Roate, George 12-039

From: Reppy, Don [DREPPY@hcr-manorcare.com]
Sent: Tuesday, April 24, 2012 11:09 AM
To: Roate, George
Cc: Kara Friedman
Subject: RE: Missing application pages
Attachments: Audited Statements Attachment 42.pdf

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I can't believe that I did not include these.

Here are the audited statements for Attachment 42. I have numbered them 318a to 318gg.

I apologize again.

Don Reppy
HCR-ManorCare
Director of Health Planning
7361 Calhoun Place #300
Rockville, MD 20855
240-453-8568
dreppy@hcr-manorcare.com

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From: Roate, George [mailto:George.Roate@Illinois.gov]
Sent: Tuesday, April 24, 2012 11:33 AM
To: Reppy, Don
Cc: Kara Friedman
Subject: RE: Missing application pages

Ok. Thanks.
Could you please forward the audited financial statements for HCR Healthcare, LLC?
Or have I overlooked them?

From: Reppy, Don [mailto:DREPPY@hcr-manorcare.com]
Sent: Tuesday, April 24, 2012 10:23 AM
To: Roate, George
Cc: Kara Friedman
Subject: RE: Missing application pages

There are no audited statements for the parent corporation HCR ManorCare Inc. or the immediate applicant, ManorCare Health Services LLC

Thus, we added an applicant, HCR Healthcare LLC, for which there are audited statements. This created three co-applicants.

The HCR Healthcare LLC audit includes anything and everything that is owned, operated, or owned and operated by the ultimate parent, HCR ManorCare Inc.

Thanks.

Don Reppy
HCR-ManorCare
Director of Health Planning

12-039

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APR 24 2012

HEALTH FACILITIES &
SERVICES REVIEW BOARD

CONSOLIDATED FINANCIAL STATEMENTS

HCR Healthcare, LLC
For the years ended December 31, 2010 and 2009
With Report of Independent Auditors

Ernst & Young LLP

ERNST & YOUNG

318 a

HCR Healthcare, LLC.

Consolidated Financial Statements

Contents

318 b

Ernst & Young

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Report of Independent Auditors

The Board of Directors of HCR Healthcare, LLC

We have audited the accompanying consolidated balance sheets of HCR Healthcare, LLC as of December 31, 2010 and 2009, and the related consolidated statements of income, cash flows and equity for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of HCR Healthcare, LLC at December 31, 2010 and 2009, and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

Toledo, Ohio
February 4, 2011

318 c

HCR Healthcare, LLC
Consolidated Balance Sheets

	December 31, 2010	December 31, 2009
	(In thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 421,219	$ 379,658
Restricted cash and cash equivalents	6,052	87,982
Restricted cash and cash equivalents of consolidated VIE	7,446	7,855
Receivables, less allowance for doubtful accounts of $93,240 and $116,163, respectively	473,314	510,969
Prepaid expenses	10,408	10,145
Deferred income taxes	41,915	60,366
Total current assets	960,354	1,056,975
Net property and equipment of consolidated VIE	2,791,542	2,874,569
Net property and equipment	351,584	296,244
Goodwill	3,495,482	3,495,482
Intangible assets	659,732	662,025
Other assets	71,607	78,225
Other assets of consolidated VIE	31,617	59,589
Total assets	$ 8,361,918	$ 8,523,109
Liabilities and Equity		
Current liabilities:		
Accounts payable	$ 114,826	$ 126,453
Employee compensation and benefits	155,375	148,535
Accrued insurance liabilities	119,010	120,784
Income taxes payable	2,926	591
Other accrued liabilities	91,332	98,868
Other accrued liabilities of consolidated VIE	8,509	8,280
Long-term debt due within one year	2,123	7,594
Net payable to affiliate	1,917	5,100
Total current liabilities	496,018	516,205
Long-term debt of consolidated VIE	4,595,942	4,595,942
Long-term debt	456,274	497,979
Deferred income taxes	915,011	915,251
Other liabilities	501,829	504,711
Equity:		
HCR Healthcare, LLC member's equity:		
Contributed capital	1,330,531	1,322,601
Retained earnings	64,681	182,704
Accumulated other comprehensive loss	(3,427)	(17,520)
Total HCR Healthcare, LLC member's equity	1,391,785	1,487,785
Noncontrolling interest	5,059	5,236
Total equity	1,396,844	1,493,021
Total liabilities and equity	$ 8,361,918	$ 8,523,109

See accompanying notes.

3184

HCR Healthcare, LLC
Consolidated Statements of Income

	Year ended December 31,	
	2010	2009
	(In thousands)	
Revenues	$ 4,168,566	$ 4,123,720
Expenses:		
Operating	3,311,695	3,304,130
General and administrative	181,404	169,524
Depreciation and amortization	150,270	135,732
	3,643,369	3,609,386
Income before other (expenses) income and income taxes	525,197	514,334
Other (expenses) income:		
Interest expense	(173,459)	(169,907)
(Loss) gain on debt extinguishment	(570)	13,184
Derivative floor expense	(123,997)	(120,306)
Unrealized derivative gain	12,073	11,698
(Loss) gain on sale of assets	(16)	174
Equity in earnings of affiliated company	6,284	5,423
Interest income and other	1,758	2,637
Total other expenses, net	(277,927)	(257,097)
Income before income taxes	247,270	257,237
Income taxes	83,715	86,077
Net income	163,555	171,160
Less net income attributable to noncontrolling interest	809	1,022
Net income attributable to controlling interest	$ 162,746	$ 170,138

See accompanying notes.

318e

HCR Healthcare, LLC

Consolidated Statements of Cash Flows

	Year ended December 31, 2010	2009
	(In thousands)	
Operating Activities		
Net income	$ 163,555	$ 171,160
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	150,270	135,732
Deferred finance fee amortization	18,799	18,978
Derivative amortization	10,504	3,434
Pension amortization	421	(218)
Loss (gain) on debt extinguishment	570	(13,184)
Unrealized derivative gain	(12,073)	(11,698)
Restricted stock and stock option compensation	6,181	10,355
Provision for bad debts	66,727	71,643
Provision for deferred income taxes	9,085	26,135
Loss (gain) on sale of assets	16	(174)
Equity in earnings of affiliated company	(6,284)	(5,423)
Changes in assets and liabilities:		
Receivables	(29,072)	(14,779)
Prepaid expenses and other assets	7,874	(9,068)
Liabilities	21,986	(51,499)
Total adjustments	245,004	160,234
Net cash provided by operating activities	408,559	331,394
Investing Activities		
Investment in property and equipment	(117,237)	(127,258)
Investment in systems development	(900)	(974)
Acquisitions	(1,013)	-
Proceeds from sale of assets	229	6,666
Net change in restricted cash and cash equivalents	82,339	2,545
Net cash used in investing activities	(36,582)	(119,021)
Financing Activities		
Net advance to affiliated company	(3,183)	-
Proceeds from issuance of debt	2,500	-
Payment of debt	(49,676)	(57,278)
Payment of financing and extinguishment costs	(51)	(1,839)
Dividends paid	(280,769)	-
Excess tax benefits from the equity plan	1,749	-
Distributions to noncontrolling interest	(986)	(528)
Net cash used in financing activities	(330,416)	(59,645)
Net increase in cash and cash equivalents	41,561	152,728
Cash and cash equivalents at beginning of year	379,658	226,930
Cash and cash equivalents at end of year	$ 421,219	$ 379,658

See accompanying notes.

