller. Exhibit 10.7 to the Company s Form 10-Q for the quarterly period ended June 30, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.30**	Change-in-Control Severance Agreement dated as of November 13, 2009 by and between Kindred Healthcare Operating, Inc. and Gregory C. Miller. Exhibit 10.37 to the Company s Form 10-K for the year ended December 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.31**	Employment Agreement dated as of November 1, 2010 by and between Kindred Healthcare Operating, Inc. and Jeffrey P. Winter. Exhibit 10.3 to the Company s Form 10-Q for the quarterly period ended September 30, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.32**	Change-in-Control Severance Agreement dated as of November 1, 2010 by and between Kindred Healthcare Operating, Inc. and Jeffrey P. Winter. Exhibit 10.4 to the Company s Form 10-Q for the quarterly period ended September 30, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.33**	Employment Agreement dated as of December 19, 2011 by and between Kindred Healthcare Operating, Inc. and Patricia M. Henry. Exhibit 10.34 to the Company s Form 10-K for the year ended December 31, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.34**	Change-in-Control Severance Agreement dated as of June 1, 2011 by and between Kindred Healthcare Operating, Inc. and Patricia M. Henry. Exhibit 10.35 to the Company s Form 10-K for the year ended December 31, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.

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Exhibit number	Description of document
10.35	Second Amended and Restated Master Lease Agreement No. 1 dated as of April 27, 2007 for Lease Executed by Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.3 to the Company s Form 10-Q for the quarterly period ended June 30, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.36	Amendment to Memorandum of Lease and Specific Property Lease Amendment dated as of June 8, 2007 by and between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.47 to the Company s Form 10-K for the year ended December 31, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.37	Amendment to Master Lease and Memorandum of Lease dated as of January 16, 2009 by and between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.1 to the Company s Form 10-Q for the quarterly period ended March 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.38	Amendment to Memorandum of Lease and Specific Property Lease Amendment dated as of October 14, 2009 by and between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.43 to the Company s Form 10-K for the year ended December 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.39	Second Amended and Restated Master Lease Agreement No. 2 dated as of April 27, 2007 for Lease Executed by Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.4 to the Company s Form 10-Q for the quarterly period ended June 30, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.40	Notice of Renewal of Renewal Group 1 dated as of April 26, 2012 under that Second Amended and Restated Master Lease Agreement No. 2. Exhibit 10.2 to the Company s Form 10-Q for the quarterly period ended June 30, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.41	Second Amended and Restated Master Lease Agreement No. 3 dated as of April 27, 2007 for Lease Executed by Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.5 to the Company s Form 10-Q for the quarterly period ended June 30, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.42	Amendment to Memorandum of Lease and Specific Property Lease Amendment dated as of March 1, 2012 by and between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.1 to the Company s Form 10-Q for the quarterly period ended March 31, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.43	Amendment to Memorandum of Lease and Specific Property Lease Amendment dated as of January 9, 2009 by and between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.2 to the Company s Form 10-Q for the quarterly period ended March 31, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.44	Second Amended and Restated Master Lease Agreement No. 4 dated as of April 27, 2007 for Lease Executed by Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.6 to the Company s Form 10-Q for the quarterly period ended June 30, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.

Exhibit number	Description of document
10.45	Amendment to Master Lease and Memorandum of Lease dated as of August 7, 2007 by and among Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.51 to the Company s Form 10-K for the year ended December 31, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.46	Notice of Renewal of Renewal Group 1 dated as of April 26, 2012 under that Second Amended and Restated Master Lease Agreement No. 4. Exhibit 10.3 to the Company s Form 10-Q for the quarterly period ended June 30, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.47	Renewal Notice to Lessor dated April 30, 2009 regarding the Second Amended and Restated Master Lease Agreements Nos. 1-4 between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc. as Tenant. Exhibit 10.1 to the Company s Form 10-Q for the quarterly period ended June 30, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.48	Side Letter dated as of May 23, 2012 to the Second Amended and Restated Master Lease Agreements Nos. 1, 2, 3 and 4. Exhibit 10.10 to the Company s Form 10-Q for the quarterly period ended June 30, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.49	Side Letter dated as of January 29, 2013 to the Second Amended and Restated Master Lease Agreements Nos. 1, 2, 3 and 4.
10.50	Master Lease Agreement No. 5 dated as of May 23, 2012 executed by Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc., as Tenant. Exhibit 10.1 to the Company s Current Report on Form 8-K dated May 23, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.51	Master Lease among Health Care Property Investors, Inc. and Health Care Property Partners, collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C. and Kindred Nursing Centers Limited Partnership, collectively, as Lessee, dated May 16, 2001. Exhibit 10.11 to the Company s Form 10-Q for the quarterly period ended June 30, 2001 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.52	First Amendment to Master Lease dated effective August 1, 2001 by and among Health Care Property Investors, Inc., Health Care Property Partners and Indiana HCP, L.P., collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C. and Kindred Nursing Centers Limited Partnership, collectively, as Lessee. Exhibit 10.53 to the Company s Form 10-K for the year ended December 31, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.53	Second Amendment to Master Lease dated as of November 18, 2003 by and among Health Care Property Investors, Inc., Health Care Property Partners and Indiana HCP, L.P., collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C. and Kindred Nursing Centers Limited Partnership, collectively, as Lessee. Exhibit 10.54 to the Company s Form 10-K for the year ended December 31, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.54	Third Amendment to Master Lease dated and effective as of June 30, 2004 by and among Health Care Property Investors, Inc. and Health Care Property Partners, collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C. and Kindred Nursing Centers Limited Partnership, collectively, as Lessee. Exhibit 10.55 to the Company s Form 10-K for the year ended December 31, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.

Exhibit number	Description of document
10.55	Fourth Amendment to Master Lease by and among Health Care Property Investors, Inc. and Health Care Property Partners, collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C. and Kindred Nursing Centers Limited Partnership, collectively, as Lessee, dated February 28, 2006. Exhibit 10.71 to the Company s Form 10-K for the year ended December 31, 2006 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.56	Fifth Amendment to Master Lease by and among Health Care Property Investors, Inc., Health Care Property Partners, and Texas HCP Holding, L.P., collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C., Kindred Nursing Centers Limited Partnership, Kindred Hospitals Limited Partnership and Transitional Hospitals Corporation of Wisconsin, Inc., collectively, as Lessee, dated January 31, 2007. Exhibit 10.72 to the Company s Form 10-K for the year ended December 31, 2006 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.57	Sixth Amendment to Master Lease by and among HCP, Inc. f/k/a Health Care Property Investors, Inc., Health Care Property Investors, Inc., Health Care Property Partners, and Texas HCP Holding, L.P., collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C., Kindred Nursing Centers Limited Partnership and Transitional Hospitals Corporation of Wisconsin, Inc., collectively, as Lessee, dated December 8, 2008. Exhibit 10.53 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.58	Master Lease Agreement dated as of February 28, 2006 by and between HCRI Massachusetts Properties Trust II, as Lessor and Kindred Nursing Centers East, L.L.C., as Tenant. Exhibit 10.6 to the Company s Form 10-Q for the quarterly period ended March 31, 2006 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.59	First Amendment to Master Lease Agreement dated as of June 20, 2007 by and between HCRI Massachusetts Properties Trust II, as Lessor and Kindred Nursing Centers East, L.L.C., as Tenant. Exhibit 10.59 to the Company s Form 10-K for the year ended December 31, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.60	Termination of Lease and Notice of Lease dated as of January 22, 2010 by and among HCRI Massachusetts Properties Trust, HCRI Massachusetts Properties Trust II and Kindred Hospitals East, L.L.C. Exhibit 10.1 to the Company s Form 10-Q for the quarterly period ended March 31, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.61	Termination of Lease and Notice of Lease dated as of January 22, 2010 by and among HCRI Massachusetts Properties Trust, HCRI Massachusetts Properties Trust II, Kindred Hospitals East, L.L.C. and KND Real Estate 26, L.L.C. Exhibit 10.2 to the Company s Form 10-Q for the quarterly period ended March 31, 2010 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.62	Agreement and Plan of Reorganization between the Company and Ventas, Inc. Exhibit 10.1 to the Company s Form 10, as amended, dated April 27, 1998 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.63**	Kindred Healthcare, Inc. 2001 Stock Incentive Plan, Amended and Restated. Exhibit 10.1 to the Company s Current Report on Form 8-K dated May 22, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.64**	Form of Kindred Healthcare, Inc. Non-Qualified Stock Option Grant Agreement under the 2001 Stock Incentive Plan, Amended and Restated. Exhibit 10.64 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.

Exhibit number	Description of document
10.65**	Form of Kindred Healthcare, Inc. Incentive Stock Option Grant Agreement under the 2001 Stock Incentive Plan, Amended and Restated. Exhibit 10.65 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.66**	Form of Kindred Healthcare, Inc. Restricted Share Award Agreement under the 2001 Stock Incentive Plan, Amended and Restated. Exhibit 10.66 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.67**	Form of Kindred Healthcare, Inc. Performance Unit Award Agreement under the 2001 Stock Incentive Plan, Amended and Restated. Exhibit 10.68 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.68**	Kindred Healthcare, Inc. 2001 Equity Plan for Non-Employee Directors (Amended and Restated). Exhibit 10.69 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.69**	Form of Kindred Healthcare, Inc. Non-Qualified Stock Option Grant Agreement under the 2001 Equity Plan for Non-Employee Directors (Amended and Restated). Exhibit 10.70 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.70**	Form of Kindred Healthcare, Inc. Restricted Share Award Agreement under the 2001 Equity Plan for Non-Employee Directors (Amended and Restated). Exhibit 10.71 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.71**	Form of Amendment No. 1 to Non-Discretionary Non-Qualified Stock Option Grant Agreement under the 2001 Equity Plan for Non-Employee Directors (Amended and Restated). Exhibit 10.72 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.72**	Form of Amendment No. 1 to Discretionary Non-Qualified Stock Option Grant Agreement under the 2001 Equity Plan for Non-Employee Directors (Amended and Restated). Exhibit 10.73 to the Company s Form 10-K for the year ended December 31, 2008 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.73**	Kindred Healthcare, Inc. 2011 Stock Incentive Plan. Annex F to the Company s Registration Statement on Form S-4 filed with the Securities and Exchange Commission on April 20, 2011 (Comm. File No. 333-173050) is hereby incorporated by reference.
10.74**	Form of Kindred Healthcare, Inc. Non-Qualified Stock Option Grant Agreement under the 2011 Stock Incentive Plan. Exhibit 10.4 to the Company s Form 10-Q for the quarterly period ended June 30, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.75**	Form of Kindred Healthcare, Inc. Incentive Stock Option Grant Agreement under the 2011 Stock Incentive Plan. Exhibit 10.5 to the Company s Form 10-Q for the quarterly period ended June 30, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.76**	Form of Kindred Healthcare, Inc. Restricted Share Award Agreement under the 2011 Stock Incentive Plan. Exhibit 10.2 to the Company s Form 10-Q for the quarterly period ended March 31, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.77**	Form of Kindred Healthcare, Inc. Stock Bonus Award Agreement under the 2011 Stock Incentive Plan. Exhibit 10.7 to the Company s Form 10-Q for the quarterly period ended June 30, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.

Exhibit number	Description of document
10.78**	Form of Kindred Healthcare, Inc. Performance Unit Award Agreement under the 2011 Stock Incentive Plan. Exhibit 10.3 to the Company s Form 10-Q for the quarterly period ended March 31, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.79**	Kindred Healthcare, Inc. 2012 Equity Plan for Non-Employee Directors. Annex A to the Company s Definitive Proxy Statement on Schedule 14A dated April 3, 2012 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.80**	Form of Kindred Healthcare, Inc. Restricted Share Award Agreement under the 2012 Equity Plan for Non-Employee Directors.
10.81**	Form of Kindred Healthcare, Inc. Non-Qualified Stock Option Grant Agreement under the 2012 Equity Plan for Non-Employee Directors.
10.82	Other Debt Instruments Copies of debt instruments for which the related debt is less than 10% of total assets will be furnished to the SEC upon request.
21	List of Subsidiaries.
23.1	Consent of Independent Registered Public Accounting Firm.
31	Rule 13a-14(a)/15d-14(a) Certifications.
32	Section 1350 Certifications.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

* The Company will furnish supplementally to the SEC upon request a copy of any omitted exhibit or annex.

** Compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 15(b) of this Annual Report on Form 10-K.

(b) Exhibits.

The response to this portion of Item 15 is submitted as a separate section of this Annual Report on Form 10-K.

(c) Financial Statement Schedules.

The response to this portion of Item 15 is included on page F-62 of this Annual Report on Form 10-K.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: February 28, 2013

KINDRED HEALTHCARE, INC.

By: /s/ Paul J. Diaz
Paul J. Diaz

Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Joel Ackerman **Joel Ackerman**	Director	February 28, 2013
/s/ Jonathan D. Blum **Jonathan D. Blum**	Director	February 28, 2013
/s/ Thomas P. Cooper, M.D. **Thomas P. Cooper, M.D.**	Director	February 28, 2013
/s/ Christopher T. Hjelm **Christopher T. Hjelm**	Director	February 28, 2013
/s/ Isaac Kaufman **Isaac Kaufman**	Director	February 28, 2013
/s/ Frederick J. Kleisner **Frederick J. Kleisner**	Director	February 28, 2013
/s/ Eddy J. Rogers, Jr. **Eddy J. Rogers, Jr.**	Director	February 28, 2013
John H. Short, Ph.D.	Director	
/s/ Phyllis R. Yale	Director	February 28, 2013

Phyllis R. Yale		
/s/ Edward L. Kuntz	Chairman of the Board	February 28, 2013
Edward L. Kuntz		
/s/ Paul J. Diaz	Director and Chief Executive Officer	February 28, 2013
Paul J. Diaz	(Principal Executive Officer)	

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Signature	Title	Date
/s/ Richard A. Lechleiter **Richard A. Lechleiter**	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	February 28, 2013
/s/ John J. Lucchese **John J. Lucchese**	Senior Vice President and Corporate Controller (Principal Accounting Officer)	February 28, 2013

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KINDRED HEALTHCARE, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

AND FINANCIAL STATEMENT SCHEDULES

(a) All other schedules have been omitted because the required information is not present or not present in material amounts.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

of Kindred Healthcare, Inc.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Kindred Healthcare, Inc. and its subsidiaries at December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Annual Report on Internal Control over Financial Reporting under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Louisville, Kentucky

February 28, 2013

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KINDRED HEALTHCARE, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

(In thousands, except per share amounts)

	Year ended December 31,		
	2012	2011	2010
Revenues	$ 6,181,291	$ 5,503,928	$ 4,346,984
Salaries, wages and benefits	3,672,475	3,243,603	2,497,293
Supplies	432,008	399,819	340,802
Rent	428,979	398,045	356,352
Other operating expenses	1,233,134	1,160,293	945,676
Other income	(10,812)	(11,191)	(11,422)
Impairment charges	110,856	118,202	
Depreciation and amortization	201,068	165,227	121,374
Interest expense	107,896	80,919	7,090
Investment income	(1,054)	(1,031)	(1,245)
	6,174,550	5,553,886	4,255,920
Income (loss) from continuing operations before income taxes	6,741	(49,958)	91,064
Provision (benefit) for income taxes	39,112	(1,905)	34,173
Income (loss) from continuing operations	(32,371)	(48,053)	56,891
Discontinued operations, net of income taxes:			
Income (loss) from operations	(2,208)	(5,666)	53
Loss on divestiture of operations	(4,745)		(453)
Loss from discontinued operations	(6,953)	(5,666)	(400)
Net income (loss)	(39,324)	(53,719)	56,491
(Earnings) loss attributable to noncontrolling interests	(1,043)	238	
Income (loss) attributable to Kindred	$ (40,367)	$ (53,481)	$ 56,491
Amounts attributable to Kindred stockholders:			
Income (loss) from continuing operations	$ (33,414)	$ (47,815)	$ 56,891
Loss from discontinued operations	(6,953)	(5,666)	(400)
Net income (loss)	$ (40,367)	$ (53,481)	$ 56,491
Earnings (loss) per common share:			
Basic:			
Income (loss) from continuing operations	$ (0.65)	$ (1.04)	$ 1.44
Discontinued operations:			
Income (loss) from operations	(0.04)	(0.12)	
Loss on divestiture of operations	(0.09)		(0.01)
Net income (loss)	$ (0.78)	$ (1.16)	$ 1.43
Diluted:			

Income (loss) from continuing operations	$	(0.65)	$	(1.04)	$	1.44
Discontinued operations:						
Income (loss) from operations		(0.04)		(0.12)		
Loss on divestiture of operations		(0.09)				(0.01)
Net income (loss)	$	(0.78)	$	(1.16)	$	1.43
Shares used in computing earnings (loss) per common share:						
Basic		51,659		46,280		38,738
Diluted		51,659		46,280		38,954

See accompanying notes.

