



**MEMORANDUM TO THE UNITED STATES REBUTTING
ALLEGATIONS OF FRAUD AGAINST RICHARD M. SCRUSHY**

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Donald V. Watkins
Donald V. Watkins, P.C.
2170 Highland Avenue
Birmingham, AL 35209
(205) 558-4665

Jonathan C. Rose
JONES DAY
51 Louisiana Ave., N.W.
Washington, DC 20001
(202) 879-3939

THIS MEMORANDUM IS SUBMITTED PURSUANT TO RULES 408 AND 410 OF THE FEDERAL RULES OF EVIDENCE. RICHARD SCRUSHY RESERVES ALL PRIVILEGES AND PROTECTIONS AFFORDED BY THOSE RULES AS WELL AS ALL OTHER APPLICABLE PRIVILEGES AND PROTECTIONS INCLUDING BUT NOT LIMITED TO THE FIFTH AND SIXTH AMENDMENTS, *MIRANDA*, THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT DOCTRINE.

THIS MEMORANDUM REPRESENTS THE VIEWS OF RICHARD SCRUSHY'S COUNSEL AS TO WHAT THEY EXPECT THE EVIDENCE TO SHOW AND REFLECTS ONLY SUCH EVIDENCE THAT THE LIMITED POWERS OF DISCOVERY AVAILABLE TO THEM HAVE UNCOVERED. NO STATEMENT OR REPRESENTATION CONTAINED HEREIN SHOULD BE CONSIDERED, OR IS INTENDED TO BE, AN ADMISSION, STIPULATION OR CONCESSION BY RICHARD SCRUSHY.

FINALLY, THIS MEMORANDUM IS SUPPLIED SOLELY TO ASSIST THE DEPARTMENT OF JUSTICE AND THE UNITED STATES ATTORNEY FOR THIS DISTRICT FOR CRIMINAL LAW ENFORCEMENT PURPOSES. CONFIDENTIAL TREATMENT OF BOTH THE DOCUMENT AND THE FACT OF ITS SUBMISSION IS REQUESTED. DISTRIBUTION OUTSIDE THE DEPARTMENT AND THE U.S. ATTORNEY'S OFFICE SHOULD NOT BE MADE WITHOUT THE CONSENT OF RICHARD SCRUSHY AND HIS UNDERSIGNED COUNSEL.

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I. INTRODUCTION

Fourteen former HealthSouth officers and employees have pled guilty to participating in what one SEC lawyer has termed, “the largest corporate fraud in history.” Clearly, several of the company’s employees engaged in fraudulent acts that went undetected by its outside auditors, its inside auditors, the Board’s Audit Committee and others responsible for overseeing such matters. What is yet far from clear is whether the fraud will live up to its advance publicity.

The Government has in plea documents and the media repeatedly alleged that Richard Scrushy, HealthSouth’s founder and former Chief Executive Officer, participated in and directed the fraudulent activity for a period of years in order to overstate HealthSouth’s earnings and assets thereby inflating the price of its stock. We submit that the Government will be unable to prove these allegations. The evidence will show instead that the frauds were the work of senior financial officers, principally Mike Martin and Bill Owens, who carefully concealed them from corporate officers not directly involved in their execution, including Mr. Scrushy.

Further, we believe the evidence will fail to support the Government’s widely publicized theories as to the size, purpose and nature of the fraud. Indeed, a very limited examination by two federal judges has revealed both careless errors in plea documents and shaky testimony by certain witnesses.¹

The evidence that the Government has discovered until now establishes that the most recent frauds were sophisticated and deliberate and executed by a number of employees at HealthSouth. There is evidence of conspiratorial “family” meetings at which employees

¹ This, in turn, raises the concern whether the emphasis to date, with respect to the pleas, has been upon quantity and speed as opposed to quality. We do not underestimate the significance of an individual’s decision to plead guilty. However, as former prosecutors, we also know that such decisions can be heavily influenced by factors other than the evidence such as an individual’s personal resources or the quality of legal advice available to him.

discussed how they were going to manipulate the financial records, not only through fraudulent bookings but through the fabrication of false invoices and other documents. But the evidence currently disclosed that purports to link Mr. Scrusby to the fraud committed by others is tenuous. Stripped of hyperbole, it consists of self-serving statements by admitted participants who claim only that Mr. Scrusby made general statements that encouraged their activity. These statements are facially ambiguous and may be innocently explained. Moreover, none of these accounts are corroborated by the documentary evidence. Indeed, not a single document that we have reviewed to date from the nearly one million pages of HealthSouth document productions to Congress and the SEC implicates Mr. Scrusby. The evidence simply does not support his indictment.

If an indictment were nonetheless returned, we submit that the prosecution would fail and that this result would significantly undermine the deterrent impact of the pleas already obtained. Moreover, a protracted and contested trial of HealthSouth's founder would again subject the company and its employees to the glare of national publicity, which it barely survived last spring.