318f

HCR Healthcare, LLC
Consolidated Statements of Equity

	Contributed Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Non-controlling Interest	Total Equity
			(In thousands)		
Balance at January 1, 2009	$ 1,312,246	$ 12,566	$ (19,398)	$ 4,742	$ 1,310,156
Contribution from parent	10,355				10,355
Distributions to noncontrolling interest				(528)	(528)
Comprehensive income:					
Net income		170,138		1,022	
Other comprehensive income, net of tax:					
Unrealized derivative loss and reclassification adjustments (Note 7)			2,742		
Pension activity (Note 13)			(864)		
Total comprehensive income attributable to HCR Healthcare					172,016
Total comprehensive income attributable to noncontrolling interest					1,022
Total comprehensive income					**173,038**
Balance at December 31, 2009	1,322,601	182,704	(17,520)	5,236	1,493,021
Contribution from parent	6,181				6,181
Tax benefit from the equity plan	1,749				1,749
Cash dividends declared		(280,769)			(280,769)
Distributions to noncontrolling interest				(986)	(986)
Comprehensive income:					
Net income		162,746		809	
Other comprehensive income, net of tax:					
Unrealized derivative loss and reclassification adjustments (Note 7)			14,652		
Pension activity (Note 13)			(559)		
Total comprehensive income attributable to HCR Healthcare					176,839
Total comprehensive income attributable to noncontrolling interest					809
Total comprehensive income					**177,648**
Balance at December 31, 2010	$ 1,330,531	$ 64,681	$ (3,427)	$ 5,059	$ 1,396,844

See accompanying notes.

3189

1. Accounting Policies

Nature of Operations

HCR Healthcare, LLC. and subsidiaries (the Company) is a provider of a range of health care services, including skilled nursing care, assisted living, post-acute medical and rehabilitation care, hospice care, home health care and rehabilitation therapy. The most significant portion of the Company's business relates to skilled nursing care and assisted living, operating 343 centers in 30 states, with 62 percent located in Florida, Illinois, Michigan, Ohio and Pennsylvania. The hospice and home health business specializes in all levels of hospice care, home health and rehabilitation therapy, with 105 offices located in 25 states. The Company not only provides rehabilitation therapy in the Company's 57 outpatient therapy clinics, but in a variety of other settings including skilled nursing centers, schools, and hospitals.

Principles of Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of HCR Healthcare, LLC and its wholly-owned subsidiaries, including but not limited to HCR III Healthcare, LLC and its subsidiaries, as well as the Company's majority-owned subsidiaries. HCR Healthcare, LLC is a wholly-owned subsidiary of Manor Care, Inc. and an indirect wholly-owned subsidiary of HCR ManorCare, Inc. Intercompany accounts and transactions with subsidiaries have been eliminated in consolidation. The net payable to affiliate of $1.9 million and $5.1 million at December 31, 2010 and 2009, respectively, does not bear interest.

HCR ManorCare, Inc. was formed for the purpose of merging its subsidiary with and into Manor Care, Inc., with Manor Care, Inc. continuing as the surviving corporation in the merger. Prior to the merger, Manor Care, Inc. was a publicly traded company. The merger was completed in December 2007.

In addition, in accordance with accounting standards for the consolidation of variable interest entities, HCR Healthcare, LLC consolidates a variable interest entity (VIE), HCR Properties, LLC and its subsidiaries because HCR III Healthcare, LLC is deemed to be the primary beneficiary. HCR Properties, LLC is a wholly-owned subsidiary of Manor Care, Inc.

The Company uses the equity method to account for investments in entities in which it has less than a majority interest but can exercise significant, but not a controlling, influence. These investments were classified on the accompanying balance sheets as other long-term assets and amounted to $18.7 million and $20.2 million at December 31, 2010 and 2009, respectively. Under the equity method, the investment, originally recorded at cost, is adjusted to recognize the Company's share of the net earnings or losses of the affiliate as they occur. Losses are limited to the extent of the Company's investments in, advances to and guarantees for the entity. The Company has a 50 percent ownership and voting interest in a pharmacy partnership, with Omnicare, Inc. having the remaining interest.

318h

Variable Interest Entity
On January 1, 2010, the Company adopted a new accounting standard that changes the consolidation analysis for a VIE. The standard requires a qualitative analysis rather than a quantitative analysis to determine the primary beneficiary of a VIE and requires continuous assessments of whether an entity is the primary beneficiary of a VIE. A VIE is a legal entity that lacks sufficient equity to finance its activities, or the equity investors of the entity as a group lack any of the characteristics of a controlling interest. The primary beneficiary of a VIE is the enterprise that has both the power to direct the activities most significant to the economic performance of the VIE and the obligation to absorb losses or receive benefits that could potentially be significant to the VIE. If the Company is determined to be the primary beneficiary of a VIE, it must account for the VIE as a consolidated subsidiary. The adoption of this standard did not change the consolidation of the VIE, HCR Properties, LLC, but expanded the disclosures regarding a VIE.

Certain of the consolidated subsidiaries of HCR Properties, LLC hold the title to the property and equipment of the skilled nursing and assisted living facilities. HCR III Healthcare, LLC (also referred to as Master Tenant) leases the property from certain subsidiaries of HCR Properties, LLC and conducts the operations of the business. HCR Properties, LLC distributes the residual lease payments to Manor Care, Inc., which represents the portion of the lease payments received from HCR III Healthcare, LLC which are not used by subsidiaries of HCR Properties, LLC to make payments with respect to their loan agreements. Manor Care, Inc. contributes the residual lease payments to the Company. The distributions were $273.4 million and $256.4 million for the years ended December 31, 2010 and 2009, respectively. HCR III Healthcare, LLC has a variable interest in HCR Properties, LLC as a result of the leasing relationship. HCR III Healthcare, LLC was considered to be the primary beneficiary based on its implicit obligation to absorb the losses of HCR Properties, LLC due to the fact that the entities are both owned by the same parent, Manor Care, Inc, and the co-dependent operations of both entities.

The consolidated balance sheets present the assets of HCR Properties, LLC that can be used only to settle obligations of this entity and the liabilities of HCR Properties, LLC for which creditors do not have recourse to the general credit of the Company. See Note 6 for a description of HCR Properties, LLC and its subsidiaries' debt of $4.6 billion. Excluding the assets that secure the mortgage, HCR Properties, LLC and its consolidated subsidiaries have assets related to deferred financing fees, derivative asset for interest rate caps, and restricted cash and cash equivalents for insurance and taxes.

Use of Estimates
The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents
Investments with a maturity of three months or less when purchased are considered cash equivalents for purposes of the statements of cash flows.

3181

Restricted Cash and Cash Equivalents
The restricted balances include amounts held as collateral or escrowed under the Company's credit or loan agreements for letters of credit, insurance and taxes, as well as funds for the Company's captive insurance subsidiary. In addition, a small portion of the Company's restricted balances includes amounts to pay the convertible debt senior notes, as discussed in Note 6.

Receivables and Revenues
Revenues are derived from services rendered to patients for long-term care, including skilled nursing and assisted living services, hospice and home health care, and rehabilitation therapy. Revenues are recorded when services are provided based on rates expected to be received under governmental programs and other third-party arrangements based on contractual terms. These revenues and receivables are stated at amounts estimated by management to be the net realizable value.

A portion of the episodic Medicare payments for home health services are received in advance of the services being rendered. All advance billings are recognized as revenue when the services are performed.

Medicare program revenues prior to June 1999 for skilled nursing facilities and October 2000 for home health agencies, as well as certain Medicaid program revenues, are subject to audit and retroactive adjustment by government representatives. Retroactive adjustments are estimated in the recording of revenues in the period the related services are rendered. These amounts are adjusted in future periods as adjustments become known or as cost reporting years are no longer subject to audits or reviews. The net receivable balance for third-party settlements was $19.8 million and $28.2 million at December 31, 2010 and 2009, respectively.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is in material compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving material allegations of potential wrongdoing. Noncompliance with such laws and regulations can be subject to regulatory actions including fines, penalties, and exclusion from the Medicare and Medicaid programs.