KINDRED HEALTHCARE, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

	Year ended December 31,		
	2012	**2011**	**2010**
Net income (loss)	$ (39,324)	$ (53,719)	$ 56,491
Other comprehensive income (loss):			
Available-for-sale securities:			
Change in unrealized investment gains (losses)	1,383	(518)	1,602
Reclassification of (gains) losses realized in net income (loss)	(95)	40	288
Net change	1,288	(478)	1,890
Interest rate swaps:			
Change in unrealized loss	(1,834)	(815)	
Reclassification of losses realized in net income (loss), net of payments	206		
Net change	(1,628)	(815)	
Defined benefit post-retirement plan:			
Unrealized loss due to fair value adjustments	(590)	(1,301)	(1,091)
Income tax expense (benefit) related to items of other comprehensive income (loss)	517	990	(241)
Other comprehensive income (loss)	(413)	(1,604)	558
Comprehensive income (loss)	(39,737)	(55,323)	57,049
(Earnings) loss attributable to noncontrolling interests	(1,043)	238	
Comprehensive income (loss) attributable to Kindred	$ (40,780)	$ (55,085)	$ 57,049

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONSOLIDATED BALANCE SHEET

(In thousands, except per share amounts)

	December 31, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 50,007	$ 41,561
Cash restricted	5,197	5,551
Insurance subsidiary investments	86,168	70,425
Accounts receivable less allowance for loss of $23,959 2012 and $29,746 2011	1,038,605	994,700
Inventories	32,021	31,060
Deferred tax assets	12,663	17,785
Income taxes	13,573	39,513
Other	35,532	32,687
	1,273,766	1,233,282
Property and equipment, at cost:		
Land	93,178	71,286
Buildings	1,209,919	1,022,275
Equipment	900,136	807,871
Construction in progress	23,670	73,631
	2,226,903	1,975,063
Accumulated depreciation	(1,083,777)	(916,022)
	1,143,126	1,059,041
Goodwill	1,041,266	1,084,655
Intangible assets less accumulated amortization of $34,854 2012 and $16,581 2011	439,767	447,207
Assets held for sale	4,131	5,612
Insurance subsidiary investments	116,424	110,227
Other	219,466	198,469
Total assets	$ 4,237,946	$ 4,138,493
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 210,668	$ 216,801
Salaries, wages and other compensation	389,009	407,493
Due to third party payors	35,420	37,306
Professional liability risks	54,088	46,010
Other accrued liabilities	137,204	130,693
Long-term debt due within one year	8,942	10,620
	835,331	848,923
Long-term debt	1,648,706	1,531,882
Professional liability risks	236,630	217,717
Deferred tax liabilities	9,764	17,955
Deferred credits and other liabilities	214,671	191,771
Noncontrolling interests-redeemable		9,704
Commitments and contingencies		
Equity:		

Stockholders equity:		
Preferred stock, $0.25 par value; authorized 1,000 shares; none issued and outstanding		
Common stock, $0.25 par value; authorized 175,000 shares; issued 53,280 shares 2012 and 52,116 shares 2011	13,320	13,029
Capital in excess of par value	1,145,922	1,138,189
Accumulated other comprehensive loss	(1,882)	(1,469)
Retained earnings	98,799	139,172
	1,256,159	1,288,921
Noncontrolling interests-nonredeemable	36,685	31,620
Total equity	1,292,844	1,320,541
Total liabilities and equity	$ 4,237,946	$ 4,138,493

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONSOLIDATED STATEMENT OF EQUITY

(In thousands)

	Redeemable noncontrolling interests	Attributable to Kindred stockholders: Shares of common stock	Par value common stock	Capital in excess of par value	Accumulated other comprehensive income/(loss)	Retained earnings	Nonredeemable noncontrolling interests	Total
Balances, December 31, 2009	$	39,104	$ 9,776	$ 820,407	$ (423)	$ 136,834	$	$ 966,594
Comprehensive income:								
Net income						56,491		56,491
Net unrealized investment gains, net of income taxes					1,229			1,229
Other					(671)			(671)
Comprehensive income								57,049
Grant of non-vested restricted stock		425	106	(106)				
Issuance of common stock in connection with employee benefit plans		96	24	25				49
Shares tendered by employees for statutory tax withholdings upon issuance of common stock		(130)	(32)	(2,147)		(168)		(2,347)
Stock-based compensation amortization				10,714				10,714
Income tax provision in connection with the issuance of common stock under employee benefit plans				(300)				(300)
Balances, December 31, 2010		39,495	9,874	828,593	135	193,157		1,031,759
Acquired noncontrolling interests	23,869						23,990	23,990
Comprehensive income (loss):								
Net income (loss)	424					(53,481)	(662)	(54,143)
Net unrealized investment losses, net of income taxes					(311)			(311)
Other					(1,293)			(1,293)
Comprehensive income (loss)	424							(55,747)
Grant of non-vested restricted stock		374	93	(93)				
Issuance of common stock in connection with employee benefit plans		415	104	3,030		(115)		3,019
Shares tendered by employees for statutory tax withholdings upon issuance of common stock		(156)	(39)	(2,983)		(389)		(3,411)
Stock-based compensation amortization				12,819				12,819
Income tax benefit in connection with the issuance of common stock under employee benefit plans				389				389
		11,988	2,997	297,429				300,426

Shares issued in connection with the RehabCare Merger								
Purchase of noncontrolling interests				(995)			(6,297)	(7,292)
Reclassification of noncontrolling interests	(14,589)						14,589	14,589
Balances, December 31, 2011	9,704	52,116	13,029	1,138,189	(1,469)	139,172	31,620	1,320,541
Comprehensive income (loss):								
Net income (loss)	140					(40,367)	903	(39,464)
Net unrealized investment gains, net of income taxes					837			837
Other					(1,250)			(1,250)
Comprehensive income (loss)	140							(39,877)
Grant of non-vested restricted stock		1,079	270	(270)				
Issuance of common stock in connection with employee benefit plans		248	62	85				147
Shares tendered by employees for statutory tax withholdings upon issuance of common stock		(163)	(41)	(1,863)		(6)		(1,910)
Stock-based compensation amortization				10,852				10,852
Income tax provision in connection with the issuance of common stock under employee benefit plans				(2,405)				(2,405)
Contributions made by noncontrolling interests							200	200
Distributions to noncontrolling interests	(571)						(3,258)	(3,258)
Purchase of noncontrolling interests	(2,031)			1,334			(22)	1,312
Reclassification of noncontrolling interests	(7,242)						7,242	7,242
Balances, December 31, 2012	$	53,280	$ 13,320	$ 1,145,922	$ (1,882)	$ 98,799	$ 36,685	$ 1,292,844

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(In thousands)

	Year ended December 31,		
	2012	2011	2010
Cash flows from operating activities:			
Net income (loss)	$ (39,324)	$ (53,719)	$ 56,491
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	201,484	165,594	121,552
Amortization of stock-based compensation costs	10,852	12,819	10,714
Amortization of deferred financing costs	9,683	7,581	1,975
Payment of lender fees related to debt issuance	(2,940)	(46,232)	
Provision for doubtful accounts	23,692	35,133	24,397
Deferred income taxes	(11,524)	195	21,446
Impairment charges	110,856	129,281	
Loss on divestiture of discontinued operations	4,745		453
Other	1,772	(2,063)	(1,723)
Change in operating assets and liabilities:			
Accounts receivable	(58,705)	(144,830)	(45,232)
Inventories and other assets	(29,382)	(802)	(14,294)
Accounts payable	(6,515)	685	9,446
Income taxes	29,991	(4,745)	3,462
Due to third party payors	(2,723)	568	1,213
Other accrued liabilities	20,600	54,241	20,088
Net cash provided by operating activities	262,562	153,706	209,988
Cash flows from investing activities:			
Routine capital expenditures	(115,175)	(132,903)	(108,896)
Development capital expenditures	(50,322)	(87,655)	(67,841)
Acquisitions, net of cash acquired	(178,212)	(715,458)	(279,794)
Sale of assets	1,260	1,714	649
Purchase of insurance subsidiary investments	(38,041)	(35,623)	(43,913)
Sale of insurance subsidiary investments	38,363	46,307	82,736
Net change in insurance subsidiary cash and cash equivalents	(21,285)	(14,213)	(8,521)
Change in other investments	1,465	1,003	2
Other	(539)	(512)	962
Net cash used in investing activities	(362,486)	(937,340)	(424,616)
Cash flows from financing activities:			
Proceeds from borrowings under revolving credit	1,784,300	2,126,800	2,030,800
Repayment of borrowings under revolving credit	(1,757,100)	(2,198,300)	(1,812,800)
Proceeds from issuance of senior unsecured notes		550,000	
Proceeds from issuance of term loan, net of discount	97,500	693,000	
Repayment of other long-term debt	(10,664)	(350,878)	(86)
Payment of deferred financing costs	(1,465)	(9,098)	(2,831)
Contribution made by noncontrolling interests	200		
Distribution made to noncontrolling interests	(3,829)		
Purchase of noncontrolling interests	(719)	(7,292)	
Issuance of common stock	147	3,019	49
Other		776	361
Net cash provided by financing activities	108,370	808,027	215,493
Change in cash and cash equivalents	8,446	24,393	865

Cash and cash equivalents at beginning of period		41,561		17,168		16,303
Cash and cash equivalents at end of period	$	50,007	$	41,561	$	17,168
Supplemental information:						
Interest payments	$	95,638	$	47,552	$	5,261
Income tax payments		20,705		1,611		11,961
Rental payments to Ventas, Inc.		260,332		253,332		246,392
Issuance of common stock in RehabCare Merger (see Note 2)				300,426		
Financing costs paid in connection with RehabCare Merger (see Note 2)				13,074		

See accompanying notes.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 ACCOUNTING POLICIES

Reporting entity

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates transitional care (TC) hospitals, inpatient rehabilitation hospitals (IRFs), nursing and rehabilitation centers, assisted living facilities, a contract rehabilitation services business and a home health and hospice business across the United States (collectively, Kindred or the Company).

Basis of presentation

The consolidated financial statements include all subsidiaries. All intercompany transactions have been eliminated. Investments in affiliates in which the Company has a 50% or less interest are accounted for by the equity method.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing and rehabilitation centers to improve its future operating results. For accounting purposes, the operating results of these businesses and the losses or impairments associated with these transactions have been classified as discontinued operations in the accompanying consolidated statement of operations for all periods presented. Assets not sold at December 31, 2012 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying consolidated balance sheet. See Note 4.

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

Recently issued accounting requirements

In July 2012, the Financial Accounting Standards Board (the FASB) issued authoritative guidance related to testing indefinite-lived intangible assets for impairment. The main provisions of the guidance state that an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If an entity determines it is not more likely than not that the fair value of an indefinite-lived intangible is less than its carrying amount, then performing the one-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the indefinite-lived intangible asset impairment test. The guidance is effective for all interim and annual reporting periods beginning after September 15, 2012. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In September 2011, the FASB issued authoritative guidance related to testing goodwill for impairment. The main provisions of the guidance state that an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step goodwill impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform Step 1 of the goodwill impairment test. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Recently issued accounting requirements (Continued)

In July 2011, the FASB issued authoritative guidance related to the presentation and disclosure of patient service revenue, provision for bad debts, and the allowance for doubtful accounts for certain healthcare entities. The provisions of the guidance require healthcare entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not assess a patient s ability to pay, to present the provision for bad debts related to those revenues as a deduction from patient service revenue (net of contractual allowances and discounts), as opposed to an operating expense. All other entities would continue to present the provision for bad debts as an operating expense. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have an impact on the Company s business, financial position, results of operations or liquidity.

In June 2011, the FASB issued authoritative guidance related to the presentation of other comprehensive income. The provisions of the guidance state that an entity has the option to present total comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The statement(s) should be presented with equal prominence to the other primary financial statements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In December 2011, the FASB amended its authoritative guidance issued in June 2011 related to the presentation of other comprehensive income. The provisions indefinitely defer the requirement to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented, for both interim and annual financial statements. All other requirements of the June 2011 update were not impacted by the amendment which remains effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In February 2013, the FASB amended its authoritative guidance issued in December 2011 related to the deferral of the requirement to present reclassification adjustments out of accumulated other comprehensive income in both the statement in which net income is presented and the statement in which other comprehensive income is presented. The amended provisions require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under United States generally accepted accounting principles to be reclassified to net income in its entirety in the same reporting period. For all other amounts, an entity is required to cross-reference to other disclosures that provide additional details about these amounts. All other requirements of the original June 2011 update were not impacted by the amendment which remains effective for all interim and annual reporting periods beginning after December 15, 2012. The adoption of the guidance will not have a material impact on the Company s business, financial position, results of operations or liquidity.

In May 2011, the FASB issued authoritative guidance related to fair value measurements. The provisions of the guidance result in applying common fair value measurement and disclosure requirements in both United States generally accepted accounting principles and International Financial Reporting Standards. The amendments primarily changed the wording used to describe many of the requirements in generally accepted accounting principles for measuring and disclosing information about fair value measurements. The guidance is

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Recently issued accounting requirements (Continued)

effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

Reclassifications

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

Revenues

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

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

	Year ended December 31,		
	2012	2011	2010
Medicare	$ 2,602,488	$ 2,389,331	$ 1,876,599
Medicaid	1,067,863	1,062,518	1,054,669
Medicare Advantage	463,912	413,793	344,334
Other	2,388,345	1,956,623	1,376,976
	6,522,608	5,822,265	4,652,578
Eliminations	(341,317)	(318,337)	(305,594)
	$ 6,181,291	$ 5,503,928	$ 4,346,984

Cash and cash equivalents

Cash and cash equivalents include highly liquid investments with an original maturity of three months or less when purchased.

Insurance subsidiary investments

The Company maintains investments for the payment of claims and expenses related to professional liability and workers compensation risks. These investments have been categorized as available-for-sale and are reported at fair value. The fair value of publicly traded debt and equity securities and money market funds are based upon quoted market prices or observable inputs such as interest rates using either a market or income valuation approach. Since the Company s insurance subsidiary investments are restricted for a limited purpose, they are classified in the accompanying consolidated balance sheet based upon the expected current and long-term cash requirements of the limited purpose insurance subsidiary.

The Company follows the authoritative guidance related to the meaning of other-than-temporary impairment and its application to certain investments to assess whether the Company s investments with unrealized loss positions are other-than-temporarily impaired.

Unrealized gains and losses, net of deferred income taxes, are

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Insurance subsidiary investments (Continued)

reported as a component of accumulated other comprehensive income (loss). Realized gains and losses and declines in value judged to be other-than-temporary are determined using the specific identification method and are reported in the Company s statement of operations. See Note 9.

Accounts receivable

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

In evaluating the collectibility of accounts receivable, the Company considers a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with third party payors and general industry conditions. Actual collections of accounts receivable in subsequent periods may require changes in the estimated provision for loss. Changes in these estimates are charged or credited to the results of operations in the period of change. Based upon improved cash collections in the Company s rehabilitation division, the Company recognized a change in estimate that reduced the provision for doubtful accounts by $8.4 million in the fourth quarter of 2012.

The provision for doubtful accounts totaled $23.7 million for 2012, $35.3 million for 2011 and $24.2 million for 2010.

Due to third party payors

The Company s hospitals and nursing and rehabilitation centers are required to submit cost reports at least annually to various state and federal agencies administering the respective reimbursement programs. In many instances, interim cash payments to the Company are only an estimate of the amount due for services provided. Any overpayment to the Company arising from the completion of a cost report is recorded as a liability.

Inventories

Inventories consist primarily of pharmaceutical and medical supplies and are stated at the lower of cost (first-in, first-out) or market.

Property and equipment

Property and equipment is carried at cost less accumulated depreciation. Depreciation expense, computed by the straight-line method, was $179.1 million for 2012, $151.8 million for 2011 and $120.1 million for 2010. These amounts include amortization of assets recorded under capital leases. Depreciation rates for buildings range generally from 20 to 45 years. Leasehold improvements are depreciated over their estimated useful lives or the remaining lease term, whichever is shorter. Estimated useful lives of equipment vary from five to 15 years. Depreciation expense is not recorded for property and equipment classified as held for sale.

Interest costs incurred during the construction of the Company s development projects are capitalized. Capitalized interest for the years ended December 31, 2012, 2011 and 2010 was $2.4 million, $1.5 million and $1.3 million, respectively. Repairs and maintenance are expensed as incurred.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Property and equipment (Continued)

The Company separates capital expenditures into two categories, routine and development, in the accompanying consolidated statement of cash flows. Purchases of routine property and equipment include expenditures at existing facilities that generally do not result in increased capacity or the expansion of services. Development capital expenditures include expenditures for the development of new facilities or the expansion of services or capacity at existing facilities.

Long-lived assets

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

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

On July 29, 2011, the Centers for Medicare and Medicaid Services (CMS) issued final rules which, among other things, significantly reduced Medicare payments to nursing centers and changed the reimbursement for the provision of group rehabilitation therapy services to Medicare beneficiaries beginning October 1, 2011 (the 2011 CMS Rules). In connection with the preparation of the Company s operating results for the third quarter of 2011, the Company determined that the impact of the 2011 CMS Rules was a triggering event in the third quarter of 2011 and accordingly tested the recoverability of nursing and rehabilitation center property and equipment asset groups impacted by the reduced Medicare payments. The Company recorded pretax impairment charges aggregating \$20.6 million (\$12.7 million net of income taxes) in the third quarter of 2011 to reflect the amount by which the carrying value of certain assets exceeded their estimated fair value. In addition, the Company recorded pretax impairment charges aggregating \$2.2 million (\$1.3 million net of income taxes) and \$3.0 million (\$1.8 million net of income taxes) in the fourth quarter of 2011 and the year ended December 31, 2012, respectively, of property and equipment expended in the same nursing and rehabilitation center asset groups. The impairment charges did not impact the Company s cash flows or liquidity.

Goodwill and intangible assets

Goodwill and indefinite-lived intangible assets primarily originated from business combinations accounted for as purchase transactions. Indefinite-lived intangible assets consist of trade names, Medicare certifications and certificates of need.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Goodwill and intangible assets (Continued)

A summary of goodwill by reporting unit follows (in thousands):

	Hospitals	Nursing and rehabilitation centers	Skilled nursing rehabilitation services	Hospital rehabilitation services	Home health	Hospice	Total
Balances, December 31, 2010	$ 213,200	$ 6,080	$ 3,363	$	$ 11,383	$ 8,394	$ 242,420
Acquisitions	531,968		149,662	167,753	37,871	6,817	894,071
Impairment charges		(6,080)	(45,999)				(52,079)
Other	243						243
Balances, December 31, 2011	745,411		107,026	167,753	49,254	15,211	1,084,655
Acquisitions					49,757	11,577	61,334
Impairment charges			(107,899)				(107,899)
Other	1,654		873	266	306	77	3,176
Balances, December 31, 2012	$ 747,065	$	$	$ 168,019	$ 99,317	$ 26,865	$ 1,041,266
Accumulated impairment charges:							
December 31, 2011	$	$ (6,080)	$ (45,999)	$	$	$	$ (52,079)
December 31, 2012	$	$ (6,080)	$ (153,898)	$	$	$	$ (159,978)

In accordance with the authoritative guidance for goodwill and other intangible assets, the Company is required to perform an impairment test for goodwill and indefinite-lived intangible assets at least annually or more frequently if adverse events or changes in circumstances indicate that the asset may be impaired.

