This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Cash Needs Drive Strategy, Aggressive Insider Selling
Kindred Healthcare Inc. (NYSE:KND)

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Business Description

Kindred Healthcare Inc., through its subsidiaries, operates as a healthcare services company primarily in the United States. It has four divisions: Hospital, Health Services, Rehabilitation, and Pharmacy. As of December 31, 2006, the company operated 81 long-term acute care hospitals with 6,419 licensed beds in 24 states; 242 nursing centers with 30,664 licensed beds in 28 states; and 46 institutional pharmacies in 26 states. Kindred Healthcare was founded in 1998 and is headquartered in Louisville, Kentucky.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Healthcare	**$32.24**	**$1.31B**	**567,901**
Industry:	52 Wk Range:	Trailing P/E:	Shrs Out:
L/T Care Facilities	**$24.46 - $36.67**	**21.00**	**40.49M**
F/T Employees:	FYE:	Forward P/E:	Short % of Float:
40,800	**31-Dec**	**17.02**	**13.20%**

Summary of 3DAdvisors Findings for KND

- **Accounting:** Spin-off appears motivated by need for cash, which is no surprise
- **Insider Trading:** Heavy selling *after* bad news and into share weakness
- **Accounting:** Landlord issues pressuring bottom line; accounting questionable
- **Accounting:** Cash flow a major concern and not likely to improve anytime soon
- **Accounting:** High velocity use of credit facility further evidence of tight cash
- **Accounting:** Frequent use of adjustments seriously undermines earnings quality
- **Accounting:** Dodging amortization expense and impairment charges
- **Governance:** Self-serving practices include questions about option grant dates

Discussion of 3DAdvisors Findings for KND

A rush by Kindred Healthcare executives to sell off big chunks of their holdings *after* the shares got clipped following both the Q1 earnings release and an adverse Medicare ruling put the Company on our radar (see the Insider Research Bulletin dated 06/05/07). There has been some additional selling since our last report. In fact, 10 out of Kindred's 11 executives who are Section 16 insiders have shown little restraint in selling, in a narrow time frame, following a rapid-fire series of negative news and Company disclosures that have hammered the shares.

Among the issues pressuring the stock after the Q107 conference call was disappointment over delays regarding the expected spin-off of Kindred's pharmacy business. The news regarding the spin-off was troublesome as the Company is in negotiations with bankers to finance the deal which is now expected to pay $125 million back to Kindred in the form of a dividend. But in completing the deal, Kindred will be giving up over $500 million in net revenue and, more importantly, a third of its income from continuing operations (before taxes). Despite efforts made by CEO **Paul Diaz** to cast the spin-off (and other issues) in a positive light during the conference call (he used the word "excited" no fewer than 11 times during the call), analysts repeatedly sought a clearer explanation for this and other strategies. For our part, questions about the spin-off provided ample motivation to keep digging.

As it turns out, this is just one of a number of moves being pursued by management that, combined with the specious trading behavior, have led us to conclude that Kindred is in more trouble than the Company and many analysts want us to believe. Other relevant items we cover here include: the regular buying back of under-performing properties from Ventas for re-sale at losses; the extent to which Kindred relies on its credit revolver; related questions concerning the Company's cash flow; "interesting" accounting stemming from the acquisition of Commonwealth Communities holdings; potential exposure to options backdating scrutiny and a plethora of additional accounting behaviors that seriously undermine earnings quality. These all combine to create a mosaic of behavioral and fundamental items that provide a compelling explanation for why Company executives have sold significant percentages of their holdings at such a seemingly inopportune time.

Accounting: Spin-off appears motivated by need for cash, which is no surprise

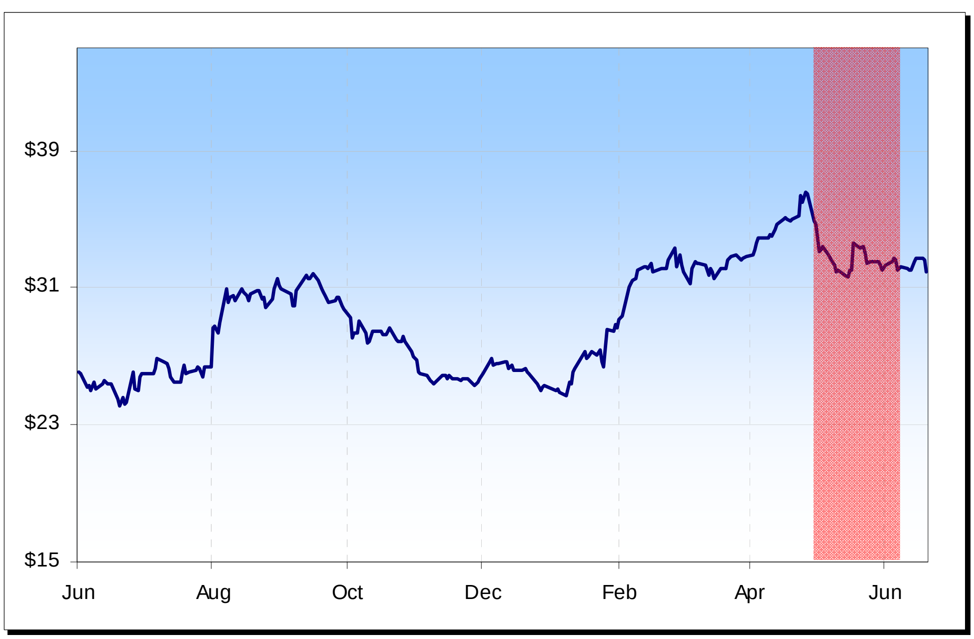
As one of our partners puts it, the planned spin-off of the Kindred Pharmacy Services (KPS) division has all the earmarks of a deal dreamed up on a Sunday afternoon at the Grand Central Hyatt by a couple of investment bankers. KPS generated $653 million in revenue in 2006 and $49 million in income. Even prior to the spin-off and merger with AmerisourceBergen's operations, it is the third largest institutional pharmacy company in the U.S. The deal's initial recipe included a $150 million dividend to be kicked back to Kindred upon closing. Delays are occurring. Initially announced to be closed by the end of the first quarter of 2007 (03/31/07), the closing was first postponed to the end of the second quarter (06/30/07) and management has now targeted a July 31st closing date. To wit, costs of the deal are mounting: Deal-related fees totaled $3 million in 2006, then another $4 million in Q107 alone. It also seems that the IRS has yet to completely rule that the transaction will qualify for tax-free treatment to holders of Kindred shares and to the Company.