The fact that HealthSouth has survived is remarkable given the unprecedented rigor of the Government's investigation to date. Following the highly-publicized execution of the March 18 search warrant, the Securities and Exchange Commission ("SEC") attempted to freeze Mr. Scrusby's assets. During the hearing on that issue and the period leading up to it, the SEC took the unorthodox step of publicly and repeatedly proclaiming that the accounting fraud at HealthSouth was one of the largest corporate frauds in history. The evidence will show that these pronouncements were greatly exaggerated and had significant adverse consequences.

The evidence also will show that the manner in which the Government conducted the early stages of its investigation had an additional adverse impact upon HealthSouth and its shareholders. On March 19, 2003, the day the FBI raid was announced, HealthSouth's stock was trading at \$3.91. By April 1, the closing price was \$0.12 and the stock even traded below \$0.10 per share at times. After HealthSouth's financial condition became clear, the stock price rebounded, moving back to \$3.21 as of September 5. Thus, the market cap of the company fell from \$1.5 billion to \$47 million and is now back over \$1 billion. This suggests that the Government's cure for the problems at HealthSouth may have exceeded the fraud disease it revealed. A revisiting of the matter through a lengthy and intensively publicized trial may jeopardize HealthSouth once again.²

The Government will no doubt face a heavy burden in any criminal case it brings against Mr. Scrusby. Virtually every possible charge will require proof that Mr. Scrusby acted both knowingly and willfully, *i.e.*, that beyond a reasonable doubt he consciously directed illegal acts. This is a tough standard, particularly in cases such as this involving intricate accounting practices that are fraught with important, yet subtle, distinctions between aggressive accounting judgments and outright fraud. The Government, for instance, has publicly alleged that earnings management was a motivation for the HealthSouth frauds. But earnings management, employed over the years by numerous corporations, can be legitimate, even if aggressively practiced, and is not, standing alone, a crime.

Proving that a respiratory therapist-turned-self-made-executive like Mr. Scrusby -- with no formal business or accounting education -- deliberately committed accounting fraud will, in our view, be impossible on the present evidence. These frauds were sophisticated and

² A chart illustrating the full and rise of HealthSouth who stock is attached as Appendix B.

complicated enough to pass muster with numerous highly-trained individuals whose job it was to detect such activity. They went undetected despite multiple levels of review and analysis of the financial statements by numerous individuals below Mr. Scrusby, including all three operating division presidents, the Chief Operating Officer (each of whom had his own separate financial staff) and the outside auditors, Ernst & Young. During this thorough and multi-tiered review, Mr. Scrusby was never informed that there was an accounting fraud in progress at HealthSouth. Mr. Scrusby also had no independent ability to determine whether any earnings management pursued by these CFOs arguably amounted to fraud.

Significantly, only five of the fourteen individuals who have pled guilty -- the five CFOs -- can conceivably implicate Mr. Scrusby by reason of direct contact with him. Each of them now, of course, stands convicted of fraud and will be hard-pressed to survive cross-examination. A jury will plainly see that each has admitted to deceiving investors for personal gain and that each stands to gain an invaluable personal benefit -- reduced or no jail time -- if they practice deception one more time to implicate Mr. Scrusby. As outlined below, the personal history of several cooperators will undermine their own credibility and that of the Government's case. In addition, our investigation has revealed no documents or other hard evidence to corroborate their stories.³

The plea testimony of the five CFOs falls well short of establishing that Mr. Scrusby committed any willful violations of the criminal law. Only three of the five -- Aaron Beam, Mike Martin and Bill Owens -- ever directly reported to Mr. Scrusby. And none of the five has

³ While we have conducted our own investigation of this matter, Mr. Scrusby's counsel has not, of course, had access to all of the evidence in the Government's possession. We also have been impaired by an inability to gain access to HealthSouth employees or HealthSouth's ongoing forensic audit, which we believe would provide strong documentary support for the positions taken here. Within the past few days in the context of civil litigation, we have gained access for the first time to many HealthSouth

testified that Mr. Scrusby attended any of the “family” meetings that were at the heart of the fraud’s execution. Nor do they establish any particular fraudulent act in which Mr. Scrusby was involved.

Just as a murder case needs a body, a case against Mr. Scrusby would need a particular act of fraud. But the Government has identified none. Rather, it appears that the Government’s potential charges against Mr. Scrusby are founded on equivocal directives like “figure it out” or “fix it.” The evidence will show that Mr. Scrusby commonly used these phrases when managing the company, and that their mere use, without more, is not indicative, or even suggestive, of criminal behavior. Such statements uttered by any hard-driving, marketing-oriented CEO with a limited accounting background are hardly incriminating. In light of the flexibility inherent in accounting standards -- and Mr. Scrusby’s necessary reliance on his experts to determine what is permissible -- such commands amount to nothing more than the ordinary exhortations of a CEO to his executive team to work hard and to solve the company’s problems; they are not orders to commit crimes. While these statements may provide a convenient hook for those seeking to enhance their deals with the Government and minimize their own culpability, they cannot form the basis for a finding of “knowing” and “willful” criminal conduct on Mr. Scrusby’s part.