The Company performs its annual goodwill impairment test at the end of each fiscal year for each of its reporting units. A reporting unit is either an operating segment or one level below the operating segment, referred to as a component. When the components within the Company s operating segments have similar economic characteristics, the Company aggregates the components of its operating segments into one reporting unit. Accordingly, the Company has determined that its reporting units are hospitals, nursing and rehabilitation centers, skilled nursing rehabilitation services, hospital rehabilitation services, home health and hospice.

In connection with the preparation of the Company s operating results for the fourth quarter of 2012, the Company determined that the impact of regulatory changes related to the Company s skilled nursing rehabilitation services reporting unit was a triggering event in the fourth quarter of 2012, simultaneously with the Company s annual impairment test. The regulatory changes included a new pre-payment manual medical review process for certain Medicare Part B services exceeding $3,700 which became effective October 1, 2012 and new rules which will become effective April 1, 2013 under the American Taxpayer Relief Act of 2012 (the Taxpayer Relief Act) that reduce Medicare Part B payments by 50% for subsequent procedures when multiple therapy services are provided on the same day. The Company tested the recoverability of its skilled nursing rehabilitation services reporting unit goodwill, other intangible assets and long-lived assets. The Company recorded a pretax impairment charge aggregating $107.9 million ($101.6 million net of income taxes) (which represented the entire skilled nursing rehabilitation services reporting unit goodwill) in the fourth quarter of 2012 to reflect the amount by which the carrying value of goodwill exceeded the estimated fair value. The Company determined that other intangible assets and long-lived assets in the skilled nursing rehabilitation services reporting unit were not impaired.

In connection with the preparation of the Company s operating results for the third quarter of 2011, the Company determined that the impact of the 2011 CMS Rules was a triggering event in the third quarter of 2011

KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Goodwill and intangible assets (Continued)

and accordingly tested the recoverability of its nursing and rehabilitation centers reporting unit goodwill and indefinite-lived intangible assets impacted by the reduced Medicare payments. The Company recorded a pretax impairment charge aggregating $6.1 million ($3.7 million net of income taxes) (which represented the entire nursing and rehabilitation centers reporting unit goodwill) in the third quarter of 2011 to reflect the amount by which the carrying value of certain assets exceeded their estimated fair value.

During the fourth quarter of 2011, the estimated negative impact from changes in the reimbursement of group rehabilitation therapy services to Medicare beneficiaries implemented by the 2011 CMS Rules on October 1, 2011 was greater than expected, and as a result, the Company lowered its cash flow expectations for its skilled nursing rehabilitation services reporting unit, causing the carrying value of goodwill of this reporting unit to exceed its estimated fair value in testing the recoverability of goodwill. As a result, the Company recorded a pretax impairment charge of $46.0 million ($42.6 million net of income taxes) in the fourth quarter of 2011. The Company also reviewed the other intangible assets and long-lived assets related to the skilled nursing rehabilitation services reporting unit and determined there were no impairments of these assets.

None of the previously discussed impairment charges impacted the Company s cash flows or liquidity.

The goodwill impairment test involves a two-step process. The first step is a comparison of each reporting unit s fair value to its carrying value. If the carrying value of the reporting unit is greater than its fair value, there is an indication that impairment may exist and the second step must be performed to measure the amount of impairment loss, if any. Based upon the results of the step one impairment test for goodwill for hospitals, hospital rehabilitation services, home health and hospice reporting units for the years ended December 31, 2012 and December 31, 2011, no goodwill impairment charges were recorded in connection with the Company s annual impairment test. Based upon the results of the step one impairment test for goodwill for all of the Company s reporting units for the year ended December 31, 2010, no impairment charges were recorded.

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

Other than the impairment of goodwill for the Company s skilled nursing rehabilitation services reporting unit, the Company has determined that there was no other goodwill or other intangible asset impairments as of December 31, 2012. Although, adverse changes in the operating environment and related key assumptions used to determine the fair value of the Company s reporting units and indefinite-lived intangible assets or declines in

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Goodwill and intangible assets (Continued)

the value of the Company s common stock may result in future impairment charges for a portion or all of these assets. Specifically, if the rate of growth of government and commercial revenues earned by the Company s reporting units were to be less than projected or if healthcare reforms were to negatively impact the Company s business, an impairment charge of a portion or all of these assets may be required. An impairment charge could have a material adverse effect on the Company s business, financial position and results of operations, but would not be expected to have an impact on the Company s cash flows or liquidity.

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

At December 31, 2011, the carrying value of the Company s certificates of need intangible assets exceeded its fair value as a result of declining earnings and cash flows related to five hospitals and two co-located nursing and rehabilitation centers in Massachusetts, all of which were acquired in 2006. The declining earnings and cash flows are attributable to a difficult long-term acute care operating environment in Massachusetts in which the Company has been unable to achieve consistent operating results, as well as automatic future Medicare reimbursement reductions triggered in December 2011 by the Budget Control Act of 2011. In addition, the Company decided in the fourth quarter of 2011 to close one of the five hospitals. The pretax impairment charge related to the certificates of need totaled $54.4 million ($33.3 million net of income taxes), of which $11.1 million ($6.8 million net of income taxes) was reclassified to discontinued operations in 2012. The Company reviewed the other long-lived assets related to these five hospitals and two co-located nursing and rehabilitation centers and determined there was no impairment. Based upon the results of the annual impairment test for indefinite-lived intangible assets other than certificates of need intangible assets discussed above for the years ended December 31, 2012, 2011 and 2010, no impairment charges were recorded.

The Company s intangible assets include both finite and indefinite-lived intangible assets. The Company s intangible assets with finite lives are amortized in accordance with the authoritative guidance for goodwill and other intangible assets using the straight-line method over their estimated useful lives ranging from two to 20 years.

Amortization expense computed by the straight-line method totaled $22.0 million for 2012, $13.4 million for 2011 and $1.3 million for 2010.

The estimated annual amortization expense for the next five years for intangible assets at December 31, 2012 follows (in thousands):

2013	$ 21,909
2014	20,382
2015	19,194
2016	16,682
2017	14,509

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Goodwill and intangible assets (Continued)

A summary of intangible assets at December 31 follows (in thousands):

	2012				2011			
	Cost	Accumulated amortization	Carrying value	Weighted average life	Cost	Accumulated amortization	Carrying value	Weighted average life
Current:								
Employment contracts	$	$	$		$ 1,166	$ (1,081)	$ 85	1 year
Non-current:								
Trade names (indefinite life)	115,400		115,400		115,400		115,400	
Medicare certifications (indefinite life)	107,487		107,487		100,819		100,819	
Certificates of need (indefinite life)	19,704		19,704		19,987		19,987	
Non-compete agreements	6,985	(3,921)	3,064	3 years	8,093	(4,203)	3,890	3 years
Leasehold interests	1,100	(661)	439	4 years	1,100	(356)	744	4 years
Trade names	24,705	(6,664)	18,041	7 years	22,905	(2,700)	20,205	7 years
Customer relationship assets	199,240	(23,608)	175,632	14 years	195,484	(9,322)	186,162	14 years
	474,621	(34,854)	439,767		463,788	(16,581)	447,207	
	$ 474,621	$ (34,854)	$ 439,767		$ 464,954	$ (17,662)	$ 447,292	

Insurance risks

Provisions for loss for professional liability risks and workers compensation risks are based upon management s best available information including actuarially determined estimates. The provisions for loss related to professional liability risks retained by the Company s wholly owned limited purpose insurance subsidiary are discounted based upon actuarial estimates of claim payment patterns. Provisions for loss related to workers compensation risks retained by the Company s limited purpose insurance subsidiary are not discounted. To the extent that expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited. See Notes 4 and 8.

Earnings per common share

Earnings per common share are based upon the weighted average number of common shares outstanding during the respective periods. The diluted calculation of earnings per common share includes the dilutive effect of stock options and performance-based restricted shares. The Company follows the provisions of the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities for purposes of calculating earnings per common share. See Note 5.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1 ACCOUNTING POLICIES (Continued)

Derivative financial instruments

In December 2011, the Company entered into two interest rate swap agreements to hedge its floating interest rate risk. The Company accounts for derivative financial instruments in accordance with the authoritative guidance for derivatives and hedging. These derivative financial instruments are recognized as liabilities in the accompanying consolidated balance sheet and are measured at fair value. The Company s derivatives are designated as cash flow hedges. See Note 16.

The interest rate swaps were assessed for hedge effectiveness for accounting purposes at inception and the Company determined the interest rate swaps continue to be effective cash flow hedges at December 31, 2012. The Company records the effective portion of the gain or loss on the derivative financial instrument in accumulated other comprehensive income (loss) as a component of stockholders equity. Any hedge ineffectiveness will be recognized in earnings as a component of interest expense. See Note 11.

Stock option accounting

The Company recognizes compensation expense in its consolidated financial statements using a Black-Scholes option valuation model for non-vested stock options. See Note 13.

Other information

The Company has performed an evaluation of subsequent events through the date on which the financial statements were issued.

NOTE 2 REHABCARE ACQUISITION

On June 1, 2011, the Company completed the acquisition of RehabCare Group, Inc. and its subsidiaries (RehabCare) (the RehabCare Merger). Upon consummation of the RehabCare Merger, each issued and outstanding share of RehabCare common stock was converted into the right to receive 0.471 of a share of Kindred common stock and $26 per share in cash, without interest (the Merger Consideration). Kindred issued approximately 12 million shares of its common stock in connection with the RehabCare Merger. The purchase price totaled $962.8 million and was comprised of $662.4 million in cash and $300.4 million of Kindred common stock at fair value. The Company also assumed $355.7 million of long-term debt in the RehabCare Merger, of which $345.4 million was refinanced on June 1, 2011. The operating results of RehabCare have been included in the accompanying consolidated financial statements of the Company since June 1, 2011.

At the RehabCare Merger date, the Company acquired 32 TC hospitals, five IRFs, approximately 1,200 rehabilitation therapy sites of service and 102 hospital-based inpatient rehabilitation units.

Operating results for 2011 included transaction costs totaling $31.3 million, financing costs totaling $13.8 million, severance costs totaling $16.8 million and a lease cancellation charge totaling $1.8 million related to the RehabCare Merger. In the accompanying consolidated statement of operations, transaction costs were included in other operating expenses, financing costs were included in interest expense, severance costs were included in salaries, wages and benefits and the lease cancellation charge was included in rent expense.

The Company recorded a $107.9 million goodwill impairment charge in its skilled nursing rehabilitation services reporting unit in 2012 related to Medicare Part B regulatory changes that became effective on October 1, 2012 and the Taxpayer Relief Act that will become effective on April 1, 2013. The Company also recorded a

KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 2 REHABCARE ACQUISITION (Continued)

$46.0 million goodwill impairment charge in its skilled nursing rehabilitation services reporting unit in 2011 related to the 2011 CMS Rules that became effective on October 1, 2011. The total amount of goodwill in the skilled nursing rehabilitation services reporting unit prior to the impairment charges was $153.9 million, substantially all of which was recorded in connection with the RehabCare Merger. See Note 1.

In connection with the RehabCare Merger, the Company entered into a new $650 million senior secured asset-based revolving credit facility (the ABL Facility) and a new $700 million senior secured term loan facility (the Term Loan Facility) (collectively, the Credit Facilities). The Company also completed the private placement of $550 million of senior notes due 2019 (the Notes). In 2011, the Company used proceeds from the Credit Facilities and the Notes to pay the Merger Consideration, repay all amounts outstanding under the Company s and RehabCare s previous credit facilities and pay transaction costs. The amounts outstanding under the Company s and RehabCare s former credit facilities that were repaid at the RehabCare Merger closing were $390.0 million and $345.4 million, respectively. The Credit Facilities also included an option to increase the credit capacity in an aggregate amount between the two facilities by $200 million. The Company executed this option to increase the capacity by $200 million in October 2012. See Note 11.

In connection with the Credit Facilities and the Notes, the Company paid $46.2 million of lender fees related to debt issuance that were capitalized as deferred financing costs during 2011 and paid $13.1 million of other financing costs that were charged to interest expense during 2011.

Purchase price allocation

The RehabCare Merger purchase price of $962.8 million was allocated based upon the estimated fair value of the tangible and intangible assets, and goodwill.

The following is the RehabCare Merger purchase price allocation (in thousands):

Cash and cash equivalents	$ 19,932
Accounts receivable	241,358
Deferred income taxes and other current assets	48,472
Property and equipment	114,079
Identifiable intangible assets:	
Customer relationships	188,900
Trade names (indefinite life)	115,400
Medicare certifications (indefinite life)	75,900
Trade name	16,600
Certificates of need (indefinite life)	7,900
Non-compete agreements	2,800
Total identifiable intangible assets	407,500
Other assets	11,023
Accounts payable and other current liabilities	(171,919)
Long-term debt, including amounts due within one year	(355,650)
Deferred income taxes and other liabilities	(157,016)
Noncontrolling interests redeemable	(23,869)
Noncontrolling interests nonredeemable	(23,990)

Total identifiable net assets	109,920
Goodwill	852,888
Net assets	$ 962,808

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 2 REHABCARE ACQUISITION (Continued)

Purchase price allocation (Continued)

The fair value allocation was measured primarily using a discounted cash flow methodology, which is considered a Level 3 input (as described in Note 16).

The value of gross contractual accounts receivable before determining uncollectable amounts totaled $257.8 million. Accounts estimated to be uncollectable totaled $16.4 million.

The weighted average life of the definite lived intangible assets consisting primarily of customer relationships is 13 years.

The aggregate goodwill arising from the RehabCare Merger was based upon the expected future cash flows of the RehabCare operations, which reflect both growth expectations and cost savings from combining the operations of the Company and RehabCare. Goodwill is not amortized and is not deductible for income tax purposes. Goodwill, before any subsequent impairment charges, was assigned to the Company s hospital reporting unit ($534.4 million), skilled nursing rehabilitation services reporting unit ($150.5 million) and hospital rehabilitation services reporting unit ($168.0 million).

The valuation technique used to measure the value of the noncontrolling interests was an average of the implied equity value of the noncontrolling interests based upon the Merger Consideration and market multiple methodologies. Redeemable noncontrolling interests as of December 31, 2011 represented the minority ownership interests containing put rights in connection with the RehabCare Merger. These redeemable noncontrolling interests were either purchased or reclassified to nonredeemable noncontrolling interests during 2012.

Pro forma information

The unaudited pro forma net effect of the RehabCare Merger assuming the acquisition occurred as of January 1, 2010 is as follows (in thousands, except per share amounts):

	Year ended December 31,	
	2011	**2010**
Revenues	$ 6,102,251	$ 5,658,118
Income from continuing operations attributable to Kindred	10,227	7,919
Income attributable to Kindred	7,807	9,647
Earnings per common share:		
Basic:		
Income from continuing operations	$ 0.20	$ 0.16
Net income	$ 0.15	$ 0.19
Diluted:		
Income from continuing operations	$ 0.20	$ 0.16
Net income	$ 0.15	$ 0.19

The unaudited pro forma financial data have been derived by combining the historical financial results of the Company and the operations acquired in the RehabCare Merger for the periods presented. The unaudited pro forma financial data includes transaction, financing and severance costs and a lease cancellation charge totaling $86.5 million incurred by both the Company and RehabCare in connection with the RehabCare Merger. These costs have been eliminated from the results of operations for 2011 and have been reflected as expenses incurred

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 2 REHABCARE ACQUISITION (Continued)

Pro forma information (Continued)

as of January 1, 2010 for purposes of the pro forma financial presentation. Revenues and earnings before interest, income taxes, impairment charges and transaction-related costs associated with RehabCare aggregated $1.4 billion and $134.5 million, respectively, for the year ended December 31, 2012 and aggregated $793.1 million and $61.5 million, respectively, from the date of the RehabCare Merger through December 31, 2011.

NOTE 3 OTHER ACQUISITIONS

The following is a summary of the Company s other significant acquisition activities. The operating results of the acquired businesses have been included in the accompanying consolidated financial statements of the Company from the respective acquisition dates. The purchase price of the acquired businesses and acquired leased facilities resulted from negotiations with each of the sellers that were based upon both the historical and expected future cash flows of the respective businesses and real estate values. All of these acquisitions were financed through operating cash flows or borrowings under the Company s revolving credit facility. Unaudited pro forma operating results are provided only for acquired businesses that are material to the Company s consolidated financial statements.

Vista Acquisition

In November 2010, the Company acquired five TC hospitals from Vista Healthcare, LLC (Vista) for a purchase price of $179.0 million in cash (the Vista Acquisition). The Vista Acquisition included four freestanding hospitals and one hospital-in-hospital with a total of 250 beds, all of which are located in southern California. The Company did not acquire the working capital of Vista or assume any of its liabilities. All of the Vista hospitals were leased at the time of the acquisition.

Vista s results of operations have been included in the Company s consolidated financial statements since November 1, 2010. Revenues and earnings before interest and income taxes aggregated $163.7 million and $32.7 million for the year ended December 31, 2012, respectively, aggregated $154.9 million and $25.3 million for the year ended December 31, 2011, respectively, and aggregated $24.3 million and $1.5 million for the year ended December 31, 2010, respectively. Vista s operations have been included in the hospital division business segment.

