KINDRED HEALTHCARE, INC
Form DEF 14A
April 04, 2007

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

## SCHEDULE 14A INFORMATION

## PROXY STATEMENT PURSUANT TO SECTION 14(a)

## OF THE SECURITIES EXCHANGE ACT OF 1934

Filed by the Registrant x

Filed by a Party other than the Registrant ¨

Check the appropriate box:

| | |
|---|---|
| ¨ Preliminary Proxy Statement | ¨ **CONFIDENTIAL, FOR USE OF THE COMMISSION ONLY (AS PERMITTED BY RULE 14A-6(E)(2))** |
| x Definitive Proxy Statement | |
| ¨ Definitive Additional Materials | |
| ¨ Soliciting Material Pursuant to Rule 14a-12 | |

# KINDRED HEALTHCARE, INC.

**(Name of Registrant as Specified in Its Charter)**

**(Name of Person(s) Filing Proxy Statement, if other than the Registrant)**

Payment of Filing Fee (Check the appropriate box):

x No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee was calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

¨ Fee paid previously with preliminary materials.

¨ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

**KINDRED HEALTHCARE, INC.**

April 4, 2007

Dear Shareholder:

You are cordially invited to attend the Annual Meeting of Shareholders of Kindred Healthcare, Inc., to be held at 10:00 a.m. (EDT) on Thursday, May 31, 2007, at Kindred s principal office at 680 South Fourth Street, Louisville, Kentucky 40202-2412.

Information concerning the business to be conducted at the meeting is included in the accompanying Notice of Annual Meeting of Shareholders and Proxy Statement. Please give all of the information contained in the Proxy Statement your careful attention.

YOUR VOTE IS VERY IMPORTANT. Whether or not you plan to attend the meeting, it is important that your shares be represented. Therefore, we urge you to sign, date and promptly return the enclosed proxy in the enclosed postage paid envelope. Please refer to the enclosed voting form for instructions. If you attend the meeting, you will, of course, have the right to vote in person.

I look forward to greeting you personally, and on behalf of the Board of Directors and management, I would like to express our appreciation for your interest in Kindred.

Sincerely,

Paul J. Diaz

President and Chief Executive Officer

Kindred Healthcare, Inc.

680 South Fourth Street

Louisville, Kentucky 40202-2412

**KINDRED HEALTHCARE, INC.**

**680 SOUTH FOURTH STREET**

**LOUISVILLE, KENTUCKY 40202-2412**

**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS**

**TO BE HELD ON MAY 31, 2007**

To the Shareholders of Kindred Healthcare, Inc.:

The Annual Meeting of Shareholders of Kindred Healthcare, Inc. ( Kindred ) will be held at 10:00 a.m. (EDT) on Thursday, May 31, 2007, at Kindred s principal office at 680 South Fourth Street, Louisville, Kentucky 40202-2412 for the following purposes:

(1) To elect a board of nine directors;

(2) To amend and restate Kindred s 2001 Stock Option Plan for Non-Employee Directors (Amended and Restated);

(3) To ratify the appointment of PricewaterhouseCoopers LLP as Kindred s independent auditor for fiscal year 2007; and

(4) To transact such other business as may properly come before the meeting.

Only shareholders of record at the close of business on April 3, 2007 will be entitled to notice of, and to vote at, the meeting and any adjournments thereof.

IT IS IMPORTANT THAT YOU VOTE YOUR SHARES. WHETHER YOU PLAN TO ATTEND THE MEETING OR NOT, PLEASE SUBMIT YOUR PROXY AS SOON AS POSSIBLE IN THE ENCLOSED POSTAGE PAID ENVELOPE IN ORDER TO AVOID ADDITIONAL SOLICITING EXPENSES TO KINDRED. THE PROXY IS REVOCABLE AND WILL NOT AFFECT YOUR RIGHT TO VOTE IN PERSON IN THE EVENT YOU FIND IT CONVENIENT TO ATTEND THE MEETING.

April 4, 2007

*Paul J. Diaz*

*President and Chief Executive Officer*

**PROXY STATEMENT**

**FOR ANNUAL MEETING OF SHAREHOLDERS**

**TO BE HELD ON MAY 31, 2007**

## GENERAL INFORMATION

This proxy statement and the accompanying form of proxy are furnished in connection with the solicitation of proxies by the Board of Directors of Kindred Healthcare, Inc. ( Kindred or the Company ) for use at the Annual Meeting of Shareholders (the Annual Meeting ), to be held at 10:00 a.m. (EDT) on May 31, 2007, at the Company s principal office at 680 South Fourth Street, Louisville, Kentucky 40202-2412, and at any adjournment or postponement thereof. Only shareholders of record on the books of the Company at the close of business on April 3, 2007 will be entitled to notice of, and to vote at, the Annual Meeting. This proxy statement is dated April 4, 2007 and was first mailed to shareholders on or about April 9, 2007.

Proxies are solicited by the Board of Directors in order to provide each shareholder with an opportunity to vote on all matters scheduled to come before the Annual Meeting, whether or not he or she attends the Annual Meeting in person. When the enclosed proxy card is returned properly signed, the shares represented by the proxy card will be voted by the proxy holders named on the proxy card in accordance with the shareholder s directions. You are urged to specify your choice by marking the appropriate box on the proxy card. If the proxy card is signed and returned without specifying a choice, the shares will be voted as recommended by the Board of Directors.

The cost of preparing, assembling and mailing the notice of the Annual Meeting, proxy statement and proxy card will be paid by the Company. In addition to the use of the mail, proxies may be solicited by directors, officers and other employees of the Company, without additional compensation, in person, by telephone or other electronic means. Furthermore, the Company has retained Georgeson Inc. ( Georgeson ), an investor relations firm, to assist with the distribution of proxy materials and to solicit proxies from brokers, banks and institutional holders by telephone or mail. The Company does not anticipate the fees paid to Georgeson, exclusive of reimbursement of costs, will exceed $10,000. Kindred will reimburse brokerage houses and other nominees for their expenses in forwarding proxy materials to beneficial owners of the Company s common stock.

### Revocability of Proxy

Executing and returning the enclosed proxy card will not affect your right to attend the Annual Meeting and vote in person. If you do attend, you may vote by ballot at the Annual Meeting, thereby effectively canceling any proxies previously given. In addition, a shareholder giving a proxy may revoke it at any time before it is voted at the Annual Meeting by filing with the Corporate Secretary of the Company any instrument revoking it, or by filing with the Company a duly executed proxy bearing a later date.

### Voting Rights and Outstanding Shares

Each share of common stock, $0.25 par value ( Common Stock ), of the Company outstanding at the close of business on April 3, 2007 is entitled to one vote at the Annual Meeting. As of April 3, 2007, there were 40,033,433 shares of Common Stock outstanding.

The presence at the Annual Meeting in person or by proxy of holders of record of a majority of the outstanding shares of Common Stock is required to constitute a quorum for the transaction of all business at the Annual Meeting. The vote of a plurality of the outstanding shares of Common Stock present in person or by proxy will be necessary to elect the director-nominees listed in this proxy statement. The affirmative vote of a majority of the outstanding shares of Common Stock present in person or by proxy will be necessary (1) to amend and restate the Company s 2001 Stock Option Plan for Non-Employee Directors (Amended and Restated) (the Directors Plan ), (2) to ratify the appointment of PricewaterhouseCoopers LLP as the Company s independent auditor for fiscal year 2007, and (3) to approve any other matters that may properly come before the Annual Meeting for shareholder consideration. Abstentions and proxies relating to street name shares for which brokers have not received voting instructions from the beneficial owner ( Broker Non-Votes ) are counted in determining whether a quorum is present. In the election of directors, the nominees receiving the highest number of votes will be elected. Therefore, abstentions or Broker Non-Votes for a director-nominee will have no effect. With respect to any matters submitted to the shareholders for their consideration other than the election of directors, abstentions will be counted as shares present and entitled to vote on such proposals in determining whether the proposals have received the requisite number of favorable votes, but Broker Non-Votes will not be counted as shares present and entitled to vote on such proposals. Thus, abstentions will have the same effect as votes against any such proposal, but Broker Non-Votes will have no effect in determining whether any such proposal has been approved by the shareholders. Therefore, it is important that you complete and return your proxy early so that your vote may be recorded.

Votes cast by proxy or in person at the Annual Meeting will be tabulated by the inspectors of election appointed for the Annual Meeting, who also will determine whether a quorum is present.

## 1. PROPOSAL TO ELECT DIRECTORS

The Board of Directors of the Company (the Board or the Board of Directors ) currently consists of nine persons. The Board of Directors has nominated the nine persons listed below to be elected as directors at the Annual Meeting. Each director elected at the Annual Meeting will serve, subject to the provisions of the Company s bylaws, until the next annual meeting of shareholders and until his or her successor is duly elected and qualified. The names and ages of the nominees proposed for election as directors, all of whom are presently directors of the Company, together with certain information concerning the nominees, are set forth below.

***THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR THE ELECTION AS DIRECTORS OF EACH OF THE NOMINEES LISTED BELOW.***

### Nominees For Director

**EDWARD L. KUNTZ** (61) has served as the Executive Chairman of the Board of Directors since January 2004. He served as the Company s Chairman of the Board and Chief Executive Officer from January 1999 to December 31, 2003. He served as President of the Company from November 1998 until January 2002. He also served as Chief Operating Officer and a director of the Company from November 1998 to January 1999. Mr. Kuntz is a director of Rotech Healthcare, Inc., a provider of home medical equipment and related products and services.