Allowance for Doubtful Accounts
The Company evaluates the collectibility of its accounts receivable based on certain factors, such as pay type, historical and current collection trends, and aging categories. The percentage that is applied to the receivable balances is based on the Company's historical experience and time limits, if any, for each particular pay source, such as private, other/insurance, Medicare and Medicaid.

Property and Equipment
Property and equipment are recorded at cost. Depreciation is provided by the straight-line method over the estimated useful lives of the assets, generally three to 10 years for equipment and furnishings and three to 40 years for buildings and improvements. Leasehold improvements are amortized over the shorter of the useful life or the contractual term of the lease.

318)

Direct incremental costs are capitalized for major development projects and are amortized over the lives of the related assets. The Company capitalizes interest on borrowings applicable to construction in progress.

Goodwill and Intangible Assets

Goodwill represents the excess of cost over the fair value of net assets of businesses acquired. Indefinite-lived intangible assets include trademarks, tradenames, and certificates of need. Goodwill and indefinite-lived intangible assets are not amortized, but are reviewed at least annually on October 1 for impairment, or more frequently if events or circumstances arise which indicate there may be an impairment of a reporting unit, using a fair value methodology. In performing this review, the fair value of the reporting unit is determined by using cash flow analysis which projects the future cash flows and discounts those cash flows to the present value. The projection of future cash flows is dependent upon assumptions regarding future levels of income, including changes in Medicare and Medicaid reimbursement regulations. If the carrying value of a reporting unit exceeds the fair value, the goodwill or indefinite-lived intangible assets are potentially impaired, subject to additional analysis. In such a case, the Company may have to record a charge to its results of operations based on the results of the additional analysis.

Intangible assets with a determinable useful life, such as non-compete agreements, are amortized on a straight-line basis over their estimated useful life.

Asset Impairments

The carrying value of property and equipment and amortizable intangible assets is reviewed quarterly to determine if facts and circumstances suggest that the assets may be impaired or that the useful life may need to be changed. The Company considers internal and external factors relating to each asset, including cash flows, contract changes, local market developments, national health care trends and other publicly available information. If these factors and the projected undiscounted cash flows of the business over the remaining useful life indicate that the asset will not be recoverable, the carrying value will be adjusted to the estimated fair value.

Systems Development Costs

Costs incurred for systems development primarily include external programming costs. These costs are capitalized and are amortized over the estimated useful lives of the related systems.

Investment in Life Insurance

Investment in corporate-owned life insurance policies is recorded in other assets based on the net cash surrender value. Changes in the net cash surrender value are recorded in operating expenses.

Insurance Liabilities

The Company purchases general and professional liability insurance and maintains an unaggregated self-insured retention per occurrence ranging from $0.5 million to $12.5 million, depending on the policy year and state. In addition, for the policy periods June 1, 2004 through May 31, 2007, there is a coverage layer of $12.5 million in excess of the self-insured retention provided by the Company's captive insurance subsidiary. For the policy period June 1, 2007 through May 31, 2008, the Company's captive insurance

318K

subsidiary provides coverage of 50 percent per claim in excess of the self-insured retention up to an aggregate coverage of $6.25 million. Provisions for estimated settlements, including incurred but not reported claims, are provided on an undiscounted basis in the period to which the coverage related. These provisions are based on internal and external evaluations of the merits of the individual claims and an analysis of claim history. Based on the Company's historical data and review of recent claims, cost and other trends, management determines the appropriate reserve. Any adjustments resulting from this review are reflected in current earnings. Claims are paid over varying periods, which generally range from one to eight years. See Note 11 for further discussion.

The Company's workers' compensation insurance consists of a combination of insured and self-insured programs and limited participation in certain state programs. The Company is responsible for $0.5 million per occurrence for insured programs. The Company is responsible for $1.0 million per occurrence for self-insured programs and maintains insurance above this amount. The Company records an estimated liability, including incurred but not reported claims, for losses attributable to workers' compensation claims based on internal evaluations and an analysis of claim history. The estimates are based on loss claim data, trends and assumptions. Claims are paid over varying periods and are generally fully paid within eight years. The workers' compensation liability consisted of short-term reserves of $26.7 million and $25.6 million at December 31, 2010 and 2009, respectively, which were included in accrued insurance liabilities, and long-term reserves of $42.0 million and $39.0 million at December 31, 2010 and 2009, respectively, which were included in other long-term liabilities. The expense for workers' compensation was $33.0 million and $31.6 million for the years ended December 31, 2010 and 2009, respectively, which was included in operating expenses.

Derivative Financial Instruments and Hedging Activities

The accounting standard for derivatives and hedging activities establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as fair value hedges, changes in the fair value of the derivative and the hedged item related to the hedged risk are recognized in earnings. For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. The Company assesses the effectiveness of each hedging relationship by comparing the changes in fair value or cash flows of the derivative hedging instrument with the changes in fair value or cash flows of the designated hedged item or transaction. For derivatives not designated as hedges, changes in fair value are recognized in earnings. The Company records all derivative activity in cash flows from operations.

318 L

Assets and Liabilities Measured at Fair Value

In 2010, the Company adopted a new accounting standard that amends and expands the disclosures about fair value measurements. The additional disclosures include the amount of transfers between Levels 1 and 2 of the fair value hierarchy, the reasons for transfers in and out of Level 3 and activity for recurring Level 3 measures. The amendments clarify certain existing disclosure requirements related to the level at which fair value disclosures should be disaggregated and the requirement to provide disclosures about the valuation techniques and inputs used in determining the fair value of assets or liabilities classified as Levels 2 or 3. The Company previously provided disclosures about the valuation techniques and inputs. See Note 8 for these disclosures.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist of cash and cash equivalents, restricted cash and cash equivalents, and derivatives, which the Company maintains with various financial institutions. The Company's credit agreement limits the types of investments. The majority of the Company's cash equivalents are invested in money market funds. As part of its cash and risk management process, the Company performs periodic evaluations of the relative credit standing of the financial institutions. The Company has not sustained credit losses from instruments held at financial institutions. The Company utilizes interest rate caps and floors to add stability to interest expense. Such contracts involve the risk of nonperformance by the counterparties with respect to the interest rate caps, which could result in a material loss if interest rates were to increase.

Advertising Expense

The cost of advertising is expensed as incurred. The Company recorded advertising expense of $13.8 million and $13.7 million for the years ended December 31, 2010 and 2009, respectively.

Stock-Based Compensation

HCR ManorCare, Inc. grants awards under its equity plan to employees of its consolidated subsidiaries. The Company accounts for the equity plan as if it adopted the plan. The Company records compensation expense with a corresponding credit to equity, representing HCR ManorCare, Inc.'s capital contribution.

Compensation costs subject to graded vesting based on a service condition are amortized to expense on a straight-line basis over the service period for each separately vesting portion of the award.

Income Taxes

The Company accounts for income taxes and related accounts under the liability method. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted rates expected to be in effect during the year in which the basis differences reverse. A valuation allowance is provided when the Company determines that it is more likely than not that a portion of the deferred tax balance will not be realized.

318M

The Company records an amount of unrecognized tax benefits when a tax position is more likely than not to be sustained. This amount is analyzed on a quarterly basis and adjusted based upon changes in facts and circumstances. The Company's effective tax rate includes the recognition and adjustments to this amount. The Company also records interest and penalties related to income taxes as income taxes in the statement of income.

Subsequent Events
The Company has evaluated subsequent events through February 4, 2011, the date the financial statements were available to be issued.