The unaudited pro forma net effect of the Vista Acquisition assuming the acquisition occurred as of January 1, 2010 is as follows (in thousands except per share amounts):

	Year ended December 31, 2010
Revenues	$ 4,476,379
Income from continuing operations attributable to Kindred	66,940
Income attributable to Kindred	66,540
Earnings per common share:	
Basic:	
Income from continuing operations	$ 1.70
Net income	$ 1.69
Diluted:	
Income from continuing operations	$ 1.69
Net income	$ 1.68

The unaudited pro forma financial data has been derived by combining the historical financial results of the Company and the operations acquired in the Vista Acquisition for the period presented.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3 OTHER ACQUISITIONS (Continued)

Other acquisitions

The following is a summary of the Company s other acquisition activities. Unaudited pro forma financial data related to the acquired businesses have not been presented because the acquisitions are not material, either individually or in the aggregate, to the Company s consolidated financial statements.

	Allocation of purchase price						
Acquisitions	**Accounts receivable**	**Property and equipment**	**Goodwill**	**Identifiable intangible assets**	**Other assets**	**Deferred income taxes and other liabilities**	**Total cash purchase price**
Year ended December 31, 2012:							
Home health and hospice acquisitions	$ 10,867	$ 1,420	$ 61,334	$ 18,475	$ 1,125	$ 18,412	$ 74,809
Acquisition of previously leased real estate		103,403					103,403
	$ 10,867	$ 104,823	$ 61,334	$ 18,475	$ 1,125	$ 18,412	$ 178,212
Year ended December 31, 2011:							
Home health and hospice acquisitions	$ 10,249	$ 981	$ 44,688	$ 13,813	$ 1,444	$ 6,444	$ 64,731
Acquisition of previously leased real estate		8,027					8,027
Other				250			250
	$ 10,249	$ 9,008	$ 44,688	$ 14,063	$ 1,444	$ 6,444	$ 73,008
Year ended December 31, 2010:							
Home health acquisition	$	$ 62	$ 11,383	$ 1,430	$ 19	$	$ 12,894
Nursing and rehabilitation centers		44,667	5,191	4,740	102	368	54,332
Acquisition of previously leased real estate		31,066					31,066
Other				2,491			2,491
	$	$ 75,795	$ 16,574	$ 8,661	$ 121	$ 368	$ 100,783

The fair value of each of the acquisitions noted above was measured primarily using discounted cash flow methodologies which are considered Level 3 inputs (as described in Note 16).

For the three years ended December 31, 2012, the Company incurred $2.2 million, $50.7 million (including the RehabCare Merger transaction and severance costs discussed previously) and $4.6 million, respectively, in transaction costs. These costs were charged to operating expenses for the periods incurred.

NOTE 4 DISCONTINUED OPERATIONS

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestiture of certain unprofitable businesses discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the losses or

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 4 DISCONTINUED OPERATIONS (Continued)

impairments related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying consolidated statement of operations. At December 31, 2012, the Company held for sale two hospitals reported as discontinued operations.

Discontinued operations included favorable pretax adjustments of $1.5 million ($0.9 million net of income taxes) in 2012, $3.2 million ($2.0 million net of income taxes) in 2011 and $5.1 million ($3.1 million net of income taxes) in 2010 resulting from changes in estimates for professional liability reserves related to prior years.

During 2012, the Company sold one TC hospital and closed two additional TC hospitals, each reported as discontinued operations, resulting in loss on divestiture of $7.8 million ($4.7 million net of income taxes).

A summary of discontinued operations follows (in thousands):

	Year ended December 31,		
	2012	2011	2010
Revenues	$ 9,408	$ 20,078	$ 27,090
Salaries, wages and benefits	7,078	11,788	18,290
Supplies	1,258	2,195	2,168
Rent	833	1,328	1,152
Other operating expenses	3,459	2,571	5,241
Impairment charges		11,079	
Depreciation	416	367	178
Interest expense			1
Investment income	(2)		(27)
	13,042	29,328	27,003
Income (loss) from operations before income taxes	(3,634)	(9,250)	87
Provision (benefit) for income taxes	(1,426)	(3,584)	34
Income (loss) from operations	(2,208)	(5,666)	53
Loss on divestiture of operations, net of income taxes	(4,745)		(453)
	$ (6,953)	$ (5,666)	$ (400)

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

	Year ended December 31,		
	2012	2011	2010
Revenues:			
Hospital division	$ 9,044	$ 19,360	$ 13,764
Nursing center division	364	718	13,326

	$ 9,408	$ 20,078	$ 27,090
Operating income (loss):			
Hospital division	$ (3,826)	$ (1,036)	$ (1,151)
Nursing center division	1,439	4,560	2,542
	$ (2,387)	$ 3,524	$ 1,391

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 4 DISCONTINUED OPERATIONS (Continued)

	Year ended December 31,		
	2012	2011	2010
Rent:			
Hospital division	$ 832	$ 1,328	$ 1,141
Nursing center division	1		11
	$ 833	$ 1,328	$ 1,152
Depreciation:			
Hospital division	$ 416	$ 367	$ 178
Nursing center division			
	$ 416	$ 367	$ 178

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

	December 31,	
	2012	2011
Long-term assets:		
Property and equipment, net	$ 4,126	$ 5,607
Other	5	5
	4,131	5,612
Current liabilities (included in other accrued liabilities)		(118)
	$ 4,131	$ 5,494

NOTE 5 EARNINGS (LOSS) PER SHARE

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 5 EARNINGS (LOSS) PER SHARE (Continued)

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

	Year ended December 31,					
	2012		2011		2010	
	Basic	Diluted	Basic	Diluted	Basic	Diluted
Earnings (loss):						
Amounts attributable to Kindred stockholders:						
Income (loss) from continuing operations:						
As reported in Statement of Operations	$ (33,414)	$ (33,414)	$ (47,815)	$ (47,815)	$ 56,891	$ 56,891
Allocation to participating unvested restricted stockholders					(1,028)	(1,022)
Available to common stockholders	$ (33,414)	$ (33,414)	$ (47,815)	$ (47,815)	$ 55,863	$ 55,869
Discontinued operations, net of income taxes:						
Income (loss) from operations:						
As reported in Statement of Operations	$ (2,208)	$ (2,208)	$ (5,666)	$ (5,666)	$ 53	$ 53
Allocation to participating unvested restricted stockholders					(1)	(1)
Available to common stockholders	$ (2,208)	$ (2,208)	$ (5,666)	$ (5,666)	$ 52	$ 52
Loss on divestiture of operations:						
As reported in Statement of Operations	$ (4,745)	$ (4,745)	$	$	$ (453)	$ (453)
Allocation to participating unvested restricted stockholders					8	8
Available to common stockholders	$ (4,745)	$ (4,745)	$	$	$ (445)	$ (445)
Net income (loss):						
As reported in Statement of Operations	$ (40,367)	$ (40,367)	$ (53,481)	$ (53,481)	$ 56,491	$ 56,491
Allocation to participating unvested restricted stockholders					(1,021)	(1,015)
Available to common stockholders	$ (40,367)	$ (40,367)	$ (53,481)	$ (53,481)	$ 55,470	$ 55,476
Shares used in the computation:						
Weighted average shares outstanding basic computation	51,659	51,659	46,280	46,280	38,738	38,738
Dilutive effect of employee stock options						135
Dilutive effect of performance-based restricted shares						81
Adjusted weighted average shares outstanding diluted computation		51,659		46,280		38,954

Earnings (loss) per common share:						
Income (loss) from continuing operations	$ (0.65)	$ (0.65)	$ (1.04)	$ (1.04)	$ 1.44	$ 1.44
Discontinued operations:						
Income (loss) from operations	(0.04)	(0.04)	(0.12)	(0.12)		
Loss on divestiture of operations	(0.09)	(0.09)			(0.01)	(0.01)
Net income (loss)	$ (0.78)	$ (0.78)	$ (1.16)	$ (1.16)	$ 1.43	$ 1.43
Number of antidilutive stock options and performance-based restricted shares excluded from shares used in the diluted earnings (loss) per common share computation		1,813		2,001		2,466

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 6 BUSINESS SEGMENT DATA

At December 31, 2012, the Company was organized into four operating divisions: the hospital division, the nursing center division, the rehabilitation division and the home health and hospice division. Based upon the authoritative guidance for business segments, the operating divisions represent five reportable operating segments, including (1) hospitals, (2) skilled nursing and rehabilitation centers, (3) skilled nursing rehabilitation services, (4) hospital rehabilitation services and (5) home health and hospice services. These reportable operating segments are consistent with information used by the Company s President and Chief Operating Officer to assess performance and allocate resources. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. Prior period segment information has been restated to conform with the current period presentation.

For segment purposes, the Company defines segment operating income as earnings before interest, income taxes, depreciation, amortization and rent. Segment operating income reported for each of the Company s operating segments excludes impairment charges, transaction costs and the allocation of corporate overhead.

Segment operating income for 2012 included employee severance costs of $3.4 million (hospital division $0.7 million, nursing center division $1.9 million, rehabilitation division $0.4 million, home health and hospice division $0.2 million and corporate $0.2 million) and contract cancellation costs of $0.9 million (corporate) incurred in connection with restructuring activities.

Segment operating income for the hospital division for 2012 also included severance costs of $2.5 million and restructuring costs of $2.0 million incurred in connection with the closing of a regional office and two TC hospitals and the cancellation of a sub-acute unit project, and $5.0 million for employment-related lawsuits. Rent expense for the hospital division for 2012 included $1.6 million incurred in connection with the closing of a regional office and two TC hospitals.

Segment operating income for the nursing center division for 2012 also included employee retention costs of $2.2 million incurred in connection with the decision to allow the leases to expire for 54 nursing and rehabilitation centers leased from Ventas, Inc. (Ventas).

Segment operating income for the hospital division for 2011 included a loss on the divestiture of a hospital of $1.5 million.

Segment operating income for 2010 included severance and retirement costs approximating $1.1 million for the hospital division, $0.5 million for the nursing center division and $1.3 million for corporate.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 6 BUSINESS SEGMENT DATA (Continued)

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

	Year ended December 31, 2012	2011	2010
Revenues:			
Hospital division	$ 2,927,495	$ 2,531,448	$ 1,959,738
Nursing center division	2,148,140	2,254,099	2,187,885
Rehabilitation division:			
Skilled nursing rehabilitation services	1,010,101	775,158	403,755
Hospital rehabilitation services	293,532	200,824	83,678
	1,303,633	975,982	487,433
Home health and hospice division	143,340	60,736	17,522
	6,522,608	5,822,265	4,652,578
Eliminations:			
Skilled nursing rehabilitation services	(223,519)	(229,677)	(224,624)
Hospital rehabilitation services	(110,510)	(83,917)	(78,926)
Nursing and rehabilitation centers	(7,288)	(4,743)	(2,044)
	(341,317)	(318,337)	(305,594)
	$ 6,181,291	$ 5,503,928	$ 4,346,984
Income (loss) from continuing operations:			
Operating income (loss):			
Hospital division	$ 600,649	$ 488,201	$ 360,369
Nursing center division	273,142	338,265	303,418
Rehabilitation division:			
Skilled nursing rehabilitation services	80,663	65,916	33,703
Hospital rehabilitation services	69,745	43,731	18,969
	150,408	109,647	52,672
Home health and hospice division	13,708	3,103	(66)
Corporate:			
Overhead	(179,063)	(174,800)	(133,961)
Insurance subsidiary	(2,127)	(2,306)	(3,153)
	(181,190)	(177,106)	(137,114)
Impairment charges	(110,856)	(118,202)	
Transaction costs	(2,231)	(50,706)	(4,644)
Operating income	743,630	593,202	574,635
Rent	(428,979)	(398,045)	(356,352)
Depreciation and amortization	(201,068)	(165,227)	(121,374)

Interest, net		(106,842)		(79,888)		(5,845)
Income (loss) before income taxes		6,741		(49,958)		91,064
Provision (benefit) for income taxes		39,112		(1,905)		34,173
	$	(32,371)	$	(48,053)	$	56,891

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 6 BUSINESS SEGMENT DATA (Continued)

	Year ended December 31,		
	2012	2011	2010
Rent:			
Hospital division	$ 217,341	$ 188,120	$ 151,966
Nursing center division	200,679	198,556	198,105
Rehabilitation division:			
Skilled nursing rehabilitation services	5,250	6,275	5,644
Hospital rehabilitation services	140	228	106
	5,390	6,503	5,750
Home health and hospice division	3,140	1,366	386
Corporate	2,429	3,500	145
	$ 428,979	$ 398,045	$ 356,352
Depreciation and amortization:			
Hospital division	$ 91,776	$ 74,543	$ 51,461
Nursing center division	53,548	50,040	45,471
Rehabilitation division:			
Skilled nursing rehabilitation services	11,061	7,191	2,169
Hospital rehabilitation services	9,309	5,637	306
	20,370	12,828	2,475
Home health and hospice division	4,442	1,449	234
Corporate	30,932	26,367	21,733
	$ 201,068	$ 165,227	$ 121,374
Capital expenditures, excluding acquisitions (including discontinued operations):			
Hospital division:			
Routine	$ 38,272	$ 46,393	$ 36,967
Development	42,265	67,321	41,140
	80,537	113,714	78,107
Nursing center division:			
Routine	20,764	34,304	37,024
Development	8,057	19,167	26,701
	28,821	53,471	63,725
Rehabilitation division:			
Skilled nursing rehabilitation services:			
Routine	2,274	1,700	2,356
Development			
	2,274	1,700	2,356
Hospital rehabilitation services:			
Routine	348	238	293
Development			

	348	238	293
Home health and hospice division:			
Routine	1,616	164	66
Development		1,167	
	1,616	1,331	66
Corporate:			
Information systems	50,341	47,718	29,786
Other	1,560	2,386	2,404
	$ 165,497	$ 220,558	$ 176,737

KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 6 BUSINESS SEGMENT DATA (Continued)

	December 31, 2012	December 31, 2011
Assets at end of period:		
Hospital division	$ 2,140,185	$ 2,056,103
Nursing center division	616,382	638,078
Rehabilitation division:		
Skilled nursing rehabilitation services	335,197	425,499
Hospital rehabilitation services	340,668	347,491
	675,865	772,990
Home health and hospice division	202,156	104,374
Corporate	603,358	566,948
	$ 4,237,946	$ 4,138,493
Goodwill:		
Hospital division	$ 747,065	$ 745,411
Rehabilitation division:		
Skilled nursing rehabilitation services		107,026
Hospital rehabilitation services	168,019	167,753
	168,019	274,779
Home health and hospice division	126,182	64,465
	$ 1,041,266	$ 1,084,655

NOTE 7 INCOME TAXES

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

Provision (benefit) for income taxes consists of the following (in thousands):

	Year ended December 31,		
	2012	2011	2010
Current:			
Federal	$ 42,403	$ (970)	$ 13,065
State	9,089	(170)	2,402
	51,492	(1,140)	15,467

Deferred	(12,380)	(765)	18,706
	$ 39,112	$ (1,905)	$ 34,173

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7 INCOME TAXES (Continued)

Reconciliation of federal statutory tax expense (income) to the provision (benefit) for income taxes follows (in thousands):

	Year ended December 31,		
	2012	**2011**	**2010**
Income tax expense (income) at federal rate	$ 2,359	$ (17,485)	$ 31,872
State income tax expense (income), net of federal income tax expense (income)	286	(1,874)	3,187
Transaction costs	284	5,894	274
Impairment charges	36,201	14,461	
Prior year contingencies	(225)	(3,348)	(2,917)
Other items, net	207	447	1,757
	$ 39,112	$ (1,905)	$ 34,173

A summary of net deferred income tax assets (liabilities) by source included in the accompanying consolidated balance sheet at December 31 follows (in thousands):

	2012		2011	
	Assets	**Liabilities**	**Assets**	**Liabilities**
Property and equipment	$	$ 2,822	$	$ 19,152
Insurance	54,800		59,784	
Accounts receivable allowances		15,571		6,671
Compensation	63,641		64,400	
Net operating losses	60,542		48,643	
Assets held for sale	9,709		9,662	
Goodwill and intangibles		142,129		133,341
Other	23,706		15,136	
	212,398	$ 160,522	197,625	$ 159,164
Reclassification of deferred tax liabilities	(160,522)		(159,164)	
Net deferred tax assets	51,876		38,461	
Valuation allowance	(48,977)		(38,631)	
	$ 2,899		$ (170)	

Deferred income taxes totaling $12.7 million and $17.8 million at December 31, 2012 and 2011, respectively, were classified as current assets, and deferred income taxes totaling $9.8 million and $18.0 million at December 31, 2012 and 2011, respectively, were classified as noncurrent liabilities.

The Company identified deferred income tax assets for state income tax NOLs of $52.7 million and $42.1 million at December 31, 2012 and 2011, respectively, and a corresponding deferred income tax valuation allowance of $48.4 million and $38.0 million at

December 31, 2012 and 2011, respectively, for that portion of the net deferred income tax assets that the Company will likely not realize in the future. The Company had deferred tax assets for federal NOLs of $7.9 million and $6.5 million at December 31, 2012 and 2011, respectively, with no deferred income tax valuation allowances at December 31, 2012 or 2011. The federal NOLs expire in various amounts through 2033.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7 INCOME TAXES (Continued)

The Company follows the provisions of the authoritative guidance for accounting for uncertainty in income taxes which clarifies the accounting for uncertain income tax issues recognized in an entity s financial statements. The guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return.

A reconciliation of unrecognized tax benefits follows (in thousands):

Balance, December 31, 2009	$ 7,743
Additions based upon tax positions related to the current year	100
Reductions due to lapses of applicable statute of limitations	(4,616)
Balance, December 31, 2010	3,227
Additions based upon tax positions related to the current year	100
Acquisitions	1,414
Reductions due to lapses of applicable statute of limitations and the conclusion of income tax examinations	(3,660)
Balance, December 31, 2011	1,081
Additions based upon tax positions related to the current year	100
Reductions due to lapses of applicable statute of limitations and the conclusion of income tax examinations	(275)
Balance, December 31, 2012	$ 906

The Company records accrued interest and penalties associated with uncertain tax positions as income tax expense in the consolidated statement of operations. Accrued interest related to uncertain tax provisions totaled $0.1 million as of December 31, 2012 and 2011.