**ANN C. BERZIN** (54) has served as a director of the Company since November 2006. Ms. Berzin is a private investor who previously served as Chairman and Chief Executive Officer of Financial Guaranty Insurance Company, a subsidiary of General Electric Capital Corporation, from 1992 to 2001. Ms. Berzin is a director of Ingersoll-Rand Company, a worldwide climate control, industrial solutions, infrastructure development and security products company. (1)

**THOMAS P. COOPER, M.D.** (62) has served as a director of the Company since May 2003. Dr. Cooper is the founder and Chairman of Vericare, Inc., a provider of mental health services to patients in long-term care facilities, since 1991. Dr. Cooper also is an adjunct professor at the Columbia University School of Business. From November 2000 to December 2001, Dr. Cooper was the Chief Executive Officer of Oncall Healthcare, Inc., a start-up venture that provided nurse triage services. Dr. Cooper is a director of Hanger Orthopedic Group, Inc., the largest operator of orthotic and prosthetic patient care centers in the United States. (2)(3)

**PAUL J. DIAZ** (45) has served as a director of the Company since May 2002, as Chief Executive Officer of the Company since January 1, 2004 and as President of the Company since January 2002. He served as the Chief Operating Officer of the Company from January 2002 to December 31, 2003. Prior to joining the

Company, he served as the managing member of Falcon Capital Partners, LLC, a private investment and consulting firm specializing in healthcare restructurings, and as Chairman and Chief Executive Officer of Capella Senior Living, LLC, a start-up venture to provide long-term healthcare services.

**MICHAEL J. EMBLER** (42) has served as a director of the Company since July 2001. Since July 2001, Mr. Embler has served as an officer of Franklin Mutual Advisers, LLC, an investment advisory firm. Mr. Embler is a director of AboveNet, Inc., a telecommunication services company. (2)(3)(4)

**GARRY N. GARRISON** (60) has served as a director of the Company since April 2001. From 1997 to 2000, Mr. Garrison served as Senior Vice President of Dynamic Healthcare Solutions, Inc., a venture capital firm specializing in high-growth, health related businesses. (2)(3)

**ISAAC KAUFMAN** (59), a certified public accountant, has served as a director of the Company since April 2001. Since September 1998, Mr. Kaufman has served as the Senior Vice President and Chief Financial Officer of Advanced Medical Management Inc., a manager of medical practices and an outpatient surgical center. Mr. Kaufman is a director of TransWorld Entertainment Corporation, a leading specialty retailer of music and video products, and Hanger Orthopedic Group, Inc., the largest operator of orthotic and prosthetic patient care centers in the United States. (1)(4)

**JOHN H. KLEIN** (60) has served as a director of the Company since April 2001. Mr. Klein has served as Chairman and Chief Executive Officer of DAVA Pharmaceuticals, Inc., a generic pharmaceutical company, since March 2004. He also has served as Chairman and Managing Director of Aston Partners, a private equity fund, since 2001. He has been the Chairman and Chief Executive Officer of Strategic Business and Technology Solutions, LLC, a strategic business and technology advisory firm, since June 1998. Mr. Klein also has served as the Chairman and Chief Executive Officer of BI Logix, Inc., a business intelligence software solutions company, since May 1998. In addition, he has served as Chairman and Chief Executive Officer of DentalLine.com, a group benefit and internet company, since July 1999. (1)(2)(4)(5)

**EDDY J. ROGERS, JR.** (66) has served as a director of the Company since August 2003. Mr. Rogers has been a partner with the law firm of Andrews Kurth LLP since October 2001. Mr. Rogers was a partner with Mayor, Day, Caldwell & Keeton, L.L.P., a law firm that merged with Andrews Kurth. (1)(4)

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(1) Member of the Audit Committee, of which Mr. Kaufman is Chairman.
(2) Member of the Executive Compensation Committee, of which Mr. Klein is Chairman.
(3) Member of the Compliance and Quality Committee, of which Dr. Cooper is Chairman.
(4) Member of the Nominating and Governance Committee, of which Mr. Klein is Chairman.
(5) Mr. Klein serves as the lead independent director for the Board of Directors.

The information contained in this proxy statement concerning the nominees is based upon statements made or confirmed to the Company by or on behalf of such nominees, except to the extent certain information appears in its records. Directors ages are given as of January 1, 2007.

**SHARES OF COMMON STOCK OF THE COMPANY REPRESENTED BY PROXIES EXECUTED AND RECEIVED IN THE ACCOMPANYING FORM WILL BE VOTED FOR THE ELECTION AS DIRECTORS OF ALL OF THE NOMINEES, UNLESS OTHERWISE SPECIFIED ON THE PROXY.** The Board of Directors does not contemplate that any of the nominees will be unable to serve as a director. However, in the event that one or more nominees are unable or unwilling to accept or are unavailable to serve, the persons named in the proxies or their substitutes will have the authority, according to their judgment, to vote or refrain from voting for other individuals as directors.

**CERTAIN INFORMATION CONCERNING THE BOARD OF DIRECTORS**

The Board of Directors has determined that the following seven directors are independent, as defined under the listing standards of the New York Stock Exchange ( NYSE ): Ms. Ann C. Berzin, Thomas P. Cooper, M.D., Mr. Michael J. Embler, Mr. Garry N. Garrison, Mr. Isaac Kaufman, Mr. John H. Klein and Mr. Eddy J. Rogers, Jr. These independent directors have regularly scheduled meetings at which members of management are not present. Mr. Klein presides as chairman of these meetings in his capacity as the Company s lead independent director.

The Board s independence determination was based on a review in which each director s independence was evaluated on a case-by-case basis. In performing the independence evaluations, the Board considers any matters that could affect the ability of each outside director to exercise independent judgment in discharging his or her responsibilities as a director, including all transactions and relationships between each such director, the director s family members and organizations with which the director or the director s family members have an affiliation and the Company, its subsidiaries and its management. Any such matters are evaluated both from the standpoint of the director and from that of persons or organizations with which the director has an affiliation. In addition, the Board also considers any other transactions, relationships or arrangements that could affect director independence. For 2006, the Board identified no such matters, transactions, relationships or arrangements.

During 2006, the Board of Directors held fifteen meetings, including six regular and nine special meetings. The independent members of the Board held four of the nine special meetings of the Board during 2006. All independent directors attended these meetings, which were called to review and discuss the proposed spin-off of the Company s institutional pharmacy business, Kindred Pharmacy Services, and its simultaneous merger with AmerisourceBergen Corporation s institutional pharmacy business, PharMerica Long-Term Care, to form a new, independent, publicly traded company ( NewCo ). Each director attended more than 75% of the total number of meetings of the Board and the applicable committees during the periods on which each served.

The Board of Directors has established an Audit Committee, a Compliance and Quality Committee, an Executive Compensation Committee, and a Nominating and Governance Committee. Each committee has a written charter which is available on the Company s website at *www.kindredhealthcare.com*. The Company s Corporate Governance Guidelines also are available on the Company s website at *www.kindredhealthcare.com*. Information on the Company s website is not part of this proxy statement. Shareholders may request a copy of the charters or the Corporate Governance Guidelines by contacting the Company, care of the Corporate Secretary, at the Company s principal office.

*Audit Committee.* The Audit Committee has four members consisting of Mr. Isaac Kaufman (Chairman), Ms. Ann C. Berzin, Mr. John H. Klein and Mr. Eddy J. Rogers, Jr. Each member of the Audit Committee is independent as defined under the listing standards of the NYSE. The Board of Directors has determined that Mr. Kaufman is the Audit Committee s financial expert as defined in Item 407 of Regulation S-K promulgated under the Securities Act of 1933, as amended (the Securities Act ), and the Securities Exchange Act of 1934, as amended (the Exchange Act ). The Audit Committee held eight meetings during 2006. The Audit Committee assists the Board of Directors in monitoring (1) the adequacy of the Company s system of internal controls, accounting policies, financial reporting practices, and the quality and integrity of the Company s financial reporting; (2) the independent auditor s qualifications and independence; and (3) the performance of the Company s internal audit function and independent auditor.

*Compliance and Quality Committee*. The Compliance and Quality Committee has three members consisting of Thomas P. Cooper, M.D. (Chairman), Mr. Michael J. Embler and Mr. Garry N. Garrison. Each member of the Compliance and Quality Committee is independent as defined under the listing standards of the NYSE. The Compliance and Quality Committee held four meetings in 2006. The Compliance and Quality Committee assists the Board of Directors in monitoring (1) the Company s compliance with applicable laws, regulations and policies; (2) the Company s compliance with its Code of Conduct; and (3) the Company s programs, policies and procedures that support and enhance the quality of care provided by the Company.

*Executive Compensation Committee.* The Executive Compensation Committee has four members consisting of Mr. John H. Klein (Chairman), Thomas P. Cooper, M.D., Mr. Michael J. Embler and Mr. Garry N. Garrison. Each member of the Executive Compensation Committee is independent as defined under the listing standards of the NYSE, and qualifies as an outside director within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended (the Code ), and a non-employee director within the meaning of Rule 16b-3 under the Exchange Act. The Executive Compensation Committee held six meetings in 2006. The Executive Compensation Committee assists the Board of Directors in fulfilling its responsibility to the shareholders, potential shareholders and the investment community by ensuring that the Company s key executives, officers and Board members are compensated in accordance with the Company s overall compensation program and executive compensation policies. The Executive Compensation Committee recommends and approves compensation policies, programs and pay levels that are necessary to support the Company s objectives and that are rational and reasonable to the value of the services rendered. The Executive Compensation Committee also reviews and discusses with management the Compensation Discussion and Analysis prepared for inclusion in our Annual Report on Form 10-K and this proxy statement and, based on such review, determines whether to recommend to the Board that the Compensation Discussion and Analysis be included in the Annual Report and the proxy statement. Furthermore, the Executive Compensation Committee prepares the Report of the Executive Compensation Committee that begins on page 34 of this proxy statement.

The Executive Compensation Committee s processes and procedures for the consideration and determination of executive compensation, including the role of our Chief Executive Officer in making recommendations to the Executive Compensation Committee and the role of compensation consultants in assisting the Executive Compensation Committee in its functions, are more fully described in the Compensation Discussion and Analysis section that begins on page 11 of this proxy statement.

*Nominating and Governance Committee.* The Nominating and Governance Committee has four members consisting of Mr. John H. Klein (Chairman), Mr. Michael J. Embler, Mr. Isaac Kaufman and Mr. Eddy J. Rogers, Jr. Each member of the Nominating and Governance Committee is independent as defined under the listing standards of the NYSE. The Nominating and Governance Committee held five meetings in 2006. The Nominating and Governance Committee assists the Board of Directors by (1) identifying individuals qualified to become Board members, approving the director nominees for the next annual meeting of shareholders and approving nominees to fill vacancies on the Board; (2) recommending to the Board nominees for director and chairperson(s) for each committee; (3) leading the Board in its annual review of the Board s performance; and (4) recommending to the Board the corporate governance guidelines applicable to the Company.

