

Edgar Filing: KINDRED HEALTHCARE INC - Form 10-Q/A

KINDRED HEALTHCARE INC  
Form 10-Q/A  
August 29, 2001

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q/A

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2000

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 001-14057

KINDRED HEALTHCARE, INC.  
(Formerly Vencor, Inc.)  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

61-1323993  
(I.R.S. Employer  
Identification No.)

680 South Fourth Street  
Louisville, KY  
(Address of principal executive offices)

40202-2412  
(Zip Code)

(502) 596-7300  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class of Common Stock                   | Outstanding at July 31, 2000 |
|---|------------------------------|
| -----<br>Common stock, \$0.25 par value | -----<br>70,264,693 shares   |

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KINDRED HEALTHCARE, INC.  
 (Formerly Vencor, Inc., a Debtor-in-Possession)  
 FORM 10-Q/A  
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KINDRED HEALTHCARE, INC.  
 (Formerly Vencor, Inc., a Debtor-in-Possession)  
 CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS  
 For the quarter and six months ended June 30, 2000 and 1999  
 (Unaudited)  
 (In thousands, except per share amounts)

|   | (Restated - See Note 2) |           |             |            |
|---|-------------------------|-----------|-------------|------------|
|   | Quarter                 |           | Six Months  |            |
|   | 2000                    | 1999      | 2000        | 1999       |
| Revenues.....                                       | \$713,424               | \$688,892 | \$1,428,880 | \$1,389,12 |
| Salaries, wages and benefits.....                   | 392,383                 | 392,748   | 797,696     | 796,64     |
| Supplies.....                                       | 94,619                  | 85,799    | 188,017     | 170,79     |
| Rent.....   | 76,788                  | 76,088    | 153,008     | 151,54     |
| Other operating expenses.....                       | 122,770                 | 134,743   | 245,359     | 247,30     |
| Depreciation and amortization.....                  | 18,168                  | 21,612    | 36,070      | 43,89      |
| Interest expense.....                               | 14,663                  | 20,032    | 30,902      | 39,56      |
| Investment income.....                              | (1,012)                 | (642)     | (2,218)     | (1,27      |
|   | 718,379                 | 730,380   | 1,448,834   | 1,448,47   |
| Loss before reorganization costs and income taxes.. | (4,955)                 | (41,488)  | (19,954)    | (59,35     |
| Reorganization costs.....                           | 2,530                   | 4,547     | 5,595       | 6,85       |

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|  |            |             |             |             |
|--|------------|-------------|-------------|-------------|
| Loss before income taxes.....  | (7,485)    | (46,035)    | (25,549)    | (66,200)    |
| Provision for income taxes.....                                      | 500        | 50          | 1,000       | 100         |
| Loss from operations.....  | (7,985)    | (46,085)    | (26,549)    | (66,300)    |
| Cumulative effect of change in accounting<br>for start-up costs..... | -          | -           | -           | (8,920)     |
| Net loss.....  | (7,985)    | (46,085)    | (26,549)    | (75,230)    |
| Preferred stock dividend requirements.....                           | (262)      | (262)       | (523)       | (523)       |
| Loss to common stockholders.....                                     | \$ (8,247) | \$ (46,347) | \$ (27,072) | \$ (75,753) |
| Loss per common share:   |            |             |             |             |
| Basic:   |            |             |             |             |
| Loss from operations.....  | \$ (0.12)  | \$ (0.66)   | \$ (0.39)   | \$ (0.99)   |
| Cumulative effect of change in accounting<br>for start-up costs..... | -          | -           | -           | (0.12)      |
| Net loss.....  | \$ (0.12)  | \$ (0.66)   | \$ (0.39)   | \$ (1.00)   |
| Diluted:   |            |             |             |             |
| Loss from operations.....  | \$ (0.12)  | \$ (0.66)   | \$ (0.39)   | \$ (0.99)   |
| Cumulative effect of change in accounting<br>for start-up costs..... | -          | -           | -           | (0.12)      |
| Net loss.....  | \$ (0.12)  | \$ (0.66)   | \$ (0.39)   | \$ (1.00)   |
| Shares used in computing loss per common share:                      |            |             |             |             |
| Basic.....   | 70,147     | 70,395      | 70,194      | 70,360      |
| Diluted.....   | 70,147     | 70,395      | 70,194      | 70,360      |

See accompanying notes.

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KINDRED HEALTHCARE, INC.  
(Formerly Vencor, Inc., a Debtor-in-Possession)  
CONDENSED CONSOLIDATED BALANCE SHEET  
(Unaudited)  
(In thousands, except per share amounts)

|  | (Restated)       |                      |
|--|------------------|----------------------|
|  | June 30,<br>2000 | December 31,<br>1999 |
|  | -----            | -----                |
| ASSETS   |                  |                      |
| Current assets:                                  |                  |                      |
| Cash and cash equivalents.....                   | \$ 183,146       | \$ 148,350           |
| Accounts receivable less allowance for loss..... | 302,445          | 324,135              |
| Inventories.....                                 | 29,711           | 28,956               |
| Insurance subsidiary investments.....            | 46,101           | 16,483               |
| Income taxes.....                                | 7,321            | 8,884                |
| Other.....                                       | 68,483           | 65,076               |
|  | -----            | -----                |

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|   |              |              |
|---|--------------|--------------|
|   | 637,207      | 591,884      |
| Property and equipment, at cost.....        | 625,422      | 615,160      |
| Accumulated depreciation.....               | (268,777)    | (243,526)    |
|   | -----        | -----        |
|   | 356,645      | 371,634      |
| Goodwill less accumulated amortization..... | 167,971      | 173,818      |
| Investment in affiliates.....               | 15,728       | 15,874       |
| Assets held for sale.....                   | 8,422        | 17,217       |
| Other.....                                  | 62,406       | 65,547       |
|   | -----        | -----        |
|   | \$ 1,248,379 | \$ 1,235,974 |
|   | =====        | =====        |

LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)

|  |              |              |
|--|--------------|--------------|
| Current liabilities:   |              |              |
| Accounts payable.....  | \$ 94,098    | \$ 101,219   |
| Salaries, wages and other compensation.....  | 155,957      | 159,482      |
| Due to third party payors.....   | 41,655       | 52,205       |
| Other accrued liabilities.....   | 82,421       | 83,967       |
|  | -----        | -----        |
|  | 374,131      | 396,873      |
| Professional liability risks.....  | 95,791       | 72,785       |
| Deferred credits and other liabilities.....  | 14,112       | 11,178       |
| Liabilities subject to compromise.....   | 1,195,660    | 1,159,417    |
| Series A preferred stock (subject to compromise).....  | 1,743        | 1,743        |
| Stockholders' equity (deficit):  |              |              |
| Common stock, \$0.25 par value; authorized 180,000 shares;<br>issued 70,265 shares -- June 30 and 70,278 shares -- December 31.. | 17,566       | 17,570       |
| Capital in excess of par value.....  | 667,118      | 667,078      |
| Accumulated deficit.....   | (1,117,742)  | (1,090,670)  |
|  | -----        | -----        |
|  | (433,058)    | (406,022)    |
|  | -----        | -----        |
|  | \$ 1,248,379 | \$ 1,235,974 |
|  | =====        | =====        |

See accompanying notes.

KINDRED HEALTHCARE, INC.  
(Formerly Vencor, Inc., a Debtor-in-Possession)  
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS  
For the six months ended June 30, 2000 and 1999  
(Unaudited)  
(In thousands)

(Rest

-----  
2000  
-----

Cash flows from operating activities:

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|   |             |
|---|-------------|
| Net loss.....   | \$ (26,549) |
| Adjustments to reconcile net loss to net cash provided by operating activities: |             |
| Depreciation and amortization.....  | 36,070      |
| Provision for doubtful accounts.....  | 17,368      |
| Unusual transactions.....   | (4,535)     |
| Reorganization costs.....   | 5,595       |
| Cumulative effect of change in accounting for start-up costs.....               | -           |
| Other.....  | 10,853      |
| Changes in operating assets and liabilities:                                    |             |
| Accounts receivable.....  | 9,816       |
| Inventories and other assets.....   | (462)       |
| Accounts payable.....   | 6,487       |
| Income taxes.....   | 1,563       |
| Due to third party payors.....  | (10,551)    |
| Other accrued liabilities.....  | 64,103      |
|   | -----       |
| Net cash provided by operating activities before reorganization costs...        | 109,758     |
| Payment of reorganization costs.....  | (3,719)     |
|   | -----       |
| Net cash provided by operating activities.....                                  | 106,039     |
|   | -----       |
| Cash flows from investing activities:   |             |
| Purchase of property and equipment.....   | (22,323)    |
| Sale of assets.....   | 13,069      |
| Surety bond deposits.....   | (4,147)     |
| Net change in investments.....  | (30,485)    |
| Collection of notes receivable.....   | 1,469       |
| Other.....  | 518         |
|   | -----       |
| Net cash used in investing activities.....                                      | (41,899)    |
|   | -----       |
| Cash flows from financing activities:   |             |
| Net change in lines of credit.....  | -           |
| Repayment of long-term debt.....  | (10,061)    |
| Payment of debtor-in-possession deferred financing costs.....                   | (600)       |
| Payment of deferred financing costs.....  | -           |
| Other.....  | (18,683)    |
|   | -----       |
| Net cash used in financing activities.....                                      | (29,344)    |
|   | -----       |
| Change in cash and cash equivalents.....  | 34,796      |
| Cash and cash equivalents at beginning of period.....                           | 148,350     |
|   | -----       |
| Cash and cash equivalents at end of period.....                                 | \$183,146   |
|   | =====       |
| Supplemental information:   |             |
| Interest payments.....  | \$ 6,164    |
| Income tax refunds.....   | 504         |

See accompanying notes.

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### NOTE 1 -- BASIS OF PRESENTATION

Kindred Healthcare Inc. ("Kindred" or the "Company") (formerly Vencor, Inc.) provides long-term healthcare services primarily through the operation of nursing centers and hospitals. At June 30, 2000, the Company's health services division operated 321 nursing centers (41,113 licensed beds) in 31 states and a rehabilitation therapy business. The Company's hospital division operated 56 hospitals (4,880 licensed beds) in 23 states and an institutional pharmacy business.

The Company and substantially all of its subsidiaries filed voluntary petitions for protection under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") on September 13, 1999. The Company currently is operating its businesses as a debtor-in-possession subject to the jurisdiction of the United States Bankruptcy Court in Delaware (the "Bankruptcy Court"). Accordingly, the unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the American Institute of Certified Public Accountants Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7") and generally accepted accounting principles applicable to a going concern, which assumes that assets will be realized and liabilities will be discharged in the normal course of business. The unaudited condensed consolidated financial statements do not include any adjustments that might result from the resolution of the Chapter 11 Cases (as defined) or other matters discussed in the accompanying notes. The Company's continued operating losses, liquidity issues and the Chapter 11 Cases raise substantial doubt about the Company's ability to continue as a going concern. The ability of the Company to continue as a going concern and the appropriateness of using the going concern basis of accounting are dependent upon, among other things, (i) the Company's ability to comply with the terms of the DIP Financing (as defined), (ii) confirmation of a plan of reorganization under the Bankruptcy Code, (iii) the Company's ability to achieve profitable operations after such confirmation, and (iv) the Company's ability to generate sufficient cash from operations to meet its obligations. The plan of reorganization and other actions during the Chapter 11 Cases could change materially the amounts currently recorded in the unaudited condensed consolidated financial statements. See Note 4.

On May 1, 1998, Ventas, Inc. ("Ventas") completed the spin-off (the "Spin-off") of its healthcare operations to its stockholders through the distribution of Vencor common stock. Ventas retained ownership of substantially all of its real property and leases such real property to the Company pursuant to four master lease agreements. In anticipation of the Spin-off, the Company was incorporated on March 27, 1998 as a Delaware corporation. For accounting purposes, the consolidated historical financial statements of Ventas became the historical financial statements of the Company upon consummation of the Spin-off. Any discussion concerning events prior to May 1, 1998 refers to the Company's business as it was conducted by Ventas prior to the Spin-off.

The Company regularly reviews the carrying value of certain long-lived assets in accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" ("SFAS 121"). SFAS 121 requires impairment losses to be recognized for long-lived assets used in operations when indications of impairment are present and the estimate of undiscounted future cash flows is not sufficient to recover asset carrying amounts. Operating results for the second quarter and six months ended June 30, 2000 include asset impairment charges of \$3.8 million and \$5.6 million, respectively.

The accompanying unaudited condensed consolidated financial statements do not include all of the disclosures normally required by generally accepted accounting principles or those normally required in annual reports on Form 10-K. Accordingly, these statements should be read in conjunction with the audited

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consolidated financial statements of the Company for the year ended December 31, 1999 filed with the Securities and Exchange Commission on Form 10-K.

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KINDRED HEALTHCARE, INC.  
(Formerly Vencor, Inc., a Debtor-in-Possession)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

NOTE 1 -- BASIS OF PRESENTATION (Continued)

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the Company's customary accounting practices and the provisions of SOP 90-7. Management believes that the financial information included herein reflects all adjustments necessary for a fair presentation of interim results and, except for the transactions described in Notes 3, 6 and 7, all such adjustments are of a normal and recurring nature.

In the fourth quarter of 1999, the Company realigned its Vencare ancillary services business. Vencare's rehabilitation, speech and occupational therapy businesses were integrated into the Company's health services division, and its institutional pharmacy business was assigned to the hospital division. Vencare's respiratory therapy and certain other ancillary businesses were discontinued. The accompanying unaudited condensed consolidated financial statements reflect the realignment of the former Vencare business for all periods presented.

Effective January 1, 2000, the Company adopted an amortization period of 20 years from the date of acquisition for goodwill. Prior thereto, the Company generally amortized such costs over 40 years.

Certain prior period amounts have been reclassified to conform with the current period presentation.