And now, Kindred management disclosed in an SEC Form 8-K on 06/21/07 that the dividend to be paid back to the Company following the spin-off will be reduced to $125 million from the originally estimated $150. If the deal closes, Kindred will have given up revenues totaling $653 million (before eliminations of $144 million) and, more importantly, almost a third of income from continuing operations (before taxes). We strongly suspect that Kindred, in a tight cash flow position with little room for additional long-term financing, may be primarily motivated by the cash dividend inuring to its benefit upon the closing of the deal.

Insider Trading: Heavy selling *after* bad news and into share weakness

On April 30th Kindred released first quarter earnings from continuing operations of $0.39, down 26% from the same quarter last year, despite posting an 11% revenue increase. Analysts expected earnings of $0.41. Some of the setback was attributed to earnings declines in both the Hospital and Pharmacy divisions. One day later, a window opened that had been preventing any trading by covered employees since April 1st and three executives immediately jumped through, selling into the earnings-related weakness (-5%). Two days later, with the Kindred shares already under pressure, CMS issued its anticipated Final Rule on Medicare reimbursement that proved more detrimental to the Company than first forecasted: an overall decrease in payments to all certified long-term acute care hospitals of 3.8%, compared to the expected 2.9%. Also released was a new regulation raising Medicare payments for skilled nursing facilities by 3.3%.

Figure 1. KND Daily Closing Price, 06/01/06 through 06/20/07. Red shaded area is where 10 insiders sold 376,191 shares. Source: Reuters and KND SEC Filings.



With the stock down nearly 9% intraday on the ruling, Executive Chairman **Ed Kuntz** liquidated more than 60% of his actionable holdings (common stock plus vested derivatives) at the lower prices. But this was only the start as, by June 11th, ten insiders would sell 376,191 shares at a weighted average price of $33.64, resulting in the heaviest month of distributions since the Company's reorganization five years ago. The trades for certain execs are clearly notable to us, with **Mark McCullough**, president of the KPS pharmacy division cashing out all stock and options including some which yielded a slight profit of just 6%. Also "skimming" options was Chief Administration and Information Officer **Richard Chapman**, who over the course of the month wiped out nearly 70% of his ownership. More details on the trades of the notable sellers can be found below.

Insider	Position	% Ownership Sold YTD
M. McCullough	Div. President	100%
W. Altman	Senior V.P.	72%
R. Chapman	Chief Admin. Officer	67%
E. Kuntz	Exec. Chairman	62%
L. Bowen	Div. President	62%
M. Riedman	General Counsel	60%
F. Battafarano	Div. President	22%

We should also point out that the two most aggressive trading periods prior to this year had surfaced ahead of substantial downward price volatility: For instance, eight of the recent 10 sellers had all surfaced in the fourth quarter of 2003 in the $25 range just months before the Company reported disappointing Q403 earnings, sending the shares down 20%. It took nearly ten months for the shares to recover. They collectively took profits again in the second quarter of 2005 at prices reaching $41 per share, shortly before releasing Q205 earnings that missed the consensus. The shares fell as much as 22% intraday on the news. Executive Chairman Kuntz, who lightened his holdings in both rounds, took more shares off the table in December 2006 at a 52-week low of $26, just weeks before an anticipated report, issued by CMS regarding proposed Medicare reimbursement changes, would send the shares down to $20. The fact management has sold on a number of occasions ahead of material news triggering excessive volatility is one we are not willing to ignore.