It is the policy of the Nominating and Governance Committee to consider director candidates recommended by shareholders who appear to be qualified to serve on the Company s Board of Directors. The Committee has not established any specific qualifications for directors. The Nominating and Governance Committee may choose not to consider an unsolicited recommendation if no vacancy exists on the Board of Directors. The Nominating and Governance Committee may recommend increasing the size of the Board of Directors if it perceives specialized needs for the Board of Directors and if qualified director candidates are identified. In order to avoid the unnecessary use of the Nominating and Governance Committee s resources, the Nominating and Governance Committee will consider only those director candidates recommended in accordance with the procedures set forth below. There have been no material changes to the procedures by which shareholders may recommend director candidates since the Company last disclosed such procedures.

To submit a recommendation of a director candidate to the Nominating and Governance Committee, a shareholder should submit the following information in writing, addressed to the Chairman of the Nominating and Governance Committee, care of the Corporate Secretary, at the Company s principal office:

1. The name of the person recommended as a director candidate;

2. All information relating to such person that is required to be disclosed in solicitations of proxies for election of directors pursuant to Regulation 14A under the Exchange Act;

3. The written consent of the person being recommended as a director candidate to being named in the proxy statement as a nominee and to serving as a director if elected;

4. As to the shareholder making the recommendation, the name and address, as they appear on the Company s records, of such shareholder; provided, however, that if the shareholder is not a registered holder of the Company s Common Stock, the shareholder should submit his or her name and address along with a current written statement from the record holder of the shares that reflects ownership of the Company s Common Stock, and the number and class of all shares of each class of stock of the Company owned of record or beneficially by such holder; and

5. A statement disclosing whether such shareholder is acting with or on behalf of any other person and, if applicable, the identity of such person.

In order for a director candidate to be considered for nomination at the Company s annual meeting of shareholders to be held in 2008, the recommendation must be received in accordance with the requirements for other shareholder proposals. See Shareholder Proposals and Director Nominations.

The Nominating and Governance Committee has generally identified director nominees based upon suggestions by outside directors, members of management and/or shareholders, and has interviewed and evaluated those persons on its own. On occasion, the Company employs outside search firms to identify and screen potential director candidates. Ms. Berzin, who was appointed to the Board of Directors on November 6, 2006, was originally identified for her position by one such outside search firm. The Company seeks directors who possess integrity, a high level of education and business experience, broad-based business acumen, an understanding of the Company s business and the healthcare industry generally, strategic thinking and a willingness to share ideas, a network of contacts and diversity of experiences, expertise and background. The Nominating and Governance Committee uses these criteria to evaluate potential nominees, and does not evaluate proposed nominees differently depending upon who has made the proposal.

*Attendance at the Annual Meeting.* The Board of Directors does not require directors to attend the annual meeting of shareholders. Mr. Kuntz, Mr. Diaz and Dr. Cooper attended the 2006 annual meeting of shareholders.

**CODE OF ETHICS AND RELATED PERSON TRANSACTIONS**

The Company has adopted a Code of Conduct that serves as its code of ethics and applies to all of the Company s directors and employees, including the principal executive officer, principal financial officer, principal accounting officer, and certain other persons performing similar functions. The text of the Company s Code of Conduct is posted on the Company s website located at *www.kindredhealthcare.com* under the Investor Information section and is available in print to any requesting shareholder. In addition, the Company intends to disclose on its website (1) the nature of any amendment to a provision of the Code of Conduct that applies to the Company s principal executive officer, principal financial officer, principal accounting officer, or persons performing similar functions and (2) the nature of any waiver, including an implied waiver, from provisions of the Code of Conduct that is granted to one of these specified individuals, the name of the person to whom the waiver was granted and the date of the waiver. Such disclosure will be made within four business days following the date of the applicable amendment or waiver. Information contained on the Company s website is not part of this proxy statement.

The Company s Code of Conduct generally prohibits the Company s directors, executive officers and employees from engaging in activities that conflict with the interests of the Company and the residents and patients served by the Company. Unless otherwise approved in accordance with the requirements of the Code of Conduct, the Company s directors, executive officers and employees are prohibited, among other things, from (1) having a direct or indirect financial or business interest in any entity that does business with the Company, (2) having a direct or indirect financial or business interest in any transaction between the Company and a third party, and (3) serving as a director, officer, employee or consultant of an organization that does business with the Company. In connection with the proposed transaction to create NewCo, Mr. Kuntz and Mr. Diaz have been requested to serve on the NewCo board of directors. The independent directors of the Board reviewed the applicable standards under the Company s Code of Conduct with respect to such service and authorized Mr. Kuntz and Mr. Diaz to become directors of NewCo.

To facilitate compliance with these prohibitions, the Code of Conduct requires that individuals report to their supervisors, or to the Board in the case of directors and executive officers, circumstances that may create or appear to create a conflict between the personal interests of the individual and the interests of the Company, regardless of the amount involved. In addition, each director and executive officer annually confirms to the Company certain information about related person transactions as part of the preparation of the Company s Annual Report on Form 10-K and its annual proxy statement. Director nominees and persons promoted to executive officer positions also must confirm such information. In addition, management reviews its records and makes additional inquiries of management personnel and, as appropriate, third parties and other resources for purposes of identifying related person transactions, including related person transactions involving beneficial owners of more than 5% of the Company s voting securities.

In accordance with the charter for the Audit Committee of the Board of Directors, the Audit Committee evaluates each related person transaction involving a director or executive officer for the purpose of determining whether to recommend to the disinterested members of the Board that the transactions are fair, reasonable and within Company policy, and whether they should be ratified and approved by the Board. The Audit Committee considers each related person transaction in light of all relevant factors and the controls implemented to protect the interests of the Company and its shareholders.

Relevant factors include:

- the benefits of the transaction to the Company;
- the terms of the transaction and whether the terms have been negotiated at arm s-length and in the ordinary course of the Company s business;
- the direct or indirect nature of the related person s interest in the transaction;

the amount involved and the expected term of the transaction; and

other facts and circumstances that bear on the materiality of the related person transaction under applicable law and listing standards. Approval by the Company s Board of Directors of any related person transaction involving a director also must be made in accordance with applicable law and the Company s organizational documents as from time to time in effect. When a vote of the disinterested directors is required, such vote is called only following full disclosure to such directors of the facts and circumstances of the relevant related person transaction.

Transactions that are not approved or ratified as required by the Code of Conduct are subject to termination by the Company, if so directed by an employee s supervisor, the Audit Committee or the Board of Directors, as applicable, taking into account such factors as such individual or body deems appropriate and relevant.

**SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The following table sets forth certain information regarding beneficial ownership of Common Stock as of January 1, 2007 (except as otherwise noted), by (1) each shareholder known by the Company to be the beneficial owner of more than 5% of its outstanding shares of Common Stock, (2) each person who is a director or nominee for director, (3) each of the Company s Named Executive Officers (as defined herein), and (4) all of the persons who are directors and executive officers of the Company, as a group.

| Name of Beneficial Owner | Amount and Nature of Beneficial Ownership (1) | Percent of Class (1) |
|---|---|---|
| **Directors, Nominees and Named Executive Officers** | | |
| Edward L. Kuntz | 290,983 | * |
| Paul J. Diaz | 943,250 | 2.3% |
| Ann C. Berzin | | * |
| Thomas P. Cooper, M.D. | 18,250 | * |
| Michael J. Embler (2) | 7,599,584 | 19.0% |
| Garry N. Garrison | 40,250 | * |
| Isaac Kaufman | 40,250 | * |
| John H. Klein | 40,250 | * |
| Eddy J. Rogers, Jr. | 23,250 | * |
| Richard A. Lechleiter | 208,771 | * |
| Frank J. Battafarano | 189,375 | * |
| Richard E. Chapman | 135,006 | * |
| **All Directors and Executive Officers as a Group** (19 persons) | 10,026,549 | 24.2% |
| **Other Security Holders with More than 5% Ownership** | | |
| Franklin Mutual Advisers, LLC (2)(3) | 7,599,584 | 19.0% |
| Dimensional Fund Advisors LP (4) | 2,798,503 | 7.0% |

* Denotes less than 1%.

(1) Includes shares subject to options which are exercisable within 60 days from January 1, 2007. The number of shares of Common Stock that may be acquired through exercise of options, which are exercisable as of, or within 60 days after, January 1, 2007, are as follows: Mr. Kuntz 143,587 shares; Mr. Diaz 557,244 shares; Dr. Cooper 18,250 shares; Mr. Embler 40,250 shares; Mr. Garrison 40,250 shares; Mr. Kaufman 40,250 shares; Mr. Klein 40,250 shares; Mr. Rogers 23,250 shares; Mr. Lechleiter 126,172 shares; Mr. Battafarano 87,544 shares; and Mr. Chapman 71,381 shares. Unless otherwise noted, the Company believes that all persons named in the table have sole voting and investment power with respect to all shares of Common Stock beneficially owned by them. The total for Mr. Battafarano includes 50 shares held jointly with his mother.

(2) Mr. Embler disclaims beneficial ownership of the securities held by Franklin Mutual Advisers, LLC ( FMA ). In addition, Mr. Embler disclaims beneficial ownership of shares underlying options issued by the Company to Mr. Embler. Mr. Embler is an officer of FMA and serves on the Board at the request of FMA. In accordance with FMA s internal policy, all cash and non-cash compensation issued to Mr. Embler in connection with his service on the Board of Directors has or will be distributed directly to the advisory clients of FMA. See note 3 below.

(3) FMA has advised the Company that advisory clients of FMA own the referenced shares. FMA has indicated that the Common Stock is beneficially owned by one or more open-end investment companies or other management accounts of FMA. Under its advisory contracts, FMA has sole voting and investment power over these securities owned by its clients which FMA manages. Michael J. Embler is an officer of FMA.

Mr. Embler and FMA disclaim beneficial ownership of the shares held by FMA. See note 2 above. The address of FMA is 101 John F. Kennedy Parkway, Short Hills, New Jersey 07078.