The other piece of hard evidence the Government has aired, the Owens recording, is similarly unimpressive. Indeed, the conversations should properly be given an innocent construction that refutes the Government’s theory. Moreover, we know that earlier recordings by Owens that have been referred to but never released contain clearly exculpatory statements that would put this recording in its proper context and exonerate Mr. Scrusby.

(continued...)

documents that so far have only supplied additional evidence of Mr. Scrusby’s remoteness from these frauds.

Circumstantial evidence will further undermine the Government's case. Much has been said in the media about Mr. Scrusby's lifestyle, but in fact Mike Martin, Bill Owens and their confederates had much more to gain from this fraud than Mr. Scrusby, who was enormously wealthy and successful before the frauds. Mr. Scrusby remains one of HealthSouth's largest shareholders and largest financial losers from the inevitable unwinding of these frauds. A wide array of witnesses will establish that Mr. Scrusby was not involved in the details of accounting, did not attend any meetings where committing fraud was ever discussed, and that Martin, Owens and others consciously kept him away from accounting and finance matters.

The evidence will show that Mr. Scrusby's focus, given his sales and marketing expertise, was upon expanding the company's horizons, developing new business opportunities and representing HealthSouth to employees, clients, governments and the general public. With his background in respiratory therapy, Mr. Scrusby focused on developing the fundamental concept that inspired the formation and success of HealthSouth: enhancing and improving a patient's treatment and experience in the face of injury or illness. This included, among other things, obtaining the necessary and appropriate accreditations for HealthSouth's approximately 1800 facilities, advancing the company name through public relations, and ensuring the pristine cleanliness and presentation of HealthSouth's facilities.

The evidence will show that Mr. Scrusby's obligations required him to travel extensively, not only for HealthSouth, but also in connection with his service on at least six other corporate boards and in a wide variety of charitable and philanthropic causes. His activities included a variety of well-publicized forays into the entertainment industry. A jury would have no problem believing that Mr. Scrusby was left with little opportunity to detect, much less direct, an accounting fraud so well hidden that Ernst & Young, in sixteen years of auditing, never caught

wind of it. Evidence that Mr. Scrushy implemented numerous controls to prevent the occurrence of fraud, and repeatedly encouraged employees to report any sign of impropriety, will no doubt reinforce that conclusion.

There are, finally, significant reasons why no federal interest would be served by the indictment of Richard Scrushy. Given the weakness of the Government's case, a trial risks turning what has been to date a very successful prosecution of corporate fraud into a highly-publicized failure, which could reduce the momentum and public support the Government currently enjoys in the prosecution of corporate fraud. Failure would significantly undercut the deterrent value of the pleas already achieved and impair the Government's credibility in the prosecution of similar cases. An unsuccessful trial may also leave the appearance that the Government launched an ill-considered prosecution based on little more than the testimony of admitted liars who are seeking lighter sentences for themselves. The diversion of resources and attention to a failed prosecution, while no visible action is taken on larger investigations, risks being portrayed as governmental ineffectiveness against corporate fraud. Finally, a protracted trial of Richard Scrushy, again calling HealthSouth's finances into question, could jeopardize once again the future of HealthSouth, which was very nearly destroyed by the Government's earlier highly-publicized enforcement efforts.

The Government's actions so far have exposed a fraud at HealthSouth and have identified the wrongdoers in HealthSouth's finance and accounting departments. However, an objective review of the evidence compels the conclusion that Mr. Scrushy did not direct or participate in any such fraud. Thus, the quantity and quality of evidence required for a federal criminal prosecution do not exist here.⁴ In these circumstances, we respectfully submit that it is in the

⁴ Grounds For Commencing Or Declining Prosecution, Department of Justice - Principles of Federal Prosecution 9-27.220 (2003) ("The attorney for the government should commence or recommend

interests of both the Government and Richard Scrushy to reach a global resolution in a civil context of all federal claims against him.

II. THE GOVERNMENT FACES THE DIFFICULT BURDEN OF PROVING THAT RICHARD SCRUSHY ACTED KNOWINGLY AND WILLFULLY

In order to convict Richard Scrushy of the crimes that the Government is most likely to allege -- specifically, securities fraud,⁵ filing a false report with the SEC, falsification of books and records, mail fraud, wire fraud, conspiracy, aiding and abetting, and submitting a false certification -- the Government will have the burden of proving, beyond a reasonable doubt, that he acted with "intent to deceive or defraud." This requires proof that the defendant acted both "knowingly" and "willfully."⁶ In other words, the Government must prove beyond a reasonable doubt that "the act was committed voluntarily and purposely, with the specific intent to do something the law forbids; that is, with bad purpose either to disobey or disregard the law." Good faith is a "complete defense" to any criminal charge requiring willful intent "since good faith on the part of the defendant is inconsistent with intent to defraud or willfulness."⁷

(continued...)