- **Richard Chapman (58)** – Executive V.P., Chief Administrative and Information Officer. Chapman, a Company officer since 1997, recently sold down his ownership to its lowest level since becoming a named executive five years ago. During his tenure he has been a frequent trader, but the 67,000 shares he sold between May 1st and May 21st stand out on a number of levels. For one, the **shares represented 67% of his ownership**, the largest percentage reduction we have seen from him. Secondly, he cleared out the majority of his profitable options, including some that were not as lucrative, such as one series with a February 2015 expiration that yielded a pre-tax profit of just 11%. In his 21 past option-related sales dating back to 2003, Chapman had never accepted a spread less than 56% when exercising options. Included in his total distribution were 43,000 shares from his common position. His ownership will not be replaced quickly as he has just 34,000 options and shares scheduled to become actionable through December 2008 (see Appendix A).

- **Lane Bowen (56)** – Executive V.P.; President, Health Services Division. Since 2002 Bowen has managed the Company's largest division (Health Services) which accounted for 42% of 2006 revenues. Shortly after reporting a 13% year-over-year increase in the division's Q1 revs, Bowen began taking profits. From May 1st to May 21st he sold 51,701 shares, more than he had sold in total over the prior five years. In all, he **shed over 60% of his actionable holdings** (common stock plus vested options) with just 10,000 new shares that will vest by year-end (see Appendix A).

- **M. Suzanne Riedman (55)** – Senior V.P., General Counsel. Riedman has been the Company's head counsel since 1999, beginning her career in Kindred's predecessor's legal department in 1995. Prior to this year, she had not been an active trader, with the exception of eight consecutive sales in June 2005 covering 62,000 shares, which proved to be quite timely. Immediately after her last sale, executed at the all-time high, the shares quickly reversed course, losing 25% of their value over the next two months before bottoming at $20 in January 2006 when an unfavorable Medicare ruling slammed the shares. This year, her behavior looks eerily similar to that of 2005, as she has now executed eight trades between May 22nd and June 11th, clearing out 41,384 shares at descending prices from $33.60 to $32.17. In all, the shares **accounted for 60% of her actionable ownership**, but this reduction would be considerably higher (78%) if we discounted vested options in jeopardy of falling underwater with the slightest price weakness. It should also be addressed that Riedman has been granted 30,000 restricted shares since 2003 and currently owns just 3,000 outright. Nearly 30,000 of the 41,000 shares she distributed this quarter came out of her common holdings, proving her resolve to sell any equity accessible. She will have 8,300 options and restricted shares scheduled to vest in July and August, followed by another 5,600 in Q108, which will not be enough to replenish her actionable ownership (see Appendix A).

- **William Altman (47)** – Senior V.P., Compliance and Government Programs. In addition to monetizing all his profitable stock options on May 18th and May 21st, none of which would have expired before 2012, Altman cashed out his common stock as well. After last selling 10,000 shares in the $39 range in June 2005, Altman recently sold 34,547 shares at $33. Following this **sale of 72% of his holdings**, all that remains are vested options that carry a $31 strike price, leaving them just narrowly in the money, and a few hundred shares of common. It will take nearly four years of option and share vesting for him to replace what he just sold in May, as just 8,000 are scheduled to become actionable through the remainder of 2007 (see Appendix A).

- **Mark McCullough (45)** – President, Pharmacy Division; Chief Operating Officer, PharMerica. Initially, it was unclear whether McCullough planned to stay on board after the Spin-Off/Merger given the fact that **Gregory Weishar** had been named the chief executive of the combined entity. His recent trading behavior gave us the impression he would be leaving the Company, as **he cleared out all of his vested options and common stock on May 7th and May 9th at $32**. His departure however, does not seem in the cards: In a press release[1] dated June 5th the Company disclosed the new entity's (PharMerica Corp.) management team and to our surprise, McCullough was named the chief operating officer. This makes the sale of his entire actionable position even more interesting, especially considering he has skimmed a significant portion of his options, not set to expire until 2012. What's more, had he held on to his stock, he, like all other KND shareholders, would have received shares of PharMerica. It seems evident that McCullough is not interested in having exposure to Kindred shares at this time.

Accounting: Landlord issues pressuring bottom line; accounting questionable

When the now-defunct Vencor was reorganized, its real estate holdings were transferred to a REIT, Ventas, through which most of Kindred's leases are structured. The relationship between the two entities has been somewhat tumultuous. In June of 2006, Ventas, intending to utilize its one-time option under its agreements with Kindred, proposed raising the annual rent payments to it by $111 million (to $317 million). In a related development, Kindred had commissioned independent appraisals to determine the value of the properties involved. As a result of the appraisals, Kindred stated that it had been overpaying and that its existing rents paid to Ventas were "already well above market". When Ventas demanded that Kindred turn over the appraisals, Kindred sued to prevent their disclosure. The situation has been resolved and now Kindred is paying $239 million annually, in rent, to Ventas, an increase of 16%.

Kindred also leases certain properties from Health Care Property Investors (HCP). In order for Kindred to exit from underperforming assets leased from either Ventas or HCP, Kindred must buy the properties outright from the REITs and resell them. This is because any cessation of Kindred's operation of these leased properties is an Event of Default under Master Leases between Kindred and the respective entities. Lately, such re-sales of purchased properties have generated losses. For instance, in August of 2006 Kindred agreed to buy the real estate related to 11 unprofitable leased nursing centers operated by it and owned by HCP. Kindred paid $36 million, terminated its $9.9 million annual rent for the 11 centers and exchanged 3 of its owned properties to HCP in return (the value of the 3 properties was not disclosed). In November, the Company entered into an agreement to resell the 11 centers for $78 million, generating a pre-tax loss of $13 million which was not booked until Q1 of 2007 even though nine of the eleven centers had already been resold as of 12/31/06. We found this delayed recordation of the loss interesting as the deal looked primarily done by year-end and, in a similar transaction in 2004, Kindred had booked the expected loss at year-end instead of sliding into the next year.