(4) Based on a Schedule 13G/A filed by Dimensional Fund Advisors LP ( Dimensional ) dated December 31, 2006 with the Securities and Exchange Commission (the SEC ). According to the Schedule 13G/A, Dimensional furnishes investment advice to four investment companies and serves as investment manager to certain other commingled group trusts and separate accounts (collectively, the Funds ). According to the Schedule 13G/A, Dimensional, in its role as investment advisor or manager, possesses investment and/or voting power over these shares that are owned by the Funds. Dimensional disclaims beneficial ownership of these shares. The address of Dimensional is 1299 Ocean Avenue, Santa Monica, California 90401.

**SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

Section 16(a) of the Exchange Act requires the Company s directors and executive officers and persons who own more than 10% of the Common Stock to file initial stock ownership reports and reports of changes in ownership with the SEC. Based on a review of these reports and on written representations from the reporting persons that no other reports were required, the Company believes that the applicable Section 16(a) reporting requirements were complied with for all transactions which occurred in 2006.

## COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS

## COMPENSATION DISCUSSION AND ANALYSIS

**Overview**

The Company s executive compensation program is designed to (1) motivate and retain executive officers, (2) award the achievement of short-term and long-term performance goals, (3) establish an appropriate relationship between executive pay and short-term and long-term performance and (4) align executive officers interests with those of the Company s shareholders. The primary elements of the Company s compensation program are base salary, annual cash incentive awards, long-term cash incentive awards and equity-based compensation. The Company believes that each element supports one or more of the objectives of the Company s compensation program and provides sufficient flexibility to the Executive Compensation Committee (the Committee ) to structure future awards to address new issues and challenges facing the Company. The Company s executive compensation program attempts to target total direct compensation for the Named Executive Officers (as defined herein) between the $50^{th}$ and $75^{th}$ percentiles of the healthcare industry, depending upon the individual performance of the Named Executive Officer, his level of responsibility, and the performance of the Company. The Company believes that this range of compensation allows it to attract and retain qualified and experienced healthcare executives.

**Performance Measures**

The primary elements of the Company s executive compensation program are designed to promote the achievement of financial and quality goals established by the Committee and to increase shareholder value. The Company uses two cash incentive plans, an annual short-term incentive plan and a long-term incentive plan. These plans provide certain of the Named Executive Officers with the opportunity to earn cash awards for achieving the following financial goals and measures: (1) targeted levels of earnings before interest, income taxes, depreciation, amortization, rent and management fees ( EBITDARM ), (2) collecting accounts receivable, (3) achieving patient admission and census goals, (4) controlling costs and improving operating efficiencies, and (5) achieving targeted levels of earnings per share. The Company believes that several of these financial goals are measures generally used by investors to value the Company s Common Stock.

As a healthcare provider, the Company also focuses a substantial portion of its short-term incentive awards on achieving measurable quality and customer service goals. These goals include: (1) operational and clinical measures of quality care, (2) customer satisfaction measures obtained from customer satisfaction surveys, and (3) employee retention. The Company believes that measurable quality and customer service goals are critical to promoting a culture of quality throughout the entire Company and enhancing the services and products offered by the Company. Moreover, the Company believes that there is a direct link between providing quality services and achieving favorable financial results.

The equity-based component of the Company s executive compensation program is designed to incentivize the Named Executive Officers to increase the value of the Company s Common Stock. As such, equity-based compensation directly links the total direct compensation of the Named Executive Officers to increases in stock price appreciation and shareholder value.

**The Executive Compensation Process**

The Committee is comprised of four directors, each of whom is independent as defined under the NYSE listing standards and qualifies as an outside director within the meaning of Section 162(m) of the Code and a non-employee director within the meaning of Rule 16b-3 under the Exchange Act. The Committee meets on a regular basis to review and oversee the Company s executive compensation program. The Committee makes all compensation decisions regarding the Named Executive Officers. Between December and February of each year, the Committee reviews base salaries and incentive compensation targets for the Company s key employees, including the Named Executive Officers, for the upcoming fiscal year. At this time, the Committee also determines whether performance targets under each of the cash incentive plans were achieved for the prior fiscal year. During 2006, the Committee awarded equity-based awards during this time period in order to better align the performance of the Company with the total direct compensation established for the Named Executive Officers.

The 2006 base salaries for the Named Executive Officers were established in December 2005. The 2006 performance targets under the Company s short-term and long-term cash incentive plans were established in February 2006. As discussed below, the awards under these plans are formulaic, based upon the achievement of measurable financial and quality goals established by the Committee. Nevertheless, the Committee retains the discretion to increase or decrease cash incentive awards for unforeseen events or circumstances, including restatements to the Company s financial statements.

The Committee generally grants equity-based awards to the Named Executive Officers each February to coincide with the Committee s evaluation of the performance of the Company and the Named Executive Officers. Considering equity-based awards at this time allows the Committee to consider the cash incentive awards being made to the Named Executive Officers for the prior year s performance. From time to time, the Committee may grant equity-based awards at other times, particularly in connection with promotions, exceptional performance or changes in a Named Executive Officer s level of responsibility.

During 2006, the Company engaged Mercer Human Resources Consulting ( Mercer ), a global human resources consulting firm, to assist management and the Committee in evaluating the Company s executive compensation program. Mercer assisted the Company by reviewing the Company s executive compensation strategy and providing compensation benchmarks to the Committee for each Named Executive Officer, including comparisons of base salary, cash incentives and equity-based compensation. Mercer also provided the Committee with other relevant market data and alternatives to consider when making compensation decisions for the Named Executive Officers. The Company also uses Mercer for various other employee benefit matters.

In addition, the Committee engaged Towers, Perrin, Forster & Crosby, Inc. ( Towers Perrin ), a global human resources consulting firm, to advise the Committee with respect to the Company s executive compensation program and in connection with setting compensation for the Named Executive Officers. Towers Perrin has been engaged directly by the Committee as an independent advisor. Towers Perrin provides no other services to the Committee or the Company.

During 2006, the Committee compared each element of compensation for the Named Executive Officers against a peer group of companies in the healthcare industry. For 2006, the Company used the following companies for compensation benchmarking purposes: Triad Hospitals, Inc., Universal Health Services, Inc., Community Health Systems, Inc., Health Management Associates, Inc., Manor Care, Inc., Healthsouth Corporation, Lifepoint Hospitals, Inc. and Genesis Healthcare Corporation. This peer group is periodically reviewed and updated by the Committee based upon recommendations from Mercer. The Committee believes these peer companies compete for executives with similar talents and expertise to those of the Named Executive Officers and also reflect the diversified nature of the Company s businesses.

In December 2006, the Committee began its annual executive compensation review process. At this time, the Committee established base salaries for the Named Executive Officers for 2007. Generally, the increases provided to the Named Executive Officers were consistent with prior years. Mr. Diaz s base salary was increased effective January 1, 2007 to $950,000. The Committee increased his salary by approximately 12% to move his base salary closer to the market median of the peer group. In February 2007, the Committee determined which performance targets were achieved in 2006 by the Named Executive Officers under the short-term incentive plan and the long-term incentive plan. In addition, the Committee considered and approved changes to the employment agreement for Mr. Kuntz. The Committee increased Mr. Kuntz s annual base salary to $855,000 and awarded him 11,000 shares of restricted stock. These shares will vest in three equal annual installments beginning on the first anniversary of the date of grant. The Committee also revised the terms of Mr. Kuntz s employment agreement to provide for the possibility of certain retirement benefits once he becomes 65 years of age. Upon reaching age 65, Mr. Kuntz may retire as Executive Chairman at his election or at the request of the

Board. Upon retirement, Mr. Kuntz would be entitled to continued coverage under the Company s health insurance plans and would be provided substantially similar office space and the services of an administrative assistant for a three-year period. In addition, all outstanding equity awards held by Mr. Kuntz would become fully vested and he would have one additional year from his date of retirement to exercise all outstanding stock options.

**Components of Executive Compensation**

The Company s executive compensation program uses the following elements to structure the total direct compensation for the Named Executive Officers:

- base salary;
- annual cash incentives;
- long-term cash incentives;
- equity-based incentive compensation; and
- retirement and other perquisites and benefits.

The Company believes that the combination of these elements enables the Committee to award competitive total direct compensation between the $50^{th}$ and $75^{th}$ percentiles in the healthcare industry.

The Committee does not have a pre-established policy for the allocation between fixed compensation, such as base salary, and variable or at risk compensation, such as short-term and long-term cash incentives and equity. However, the Committee places a significant portion of total direct compensation for the Named Executive Officers at risk. At risk compensation under the Company s cash incentive plans incentivizes the Named Executive Officers to reach or exceed desired financial and quality goals. Moreover, at risk compensation under the Company s equity incentive plans incentivizes the Named Executive Officers since the full benefit of equity-based compensation cannot be realized unless the Named Executive Officers are able to grow the value of the Common Stock over several years.

The Committee generally structures base salaries to be at or below the $50^{th}$ percentile of the healthcare industry because it believes a greater portion of total direct compensation should be subject to the attainment of performance goals. The Company s annual short-term and long-term incentive plans provide certain of the Named Executive Officers with the ability to achieve significant additional cash compensation, typically above the median level of the peer group for such awards. As discussed below, Mr. Kuntz does not participate in the Company s annual short-term and long-term incentive plans. The Named Executive Officers are generally awarded equity-based compensation below the median level of the peer group. The Committee considers the amount of total cash compensation earned by the Named Executive Officers in determining the amount of the equity-based compensation.

**Base Salary**

Base salaries are provided to the Named Executive Officers to compensate them for their services performed during the year. The base salary for each Named Executive Officer is determined annually by the Committee following a review of each individual executive officer s performance, changes in executive officer responsibility, relevant comparable industry data, an assessment of overall Company performance, and general market salary increases for all employees. As noted above, the Committee generally structures base salaries to be at or below the $50^{th}$ percentile of its peer group. Salary adjustments also may be considered in connection with promotions or other changes in job responsibility. As part of its analysis, the Committee considers salary comparisons prepared by Mercer to determine if base salaries for the Named Executive Officers are competitive with similarly situated executives in the peer group and the healthcare industry generally. The Chief Executive Officer also makes recommendations on base salaries for the other Named Executive Officers.