NOTE 2 -- RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

On August 14, 2001, the Company announced that it will restate certain of its previously issued consolidated financial statements. The Company recently determined that an oversight related to the allowance for professional liability risks had occurred in its consolidated financial statements beginning in 1998. The oversight resulted in the understatement of the provision for professional liability claims in 1998, 1999 and 2000 because the Company did not record a reserve for claims incurred but not reported at the respective balance sheet dates. The cumulative understatement of professional liability claims reserves approximated \$5 million at December 31, 1998, \$28 million at December 31, 1999 and \$39 million at December 31, 2000. The restatement had no effect on previously reported cash flows from operations.

The unaudited consolidated financial statements included herein amend those previously included in the Company's Quarterly Report on Form 10-Q for the three months ended June 30, 2000. Consolidated financial statement information and related disclosures included in these amended unaudited condensed consolidated financial statements reflect, where appropriate, changes resulting from the restatement.

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NOTE 2 -- RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS (continued)

The effect of the restatement on the Company's previously issued unaudited condensed consolidated financial statements follows (in thousands, except per share amounts):

|                           | Three months ended June 30, |             |                        |             | Six months ended June 30, |             |
|---------------------------|-----------------------------|-------------|------------------------|-------------|---------------------------|-------------|
|                           | 2000                        |             | 1999                   |             | 2000                      |             |
|                           | As previously reported      | As restated | As previously reported | As restated | As previously reported    | As restated |
| Loss from operations..... | \$ (5,192)                  | \$ (7,985)  | \$ (40,531)            | \$ (46,085) | \$ (20,963)               | \$ (20,963) |
| Net loss.....             | (5,192)                     | (7,985)     | (40,531)               | (46,085)    | (20,963)                  | (20,963)    |
| Loss per common share:    |                             |             |                        |             |                           |             |
| Basic:                    |                             |             |                        |             |                           |             |
| Loss from operations...   | \$ (0.08)                   | \$ (0.12)   | \$ (0.58)              | \$ (0.66)   | \$ (0.31)                 | \$ (0.31)   |
| Net loss.....             | (0.08)                      | (0.12)      | (0.58)                 | (0.66)      | (0.31)                    | (0.31)      |
| Diluted:.....             |                             |             |                        |             |                           |             |
| Loss from operations...   | \$ (0.08)                   | \$ (0.12)   | \$ (0.58)              | \$ (0.66)   | \$ (0.31)                 | \$ (0.31)   |
| Net loss.....             | (0.08)                      | (0.12)      | (0.58)                 | (0.66)      | (0.31)                    | (0.31)      |

|                                   | June 30, 2000          |             |
|-----------------------------------|------------------------|-------------|
|                                   | As previously reported | As restated |
| Professional liability risks..... | \$ 62,492              | \$ 9,999    |
| Total liabilities.....            | 1,646,395              | 1,676,395   |
| Accumulated deficit.....          | (1,084,443)            | (1,114,443) |
| Stockholders' deficit.....        | (399,759)              | (434,759)   |

NOTE 3 -- ACCOUNTING CHANGE

Effective January 1, 1999, the Company adopted the provisions of the American Institute of Certified Public Accountants Statement of Position 98-5, "Reporting on the Costs of Start-Up Activities" ("SOP 98-5"), which requires the Company to expense start-up costs, including organizational costs, as incurred. In accordance with the provisions of SOP 98-5, the Company wrote off \$8.9 million of such unamortized costs as a cumulative effect of change in accounting principle in the first quarter of 1999.

NOTE 4 -- PROCEEDINGS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE

On September 13, 1999, the Company and substantially all of its subsidiaries filed voluntary petitions for protection under Chapter 11 of the Bankruptcy Code. The Chapter 11 cases have been consolidated for purposes of joint administration under Case Nos. 99-3199 (MFW) through 99-3327 (MFW) (collectively, the "Chapter 11 Cases"). The Company currently is operating its businesses as a debtor-in-possession subject to the jurisdiction of the Bankruptcy Court.



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On September 14, 1999, the Company received approval from the Bankruptcy Court to pay pre-petition and post-petition employee wages, salaries, benefits and other employee obligations. The Bankruptcy Court also approved orders granting authority, among other things, to pay pre-petition claims of certain critical vendors, utilities and patient obligations. All other pre-petition liabilities are classified in the unaudited condensed consolidated balance sheet as liabilities subject to compromise. The Company currently is paying the post-petition claims of all vendors and providers in the ordinary course of business.

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KINDRED HEALTHCARE, INC.  
(Formerly Vencor, Inc., a Debtor-in-Possession)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

NOTE 4 -- PROCEEDINGS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE (Continued)

In connection with the Chapter 11 Cases, the Company entered into a \$100 million debtor-in-possession financing agreement (the "DIP Financing") with a bank group led by Morgan Guaranty Trust Company of New York (collectively, the "DIP Lenders"). The Bankruptcy Court granted final approval of the DIP Financing on October 1, 1999. The DIP Financing, which was initially scheduled to mature on March 13, 2000, is comprised of a \$75 million tranche A revolving loan (the "Tranche A Loan") and a \$25 million tranche B revolving loan (the "Tranche B Loan"). Interest is payable at prime rate plus 2 1/2% on the Tranche A Loan and prime rate plus 4 1/2% on the Tranche B Loan.

Available aggregate borrowings under the Tranche A Loan were initially limited to \$45 million in September 1999 and increased to \$65 million in October, \$70 million in November and \$75 million thereafter. Pursuant to an amendment to the DIP Financing, the aggregate borrowing limitations under the Tranche A Loans are limited to approximately \$68 million until maturity and are reduced for asset sales made by the Company. At June 30, 2000, aggregate available borrowings under the Tranche A Loan were \$63 million. Borrowings under the Tranche B Loan require the approval of lenders holding at least 75% of the credit exposure under the DIP Financing. The DIP Financing is secured by substantially all of the assets of the Company and its subsidiaries, including certain owned real property. The DIP Financing contains standard representations and warranties and other affirmative and restrictive covenants. At June 30, 2000, there were no outstanding borrowings under the DIP Financing.

Since the consummation of the DIP Financing, the Company and the DIP Lenders have agreed to several amendments to the DIP Financing. These amendments approved various changes to the DIP Financing including (i) extending the period of time for the Company to file its plan of reorganization, (ii) approving certain transactions, (iii) revising the Company's cash plan originally submitted with the DIP Financing and (iv) revising certain financial covenants. In December 1999, the Company informed the DIP Lenders that it planned to record a significant charge to earnings in the fourth quarter of 1999 related to the valuation of accounts receivable that could have resulted in noncompliance with certain covenants in the DIP Financing requiring minimum Consolidated EBITDAR and a minimum Net Amount of Eligible Accounts (both as defined in the DIP Financing). In connection with the third amendment to the DIP Financing, the Company received a waiver from compliance with these covenants of the DIP Financing through February 14, 2000. The Company received subsequent waivers from compliance with these covenants in later amendments.

At December 31, 1999, the Company was not in compliance with the DIP Financing covenant related to the minimum Net Amount of Eligible Accounts (accounts receivable). Since there were no outstanding borrowings under the DIP

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Financing at December 31, 1999, the event of default had no effect on the Company's 1999 consolidated financial statements. Effective April 12, 2000, the Company and the DIP Lenders agreed to an additional amendment to the DIP Financing to revise the covenant related to the minimum Net Amount of Eligible Accounts. In the amendment, the DIP Lenders also waived all events of default regarding this covenant that occurred prior to the date of the amendment.

On June 12, 2000, the Company entered into a commitment letter (the "Commitment Letter") with certain of the DIP Lenders to finance an amended and restated debtor-in-possession credit agreement in an aggregate principal amount of \$90 million (the "Restated DIP"). The Restated DIP would become effective in the event the Company became involved in a legal proceeding against Ventas. The Commitment Letter will expire on August 31, 2000 unless the Company obtains Bankruptcy Court approval of the Commitment Letter and pays all fees payable upon such approval. The hearing on the motion is scheduled for August 23, 2000. Under the terms of the Commitment Letter, the Restated DIP will not be available unless it becomes effective on or prior to September 30, 2000.

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KINDRED HEALTHCARE, INC.  
(Formerly Vencor, Inc., a Debtor-in-Possession)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

NOTE 4 -- PROCEEDINGS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE (Continued)

In the recent amendments to the DIP Financing, the parties agreed, among other things, to extend the maturity date of the DIP Financing until September 30, 2000 and to extend the period of time for the Company to file its plan of reorganization to August 17, 2000.

On November 4, 1999, the Company received approval (subject to certain conditions) to implement a management retention plan (the "Management Retention Plan") to enhance the ability of the Company to retain key management employees during the reorganization period. Under the Management Retention Plan, bonuses aggregating \$7.3 million will be awarded to certain key management employees based upon various percentages of their annual salary. The Management Retention Plan provides that the retention bonuses be paid in three equal amounts upon: (i) the Bankruptcy Court's approval of the Management Retention Plan, (ii) the effective date of the plan of reorganization and (iii) three months following the effective date of the plan of reorganization.

Under the Bankruptcy Code, actions to collect pre-petition indebtedness against the Company are subject to an automatic stay and other contractual obligations against the Company may not be enforced. The automatic stay does not necessarily apply to certain actions against Ventas for which the Company has agreed to indemnify Ventas in connection with the Spin-off. In addition, the Company may assume or reject executory contracts, including lease obligations, under the Bankruptcy Code. Parties affected by these rejections may file claims with the Bankruptcy Court in accordance with the reorganization process.

As previously disclosed, the Company is developing a plan of reorganization through negotiations with key parties including its senior bank lenders (the "Senior Lenders"), the holders of the Company's \$300 million 9 7/8% Guaranteed Senior Subordinated Notes due 2005 (the "1998 Notes"), Ventas, the Department of Justice (the "DOJ"), acting on behalf of the Health Care Financing Administration ("HCFA") and the Department of Health and Human Services' Office of the Inspector General (the "OIG") and the advisors to the official committee of unsecured creditors. The Company has made substantial progress in its discussions with Ventas, the Senior Lenders, the holders of the 1998 Notes, the

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DOJ and the unsecured creditors committee toward a consensual plan of reorganization.

On August 11, 2000, the Company filed a motion to extend its exclusive right to submit a plan of reorganization through September 29, 2000. The hearing on this motion is scheduled for September 6, 2000. The Bankruptcy Court currently has extended the Company's exclusive right to submit a plan of reorganization through August 17, 2000. The Company has requested an interim order from the Bankruptcy Court to maintain the Company's exclusive right to file a plan of reorganization until the motion is decided. The Company also will seek approval under the DIP Financing to permit the Company to extend the period of time to file its plan of reorganization.

On August 8, 2000, the Company announced that it had entered into a Corporate Integrity Agreement (the "Corporate Integrity Agreement") with the OIG. Under the Corporate Integrity Agreement, the Company will implement a comprehensive internal quality improvement program in its nursing centers and long-term hospitals and its regional and corporate offices. The Company believes the Corporate Integrity Agreement will be part of an overall settlement with the DOJ. The Corporate Integrity Agreement must be approved by the Bankruptcy Court and would become effective concurrent with the Company's emergence from Chapter 11.

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KINDRED HEALTHCARE, INC.  
(Formerly Vencor, Inc., a Debtor-in-Possession)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

NOTE 4 -- PROCEEDINGS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE (Continued)

A substantial portion of pre-petition liabilities are subject to settlement under the plan of reorganization to be submitted by the Company. The plan of reorganization must be voted upon by certain of the impaired creditors of the Company and approved by the Bankruptcy Court. There can be no assurance that the plan of reorganization to be proposed by the Company will be approved by the requisite holders of claims, confirmed by the Bankruptcy Court or that it will be consummated. If the plan of reorganization is not accepted by the required number of impaired creditors and the Company's exclusive right to file and solicit acceptance of a plan of reorganization ends, any party in interest may subsequently file its own plan of reorganization for the Company.

A plan of reorganization must be confirmed by the Bankruptcy Court after certain findings required by the Bankruptcy Code are made by the Bankruptcy Court. The Bankruptcy Court may confirm a plan of reorganization notwithstanding the non-acceptance of the plan by an impaired class of creditors or equity holders if certain requirements of the Bankruptcy Code are satisfied. The Company believes that any plan of reorganization likely will result in the Company's common stock having no value.

#### Events Leading to Reorganization

The Company reported a net loss from operations in 1998 aggregating \$578 million, resulting in certain financial covenant violations under the Company's \$1.0 billion bank credit facility (the "Credit Agreement"). Namely, the covenants regarding minimum net worth, total leverage ratio, senior leverage ratio and fixed charge coverage ratio were not satisfied at December 31, 1998. Prior to the commencement of the Chapter 11 Cases, the Company received a series of temporary waivers of these covenant violations. The waivers generally included certain borrowing limitations under the \$300 million revolving credit

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portion of the Credit Agreement. The final waiver was scheduled to expire on September 24, 1999.

The Company was informed on April 9, 1999 by HCFA that the Medicare program had made a demand for repayment of approximately \$90 million of reimbursement overpayments by April 23, 1999. On April 21, 1999, the Company reached an agreement with HCFA to extend the repayment of such amounts over 60 monthly installments (the "HCFA Agreement"). Under the HCFA Agreement, monthly payments of approximately \$1.5 million commenced in May 1999. Since December 1999, the balance of the overpayments bears interest at a statutory rate approximating 13.4%, resulting in a monthly payment of approximately \$2.0 million through March 2004. If the Company is delinquent with two consecutive payments, the HCFA Agreement will be defaulted and all subsequent Medicare reimbursement payments to the Company may be withheld. Amounts due under the HCFA Agreement aggregated \$71.4 million and have been classified as liabilities subject to compromise in the Company's unaudited condensed consolidated balance sheet at June 30, 2000. The Company has received Bankruptcy Court approval to continue to make the monthly payments under the HCFA Agreement during the pendency of the Chapter 11 Cases.

On May 3, 1999, the Company elected not to make the interest payment of approximately \$14.8 million due on the 1998 Notes. The failure to pay interest resulted in an event of default under the 1998 Notes.