To the extent the unrecognized income tax benefits become realized or the related accrued interest is no longer necessary, the Company s provision for income taxes would be favorably impacted by $0.9 million.

The federal statute of limitations remains open for tax years 2009 through 2011. During 2011, the Company resolved federal income tax audits for the 2007 through 2009 tax years. The Company is currently under examination by the Internal Revenue Service (the IRS) for the 2010 through 2012 tax years. The Company has been accepted into the IRS s Compliance Assurance Process (CAP) for the 2012 and 2013 tax years. CAP is an enhanced, real-time review of a company s tax positions and compliance. The Company expects participation in CAP to improve the timeliness of its federal tax examinations.

State jurisdictions generally have statutes of limitations for tax returns ranging from three to five years. The state impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification to the states. Currently, the Company has various state income tax returns under examination.

During 2010, the Company received approval from the IRS for an accounting method change for income tax purposes that resulted in a non-recurring reduction in income tax payments of approximately $25 million. In connection with the RehabCare Merger, the accounting method change was extended in 2012 for the 2011 tax year to certain entities and resulted in a non-recurring reduction in income tax payments of approximately $8 million during 2012. The Company s earnings were not impacted by these transactions.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8 INSURANCE RISKS

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

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

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

	Year ended December 31,		
	2012	2011	2010
Professional liability:			
Continuing operations	$ 76,815	$ 63,029	$ 55,536
Discontinued operations	(316)	(2,904)	(4,213)
Workers compensation:			
Continuing operations	$ 58,859	$ 58,414	$ 42,567
Discontinued operations	(27)	(373)	(1,262)

Changes in the allowance for professional liability risks and workers compensation risks for the years ended December 31 follow (in thousands) (including discontinued operations):

	2012			2011		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
Allowance for insurance risks at beginning of year	$ 263,727	$ 170,687	$ 434,414	$ 249,224	$ 84,180	$ 333,404
Provision for loss for retained insurance risks:						
Current year	72,111	52,871	124,982	63,650	47,826	111,476
Prior years	(7,906)	(1,956)	(9,862)	(15,701)	1,678	(14,023)
	64,205	50,915	115,120	47,949	49,504	97,453
Provision for reinsurance and insurance, administrative and overhead costs	12,294	7,917	20,211	12,176	8,537	20,713
Discount accretion	1,652		1,652	1,920		1,920
Contributions from managed facilities	105	405	510	83	329	412
Acquisitions				9,569	11,312	20,881
Payments for retained insurance risks:						
Current year	(5,203)	(11,518)	(16,721)	(5,513)	(12,939)	(18,452)
Prior years	(54,691)	(29,218)	(83,909)	(42,961)	(23,181)	(66,142)

	(59,894)	(40,736)	(100,630)	(48,474)	(36,120)	(84,594)
Payments for reinsurance and insurance, administrative and overhead costs	(12,294)	(7,917)	(20,211)	(12,176)	(8,537)	(20,713)
Change in reinsurance and other recoverables	20,923	12,090	33,013	3,456	61,482	64,938
Allowance for insurance risks at end of year	$ 290,718	$ 193,361	$ 484,079	$ 263,727	$ 170,687	$ 434,414

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8 INSURANCE RISKS (Continued)

	2010		
	Professional liability	Workers compensation	Total
Allowance for insurance risks at beginning of year	$ 242,202	$ 82,122	$ 324,324
Provision for loss for retained insurance risks:			
Current year	63,886	39,677	103,563
Prior years	(24,311)	(6,936)	(31,247)
	39,575	32,741	72,316
Provision for reinsurance and insurance, administrative and overhead costs	11,748	8,564	20,312
Discount accretion	2,811		2,811
Contributions from managed facilities	71	255	326
Acquisitions			
Payments for retained insurance risks:			
Current year	(3,157)	(11,714)	(14,871)
Prior years	(44,951)	(20,416)	(65,367)
	(48,108)	(32,130)	(80,238)
Payments for reinsurance and insurance, administrative and overhead costs	(11,748)	(8,564)	(20,312)
Change in reinsurance and other recoverables	12,673	1,192	13,865
Allowance for insurance risks at end of year	$ 249,224	$ 84,180	$ 333,404

A summary of the assets and liabilities related to insurance risks included in the accompanying consolidated balance sheet at December 31 follows (in thousands):

	2012			2011		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
Assets:						
Current:						
Insurance subsidiary investments	$ 53,133	$ 33,035	$ 86,168	$ 44,678	$ 25,747	$ 70,425
Reinsurance recoverables	5,382		5,382	323		323
Other		150	150		150	150
	58,515	33,185	91,700	45,001	25,897	70,898
Non-current:						
Insurance subsidiary investments	46,546	69,878	116,424	39,048	71,179	110,227
Reinsurance and other recoverables	58,025	76,794	134,819	44,356	64,704	109,060
Deposits	3,977	1,574	5,551	3,643	1,623	5,266
Other		40	40		42	42
	108,548	148,286	256,834	87,047	137,548	224,595
	$ 167,063	$ 181,471	$ 348,534	$ 132,048	$ 163,445	$ 295,493

Liabilities:						
Allowance for insurance risks:						
Current	$ 54,088	$ 37,096	$ 91,184	$ 46,010	$ 32,198	$ 78,208
Non-current	236,630	156,265	392,895	217,717	138,489	356,206
	$ 290,718	$ 193,361	$ 484,079	$ 263,727	$ 170,687	$ 434,414

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8   INSURANCE RISKS (Continued)

Provisions for loss for professional liability risks retained by the Company s limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 1% to 5% depending upon the policy year. The discount rate was 1% for the 2010 through 2012 policy years and 2% to 5% for all prior policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $293.3 million at December 31, 2012 and $266.5 million at December 31, 2011.

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

NOTE 9   INSURANCE SUBSIDIARY INVESTMENTS

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

The cost for equities, amortized cost for debt securities and estimated fair value of the Company s insurance subsidiary investments at December 31 follows (in thousands):

	2012				2011			
	Cost	Unrealized gains	Unrealized losses	Fair value	Cost	Unrealized gains	Unrealized losses	Fair value
Cash and cash equivalents (a)	$ 140,162	$	$	$ 140,162	$ 118,877	$	$	$ 118,877
Debt securities:								
Corporate bonds	21,352	118	(16)	21,454	23,134	163	(48)	23,249
Debt securities issued by U.S. government agencies	16,624	89		16,713	18,173	120	(5)	18,288
U.S. Treasury notes	6,131	3		6,134	3,867	10		3,877
Debt securities issued by foreign governments					625	8		633
Commercial mortgage-backed securities					137	6		143
	44,107	210	(16)	44,301	45,936	307	(53)	46,190
Equities by industry:								
Consumer	2,171	599	(15)	2,755	2,171	329	(45)	2,455
Industrials	2,039	331	(53)	2,317	2,039	248	(111)	2,176
Technology	1,482	268	(70)	1,680	1,482	215	(99)	1,598
Healthcare	1,474	179	(14)	1,639	1,474	77	(72)	1,479
Financial services	1,419	284	(86)	1,617	1,419	89	(227)	1,281
Other	2,554	706	(243)	3,017	2,554	345	(209)	2,690
	11,139	2,367	(481)	13,025	11,139	1,303	(763)	11,679

Certificates of deposit	5,101	3		5,104	3,905	3	(2)	3,906
	$ 200,509	$ 2,580	$ (497)	$ 202,592	$ 179,857	$ 1,613	$ (818)	$ 180,652

(a) Includes $3.7 million and $2.2 million of money market funds at December 31, 2012 and 2011, respectively.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9 INSURANCE SUBSIDIARY INVESTMENTS (Continued)

The fair value by maturity periods at December 31, 2012 of available-for-sale investments of the Company s insurance subsidiary follows. Equities generally do not have maturity dates.

(In thousands)	Contractual maturities
Within one year	$ 162,733
One year to five years	26,834
After five years	
Equities	13,025
	$ 202,592

Since the Company s insurance subsidiary investments are restricted for a limited purpose, they are classified in the accompanying consolidated balance sheet based upon the expected current and long-term cash requirements of the limited purpose insurance subsidiary.

Net investment income earned by the Company s insurance subsidiary investments follows (in thousands):

	Year ended December 31,		
	2012	2011	2010
Interest income	$ 1,290	$ 1,399	$ 1,986
Net amortization of premium and accretion of discount	(406)	(322)	(394)
Gains on sale of investments	123	265	524
Losses on sale of investments	(28)	(73)	(84)
Other-than-temporary impairments		(232)	(728)
Investment expenses	(115)	(119)	(148)
	$ 864	$ 918	$ 1,156

The available-for-sale investments of the Company s insurance subsidiary which have unrealized losses at December 31, 2012 and 2011 are shown below. The investments are categorized by the length of time that individual securities have been in a continuous unrealized loss position at December 31, 2012 and 2011.

December 31, 2012	Less than one year		One year or greater		Total	
(In thousands)	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Debt securities:						
Corporate bonds	$ 4,115	$ 7	$ 257	$ 9	$ 4,372	$ 16
Equities by industry:						
Consumer			234	15	234	15

Industrials			367	53	367	53
Technology			482	70	482	70
Healthcare	78	9	188	5	266	14
Financial services	48	1	339	85	387	86
Other	343	45	416	198	759	243
	469	55	2,026	426	2,495	481
	$ 4,584	$ 62	$ 2,283	$ 435	$ 6,867	$ 497

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9 INSURANCE SUBSIDIARY INVESTMENTS (Continued)

December 31, 2011	Less than one year		One year or greater		Total	
(In thousands)	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Debt securities:						
Corporate bonds	$ 8,524	$ 48	$	$	$ 8,524	$ 48
Debt securities issued by U.S. government agencies	3,516	5			3,516	5
	12,040	53			12,040	53
Equities by industry:						
Consumer	79	11	308	34	387	45
Industrials	290	25	334	86	624	111
Technology	215	55	239	44	454	99
Healthcare	137	15	529	57	666	72
Financial services	623	196	62	31	685	227
Other	801	155	280	54	1,081	209
	2,145	457	1,752	306	3,897	763
Certificates of deposit	2,048	2			2,048	2
	$ 16,233	$ 512	$ 1,752	$ 306	$ 17,985	$ 818

The unrealized losses on equities totaling $0.5 million at December 31, 2012 were due generally to market fluctuations. Accordingly, the Company believes these unrealized losses are temporary in nature.

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

The Company considered the severity and duration of its unrealized losses at December 31, 2012 for various investments held in its insurance subsidiary investment portfolio and determined that these unrealized losses were temporary and did not record any impairment losses related to these investments. The Company recognized $0.2 million and $0.7 million pretax other-than-temporary impairments in 2011 and 2010, respectively, for various investments held in its insurance subsidiary investment portfolio. These investments were determined to be impaired after considering the duration of the declines in value and the likelihood of near term price recovery of each investment. Because the Company considered the remaining unrealized losses at December 31, 2012 and 2011 to be temporary, the Company did not record any additional impairment losses related to these investments.

As a result of deterioration in professional liability and workers compensation underwriting results of the Company s limited purpose insurance subsidiary in 2011, the Company made a capital contribution of $8.6 million in 2012 to its limited purpose insurance subsidiary. Conversely, as a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary in 2010 and 2009, the Company received distributions of $3.5 million in 2011 and $21.8 million in 2010 from its limited purpose insurance subsidiary. These transactions were completed in accordance with applicable regulations. Neither the capital contribution nor the distributions had any impact on earnings.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 10 LEASES

The Company leases real estate and equipment under cancelable and non-cancelable arrangements. The following table sets forth rent expense by business segment (in thousands):

	Year ended December 31,		
	2012	2011	2010
Hospital division:			
Buildings:			
Ventas	$ 101,831	$ 94,320	$ 93,372
Other landlords	78,238	61,013	32,318
Equipment	37,272	32,787	26,276
	217,341	188,120	151,966
Nursing center division:			
Buildings:			
Ventas	158,643	156,581	156,101
Other landlords	40,103	39,670	39,825
Equipment	1,933	2,305	2,179
	200,679	198,556	198,105
Rehabilitation division:			
Skilled nursing rehabilitation services:			
Buildings	1,139	729	67
Equipment	4,111	5,546	5,577
	5,250	6,275	5,644
Hospital rehabilitation services:			
Buildings	52	120	4
Equipment	88	108	102
	140	228	106
Home health and hospice division:			
Buildings	2,754	1,199	374
Equipment	386	167	12
	3,140	1,366	386
Corporate:			
Buildings	2,242	3,356	107
Equipment	187	144	38
	2,429	3,500	145
	$ 428,979	$ 398,045	$ 356,352

Various facility leases include contingent annual rent escalators based upon a change in the Consumer Price Index or other agreed upon terms such as a patient revenue test. These contingent rents are included in rent expense in the year incurred. The Company recorded contingent rent of $1.3 million, $1.1 million and $0.6 million for the years ended December 31, 2012, 2011 and 2010, respectively.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 10 LEASES (Continued)

Future minimum payments under non-cancelable operating leases are as follows (in thousands):

	Minimum payments		
	Ventas	**Other**	**Total**
2013	$ 230,905	$ 121,701	$ 352,606
2014	218,620	115,513	334,133
2015	125,771	101,827	227,598
2016	79,391	94,864	174,255
2017	80,683	67,946	148,629
Thereafter	167,039	304,467	471,506

At December 31, 2012, the Company leased from Ventas and its affiliates 38 TC hospitals and 159 nursing and rehabilitation centers under four master lease agreements (the Master Lease Agreements). The Company has also entered into an additional lease agreement with Ventas for ten TC hospitals that will be effective on May 1, 2013 (the 2013 Lease Agreement). There are several bundles of leased properties under each Master Lease Agreement, with each bundle containing approximately six to 20 leased nursing and rehabilitation centers and TC hospitals.

The Master Lease Agreements initially provided that the Company could renew all or none of the facilities within each bundle up to a maximum of three separate five year renewal terms by providing written notice between 12 and 18 months prior to the expiration of the lease term for such bundle.

Under the Master Lease Agreements, the Company had 73 nursing and rehabilitation centers and 16 TC hospitals within ten separate bundles eligible for renewal prior to an April 30, 2012 lease renewal notice date. The Company renewed three of these renewal bundles, containing 19 nursing and rehabilitation centers and six TC hospitals (collectively, the Renewal Facilities) for an additional five years.

The Renewal Facilities contain 2,178 licensed nursing and rehabilitation center beds and 616 licensed hospital beds and generated revenues of approximately $443 million for the year ended December 31, 2012. The current annual rent for the Renewal Facilities approximates $47 million.

The Company did not renew seven renewal bundles containing 54 nursing and rehabilitation centers (the Expiring Facilities). The Expiring Facilities contain 6,140 licensed nursing and rehabilitation center beds and generated revenues of approximately $475 million for the year ended December 31, 2012. The current annual rent for these facilities approximates $57 million. The Company has also entered into an agreement with Ventas to provide Ventas with more flexibility to accelerate the transfer of the Expiring Facilities. The Company will continue to operate the Expiring Facilities and include the Expiring Facilities in its results from continuing operations through the expiration of the lease term. When the Company terminates its operations of the Expiring Facilities, these facilities will be reclassified to discontinued operations.

On May 24, 2012, the Company entered into the 2013 Lease Agreement covering the ten TC hospitals that were otherwise scheduled to expire on April 30, 2013. The 2013 Lease Agreement will be effective on May 1, 2013 and will have a term of ten years with three five-year renewal options. The annual rent for the 2013 Lease Agreement will be $28 million and is subject to annual increases based on the increase in the Consumer Price Index (subject to an annual 4% cap). The current annual rent for these ten TC hospitals approximates $22 million. These ten TC hospitals contain 1,066 licensed hospital beds and generated revenues of approximately $283 million for the year ended December 31, 2012.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 10 LEASES (Continued)

The following chart sets forth the current lease renewals under the existing Master Lease Agreements:

			Facility renewals		
Renewal Group	**Expiration date**	**Renewal date**	**Nursing and rehabilitation centers**	**TC hospitals**	**Renewal bundles**
Group 1	April 30, 2015	October 31, 2013 April 29, 2014	86	22	10
Group 2	April 30, 2018	October 31, 2016 April 29, 2017	7	1	1
Group 3	April 30, 2018	October 31, 2016 April 29, 2017	12	5	2

Renewal Group 1

In 2009, the Company entered into agreements with Ventas to renew all of the Group 1 facilities (12,101 licensed beds) for an additional five years. The current term for the Group 1 facilities expires on April 30, 2015. The current annual rent for the Group 1 facilities approximates $136 million. At the Company s option, the Group 1 facilities may be extended for up to two five-year renewal terms beyond the current renewal term at the greater of: (1) the then existing rental rate plus the then existing escalation amount per annum or (2) the then fair market value rental rate. Upon any such renewal, the fair market value rental rate is determined through an appraisal procedure described in the Master Lease Agreements.

Renewal Group 2

The Group 2 facilities contain seven nursing and rehabilitation centers (766 licensed beds) and one TC hospital (109 licensed beds). The current annual rent for the Group 2 facilities approximate $15 million. As noted above, the Group 2 facilities are grouped into one renewal bundle. At the Company s option, the Group 2 facilities may be extended for one five-year renewal term beyond the current term at the greater of: (1) the then existing rental rate plus the then existing escalation amount per annum or (2) the then fair market value rental rate. Upon any such renewal, the fair market value rental rate is determined through an appraisal procedure described in the Master Lease Agreements.