2. Divestitures

During December 2010, HCR ManorCare, Inc. signed an agreement to sell the real estate of substantially all of its skilled nursing and assisted living facilities for $6.1 billion to HCP, Inc (HCP). The transaction has been approved by HCP's Board of Directors and the shareholders of HCR ManorCare, Inc., and is structured as a sale of the equity interests of HCR Properties, LLC. The Company intends to repay its CMBS and Mezzanine variable-rate debt and terminate its interest rate caps and floors contemporaneous with this transaction. HCR III Healthcare, LLC will continue to operate these facilities pursuant to a long-term triple-net master lease, for which the lease payments will be guaranteed by HCR ManorCare, Inc. The transaction will be accounted for as a failed sale-leaseback with the proceeds recorded as a liability. The assets subject to the sale-leaseback will remain on the balance sheet and continue to be depreciated. The transaction is expected to close in the first quarter of 2011, subject to the completion of certain regulatory approvals, third party consents, and other customary closing conditions.

During 2009, the Company sold one skilled nursing facility in Illinois and one in Ohio for $6.5 million, resulting in a net gain of approximately $0.2 million. The results of operations of the divested facilities were not material to the consolidated results of operations.

3. Revenues

The Company receives reimbursement under the federal Medicare program and various state Medicaid programs. Revenues under these programs totaled $2.9 billion and $2.8 billion for years ended December 31, 2010 and 2009, respectively.

Revenues by type of health care services were as follows:

	Year ended December 31,	
	2010	2009
	(In thousands)	
Skilled nursing and assisted living services	$ 3,638,091	$ 3,571,721
Hospice and home health services	441,699	457,238
Rehabilitation services	57,822	64,844
Other services	30,954	29,917
	$ 4,168,566	$ 4,123,720

318 N

4. Property and Equipment

At December 31, property and equipment consisted of the following:

	2010	2009
	(In thousands)	
Land and improvements	$ 471,841	$ 464,316
Buildings and improvements	2,703,705	2,650,929
Equipment and furnishings	264,603	212,420
Capitalized leases	33,332	31,885
Construction in progress	41,319	39,156
	3,514,800	3,398,706
Less accumulated depreciation	371,674	227,893
Net property and equipment	$ 3,143,126	$ 3,170,813

Depreciation expense, including amortization of capitalized leases, amounted to $144.0 million and $123.6 million for the years ended December 31, 2010 and 2009, respectively. Accumulated depreciation included $3.6 million and $2.0 million at December 31, 2010 and 2009, respectively, relating to capitalized leases.

Capitalized systems development costs of $11.1 million at December 31, 2010 and $10.2 million at December 31, 2009, net of accumulated amortization of $9.9 million and $7.6 million, respectively, were included in other assets. Amortization expense related to capitalized systems development costs was $2.3 million and $3.4 million for the years ended December 31, 2010 and 2009, respectively.

5. Goodwill and Intangible Assets

There were no changes in the carrying amount of goodwill during 2010 or 2009. There were no accumulated impairment losses at December 31, 2010. At December 31, 2010 and 2009, the carrying amount of goodwill by segment was $2.8 billion for long-term care and $0.6 million for hospice and home health.

At December 31, intangible assets consisted of the following:

	2010	2009
	(In thousands)	
Owned trademarks and tradenames (non-amortizing)	$ 630,979	$ 630,979
Certificates of need (non-amortizing)	28,753	27,100
Non-compete agreements	21,800	21,800
	681,532	679,879
Less accumulated amortization	21,800	17,854
Net intangible assets	$ 659,732	$ 662,025

Amortization expense was $3.9 million and $8.7 million for the years ended December 31, 2010 and 2009, respectively.

3180

6. Debt

At December 31, debt consisted of the following:

	2010	2009
	(In thousands)	
Revolving credit facility	$ -	$ -
Convertible senior notes	144	277
Term loan	434,337	483,064
Commercial mortgage-backed securities (CMBS)	2,997,353	2,997,353
Mezzanine loans	1,598,589	1,598,589
Other loan	2,000	-
Capital lease obligations	21,916	22,232
	5,054,339	5,101,515
Less amounts due within one year	2,123	7,594
Long-term debt	$ 5,052,216	$ 5,093,921

Revolving Credit Facility and Term Loan. In December 2007, HCR Healthcare, LLC entered into a credit agreement with a group of lenders that provides for a $200 million revolving credit facility and $700 million term loan. The debt is secured by assets of HCR Healthcare, LLC and certain of its subsidiaries. This credit agreement contains various covenants, restrictions and events of default. Among other things, these provisions require the borrower to maintain certain financial ratios and impose certain limits on its ability to incur indebtedness, create liens, pay dividends, and dispose of assets.

The revolving credit facility expires on the earlier of December 21, 2013 or the date six months prior to the final maturity date of the CMBS debt. The term loan expires on the earlier of December 21, 2014 or the date six months prior to the final maturity date of the CMBS debt. The interest rate on borrowings under the revolving credit facility and term loan is, at the borrower's option, the prime rate plus a margin or Eurodollar rate plus a margin. The margin is linked to the borrower's Consolidated Total Senior Leverage Ratio, as defined in the agreement. The revolving credit facility also provides for a fee on the total amount of the facility, depending on the same key ratio. In addition to direct borrowings, the credit facility may be used to support the issuance of letters of credit. As of December 31, 2010, there were no loans outstanding under this facility. After consideration of usage for letters of credit, $122.8 million was available for future borrowing. The interest rate on the term loan was 2.8 percent and 2.7 percent at December 31, 2010 and 2009, respectively, based on the borrower's election to borrow at the Eurodollar rate plus a margin. The term loan required repayment of principal in equal consecutive quarterly installments of $1.75 million, which was reduced to $0.3 million as a result of a mandatory prepayment in 2010. The Company paid a total of $2.6 million and $7.0 million during the years ended December 31, 2010 and 2009, respectively, related to quarterly installments. In addition, there are certain mandatory prepayments based on incurrence of debt, asset sales, excess cash flow and release of cash collateral, as defined in the agreement. During 2010, the Company made a mandatory prepayment of $46.1 million related to the release of cash collateral for deposit letters of credit. The debt extinguishment resulted in a loss of $0.6 million from the amortization of deferred finance fees. Through several open market transactions during 2009, the Company paid an additional $46.4 million toward the repurchase of its term loan debt at an average price of approximately 76 percent of par value. The debt extinguishments resulted

318 p

in net gains of $13.2 million in 2009 after deducting fees of $0.5 million and amortization of deferred finance fees of $1.2 million.

Commercial Mortgage-Backed Securities (CMBS) and Mezzanine Loans. In December 2007, subsidiaries of HCR Properties, LLC entered into loan agreements with aggregate proceeds of $4.6 billion, consisting of CMBS totaling $3.0 billion and Mezzanine loans totaling $1.6 billion. The CMBS and Mezzanine debt are non-recourse and expire on January 9, 2012, subject to a one-year extension at the borrower's option if certain criteria are met. CMBS debt is secured by mortgages on the assets of certain of the subsidiaries of HCR Properties, LLC, with a net book value of $2.8 billion at December 31, 2010. Interest on the CMBS and Mezzanine loans is payable monthly at LIBOR plus a spread, as defined in the loan agreements. Principal and any unpaid interest are payable at maturity. At December 31, 2010 and 2009, the weighted-average interest rate on the CMBS and Mezzanine loans was 2.8 percent and 2.7 percent, respectively. See Note 7 for discussion on interest rate caps and floors entered into with respect to the CMBS and Mezzanine debt. During 2009, the Company paid a total of $3.6 million on its CMBS and Mezzanine loans due to the sale of a facility and excess land.

The convertible senior notes, term loan, other loan, and capital lease obligations are not obligations of HCR Properties, LLC. The CMBS and Mezzanine debt are not obligations of HCR Healthcare, LLC or HCR III Healthcare, LLC. HCR Properties, LLC and its subsidiaries' assets and credit are not available to satisfy the debts and other obligations of any of their affiliates or any other person. HCR III Healthcare, LLC and its subsidiaries' assets and credit are not available to satisfy the debts and other obligations of any of their affiliates or any other person.