In accordance with SOP 90-7, outstanding borrowings under the Credit Agreement (\$509.1 million) and the principal amount of the 1998 Notes (\$300 million) are presented as liabilities subject to compromise in the Company's unaudited condensed consolidated balance sheet at June 30, 2000. If the Chapter 11 Cases had not been filed, the Company would have reported a working capital deficit approximating \$873 million at June 30, 2000. The unaudited condensed consolidated financial statements do not include any adjustments that might result from the resolution of the Chapter 11 Cases or other matters discussed herein. During the pendency of the Chapter 11

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KINDRED HEALTHCARE, INC.  
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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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NOTE 4 -- PROCEEDINGS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE (Continued)

Events Leading to Reorganization (Continued)

Cases, the Company is continuing to record the contractual amount of interest expense related to the Credit Agreement. No interest costs have been recorded related to the 1998 Notes since the filing of the Chapter 11 Cases. Contractual interest expense not accrued for the 1998 Notes during the second quarter and first half of 2000 were \$7.4 million and \$14.8 million, respectively.

As previously reported, the Company has been informed by the DOJ that the Company and Ventas are the subjects of ongoing investigations into various Medicare reimbursement issues, including hospital cost reporting issues, Vencare billing practices and various quality of care issues in the hospitals and nursing centers formerly operated by Ventas and currently operated by the Company. The Company has cooperated fully in these investigations. The DOJ has informed the Company that it has intervened in several pending qui tam actions asserted against the Company and/or Ventas in connection with these investigations. The Company and Ventas are engaged in active discussions with the DOJ that may result in a resolution of some or all of the DOJ investigations

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including the pending qui tam actions. In addition, the DOJ has filed proofs of claims with respect to certain alleged claims in the Chapter 11 Cases. The Company believes that the DOJ's intervention in these actions will facilitate the ability of the parties to reach a final resolution. Such a resolution with the DOJ could include a payment to the Federal government which could have a material adverse effect on the Company's liquidity and financial position. See Note 11.

### Agreements with Ventas

On March 18, 1999, the Company served Ventas with a demand for mediation pursuant to the Agreement and Plan of Reorganization governing the Spin-off (the "Spin-off Agreement"). The Company was seeking a reduction in rent and other concessions under its lease agreements with Ventas (the "Master Lease Agreements"). On March 31, 1999, the Company and Ventas entered into a standstill agreement (the "Standstill Agreement") which provided that both companies would postpone through April 12, 1999 any claims either may have against the other. On April 12, 1999, the Company and Ventas entered into a second standstill agreement (the "Second Standstill") which provided that neither party would pursue any claims against the other or any other third party related to the Spin-off as long as the Company complied with certain rent payment terms. The Second Standstill was scheduled to terminate on May 5, 1999. The Company and Ventas also agreed that any statutes of limitations or other time-related constraints in a bankruptcy or other proceeding that might be asserted by one party against the other would be extended and tolled from April 12, 1999 until May 5, 1999 or until the termination of the Second Standstill (the "Tolling Agreement").

As a result of the Company's failure to pay rent, Ventas served the Company with notices of nonpayment under the Master Lease Agreements. Subsequently, the Company and Ventas entered into further amendments to the Second Standstill and the Tolling Agreement to extend the time during which no remedies may be pursued by either party and to extend the date by which the Company may cure its failure to pay rent.

In connection with the Chapter 11 Cases, the Company and Ventas entered into a stipulation (the "Stipulation") which provides for the payment by the Company of a reduced monthly rent of approximately \$15.1 million beginning in September 1999. The Stipulation was approved by the Bankruptcy Court. The difference between the \$19.3 million base rent under the Master Lease Agreements and the reduced monthly rent is being accrued as an administrative expense subject to compromise in the Chapter 11 Cases. Unpaid August 1999 rent of approximately \$18.9 million will constitute a claim by Ventas in the Chapter 11 Cases which claim is potentially subject to dispute.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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NOTE 4 -- PROCEEDINGS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE (Continued)

### Agreements with Ventas (Continued)

The Stipulation also continues to toll any statutes of limitations or other time constraints in a bankruptcy proceeding for claims that might be asserted by the Company against Ventas. The Stipulation automatically renews for one-month periods unless either party provides a 14-day notice of termination. The

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Stipulation also may be terminated prior to its expiration upon a payment default by the Company, the consummation of a plan of reorganization or the occurrence of certain defaults under the DIP Financing.

The Stipulation also provides that the Company will continue to fulfill its indemnification obligations arising from the Spin-off.

If the Company and Ventas are unable to resolve their disputes or maintain an interim resolution, the Company may seek to pursue claims against Ventas arising out of the Spin-off and seek judicial relief barring Ventas from exercising any remedies based on the Company's failure to pay some or all of the rent to Ventas. The Company's failure to pay rent or otherwise comply with the Stipulation, in the absence of judicial relief, would result in an "Event of Default" under the Master Lease Agreements. Upon an Event of Default under the Master Lease Agreements, assuming Ventas were to be granted relief from the automatic stay by the Bankruptcy Court, the remedies available to Ventas include, without limitation, terminating the Master Lease Agreements, repossessing and reletting the leased properties and requiring the Company to (i) remain liable for all obligations under the Master Lease Agreements, including the difference between the rent under the Master Lease Agreements and the rent payable as a result of reletting the leased properties or (ii) pay the net present value of the rent due for the balance of the terms of the Master Lease Agreements. Such remedies, however, would be subject to the supervision of the Bankruptcy Court.

On May 31, 2000, the Company announced that the Bankruptcy Court had approved a tax stipulation agreement between the Company and Ventas (the "Tax Stipulation"). In connection with the Spin-off, the Company and Ventas entered into a tax allocation agreement under which Ventas agreed that the Company would be entitled to any tax refunds associated with its former healthcare operations. In February 2000, a Federal tax refund in excess of \$26 million was received by Ventas. The Company has asserted that it is entitled to the refund under several grounds, including the terms of the existing tax allocation agreement. Accordingly, the Company demanded that Ventas enter into the Tax Stipulation which provides that certain refunds of Federal, state and local taxes received by either party on or after September 13, 1999 be held by the recipient of such refunds in segregated interest bearing accounts. The Tax Stipulation requires notification before either party can withdraw funds from the segregated accounts.

### Liabilities Subject to Compromise

"Liabilities subject to compromise" refers to liabilities incurred prior to the commencement of the Chapter 11 Cases. These liabilities, consisting primarily of long-term debt, amounts due to third party payors and certain accounts payable and accrued liabilities, represent the Company's estimate of known or potential claims to be resolved in connection with the Chapter 11 Cases. Such claims remain subject to future adjustments based on assertions of additional claims, negotiations, actions of the Bankruptcy Court, further developments with respect to disputed claims, future rejection of executory contracts or unexpired leases, determination as to the value of any collateral securing claims, treatment under the plan of reorganization and other events. Payment terms for these amounts will be established in connection with the plan of reorganization.

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NOTE 4 -- PROCEEDINGS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE (Continued)

### Liabilities Subject to Compromise (Continued)

The Company has received approval from the Bankruptcy Court to pay pre-petition and post-petition employee wages, salaries, benefits and other employee obligations. The Bankruptcy Court also approved orders granting authority, among other things, to pay pre-petition claims of certain critical vendors, utilities and patient obligations. All other pre-petition liabilities are classified in the unaudited condensed consolidated balance sheet as liabilities subject to compromise.

A summary of the principal categories of claims classified as liabilities subject to compromise under the Chapter 11 Cases follows (in thousands):

|  | June 30,<br>2000 | December 31,<br>1999 |
|--|------------------|----------------------|
|  | -----            | -----                |
| Long-term debt:                        |                  |                      |
| Credit Agreement.....                  | \$ 509,143       | \$ 506,114           |
| 1998 Notes.....                        | 300,000          | 300,000              |
| Amounts due under the HCFA Agreement.. | 71,432           | 80,296               |
| 8 5/8% Senior Subordinated Notes.....  | 2,391            | 2,391                |
| Unamortized deferred financing costs.. | (11,461)         | (12,626)             |
| Other.....                             | 3,397            | 4,592                |
|  | -----            | -----                |
|  | 874,902          | 880,767              |
|  | -----            | -----                |
| Due to third party payors.....         | 112,694          | 112,694              |
| Accounts payable.....                  | 33,065           | 33,693               |
| Accrued liabilities:                   |                  |                      |
| Interest.....                          | 67,076           | 45,521               |
| Ventas rent.....                       | 57,137           | 33,884               |
| Other.....                             | 50,786           | 52,858               |
|  | -----            | -----                |
|  | 174,999          | 132,263              |
|  | -----            | -----                |
|  | \$1,195,660      | \$1,159,417          |
|  | =====            | =====                |

Substantially all of the liabilities subject to compromise would have been classified as current liabilities if the Chapter 11 Cases had not been filed.

NOTE 5 -- REVENUES

Revenues are recorded based upon estimated amounts due from patients and third party payors for the provision of healthcare services, including anticipated settlements under reimbursement agreements with Medicare, Medicaid and other third party payors.

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

Quarter

Six Months

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|                     | 2000      | 1999      | 2000        | 1999        |
|---------------------|-----------|-----------|-------------|-------------|
| Medicare.....       | \$249,057 | \$239,576 | \$ 512,934  | \$ 493,968  |
| Medicaid.....       | 220,562   | 224,757   | 443,075     | 443,382     |
| Private and other.. | 258,178   | 239,941   | 501,831     | 483,489     |
|                     | 727,797   | 704,274   | 1,457,840   | 1,420,839   |
| Elimination.....    | (14,373)  | (15,382)  | (28,960)    | (31,715)    |
|                     | \$713,424 | \$688,892 | \$1,428,880 | \$1,389,124 |

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KINDRED HEALTHCARE, INC.  
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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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NOTE 6 -- UNUSUAL TRANSACTIONS

Operating results for each period presented include certain unusual transactions. These transactions are included in other operating expenses in the unaudited condensed consolidated statement of operations for the respective periods in which they were recorded.

In the second quarter of 2000, the Company recorded a \$4.5 million gain on the sale of a closed hospital. In the second quarter of 1999, the Company recorded a charge of \$20.8 million associated with the write-off of the Company's remaining investment in Behavioral Healthcare Corporation ("BHC") (\$15.2 million) and the cancellation of a nursing center software development project (\$5.6 million).

NOTE 7 -- REORGANIZATION COSTS

Reorganization costs, consisting principally of professional fees, aggregated \$2.5 million and \$4.6 million in the second quarters of 2000 and 1999, respectively, and \$5.6 million and \$6.9 million for the respective six month periods.

NOTE 8 -- EARNINGS PER SHARE

Basic and diluted earnings per common share are based upon the weighted average number of common shares outstanding. No incremental shares were included in the calculations of the diluted loss per common share since the result would be antidilutive.

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### NOTE 9 -- BUSINESS SEGMENT DATA

The Company operates two business segments: the health services division and the hospital division. The health services division operates nursing centers and a rehabilitation therapy business. The hospital division operates hospitals and an institutional pharmacy business. The Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company's business segments excludes allocations of corporate overhead.

The following table sets forth the Company's revenues, operating results and assets by business segment (in thousands):

|  | (Restated) |           |             |
|--|------------|-----------|-------------|
|  | Quarter    |           | S           |
|  | 2000       | 1999      | 2000        |
| Revenues:  |            |           |             |
| Health services division:                                    |            |           |             |
| Nursing centers.....   | \$413,159  | \$397,930 | \$ 825,862  |
| Rehabilitation services.....                                 | 33,173     | 50,234    | 67,550      |
| Other ancillary services.....                                | (2)        | 12,855    | (7)         |
| Elimination.....   | (18,509)   | (34,564)  | (36,600)    |
|  | -----      | -----     | -----       |
|  | 427,821    | 426,455   | 856,805     |
| Hospital division:   |            |           |             |
| Hospitals.....   | 250,027    | 234,868   | 503,618     |
| Pharmacy.....  | 49,949     | 42,951    | 97,417      |
|  | -----      | -----     | -----       |
|  | 299,976    | 277,819   | 601,035     |
|  | -----      | -----     | -----       |
|  | 727,797    | 704,274   | 1,457,840   |
| Elimination of pharmacy charges to Company nursing centers.. | (14,373)   | (15,382)  | (28,960)    |
|  | -----      | -----     | -----       |
|  | \$713,424  | \$688,892 | \$1,428,880 |
|  | =====      | =====     | =====       |
| Income (loss) from operations:                               |            |           |             |
| Operating income (loss):                                     |            |           |             |
| Health services division:                                    |            |           |             |
| Nursing centers.....   | \$ 75,348  | \$ 55,027 | \$ 144,060  |
| Rehabilitation services.....                                 | (1,059)    | 8,311     | (573)       |
| Other ancillary services.....                                | 242        | 1,035     | 372         |
|  | -----      | -----     | -----       |
|  | 74,531     | 64,373    | 143,859     |
| Hospital division:   |            |           |             |
| Hospitals.....   | 51,547     | 58,443    | 106,945     |
| Pharmacy.....  | 789        | 3,289     | (411)       |
|  | -----      | -----     | -----       |
|  | 52,336     | 61,732    | 106,534     |
| Corporate overhead.....                                      | (27,750)   | (29,676)  | (57,120)    |
| Unusual transactions.....                                    | 4,535      | (20,827)  | 4,535       |
| Reorganization costs.....                                    | (2,530)    | (4,547)   | (5,595)     |
|  | -----      | -----     | -----       |
| Operating income.....  | 101,122    | 71,055    | 192,213     |
| Rent.....  | (76,788)   | (76,088)  | (153,008)   |
| Depreciation and amortization.....                           | (18,168)   | (21,612)  | (36,070)    |

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|                                 |            |             |             |
|---------------------------------|------------|-------------|-------------|
| Interest, net.....              | (13,651)   | (19,390)    | (28,684)    |
|                                 | -----      | -----       | -----       |
| Loss before income taxes.....   | (7,485)    | (46,035)    | (25,549)    |
| Provision for income taxes..... | 500        | 50          | 1,000       |
|                                 | -----      | -----       | -----       |
|                                 | \$ (7,985) | \$ (46,085) | \$ (26,549) |
|                                 | =====      | =====       | =====       |

June 30, 2000

Assets:

|                               |             |
|-------------------------------|-------------|
| Health services division..... | \$ 489,778  |
| Hospital division.....        | 318,538     |
| Corporate.....                | 440,063     |
|                               | -----       |
|                               | \$1,248,379 |
|                               | =====       |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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NOTE 10 -- INCOME TAXES

The provision for income taxes is based upon management's estimate of taxable income or loss for the year and includes the effect of certain non-deductible items such as goodwill amortization and the recording of additional deferred tax valuation allowances.