For 2006, the base salaries of the Named Executive Officers were increased from the prior year by the following percentages: Mr. Diaz 2.5%; Mr. Lechleiter 10.7%; Mr. Kuntz 2.5%; Mr. Battafarano 12.4%; and Mr. Chapman 2.5%. The increase provided to Mr. Lechleiter was primarily based on his 2005 performance and the Committee s desire to move his base salary closer to the market median of the peer group. The increase for Mr. Battafarano was based on his significant contributions in growing and managing the Company s hospital division and the strong performance of that division over the last few years. The increases for the other Named Executive Officers reflect standard cost of living adjustments.

While certain aspects of performance of the Named Executive Officers can be measured in financial and quality metrics, the Committee also evaluates the Named Executive Officers in other performance areas that are more subjective. These areas include the success of the Named Executive Officer in developing and executing the Company s strategic objectives, capitalizing on growth opportunities, addressing significant challenges affecting the Company, developing key employees and exercising leadership.

**Cash Incentives**

Under the Company s executive compensation program, a significant portion of total cash compensation for the Named Executive Officers is subject to the attainment of measurable financial and quality goals. This approach creates a direct incentive for the Named Executive Officers to achieve pre-established performance objectives and places a significant percentage of each Named Executive Officer s total direct compensation at risk. The Company s cash incentive plans also provide sufficient flexibility to allow the Committee to establish non-routine goals that may be integral to the success of the Company over the short-term or long-term. Given the nature of his employment responsibilities and the unique role he plays in the Company, Mr. Kuntz does not participate in the Company s cash incentive plans. See Employment and Other Agreements for a discussion of Mr. Kuntz s areas of responsibility.

The Company maintains both an annual short-term incentive plan and a long-term incentive plan. Under the short-term incentive plan, the Committee establishes annual financial and quality goals for the Company s key employees, including the Named Executive Officers. For 2006, the financial objectives for the participating Named Executive Officers were based upon: (1) achieving targeted levels of EBITDARM, (2) collecting accounts receivable, (3) achieving patient admission and census goals, (4) controlling costs and operating efficiencies, and (5) achieving targeted levels of earnings per share. The quality goals under the short-term incentive plan for 2006 included: (1) operational and clinical measures of quality care, (2) customer satisfaction measures obtained from customer satisfaction surveys, and (3) employee retention. The Committee links a percentage of the total potential cash award to each of the individual financial and quality goals. For 2006, the financial goals comprised between 60% to 70% of the targeted awards and the quality goals comprised between 30% to 40% of the targeted awards for the Named Executive Officers. These financial and quality goals vary based upon the operational responsibilities of the Named Executive Officer and are tailored for the operating division to which the Named Executive Officer is assigned.

Annual cash bonuses under the short-term incentive plan are based upon a percentage of the participating Named Executive Officer s base salary. No awards are granted under the short-term incentive plan until certain minimum levels of performance are achieved. The minimum awards available for 2006 for the participating Named Executive Officers was 24% of their respective base salaries. Target awards for the participating Named Executive Officers under the short-term incentive plan for 2006 were 60% of their respective base salaries. The short-term incentive plan also provides additional compensation above the target award level for performance exceeding the target goals. The maximum awards available for 2006 for the participating Named Executive Officers were 75% of their respective base salaries. Over the past five years, the participating Named Executive Officers have achieved an average award under the short-term incentive plan between the target and maximum goals. Generally, the Committee attempts to set target goals that are reasonable and attainable by the Named Executive Officers assuming good performance.

Based upon the financial and quality goals achieved in 2006, the Committee made annual cash awards to the following Named Executive Officers equal to the following percentages of their base salaries under the short- term incentive plan: Mr. Diaz 69%; Mr. Lechleiter 69%; Mr. Battafarano 58%; and Mr. Chapman 69%.

The Company s long-term incentive plan provides cash awards to the Company s key employees, including certain of the Named Executive Officers, upon the attainment of specified performance objectives. For 2006, the performance period under the long-term incentive plan covered one year. For each performance period, the Committee selects participants who are in a position to contribute materially to the success of the Company and establishes the performance goal or goals to be measured under the plan. For 2006, one-half of the potential award was based upon achieving various levels of earnings before interest, income taxes, depreciation, amortization and rent (the EBITDAR goal ). The other one-half of the potential award was based upon the Company achieving various levels of earnings per share (the EPS goal ). These goals were the same for each participating Named Executive Officer.

Under the long-term incentive plan, participants are eligible to receive cash awards based upon a percentage of their base salary. These percentages vary depending upon the participant s position within the Company and the extent to which the performance goals established by the Committee are attained. No awards are granted under the long-term incentive plan until certain minimum levels of performance are achieved. The minimum potential awards for 2006 under the long-term incentive plan were 10% of the base salary of the Chief Executive Officer and 9% of the base salary for the other participating Named Executive Officers. Target awards for 2006 under the long-term incentive plan were 50% of the base salary of the Chief Executive Officer and 45% of the base salary of the other participating Named Executive Officers. The maximum potential awards for 2006 under the long-term incentive plan were 100% of the base salary of the Chief Executive Officer and 90% of the base salary for the other participating Named Executive Officers. Over the past five years, the Company has achieved an average award under the long-term incentive plan between the target and maximum goals. Generally, the Committee attempts to set target goals that are reasonable and attainable by the participating Named Executive Officers assuming good performance.

Cash awards under the long-term incentive plan are payable in three equal annual installments on or about each of the first, second, and third anniversaries of the end of the relevant performance period, provided generally that the participant is employed by the Company at the time payments are due. This delayed payment feature serves as a significant retention vehicle for the Company.

Based upon the goals established by the Committee for the 2006 performance period, the Named Executive Officers achieved the maximum EBITDAR goal and EPS goal. As a result, the 2006 awards under the long-term incentive plan were 100% of the base salary for the Chief Executive Officer and 90% of the base salaries for the other participating Named Executive Officers. The 2006 awards will be paid in three equal annual installments commencing on or about December 14, 2007.

**Equity-Based Compensation**

The Company uses equity-based compensation as a key component of its overall executive compensation strategy. Such awards provide a direct and long-term link between the results achieved for the Company s shareholders and the total direct compensation provided to the Named Executive Officers. Stock-based compensation is designed to retain the Named Executive Officers through time-based vesting conditions and to motivate them to enhance the value of the Common Stock by aligning the financial interests of the Named Executive Officers with those of the Company s shareholders. Equity-based compensation also provides an effective incentive for management to create shareholder value over several years since the full benefit of this element of compensation is primarily realized as a result of the appreciation in the price of the Common Stock.

The Company does not currently have a security ownership policy for its Named Executive Officers. However, the Committee may consider adopting a formal security ownership policy for its Named Executive Officers following the completion of the proposed spin-off of its pharmacy division. The Committee generally does not take into consideration equity awards granted in previous years when evaluating awards for the current year.

Consistent with prior years, the Committee awarded both stock options and restricted stock in 2006. When evaluating equity-based compensation, the Committee considers the accounting costs associated with the form of equity award and believes that the current mixture of equity awards between stock options and restricted stock is an appropriate method to achieve the Company s compensation strategies in relation to the total cost to the Company and is consistent with the equity allocation trends of the peer group. The Committee believes that stock options and restricted stock provide incentives to the Named Executive Officers to grow the Company s stock price since the full benefit of these awards cannot be achieved unless the value of the Common Stock increases. In addition, the Committee uses stock options, which vest over several years, and service-based restricted stock to promote retention of the Named Executive Officers and to build their ownership stake in the Company.

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. Stock options are awarded at the closing price of the Company s Common Stock on the NYSE on the date of grant. The Committee does not grant options with an exercise price that is less than the closing price of the Common Stock on the NYSE on the grant date and it does not grant stock options that are priced on a date other than the grant date.

The amount of equity awarded to the Named Executive Officers is based upon a number of factors. First, the Committee considers an overall assessment of the Company s performance and the equity granting practices of other companies in the healthcare industry and its peer group. In addition, the Committee considers information prepared by Mercer with respect to the form of the equity awards and considers the relative costs. Based on this assessment, the Committee then establishes an aggregate pool of potential equity awards for all participants in the equity-based incentive plan, including the Named Executive Officers.

The Committee considers the overall performance of the Named Executive Officer and his actual and potential contribution to the Company s growth and long-term performance in determining individual awards. In addition, the Committee considers benchmarks from the peer group in evaluating potential awards to the Named Executive Officers. The Chief Executive Officer also provides an assessment of the overall level of performance for the other Named Executive Officers. The assessment of actual and potential contribution is based upon the Committee s subjective evaluation of each Named Executive Officer. Based on these assessments, the Committee ranks each Named Executive Officer in one of three award levels and grants equity-based awards to the participants in each level from the Company s aggregate pool of available equity awards established by the Committee.

The Committee granted stock options and restricted stock to the Named Executive Officers in February 2006. After evaluating the performance of the Company, the Committee established an aggregate pool of approximately 750,000 shares for potential equity awards, which represented approximately the 25$^{th}$ percentile of the peer group. The Committee evaluated the size of the aggregate pool and determined that the pool would not cause an excessive dilution of shareholder equity. The size of the 2006 aggregate pool was somewhat less than the Company s annual run rate (shares subject to awards made under the Company s equity plan as a percentage of the total shares outstanding) and was below the 2006 median for the peer group.

In connection with the February 2006 grant, the Committee granted stock option awards to the Named Executive Officers covering the following number of shares: Mr. Diaz 67,017 shares; Mr. Lechleiter 18,751 shares; Mr. Kuntz 23,974 shares; Mr. Battafarano 19,690 shares; and Mr. Chapman 17,356 shares. These options have an exercise price of $21.99 per share, vest in four equal annual installments beginning on the first anniversary of the date of grant and expire seven years from the date of grant. On the same date, the Committee also granted awards of restricted Common Stock to the Named Executive Officers. The number of shares of restricted Common Stock granted to the Named Executive Officers were as follows: Mr. Diaz 55,289 shares; Mr. Lechleiter 15,470 shares; Mr. Kuntz 19,779 shares; Mr. Battafarano 16,244 shares; and

Mr. Chapman 14,319 shares. These shares will vest in four equal annual installments beginning on the first anniversary of the date of grant.