Convertible Senior Notes. As a result of the merger, a fundamental change under the indentures occurred with respect to the convertible senior notes because of a change in control. Pursuant to the indentures, each holder has a right to require the Company to purchase any or all of the holder's convertible senior notes. The Company sent a notice of fundamental change to all holders stating the purchase price in cash. The Company funded an escrow account in 2007 for the total amount of the purchase price. The Company has an escrow account, which is classified as restricted cash and cash equivalents, with a balance equivalent to the remaining obligations of the convertible senior notes.

Capital Lease Obligations. In 2009, a subsidiary of the Company entered into a new lease agreement for the corporate headquarters. Manor Care, Inc. guaranteed the obligation. The new lease agreement was recorded as a capital lease due to the transfer of ownership for a nominal fee at the end of the 20-year lease. The Company recorded a noncash asset and liability of $14.3 million.

Fair Value. At December 31, 2010 and 2009, the carrying value of the Company's debt, excluding capitalized lease obligations, was $5.0 billion and $5.1 billion, and the fair value was $4.7 billion and $4.4 billion, respectively. At December 31, 2010 and 2009, the fair value of the Company's variable-rate debt was calculated using cash flows based upon the variable interest rate in effect at year end discounted at a current replacement spread over LIBOR based on current market conditions. The fair value of the convertible senior notes was the same as the carrying value because the notes were recorded at fair value due to the right to require the Company to purchase the notes under the fundamental change provision discussed above.

3182

Other Information. Interest paid, primarily related to debt, amounted to $146.3 million and $154.2 million for the years ended December 31, 2010 and 2009, respectively. Capitalized interest costs were $0.7 million and $0.9 million for the years ended December 31, 2010 and 2009, respectively.

Debt maturities for the five years subsequent to December 31, 2010 are as follows: 2011 – $2.1 million; 2012 – $435.1 million; 2013 – $4.6 billion; 2014 – $0.5 million; and 2015 – $0.5 million The Company has assumed that it will extend the CMBS and Mezzanine debt for one year, which is permitted under the loan agreements if certain criteria are met, until 2013.

7. Derivative Financial Instruments and Hedging Activities

Risk Management Objective of Using Derivatives. The Company is exposed to certain risk arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its debt funding and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's investments and borrowings. As of December 31, 2010 and 2009, no derivatives were designated as fair value hedges or hedges of net investments in foreign operations. Additionally, the Company does not use derivatives for trading or speculative purposes.

Cash Flow Hedges of Interest Rate Risk. The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, HCR Properties, LLC and its subsidiaries use interest rate caps as part of its interest rate risk management strategy. Interest rate caps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. HCR Healthcare, LLC entered into interest rate floors in conjunction with its ultimate parent company, HCR ManorCare, Inc., to reduce the net cost of purchasing interest rate caps to hedge the variable cash flows associated with existing variable-rate debt. Interest rate floors are not designated as hedges, as they do not meet the strict hedge accounting requirements.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in other comprehensive income (OCI) and is subsequently reclassified from accumulated other comprehensive income (AOCI) into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. Amounts reported in AOCI related to derivatives will be reclassified to interest expense as interest payments are made on the Company's variable-rate debt. The payment of $3.6 million of CMBS and Mezzanine variable rate debt in 2009 created a minor ineffective portion.

318 R

During December 2007, the Company entered into 24 interest rate caps, which expire in January 2012, to hedge the variable cash flows associated with the CMBS and Mezzanine variable-rate debt of $4.6 billion for an up-front premium of $36.9 million. In conjunction with these transactions, the Company sold three interest rate floors, which expire in January 2012, to reduce the net cost of purchasing interest rate caps for an up-front premium received of $28.3 million. During the first quarter of 2009, the Company modified certain interest rate caps to reduce the strike rate on $2.5 billion of the total outstanding notional amount for an up-front premium of $14.2 million. As a result of these modifications, the Company discontinued prospectively the hedge accounting on 16 of its interest rate caps for $3.57 billion of the notional amount, as this portion no longer met the strict hedge accounting requirements. The Company continued to report the net loss at the time of the modification related to the discontinued cash flow hedges in AOCI and was reclassifying these losses into earnings during the original contractual terms of the derivative agreements as the hedged forecasted transactions were expected to occur.

As discussed in Note 2, HCR ManorCare, Inc. signed an agreement in December 2010 to sell HCR Properties, LLC's equity interests, which is expected to close at the end of the first quarter of 2011. The Company intends to repay its CMBS and Mezzanine variable-rate debt and terminate its interest rate caps contemporaneous with this transaction. As a result, the Company discontinued prospectively the hedge accounting on its remaining eight interest rate caps with a notional amount of $1.03 billion as the hedged transactions were no longer probable to occur. As of December 31, 2010, the Company had no derivatives qualifying as cash flow hedges of interest rate risk. All prospective changes in the fair value of outstanding derivatives will be recorded directly to earnings.

During December 2010, the Company reclassified $14.7 million of losses from AOCI to earnings as a missed forecast. The missed forecast represented those losses related to estimated hedged transactions that were expected to occur after March 31, 2011. The losses were required to be recognized in earnings as these hedged transactions were deemed probable not to occur as originally forecasted. During the first quarter of 2011, the Company estimates that $3.9 million will be reclassified from AOCI to earnings as an increase to interest expense.

Non-Designated Hedges. Derivatives not designated as hedges are not speculative and are used to manage the Company's exposure to interest rate movements and other identified risks but do not meet the strict hedge accounting requirements. The Company uses interest rate caps and floors as part of its interest rate risk management strategy. Interest rate caps involve the receipt of variable-rate amounts from a counterparty if interest rates rise above the strike rate on the contract. Interest rate floors involve the payment of variable-rate amounts to a counterparty if interest rates fall below the strike rate on the contract. Changes in the fair value are recorded directly in earnings. As of December 31, 2010, the Company had 24 interest rate caps for a notional amount of $4.6 billion and three interest rate floors for a notional amount of $4.6 billion that were not designated as hedges in qualifying hedging relationships.

3185

Balance Sheet Classification. The fair value of the Company's derivative financial instruments and their classification on the consolidated balance sheets was as follows as of December 31, 2010 and 2009:

	Asset Derivatives		Liability Derivatives	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
As of December 31, 2010	(In thousands)			
Non-designated hedges				
Interest Rate Caps	Other assets	$ 159		$ -
Interest Rate Floors	Other assets	-	Other liabilities	118,201
		$ 159		$ 118,201
As of December 31, 2009				
Designated hedges				
Interest Rate Caps	Other assets	$ 1,179	Other liabilities	$ -
Non-designated hedges				
Interest Rate Caps	Other assets	11,014		-
Interest Rate Floors	Other assets	-	Other liabilities	155,916
		$ 12,193		$ 155,916

Income Statement Effect. The effect of the Company's derivative financial instruments on the consolidated statements of income was as follows:

Derivatives Designated as Cash Flow Hedges
Interest Rate Caps:

Amount of gain/credit or (loss/expense)	Location	Year ended December 31, 2010	2009
		(In thousands)	
Recognized in OCI (effective portion)	OCI	$ (1,130)	$ 1,052
Reclassified from AOCI into income (effective portion)	Interest expense	(10,504)	(3,434)
Recognized in income (missed forecast, ineffective portion and amount excluded from effectiveness testing)	Unrealized derivative loss	(14,742)	(53)