The provision for income taxes for the second quarter of 2000 and 1999 included charges of \$2.5 million and \$11.8 million, respectively, related to the deferred tax valuation allowance. For the six months ended June 30, 2000 and 1999, charges related to the deferred tax valuation allowance totaled \$8.4 million and \$15.8 million, respectively. In addition, the Company recorded a valuation allowance of \$3.4 million in the first quarter of 1999 related to the change in accounting for start-up costs. At June 30, 2000, the deferred tax valuation allowance included in the Company's unaudited condensed consolidated balance sheet aggregated \$368.4 million.

NOTE 11 -- LITIGATION

Summary descriptions of various significant legal and regulatory activities follow:

On September 13, 1999, the Company and substantially all of its subsidiaries filed voluntary petitions for protection under Chapter 11 of the Bankruptcy Code. The Chapter 11 Cases have been styled In re: Vencor, Inc., et al., Debtors and Debtors in Possession, Case Nos. 99-3199 (MFW) through 99-3327 (MFW), Chapter 11, Jointly Administered. See Note 4 for further discussion of the Chapter 11 Cases.

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On March 18, 1999, the Company served Ventas with a demand for mediation pursuant to the Spin-off Agreement. The Company was seeking a reduction in rent and other concessions under its Master Lease Agreements with Ventas. On March 31, 1999, the Company and Ventas entered into the Standstill Agreement which provided that both companies would postpone through April 12, 1999 any claims either may have against the other. On April 12, 1999, the Company and Ventas entered into the Second Standstill which provided that neither party would pursue any claims against the other or any other third party related to the Spin-off as long as the Company complied with certain rent payment terms. The Second Standstill was scheduled to terminate on May 5, 1999. Pursuant to the Tolling Agreement, the Company and Ventas also agreed that any statutes of limitations or other time-related constraints in a bankruptcy or other proceeding that might be asserted by one party against the other would be extended and tolled from April 12, 1999 until May 5, 1999 or until the termination of the Second Standstill. As a result of the Company's failure to pay rent, Ventas served the Company with notices of nonpayment under the Master Lease Agreements. Subsequently, the Company and Ventas entered into further amendments to the Second Standstill and the Tolling Agreement to extend the time during which no remedies may be pursued by either party and to extend the date by which the Company may cure its failure to pay rent.

In connection with the Chapter 11 Cases, the Company and Ventas entered into the Stipulation which provides for the payment by the Company of a reduced monthly rent of approximately \$15.1 million beginning in September 1999. The Stipulation was approved by the Bankruptcy Court. The Stipulation also continues to toll any statutes of limitations or other time constraints in a bankruptcy proceeding for claims that might be asserted by the Company against Ventas. The Stipulation automatically renews for one-month periods unless either party provides a 14-day notice of termination. The Stipulation also may be terminated prior to its expiration upon a payment default by the Company, the consummation of the plan of reorganization or the occurrence of certain defaults under the DIP Financing. The Stipulation also provides that the Company will continue to fulfill its indemnification obligations arising from the Spin-off.

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### NOTE 11 -- LITIGATION (Continued)

If the Company and Ventas are unable to resolve their disputes or maintain an interim resolution, the Company may seek to pursue claims against Ventas arising out of the Spin-off and seek judicial relief barring Ventas from exercising any remedies based on the Company's failure to pay some or all of the rent to Ventas. The Company's failure to pay rent or comply with the Stipulation, in the absence of judicial relief, would result in an "Event of Default" under the Master Lease Agreements. Upon an Event of Default under the Master Lease Agreements, assuming Ventas were to be granted relief from the automatic stay by the Bankruptcy Court, the remedies available to Ventas include terminating the Master Lease Agreements, repossessing and reletting the leased properties and requiring the Company to (i) remain liable for all obligations under the Master Lease Agreements, including the difference between the rent under the Master Lease Agreements and the rent payable as a result of reletting the leased properties or (ii) pay the net present value of the rent due for the balance of the terms of the Master Lease Agreements. Such remedies, however, would be subject to the supervision of the Bankruptcy Court.

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The Company's subsidiary, formerly named TheraTx, Incorporated ("TheraTx"), is a plaintiff in a declaratory judgment action entitled TheraTx, Incorporated v. James W. Duncan, Jr., et al., No. 1:95-CV-3193, filed in the United States District Court for the Northern District of Georgia and currently pending in the United States Court of Appeals for the Eleventh Circuit, No. 99-11451-FF. The defendants have asserted counterclaims against TheraTx under breach of contract, securities fraud, negligent misrepresentation and fraud theories for allegedly not performing as promised under a merger agreement related to TheraTx's purchase of a company called PersonaCare, Inc. and for allegedly failing to inform the defendants/counterclaimants prior to the merger that TheraTx's possible acquisition of Southern Management Services, Inc. might cause the suspension of TheraTx's shelf registration under relevant rules of the Securities and Exchange Commission (the "Commission"). The court granted summary judgment for the defendants/counterclaimants and ruled that TheraTx breached the shelf registration provision in the merger agreement, but dismissed the defendants' remaining counterclaims. Additionally, the court ruled after trial that defendants/counterclaimants were entitled to damages and prejudgment interest in the amount of approximately \$1.3 million and attorneys' fees and other litigation expenses of approximately \$700,000. The Company and the defendants/counterclaimants both have appealed the court's rulings. The Company is defending the action vigorously.

The Company is pursuing various claims against private insurance companies who issued Medicare supplement insurance policies to individuals who became patients of the Company's hospitals. After the patients' Medicare benefits are exhausted, the insurance companies become liable to pay the insureds' bills pursuant to the terms of these policies. The Company has filed numerous collection actions against various of these insurers to collect the difference between what Medicare would have paid and the hospitals' usual and customary charges. These disputes arise from differences in interpretation of the policy provisions and Federal and state laws governing such policies. Various courts have issued various rulings on the different issues, some of which have been adverse to the Company and most of which have been appealed. The Company intends to continue to pursue these claims vigorously. If the Company does not prevail on these issues, future results of operations and liquidity would be materially adversely affected.

A class action lawsuit entitled A. Carl Helwig v. Vencor, Inc., et al., was filed on December 24, 1997 in the United States District Court for the Western District of Kentucky (Civil Action No. 3-97CV-8354). The class action claims were brought by an alleged stockholder of the Company's predecessor against the Company and Ventas and certain current and former executive officers and directors of the Company and Ventas. The complaint alleges that the Company, Ventas and certain current and former executive officers of the Company and Ventas during a

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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NOTE 11 -- LITIGATION (Continued)

specified time frame violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), by, among other things, issuing to the investing public a series of false and misleading statements concerning Ventas' then current operations and the inherent value of its common stock. The

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complaint further alleges that as a result of these purported false and misleading statements concerning Ventas' revenues and successful acquisitions, the price of the common stock was artificially inflated. In particular, the complaint alleges that the defendants issued false and misleading financial statements during the first, second and third calendar quarters of 1997 which misrepresented and understated the impact that changes in Medicare reimbursement policies would have on Ventas' core services and profitability. The complaint further alleges that the defendants issued a series of materially false statements concerning the purportedly successful integration of Ventas' recent acquisitions and prospective earnings per share for 1997 and 1998 which the defendants knew lacked any reasonable basis and were not being achieved. The suit seeks damages in an amount to be proven at trial, pre-judgment and post-judgment interest, reasonable attorneys' fees, expert witness fees and other costs, and any extraordinary equitable and/or injunctive relief permitted by law or equity to assure that the plaintiff has an effective remedy. In December 1998, the defendants filed a motion to dismiss the case. The court converted the defendants' motion to dismiss into a motion for summary judgment and granted summary judgment as to all defendants. The plaintiff appealed the ruling to the United States Court of Appeals for the Sixth Circuit (the "Sixth Circuit"). On April 24, 2000, the Sixth Circuit affirmed the district court's dismissal of the action on the grounds that the plaintiff failed to state a claim upon which relief could be granted. On July 14, 2000, the Sixth Circuit granted the plaintiff's petition for a rehearing en banc. The Company is defending this action vigorously.

A shareholder derivative suit entitled Thomas G. White on behalf of Vencor, Inc. and Ventas, Inc. v. W. Bruce Lunsford, et al., Case No. 98CI03669, was filed in June 1998 in the Jefferson County, Kentucky, Circuit Court. The suit was brought on behalf of the Company and Ventas against certain current and former executive officers and directors of the Company and Ventas. The complaint alleges that the defendants damaged the Company and Ventas by engaging in violations of the securities laws, engaging in insider trading, fraud and securities fraud and damaging the reputation of the Company and Ventas. The plaintiff asserts that such actions were taken deliberately, in bad faith and constitute breaches of the defendants' duties of loyalty and due care. The complaint is based on substantially similar assertions to those made in the class action lawsuit entitled A. Carl Helwig v. Vencor, Inc., et al., discussed above. The suit seeks unspecified damages, interest, punitive damages, reasonable attorneys' fees, expert witness fees and other costs, and any extraordinary equitable and/or injunctive relief permitted by law or equity to assure that the Company and Ventas have an effective remedy. The Company believes that the allegations in the complaint are without merit and intends to defend this action vigorously.

A class action lawsuit entitled Jules Brody v. Transitional Hospitals Corporation, et al., Case No. CV-S-97-00747-PMP, was filed on June 19, 1997 in the United States District Court for the District of Nevada on behalf of a class consisting of all persons who sold shares of Transitional Hospitals Corporation ("Transitional") common stock during the period from February 26, 1997 through May 4, 1997, inclusive. The complaint alleges that Transitional purchased shares of its common stock from members of the investing public after it had received a written offer to acquire all of Transitional's common stock and without making the required disclosure that such an offer had been made. The complaint further alleges that defendants disclosed that there were "expressions of interest" in acquiring Transitional when, in fact, at that time, the negotiations had reached an advanced stage with actual firm offers at substantial premiums to the trading price of Transitional's stock having been made which were actively being considered by Transitional's Board of Directors. The complaint asserts claims pursuant to Sections 10(b), 14(e) and 20(a) of the Exchange Act, and common law principles of negligent misrepresentation and names as defendants Transitional as well as certain former senior executives and directors of Transitional. The plaintiff seeks class

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

NOTE 11 -- LITIGATION (Continued)

certification, unspecified damages, attorneys' fees and costs. In June 1998, the court granted the Company's motion to dismiss with leave to amend the Section 10(b) claim and the state law claims for misrepresentation. The court denied the Company's motion to dismiss the Section 14(e) and Section 20(a) claims, after which the Company filed a motion for reconsideration. On March 23, 1999, the court granted the Company's motion to dismiss all remaining claims and the case was dismissed. The plaintiff has appealed this ruling. The Company is defending this action vigorously.

On April 14, 1999, a lawsuit entitled Lenox Healthcare, Inc., et al. v. Vencor, Inc., et al., Case No. BC 208750, was filed in the Superior Court of Los Angeles, California by Lenox Healthcare, Inc. ("Lenox") asserting various causes of action arising out of the Company's sale and lease of several nursing centers to Lenox in 1997. Lenox subsequently removed certain of its causes of action and refiled these claims before the United States District Court for the Western District of Kentucky in a case entitled Lenox Healthcare, Inc. v. Vencor, Inc., et al., Case No. 3:99 CV-348-H. The Company has asserted counterclaims, including RICO claims, against Lenox in the Kentucky action. The Company believes that the allegations made by Lenox in both complaints are without merit and intends to defend these actions vigorously. Lenox and its subsidiaries filed for protection under Chapter 11 of the Bankruptcy Code on November 3, 1999. The Company has not determined the effect, if any, such filing will have on the Company's financial condition, results of operations or liquidity. By virtue of both the Company's and Lenox's separate filings for Chapter 11 protection, the two Lenox actions and the Company's counterclaims are stayed.

The Company has been informed by the DOJ that the Company and Ventas are the subjects of ongoing investigations into various Medicare reimbursement issues, including hospital cost reporting issues, Vencare billing practices and various quality of care issues in the hospitals and nursing centers formerly operated by Ventas and currently operated by the Company. These investigations include some matters for which the Company indemnified Ventas in the Spin-off. In cases where neither the Company nor any of its subsidiaries are defendants but Ventas is the defendant, the Company had agreed to defend and indemnify Ventas for such claims as part of the Spin-off. The Stipulation entered into with Ventas provides that the Company will continue to fulfill its indemnification obligations arising from the Spin-off. The Company has cooperated fully in the investigations.

The DOJ has informed the Company that it has intervened in several pending qui tam actions asserted against the Company and/or Ventas in connection with these investigations. The Company and Ventas are engaged in active settlement discussions with the DOJ that may result in a resolution of some or all of the DOJ investigations including the pending qui tam actions. In addition, the DOJ has filed proofs of claims with respect to certain alleged claims in the Chapter 11 Cases. Such a resolution with the DOJ could include a payment to the Federal government which could have a material adverse effect on the Company's liquidity and financial position. However, there can be no assurance that a settlement or other resolution will be consummated with the DOJ.

The following is a summary of the qui tam actions pending against the Company

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and/or Ventas in which the DOJ has intervened. In connection with the DOJ's intervention, the courts ordered these previously non-public actions to be unsealed. Certain of the actions described below name other defendants in addition to the Company and Ventas.