Following the HCP deal was a similar but larger transaction with Ventas. This time, Kindred will acquire 22 facilities from Ventas for $171 million, plus a termination fee of $4 million. Kindred expects to resell the properties by 12/31/07 and plans to record a loss of between $60 and $70 million in the second quarter of 2007 relating to the divestitures. An interesting side-bar to the deal is that Ventas, in agreeing to the arrangement, has also agreed not to contest the proposed pharmacy spin-off. Kindred

[1] "AmeriSourceBergen, Kindred Name Execs", BusinessWire-First Call, June 5, 2007

management goes to great lengths to explain its strategic rationale for transactions, such as the transaction above:

> **Analyst:** Okay. On the SNF side and the transaction, can you tell us a little bit about the considerations that went into the buyout prices? I guess all-in $175 million for those 22 facilities? It obviously wasn't an EBITDAR multiple, so is it comparable bed values in those zip codes, or is it a variety of different considerations that were separate from the financials?
>
> **Rich Lechleiter, Kindred CFO:** Yes, I think that's correct; there were a number of different issues. You know the value of the insurance reform, the value of the bed-management issues to be, as we just chatted about, to be proactive in terms of growth and continuing to grow but also defensive and protect ourselves in the context of all the different regulatory changes. But you know, let me be clear. You know, we had the option to reject bundles that were underperforming with a whole host of assets, some good, some bad. This is a much better outcome for Ventas and Kindred when one looks at the totality of this transaction.
>
> I'm not sure if I can express my confidence in this any more strongly, that this is a great transaction for both companies and really allows us to continue to move our hospital business and nursing home business forward, create more value for our patients and customers, and see opportunities to grow in our cluster markets over the next few years.
>
> You are right to say that it's going to be difficult to pencil that out asset-by-asset, but these are assets in Wyoming, and Maine, and California, quite disparate geographically, quite disparate from a value perspective, but it's a major step for us in rationalizing the portfolio and moving our cluster market strategy forward where we really think we have more opportunities for future success.

The entire above verbiage aside, in the final analysis, the motivation is most likely nothing more than shutting down losing operations which must be first acquired at a substantial loss to Kindred.

<u>Accounting: Cash flow a major concern and not likely to improve anytime soon</u>

There can be little doubt that Kindred's CFO loses plenty of sleep thinking about cash. In 2006, virtually the entire cash from operations came from depreciation. In Q1 of 2007, most of Kindred's Cash from Operations coming from depreciation was subsequently sucked up by working capital changes not the least of which involve increases in Accounts Receivables. During the Q1 conference call, management focused on inflows of cash: The $37 million that came back to Kindred from its captive insurance company; the $80 to $90 million of cash that would result from the asset sales related to the last Ventas transaction (where Kindred will be booking the $60 to $70 million loss); the upcoming spin-off which is expected to now generate $125 million net cash. All of these, of course, are one-time, non-recurring infusions of cash.

To this, a logical question was posed during the Q1 call:

> **Analyst:** Do you think you can internally finance all of that development and routine spending this year, or will you have to borrow more?
>
> **Rich Lechleiter, CFO:** Well, we've already -- as you've seen in Q1, we have already gotten the -- you know, we had the sales proceeds, the net proceeds, if you will, from the HCP transaction, which was about $42 million after-tax. That's going toward this. The $37 million that we took out of the captive in Q1 effectively goes toward that funding as well. You've got the expected level of dividend coming in from the transaction with the spin-off of KPS. So I think, is there enough cash flow from operations to fund the $200 million? The answer is no. But we should be in a position, by the end of this year, from a balance-sheet perspective, to be levered at a lower level, if you will, than we are today.

It seems likely that Kindred will have to rely on one-time injections, such as those above, in order to keep cash flow positive for at least the intermediate term. In addition to higher rent charges taking a toll, lower Medicare revenues come into play as the Company estimates a $20 million Medicare-related revenue reduction for the second half of 2007. Looking at the income statement for 2006, one cannot attribute the major decline in income to any one category but rather, after achieving a 10% increase in revenue, nearly every cost and expense category increased by a greater percentage than did revenue. Kindred management speaks of major efforts to control and reduce costs, but the efforts don't seem to have borne much fruit. The profit slide continued in Q107 as Kindred's revenues increased 11% year-over-year while net income declined by 68%.