During the fall of 2006, the Committee further assessed the competitiveness of the total direct compensation paid to Mr. Diaz. The Committee considered the recommendations of Mercer which indicated that Mr. Diaz s projected 2006 total direct compensation was well below the 2006 median for chief executive officer compensation in the peer group and the healthcare industry generally. In December 2006, the Committee awarded Mr. Diaz 44,711 shares of restricted stock in order to more closely align Mr. Diaz s compensation with the 2006 median for chief executive officers in the peer group. These shares will vest in three equal annual installments beginning on the first anniversary of the date of grant. As noted above, the Committee also increased Mr. Diaz s base salary effective January 1, 2007.

In making this grant, the Committee considered the performance of Mr. Diaz in leading the Company s four businesses through significantly changing reimbursement environments, the Company s improvements in employee turnover and quality measures, and his efforts to unlock substantial shareholder value associated with the proposed spin-off of the Company s pharmacy division. The Committee granted this award of restricted stock based upon its subjective evaluation that the number of shares and terms were appropriate and desirable considering Mr. Diaz s significant contributions to the Company and the Committee s desire to award total direct compensation between the 50th and 75th percentiles of the peer group. The Committee also considered the retention benefits of awarding restricted stock.

**Section 401(k) Plan and Other Perquisites and Benefits**

The Company maintains a Section 401(k) plan (the 401(k) Plan ) that is a tax-qualified defined contribution retirement savings plan under which all eligible employees, including the Named Executive Officers, are eligible to contribute the lesser of (1) 30% of their pay or (2) the limit prescribed by the IRS, on a pre-tax basis. After one year of service, the Company matches 25% of the first 6% of pay that a participant contributes to the 401(k) Plan and may also provide additional profit sharing contributions based upon the Company s achievement of financial goals established by the Committee. All employee contributions to the 401(k) Plan are fully vested upon contribution and the Company s matching contribution vests in equal installments over four years or in full immediately once the employee has four years of service. Contributions to the 401(k) Plan by the Named Executive Officers are usually limited by IRS rules.

In addition, the Named Executive Officers can participate in the Kindred Deferred Compensation Plan (the DCP ), which is available to certain highly compensated employees. A participant in the DCP may elect to defer up to 25% of his or her base salary and up to 100% of his or her annual short-term incentive award into the DCP during each plan year. In addition, the Company will credit such participant s account balance with an amount equal to (1) the 401(k) Plan contribution that would be calculated using the matching contribution formula in effect for such plan year, less (2) the amount such participant would receive during the plan year as a matching contribution under the 401(k) Plan if such participant had contributed the maximum amount of elective deferral contribution permissible under the administrative provisions of the 401(k) Plan for persons of such participant s status. The DCP is discussed in further detail under the heading Non-Qualified Deferred Compensation Table-Fiscal Year 2006.

The Company also provides certain key employees, including the Named Executive Officers, with perquisites and other personal benefits that the Company and the Committee believe are reasonable and consistent with the overall executive compensation program to attract and retain qualified executives and other key employees. Such benefits provided to the Named Executive Officers include the payment of life insurance premiums, personal use of the Company s aircraft and the ability to receive a discounted cash payment in lieu of accumulated paid time off benefits.

**Employment and Other Agreements**

For several years, the Company has had employment agreements containing substantially similar terms with its executive officers, including the Named Executive Officers. Effective January 1, 2004, the Company entered into an employment agreement with Mr. Diaz in connection with his promotion to Chief Executive Officer. The agreement has a three-year term, which is extended automatically each day by one day unless the Company notifies Mr. Diaz of its intent not to extend the term. Upon such notification, the employment agreement will terminate in three years. Mr. Diaz s employment agreement provides for a base salary and the ability to participate in the Company s short-term and long-term incentive plans, the Company s equity-based plans and other employee benefit plans. Mr. Diaz may receive increases in his base salary as approved by the Committee.

Mr. Diaz s employment agreement also provides for severance payments if his employment is terminated under certain circumstances. The amount and circumstances giving rise to these severance payments are discussed in further detail under the heading Potential Payments Upon Termination or Change in Control.

Effective February 22, 2006, the Company entered into an employment agreement with Mr. Kuntz, in his capacity as Executive Chairman of the Board of Directors of the Company. Mr. Kuntz s previous employment agreement was scheduled to expire at the end of 2006. The Committee entered into a new agreement based upon its desire to retain Mr. Kuntz s services in the same capacity. The new agreement has substantially similar terms to his previous agreement, except that the term was reduced from three years to one year, subject to automatic extension each day by one day unless the Company notifies Mr. Kuntz of its intent not to extend the term. Upon such notification, the employment agreement will terminate in one year. Mr. Kuntz s employment agreement provides for a base salary and the ability to participate in certain employee benefit plans of the Company. Mr. Kuntz also continues to vest in his existing stock options and restricted stock. Mr. Kuntz does not, however, participate in or accrue additional benefits under the Company s short-term incentive or long-term incentive plans. Mr. Kuntz may receive increases in his base salary as approved by the Committee.

As Executive Chairman, Mr. Kuntz performs the following duties: (a) coordinates all matters and committee activities of the Board and acts as the principal liaison between the Board and senior management; (b) engages in public lobbying and relationships with various healthcare related organizations; (c) advises the Chief Executive Officer and senior management on strategic initiatives including financing, acquisition and development activities; (d) advises the Chief Executive Officer and senior management concerning all compliance and regulatory matters; and (e) such other similar matters as reasonably requested by the Board. Mr. Kuntz is required to devote approximately two days per week or sixty hours per month to the business of the Company.

Mr. Kuntz s employment agreement also provides for severance payments if his employment is terminated under certain circumstances. The amount and circumstances giving rise to these severance payments are discussed in further detail under the heading Potential Payments Upon Termination or Change in Control.

For several years, the Company also has had employment agreements with Mr. Lechleiter, Mr. Battafarano, and Mr. Chapman. The agreements for these Named Executive Officers generally contain substantially similar terms. These agreements have a one-year term, which is extended automatically each day by one day unless the Company notifies the Named Executive Officer of its intent not to extend the term. Upon such notification, the employment agreement will terminate in one year.

The employment agreements provide a base salary and the ability of these Named Executive Officers to participate in the Company s short-term and long-term cash incentive plans, the Company s equity-based plans and other employee benefit plans. The Named Executive Officer may receive increases in his base salary as approved by the Committee.

The employment agreements also provide for severance payments if the Named Executive Officer s employment is terminated under certain circumstances. The amount and circumstances giving rise to these severance payments are discussed in further detail under the heading Potential Payments Upon Termination or Change in Control.

For several years, the Company has had Change in Control Severance Agreements with its executive officers, including each of the Named Executive Officers. These agreements for the Named Executive Officers generally contain substantially similar terms. These agreements provide for the payment of severance benefits under certain circumstances. The amount and circumstances giving rise to these severance benefits are discussed in further detail under the heading Potential Payments Upon Termination or Change in Control.

**Executive Compensation Tax Deductibility**

Section 162(m) of the Code generally provides that the compensation paid by publicly held corporations to the chief executive officer and the four most highly paid senior executive officers in excess of $1,000,000 per executive will be deductible by the Company only if paid pursuant to qualifying performance-based compensation plans approved by shareholders of the Company. Compensation as defined by the Code includes, among other things, base salary, incentive compensation and gains on stock options and restricted Common Stock. Although the Company attempts to structure all incentive compensation to be deductible for federal income tax purposes, the Company s primary policy is to maximize the effectiveness of the Company s executive compensation program. In that regard, the Committee intends to remain flexible to take actions which are deemed to be in the best interests of the Company and its shareholders. Such actions may not always qualify for tax deductibility under the Code.

Beginning on January 1, 2006, the Company began accounting for equity-based incentive compensation in accordance with the requirements of Statement of Financial Accounting Standards No. 123 (revised 2004) ( SFAS 123R ).

**SUMMARY COMPENSATION TABLE**

The following table sets forth certain information regarding compensation of (1) each person who served as Chief Executive Officer during fiscal year 2006, (2) each person who served as Chief Financial Officer during fiscal year 2006, and (3) the Company s three most highly compensated executive officers other than the Chief Executive Officer and Chief Financial Officer who were serving as executive officers as of December 31, 2006 (collectively referred to as the Named Executive Officers ).

The Named Executive Officers did not receive payments which would be characterized as Bonus payments for the year ended December 31, 2006. Amounts listed under the column entitled Non-Equity Incentive Plan Compensation were determined by the Committee at its February 27, 2007 meeting.

| Name and Principal Position | Year | Salary | Stock Awards (1) | Option Awards (1) | Non-Equity Incentive Plan Compensation (2) | Changes in Pension Value and Nonqualified Deferred Compensation Earnings | All Other Compensation (3) | Total |
|---|---|---|---|---|---|---|---|---|
| Paul J. Diaz, President and Chief Executive Officer | 2006 | $ 847,906 | $ 2,686,970 | $ 1,240,144 | $ 1,432,779 | $ 324(4) | $ 168,366 | $ 6,376,489 |
| Richard A. Lechleiter, Executive Vice President and Chief Financial Officer | 2006 | $ 398,513 | $ 636,284 | $ 231,657 | $ 635,288 | $ 387(4) | $ 54,570 | $ 1,956,699 |
| Edward L. Kuntz, Executive Chairman of the Board of Directors | 2006 | $ 635,928 | $ 925,749 | $ 555,136 | | | $ 7,868 | $ 2,124,681 |
| Frank J. Battafarano, Executive Vice President and President, Hospital Division | 2006 | $ 418,226 | $ 759,025 | $ 222,712 | $ 619,941 | $ 9,746(5) | $ 33,183 | $ 2,062,833 |
| Richard E. Chapman, Executive Vice President and Chief Administrative and Information Officer | 2006 | $ 369,893 | $ 560,582 | $ 211,936 | $ 588,015 | $ 365(4) | $ 8,607 | $ 1,739,398 |

(1) These amounts represent the dollar amount recognized for financial statement reporting purposes for the fiscal year ended December 31, 2006, in accordance with SFAS 123R. As such, these amounts reflect awards granted in and prior to 2006. In each case, the amount of compensation expense was calculated excluding forfeiture assumptions. The assumptions used in calculating these amounts with respect to awards made in fiscal year 2006 are discussed in Note 15 to the Company s audited financial statements for the year ended December 31, 2006 included in the Company s Annual Report on Form 10-K filed with the SEC on March 1, 2007.