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NOTE 11 -- LITIGATION (Continued)

(a) The Company, Ventas and the Company's subsidiary, American X-Rays, Inc. ("AXR"), are defendants in a civil qui tam action styled United States ex rel. Doe v. American X-Rays Inc., et al., No. LR-C-95-332, pending in the United States District Court for the Eastern District of Arkansas and served on AXR on July 7, 1997. The DOJ intervened in the suit which was brought under the Federal Civil False Claims Act and added the Company and Ventas as defendants. The Company acquired an interest in AXR when The Hillhaven Corporation ("Hillhaven") was merged into the Company in September 1995 and purchased the remaining interest in AXR in February 1996. AXR provided portable X-ray services to nursing centers (including some of those operated by Ventas or the Company) and other healthcare providers. The civil suit alleges that AXR submitted false claims to the Medicare and Medicaid programs. The suit seeks damages in an amount of not less than \$1,000,000, treble damages and civil penalties. The Company has defended this action vigorously. The court has dismissed the action based upon the possible pending settlement between the DOJ and Vencor and Ventas. In a related criminal investigation, the United States Attorney's Office for the Eastern District of Arkansas ("USAO") indicted four former employees of AXR; those individuals were convicted of various fraud related counts in January 1999. AXR had been informed previously that it was not a target of the criminal investigation, and AXR was not indicted. However, the Company received several grand jury subpoenas for documents and witnesses which it moved to quash. The USAO has withdrawn the subpoenas which rendered the motion moot.

(b) The Company's subsidiary, Medisave Pharmacies, Inc. ("Medisave"), Ventas and Hillhaven (former parent company to Medisave), are the defendants in a civil qui tam action styled United States ex rel. Danley v. Medisave Pharmacies, Inc., et al., No. CV-N-96-00170-HDM, filed in the United States District Court for the District of Nevada on March 15, 1996. The plaintiff alleges that Medisave, an institutional pharmacy provider, formerly owned by Ventas and owned by the Company since the Spin-off: (1) charged the Medicare program for unit dose drugs when bulk drugs were administered and charged skilled nursing facilities more for the same drugs for Medicare patients than for non-Medicare patients; (2) improperly claimed special dispensing fees that it was not entitled to under Medicaid; and (3) recouped unused drugs from skilled nursing facilities and returned these drugs to its stock without crediting Medicare or Medicaid, all in violation of the Federal Civil False Claims Act. The complaint also alleges that Medisave had a policy of offering kickbacks, such as free equipment, to skilled nursing centers to secure and maintain their business. The complaint seeks treble damages, other unspecified damages, civil penalties, attorneys' fees and other costs. The Company disputes the allegations in the complaint. The defendants intend to defend this action vigorously.

(c) Ventas and the Company's subsidiary, Vencare, Inc. ("Vencare"), among

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others, are defendants in the action styled United States ex rel. Roberts v. Vencor, Inc., et al., No. 3:97CV-349-J, filed in the United States District Court for the Western District of Kansas on June 25, 1996 and consolidated with the action styled United States of America ex rel. Meharg, et al. v. Vencor, Inc., et al., No. 3:98SC-737-H, filed in the United States District Court for the Middle District of Florida on June 4, 1998. The complaint alleges that the defendants knowingly submitted and conspired to submit false claims and statements to the Medicare program in connection with their purported provision of respiratory therapy services to skilled nursing center residents. The defendants allegedly billed Medicare for respiratory therapy services and supplies when those services were not medically necessary, billed for services not provided, exaggerated the time required to provide services or exaggerated the productivity of their therapists. It is further alleged that the defendants presented false claims and statements to the Medicare program in violation of the Federal Civil False Claims Act, by, among other things, allegedly causing skilled nursing centers with which they had respiratory therapy contracts, to present false claims to Medicare for respiratory therapy services and supplies. The complaint seeks treble damages, other unspecified damages, civil penalties, attorneys' fees and other costs. The Company disputes the allegations in the complaint. The defendants intend to defend this action vigorously.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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NOTE 11 -- LITIGATION (Continued)

(d) In United States ex rel. Kneepkens v. Gambro Healthcare, Inc., et al., No. 97-10400-GAO, filed in the United States District Court for the District of Massachusetts on October 15, 1998, the Company's subsidiary, Transitional, and two unrelated entities, Gambro Healthcare, Inc. and Dialysis Holdings, Inc., are defendants in this suit alleging that they violated the Federal Civil False Claims Act and the Medicare and Medicaid antikickback, antifraud and abuse amendments (the "Antikickback Amendments") and committed common law fraud, unjust enrichment and payment by mistake of fact. Specifically, the complaint alleges that a predecessor to Transitional formed a joint venture with Damon Clinical Laboratories to create and operate a clinical testing laboratory in Georgia that was then used to provide lab testing for dialysis patients, and that the joint venture billed at below cost in return for referral of substantially all non-routine testing in violation of the Antikickback Amendments. It is further alleged that a predecessor to Transitional and Damon Clinical Laboratories used multiple panel testing of end stage renal disease rather than single panel testing that allegedly resulted in the generation of additional revenues from Medicare and that the entities allegedly added non-routine tests to tests otherwise ordered by physicians that were not requested or medically necessary but resulted in additional revenue from Medicare in violation of the Antikickback Amendments. Transitional has moved to dismiss the case. Transitional disputes the allegations in the complaint and is defending the action vigorously.

(e) The Company and/or Ventas are defendants in the action styled United States ex rel. Huff and Dolan v. Vencor, Inc., et al., No. 97-4358 AHM (Mcx), filed in the United States District Court for the Central District of California on June 13, 1997. The plaintiff alleges that the defendant violated the Federal Civil False Claims Act by submitting false claims to the Medicare, Medicaid and CHAMPUS programs by allegedly: (1) falsifying patient bills and



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submitting the bills to the Medicare, Medicaid and CHAMPUS programs, (2) submitting bills for intensive and critical care not actually administered to patients, (3) falsifying patient charts in relation to the billing, (4) charging for physical therapy services allegedly not provided and pharmacy services allegedly provided by non-pharmacists, and (5) billing for sales calls made by nurses to prospective patients. The complaint seeks treble damages, other unspecified damages, civil penalties, attorneys' fees and other costs. Defendants dispute the allegations in the complaint. The Company, on behalf of itself and Ventas, intends to defend this action vigorously.

(f) Ventas is the defendant in the action styled United States ex rel. Brzycki v. Vencor, Inc., Civ. No. 97-451-JD, filed in the United States District Court for the District of New Hampshire on September 8, 1997. Ventas is alleged to have knowingly violated the Federal Civil False Claims Act by submitting and conspiring to submit false claims to the Medicare program. The complaint alleges that Ventas: (1) fabricated diagnosis codes by ordering medically unnecessary services, such as respiratory therapy; (2) changed referring physicians' diagnoses in order to qualify for Medicare reimbursement; and (3) billed Medicare for oxygen use by patients regardless of whether the oxygen was actually administered to particular patients. The complaint further alleges that Ventas paid illegal kickbacks to referring healthcare professionals in the form of medical consulting service agreements as an alleged inducement to refer patients, in violation of the Federal Civil False Claims Act, the Antikickback Amendments and the Stark provisions. It is additionally alleged that Ventas consistently submitted Medicare claims for clinical services that were not performed or were performed at lower actual costs. The complaint seeks unspecified damages, civil penalties, attorneys' fees and costs. Ventas disputes the allegations in the complaint. The Company, on behalf of Ventas, intends to defend the action vigorously.

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NOTE 11 -- LITIGATION (Continued)

(g) United States ex rel. Lanford and Cavanaugh v. Vencor, Inc., et al., Civ. No. 97-CV-2845, was filed against Ventas in the United States District Court for the Middle District of Florida, on November 24, 1997. The United States of America intervened in this civil qui tam lawsuit on May 17, 1999. On July 23, 1999, the United States filed its amended complaint in the lawsuit and added the Company as a defendant. The lawsuit alleges that the Company and Ventas knowingly submitted false claims and false statements to the Medicare and Medicaid programs including, but not limited to, claims for reimbursement of costs for certain ancillary services performed in defendants' nursing centers and for third party nursing center operators that the United States alleges are not properly reimbursable costs through the hospitals' cost reports. The lawsuit involves the Company's hospitals which were owned by Ventas prior to the Spin-off. The complaint does not specify the amount of damages sought. The Company and Ventas dispute the allegations in the amended complaint and intend to defend this action vigorously.

(h) In United States ex rel. Harris and Young v. Vencor, Inc., et al., filed in the Eastern District of Missouri on May 25, 1999, the defendants include the Company, Vencare, and Ventas. The defendants allegedly submitted and conspired to submit false claims for payment to the Medicare and CHAMPUS programs, in violation of the Federal Civil False Claims Act. According to the

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complaint, the Company, through its subsidiary, Vencare, allegedly (1) over billed for respiratory therapy services, (2) rendered medically unnecessary treatment, and (3) falsified supply, clinical and equipment records. The defendants also allegedly encouraged or instructed therapist to falsify clinical records and over prescribe therapy services. The complaint seeks treble damages, other unspecified damages, civil penalties, attorneys' fees and other costs. The Company disputes the allegations in the complaint and intends to defend this action vigorously.

(i) In United States ex rel. George Mitchell, et al. v. Vencor, Inc., et al., filed in the United States District Court for the Southern District of Ohio on August 13, 1999, the defendants, consisting of the Company and its two subsidiaries, Vencare and Vencor Hospice, Inc., are alleged to have violated the Federal Civil False Claims Act by obtaining improper reimbursement from Medicare concerning the treatment of hospice patients. Defendants are alleged to have obtained inflated Medicare reimbursement for admitting, treating and/or failing to discharge in a timely manner hospice patients who were not "hospice appropriate." The complaint further alleges that the defendants obtained inflated reimbursement for providing medications for these hospice patients. The complaint alleges damages in excess of \$1,000,000. The Company disputes the allegations in the complaint and intends to defend vigorously the action.

(j) In Gary Graham, on Behalf of the United States of America v. Vencor Operating, Inc. et. al., filed in the United States District Court for the Southern District of Florida on or about June 8, 1999, the defendants, including the Company, its subsidiary, Vencor Operating, Inc., Ventas, Hillhaven and Medisave, are alleged to have presented or caused to be presented false or fraudulent claims for payment to the Medicare program in violation of, among other things, the Federal Civil False Claims Act. The complaint alleges that Medisave, a subsidiary of the Company which was transferred from Ventas to the Company in the Spin-off, systematically up-charged for drugs and supplies dispensed to Medicare patients. The complaint seeks unspecified damages, civil penalties, interest, attorneys' fees and other costs. The Company disputes the allegations in the complaint and intends to defend this action vigorously.

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### NOTE 11 -- LITIGATION (Continued)

(k) In United States, et al., ex rel. Phillips-Minks, et al. v. Transitional Corp., et al., filed in the United States District Court for Southern District of California on July 23, 1998, the defendants, including Transitional and Ventas, are alleged to have submitted and conspired to submit false claims and statements to Medicare, Medicaid, and other Federal and state funded programs during a period commencing in 1993. The conduct complained of allegedly violates the Federal Civil False Claims Act, the California False Claims Act, the Florida False Claims Act, the Tennessee Health Care False Claims Act, and the Illinois Whistleblower Reward and Protection Act. Defendant allegedly submitted improper and erroneous claims to Medicare, Medicaid and other programs, for improper or unnecessary services and services not performed, inadequate collections efforts associated with billing and collecting bad debts, inflated and nonexistent laboratory charges, false and inadequate documentation of claims, splitting charges, shifting revenues and

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expenses, transferring patients to hospitals that are reimbursed by Medicare at a higher level, failing to return duplicate reimbursement payments, and improperly allocating hospital insurance expenses. In addition, the complaint alleges that the defendants were inconsistent in their reporting of cost report data, paid kickbacks to increase patient referrals to hospitals, and incorrectly reported employee compensation resulting in inflated employee 401(k) contributions. The complaint seeks unspecified damages. The Company disputes the allegations in the complaint and intends to defend this action vigorously.

In connection with the Spin-off, liabilities arising from various legal proceedings and other actions were assumed by the Company and the Company agreed to indemnify Ventas against any losses, including any costs or expenses, it may incur arising out of or in connection with such legal proceedings and other actions. The indemnification provided by the Company also covers losses, including costs and expenses, which may arise from any future claims asserted against Ventas based on the former healthcare operations of Ventas. In connection with its indemnification obligation, the Company has assumed the defense of various legal proceedings and other actions. The Stipulation entered into with Ventas provides that the Company will continue to fulfill its indemnification obligations arising from the Spin-off.

The Company is a party to certain legal actions and regulatory investigations arising in the normal course of its business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory investigations. In addition, there can be no assurance that the DOJ, HCFA or other regulatory agencies will not initiate additional investigations related to the Company's businesses in the future, nor can there be any assurance that the resolution of any litigation or investigations, either individually or in the aggregate, would not have a material adverse effect on the Company's results of operations, liquidity or financial position. In addition, the above litigation and investigations (as well as future litigation and investigations) are expected to consume the time and attention of the Company's management and may have a disruptive effect upon the Company's operations.