Federal prosecution if he/she believes that the person's conduct constitutes a Federal offense and that the admissible evidence will probably be sufficient to obtain and sustain a conviction, unless, in his/her judgment, the prosecution should be declined because: (1) No substantial Federal interest would be served by the prosecution; (2) The person is subject to effective prosecution in another jurisdiction; or (3) There exists an adequate non-criminal alternative to prosecution.").

⁵ 11th Cir. Pattern Crim. Jury Instr. at OI 51.1 (defining "intent to defraud" for purposes of wire fraud, 18 U.S.C. § 1343); *see also* 11th Cir. Pattern Civ. Jury Instr. at FI 4.1, 4.2 (defining "intent to deceive, manipulate, or defraud" for purposes of 17 C.F.R. § 240.10b-5(a) & (b)); 15 U.S.C. § 77x; 15 U.S.C. § 78ff(a).

⁶ 11th Cir. Pattern Crim. Jury Instr. at BI 9.1. To establish a violation of Section 10(b) of the Securities Exchange Act of 1934, the Government must show the "'requisite scienter to establish securities fraud.' 'Scienter is a mental state embracing intent to deceive, manipulate or defraud.'" *See, e.g., Securities & Exchange Comm'n. v. HealthSouth Corp.*, 261 F. Supp. 2d 1298, 1322 (N.D. Ala. 2003) (citations omitted) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)).

⁷ 11th Cir. Pattern Crim. Jury Instr. at SI 17; *see also United States v. Peterson*, 101 F.3d 375, 383 and n.8 (5th Cir. 1996); *United States v. Gross*, 961 F.2d 1097, 1102-03 (3d Cir. 1992).

Therefore, a showing that Mr. Scrusby was merely careless or inattentive to the behavior of other HealthSouth officers or employees will not support his conviction for any of the crimes likely to be charged: "Evidence which establishes only that a person made a mistake in judgment or an error in management, or was careless, does not establish fraudulent intent."⁸ The Government will have to prove that he was aware of the fraud and acted deliberately to further its goals.

The Government faces the same burden on charges for criminal conspiracy or aiding and abetting. To prove conspiracy, "the Government must prove at least the degree of criminal intent necessary for the substantive offense itself."⁹ To prove aiding and abetting, the Government must prove that the defendant possessed the "same state of mind as required for the principal offense."¹⁰ Because the relevant underlying crimes require proof of willfulness, any conspiracy or aiding and abetting charge will also require proof of willfulness.

The Government will have a difficult time showing willfulness in this case because financial management, reporting and accounting are disciplines replete with judgmental questions -- questions on which a CEO untrained in accounting would properly and inevitably defer to his CFO, Controller and their financial staffs and the outside accountants. To the extent that the Government premises any charges merely on Mr. Scrusby's alleged desire to manage earnings in order to meet Wall Street's expectations, proving a willful violation of law will be especially difficult.

⁸ 11th Cir. Pattern Crim. Jury Instr. at SI 17 (explaining good faith defense to charge to defraud).

⁹ *United States v. Feola*, 420 U.S. 671, 686 (1975); see also *United States v. Ross*, 131 F.3d 970, 980-81 (11th Cir. 1997).

¹⁰ *United States v. Valencia*, 907 F.2d 671, 680 (7th Cir. 1990).

Far from being necessarily illegal or fraudulent, “earnings management does not [even] imply a violation of Generally Accepted Accounting Principles (“GAAP”), because there is a range of discretion within the boundaries of judgment that is permitted, in fact required, under GAAP-based accrual accounting.”¹¹ Indeed, Congressman Richard Baker, the Chairman of the House Subcommittee on Capital Markets, Insurance and Government of the Committee on Financial Services, recognized “[t]here are those who have used similar instruments [earnings management tools] for legitimate business purposes and, in fact, have profited from their use, resulting in enhanced corporate value for shareholders.”¹² Simply put, as the former chairman of the Financial Standards Accounting Board, Dennis R. Beresford, has acknowledged, “[t]here is good managed earnings and there is bad managed earnings.”¹³

Others have noted that “more often [than not] the machinations that companies go through [in earnings management] are perfectly legal.”¹⁴ Therefore, to establish willful violations in this case, the Government will have to establish more than simply that Mr. Scrushy may have encouraged aggressive efforts to manage earnings -- it will have to establish that he

¹¹ William H. Beaver, *What Have We Learned from the Recent Corporate Scandals That We Did Not Already Know?*, 8 Stan. J. L. Bus. & Fin. 155, 163 (2002).

¹² *Corporate Accounting Practices: Is there a Credibility GAAP?: Hearings Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm. on Financial Services*, 107 Cong. 1 (2002) (opening remarks of Rep. Richard H. Baker, chairman of the subcommittee).