3187

Derivatives Not Designated as Hedging Instruments

Amount of gain (loss) recognized in income	Location	Year ended December 31, 2010	2009
		(In thousands)	
Interest Rate Caps	Unrealized derivative loss	$ (10,899)	$ (6,936)
Interest Rate Floors	Unrealized derivative gain	37,714	18,687
Interest Rate Floors	Derivative floor expense	(123,997)	(120,306)
Total		$ (97,182)	$ (108,555)

Other Comprehensive Loss. The derivative activity included in other comprehensive loss was as follows:

	2010	2009
	(In thousands)	
Balance at January 1	$ (17,020)	$ (19,762)
Unrealized (loss) gain on hedging derivatives, net of income tax benefit (expense) of $442 and $(413), respectively	(688)	639
Reclassification adjustment for losses recognized in earnings during the period, net of income tax benefit of $9,902 and $1,357, respectively	15,340	2,103
Net derivative activity	14,652	2,742
Balance at December 31	$ (2,368)	$ (17,020)

Credit-Risk-Related Contingent Features. The Company has agreements with each of its derivative counterparties that contain a provision where the Company could be declared in default on its derivative obligations if repayment of the underlying indebtedness is accelerated by the lender due to the Company's default on the indebtedness. As of December 31, 2010 and 2009, the fair value of derivatives in a liability position related to these agreements was $118.2 million and $155.9 million, respectively. As of December 31, 2010, the Company has not posted any collateral related to these agreements. If the Company breached any of these provisions it would be required to settle its obligations under the agreements at their termination value of $129.5 million and $175.4 million as of December 31, 2010 and 2009, respectively.

8. Fair Value Measurements

The Company measures certain financial assets and liabilities at fair value on a recurring basis. Fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

318 U

The following three-tier hierarchy prioritizes the inputs used in measuring fair value:

Level 1: Observable inputs such as quoted prices in active markets;
Level 2: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly; and
Level 3: Unobservable inputs for which there is little or no market data, which requires the Company to develop assumptions.

The fair value of the Company's financial assets and liabilities was determined using the following inputs at December 31, 2010 and 2009:

	Fair Value at December 31, 2010		
	Level 1	Level 2	Level 3
		(In thousands)	
Assets:			
Cash and cash equivalents	$ 421,219	$ -	$ -
Restricted cash and cash equivalents	13,498	-	-
Derivative asset for interest rate caps	-	159	-
Total assets	$ 434,717	$ 159	$ -
Liabilities:			
Derivative liability for interest rate floors	$ -	$ 118,201	$ -

	Fair Value at December 31, 2009		
	Level 1	Level 2	Level 3
		(In thousands)	
Assets:			
Cash and cash equivalents	$ 379,658	$ -	$ -
Restricted cash and cash equivalents	95,837	-	-
Derivative asset for interest rate caps	-	12,193	-
Total assets	$ 475,495	$ 12,193	$ -
Liabilities:			
Derivative liability for interest rate floors	$ -	$ 155,916	$ -

There were no transfers between Level 1 and Level 2 during the years ended December 31, 2010 or 2009. There were no assets or liabilities classified in Level 3 during the years ended December 31, 2010 or 2009.

The valuation of interest rate caps and floors was determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflected the contractual terms of the derivatives, including the period to maturity, and used observable market-based inputs, including interest rate curves and implied volatilities. The Company incorporated credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. Although the Company determined

318 V

that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads, to evaluate the likelihood of default by itself and its counterparties. However, as of December 31, 2010 and 2009, the Company assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and determined that the credit valuation adjustments were not significant to the overall valuation of its derivatives. As a result, the Company determined that its derivative valuations in their entirety were classified in Level 2 of the fair value hierarchy.

9. Leases

The Company leases certain property and equipment under both operating and capital leases, which expire at various dates through 2036. Certain of the facility leases contain purchase options.

Payments under non-cancelable operating leases, minimum lease payments and the present value of net minimum lease payments under capital leases as of December 31, 2010 are as follows:

	Operating Leases	Capital Leases
	(In thousands)	
2011	$ 10,927	$ 2,100
2012	7,271	2,103
2013	5,285	2,116
2014	4,335	2,199
2015	3,148	2,113
Later years	3,795	36,069
Total minimum lease payments	$ 34,761	46,700
Less amount representing interest		24,784
Present value of net minimum lease payments (included in long-term debt - see Note 6)		$ 21,916

Rental expense was $16.5 million and $19.6 million for the years ended December 31, 2010 and 2009, respectively.

318 W

10. Income Taxes

The provision for income taxes consisted of the following:

	Year ended December 31, 2010	2009
	(In thousands)	
Current:		
Federal	$ 75,193	$ 55,923
State and local	2,397	16,936
	77,590	72,859
Deferred:		
Federal	2,561	30,380
State and local	6,524	(4,245)
	9,085	26,135
Interest and penalties income	(2,960)	(12,917)
Provision for income taxes	$ 83,715	$ 86,077

The reconciliation of the amount computed by applying the statutory federal income tax rate to income before income taxes to the provision for income taxes was as follows:

	Year ended December 31, 2010	2009
	(In thousands)	
Income taxes computed at statutory rate	$ 86,545	$ 90,033
Differences resulting from:		
State and local income taxes, net of federal effect	5,799	8,249
Interest income, net of federal effect	(1,635)	(8,451)
Effect of change in unrecognized tax benefits	(4,326)	-
Other	(2,668)	(3,754)
Provision for income taxes	$ 83,715	$ 86.077

318 X

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. Significant components of the Company's federal and state deferred tax assets and liabilities were as follows at December 31:

	2010	2009
	(In thousands)	
Deferred tax assets:		
Accrued insurance liabilities	$ 104,531	$ 93,227
Employee compensation and benefits	94,552	85,459
Hedge transactions	44,297	88,782
State net operating loss and credit carryforward	22,246	23,565
Allowance for receivables and settlements	7,101	25,588
Other	14,229	20,792
	286,956	337,413
Valuation allowance	(13,477)	(12,569)
	273,479	324,844
Deferred tax liabilities:		
Depreciable/amortizable assets	1,112,680	1,115,408
Tax accounting method change	18,361	36,819
Leveraged leases	10,503	13,794
Other	5,031	13,708
	1,146,575	1,179,729
Net deferred tax liabilities	$ 873,096	$ 854,885

The Company has deferred tax assets related to state net operating loss and credit carryforwards with expiration dates varying from 2011 through 2030. These potential future state tax benefits have been partially offset by a valuation allowance based on the Company's analysis of the likelihood of generating sufficient taxable income in the various state jurisdictions to utilize the benefits before expiration.

A reconciliation of the beginning and ending amount of unrecognized tax benefits was as follows:

	2010	2009
	(In thousands)	
Balance at January 1	$ 28,230	$ 96,414
Increases related to current-year tax positions	4,120	11,110
Increases related to prior-year tax positions	1,798	835
Decreases related to prior-year tax positions	(16,410)	(76,349)
Settlements	(3,354)	-
Lapse of statute	-	(3,780)
Balance at December 31	$ 14,384	$ 28,230

318Y

In early 2009, the Internal Revenue Service approved the Company's 2008 request to change an accounting method. Resolution of this uncertainty in 2009 caused $68.0 million of the beginning balance of unrecognized tax benefits to be reclassified to deferred tax liability accounts. This change also resulted in the reversal of accrued interest expense of $13.1 million related to this item, which was included in the income taxes line item.

Included in the 2010 and 2009 ending balance of unrecognized tax benefits are potential benefits of $7.1 million and $13.5 million that if recognized, would affect the effective income tax rate. At December 31, 2010 and 2009, the amount of interest and penalties accrued related to tax uncertainties was $2.5 million and $7.2 million, respectively, which was included in other long-term liabilities. Interest and penalties related to income tax uncertainties included in the statement of income was $4.2 million of income in 2010 and $12.9 million of income in 2009.