### NOTE 12 -- THIRD PARTY SETTLEMENTS

In January 2000, the Company filed its hospital cost reports for the year ended August 31, 1999. Cost reports are filed annually in settlement of amounts due to or from the various agencies administering the reimbursement programs. These cost reports indicated amounts due from the Company aggregating \$58 million. This liability arose during 1999 as part of the Company's routine settlement of Medicare reimbursement overpayments. Such amounts are classified as liabilities subject to compromise in the unaudited condensed consolidated balance sheet and, accordingly, no funds were disbursed by the Company in settlement of such pre-petition liabilities.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Cautionary Statement

Certain statements made in this Form 10-Q/A, including, but not limited to, statements containing the words such as "anticipate," "believe," "plan," "estimate," "expect," "intend," "may" and other similar expressions are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are inherently uncertain, and stockholders must recognize that actual results may differ materially from the Company's expectations as a result of a variety of factors, including,

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without limitation, those discussed below. Such forward-looking statements are based on management's current expectations and include known and unknown risks, uncertainties and other factors, many of which the Company is unable to predict or control, that may cause the Company's actual results or performance to differ materially from any future results or performance expressed or implied by such forward-looking statements. Factors that may affect the plans or results of the Company include, without limitation, the ability of the Company to continue as a going concern; the delays or the inability to complete the Company's plan of reorganization; the ability of the Company to operate pursuant to the terms of the DIP Financing; the ability of the Company to operate successfully under the Chapter 11 Cases; risks associated with operating a business in Chapter 11; adverse actions which may be taken by creditors and the outcome of various bankruptcy proceedings; adverse developments with respect to the Company's liquidity or results of operations; the Company's ability to attract patients given its current financial position; the ability of the Company to attract and retain key executives and other personnel; the effects of healthcare reform and legislation on the Company's business strategy and operations; the Company's ability to control costs, including labor costs, in response to the prospective payment system, implementation of the Corporate Integrity Agreement and other regulatory actions; adverse developments with respect to the Company's settlement discussions with the DOJ concerning ongoing investigations; and the dramatic increase in the costs of defending and insuring against alleged patient care liability claims. Many of these factors are beyond the control of the Company and its management. The Company cautions investors that any forward-looking statements made by the Company are not guarantees of future performance. The Company disclaims 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.

### General

The business segment data in Note 9 of the Notes to Condensed Consolidated Financial Statements should be read in conjunction with the following discussion and analysis.

The Company provides long-term healthcare services primarily through the operation of nursing centers and hospitals. At June 30, 2000, the Company's health services division operated 321 nursing centers (41,113 licensed beds) in 31 states and a rehabilitation therapy business. The Company's hospital division operated 56 hospitals (4,880 licensed beds) in 23 states and an institutional pharmacy business.

Vencare Realignment. In the fourth quarter of 1999, the Company realigned its Vencare ancillary services business. Vencare's rehabilitation, speech and occupational therapy businesses were integrated into the Company's health services division, and its institutional pharmacy business was assigned to the hospital division. Vencare's respiratory therapy and certain other ancillary businesses were discontinued. Financial and operating data presented in the following discussion and analysis reflect the realignment of the former Vencare business for all periods presented.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

### General (Continued)

Reorganization. On September 13, 1999, the Company and substantially all of its subsidiaries filed voluntary petitions for protection under Chapter 11 of

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the Bankruptcy Code. The Company currently is operating its businesses as a debtor-in-possession subject to the jurisdiction of the Bankruptcy Court. The Company's continued operating losses, liquidity issues and the Chapter 11 Cases raise substantial doubt about the Company's ability to continue as a going concern. The ability of the Company to continue as a going concern and the appropriateness of using the going concern basis of accounting are dependent upon, among other things, (i) the Company's ability to comply with the terms of the DIP Financing, (ii) confirmation of the plan of reorganization under the Bankruptcy Code, (iii) the Company's ability to achieve profitable operations after such confirmation, and (iv) the Company's ability to generate sufficient cash from operations to meet its obligations. The plan of reorganization and other actions during the Chapter 11 Cases could change materially the amounts currently recorded in the unaudited condensed consolidated financial statements. See Note 4 of the Notes to Condensed Consolidated Financial Statements.

Spin-off. On May 1, 1998, Ventas completed the Spin-off through the distribution of Vencor common stock to its stockholders. Ventas retained ownership of substantially all of its real property and leases such real property to the Company pursuant to the Master Lease Agreements. In anticipation of the Spin-off, the Company was incorporated on March 27, 1998. For accounting purposes, the consolidated historical financial statements of Ventas became the historical financial statements of the Company upon consummation of the Spin-off. Any discussion concerning events prior to May 1, 1998 refers to the Company's business as it was conducted by Ventas prior to the Spin-off.

The unaudited condensed consolidated financial statements have been prepared on the basis of accounting principles applicable to going concerns and contemplate the realization of assets and settlement of liabilities and commitments in the normal course of business. The unaudited condensed consolidated financial statements do not include any adjustments that might result from the resolution of the Chapter 11 Cases or other matters discussed herein.

### Results of Operations

#### Regulatory Changes

Legislative and regulatory activities in the long-term healthcare industry have had a significant negative impact on the Company's operating results.

The Balanced Budget Act of 1997 (the "Budget Act"), contained extensive changes to the Medicare and Medicaid programs intended to reduce the projected amount of increase in payments under those programs over a five year period. Virtually all spending reductions come from reimbursements to providers and changes in program components. The Budget Act has affected adversely the revenues in each of the Company's operating divisions.

The Budget Act established a Medicare prospective payment system ("PPS") for nursing centers for cost reporting periods beginning on or after July 1, 1998. While most nursing centers in the United States became subject to PPS during the first quarter of 1999, all of the Company's nursing centers adopted PPS on July 1, 1998. During the first three years, the per diem rates for nursing centers are based on a blend of facility-specific costs and Federal costs. Thereafter, the per diem rates are based solely on Federal costs. The payments received under PPS cover all services for Medicare patients including all ancillary services, such as respiratory therapy, physical therapy, occupational therapy, speech therapy and certain covered pharmaceuticals.

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### RESULTS OF OPERATIONS (Continued)

#### Results of Operations (Continued)

##### Regulatory Changes (Continued)

In November 1999, the Balanced Budget Refinement Act (the "BBRA") was enacted to provide a measure of relief for some of the impact of PPS. The BBRA made a temporary 20% upward adjustment in the payment rates for the care of higher acuity patients and allowed nursing centers to transition more rapidly to the Federal payment rates. The BBRA also imposed a two-year moratorium on certain therapy limitations for skilled nursing center patients. Effective October 1, 2000, the BBRA will adjust all payment categories up by 4% for two years.

In April 2000, HCFA published a proposed rule which set forth updates to the Resource Utilization Grouping ("RUG") payment rates used under PPS for nursing centers. On July 31, 2000, HCFA issued a final rule which indefinitely postponed any refinements to the RUG categories used under PPS. It also provided for the continuance of Medicare payment relief set forth in the BBRA, including the 20% upward adjustment for certain higher acuity RUG categories through September 30, 2001 and the scheduled 4% increase (to be effective October 2000) for all RUG categories through September 30, 2002.

Despite the effects of the BBRA and the HCFA ruling discussed above, revenues recorded under PPS in the Company's health services division are substantially less than the cost-based reimbursement it received before the enactment of the Budget Act.

The Budget Act also reduced payments made to the hospitals operated by the Company's hospital division by reducing incentive payments pursuant to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), allowable costs for capital expenditures and bad debts, and payments for services to patients transferred from a general acute care hospital. The reductions in allowable costs for capital expenditures became effective October 1, 1997. The reductions in the TEFRA incentive payments and allowable costs for bad debts became effective between May 1, 1998 and September 1, 1998. The reductions for payments for services to patients transferred from a general acute care hospital became effective October 1, 1998. These reductions have had a material adverse impact on hospital revenues. In addition, these reductions also may affect adversely the hospital division's ability to develop additional long-term care hospitals in the future.

Under PPS, the volume of ancillary services provided per patient day to nursing center patients has declined dramatically. As previously discussed, Medicare reimbursements to nursing centers under PPS include substantially all services provided to patients, including ancillary services. Prior to the implementation of PPS, the costs of such services were reimbursed under cost-based reimbursement rules. The decline in the demand for ancillary services is mostly attributable to efforts by nursing centers to reduce operating costs. As a result, many nursing centers are electing to provide ancillary services to their patients through internal staff or are seeking lower acuity patients who require less ancillary services. In response to PPS and a significant decline in the demand for ancillary services, the Company realigned its Vencare division in the fourth quarter of 1999 by integrating the rehabilitation, speech and occupational therapy businesses into the health services division and assigning the institutional pharmacy business to the hospital division. Vencare's respiratory therapy and other ancillary businesses were discontinued.

There also continues to be state legislative proposals that would impose more limitations on government and private payments to providers of healthcare services such as the Company. Many states have enacted or are considering

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enacting measures that are designed to reduce their Medicaid expenditures and to make certain changes to private healthcare insurance. Some states also are considering regulatory changes that include a moratorium on the designation of additional long-term care hospitals. Regulatory changes in the Medicare and Medicaid reimbursement systems applicable to the hospital division also are being considered. There also are a number of legislative proposals including cost caps and the establishment of Medicaid prospective payment systems for nursing centers. Moreover, by repealing the Boren Amendment, the Budget Act eases existing impediments on the states' ability to reduce their Medicaid reimbursement levels.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Results of Operations (Continued)

##### Regulatory Changes (Continued)

The Company could be affected adversely by the continuing efforts of governmental and private third-party payors to contain the amount of reimbursement for healthcare services. There can be no assurance that payments under governmental and private third-party payor programs will remain at levels comparable to present levels or will be sufficient to cover the costs allocable to patients eligible for reimbursement pursuant to such programs. In addition, there can be no assurance that facilities operated by the Company, or the provision of services and supplies by the Company, will meet the requirements for participation in such programs.

There can be no assurance that future healthcare legislation or other changes in the administration or interpretation of governmental healthcare programs will not have a material adverse effect on the Company's results of operations, liquidity and financial position.

##### Health Services Division - Nursing Centers

Revenues increased 4% to \$413 million in the second quarter of 2000 from \$398 million in the same period last year. For the six months ended June 30, 2000, nursing center revenues increased 4% to \$826 million from \$796 million a year ago. The increase in both periods was primarily attributable to increased Medicare and Medicaid reimbursement rates and price increases to private payors. Medicare revenues per patient day under PPS were \$301 in the second quarter of 2000 compared to \$289 in the second quarter a year ago, and \$296 for the six months ended June 30, 2000 compared to \$291 in the prior year. Despite a decline in patient acuity levels, the increase in Medicare reimbursement rates for both periods resulted primarily from regulatory changes associated with the BBRA and an increase in therapy services.

Nursing center operating income increased 37% to \$75 million in the second quarter of 2000 from \$55 million last year. Operating income for the first six months of 2000 increased 31% to \$144 million from \$110 million last year. A substantial portion of the improvement in operating margins in both periods resulted from operating efficiencies related to the fourth quarter 1999 Vencare realignment. In the aggregate, operating costs (wages, benefits, supplies and other expenses) per patient day declined slightly for both the second quarter and six month period compared to a year ago.

##### Health Services Division - Rehabilitation Services

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Revenues declined 34% to \$34 million in the second quarter of 2000 from \$51 million a year ago. For the first six months of 2000, revenues declined 35% to \$68 million from \$105 million for the same period last year. The decline in revenues was primarily attributable to continued reductions in the demand for ancillary services in response to fixed reimbursement rates under PPS. Approximately one-half of the revenue decline in both periods was attributable to Company-operated nursing centers. Under PPS, the reimbursement for ancillary services provided to nursing center patients is a component of the total reimbursement allowed per nursing center patient. As a result, many nursing center customers (including the Company's nursing centers) have elected to provide ancillary services to their patients through internal staff and no longer contract with outside parties for ancillary services.

Rehabilitation services reported a \$1 million operating loss for both the second quarter and six months ended June 30, 2000 compared to operating income of \$8 million and \$15 million last year, respectively. The reduction in operating income reflects a continued decline in customer demand resulting from PPS. In addition, effective January 1, 2000, revenues for rehabilitation services provided to Company-operated nursing centers approximated the costs of providing such services. Accordingly, 2000 operating results do not reflect any operating income related to intercompany transactions. While the health services division will continue to provide rehabilitation services to nursing center customers, revenues and operating income related to these services may continue to decline.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Results of Operations (Continued)

##### Health Services Division - Other Ancillary Services

Other ancillary services refers to certain ancillary businesses (primarily respiratory therapy) that were discontinued as part of the Vencare realignment in the fourth quarter of 1999.

##### Hospital Division - Hospitals

Revenues increased 6% to \$250 million in the second quarter of 2000 from \$235 million in the same period a year ago, while revenues increased 6% for the six month period to \$504 million in 2000 from \$473 million in 1999. The increase in both periods was primarily attributable to growth in patient days.

Revenues per patient day increased 1% in the second quarter and six month period compared to the respective periods a year ago. Despite increases in private payor rates, Medicare revenues per patient day declined 2% in both periods. Medicare revenues recorded by the Company's hospitals in prior years included reimbursement for expenses related to certain costs associated with hospital-based ancillary services previously provided by the Vencare division to its nursing center customers. In connection with the continued settlement discussions with the DOJ, the Company has agreed to discontinue recording such revenues and has excluded such costs from its Medicare cost reports since September 1, 1999. Medicare revenues related to the reimbursement of such costs aggregated \$7 million in the second quarter of 1999 and \$14 million for the first six months of 1999.

Hospital operating income declined 12% to \$52 million in the second quarter of 2000 from \$58 million in the second quarter of 1999 and declined 8% to \$107



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million for the first six months of 2000 from \$116 million last year. Despite an increase in patient days, hospital operating costs per patient day increased 7% to \$757 from \$706 in the second quarter of 2000 compared to 1999 and increased 5% to \$743 from \$707 for the six months ended June 30, 2000 compared to last year. The increase in both periods was primarily attributable to growth in labor and pharmaceutical costs and provisions for loss related to asset impairments. Operating income also was adversely impacted by the previously discussed reduction in Medicare reimbursement for hospital-based ancillary services.

### Hospital Division - Pharmacy

Revenues increased 16% to \$50 million in the second quarter of 2000 compared to \$43 million a year ago and increased 13% to \$97 million for the first six months of 2000 compared to \$86 million last year. The increases resulted primarily from growth in the number of nursing center customers.

Operating income declined to \$1 million in the second quarter of 2000 compared to \$3 million in the same period of the prior year. For the six month period, the pharmacy business reported an operating loss of \$0.4 million compared to operating income of \$7 million for the first six months of 1999. The decline in operating income in both periods was primarily attributable to pricing pressures associated with PPS and pharmaceutical cost increases. Supply costs as a percentage of revenues rose to 61% in the second quarter of 2000 from 55% in 1999. For the six months ended June 30, 2000, supply costs as a percentage of revenues rose to 64% from 54% last year.