¹³ Jennifer Files, *Changes Help Improve Reporting: But Analysts Still See Warning Flags on Accounting Practices*, S.J. Merc. News, Oct. 7, 2002, at 1; see also Jim Fredrick, *The Trouble with Earnings: A No-Nonsense Guide to Some of the Most Popular Ways Companies Can Manipulate the Accounting Rules to Get the Numbers They Want*, Money, Mar. 1, 2002, at 72, available at 2002 WL 2091105 (“There is nothing necessarily wrong with ‘earnings management.’”).

¹⁴ Jon Birger, *Special Report: GE’s Glowing Numbers*, Money, Nov. 2000, at 112; see also Richard C. Sauer, *Financial Statement Fraud: The Boundaries of Liability Under the Federal Securities Laws*, 57 Bus. Law. 955, 957 (May 2002) (“[n]ot all conduct that may be described as earnings management is illegal.”).

personally knew as he was doing so that the accounting measures being resorted to were not simply aggressive, but were fraudulent.

III. THE GOVERNMENT'S CASE AGAINST RICHARD SCRUSHY HAS NO COHERENT THEORY AND RESTS PRECARIOUSLY UPON THE DUBIOUS CREDIBILITY OF ITS COOPERATING WITNESSES

The Government has, in a very short period of time, obtained pleas from fourteen individuals for their respective roles in the HealthSouth financial frauds. This success, however, has been horizontal in a small area of the company, rather than vertical. The Government's early cooperators have failed to provide factual or theoretical support for Mr. Scrushy's motivation to direct these frauds or actual evidence of his participation in them. Instead, the early cooperators have convincingly demonstrated only their own involvement in the frauds and directly implicated other subordinates who assisted in carrying them out.

Without documentary or other evidence to corroborate whatever factually-enriched claims these key cooperating witnesses may be making to Government prosecutors about Richard Scrushy, their testimony against him is unlikely to be persuasive. While the "family" meetings convened by the cooperators are well-documented, there is no documentary evidence that Mr. Scrushy directed them, participated in them, or even knew about them. Nor has a convincing theory been advanced consistent with the facts explaining how these frauds benefited HealthSouth or Mr. Scrushy personally. Indeed, these frauds have all the hallmarks of a series of activities undertaken by particular corporate officers (especially Mike Martin and Bill Owens) designed to achieve short-range objectives or to mask short-range failures from discovery by Richard Scrushy and the Board. The current evidence has fallen far short of proving the original charge of a high-level conspiracy orchestrated by Richard Scrushy with the primary goal of elevating the price of HealthSouth shares through the artificial inflation of the company's earnings and assets.

A. The Numerous Executives And Levels Of Financial Review Below The CEO Position Insulated Richard Scrushy From The HealthSouth Frauds.

The basic corporate organization of HealthSouth and its procedure for generating financial statements and budgets cast serious doubt on the Government's theory that Richard Scrushy orchestrated a massive fraud from his position as CEO. Only one individual technically reports to the CEO, the President. *See* Organizational Chart (attached as Appendix C). The President, in turn, has only six direct reports: the three Operating Division Presidents (Surgery, Hospitals and Outpatient), the two Executive Vice Presidents (General Counsel and Development, Mergers and Acquisitions) and the CFO. *Id.*

With the exception of the General Counsel, each of these executive officers had their own financial staffs. The Operating Division Presidents employed Controllers. The Controllers, in turn, employed Assistant Controllers. The Operating Division Presidents also had Senior Vice Presidents, and the Senior Vice Presidents in turn had Group Vice Presidents. The Group Vice Presidents received reports from their Regional Vice Presidents, and the Regional Vice Presidents received reports from their Regional Controllers.

At every link in the chain, each of these executive officers had financial staffs scrubbing their division, region or other area of responsibility's financial numbers. These financial staffs were often sizeable. Indeed, James Bennett, the President of HealthSouth from approximately 1995 to 2000, employed a financial staff of approximately 15 to 20 individuals.¹⁵ There is no evidence that any of these individuals ever reported any impropriety to Richard Scrushy.

In addition, as described in more detail below, the development of HealthSouth's financial statements and budgets was an intensive and intricate process that required the repeated

¹⁵ When Bill Owens took over as President in August 2000, he incorporated Bennett's financial staff into his already large corporate accounting department.

delivery and verification of financial information between and among facilities, divisions and corporate accounting. Literally thousands of employees were involved in the inputting and verification of the information in the financial statements. Given this complex process, and the numerous individuals checking and verifying other individuals' work, Mr. Scrushy had no reason to suspect or detect the massive accounting fraud that the Government alleges was in process. It is equally implausible that he could have been personally directing or participating in such a fraud without the knowledge of the senior officials in the operating divisions.