(2) These amounts represent amounts earned in 2006 under the Company s short-term incentive plan and the long-term incentive plan. The amounts earned under the Company s short-term incentive plan during 2006 by the Named Executive Officers were as follows:

| Year | Mr. Diaz | Mr. Lechleiter | Mr. Kuntz | Mr. Battafarano | Mr. Chapman |
|---|---|---|---|---|---|
| 2006 | $ 584,077 | $ 275,283 | | $ 241,928 | $ 254,799 |

The amounts earned under the Company s long-term incentive plan during 2006 by the Named Executive Officers were as follows:

| Year | Mr. Diaz | Mr. Lechleiter | Mr. Kuntz | Mr. Battafarano | Mr. Chapman |
|---|---|---|---|---|---|
| 2006 | $ 848,702 | $ 360,005 | | $ 378,013 | $ 333,216 |

Awards earned under the long-term incentive plan during 2006 will be paid in three equal annual installments commencing on or about December 14, 2007, provided generally that the participant is employed by the Company at the time payments are due.

(3) The amounts in this column include Company contributions for the benefit of the Named Executive Officers to the Company s 401(k) Plan and the DCP, the payment of life insurance premiums, certain transportation-related benefits ( TRB ) and discounted cash payments in lieu of accumulated paid time off benefits ( PTO ) as follows:

| | 401(k) | DCP | Life | TRB | PTO | Total |
|---|---|---|---|---|---|---|
| Mr. Diaz | $ 3,219 | $ 4,239 | $ 1,439 | $ 159,469 | | $ 168,366 |
| Mr. Lechleiter | $ 3,219 | | $ 632 | $ 43,026 | $ 7,693 | $ 54,570 |
| Mr. Kuntz | $ 3,219 | | $ 4,649 | | | $ 7,868 |
| Mr. Battafarano | $ 3,219 | $ 3,364 | $ 1,914 | $ 24,686 | | $ 33,183 |
| Mr. Chapman | $ 3,219 | $ 1,850 | $ 1,656 | $ 1,882 | | $ 8,607 |

For purposes of determining the value of transportation-related benefits for 2006, the Company based the calculation on the aggregate incremental cost to the Company to provide use of the Company s aircraft or chartered aircraft to each Named Executive Officer and such Named Executive Officer s family. The aggregate incremental cost for the Company aircraft is based on a cost-per-flight-hour charge developed from the annual direct costs to operate the Company s aircraft. The incremental cost for any chartered aircraft is the actual cost of the chartered aircraft paid by the Company.

(4) These amounts represent the above-market interest earned by such Named Executive Officer in the DCP during 2006. For purposes of this calculation, above-market interest equals the amount of interest in excess of 120% of the federal long-term rate as of October 1, 2005, which was 4.40%.

(5) This amount includes the above-market interest earned by Mr. Battafarano in the DCP during 2006 of $2,990, plus the aggregate change in actuarial present value of Mr. Battafarano s accumulated benefit under the Company s Supplemental Executive Retirement Plan (the SERP ) of $6,756. Mr. Battafarano is the only Named Executive Officer participating in the SERP. See the Pension Benefits Table Fiscal Year 2006 for a description of the benefit calculation and assumptions used to calculate this amount.

**GRANTS OF PLAN-BASED AWARDS TABLE    FISCAL YEAR 2006**

The following table sets forth information regarding grants of awards under incentive compensation programs to the Company s Named Executive Officers during fiscal year 2006.

| Name | Grant Date | Estimated Possible/ Future Payouts Under Non-Equity Incentive Plan Awards: Threshold | Target | Maximum | All Other Stock Awards: Number of Shares of Stock or Units (#)(3)(4) | All Other Option Awards: Number of Securities Underlying Options (#)(3)(5) | Exercise or Base Price of Option Awards | Grant Date Fair Value (6) |
|---|---|---|---|---|---|---|---|---|
| Paul J. Diaz | | | | | | | | |
| Short-term incentive plan (1) | N/A | $ 203,688 | $ 509,221 | $ 636,526 | | | | |
| Long-term incentive plan (2) | N/A | $ 84,870 | $ 424,351 | $ 848,702 | | | | |
| | 2/23/06 | | | | 55,289 | | | $ 1,215,805 |
| | 12/14/06 | | | | 44,711 | | | $ 1,182,606 |
| | 2/23/06 | | | | | 67,017 | $ 21.99 | $ 713,061 |
| Richard A. Lechleiter | | | | | | | | |
| Short-term incentive plan (1) | N/A | $ 96,001 | $ 240,003 | $ 300,004 | | | | |
| Long-term incentive plan (2) | N/A | $ 36,000 | $ 180,002 | $ 360,005 | | | | |
| | 2/23/06 | | | | 15,470 | | | $ 340,185 |
| | 2/23/06 | | | | | 18,751 | $ 21.99 | $ 199,510 |
| Edward L. Kuntz | 2/23/06 | | | | 19,779 | | | $ 434,940 |
| | 2/23/06 | | | | | 23,974 | $ 21.99 | $ 255,083 |
| Frank J. Battafarano | | | | | | | | |
| Short-term incentive plan (1) | N/A | $ 100,803 | $ 252,008 | $ 315,010 | | | | |
| Long-term incentive plan (2) | N/A | $ 37,801 | $ 189,006 | $ 378,013 | | | | |
| | 2/23/06 | | | | 16,244 | | | $ 357,206 |
| | 2/23/06 | | | | | 19,690 | $ 21.99 | $ 209,501 |
| Richard E. Chapman | | | | | | | | |
| Short-term incentive plan (1) | N/A | $ 88,858 | $ 222,144 | $ 277,680 | | | | |
| Long-term incentive plan (2) | N/A | $ 33,322 | $ 166,608 | $ 333,216 | | | | |
| | 2/23/06 | | | | 14,319 | | | $ 314,875 |
| | 2/23/06 | | | | | 17,356 | $ 21.99 | $ 184,668 |

(1) These amounts reflect possible payouts under the Company s short-term incentive plan. Actual awards for 2006 have been disclosed in the Summary Compensation Table under the column Non-Equity Incentive Plan Compensation.

(2) These amounts reflect possible future payouts under the Company s long-term incentive plan. Actual awards for 2006 have been disclosed in the Summary Compensation Table under the column Non-Equity Incentive Plan Compensation. Awards under the long-term incentive plan are payable in three equal annual installments on or about each of the first, second and third anniversaries of the end of the relevant performance period, provided generally that the participant is employed by the Company at the time the payments are due.

(3) These amounts reflect awards under the Kindred Healthcare, Inc. 2001 Stock Incentive Plan, Amended and Restated (the Equity Incentive Plan ).

(4) The shares of restricted Common Stock granted on February 23, 2006 vest in four equal annual installments, beginning on the first anniversary of the date of grant, and the shares of restricted Common Stock granted on December 14, 2006 vest in three equal annual installments, beginning on the first anniversary of the date of grant.

(5) All stock options granted on February 23, 2006 become exercisable in four equal annual installments, beginning on the first anniversary of the date of grant, and have a seven-year term.

(6) These amounts represent the grant date fair value calculated in accordance with SFAS 123R. In each case, the amount was calculated excluding forfeiture assumptions. The assumptions used in calculating these amounts are discussed in Note 15 to the Company s audited financial statements for the year ended December 31, 2006 included in the Company s Annual Report on Form 10-K filed with the SEC on March 1, 2007.

The Company s short-term incentive plan, long-term incentive plan and employment agreements with the Named Executive Officers are more fully described in the Compensation Discussion and Analysis section that begins on page 11 of this proxy statement.

**OUTSTANDING EQUITY AWARDS AT END OF 2006 FISCAL YEAR**

The following table sets forth information regarding outstanding equity awards held by the Company s Named Executive Officers as of December 31, 2006.