### Corporate Overhead

Operating income for the Company's operating divisions excludes allocation of corporate overhead. These costs aggregated \$28 million and \$30 million in the second quarters of 2000 and 1999, respectively, and \$57 million in the first six months of both years. As a percentage of revenues (before eliminations), corporate overhead was 3.8% and 4.2% for the respective quarters of 2000 and 1999, and 3.9% and 4.0% for the respective six month periods.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

### Results of Operations (Continued)

#### Unusual Transactions

Operating results for each period presented include certain unusual transactions. These transactions are included in other operating expenses in the unaudited condensed consolidated statement of operations for the respective periods in which they were recorded.

In the second quarter of 2000, the Company recorded a \$5 million gain on the sale of a closed hospital. In the second quarter of 1999, the Company recorded a charge of \$21 million associated with the write-off of the Company's remaining investment in BHC (\$15 million) and the cancellation of a nursing center software development project (\$6 million).

#### Capital Costs

The Company leases substantially all of its facilities. Depreciation and amortization, rents and net interest costs aggregated \$109 million in the second

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quarter of 2000 compared to \$117 million for the same period last year and \$218 million and \$234 million for the first six months of 2000 and 1999, respectively. While rents were relatively unchanged, depreciation and amortization declined primarily as a result of significant write-offs of property, equipment and goodwill in the fourth quarter of 1999 in connection with the Company's valuation of its long-lived assets required by SFAS 121. On January 1, 2000, the Company changed its goodwill amortization period from 40 years to 20 years from the date of acquisition. The impact of this change was not material. See Note 1 of the Notes to Condensed Consolidated Financial Statements.

During the pendency of the Chapter 11 Cases, the Company is continuing to record the contractual amount of interest expense related to the Credit Agreement and the rents due to Ventas under the Master Lease Agreements. No interest costs have been recorded related to the 1998 Notes since the filing of the Chapter 11 Cases. Contractual interest expense not accrued for the 1998 Notes approximated \$7 million and \$15 million for the second quarter and first six months of 2000, respectively.

### Income Taxes

The provision for income taxes is based upon management's estimate of taxable income or loss for the year and includes the effect of certain non-deductible items such as goodwill amortization and the recording of additional deferred tax valuation allowances.

The provision for income taxes for the second quarter of 2000 and 1999 included charges of \$2 million and \$12 million, respectively, related to the deferred tax valuation allowance. For the six months ended June 30, 2000 and 1999, charges related to the deferred tax valuation allowance totaled \$8 million and \$16 million, respectively. In addition, the Company recorded a valuation allowance of \$3 million in the first quarter of 1999 related to the change in accounting for start-up costs. At June 30, 2000, the deferred tax valuation allowance included in the Company's unaudited condensed consolidated balance sheet aggregated \$368 million.

### Consolidated Results

The Company reported a pretax loss from operations before reorganization costs of \$5 million in the second quarter of 2000 compared to \$41 million in the second quarter of 1999. For the six months ended June 30, 2000, the Company recorded a pretax loss from operations before reorganization costs of \$20 million compared to \$59 million for the same period of 1999.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

### Results of Operations (Continued)

#### Consolidated Results (Continued)

Reorganization costs, consisting principally of professional fees, aggregated \$3 million and \$5 million in the second quarters of 2000 and 1999, respectively, and \$6 million and \$7 million for the respective six month periods.

The net loss from operations in the second quarter of 2000 aggregated \$8 million compared to a net loss of \$46 million in the second quarter of 1999. For the six months ended June 30, 2000, the Company's net loss from operations

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totalled \$27 million compared to a net loss of \$66 million a year ago. In addition, the Company recorded a \$9 million charge in the first quarter of 1999 to reflect the change in accounting for start-up costs. See Note 3 of the Notes to Condensed Consolidated Financial Statements.

### Liquidity

As previously discussed, the Company and substantially all of its subsidiaries filed voluntary petitions for protection under Chapter 11 of the Bankruptcy Code on September 13, 1999. The Company currently is operating its businesses as a debtor-in-possession subject to the jurisdiction of the Bankruptcy Court.

On September 14, 1999, the Company received approval from the Bankruptcy Court to pay pre-petition and post-petition employee wages, salaries, benefits and other employee obligations. The Bankruptcy Court also approved orders granting authority, among other things, to pay pre-petition claims of certain critical vendors, utilities and patient obligations. All other pre-petition liabilities are classified in the unaudited condensed consolidated balance sheet as liabilities subject to compromise. The Company currently is paying the post-petition claims of all vendors and providers in the ordinary course of business.

In connection with the Chapter 11 Cases, the Company entered into the DIP Financing aggregating \$100 million. The Bankruptcy Court granted final approval of the DIP Financing on October 1, 1999. The DIP Financing, which was initially scheduled to mature on March 13, 2000, is comprised of the Tranche A Loan and the Tranche B Loan. Interest is payable at prime rate plus 2 1/2% on the Tranche A Loan and prime rate plus 4 1/2% on the Tranche B Loan.

Available aggregate borrowings under the Tranche A Loan were initially limited to \$45 million in September 1999 and increased to \$65 million in October, \$70 million in November and \$75 million thereafter. Pursuant to an amendment to the DIP Financing, the aggregate borrowing limitations under the Tranche A Loans are limited to approximately \$68 million until maturity and are reduced for asset sales made by the Company. At June 30, 2000, aggregate available borrowings under the Tranche A Loan were \$63 million. Borrowings under the Tranche B Loan require the approval of lenders holding at least 75% of the credit exposure under the DIP Financing. The DIP Financing is secured by substantially all of the assets of the Company and its subsidiaries, including certain owned real property. The DIP Financing contains standard representations and warranties and other affirmative and restrictive covenants. At June 30, 2000, there were no outstanding borrowings under the DIP Financing.

Since the consummation of the DIP Financing, the Company and the DIP Lenders have agreed to several amendments to the DIP Financing. These amendments approved various changes to the DIP Financing including (i) extending the period of time for the Company to file its plan of reorganization, (ii) approving certain transactions, (iii) revising the Company's cash plan originally submitted with the DIP Financing and (iv) revising certain financial covenants. In December 1999, the Company informed the DIP Lenders that it planned to record a significant charge to earnings in the fourth quarter of 1999 related to the valuation of accounts receivable that could have resulted in noncompliance with certain covenants in the DIP Financing requiring minimum Consolidated EBITDAR and a minimum Net Amount of

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### Liquidity (Continued)

Eligible Accounts (both as defined in the DIP Financing). In connection with the third amendment to the DIP Financing, the Company received a waiver from compliance with these covenants of the DIP Financing through February 14, 2000. The Company received subsequent waivers from compliance with these covenants in later amendments.

At December 31, 1999, the Company was not in compliance with the DIP Financing covenant related to the minimum Net Amount of Eligible Accounts (accounts receivable). Since there were no outstanding borrowings under the DIP Financing at December 31, 1999, the event of default had no effect on the Company's 1999 consolidated financial statements. Effective April 12, 2000, the Company and the DIP Lenders agreed to an additional amendment to the DIP Financing to revise the covenant related to the minimum Net Amount of Eligible Accounts. In the amendment, the DIP Lenders also waived all events of default regarding this covenant that occurred prior to the date of the amendment.

On June 12, 2000, the Company entered into the Commitment Letter with certain of the DIP Lenders to finance the Restated DIP. The Restated DIP would become effective in the event the Company became involved in a legal proceeding against Ventas. The Commitment Letter will expire on August 31, 2000 unless the Company obtains Bankruptcy Court approval of the Commitment Letter and pays all fees payable upon such approval. The hearing on the motion is scheduled for August 23, 2000. Under the terms of the Commitment Letter, the Restated DIP will not be available unless it becomes effective on or prior to September 30, 2000.

In the recent amendments to the DIP Financing, the parties agreed, among other things, to extend the maturity date of the DIP Financing until September 30, 2000 and to extend the period of time for the Company to file its plan of reorganization to August 17, 2000.

Under the Bankruptcy Code, actions to collect pre-petition indebtedness against the Company are subject to an automatic stay and other contractual obligations against the Company may not be enforced. The automatic stay does not necessarily apply to certain actions against Ventas for which the Company has agreed to indemnify Ventas in connection with the Spin-off. In addition, the Company may assume or reject executory contracts, including lease obligations, under the Bankruptcy Code. Parties affected by these rejections may file claims with the Bankruptcy Court in accordance with the reorganization process.

As previously disclosed, the Company is developing a plan of reorganization through negotiations with key parties including its Senior Lenders, the holders of the 1998 Notes, Ventas, the DOJ, and the advisors to the official committee of unsecured creditors. The Company has made substantial progress in its discussions with Ventas, the Senior Lenders, the holders of the 1998 Notes, the DOJ and the unsecured creditors committee toward a consensual plan of reorganization.

On August 11, 2000, the Company filed a motion to extend its exclusive right to submit a plan of reorganization through September 29, 2000. The hearing on this motion is scheduled for September 6, 2000. The Bankruptcy Court currently has extended the Company's exclusive right to submit a plan of reorganization through August 17, 2000. The Company has requested an interim order from the Bankruptcy Court to maintain the Company's exclusive right to file a plan of reorganization until the motion is decided. The Company also will seek approval under the DIP Financing to permit the Company to extend the period of time to file its plan of reorganization.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Liquidity (Continued)

A substantial portion of pre-petition liabilities are subject to settlement under the plan of reorganization to be submitted by the Company. The plan of reorganization must be voted upon by certain of the impaired creditors of the Company and approved by the Bankruptcy Court. There can be no assurance that the plan of reorganization to be proposed by the Company will be approved by the requisite holders of claims, confirmed by the Bankruptcy Court or that it will be consummated. If the plan of reorganization is not accepted by the required number of impaired creditors and the Company's exclusive right to file and solicit acceptance of a plan of reorganization ends, any party in interest may subsequently file its own plan of reorganization for the Company.

A plan of reorganization must be confirmed by the Bankruptcy Court after certain findings required by the Bankruptcy Code are made by the Bankruptcy Court. The Bankruptcy Court may confirm a plan of reorganization notwithstanding the non-acceptance of the plan by an impaired class of creditors or equity holders if certain requirements of the Bankruptcy Code are satisfied. The Company believes that any plan of reorganization likely will result in the Company's common stock having no value.

The Company was informed on April 9, 1999 by HCFA that the Medicare program had made a demand for repayment of approximately \$90 million of reimbursement overpayments by April 23, 1999. On April 21, 1999, the Company entered into the HCFA Agreement under which monthly payments of approximately \$1.5 million commenced in May 1999. Since December 1999, the balance of the overpayments bears interest at a statutory rate approximating 13.4%, resulting in a monthly payment of approximately \$2 million through March 2004. If the Company is delinquent with two consecutive payments, the HCFA Agreement will be defaulted and all subsequent Medicare reimbursement payments to the Company may be withheld. Amounts due under the HCFA Agreement aggregated \$71 million and have been classified as liabilities subject to compromise in the Company's unaudited condensed consolidated balance sheet at June 30, 2000. The Company has received Bankruptcy Court approval to continue to make the monthly payments under the HCFA Agreement during the pendency of the Chapter 11 Cases.

#### Liabilities Subject to Compromise

"Liabilities subject to compromise" refers to liabilities incurred prior to the commencement of the Chapter 11 Cases. These liabilities, consisting primarily of long-term debt, amounts due to third party payors and certain accounts payable and accrued liabilities, represent the Company's estimate of known or potential claims to be resolved in connection with the Chapter 11 Cases. Such claims remain subject to future adjustments based on assertions of additional claims, negotiations, actions of the Bankruptcy Court, further developments with respect to disputed claims, future rejection of executory contracts or unexpired leases, determination as to the value of any collateral securing claims, treatment under the plan of reorganization and other events. Payment terms for these amounts will be established in connection with the plan of reorganization.

The Company has received approval from the Bankruptcy Court to pay pre-petition and post-petition employee wages, salaries, benefits and other employee obligations. The Bankruptcy Court also approved orders granting authority, among other things, to pay pre-petition claims of certain critical vendors, utilities and patient obligations. All other pre-petition liabilities are classified in the unaudited condensed consolidated balance sheet as liabilities subject to compromise.

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Substantially all of the liabilities subject to compromise would have been classified as current liabilities if the Chapter 11 Cases had not been filed.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Liquidity (Continued)

##### Cash Flows

Since the filing of the Chapter 11 Cases, cash flows from operations have allowed the Company to fund post-petition obligations, sustain adequate liquidity levels and minimize borrowings under the DIP Financing. Cash flows from operations before reorganization costs totaled \$110 million for the six months ended June 30, 2000 compared to \$85 million in the first six months of 1999. Cash flows in 1999 were reduced by \$12 million in connection with the settlement of certain litigation. There can be no assurance, however, that the Company can maintain its current liquidity levels during the pendency of the Chapter 11 Cases.

In January 2000, the Company filed its hospital cost reports for the year August 31, 1999. Cost reports are filed annually in settlement of amounts due to or from the various agencies administering the reimbursement programs. These cost reports indicated amounts due from the Company aggregating \$58 million. This liability arose during 1999 as part of the Company's routine settlement of Medicare reimbursement overpayments. Such amounts are classified as liabilities subject to compromise in the unaudited condensed consolidated balance sheet and, accordingly, no funds were disbursed by the Company in settlement of such pre-petition liabilities.

##### Capital Resources

Capital expenditures for the first six months of 2000 aggregated \$22 million compared to \$51 million a year ago. Capital expenditures could approximate \$80 million in 2000. Management believes that its capital expenditure program is adequate to improve and equip existing facilities.

Capital expenditures in both periods were financed through internally generated funds. At June 30, 2000, the estimated cost to complete and equip construction in progress approximated \$14 million. There can be no assurance that the Company will have sufficient resources to finance its capital expenditures program in 2000.