Renewal Group 3

The Group 3 facilities contain 12 nursing and rehabilitation centers (1,412 licensed beds) and five TC hospitals (507 licensed beds). The current annual rent for the Group 3 facilities approximate $32 million. As noted above, the Group 3 facilities are grouped into two separate renewal bundles. At the Company s option, the Group 3 facilities may be extended for up to two five-year renewal terms beyond the current term at the greater of: (1) the then existing rental rate plus the then existing escalation amount per annum or (2) the then fair market value rental rate. Upon any such renewal, the fair market value rental rate is determined through an appraisal procedure described in the Master Lease Agreements.

Conditions to effectiveness of renewals

The Company may not extend the Master Lease Agreements beyond any previously exercised renewal term if, at the time the Company seeks such extension and at the time such extension takes effect: (1) an event of default has occurred and is continuing or (2) a Medicare/Medicaid event of default and/or a licensed bed event of default has occurred and is continuing with respect to three or more leased properties subject to a particular Master Lease Agreement. The renewal term of each Master Lease Agreement is subject to termination upon default by the Company (subject to certain exceptions) and certain other conditions described in the Master Lease Agreements.

KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 10   LEASES (Continued)

Rent appraisal process and the Company s right to revoke such renewals

Under the Master Lease Agreements, if the Company provides Ventas with notice that it intends to renew one or more renewal bundles, Ventas may then initiate an appraisal process to establish a new fair market rental (as defined in the Master Lease Agreements) (FMR) for any or all of these bundles.

Under the appraisal process, an independent appraiser determines the FMR for each renewal bundle and each property within such renewal bundle. Once FMR is determined, the appraiser sends to both parties simultaneously the aggregate FMR for such renewal bundle and the FMR for each property within the bundle. Ventas, in its sole discretion, then determines whether: (1) to accept the appraised FMR for the renewal bundle in the aggregate or (2) make no changes to the current base rent and contingent annual rent escalator for the renewal bundle. If Ventas selects the new FMR for a renewal bundle, then the new FMR would become effective at the start of the renewal term unless the Company elects to revoke its renewal by the applicable deadline set forth in the Master Lease Agreements.

The determination of FMR requires certain levels of subjectivity and judgment related to the many variables that may be considered under the circumstances. As a result, it is important for investors to consider the possibility of a wide range of outcomes with respect to the appraisal process.

NOTE 11   LONG-TERM DEBT

Capitalization

A summary of long-term debt at December 31 follows (in thousands):

	2012	2011
Term Loan Facility, net of unamortized original issue discount of $7.8 million at December 31, 2012 and $6.4 million at December 31, 2011	$ 781,694	$ 690,083
Notes	550,000	550,000
ABL Facility	320,700	293,500
Capital lease obligations	609	3,945
Other	4,645	4,974
Total debt, average life of 5 years (weighted average rate 5.9% for 2012 and 6.0% for 2011)	1,657,648	1,542,502
Amounts due within one year	(8,942)	(10,620)
Long-term debt	$ 1,648,706	$ 1,531,882

The following table summarizes scheduled maturities of long-term debt for the years 2013 through 2017 (in thousands):

	Term Loan Facility	Notes	ABL Facility	Capital leases	Other	Total
2013	$ 8,000	$	$	$ 607	$ 335	$ 8,942

2014	8,000		2	341	8,343
2015	8,000			3,836	11,836
2016	8,000	320,700		123	328,823
2017	8,000			10	8,010

The estimated fair value of the Company s long-term debt approximated $1.6 billion at December 31, 2012 and $1.4 billion at December 31, 2011. See Note 16.

KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11 LONG-TERM DEBT (Continued)

Credit facilities and notes

In connection with the RehabCare Merger, the Company entered into the Credit Facilities and completed a private placement of the Notes. In 2011, the Company used proceeds from the Credit Facilities and the Notes to pay the Merger Consideration, repay all amounts outstanding under the Company s and RehabCare s previous credit facilities and to pay transaction costs. The amounts outstanding under the Company s and RehabCare s former credit facilities that were repaid at the RehabCare Merger closing were $390.0 million and $345.4 million, respectively.

The Credit Facilities also included an option to increase the credit capacity in an aggregate amount between the two facilities by $200 million. In October 2012, the Company executed this option by completing modifications to increase by $100 million its Term Loan Facility and expanding by $100 million the borrowing capacity under its ABL Facility. The additional Term Loan Facility borrowings were issued at 97.5% and the net proceeds were used to pay down a portion of the outstanding balance under the ABL Facility. The aggregate amount outstanding under the Term Loan Facility at December 31, 2012 was $789.5 million. In connection with the $100 million expansion of the borrowing capacity under the Company s ABL Facility, the Company also modified the accounts receivable borrowing base which will allow the Company to more easily access the full amount of the available credit. As of December 31, 2012, the Company s unused credit capacity totaled $419.9 million under the ABL Facility. The other terms of the Term Loan Facility and the ABL Facility were unchanged.

In connection with the Credit Facilities and the Notes, the Company paid $46.2 million of lender fees related to debt issuance that were capitalized as deferred financing costs during 2011 and paid $13.1 million of other financing costs that were charged to interest expense during 2011.

All obligations under the Credit Facilities are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company s existing and future direct and indirect domestic 100% owned subsidiaries, as well as certain non-100% owned domestic subsidiaries as the Company may determine from time to time in its sole discretion. The Notes are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company s domestic 100% owned subsidiaries.

The agreements governing the Credit Facilities and the indenture governing the Notes include a number of restrictive covenants that, among other things and subject to certain exceptions and baskets, impose operating and financial restrictions on the Company and certain of its subsidiaries. The Company s ability to pay dividends is limited to certain restricted payment baskets, which may expand based upon accumulated earnings. In addition, the Company is required to comply with a minimum fixed charge coverage ratio and a maximum total leverage ratio under the Credit Facilities. These financing agreements governing the Credit Facilities and the indenture governing the Notes also contain customary affirmative covenants and events of default.

ABL Facility

The ABL Facility has a five-year tenor and is secured by a first priority lien on eligible accounts receivable, cash, deposit accounts, and certain other assets and property and proceeds from the foregoing (the First Priority ABL Collateral). The ABL Facility has a second priority lien on substantially all of the Company s other assets and properties. As of December 31, 2012, the Company had $320.7 million outstanding under the ABL Facility. In addition, $9.4 million of letters of credit were issued under the ABL Facility as of December 31, 2012.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11 LONG-TERM DEBT (Continued)

ABL Facility (Continued)

Borrowings under the ABL Facility bear interest at a rate per annum equal to the applicable margin plus, at the Company s option, either: (1) the London Interbank Offered Rate (LIBOR) determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. At December 31, 2012, the applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. The applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

Term Loan Facility

The Term Loan Facility has a tenor of seven years and is secured by a first priority lien on substantially all of the Company s assets and properties other than the First Priority ABL Collateral and a second priority lien on the First Priority ABL Collateral. The Term Loan Facility net proceeds at the RehabCare Merger totaled $693.0 million, net of a $7.0 million original issue discount that will be amortized over the tenor of the Term Loan Facility.

Borrowings under the Term Loan Facility bear interest at a rate per annum equal to an applicable margin plus, at the Company s option, either: (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings.

Notes

In connection with the RehabCare Merger, the Company completed a private placement of the Notes. The Notes bear interest at an annual rate equal to 8.25% and are senior unsecured obligations of the Company and the subsidiary guarantors, ranking *pari passu* with all of their respective existing and future senior unsubordinated indebtedness. The indenture contains certain restrictive covenants that will, among other things, limit the Company and certain of its subsidiaries ability to incur, assume or guarantee additional indebtedness; pay dividends; make distributions or redeem or repurchase stock; restrict dividends, loans or asset transfers from its subsidiaries; sell or otherwise dispose of assets; and enter into transactions with affiliates. These covenants are subject to a number of limitations and exceptions. The indenture also contains customary events of default.

Pursuant to a registration rights agreement, the Company filed with the Securities and Exchange Commission (the SEC) a registration statement related to an offer to exchange the Notes for an issue of SEC-registered notes with substantially identical terms. The exchange offer commenced on October 13, 2011 and was completed on November 10, 2011.

Interest rate swaps

In December 2011, the Company entered into two interest rate swap agreements to hedge its floating interest rate on an aggregate of $225.0 million of outstanding Term Loan Facility debt. The interest rate swaps have an effective date of January 9, 2012, and expire on January 11, 2016. The Company is required to make payments

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11 LONG-TERM DEBT (Continued)

Interest rate swaps (Continued)

based upon a fixed interest rate of 1.8925% calculated on the notional amount of $225.0 million. In exchange, the Company will receive interest on $225.0 million at a variable interest rate that is based upon the three-month LIBOR rate, subject to a minimum rate of 1.5%. The Company determined the interest rate swaps continue to be effective cash flow hedges at December 31, 2012. The fair value of the interest rate swaps recorded in other accrued liabilities was $2.6 million and $0.8 million at December 31, 2012 and 2011, respectively.

NOTE 12 CONTINGENCIES

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

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

Principal contingencies are described below:

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

Professional liability risks The Company has provided for losses for professional liability risks based upon management s best available information including actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Notes 4 and 8.

Income taxes The Company is subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties.

Litigation The Company is a party to various legal actions (some of which are not insured), and regulatory and other governmental audits and investigations in the ordinary course of business. The Company cannot predict the ultimate outcome of pending litigation and regulatory and other governmental audits and investigations. These matters could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The U.S. Department of Justice, CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company s businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company s business, financial position, results of operations and liquidity. See Note 19.

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

NOTE 13 CAPITAL STOCK

In May 2011, the shareholders of the Company approved an additional three million shares of common stock that could be issued under the Company s incentive compensation plans to Company employees. In May 2012, the shareholders of the Company approved an additional 200,000 shares of common stock that could be issued under the Company s equity compensation plan to the Company s non-employee directors.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 13 CAPITAL STOCK (Continued)

Plan descriptions

The Company maintains plans under which approximately four million service-based restricted shares, performance-based restricted shares and options to purchase common stock may be granted to directors, officers and other key employees. Exercise provisions vary, but most stock options are exercisable in whole or in part beginning one to four years after grant and ending seven to ten years after grant. Shares of common stock available for future grants were 2,301,320, 3,513,109 and 1,049,230 at December 31, 2012, 2011 and 2010, respectively.

Stock options

There were no stock option grants during the three years ended December 31, 2012.

At December 31, 2012, unearned compensation costs related to non-vested stock options was immaterial. Compensation expense related to stock options approximated $0.1 million ($0.1 million net of income taxes) for the year ended December 31, 2012, $0.3 million ($0.2 million net of income taxes) for the year ended December 31, 2011 and $1.2 million ($1.0 million net of income taxes) for the year ended December 31, 2010.

Activity in the various plans is summarized below:

	Shares under option	Option price per share	Weighted average exercise price
Balances, December 31, 2011	3,053,107	$ 4.89 to $28.41	$ 18.94
Exercised	(48,508)	6.94 to 8.43	7.95
Canceled	(1,241,102)	4.89 to 28.41	20.47
Balances, December 31, 2012	1,763,497	$ 6.10 to $25.83	$ 18.16

The intrinsic value of the stock options exercised during 2012 and 2011 approximated $0.2 million and $2.8 million, respectively, and was immaterial for 2010. Cash received from stock option exercises in 2012, 2011 and 2010 totaled $0.1 million, $3.0 million and $0.1 million, respectively.

A summary of stock options outstanding at December 31, 2012 follows:

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding at December 31, 2012	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable at December 31, 2012	Weighted average exercise price
$6.10 to $8.44	106,050	1 year	$ 8.02	106,050	$ 8.02

$11.53 to $15.27	430,002	3 years	14.71	426,252	14.70
$16.81 to $22.72	897,460	1 year	18.31	897,460	18.31
$23.25 to $25.83	329,985	2 years	25.52	329,985	25.52
	1,763,497	2 years	$ 18.16	1,759,747	$ 18.17

The intrinsic value of the stock options outstanding and stock options that are exercisable as of December 31, 2012 each approximated $0.3 million.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 13 CAPITAL STOCK (Continued)

Service-based restricted shares

At December 31, 2012, unearned compensation costs related to non-vested service-based restricted shares aggregated $10.0 million. These costs will be expensed over the remaining weighted average vesting period of approximately three years. Compensation expense related to these awards approximated $7.6 million ($4.6 million net of income taxes) for the year ended December 31, 2012, $7.1 million ($4.4 million net of income taxes) for the year ended December 31, 2011 and $6.1 million ($3.8 million net of income taxes) for the year ended December 31, 2010.

A summary of non-vested service-based restricted shares follows:

	Non-vested service-based restricted shares	Weighted average fair value at date of grant
Balances, December 31, 2011	776,495	$ 20.70
Granted	1,125,146	9.98
Vested	(288,625)	20.80
Canceled	(46,047)	14.26
Balances, December 31, 2012	1,566,969	$ 13.17

The fair value of restricted shares vested during 2012, 2011 and 2010 was $3.2 million, $7.0 million and $5.9 million, respectively.

Performance-based restricted shares

Performance-based restricted share awards vest over a three-year period based upon the attainment of various performance measures in each performance period. Compensation expense related to these awards approximated $3.2 million ($2.0 million net of income taxes) for the year ended December 31, 2012, $5.4 million ($3.3 million net of income taxes) for the year ended December 31, 2011 and $3.4 million ($2.1 million net of income taxes) for the year ended December 31, 2010.

A summary of non-vested performance-based restricted shares follows:

	Non-vested performance-based restricted shares	Weighted average fair value at date of grant
Balances, December 31, 2011	480,065	
Granted	605,596	$ 9.39
Vested	(219,576)	24.45
Canceled	(29,336)	$ 9.81
Balances, December 31, 2012	836,749	

The performance measures and fair value for each vesting period of a performance-based restricted share award are established annually. The performance measures and fair value for the non-vested performance-based restricted shares have not been established for vesting periods with performance measures determined after December 31, 2012.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14 EMPLOYEE BENEFIT PLANS

The Company maintains defined contribution retirement plans covering employees who meet certain minimum eligibility requirements. Benefits are determined as a percentage of a participant s contributions and generally are vested based upon length of service. Retirement plan expense was $4.6 million for 2012, $6.0 million for 2011 and $2.5 million for 2010. Amounts equal to retirement plan expense are funded annually.

NOTE 15 ACCRUED LIABILITIES

A summary of other accrued liabilities at December 31 follows (in thousands):

	2012	2011
Taxes other than income	$ 46,114	$ 51,901
Patient accounts	43,124	42,782
Accrued interest	14,096	12,836
Other	33,870	23,174
	$ 137,204	$ 130,693

NOTE 16 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

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

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

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 16 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

The Company s assets and liabilities measured at fair value on a recurring and non-recurring basis and any associated losses for the years ended December 31, 2012 and 2011 are summarized below (in thousands):

	Fair value measurements			Assets/ liabilities at fair value	Total losses
	Level 1	Level 2	Level 3		
December 31, 2012:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$	$ 21,454	$	$ 21,454	$
Debt securities issued by U.S. government agencies		16,713		16,713	
U.S. Treasury notes	6,134			6,134	
	6,134	38,167		44,301	
Available-for-sale equity securities	13,025			13,025	
Money market funds	7,438			7,438	
Certificates of deposit		5,104		5,104	
Total available-for-sale investments	26,597	43,271		69,868	
Deposits held in money market funds	347	3,978		4,325	
	$ 26,944	$ 47,249	$	$ 74,193	$
Liabilities:					
Interest rate swaps	$	$ (2,649)	$	$ (2,649)	$
Non-recurring:					
Assets:					
Hospital available for sale	$	$	$ 105	$ 105	$ (569)
Property and equipment			286	286	(3,630)
Goodwill skilled nursing rehabilitation services					(107,899)
Intangible assets Medicare license					(2,530)
	$	$	$ 391	$ 391	$ (114,628)
Liabilities	$	$	$	$	$
December 31, 2011:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$	$ 23,249	$	$ 23,249	$
Debt securities issued by U.S. government agencies		18,288		18,288	
U.S. Treasury notes	3,877			3,877	
Debt securities issued by foreign governments		633		633	
Commercial mortgage-backed securities		143		143	

	3,877	42,313		46,190	
Available-for-sale equity securities	11,679			11,679	
Money market funds	6,263			6,263	
Certificates of deposit		3,906		3,906	
Total available-for-sale investments	21,819	46,219		68,038	
Deposits held in money market funds	353	3,643		3,996	
	$ 22,172	$ 49,862	$	$ 72,034	$
Liabilities:					
Interest rate swaps	$	$ (815)	$	$ (815)	$
Non-recurring:					
Assets:					
Hospital available for sale	$	$	$ 1,200	$ 1,200	$ (1,490)
Property and equipment			6,604	6,604	(22,836)
Goodwill nursing and rehabilitation centers					(6,080)
Goodwill skilled nursing rehabilitation services			107,026	107,026	(45,999)
Intangible assets certificates of need			1,000	1,000	(54,366)
	$	$	$ 115,830	$ 115,830	$ (130,771)
Liabilities	$	$	$	$	$

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 16 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Recurring measurements

The Company s available-for-sale investments held by its limited purpose insurance subsidiary consist of debt securities, equities, money market funds and certificates of deposit. These available-for-sale investments and the insurance subsidiary s cash and cash equivalents of $136.5 million as of December 31, 2012 and $116.7 million as of December 31, 2011, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The Company also has available-for-sale investments totaling $3.7 million as of December 31, 2012 and $4.1 million as of December 31, 2011 related to a deferred compensation plan that is maintained for certain of the Company s current and former employees.

The fair value of actively traded debt and equity securities and money market funds are based upon quoted market prices and are generally classified as Level 1. The fair value of inactively traded debt securities and certificates of deposit are based upon either quoted market prices of similar securities or observable inputs such as interest rates using either a market or income valuation approach and are generally classified as Level 2. The Company s investment advisors obtain and review pricing for each security. The Company is responsible for the determination of fair value and as such the Company reviews the pricing information from its advisors in determining reasonable estimates of fair value. Based upon the Company s internal review procedures, there were no adjustments to the prices during 2012 or 2011.