<u>Accounting: High velocity use of credit facility further evidence of tight cash</u>

With the above said, we are compelled to note the high velocity employed by Kindred with regards to the utilization of its credit revolver. This credit facility is capped at $400 million and can go to $500 million for "acquisitions and certain investments". There were no loans outstanding under this facility at 12/31/05 and $129 million at 12/31/06. During the period, however, borrowings under the facility totaled $1.5 billion with repayments of $1.33 billion. Q107 shows the facility still heavily and constantly utilized: During the period, $437 million was borrowed with $453 million being repaid, leaving the outstanding balance at 03/31/07 at $113 million. Seldom have we seen a company so dependent on one credit facility as its sole source of borrowing power.

Kindred's credit facility is collateralized by substantially all of the Company's assets, including certain owned real property and is guaranteed by substantially all of the Company's subsidiaries. We feel that the Company's ability to obtain additional long-term financing should be considered to be severely limited. Clearly it could not be done without the permission of the existing lenders.

<u>Accounting: Frequent use of adjustments seriously undermines earnings quality</u>

Exacerbating the problem with Kindred's earnings quality is the fact that, in any given quarter, Kindred can be relied on to tweak things in multiple areas. With only 40 million shares outstanding, the effects can be fairly dramatic. For instance, in Q107, despite a 5% increase in gross receivables, Kindred took $8 million out of the A/R allowance. Had they kept it at the 12/31/06 level, income from continuing operations would have been cut in half. We think they were scraping the bottom of the barrel. Kindred also juiced 2006 earnings by $19.3 million by changing their professional liability reserves. They then got another $7 million boost in Q107 from the same source. It looks as if without adjustments in reserves, allowances, etc., Q107 would have shown no profit at all (keep in mind the heavy insider selling that took place immediately following the Q107 earnings release).

Kindred's 2006 SEC Form 10-K discloses a long list of past earnings adjustments occurring in practically every period. We rarely see such an extensive "Significant Quarterly Adjustments" section in an SEC Form 10-K[2]:

> ***Fourth quarter 2006***
> Operating results for the fourth quarter of 2006 included pretax income of $6.4 million related to a favorable actuarial adjustment of professional liability costs, pretax income of $2.3 million related to favorable settlements of prior year hospital Medicare cost reports, pretax income of $1.5 million from insurance recoveries related to hurricane losses, a pretax charge of $4.2 million to adjust certain estimated institutional pharmacy Medicare Part D revenues recorded in the first nine months of 2006, a pretax charge of $3.1 million to adjust the accounts receivable of an acquired institutional pharmacy, and a pretax charge of $5.3 million for professional fees and other costs incurred in connection with the Proposed Pharmacy Transaction and the rent reset issue with Ventas. The Company also recorded favorable income tax adjustments that increased net income by $3.5 million.
>
> ***Third quarter 2006***
> Operating results for the third quarter of 2006 included pretax income of $1.3 million related to an insurance recovery and a favorable adjustment of a prior year tax dispute, and a pretax charge of $3.5 million for costs incurred in connection with the Proposed Pharmacy Transaction and professional fees incurred in connection with the Ventas rent reset issue. Third quarter 2006 results also included a charge of $0.6 million related to a change in estimate of the Company's annual effective income tax rate.
>
> ***Second quarter 2006***
> Operating results for the second quarter of 2006 included pretax income of $4.3 million related to favorable settlements of prior year hospital Medicare cost reports, a pretax charge of $3.3 million in connection with the settlement of a prior year tax dispute and a pretax charge of $1 million for investment banking services and costs related to the rent reset issue with Ventas.
>
> ***First quarter 2006***
> Operating results for the first quarter of 2006 included pretax income of $1.9 million related to the favorable settlement of prior year hospital Medicare cost reports, a $1.3 million pretax gain from an institutional pharmacy joint venture transaction, a pretax charge of $2.7 million related primarily to revisions to prior estimates for accrued contract labor costs in the Company's rehabilitation division, and a pretax charge of $1.3 million for investment banking services and costs related to the rent reset issue with Ventas.

[2] Kindred Healthcare Inc. 2006 SEC Form 10-K, filed 03/01/07, page F-36.

The list of adjustments during 2005 is no less extensive. It seems that the disclosure of these exists because the amounts are significant, out of period and constant rather than infrequent.

Accounting: Dodging amortization expense and impairment charges

The acquisition of Commonwealth Communities Holdings LLC, in February of 2006, added an interesting intangible to the books that Kindred gives a perpetual life to. These "Certificates of Need" (CON) were allocated into the deal price at $76 million and will not be amortized. The entire deal was for $124 million in cash, with Goodwill allocated at $32.7 million. We have found other companies who, unlike Kindred, amortize CONs over a definite period. We have also spotted companies that claim an indefinite life on CONs and, like Kindred, choose not to amortize them. Where Kindred differs from the examples that we've seen in either case is the large amount ($76 million) carried on its books as Certificates of Need. These CONs are nothing more than an authorization of a commitment from a government body to add health care capacity.

We have spoken with one private hospital CFO who expressed surprise over the size of Kindred's CONs, not to mention the fact that they are being considered as having perpetual lives and are not being amortized.

Kindred utilizes an interesting practice when assessing the value of its long-lived assets: If a group of facilities is under a master lease agreement, the estimate of cash flows for the entire group is used in the assessment. This means that there could be some facilities in the group for which future cash flows will not recover their carrying value. Thus, Kindred's grouping of them presents an interesting opportunity to stave off impairment expense that would otherwise be required if one or more facilities in a group should be underperforming. This point becomes a bit more expressive when one considers that in Q4, Kindred disclosed that results from some of its recently-acquired pharmacies were poor.