The Company or one or more of its subsidiaries files income tax returns in the U.S. federal jurisdiction and most states. Settlements were reached with certain states in 2010 and the related uncertain tax positions for such states have been eliminated. The Internal Revenue Service examination of tax years ended in 2007 and 2008 was concluded in 2010. All federal tax uncertain tax items from such years were settled or effectively settled resulting in an overall reduction of federal tax expense of $4.3 million. With few exceptions, the Company is no longer subject to U.S. federal, state, or local income tax examinations for years before 2006. Within the next twelve months, there is not expected to be a significant change in the balance of unrecognized tax benefits.

In late 2009, the Company filed an appeal of a decision by the United States Court of Federal Claims denying refunds of certain federal tax credits for tax years 2001 and earlier. On January 21, 2011, the judgment of the Court was affirmed and the credits were denied. There are no unrecognized tax benefits recorded that are attributable to these claims.

Income taxes and interest paid, net of refunds, amounted to $85.0 million and $141.5 million for the years ended December 31, 2010 and 2009, respectively.

11. Commitments/Contingencies

One or more subsidiaries or affiliates of the Company have been identified as potentially responsible parties (PRPs) in a variety of actions (the Actions) relating to waste disposal sites which allegedly are subject to remedial action under the Comprehensive Environmental Response Compensation Liability Act, as amended, 42 U.S.C. Sections 9601 et seq. (CERCLA) and similar state laws. CERCLA imposes retroactive, strict joint and several liability on PRPs for the costs of hazardous waste clean-up. The Actions arise out of the alleged activities of Cenco, Incorporated and its subsidiary and affiliated companies (Cenco). Cenco was acquired in 1981 by a wholly owned subsidiary of the Company. The Actions allege that Cenco transported and/or generated hazardous substances that came to be located at the sites in question. Environmental proceedings such as the Actions may involve owners and/or operators of the hazardous waste site, multiple waste generators and multiple waste transportation disposal companies. Such proceedings involve efforts by governmental entities and/or private parties to allocate or recover site investigation and clean-up costs, which costs may be substantial. The potential liability

3182

exposure for currently pending environmental claims and litigation, without regard to insurance coverage, cannot be quantified with precision because of the inherent uncertainties of litigation in the Actions and the fact that the ultimate cost of the remedial actions for some of the waste disposal sites where subsidiaries or affiliates of the Company are alleged to be a potentially responsible party has not yet been quantified. At December 31, 2010 and 2009, the Company had $3.0 million and $3.7 million, respectively, accrued in other long-term liabilities based on its current assessment of the likely outcome of the Actions. The amount of the Company's reserve was based on management's continual monitoring of the litigation activity, estimated clean-up costs and the portion of the liability for which the Company is responsible. At December 31, 2010 and 2009, there were no receivables related to insurance recoveries.

The Company is party to various other legal matters arising in the ordinary course of business, including patient care-related claims and litigation. The general and professional liability consisted of short-term reserves of $63.6 million and $67.0 million at December 31, 2010 and 2009, respectively, which were included in accrued insurance liabilities, and long-term reserves of $156.1 million and $123.0 million, respectively, which were included in other long-term liabilities. The expense for general and professional liability claims, premiums and administrative fees was $115.0 million and $86.6 million for the years ended December 31, 2010 and 2009, respectively, which was included in operating expenses. Although management believes that the Company's liability reserves are adequate, there can be no assurance that such provision and liability will not require material adjustment in future periods.

As of December 31, 2010, the Company had contractual commitments of $21.8 million relating to its internal construction program. As of December 31, 2010, the Company had total letters of credit of $77.2 million that benefit certain third-party insurers, and 87 percent of these letters of credit related to recorded liabilities.

12. Stock-Based Compensation

Plan Information. HCR ManorCare, Inc.'s Equity Incentive Plan (Equity Plan) that was approved by its Board of Directors in December 2007 allows it to grant awards of non-qualified stock options, incentive stock options, restricted stock, restricted stock units and stock appreciation rights to key employees, consultants and directors. HCR ManorCare, Inc. has not awarded incentive stock options, restricted stock units or stock appreciation rights under the Equity Plan. A maximum of 19,348,540 shares of HCR ManorCare, Inc.'s common stock were authorized for issuance under the Equity Plan. Shares covered by expired or canceled options, by surrender or repurchase of restricted stock, or by shares withheld for the exercise price or tax withholding thereon, could also be awarded under the Equity Plan.

The Company's stock-based compensation expense was $6.2 million and $10.4 million for the years ended December 31, 2010 and 2009, respectively, which includes time-vested stock options, performance-vested stock options, and restricted stock. Stock-based compensation expense was recorded in general and administrative expenses. The income tax benefit related to stock-based compensation expense was $2.3 million and $3.8 million for the year ended December 31, 2010 and 2009, respectively. In addition, there was $1.7 million of excess tax benefits related to the Equity Plan, which was recorded as additional capital and classified as a financing cash flow for 2010. At December 31, 2010, there was $1.0 million of total unrecognized compensation cost related to non-vested time stock options. The cost is expected to be

318 AA

recognized over one year. This does not include the expense for performance option awards or liquidity event options that will be expensed, as the performance or event is considered to be probable of vesting.

Stock Options. During 2007, options were granted to certain officers. During 2008, options were granted to certain officers, key employees and directors. For officers and key employees, the components of the total options were as follows: 50 percent time-vested, 25 percent performance-vested, 16.7 percent based on liquidity event A and 8.3 percent based on liquidity event B. Directors were awarded a total of 75,000 time options.

- The time options for officers and key employees vest 25 percent per year on the anniversary of the grant date as long as the employee remains employed. The time options for directors vest 20 percent per year on the anniversary of the grant date. The vesting of all time options for officers and employees will accelerate immediately upon a liquidity event, as defined below. In addition, the vesting of 25 percent of the time options for certain officers will accelerate immediately upon certain defined termination of service reasons.
- The performance options pertain to the calendar years 2008 through 2012, with 20 percent based on each year. The performance criteria for earnings before interest, taxes, depreciation and amortization (EBITDA) were established for each year. There is prorated vesting if EBITDA is at least 90 percent but less than 100 percent of target. Provided the employee is still employed on the last day of the year, the awards will vest after HCR ManorCare, Inc.'s Board of Directors certifies that the relevant EBITDA target has been met for that year. There are certain catch-up vesting provisions for years when performance awards did not vest. Upon the occurrence of a liquidity event, if the EBITDA would have been achieved at target for that year, then all unvested tranches of the performance option will automatically vest. In January 2010, the Compensation Committee of HCR ManorCare, Inc.'s Board of Directors certified the performance against the criteria previously set by the Committee, which resulted in 973,700 performance options vesting effective December 31, 2009, which included 2008 catch-up vesting and 2009 vesting. The Compensation Committee of HCR ManorCare, Inc.'s Board of Directors has not certified the performance for 2010.
- A liquidity event is based on certain transactions or certain changes in ownership levels of private equity investors, as defined in the agreement. Liquidity events A and B are based on certain internal rates of return of the private equity investors.

318 BB

The stock option activity for 2010 was as follows:

	Shares	Exercise Price	Weighted-Average Remaining Contractual Term (years)
Outstanding at December 31, 2009	17,006,493	$ 10.00	
Forfeited	(61,950)	10.00	
Exercised	(7,000)	10.00	
Outstanding at December 31, 2010	16,937,543	10.00	7.0
Exercisable at December 31, 2010	7,793,841	10.00	7.0

The exercise price of the options was $10.00. The market price was $10.00 based on the stock price paid by outside investors. The Company estimates the value of its stock options based on the calculated value instead of fair value because it is not practical to estimate the volatility of its share price. The Company does not maintain an internal market for its shares. The Company uses the Black-Scholes option valuation model to estimate the calculated value of its stock-based compensation. An option's maximum term is 10 years. During 2010 and 2009, there were no option awards. During 2010, the cash received for the exercise of stock options was $0.1 million with no intrinsic value. During 2009, there were no options exercised.