B. None Of The Former CFOs Can Credibly Testify That Richard Scrushy Participated In The Fraud

While the pleas for the Government's cooperating witnesses appear to have been drafted from the same template and are replete with formulaic references to "the CEO," only a few of these witnesses even purport to have first-hand information about Mr. Scrushy's alleged involvement in the frauds. Because only a small number of cooperating witnesses ever interacted with Mr. Scrushy on business matters (principally the five CFOs), they are the only witnesses who could possibly implicate him.¹⁶ But none of these can attribute any "directives" to him other than a general injunction to "fix it" or "go figure it out." The evidence will show that these imperatives were frequently used by Mr. Scrushy in a variety of management contexts,

¹⁶ The guilty pleas entered by most of the lower level individuals -- those who simply executed certain aspects of the fraud -- do not implicate Mr. Scrushy and will therefore not be further addressed here. Virginia Valentine, Angela Ayers, Cathy Edwards, Rebecca Morgan, Kenneth Livesay, Emery Harris, Jason Brown, and Richard Botts all fall into this category of cooperating witnesses who do not have any basis for linking Scrushy with any fraud that occurred at HealthSouth. Scrushy has never even met a number of them, let alone attended a meeting with any of them at which accounting issues were discussed. The Government's recent plea for Will Hicks demonstrates a similar inability to incriminate Scrushy. While the Hicks plea proffers that Hicks informed the CEO and others about the need for another investment in the company in question, in the carefully crafted paragraphs that follow Hicks pleads that it was not the CEO, but an unnamed "Senior Officer" who instructed him to commit the fraud. Hicks Stmt. at ¶ 13.

but they will hardly be persuasive as evidence that Mr. Scrushy instructed anyone to commit fraud.

Aaron Beam was one of the five original founders of HealthSouth and served as its CFO from 1984 until October 1997. Although by title responsible for the company's finances during a period of rapid growth within HealthSouth, Beam was repeatedly criticized by subordinates as simply incapable of meeting his increasingly demanding responsibilities.¹⁷ His presence at the company in the early years was secure because of his position as a founder. However, in later years his participation in external dealings for the company became increasingly detrimental. Finally, inadequate performance and criticism from subordinates compelled Beam and Mr. Scrushy to negotiate his early retirement from the company.

Beam's references to Mr. Scrushy in connection with his plea are perfunctory and unspecific. Consistent with the Government's plea template, Beam claims that he was instructed by "the then CEO" to fix the books and records so that they would reflect Wall Street's earnings per share projections. Beam Stmt. at ¶ 8. According to Beam, he and the CEO then signed numerous documents filed with the SEC starting in 1996 knowing their contents to be false. *Id.* at ¶ 9. Beam's remoteness from present events and his internal status as a non-serious figure is the first of many questions about his inclusion in the group from whom pleas have been extracted. The bank whom he allegedly defrauded years ago says the loans were repaid without

¹⁷ Although Beam has been known to refer to himself as "a CPA by training," he never worked as a public accountant and was clearly overmatched for the duties and responsibilities of a CFO. It was for that reason that Bill Owens, a CPA from Ernst & Young, was hired as the company's Controller and Beam's safety net on accounting and other more sophisticated financial issues. Similarly, Mike Martin was hired as Treasurer to backstop Beam on complex debt issues including credit lines from multiple banks, and to interface with Wall Street. Soon thereafter, Beam was excluded from significant financial presentations or negotiations on behalf of the company. Ridiculed by Martin and others, Beam was widely regarded within the company as a gambling, alcoholic non-entity whose consuming passion was his nightlife, which included his ownership of several local bars and nightclubs.

loss. Transcript of Aaron Beam's Guilty Plea at 18-19 (May 5, 2003). For many reasons, Beam's ability to provide credible assistance to the Government's case seems questionable.

The credibility of Michael Martin should be of serious concern to the Government. At his allocution, Judge Clemon conducted a limited examination of the basis for Martin's plea. It seems apparent from many of Martin's responses during that examination that he was unprepared to respond and resorted to making up inherently incredible answers on the spot.

Martin, who was HealthSouth's CFO from October 1997-2000, claims that the first time he had a discussion with Mr. Scrushy regarding HealthSouth having false numbers was in 1993. Transcript of Michael Martin's Guilty Plea ("Martin Plea Tr.") at 11 (May 1, 2003). According to Martin, he and other senior executives were instructed at that time to "fix" the "numbers," and they in turn "had to make an acquisition" in order "to make up the difference in earnings." *Id.* at 11-12. Martin claims that Mr. Scrushy later began telling Martin and other senior executives on a regular (monthly) basis to fix the numbers, with such general exhortations as "you guys figure it out." *Id.* at 13. Martin charges that Scrushy allegedly gave similar instructions until the time Martin left the company in early 2000. *Id.* at 15-16. He estimates that Mr. Scrushy directed him to "fix" "the numbers" every month he was CFO, or approximately 24 times. *Id.* at 16.