Governance: Self-serving practices include questions about option grant dates

We note some interesting compensation practices occurring over the past few years which may stem from the vested interests of certain current and former Executive Compensation Committee (ECC) members. Upon the Company's emergence from Chapter 11 protection in April 2001, a new board was appointed that included representatives of the then principal security holders. One current board member, **Michael Emblem**, is an officer of Franklin Mutual Advisors which owned 26% of the outstanding KND shares in 2001 and remains the largest shareholder with a 19% stake. Former ECC member, **David Tepper**, is president of Appaloosa Management L.P., which owned 25% of Kindred's outstanding shares in 2001. He was joined on the board by **James Bolin**, Appaloosa's vice president and secretary. Another ECC member, **Thomas Cooper**, is the Chairman and Chief Executive of Vericare Inc., a company that used to provide mental health services to nursing facilities owned by Kindred. While it is not rare to see this many involved parties on a new board following a reorganization, we can not help but to draw the connection to their compensation liberalness.

Though Kindred has never been targeted for option backdating practices, we can point to a number of option and restricted stock grants, distinguished in Figure 2 below with red diamonds, issued to executives dating back to 2002 where the timing appears to be overly beneficial for the recipients. For starters, CEO Diaz was hired on January 1, 2002, at which time KND shares traded above $24. His initial grant was delayed until the end of January, after the shares traded down to a new low of $19. This one month grant delay is definitely not standard practice. Just one month later, CFO Lechleiter was hired and issued his new-hire grant on the very same day. Subsequently, options were granted in July 2004 on one of the more volatile trading days of the year, while awards issued in 2005 were even more irregular.

Figure 2. KND Daily Closing Price, 01/31/02 through 05/31/07. Red diamonds are the option grant dates that appear suspicious. Source: Reuters, 3DA, KND SEC Filings.

After historically issuing options in February or July, the ECC made awards in April after the shares traded down from $36 to $31, and then again in August, just days after the issue lost 20% on a disappointing Q2 earnings report, reaching a new six-month low. It is, most likely, not happenstance the Company has loosely defined option policies, which leaves the door open for ECC grant timing manipulation:

> ***While the Committee does not have a formal policy with respect to the timing of grants of equity-based awards in connection with the release of material non-public information, the Committee generally considers issues raised by the timing of award grants when making such awards.***[3]

[3] Kindred Healthcare Inc. 2006 Proxy Statement, Filed on April 4, 2007, Compensation Discussion and Analysis, Pg. 16.

We are also very interested in the sizeable compensation package provided to former CEO and now “Executive Chairman” Kuntz, who served as the Company’s chief executive for four years between 1999 and 2003. Under a renewed employment agreement signed in February, Kuntz receives a base salary of $855,000, not far from the $950,000 base of CEO Diaz, and sizeable option and restricted stock grants more in line with top executives than his peer board members, for performing the following duties:

- Coordinates all matters and committee activities of the Board and acts as the principal liaison between the Board and senior management
- Engages in public lobbying and relationships with various healthcare related organizations
- Advises the Chief Executive Officer and senior management on strategic initiatives including financing, acquisition and development activities
- Advises the Chief Executive Officer and senior management concerning all compliance and regulatory matters
- Such other similar matters as reasonably requested by the Board.

These seem to us to be fairly routine responsibilities for a corporate chairman. We question the need for the large compensation package, especially in light of the fact he is required to devote only approximately two days per week to the business of the Company. What’s more, in the event of an involuntary termination or change of control, Kuntz would receive a cash payment in excess of $3.5 million, *more than any named officer (outside of CEO Diaz) is entitled to*. This certainly is not common practice and makes us wonder why the board has gone to great (and expensive) lengths to retain his services.

3D ADVISORS

Appendix A

Option and Restricted Stock Vesting Schedules for Selected Kindred Healthcare Inc. Insiders