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

The fair value of the derivative liability associated with the interest rate swaps is estimated using industry-standard valuation models, which are Level 2 measurements. Such models project future cash flows and discount the future amounts to a present value using market-based observable inputs, including interest rate curves. See Note 11.

The following table presents the carrying amounts and estimated fair values of the Company s financial instruments. The carrying value is equal to fair value for financial instruments that are based upon quoted market prices or current market rates. The Company s long-term debt is based upon Level 2 inputs.

	2012		2011	
(In thousands)	**Carrying value**	**Fair value**	**Carrying value**	**Fair value**
Cash and cash equivalents	$ 50,007	$ 50,007	$ 41,561	$ 41,561
Cash restricted	5,197	5,197	5,551	5,551
Insurance subsidiary investments	202,592	202,592	180,652	180,652
Tax refund escrow investments	207	207	211	211
Long-term debt, including amounts due within one year (excluding capital lease obligations totaling $0.6 million and $3.9 million at December 31, 2012, and 2011, respectively)	1,657,039	1,630,649	1,538,557	1,406,751

Non-recurring measurements

At September 30, 2012, the Company reviewed the indefinite-lived and long-lived assets related to the divestiture of a TC hospital and determined its indefinite-lived Medicare license and property and equipment were impaired. As a result, the Company recorded a pretax loss on divestiture of $3.2 million in discontinued operations. The fair value of the assets were measured using a Level 3 input of the offer.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 16 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Non-recurring measurements (Continued)

In September 2012, the Company reduced the fair value of a hospital held for sale based upon a pending offer, which resulted in a pretax loss of $0.5 million recorded in discontinued operations. The primary reason for the reduction was the general deterioration in the real estate market where the hospital is located. The fair value of the asset was measured using a Level 3 input of the pending offer.

In connection with the preparation of the Company s operating results for the fourth quarter of 2012, the Company determined that the impact of regulatory changes related to the Company s skilled nursing rehabilitation services reporting unit was a triggering event in the fourth quarter of 2012, simultaneously with the Company s annual impairment test. The regulatory changes included a new pre-payment manual medical review process for certain Medicare Part B services exceeding $3,700 which became effective October 1, 2012 and new rules which will become effective April 1, 2013 under the Taxpayer Relief Act that reduce Medicare Part B payments by 50% for subsequent procedures when multiple therapy services are provided on the same day. The Company tested the recoverability of its skilled nursing rehabilitation services reporting unit goodwill, other intangible assets and long-lived assets. The Company recorded a pretax impairment charge aggregating $107.9 million (which represented the entire skilled nursing rehabilitation services reporting unit goodwill) in the fourth quarter of 2012 to reflect the amount by which the carrying value of goodwill exceeded the estimated fair value. The impairment charge did not impact the Company s cash flows or liquidity. The fair value of goodwill was measured using both Level 2 and Level 3 inputs such as discounted cash flows, market multiple analysis, replacement costs and sales comparison methodologies.

On July 29, 2011, CMS issued the 2011 CMS Rules. In connection with the preparation of the Company s operating results for the third quarter of 2011, the Company determined that the impact of the 2011 CMS Rules was a triggering event in the third quarter of 2011 and accordingly tested the recoverability of its nursing and rehabilitation centers reporting unit goodwill, intangible assets and property and equipment asset groups impacted by the reduced Medicare payments. The Company recorded pretax impairment charges aggregating $26.7 million in the third quarter of 2011. The charges included $6.1 million of goodwill (which represented the entire nursing and rehabilitation centers reporting unit goodwill) and $20.6 million of property and equipment. In addition, the Company recorded pretax impairment charges aggregating $2.2 million and $3.0 million in the fourth quarter of 2011 and the year ended December 31, 2012, respectively, of property and equipment expended in the same nursing and rehabilitation center asset groups. These charges reflected the amount by which the carrying value of certain assets exceeded their estimated fair value. The fair value of goodwill was measured using both Level 2 and Level 3 inputs such as discounted cash flows, market multiple analysis, replacement costs and sales comparison methodologies. The fair value of property and equipment was measured using Level 3 inputs such as replacement costs factoring in depreciation, economic obsolesce and inflation trends.

During the fourth quarter of 2011, the estimated negative impact from changes in the reimbursement of group rehabilitation therapy services to Medicare beneficiaries implemented by the 2011 CMS Rules on October 1, 2011 was greater than expected, and as a result, the Company lowered its cash flow expectations for its skilled nursing rehabilitation services reporting unit, causing the carrying value of goodwill of this reporting unit to exceed its estimated fair value in testing the recoverability of goodwill. As a result, the Company recorded a pretax impairment charge of $46.0 million in the fourth quarter of 2011. The impairment charge did not impact the Company s cash flows or liquidity. The fair value of goodwill was measured using both Level 2 and Level 3 inputs such as discounted cash flows, market multiple analysis, replacement costs and sales comparison methodologies.

At December 31, 2011, the carrying value of the Company s certificates of need intangible assets exceeded its fair value as a result of a declining earnings and cash flows related to five hospitals and two co-located nursing and rehabilitation centers in Massachusetts, all of which were acquired in 2006. The declining earnings

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 16 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Non-recurring measurements (Continued)

and cash flows are attributable to a difficult long-term acute care operating environment in Massachusetts in which the Company has been unable to achieve consistent operating results, as well as automatic future Medicare reimbursement reductions triggered in December 2011 by the Budget Control Act of 2011. In addition, the Company decided in the fourth quarter of 2011 to close one of the five hospitals. The pretax impairment charge related to the certificates of need totaled $54.4 million, of which $11.1 million was reclassified to discontinued operations in 2012. The Company reviewed the other long-lived assets related to these five hospitals and two co-located nursing and rehabilitation centers and determined there was no impairment. The fair value of the assets were measured using Level 3 unobservable inputs using both a replacement cost methodology and an excess earnings method, a form of discounted cash flows, which is based upon the concept that net after-tax cash flows provide a return supporting all of the assets of a business enterprise.

In December 2011, the Company reduced the fair value of a hospital held for sale based upon a pending offer, resulting in a pretax loss of $1.5 million recorded in continuing operations. The primary reason for the reduction was the general deterioration in the real estate market where the hospital is located. The fair value of the asset was measured using the Level 2 observable input of the pending offer.

NOTE 17 NONCONTROLLING INTERESTS

As of December 31, 2012, the Company had ownership ranging from 51% to 99% in various joint ventures.

During 2012, the Company completed various partial buyouts of noncontrolling interests. During 2011, the Company completed two joint venture buyouts, one a full buyout and the other a partial buyout, of noncontrolling interests. In accordance with the authoritative guidance of noncontrolling interests, these payments have been accounted for as equity transactions.

The following table reflects the effects on the Company s equity for the years ended December 31, 2012 and 2011 related to these buyouts in the Company s ownership interest in consolidated subsidiaries (amounts in thousands):

December 31, 2012:	
Decrease in carrying value of noncontrolling interests for purchase of noncontrolling interests in subsidiaries	$ 2,053
Increase in Company s capital in excess of par value for purchase of noncontrolling interests in subsidiaries	(1,334)
Total cash consideration paid in exchange for purchase of noncontrolling interests	$ 719

December 31, 2011:	
Decrease in carrying value of noncontrolling interests for purchase of noncontrolling interests in subsidiaries	$ 6,297
Decrease in Company s capital in excess of par value for purchase of noncontrolling interests in subsidiaries	995
Total cash consideration paid in exchange for purchase of noncontrolling interests	$ 7,292

Redeemable noncontrolling interests as of December 31, 2011 represented the minority ownership interests containing put rights in connection with the RehabCare Merger. These redeemable noncontrolling interests were either purchased or reclassified to nonredeemable noncontrolling interests during 2012.

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X, Rule 3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered. The Company s Notes issued on June 1, 2011, are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company s domestic 100% owned subsidiaries. The equity method has been used with respect to the parent company s investment in subsidiaries.

The following condensed consolidating financial data present the financial position of the parent company/issuer, the guarantor subsidiaries and the non-guarantor subsidiaries as of December 31, 2012 and December 31, 2011, and the respective results of operations and cash flows for the three years ended December 31, 2012.

Condensed Consolidating Statement of Operations

	Year ended December 31, 2012				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Revenues	$	$ 5,801,621	$ 480,117	$ (100,447)	$ 6,181,291
Salaries, wages and benefits	214	3,497,527	174,734		3,672,475
Supplies		395,920	36,088		432,008
Rent		398,327	30,652		428,979
Other operating expenses	4	1,121,496	212,081	(100,447)	1,233,134
Other income		(10,812)			(10,812)
Impairment charges		110,856			110,856
Depreciation and amortization		189,157	11,911		201,068
Management fees	(218)	(12,483)	12,701		
Intercompany interest (income) expense from affiliates	(113,745)	100,021	13,724		
Interest expense (income)	107,243	(19,542)	20,195		107,896
Investment income		(173)	(881)		(1,054)
Equity in net loss of consolidating affiliates	44,433			(44,433)	
	37,931	5,770,294	511,205	(144,880)	6,174,550
Income (loss) from continuing operations before income taxes	(37,931)	31,327	(31,088)	44,433	6,741
Provision (benefit) for income taxes	2,436	42,300	(5,624)		39,112
Loss from continuing operations	(40,367)	(10,973)	(25,464)	44,433	(32,371)
Discontinued operations, net of income taxes:					
Loss from operations		(2,208)			(2,208)
Loss on divestiture of operations		(4,745)			(4,745)
Loss from discontinued operations		(6,953)			(6,953)

Net loss	(40,367)	(17,926)	(25,464)	44,433	(39,324)
Earnings attributable to noncontrolling interests			(1,043)		(1,043)
Loss attributable to Kindred	$ (40,367)	$ (17,926)	$ (26,507)	$ 44,433	$ (40,367)
Comprehensive loss	$ (40,780)	$ (18,272)	$ (24,627)	$ 43,942	$ (39,737)
Comprehensive loss attributable to Kindred	$ (40,780)	$ (18,272)	$ (25,670)	$ 43,942	$ (40,780)

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations (Continued)

	Year ended December 31, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$	$ 5,291,393	$ 299,760	$ (87,225)	$ 5,503,928
Salaries, wages and benefits	467	3,147,701	95,435		3,243,603
Supplies		378,883	20,936		399,819
Rent	3	380,339	17,703		398,045
Other operating expenses	85	1,096,031	151,402	(87,225)	1,160,293
Other income		(11,191)			(11,191)
Impairment charges		118,202			118,202
Depreciation and amortization		157,635	7,592		165,227
Management fees	(555)	(8,014)	8,569		
Intercompany interest (income) expense from affiliates	(88,234)	79,779	8,455		
Interest expense (income)	80,181	(10,813)	11,551		80,919
Investment income		(113)	(918)		(1,031)
Equity in net loss of consolidating affiliates	58,528			(58,528)	
	50,475	5,328,439	320,725	(145,753)	5,553,886
Loss from continuing operations before income taxes	(50,475)	(37,046)	(20,965)	58,528	(49,958)
Provision (benefit) for income taxes	3,006	446	(5,357)		(1,905)
Loss from continuing operations	(53,481)	(37,492)	(15,608)	58,528	(48,053)
Loss from discontinued operations, net of income taxes		(5,666)			(5,666)
Net loss	(53,481)	(43,158)	(15,608)	58,528	(53,719)
Loss attributable to noncontrolling interests			238		238
Loss attributable to Kindred	$ (53,481)	$ (43,158)	$ (15,370)	$ 58,528	$ (53,481)
Comprehensive loss	$ (55,085)	$ (44,451)	$ (15,919)	$ 60,132	$ (55,323)
Comprehensive loss attributable to Kindred	$ (55,085)	$ (44,451)	$ (15,681)	$ 60,132	$ (55,085)

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations (Continued)

	Year ended December 31, 2010				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$	$ 4,344,937	$ 77,201	$ (75,154)	$ 4,346,984
Salaries, wages and benefits	331	2,496,962			2,497,293
Supplies	1	340,801			340,802
Rent	3	356,349			356,352
Other operating expenses	72	950,563	70,195	(75,154)	945,676
Other income		(11,422)			(11,422)
Depreciation and amortization		121,374			121,374
Management fees	(407)	407			
Intercompany interest (income) expense from affiliates	(34,023)	34,023			
Interest expense	6,954	136			7,090
Investment income		(89)	(1,156)		(1,245)
Equity in net income of consolidating affiliates	(39,843)			39,843	
	(66,912)	4,289,104	69,039	(35,311)	4,255,920
Income from continuing operations before income taxes	66,912	55,833	8,162	(39,843)	91,064
Provision for income taxes	10,421	20,824	2,928		34,173
Income from continuing operations	56,491	35,009	5,234	(39,843)	56,891
Discontinued operations, net of income taxes:					
Income from operations		53			53
Loss on divestiture of operations		(453)			(453)
Loss from discontinued operations		(400)			(400)
Net income	$ 56,491	$ 34,609	$ 5,234	$ (39,843)	$ 56,491
Comprehensive income	$ 57,049	$ 33,938	$ 6,463	$ (40,401)	$ 57,049
Comprehensive income attributable to Kindred	$ 57,049	$ 33,938	$ 6,463	$ (40,401)	$ 57,049

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Balance Sheet

(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
	As of December 31, 2012				
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 37,370	$ 12,637	$	$ 50,007
Cash restricted		5,197			5,197
Insurance subsidiary investments			86,168		86,168
Accounts receivable, net		940,524	98,081		1,038,605
Inventories		29,023	2,998		32,021
Deferred tax assets		12,663			12,663
Income taxes		13,187	386		13,573
Other		15,118	20,414		35,532
		1,053,082	220,684		1,273,766
Property and equipment, net		1,090,523	52,603		1,143,126
Goodwill		771,533	269,733		1,041,266
Intangible assets, net		417,092	22,675		439,767
Assets held for sale		4,131			4,131
Insurance subsidiary investments			116,424		116,424
Investment in subsidiaries	221,799			(221,799)	
Intercompany	2,655,242			(2,655,242)	
Deferred tax assets	1,040		13,932	(14,972)	
Other	47,364	108,143	63,959		219,466
	$ 2,925,445	$ 3,444,504	$ 760,010	$ (2,892,013)	$ 4,237,946
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	$ 168	$ 195,268	$ 15,232	$	$ 210,668
Salaries, wages and other compensation		345,223	43,786		389,009
Due to third party payors		35,420			35,420
Professional liability risks		3,623	50,465		54,088
Other accrued liabilities	16,724	111,113	9,367		137,204
Long-term debt due within one year	8,000	102	840		8,942
	24,892	690,749	119,690		835,331
Long-term debt	1,644,394	358	3,954		1,648,706
Intercompany		2,328,711	326,531	(2,655,242)	
Professional liability risks		68,116	168,514		236,630
Deferred tax liabilities		24,736		(14,972)	9,764

Deferred credits and other liabilities		143,722	70,949		214,671
Commitments and contingencies					
Equity:					
Stockholders equity	1,256,159	188,112	33,687	(221,799)	1,256,159
Noncontrolling interests-nonredeemable			36,685		36,685
	1,256,159	188,112	70,372	(221,799)	1,292,844
	$ 2,925,445	$ 3,444,504	$ 760,010	$ (2,892,013)	$ 4,237,946

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Balance Sheet (Continued)

	As of December 31, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 21,825	$ 19,736	$	$ 41,561
Cash restricted		5,551			5,551
Insurance subsidiary investments			70,425		70,425
Accounts receivable, net		908,100	86,600		994,700
Inventories		28,220	2,840		31,060
Deferred tax assets		17,785			17,785
Income taxes		39,184	329		39,513
Other		30,489	2,198		32,687
		1,051,154	182,128		1,233,282
Property and equipment, net		1,007,187	51,854		1,059,041
Goodwill		815,787	268,868		1,084,655
Intangible assets, net		420,468	26,739		447,207
Assets held for sale		5,612			5,612
Insurance subsidiary investments			110,227		110,227
Investment in subsidiaries	266,817			(266,817)	
Intercompany	2,503,209			(2,503,209)	
Deferred tax assets			12,387	(12,387)	
Other	52,623	92,231	53,615		198,469
	$ 2,822,649	$ 3,392,439	$ 705,818	$ (2,782,413)	$ 4,138,493
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	$ 102	$ 196,326	$ 20,373	$	$ 216,801
Salaries, wages and other compensation	43	371,022	36,428		407,493
Due to third party payors		37,306			37,306
Professional liability risks		3,582	42,428		46,010
Other accrued liabilities		121,959	8,734		130,693
Long-term debt due within one year	7,000	96	3,524		10,620
	7,145	730,291	111,487		848,923
Long-term debt	1,526,583	460	4,839		1,531,882
Intercompany		2,169,985	333,224	(2,503,209)	
Professional liability risks		108,853	108,864		217,717
Deferred tax liabilities		30,342		(12,387)	17,955
Deferred credits and other liabilities		130,466	61,305		191,771
Noncontrolling interests-redeemable			9,704		9,704

Commitments and contingencies					
Equity:					
Stockholders equity	1,288,921	222,042	44,775	(266,817)	1,288,921
Noncontrolling interests-nonredeemable			31,620		31,620
	1,288,921	222,042	76,395	(266,817)	1,320,541
	$ 2,822,649	$ 3,392,439	$ 705,818	$ (2,782,413)	$ 4,138,493