Martin's claims concerning events in 1993 are facially incredible because Martin had no responsibility for the preparation or the presentation of HealthSouth's financials in 1993. He was at that time the company's Treasurer and responsible for the company's banking relationships, bank deposits and statements of cash balances. At that time, he would have had no responsibility for the preparation of HealthSouth's "numbers" or financial statements. Likewise he had no responsibility for either "meeting Wall Street's expectations" at HealthSouth or deciding to "make up the difference in earnings" as he now alleges.

Martin's persistent inability to identify any specific dispositive instruction establishing Richard Scrushy's knowledge of or involvement in the alleged frauds is perhaps the greatest substantive weakness of his current testimony. At his plea hearing, Judge Clemon asked Martin whether he acted at the direction of Mr. Scrushy in executing the alleged frauds. He responded in the affirmative, but when pressed by Judge Clemon to identify specifically what Mr. Scrushy said to him, all Martin could come up with was that Mr. Scrushy instructed him to "figure it out." *Id.* at 13, 14.

The vagueness and confusion of Martin's testimony is perhaps best explained by our discovery that Martin subsequently admitted to a trusted associate that his claims at the plea hearing regarding Mr. Scrushy were untrue both as to Mr. Scrushy's participation in monthly meetings discussing financial results and Mr. Scrushy's alleged instructions to "fix" the numbers to reflect inaccurate results. Whatever the reason for Martin's untrue testimony to Judge Clemons, it seems clear that if Richard Scrushy had truly directed Martin to falsify numbers in monthly meetings, on a regular basis, he would have been able to identify less ambiguous directives than "figure it out" or "fix it."

Like Beam and Martin, Bill Owens implicates Mr. Scrushy only as having issued vague directives. Bill Owens served as HealthSouth's Controller from 1986 to February 2000. At that time, he was named CFO and held that position until August 2001. He was then promoted to President and COO, serving in that position until August 8, 2002 when he was named CEO. Owens was demoted from President and CEO back down to CFO on January 6, 2003, and held that position until he was terminated in March 2003.

Owens asserts that Mr. Scrushy was a part of the fraudulent scheme from the beginning (Owens Stmt. at ¶ 3), that he received preliminary financial reports on a monthly and quarterly

basis, and that he “demanded” that accounting personnel adjust the reports to ensure that Wall Street expectations were met. *Id.* at ¶ 4.¹⁸ Owens says little more to describe what role Mr. Scrushy played in the alleged fraud.¹⁹

Defense witnesses will flatly contradict Owens’ charge against Mr. Scrushy.²⁰ One such witness is Jim Goodreau, who was HealthSouth’s Director of Corporate Security, and was hired by the company following a distinguished career as an Alabama state trooper and member of the Montgomery, Alabama Police Department. Goodreau, who estimates that, from 1996 to August 2002, he was with Mr. Scrushy at least 80% of his waking life (Transcript of Hearing on Petition for Asset Freeze (“Freeze Hr’g Tr.”) at 786), testified that during that time he never heard anything to suggest that Mr. Scrushy knew about a financial fraud at HealthSouth. *Id.* Indeed, Goodreau never heard anyone inform Mr. Scrushy of financial fraud and has no information to suggest that Mr. Scrushy played any role in the financial fraud at HealthSouth. *Id.* at 786-87, 1325-26. Goodreau also never heard Mr. Scrushy ask anyone in corporate accounting department to change records, or alter financial statements to beat Wall Street’s earnings expectations. *Id.* In particular, though he accompanied Owens and Mr. Scrushy on their many travels to investor or investment banking conferences, he never heard Owens tell Mr. Scrushy

¹⁸ Owens further suggests that the CEO was aware that financial statements filed with the SEC were fraudulent as a result of his instructions. *Id.* at ¶ 9. He claims that the CEO was at a meeting in August 2002 with Owens and the CFO, at which it was decided that the CFO would sign a statement certifying that HealthSouth’s financial reporting was accurate, when all three knew such reports to be fraudulent. *Id.* at ¶ 10.

¹⁹ In the factual statement of the basis for Owens’ plea, the Government makes the disingenuous statement that at some point Owens “became aware that the accounting personnel designed their fictitious entries to avoid detection,” presumably by Ernst & Young. *Id.* at ¶ 7 (emphasis added). As a former Ernst & Young auditor, Owens was well aware of Ernst & Young’s threshold levels, and Owens is most likely the person who initially designed the scheme to avoid detection as opposed to having inadvertently discovered a scheme of deception already in use.

²⁰ In addition, at least one cooperating witness has already informed the Government that Mr. Scrushy had nothing to do with the fraud at HealthSouth.

that financial information was false or that the accounting department had altered invoices. *Id.* at 790. Rather, when Mr. Scrusby asked Owens about the quality of the numbers, Owens typically replied, “[t]he numbers are great; they’re strong; they’re looking really good.” *Id.* at 792.