Grant Date	Equity Type	Options/ Shares	Strike Price (Options)	First Vesting Date	Expiration Date (Options)	Remaining Options/Shares in Series	Unvested Options/Shares in Series	Vesting Dates of Remaining Restricted Shares/Options
William Altman, Senior V.P.- Compliance and Government Programs. Common stock holdings: 481 shares								
07/26/04	Options	8,659	$23.89	07/26/05	07/26/14	2,886	2,886	07/26/07
07/26/04	R. Stock	6,494	N/A	07/26/05	07/26/07	2,164	2,164	07/26/07
04/27/05	Options	5,503	$31.09	04/27/06	04/27/15	5,503	0	Fully Vested
04/27/05	R. Stock	2,908	N/A	04/27/06	04/27/09	1,454	1,454	04/27/08, 04/27/09
08/10/05	Options	7,509	$31.14	08/10/06	08/10/16	7,509	0	Fully Vested
08/10/05	R. Stock	6,195	N/A	08/10/06	08/10/09	4,647	4,647	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	6,227	$21.99	02/23/07	02/23/16	4,671	4,671	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	5,138	N/A	02/23/07	02/23/10	3,854	3,854	02/23/08, 02/23/09, 02/23/10
04/25/07	R. Stock	20,819	N/A	04/25/08	04/25/11	20,819	20,819	04/25/08, 04/25/09, 04/25/10, 04/25/11
Frank Battafarano, Executive V.P., President-Hospital Division. Common stock holdings: 46,073 shares								
07/23/02	Options		$15.91	07/23/03	07/23/12	4,984	0	Fully Vested
07/22/03	Options	25,330	$11.02	07/22/04	07/22/13	13,174	0	Fully Vested
07/26/04	Options	15,206	$23.89	07/26/05	07/26/14	15,206	5,069	07/26/07
07/26/04	R. Stock	11,404	N/A	07/26/05	07/26/07	3,802	3,802	07/26/07
02/23/05	Options	10,000	$30.42	02/23/06	02/23/15	10,000	0	Fully Vested
02/23/05	R. Stock	15,000	N/A	02/23/06	02/23/08	5,000	5,000	02/23/08
04/27/05	Options	9,971	$31.09	04/27/06	04/27/15	9,971	0	Fully Vested
04/27/05	R. Stock	8,226	N/A	04/27/06	04/27/09	4,113	4,113	04/27/08, 04/27/09
08/10/05	Options	27,500	$31.14	08/10/06	08/10/16	27,500	0	Fully Vested
08/10/05	R. Stock	22,500	N/A	08/10/06	08/10/09	16,875	16,875	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	67,017	$21.99	02/23/07	02/23/16	67,017	50,263	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	55,289	N/A	02/23/07	02/23/10	41,467	41,467	02/23/08, 02/23/09, 02/23/10
04/25/07	R. Stock	16,276	N/A	04/25/08	04/25/11	16,276	16,276	04/25/08, 04/25/09, 04/25/10, 04/25/11
Paul Diaz, President, Chief Executive Officer. Common stock holdings: 250,571 shares								
01/28/02	Options	200,000	$19.38	01/28/03	01/28/12	192,500	0	Fully Vested
07/23/02	Options	35,000	$15.91	07/23/03	07/23/12	11,214	0	Fully Vested
07/22/03	Options	77,184	$11.02	07/22/04	07/22/13	51,456	0	Fully Vested
10/28/03	Options	120,000	$19.75	10/28/04	10/28/13	80,000	0	Fully Vested
07/26/04	Options	67,220	$23.89	07/26/05	07/26/14	67,220	22,407	07/26/07
07/26/04	R. Stock	50,415	N/A	07/26/05	07/26/07	16,805	16,805	07/26/07
04/27/05	Options	58,584	$31.09	04/27/06	04/27/15	58,584	0	Fully Vested
04/27/05	R. Stock	48,332	N/A	04/27/06	04/27/09	24,166	4,113	04/27/08, 04/27/09
08/10/05	Options	101,923	$31.14	08/10/06	08/10/16	101,923	0	Fully Vested

Appendix A

Option and Restricted Stock Vesting Schedules for Selected Kindred Healthcare Inc. Insiders

Grant Date	Equity Type	Options/ Shares	Strike Price (Options)	First Vesting Date	Expiration Date (Options)	Remaining Options/Shares in Series	Unvested Options/Shares in Series	Vesting Dates of Remaining Restricted Shares/Options
08/10/05	R. Stock	84,087	N/A	08/10/06	08/10/09	63,066	63,066	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	101,923	$21.99	02/23/07	02/23/16	67,017	50,263	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	84,087	N/A	02/23/07	02/23/10	41,467	41,467	02/23/08, 02/23/09, 02/23/10
04/25/07	R. Stock	71,139	N/A	04/25/08	04/25/11	71,139	71,139	04/25/08, 04/25/09, 04/25/10, 04/25/11
Lane Bowen, Executive V.P., President-Health Services Division. Common stock holdings: 7,079 shares								
07/26/04	Options	15,206	$23.89	07/26/05	07/26/14	5,069	5,069	07/26/07
07/26/04	R. Stock	11,404	N/A	07/26/05	07/26/07	3,802	3,802	07/26/07
02/23/05	Options	10,000	$30.42	02/23/06	02/23/15	10,000	0	Fully Vested
02/23/05	R. Stock	15,000	N/A	02/23/06	02/23/08	5,000	5,000	02/23/08
04/27/05	Options	7,307	$31.09	04/27/06	04/27/15	7,307	0	Fully Vested
04/27/05	R. Stock	6,028	N/A	04/27/06	04/27/09	3,014	3,014	04/27/08, 04/27/09
08/10/05	Options	7,050	$31.14	08/10/06	08/10/16	7,050	0	Fully Vested
08/10/05	R. Stock	5,816	N/A	08/10/06	08/10/09	4,362	4,362	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	13,153	$21.99	02/23/07	02/23/16	9,865	9,865	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	10,851	N/A	02/23/07	02/23/10	8,139	8,139	02/23/08, 02/23/09, 02/23/10
04/25/07	R. Stock	24,961	N/A	04/25/08	04/25/11	24,961	24,961	04/25/08, 04/25/09, 04/25/10, 04/25/11
Richard Chapman, Executive V.P., Chief Administrative and Information Officer. Common stock holdings: 13,707 shares								
07/26/04	Options	15,206	$23.89	07/26/05	07/26/14	5,069	5,069	07/26/07
07/26/04	R. Stock	11,404	N/A	07/26/05	07/26/07	2,851	2,851	07/26/07
02/23/05	R. Stock	15,000	N/A	02/23/06	02/23/08	5,000	5,000	02/23/08
04/27/05	Options	7,307	$31.09	04/27/06	04/27/15	7,307	0	Fully Vested
04/27/05	R. Stock	6,028	N/A	04/27/06	04/27/09	3,014	3,014	04/27/08, 04/27/09
08/10/05	Options	12,712	$31.14	08/10/06	08/10/16	12,712	0	Fully Vested
08/10/05	R. Stock	10,488	N/A	08/10/06	08/10/09	7,866	7,866	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	17,356	$21.99	02/23/07	02/23/16	13,017	13,017	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	14,319	N/A	02/23/07	02/23/10	10,740	10,740	02/23/08, 02/23/09, 02/23/10
04/25/07	R. Stock	14,347	N/A	04/25/08	04/25/11	14,347	14,347	04/25/08, 04/25/09, 04/25/10, 04/25/11
Ed Kuntz, Executive Chairman. Common stock holdings: 41,992 shares								
07/23/02	Options	80,000	$15.91	07/23/03	07/23/12	20,000	0	Fully Vested
07/26/04	Options	39,746	$23.89	07/26/05	07/26/14	26,497	13,249	07/26/07
07/26/04	R. Stock	29,809	N/A	07/26/05	07/26/07	9,937	9,937	07/26/07
04/27/05	Options	19,164	$31.09	04/27/06	04/27/15	19,164	0	Fully Vested
04/27/05	R. Stock	15,810	N/A	04/27/06	04/27/09	7,905	7,905	04/27/08, 04/27/09