##### Other Information

The Company is a party to certain material legal actions and regulatory investigations. See Note 11 of the Notes to Condensed Consolidated Financial Statements.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Condensed Consolidated Statement of Operations (Unaudited)

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(In thousands, except per share amounts)

|  | (Restated)    |             |             |              |          |
|--|---------------|-------------|-------------|--------------|----------|
|  | 1999 Quarters |             |             |              | 200      |
|  | First         | Second      | Third       | Fourth       | First    |
| Revenues.....  | \$700,232     | \$688,892   | \$681,924   | \$ 594,593   | \$715,4  |
| Salaries, wages and benefits.....                                    | 403,894       | 392,748     | 393,535     | 376,050      | 405,3    |
| Supplies.....  | 84,997        | 85,799      | 81,484      | 95,509       | 93,3     |
| Rent.....  | 75,452        | 76,088      | 77,423      | 76,157       | 76,2     |
| Other operating expenses.....  | 112,561       | 134,743     | 122,502     | 594,607      | 122,5    |
| Depreciation and amortization.....                                   | 22,285        | 21,612      | 24,126      | 25,173       | 17,9     |
| Interest expense.....  | 19,536        | 20,032      | 26,030      | 14,844       | 16,2     |
| Investment income.....   | (631)         | (642)       | (673)       | (3,242)      | (1,2     |
|  | 718,094       | 730,380     | 724,427     | 1,179,098    | 730,4    |
| Loss before reorganization costs<br>and income taxes.....            | (17,862)      | (41,488)    | (42,503)    | (584,505)    | (14,9    |
| Reorganization costs.....  | 2,312         | 4,547       | 5,443       | 6,304        | 3,0      |
| Loss before income taxes.....  | (20,174)      | (46,035)    | (47,946)    | (590,809)    | (18,0    |
| Provision for income taxes.....                                      | 50            | 50          | 50          | 350          | 5        |
| Loss from operations.....  | (20,224)      | (46,085)    | (47,996)    | (591,159)    | (18,5    |
| Cumulative effect of change in<br>accounting for start-up costs..... | (8,923)       | -           | -           | -            | -        |
| Net loss.....  | (29,147)      | (46,085)    | (47,996)    | (591,159)    | (18,5    |
| Preferred stock dividend<br>requirements.....                        | (261)         | (262)       | (261)       | (262)        | (2       |
| Loss to common<br>stockholders.....                                  | \$ (29,408)   | \$ (46,347) | \$ (48,257) | \$ (591,421) | \$ (18,8 |
| Loss per common share:   |               |             |             |              |          |
| Basic:   |               |             |             |              |          |
| Loss from operations.....  | \$ (0.29)     | \$ (0.66)   | \$ (0.69)   | \$ (8.39)    | \$ (0.   |
| Cumulative effect of change in<br>accounting for start-up costs..    | (0.13)        | -           | -           | -            | -        |
| Net loss.....  | \$ (0.42)     | \$ (0.66)   | \$ (0.69)   | \$ (8.39)    | \$ (0.   |
| Diluted:   |               |             |             |              |          |
| Loss from operations.....  | \$ (0.29)     | \$ (0.66)   | \$ (0.69)   | \$ (8.39)    | \$ (0.   |
| Cumulative effect of change in<br>accounting for start-up costs..    | (0.13)        | -           | -           | -            | -        |
| Net loss.....  | \$ (0.42)     | \$ (0.66)   | \$ (0.69)   | \$ (8.39)    | \$ (0.   |
| Shares used in computing loss<br>per common share:                   |               |             |             |              |          |
| Basic.....   | 70,326        | 70,395      | 70,438      | 70,463       | 70,2     |
| Diluted.....   | 70,326        | 70,395      | 70,438      | 70,463       | 70,2     |

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Operating Data  
(Unaudited)  
(In thousands)

|  | 1999 Quarters |           |           |            | 2000 First Quarter |
|--|---------------|-----------|-----------|------------|--------------------|
|  | First         | Second    | Third     | Fourth     |                    |
| Revenues:  |               |           |           |            |                    |
| Health services division:  |               |           |           |            |                    |
| Nursing centers.....   | \$398,374     | \$397,930 | \$399,907 | \$ 398,033 | \$412,000          |
| Rehabilitation services.....                                       | 54,365        | 50,234    | 46,088    | 45,044     | 34,000             |
| Other ancillary services.....                                      | 16,263        | 12,855    | 10,477    | 3,932      | 10,000             |
| Elimination.....   | (34,205)      | (34,564)  | (31,770)  | (27,728)   | (18,000)           |
|  | 434,797       | 426,455   | 424,702   | 419,281    | 428,000            |
| Hospital division:   |               |           |           |            |                    |
| Hospitals.....   | 238,522       | 234,868   | 230,682   | 146,476    | 253,000            |
| Pharmacy.....  | 43,246        | 42,951    | 40,707    | 44,589     | 47,000             |
|  | 281,768       | 277,819   | 271,389   | 191,065    | 301,000            |
| Elimination of pharmacy charges<br>to Company nursing centers..... | (16,333)      | (15,382)  | (14,167)  | (15,753)   | (14,000)           |
|  | \$700,232     | \$688,892 | \$681,924 | \$ 594,593 | \$715,000          |
| Income (loss) from operations (restated):                          |               |           |           |            |                    |
| Operating income (loss):   |               |           |           |            |                    |
| Health services division:  |               |           |           |            |                    |
| Nursing centers.....   | \$ 54,963     | \$ 55,027 | \$ 51,722 | \$ 7,416   | \$ 68,000          |
| Rehabilitation services.....                                       | 6,847         | 8,311     | 5,191     | (17,458)   | 10,000             |
| Other ancillary services.....                                      | 3,596         | 1,035     | 1,333     | (1,798)    | 10,000             |
|  | 65,406        | 64,373    | 58,246    | (11,840)   | 69,000             |
| Hospital division:   |               |           |           |            |                    |
| Hospitals.....   | 57,198        | 58,443    | 52,871    | (36,462)   | 55,000             |
| Pharmacy.....  | 3,951         | 3,289     | 585       | (7,483)    | (1,000)            |
|  | 61,149        | 61,732    | 53,456    | (43,945)   | 54,000             |
| Corporate overhead.....  | (27,775)      | (29,676)  | (27,299)  | (24,197)   | (29,000)           |
| Unusual transactions.....  | -             | (20,827)  | -         | (391,591)  | 10,000             |
| Reorganization costs.....  | (2,312)       | (4,547)   | (5,443)   | (6,304)    | (3,000)            |
|  | 96,468        | 71,055    | 78,960    | (477,877)  | 91,000             |
| Rent.....  | (75,452)      | (76,088)  | (77,423)  | (76,157)   | (76,000)           |
| Depreciation and amortization....                                  | (22,285)      | (21,612)  | (24,126)  | (25,173)   | (17,000)           |
| Interest, net.....   | (18,905)      | (19,390)  | (25,357)  | (11,602)   | (15,000)           |
| Loss before income taxes.....                                      | (20,174)      | (46,035)  | (47,946)  | (590,809)  | (18,000)           |



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|                                 |             |             |             |              |             |
|---------------------------------|-------------|-------------|-------------|--------------|-------------|
| Provision for income taxes..... | 50          | 50          | 50          | 350          |             |
|                                 | -----       | -----       | -----       | -----        | -----       |
|                                 | \$ (20,224) | \$ (46,085) | \$ (47,996) | \$ (591,159) | \$ (18,111) |
|                                 | =====       | =====       | =====       | =====        | =====       |

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Operating Data (Continued)  
(Unaudited)

|                             | 1999 Quarters |           |           |           | 2000 Quarters |           |
|-----------------------------|---------------|-----------|-----------|-----------|---------------|-----------|
|                             | First         | Second    | Third     | Fourth    | First         | Second    |
| Nursing Center Data:        |               |           |           |           |               |           |
| End of period data:         |               |           |           |           |               |           |
| Number of nursing centers:  |               |           |           |           |               |           |
| Leased and owned.....       | 280           | 280       | 280       | 282       | 280           | 280       |
| Managed.....                | 13            | 13        | 13        | 13        | 40            | 41        |
|                             | -----         | -----     | -----     | -----     | -----         | -----     |
|                             | 293           | 293       | 293       | 295       | 320           | 321       |
|                             | =====         | =====     | =====     | =====     | =====         | =====     |
| Number of licensed beds:    |               |           |           |           |               |           |
| Leased and owned.....       | 36,924        | 36,726    | 36,675    | 36,912    | 36,653        | 36,677    |
| Managed.....                | 1,661         | 1,661     | 1,661     | 1,661     | 4,262         | 4,436     |
|                             | -----         | -----     | -----     | -----     | -----         | -----     |
|                             | 38,585        | 38,387    | 38,336    | 38,573    | 40,915        | 41,113    |
|                             | =====         | =====     | =====     | =====     | =====         | =====     |
| Revenue mix %:              |               |           |           |           |               |           |
| Medicare.....               | 28            | 27        | 24        | 26        | 28            | 28        |
| Medicaid.....               | 47            | 48        | 51        | 50        | 48            | 48        |
| Private and other.....      | 25            | 25        | 25        | 24        | 24            | 24        |
| Patient days:               |               |           |           |           |               |           |
| Medicare.....               | 380,748       | 366,272   | 339,303   | 349,965   | 398,329       | 382,933   |
| Medicaid.....               | 1,867,554     | 1,911,111 | 1,967,721 | 1,972,577 | 1,918,732     | 1,917,429 |
| Private and other.....      | 633,137       | 623,665   | 626,903   | 617,483   | 590,619       | 579,128   |
|                             | -----         | -----     | -----     | -----     | -----         | -----     |
|                             | 2,881,439     | 2,901,048 | 2,933,927 | 2,940,025 | 2,907,680     | 2,879,490 |
|                             | =====         | =====     | =====     | =====     | =====         | =====     |
| Hospital Data:              |               |           |           |           |               |           |
| End of period data:         |               |           |           |           |               |           |
| Number of hospitals.....    | 57            | 56        | 56        | 56        | 56            | 56        |
| Number of licensed beds.... | 4,937         | 4,935     | 4,907     | 4,931     | 4,931         | 4,880     |
| Revenue mix %:              |               |           |           |           |               |           |
| Medicare.....               | 59            | 56        | 55        | 65        | 58            | 53        |
| Medicaid.....               | 10            | 10        | 11        | 11        | 10            | 9         |
| Private and other.....      | 31            | 34        | 34        | 24        | 32            | 38        |
| Patient days:               |               |           |           |           |               |           |
| Medicare.....               | 175,953       | 171,011   | 159,739   | 163,273   | 188,063       | 177,083   |
| Medicaid.....               | 29,939        | 29,675    | 30,674    | 29,561    | 31,964        | 33,416    |

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|                        |         |         |         |         |         |         |
|------------------------|---------|---------|---------|---------|---------|---------|
| Private and other..... | 49,924  | 49,165  | 47,756  | 45,631  | 51,747  | 51,743  |
|                        | -----   | -----   | -----   | -----   | -----   | -----   |
|                        | 255,816 | 249,851 | 238,169 | 238,465 | 271,774 | 262,242 |
|                        | =====   | =====   | =====   | =====   | =====   | =====   |

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's only significant exposure to market risk is changes in the levels of various interest rates. In this regard, changes in LIBOR interest rates affect the interest paid on its borrowings. In addition, the interest rates on the DIP Financing are affected by changes in the Federal Funds rate and the prime rate of Morgan Guaranty Trust Company of New York. To mitigate the impact of fluctuations in these interest rates, the Company generally maintains a portion of its borrowings on a fixed rate, long-term basis. Prior to its financial difficulties, the Company also entered into certain interest rate swap transactions. The Company had no active interest rate swap agreements at June 30, 2000.

As previously discussed, the Company filed the Chapter 11 Cases on September 13, 1999. Accordingly, all amounts disclosed in the table below are subject to compromise in connection with the Chapter 11 Cases. While the fair values of the Company's debt obligations declined significantly as a result of the Chapter 11 Cases, such amounts do not reflect any adjustments that might result from the resolution of the Chapter 11 Cases or other matters discussed herein.

Under the Bankruptcy Code, actions to collect pre-petition indebtedness against the Company are subject to an automatic stay and other contractual obligations against the Company may not be enforced. In addition, the Company may assume or reject executory contracts under the Bankruptcy Code.

The following table provides information about the Company's financial instruments that are sensitive to changes in interest rates. The table constitutes a forward-looking statement. For long-term debt, 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 |          |           |          |           |            |
|------------------------------|---------------------|----------|-----------|----------|-----------|------------|
|                              | 2000                | 2001     | 2002      | 2003     | 2004      | Thereafter |
|                              | -----               | -----    | -----     | -----    | -----     | -----      |
| Liabilities:                 |                     |          |           |          |           |            |
| Long-term debt, including    |                     |          |           |          |           |            |
| amounts due within one year: |                     |          |           |          |           |            |
| Fixed rate.....              | \$ 7,348            | \$17,802 | \$ 19,453 | \$21,145 | \$ 7,574  | \$303,898  |
| Average interest rate.....   | 12.00%              | 12.00%   | 12.00%    | 12.00%   | 10.00%    | 10.00%     |
| Variable rate.....           | \$22,503            | \$61,974 | \$128,640 | \$79,535 | \$177,344 | \$ 39,147  |
| (a) Average interest rate    |                     |          |           |          |           |            |

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(a) Interest is payable, depending on the debt instrument, certain leverage ratios and other factors, at a rate of LIBOR plus 3/4% to 3 1/2% or the prime rate plus 2% to 3 1/2%.

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SIGNATURES

Pursuant to the requirements 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.

KINDRED HEALTHCARE, INC.

Date: August 29, 2001  
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/s/ EDWARD L. KUNTZ  
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Edward L. Kuntz  
Chairman of the Board, Chief  
Executive Officer and President

Date: August 29, 2001  
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/s/ RICHARD A. SCHWEINHART  
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Richard A. Schweinhart  
Senior Vice President and Chief  
Financial Officer (Principal  
Financial Officer)

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