Restricted Stock. An officer was awarded restricted stock in 2007. The grant-date fair value was $10.00 based on the stock price paid by outside investors. The shares vest 25 percent on the first anniversary date, 25 percent on the second anniversary date and 50 percent on the third anniversary date. The fair value of shares that vested was $7.4 million and $3.7 million for the years ended December 31, 2101 and 2009, respectively. The restricted stock activity for 2010 was as follows:

	Shares	Grant-Date Fair Value
Restricted stock at December 31, 2009	744,175	$ 10.00
Restrictions lapse due to time	(744,175)	10.00
Restricted stock at December 31, 2010	-	

In addition, certain officers rolled over the value of prior company shares that were converted into 401,010 HCR ManorCare, Inc. restricted shares. These shares are subject to transfer restrictions and shall become immediately vested upon the earliest to occur of the fifth anniversary, certain defined termination of service reasons, or a liquidity event. The holders of the restricted stock and rollover restricted stock have the right to receive non-forfeitable dividends.

318 cc

13. Employee Benefit Plans

Defined Benefit Plans. The Company has one qualified and two non-qualified defined benefit pension plans. The qualified plan is an underfunded plan with continuing benefits. The unfunded non-qualified plans include one plan with frozen future benefits and one with continuing benefits.

Obligations and Funded Status. The funded status of the plans was as follows:

	2010	2009
	(In thousands)	
Change in projected benefit obligation		
Benefit obligation at beginning of year	$ 46,608	$ 40,270
Service cost	3,900	3,540
Interest cost	2,469	2,374
Amendments	1,849	-
Actuarial (gain) loss	(399)	1,409
Benefits paid	(443)	(985)
Benefit obligation at end of year	53,984	46,608
Change in plan assets		
Fair value of plan assets at beginning of year	2,031	1,041
Actual return on plan assets	286	413
Employer contribution	423	1,562
Benefits paid	(443)	(985)
Fair value of plan assets at end of year	2,297	2,031
Funded status at end of year	$ (51,687)	$ (44,577)
Amounts recognized in the balance sheets consisted of:		
Current liabilities	$ (211)	$ (211)
Long-term liabilities	(51,476)	(44,366)
	$ (51,687)	$ (44,577)
Amounts in accumulated other comprehensive income that have not been recognized in net periodic pension cost, net of tax:		
Net actuarial loss	$ 119	$ 500
Prior service cost	940	-
	$ 1,059	$ 500
Accumulated benefit obligation for all plans	$ 42,234	$ 34,433

The Company expects to recognize $0.1 million of the net actuarial loss and $0.4 million of the prior service cost in net pension cost in 2011.

318 dd

Components of Net Pension Cost

	2010	2009
	(In thousands)	
Service cost	$ 3,900	$ 3,540
Interest cost	2,469	2,374
Expected return on plan assets	(150)	(164)
Amortization of prior service cost	370	-
Amortization of net loss (gain)	51	(218)
Net pension cost	$ 6,640	$ 5,532

Other Changes in Benefit Obligations Recognized in Other Comprehensive Income

	2010	2009
	(In thousands)	
Net actuarial gain (loss), net of tax (benefit) of $186 and $(434), respectively	$ 349	$ (725)
Prior service cost, net of tax (benefit) of $(674)	(1,175)	-
Reclassifications adjustments, net of tax:		
Amortization of prior service cost, net of tax of $135	235	-
Amortization of net loss (gain), net of tax (benefit) of $19 and $(79), respectively	32	(139)
Other comprehensive loss, net of tax (benefit) of $(334) and $(513), respectively	$ (559)	$ (864)

Disclosure Assumptions

	2010	2009
For determining benefit obligations at December 31:		
Weighted-average discount rate	4.74%	5.47%
Rate of compensation increase	5.00%	5.00%

	2010	2009
For determining net pension cost for the year:		
Weighted-average discount rate	5.47%	6.62%
Expected return on assets	7.00%	8.50%
Rate of compensation increase	5.00%	5.00%

The rate of compensation increase applies to plans with continuing benefits. The expected long-term rate of return on plan assets is based on the historical trend for the Company's qualified pension plan.

318
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Plan Asset Allocation. The Company measures the assets held in its qualified defined benefit pension plan at fair value. A fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset. The three levels of the fair value hierarchy are described in Note 8. It was determined that all of the Company's pension assets would fall within Level 1 of the hierarchy, meaning that their fair value could be determined through observable inputs such as quoted prices in active markets. The fair values of the Company's defined benefit pension plan assets at December 31 were as follows:

	2010	2009
	(In thousands)	
Asset Category:		
Cash and cash equivalents	$ 47	$ 55
Equity securities	1,595	1,389
Debt securities	655	587
Total assets	$ 2,297	$ 2,031

The Company's investment strategy for its defined benefit plan is targeted toward 70 percent equity investments and 30 percent fixed income and is rebalanced from time to time to approximate that mix. Equity investments consist of domestic and international mutual funds in large and small cap companies. Fixed income investments consist of bond funds.

Cash Flows. The expected benefit payments for the 10 years subsequent to December 31, 2010 are as follows: 2011 – $0.5 million; 2012 – $1.5 million; 2013 – $0.4 million; 2014 – $27.4 million; 2015 – $2.9 million and 2016-2020 – $10.8 million. In 2011, the Company expects to contribute pension payments of approximately $0.3 million.

Other Information. In addition to the benefit liabilities in the tables above, the Company has a supplemental obligation to certain officers. The Company has committed to fund this obligation by releasing a portion of the Company's interest in the cash surrender values of split-dollar life insurance arrangements to these officers upon retirement, if necessary. The Company's share of the cash surrender value of the policies was $20.9 million and $21.4 million at December 31, 2010 and 2009, respectively. The balances were included in other long-term assets. The Company's obligation of $16.7 million and $16.9 million at December 31, 2010 and 2009, respectively, was included in other long-term liabilities.

Defined Contribution Plans. The Company maintains a savings program qualified under Section 401(k) of the Internal Revenue Code and three non-qualified, deferred compensation programs. The Company contributes matching contributions up to a maximum of 3 percent of the participant's compensation, as defined in each plan. The Company's expense for these plans was $21.0 million and $22.8 million for the years ended December 31, 2010 and 2009, respectively.

318ff

14. Segment Information

The Company provides a range of health care services. The Company has two reportable operating segments – long-term care, which includes the operation of skilled nursing and assisted living facilities, and hospice and home health. The Other category includes the non-reportable segments and corporate items. The revenues in the Other category include other health care services. Asset information, including capital expenditures, is not reported by segment by the Company.

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies (see Note 1). The Company evaluates performance and allocates resources based on operating margin, which represents revenues less operating expenses. The operating margin does not include general and administrative expenses, depreciation and amortization, other income and expense items, and income taxes.

	Long-term Care	Hospice and Home Health	Other	Total
		(In thousands)		
Year ended December 31, 2010:				
Revenues from external customers	$ 3,638,091	$ 441,699	$ 88,776	$ 4,168,566
Intersegment revenues	-	-	111	111
Depreciation and amortization	131,275	3,781	15,214	150,270
Operating margin	768,753	75,887	12,231	856,871
Year ended December 31, 2009:				
Revenues from external customers	$ 3,571,721	$ 457,238	$ 94,761	$ 4,123,720
Intersegment revenues	-	-	419	419
Depreciation and amortization	112,075	3,656	20,001	135,732
Operating margin	735,411	71,749	12,430	819,590

31899