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Option and Restricted Stock Vesting Schedules for Selected Kindred Healthcare Inc. Insiders

Grant Date	Equity Type	Options/ Shares	Strike Price (Options)	First Vesting Date	Expiration Date (Options)	Remaining Options/Shares in Series	Unvested Options/Shares in Series	Vesting Dates of Remaining Restricted Shares/Options
08/10/05	Options	33,341	$31.14	08/10/06	08/10/16	33,341	0	Fully Vested
08/10/05	R. Stock	27,506	N/A	08/10/06	08/10/09	20,630	20,630	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	23,974	$21.99	02/23/07	02/23/16	23,974	17,981	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	19,779	N/A	02/23/07	02/23/10	14,835	14,835	02/23/08, 02/23/09, 02/23/10
02/22/07	R. Stock	11,000	N/A	02/22/08	02/22/10	11,000	11,000	02/22/08, 02/22/09, 02/22/10
04/25/07	R. Stock	35,569	N/A	04/25/08	04/25/11	35,569	35,569	04/25/08, 04/25/09, 04/25/10, 04/25/11
Mark McCullough, President-Pharmacy Division. Common stock holdings: 0 shares								
07/26/04	Options	8,659	$23.89	07/26/05	07/26/14	2,886	2,886	07/26/07
07/26/04	R. Stock	6,494	N/A	07/26/05	07/26/07	2,165	2,165	07/26/07
04/27/05	R. Stock	6,028	N/A	04/27/06	04/27/09	3,014	3,014	04/27/08, 04/27/09
08/10/05	R. Stock	8,500	N/A	08/10/06	08/10/09	6,375	6,375	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	10,816	$21.99	02/23/07	02/23/16	8,112	8,112	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	8,924	N/A	02/23/07	02/23/10	6,693	6,693	02/23/08, 02/23/09, 02/23/10
M. Suzanne Riedman, Senior V.P., General Counsel. Common stock holdings: 3,151 shares								
07/22/03	Options	16,742	$11.02	07/22/04	07/22/13	8,040	0	Fully Vested
07/26/04	Options	10,345	$23.89	07/26/05	07/26/14	3,448	3,448	07/26/07
07/26/04	R. Stock	7,759	N/A	07/26/05	07/26/07	2,586	2,586	07/26/07
04/27/05	Options	6,332	$31.09	04/27/06	04/27/15	6,332	0	Fully Vested
04/27/05	R. Stock	3,346	N/A	04/27/06	04/27/09	1,676	1,673	04/27/08, 04/27/09
08/10/05	Options	11,016	$31.14	08/10/06	08/10/16	11,016	0	Fully Vested
08/10/05	R. Stock	5,821	N/A	08/10/06	08/10/09	4,366	4,366	08/10/07, 08/10/08, 08/10/09
02/23/06	Options	8,810	$21.99	02/23/07	02/23/16	7,409	6,608	02/23/08, 02/23/09, 02/23/10
02/23/06	R. Stock	7,269	N/A	02/23/07	02/23/10	5,452	5,452	02/23/08, 02/23/09, 02/23/10
04/25/07	R. Stock	6,521	N/A	04/25/08	04/25/11	6,521	6,521	04/25/08, 04/25/09, 04/25/10, 04/25/11