| | Option Awards | | | | | Stock Awards | |
|---|---|---|---|---|---|---|---|
| Name | Number of Securities Underlying Unexercised Options (#) Exercisable | Number of Securities Underlying Unexercised Options (#) Unexercisable | Option Grant Date | Option Exercise Price | Option Expiration Date | Number of Shares or Units of Stock That Have Not Vested (#) | Market Value of Shares or Units of Stock That Have Not Vested (1) |
| Paul J. Diaz | 192,500 | 0 | 1/28/02 | $ 19.38 | 1/28/12 (2) | 216,120 | $ 5,457,030 |
| | 11,214 | 0 | 7/23/02 | $ 15.91 | 7/23/12 (2) | | |
| | 51,456 | 0 | 7/22/03 | $ 11.03 | 7/22/13 (3) | | |
| | 80,000 | 0 | 10/28/03 | $ 19.75 | 10/28/13 (3) | | |
| | 44,813 | 22,407 | 7/26/04 | $ 23.89 | 7/26/14 (3) | | |
| | 58,584 | 0 | 4/27/05 | $ 31.09 | 4/27/12 (2)(4) | | |
| | 101,923 | 0 | 8/10/05 | $ 31.14 | 8/10/12 (2)(4) | | |
| | 0 | 67,017 | 2/23/06 | $ 21.99 | 2/23/13 (2) | | |
| Richard A. Lechleiter | 29,600 | 0 | 2/25/02 | $ 20.00 | 2/25/12 (2) | 45,618 | $ 1,151,855 |
| | 20,000 | 0 | 7/23/02 | $ 15.91 | 7/23/12 (2) | | |
| | 25,330 | 0 | 7/22/03 | $ 11.03 | 7/22/13 (3) | | |
| | 10,137 | 5,069 | 7/26/04 | $ 23.89 | 7/26/14 (3) | | |
| | 10,000 | 0 | 2/23/05 | $ 30.42 | 2/23/15 (3)(4) | | |
| | 9,642 | 0 | 4/27/05 | $ 31.09 | 4/27/12 (2)(4) | | |
| | 16,776 | 0 | 8/10/05 | $ 31.14 | 8/10/12 (2)(4) | | |
| | 0 | 18,751 | 2/23/06 | $ 21.99 | 2/23/13 (2) | | |
| Edward L. Kuntz | 20,000 | 0 | 7/23/02 | $ 15.91 | 7/23/12 (2) | 62,203 | $ 1,570,626 |
| | 38,592 | 0 | 7/22/03 | $ 11.03 | 7/22/13 (3) | | |
| | 26,497 | 13,249 | 7/26/04 | $ 23.89 | 7/26/14 (3) | | |
| | 19,164 | 0 | 4/27/05 | $ 31.09 | 4/27/12 (2)(4) | | |
| | 33,341 | 0 | 8/10/05 | $ 31.14 | 8/10/12 (2)(4) | | |
| | 0 | 23,974 | 2/23/06 | $ 21.99 | 2/23/13 (2) | | |
| Frank J. Battafarano | 9,984 | 0 | 7/23/02 | $ 15.91 | 7/23/12 (2) | 53,090 | $ 1,340,523 |
| | 15,030 | 0 | 7/22/03 | $ 11.03 | 7/22/13 (3) | | |
| | 10,137 | 5,069 | 7/26/04 | $ 23.89 | 7/26/14 (3) | | |
| | 10,000 | 0 | 2/23/05 | $ 30.42 | 2/23/15 (3)(4) | | |
| | 9,971 | 0 | 4/27/05 | $ 31.09 | 4/27/12 (2)(4) | | |
| | 27,500 | 0 | 8/10/05 | $ 31.14 | 8/10/12 (2)(4) | | |
| | 0 | 19,690 | 2/23/06 | $ 21.99 | 2/23/13 (2) | | |
| Richard E. Chapman | 10,000 | 0 | 7/23/02 | $ 15.91 | 7/23/12 (2) | 40,507 | $ 1,022,802 |
| | 16,886 | 0 | 7/22/03 | $ 11.03 | 7/22/13 (3) | | |
| | 10,137 | 5,069 | 7/26/04 | $ 23.89 | 7/26/14 (3) | | |
| | 10,000 | 0 | 2/23/05 | $ 30.42 | 2/23/15 (3)(4) | | |
| | 7,307 | 0 | 4/27/05 | $ 31.09 | 4/27/12 (2)(4) | | |
| | 12,712 | 0 | 8/10/05 | $ 31.14 | 8/10/12 (2)(4) | | |
| | 0 | 17,356 | 2/23/06 | $ 21.99 | 2/23/13 (2) | | |

(1) Market value is calculated by multiplying the total number of restricted shares of Common Stock that have not vested by $25.25, which was closing price of the Common Stock on the NYSE on December 29, 2006.

(2) As initially granted, these options vest in four equal annual installments beginning on the first anniversary of the date of grant.

(3) As initially granted, these options vest in three equal annual installments beginning on the first anniversary of the date of grant.

(4) As initially granted, these options vest in either three or four equal annual installments beginning on the first anniversary of the date of grant. On December 14, 2005, the Executive Compensation Committee accelerated the vesting of all unvested stock options under the Equity Incentive Plan which had exercise prices greater than the closing price of the Common Stock on December 14, 2005 of $26.48 per share.

**OPTION EXERCISES AND STOCK VESTED TABLE FISCAL YEAR 2006**

The following table sets forth information regarding each exercise of stock options and all vesting of restricted stock during the year ended December 31, 2006.

| | Option Awards | | Stock Awards | |
|---|---|---|---|---|
| **Name** | **Number of Shares Acquired on Exercise** | **Value Realized on Exercise** | **Number of Shares Acquired on Vesting** | **Value Realized on Vesting** |
| Paul J. Diaz | | | 109,205 | $ 2,998,640 |
| Richard A. Lechleiter | | | 20,583 | $ 529,598 |
| Edward L. Kuntz | | | 49,708 | $ 1,322,595 |
| Frank J. Battafarano | 6,856 | $ 68,636 | 22,816 | $ 597,497 |
| Richard E. Chapman | | | 19,264 | $ 492,141 |

**PENSION BENEFITS TABLE FISCAL YEAR 2006**

The following table sets forth information regarding each plan providing payments or other benefits at, following or in connection with the retirement of the Named Executive Officers.

The Company adopted the SERP on January 1, 1998 to attract and retain talented executives by providing additional compensation in the form of a monthly retirement benefit. Upon a participant s normal retirement, such participant would be entitled to receive a monthly retirement benefit for the remainder of such participant s lifetime in an amount equal to one-twelfth of the product of (1) the participant s maximum retirement benefit percentage (between 50-100% based on such participant s position within the Company); (2) the participant s salary and short-term target bonus in the year of termination of employment; and (3) the participant s vesting percentage which increased 5% for each additional year of service up to a maximum of 100%. Effective December 31, 1999, the SERP was amended to eliminate the accrual of any additional benefits and to freeze certain accumulated benefits. The SERP was terminated in February 2001. The termination of the SERP had no effect on the future payment of vested benefits under the SERP. Mr. Battafarano is the only Named Executive Officer participating in the SERP. Pursuant to the provisions of the SERP, Mr. Battafarano has elected to receive a lump sum payment equal to the present value of his accumulated benefit upon retirement in lieu of a monthly retirement benefit.

| **Name** | **Plan Name** | **Number of Years Credited Service** | **Present Value of Accumulated Benefit** | **Payments During Last Fiscal Year (2)** |
|---|---|---|---|---|
| Paul J. Diaz | | | | |
| Richard A. Lechleiter | | | | |
| Edward L. Kuntz | | | | |
| Frank J. Battafarano | Supplemental Executive Retirement Plan | 8 | $ 728,671 (1) | |
| Richard E. Chapman | | | | |

(1) As set forth in the SERP, the present value of any future payment stream is determined using the following assumptions: (i) mortality based upon the 1994 Group Annuity Mortality Table (50% males/50% females); and (ii) a discount rate equal to the rolling average of the yield on U.S. Treasury ten-year notes for the three months preceding the attainment of age 65. The following data also was used to calculate this amount: a maximum retirement benefit percentage of 70%; eligible base salary of $215,000 and short-term target bonus of $129,000; and a vesting percentage of 40% for eight years of service.

(2) No benefits are payable until age 65.

**NONQUALIFIED DEFERRED COMPENSATION TABLE FISCAL YEAR 2006**

| Name | Executive Contributions in Last Fiscal Year | Registrant Contributions in Last Fiscal Year (1) | Aggregate Earnings in Last Fiscal Year (2) | Aggregate Withdrawals/ Distrim; BORDER-BOTTOM: #000000 2px solid; TEXT-ALIGN: right; WIDTH: 9%; BACKGROUND-COLOR: #ffffff" valign="bottom"> (857 ) | | (1,779) | (2,124) |
|---|---|---|---|---|---|---|---|
| Net cash used in investment activities | (7,344 ) | (31,485 ) | (27,439 ) | | (55,411) | | |
| Cash flows from financing activities: | | | | | | | |
| Shares issued under employee stock-based plans | 56 | 347 | 294 | | 2,488 | | |
| Net cash provided by financing activities | 56 | 347 | 294 | | 2,488 | | |
| Decrease in cash and cash equivalents | (3,855 ) | (21,712 ) | (3,930 ) | | (386 ) | | |
| Cash and cash equivalents – beginning of period | 27,622 | 41,732 | 27,697 | | 20,406 | | |
| Cash and cash equivalents – end of period | 23,767 | 20,020 | 23,767 | | 20,020 | | |

NOVA MEASURING INSTRUMENTS LTD.
RECONCILIATION OF GAAP TO NON-GAAP RESULTS
(U.S. dollars in thousands, except percentage and per share data) - (Unaudited)

| | Three months ended September 30, 2018 | June 30, 2018 | September 30, 2017 |
|---|---|---|---|
| GAAP cost of revenues | 26,104 | 26,188 | 21,179 |
| Stock-based compensation in cost of products | (161) | (114) | (113) |
| Stock-based compensation in cost of services | (122) | (92) | (57) |
| Non-GAAP cost of revenues | 25,821 | 25,982 | 21,009 |
| | | | |
| GAAP gross profit | 37,467 | 35,700 | 32,879 |
| Gross profit adjustments | 283 | 206 | 170 |
| Non-GAAP gross profit | 37,750 | 35,906 | 33,049 |
| GAAP gross margin as a percentage of revenues | 59 % | 58 % | 61 % |
| Non-GAAP gross margin as a percentage of revenues | 59 % | 58 % | 61 % |
| | | | |
| GAAP operating expenses | 21,717 | 22,079 | 18,277 |
| Stock-based compensation in research and development | (484) | (386) | (259) |
| Stock-based compensation in sales and marketing | (285) | (259) | (95) |
| Stock-based compensation in general and administrative | (202) | (142) | (145) |
| Amortization of acquired intangible assets | (653) | (654) | (641) |
| Non-GAAP operating expenses | 20,093 | 20,638 | 17,137 |
| Non-GAAP operating income | 17,657 | 15,268 | 15,912 |
| GAAP operating margin as a percentage of revenues | 25 % | 22 % | 27 % |
| Non-GAAP operating margin as a percentage of revenues | 28 % | 25 % | 29 % |
| | | | |
| GAAP tax on income | 3,312 | 2,274 | 3,726 |
| Certain discrete tax items | 137 | 137 | (289) |
| Non-GAAP tax on income | 3,449 | 2,411 | 3,437 |
| | | | |
| GAAP net income | 13,310 | 11,833 | 11,502 |
| Amortization of acquired intangible assets | 653 | 654 | 641 |
| Stock-based compensation expenses | 1,254 | 993 | 669 |
| Certain discrete tax items | (137) | (137) | 289 |
| Non-GAAP net income | 15,080 | 13,343 | 13,101 |
| | | | |
| GAAP basic earnings per share | 0.47 | 0.42 | 0.41 |
| Non-GAAP basic earnings per share | 0.54 | 0.48 | 0.47 |
| | | | |
| GAAP diluted earnings per share | 0.46 | 0.41 | 0.40 |
| Non-GAAP diluted earnings per share | 0.52 | 0.46 | 0.46 |
| | | | |
| Shares used for calculation of earnings per share: | | | |
| Basic | 28,047 | 27,977 | 27,788 |
| Diluted | 28,777 | 28,766 | 28,601 |