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows

	Year ended December 31, 2012				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Net cash provided by operating activities	$ 23,465	$ 210,791	$ 28,306	$	$ 262,562
Cash flows from investing activities:					
Routine capital expenditures		(106,075)	(9,100)		(115,175)
Development capital expenditures		(44,860)	(5,462)		(50,322)
Acquisitions, net of cash acquired		(178,212)			(178,212)
Sale of assets		1,260			1,260
Purchase of insurance subsidiary investments			(38,041)		(38,041)
Sale of insurance subsidiary investments			38,363		38,363
Net change in insurance subsidiary cash and cash equivalents			(21,285)		(21,285)
Change in other investments		1,465			1,465
Capital contribution to insurance subsidiary		(8,600)		8,600	
Other		(539)			(539)
Net cash used in investing activities		(335,561)	(35,525)	8,600	(362,486)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	1,784,300				1,784,300
Repayment of borrowings under revolving credit	(1,757,100)				(1,757,100)
Proceeds from issuance of term loan, net of discount	97,500				97,500
Repayment of other long-term debt	(7,000)	(95)	(3,569)		(10,664)
Payment of deferred financing costs	(1,465)				(1,465)
Contribution made by noncontrolling interests			200		200
Distribution made to noncontrolling interests			(3,829)		(3,829)
Purchase of noncontrolling interests			(719)		(719)
Issuance of common stock	147				147
Capital contribution to insurance subsidiary			8,600	(8,600)	
Change in intercompany accounts	(139,847)	140,410	(563)		
Net cash provided by (used in) financing activities	(23,465)	140,315	120	(8,600)	108,370

Change in cash and cash equivalents		15,545	(7,099)		8,446
Cash and cash equivalents at beginning of period		21,825	19,736		41,561
Cash and cash equivalents at end of period	$	$ 37,370	$ 12,637	$	$ 50,007

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Year ended December 31, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Net cash provided by (used in) operating activities	$ (34,018)	$ 175,419	$ 15,805	$ (3,500)	$ 153,706
Cash flows from investing activities:					
Routine capital expenditures		(128,976)	(3,927)		(132,903)
Development capital expenditures		(87,655)			(87,655)
Acquisitions, net of cash acquired		(745,630)	30,172		(715,458)
Sale of assets		1,714			1,714
Purchase of insurance subsidiary investments			(35,623)		(35,623)
Sale of insurance subsidiary investments			46,307		46,307
Net change in insurance subsidiary cash and cash equivalents			(14,213)		(14,213)
Change in other investments		1,003			1,003
Other		(512)			(512)
Net cash provided by (used in) investing activities		(960,056)	22,716		(937,340)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	2,126,800				2,126,800
Repayment of borrowings under revolving credit	(2,198,300)				(2,198,300)
Proceeds from issuance of senior unsecured notes	550,000				550,000
Proceeds from issuance of term loan, net of discount	693,000				693,000
Repayment of other long-term debt	(3,500)	(345,469)	(1,909)		(350,878)
Payment of deferred financing costs	(9,098)				(9,098)
Purchase of noncontrolling interests			(7,292)		(7,292)
Issuance of common stock	3,019				3,019
Change in intercompany accounts	(1,128,679)	1,134,763	(6,084)		
Insurance subsidiary distribution			(3,500)	3,500	
Other	776				776
Net cash provided by (used in) financing activities	34,018	789,294	(18,785)	3,500	808,027
Change in cash and cash equivalents		4,657	19,736		24,393
Cash and cash equivalents at beginning of period		17,168			17,168

Cash and cash equivalents at end of period	$	$ 21,825	$ 19,736	$	$ 41,561

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Year ended December 31, 2010				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Net cash provided by (used in) operating activities	$ 36,973	$ 198,901	$ (4,086)	$ (21,800)	$ 209,988
Cash flows from investing activities:					
Routine capital expenditures		(108,896)			(108,896)
Development capital expenditures		(67,841)			(67,841)
Acquisitions		(279,794)			(279,794)
Sale of assets		649			649
Purchase of insurance subsidiary investments			(43,913)		(43,913)
Sale of insurance subsidiary investments			82,736		82,736
Net change in insurance subsidiary cash and cash equivalents			(8,521)		(8,521)
Change in other investments		2			2
Other		962			962
Net cash provided by (used in) investing activities		(454,918)	30,302		(424,616)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	2,030,800				2,030,800
Repayment of borrowings under revolving credit	(1,812,800)				(1,812,800)
Repayment of other long-term debt		(86)			(86)
Payment of deferred financing costs	(2,831)				(2,831)
Issuance of common stock	49				49
Change in intercompany accounts	(252,446)	256,862	(4,416)		
Insurance subsidiary distribution			(21,800)	21,800	
Other	255	106			361
Net cash provided by (used in) financing activities	(36,973)	256,882	(26,216)	21,800	215,493
Change in cash and cash equivalents		865			865
Cash and cash equivalents at beginning of period		16,303			16,303
Cash and cash equivalents at end of period	$	$ 17,168	$	$	$ 17,168

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 19 LEGAL AND REGULATORY PROCEEDINGS

The Company provides services in a highly regulated industry and is subject to various legal actions (some of which are not insured) and regulatory and other governmental audits and investigations from time to time. These matters could (1) require the Company to pay substantial damages, fines, penalties or amounts in judgments or settlements, which individually or in the aggregate could exceed amounts, if any, that may be recovered under the Company s insurance policies where coverage applies and is available; (2) cause the Company to incur substantial expenses; (3) require significant time and attention from the Company s management; (4) subject the Company to sanctions including possible exclusions from the Medicare and Medicaid programs; and (5) cause the Company to close or sell one or more facilities or otherwise modify the way the Company conducts business. The ultimate resolution of these matters, whether as a result of litigation or settlement, could have a material adverse effect on the Company s business, financial position, results of operations and liquidity.

In accordance with authoritative accounting guidance related to loss contingencies, the Company records an accrued liability for litigation and regulatory matters that are both probable and can be reasonably estimated. Additional losses in excess of amounts accrued may be reasonably possible. The Company reviews loss contingencies that are reasonably possible and determines whether an estimate of the possible loss or range of loss, individually or in aggregate, can be disclosed in the Company s consolidated financial statements. These estimates are based upon currently available information for those legal and regulatory proceedings in which the Company is involved, taking into account the Company s best estimate of losses for those matters for which such estimate can be made. The Company s estimates involve significant judgment, given that (1) these legal and regulatory proceedings are in early stages; (2) discovery is not completed; (3) damages sought in these legal and regulatory proceedings can be unsubstantiated or indeterminate; (4) the matters present legal uncertainties or evolving areas of law; (5) there are often significant facts in dispute; and (6) there is a wide range of possible outcomes. Accordingly, the Company s estimated loss or range of loss may change from time to time, and actual losses may be more or less than the current estimate. At this time, no estimate of the possible loss or range of loss, individually or in the aggregate, in excess of the amounts accrued, if any, can be made regarding the matters described below.

Set forth below are descriptions of the Company s significant legal proceedings.

Medicare and Medicaid payment reviews, audits and investigations as a result of the Company s participation in the Medicare and Medicaid programs, the Company faces and is currently subject to various governmental reviews, audits and investigations to verify the Company s compliance with these programs and applicable laws and regulations. The Company is routinely subject to audits under various government programs, such as the CMS Recovery Audit Contractor program, in which third party firms engaged by CMS conduct extensive reviews of claims data and medical and other records to identify potential improper payments to healthcare providers under the Medicare program. In addition, the Company, like other hospitals, nursing center operators and rehabilitation therapy service contractors, is subject to ongoing investigations by the U.S. Department of Health and Human Services Office of Inspector General into the billing of rehabilitation services provided to Medicare patients and general compliance with conditions of participation in the Medicare and Medicaid programs. Private pay sources such as third party insurance and managed care entities also often reserve the right to conduct audits. The Company s costs to respond to and defend any such reviews, audits and investigations can be significant and are likely to increase in the current enforcement environment. These audits and investigations may require the Company to refund or retroactively adjust amounts that have been paid under the relevant government program or by other payors. Further, an adverse review, audit or investigation also could result in other adverse consequences, particularly if the underlying conduct is found to be pervasive or systemic. These consequences include (1) state or federal agencies imposing fines, penalties and other sanctions on the Company; (2) loss of the

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KINDRED HEALTHCARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 19 LEGAL AND REGULATORY PROCEEDINGS (Continued)

Company s right to participate in the Medicare or Medicaid programs or one or more third party payor networks; and/or (3) damage to the Company s reputation in various markets, which could adversely affect the Company s ability to attract patients, residents and employees.

Whistleblower lawsuits the Company is also subject to *qui tam* or whistleblower lawsuits under the False Claims Act and comparable state laws for allegedly submitting fraudulent bills for services to the Medicare and Medicaid programs. These lawsuits involve monetary damages, fines, attorneys fees and the award of bounties to private *qui tam* plaintiffs who successfully bring these lawsuits and to the respective government programs. The Company also could be subject to civil penalties (including the loss of the Company s licenses to operate one or more facilities or healthcare activities), criminal penalties (for violations of certain laws and regulations), and exclusion of one or more facilities or healthcare activities from participation in the Medicare, Medicaid and other federal and state healthcare programs.

Employment-related lawsuits the Company s operations are subject to a variety of federal and state employment-related laws and regulations, including but not limited to the U.S. Fair Labor Standards Act, regulations of the Equal Employment Opportunity Commission, the Office of Civil Rights and state attorneys general, federal and state wage and hour laws and a variety of laws enacted by the federal and state governments that govern these and other employment-related matters. Accordingly, the Company is currently subject to employee-related claims, class action and other lawsuits and proceedings in connection with the Company s operations, including but not limited to those related to alleged wrongful discharge, illegal discrimination and violations of equal employment and federal and state wage and hour laws. Because labor represents such a large portion of the Company s operating costs, non-compliance with these evolving federal and state laws and regulations could subject the Company to significant back pay awards, fines and additional lawsuits and proceedings. These claims, lawsuits and proceedings are in various stages of adjudication or investigation and involve a wide variety of claims and potential outcomes. Based upon currently available information, the Company has recorded a $5 million loss provision related to these claims, lawsuits and proceedings during 2012, but the actual losses may be more than the provision for loss.

Minimum staffing lawsuits various states in which the Company operates hospitals and nursing and rehabilitation centers have established minimum staffing requirements or may establish minimum staffing requirements in the future. While the Company seeks to comply with all applicable staffing requirements, the regulations in this area are complex and the Company may experience compliance issues from time to time. Failure to comply with such minimum staffing requirements may result in one or more facilities failing to meet the conditions of participation under relevant federal and state healthcare programs and the imposition of significant fines, damages or other sanctions. Private litigation involving these matters also has become more common, and certain of the Company s facilities are the subject of a class action lawsuit involving claims that these facilities did not meet relevant staffing requirements from time to time since 2006.

Ordinary course matters in addition to the matters described above, the Company is subject to investigations, claims and lawsuits in the ordinary course of business, including professional liability claims, particularly in the Company s hospital and nursing and rehabilitation center operations. In many of these claims, plaintiffs attorneys are seeking significant fines and compensatory and punitive damages, along with attorneys fees. The Company maintains professional and general liability insurance in amounts and coverage that management believes are sufficient for the Company s operations. However, the Company s insurance may not cover all claims against the Company or the full extent of the Company s liability.

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KINDRED HEALTHCARE, INC.

QUARTERLY CONSOLIDATED FINANCIAL INFORMATION (UNAUDITED)

(In thousands, except per share amounts)

The following table represents summary quarterly consolidated financial information (unaudited) for the years ended December 31, 2012 and 2011:

	2012 (a)			
	First	Second	Third	Fourth
Revenues	$ 1,576,359	$ 1,533,235	$ 1,523,976	$ 1,547,721
Net income (loss):				
Income (loss) from continuing operations	20,955	16,216	10,350	(79,892)
Discontinued operations, net of income taxes:				
Loss from operations	(1,143)	(597)	(463)	(5)
Loss on divestiture of operations	(1,170)	(356)	(2,280)	(939)
Net income (loss)	18,642	15,263	7,607	(80,836)
(Earnings) loss attributable to noncontrolling interests	(451)	239	(41)	(790)
Income (loss) attributable to Kindred	18,191	15,502	7,566	(81,626)
Earnings (loss) per common share:				
Basic:				
Income (loss) from continuing operations	0.39	0.31	0.19	(1.56)
Discontinued operations:				
Loss from operations	(0.02)	(0.01)	(0.01)	
Loss on divestiture of operations	(0.02)	(0.01)	(0.04)	(0.02)
Net income (loss)	0.35	0.29	0.14	(1.58)
Diluted:				
Income (loss) from continuing operations	0.39	0.31	0.19	(1.56)
Discontinued operations:				
Loss from operations	(0.02)	(0.01)	(0.01)	
Loss on divestiture of operations	(0.02)	(0.01)	(0.04)	(0.02)
Net income (loss)	0.35	0.29	0.14	(1.58)
Shares used in computing earnings (loss) per common share:				
Basic	51,603	51,664	51,676	51,692
Diluted	51,638	51,675	51,709	51,692
Market prices:				
High	13.62	10.87	12.76	12.13
Low	8.63	7.60	8.80	9.68

	2011 (a)			
	First	Second	Third	Fourth
Revenues	$ 1,189,851	$ 1,288,478	$ 1,508,164	$ 1,517,435
Net income (loss):				
Income (loss) from continuing operations	22,679	(6,343)	1,145	(65,534)
Income (loss) from discontinued operations	(582)	390	881	(6,355)
Net income (loss)	22,097	(5,953)	2,026	(71,889)
(Earnings) loss attributable to noncontrolling interests		421	(241)	58
Income (loss) attributable to Kindred	22,097	(5,532)	1,785	(71,831)
Earnings (loss) per common share:				
Basic:				
Income (loss) from continuing operations	0.57	(0.14)	0.02	(1.28)
Income (loss) from discontinued operations	(0.01)	0.01	0.01	(0.12)
Net income (loss)	0.56	(0.13)	0.03	(1.40)
Diluted:				
Income (loss) from continuing operations	0.56	(0.14)	0.02	(1.28)
Income (loss) from discontinued operations	(0.01)	0.01	0.01	(0.12)
Net income (loss)	0.55	(0.13)	0.03	(1.40)
Shares used in computing earnings (loss) per common share:				

Basic	39,035	43,231	51,329	51,335
Diluted	39,543	43,231	51,406	51,335
Market prices:				
High	26.27	28.99	23.69	13.12
Low	17.85	20.53	8.62	7.67

(a) See accompanying discussion of certain quarterly items.

KINDRED HEALTHCARE, INC.

QUARTERLY CONSOLIDATED FINANCIAL INFORMATION (UNAUDITED) (Continued)

SIGNIFICANT QUARTERLY ADJUSTMENTS

The following is a description of significant quarterly adjustments recorded during 2012, 2011 and 2010:

Fourth quarter 2012

Operating results for the fourth quarter of 2012 included pretax charges related to employee severance costs of $3.4 million and contract cancellation costs of $0.9 million incurred in connection with restructuring activities, employee retention costs incurred in connection with the decision to allow the leases to expire for 54 nursing and rehabilitation centers leased from Ventas of $0.9 million, transaction-related costs of $0.6 million, a lease cancellation charge of $0.1 million and impairment charges of $107.9 million.

Third quarter 2012

Operating results for the third quarter of 2012 included pretax charges related to employee retention costs incurred in connection with the decision to allow the leases to expire for 54 nursing and rehabilitation centers leased from Ventas of $0.6 million, transaction-related costs of $0.5 million and a lease cancellation charge of $0.6 million.

Second quarter 2012

Operating results for the second quarter of 2012 included pretax charges related to employment-related lawsuits of $5.0 million, costs incurred in connection with the closing of two TC hospitals and the cancellation of a sub-acute unit project of $2.3 million, costs incurred in connection with the decision to allow the leases to expire for 54 nursing and rehabilitation centers leased from Ventas of $0.7 million, transaction-related costs of $0.6 million and a lease cancellation charge of $0.9 million.

First quarter 2012

Operating results for the first quarter of 2012 included pretax charges related to costs incurred in connection with the closing of a regional office of $2.2 million and transaction-related costs of $0.5 million.

Fourth quarter 2011

Operating results for the fourth quarter of 2011 included pretax charges related to severance and retirement costs of $0.6 million, transaction-related costs of $4.4 million, a lease cancellation charge of $1.8 million, impairment charges of $91.5 million and a loss on the divestiture of a hospital of $1.5 million.

Third quarter 2011

Operating results for the third quarter of 2011 included pretax charges related to severance and retirement costs of $1.3 million, transaction-related costs of $5.3 million and impairment charges of $26.7 million.

Second quarter 2011

Operating results for the second quarter of 2011 included pretax charges related to severance and retirement costs of $14.9 million, transaction-related costs of $20.0 million and financing costs related to the RehabCare Merger of $11.8 million.

First quarter 2011

Operating results for the first quarter of 2011 included pretax charges related to transaction-related costs of $4.2 million and financing costs related to the RehabCare Merger of $2.0 million.

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KINDRED HEALTHCARE, INC.

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

FOR THE YEARS ENDED DECEMBER 31, 2012, 2011 AND 2010

(In thousands)

		Additions				
	Balance at beginning of period	Charged to costs and expenses	Other	Acquisitions	Deductions or payments	Balance at end of period
Allowance for loss on accounts receivable:						
Year ended December 31, 2010	$ 20,156	$ 24,397	$	$	$ (30,969)	$ 13,584
Year ended December 31, 2011	13,584	35,133			(18,971)	29,746
Year ended December 31, 2012	29,746	23,692			(29,479)	23,959
Allowance for deferred taxes:						
Year ended December 31, 2010	$ 35,070	$	$ 3,833(a)	$	$ (472)	$ 38,431
Year ended December 31, 2011	38,431		163(a)	112	(75)	38,631
Year ended December 31, 2012	38,631		7,352(a)	3,031	(37)	48,977

(a) The Company identified deferred income tax assets for state income tax NOLs of $52.7 million, $42.1 million, and $42.2 million at December 31, 2012, December 31, 2011 and December 31, 2010, respectively, and a corresponding deferred income tax valuation allowance of $48.4 million, $38.0 million and $37.8 million at December 31, 2012, December 31, 2011 and December 31, 2010, respectively, after determining that a portion of these net deferred income tax assets were not realizable.