Indeed, under the leadership of Martin and Owens, the accounting department was known for its propensity to give Mr. Scrusby good news knowing that his focus was elsewhere. In fact, Goodreau testified that Owens admitted to him that Mr. Scrusby knew nothing about the accounting problems.²¹ In late August 2002, Owens discussed with Goodreau his concern that “there was some accounting problems at the office. . . . I don’t think it’s Enron, but the number is significant.” *Id.* at 809. Goodreau asked whether Mr. Scrusby knew, and Owens said “no.” *Id.* Owens agreed he would tell Mr. Scrusby, but Goodreau followed up with Owens five or six times and each time Owens indicated that he had not yet told Mr. Scrusby. *Id.* at 810, 812.²²

The allegations of Weston Smith, HealthSouth’s CFO from August 2001 to August 2002, track Owens’ account of Mr. Scrusby’s alleged involvement and suffer from the same defects. The Smith Rule 11(f) Factual Basis, for example, contains virtually identical language to that of Owens on Mr. Scrusby’s regular receipt of preliminary financial reporting and his supposed demands for alterations. Owens Stmt. at ¶ 4; Smith Stmt. at ¶ 4. According to Smith, the CEO “issued instructions” as to the target numbers the accounting staff were expected to fabricate. Smith Stmt. at ¶ 5. But this allegation contradicts evidence that we have discovered indicating

²¹ Goodreau’s testimony is particularly compelling in light of his close personal friendship with Owens. Goodreau and Owens enjoy many common interests and have spent considerable time together inside and outside of the office. They have golfed together, vacationed together with their families, and confided in each other on highly personal matters.

²² Nearly six months later, with federal investigators closing in, Owens asked Goodreau whether it was possible to hire someone to break into HealthSouth’s computer system and change the numbers if Owens told Goodreau which numbers needed to be changed. Freeze H’rg Tr. at 814, 816. Two days later, however, he abruptly told Goodreau, “[d]on’t worry about it. Don’t worry about what I told you; just forget about it.” *Id.* at 838.

that Smith did not implicate Richard Scrushy when he initially confessed his fraud involvement to a third party. Regardless, Smith's minimal direct contact with Mr. Scrushy, in contrast to his close personal friendship, and indeed personal and business dependence upon Owens, renders Smith's allegations about Mr. Scrushy unpersuasive.

Malcolm "Tad" McVay, HealthSouth's CFO from August 2002 to January 6, 2003, claims to have told Mr. Scrushy on numerous occasions that the cash on HealthSouth's balance sheet was improperly inflated and that Mr. Scrushy already knew that fact. Transcript of Malcolm McVay's Guilty Plea at 14-15 (May 1, 2003). McVay's confused and uncertain responses to questions from Judge Clemon are only the first example of the multiple difficulties concerning McVay's credibility. With regard to the alleged cash overstatement, McVay will need to explain why he expressly advised Richard Scrushy as late as March 2003, by e-mail, that HealthSouth had approximately \$200-\$300 million in cash available to invest and why he and Bill Owens remained silent when Richard Scrushy referred to this amount of cash being available in discussions with Source Medical regarding needed funding.

McVay's other accounts of Mr. Scrushy's statements are hardly probative. For example, McVay claimed that Mr. Scrushy observed that he had bought numerous companies in the past and that all companies play games with accounting. This statement was allegedly made in order to persuade McVay to do the same thing. *Id.* at 15. That a number of companies purchased by HealthSouth had "played games" with accounting in their prior incarnations was hardly news to McVay. Further, it is impossible to transform such a statement from Mr. Scrushy into an instruction to McVay to commit fraud.

Finally, the credibility of any story that one or more of these witnesses may be willing to develop as to Mr. Scrushy's participation in the fraud is seriously undermined by the absence of

documentary or other corroborating evidence to support any such claims. There is no document -- either disclosed by the Government or apparent from the hundreds of thousands of HealthSouth documents reviewed by counsel -- that implicates Mr. Scrushy. That no e-mail to, from, or involving Mr. Scrushy in connection with the fraud has surfaced, for example, is highly exculpatory given the real co-conspirators' willingness to discuss the fraud in certain e-mail exchanges. *See, e.g.*, E-mail from W. Smith to W. Owens (Aug. 8, 2002) (HHEC 461-00396).

C. The Evidence Will Show That The Key Conspirators Went To Great Lengths To Conceal Financial And Accounting Matters From Mr. Scrushy

During the course of our investigation, several witnesses in interviews confirmed that at the top level of HealthSouth's financial staff, and particularly by the CFOs, there was a concerted effort over time to prevent relevant financial information from reaching Richard Scrushy. These witnesses have particularly described efforts on the part of several CFOs to portray themselves as the supreme authority on the financial affairs at HealthSouth and corresponding efforts to prevent Mr. Scrushy from knowing the details -- and on occasion, anything at all -- about significant financial matters. Their apparent motivation was to keep all bad news from Mr. Scrushy as well as to aggrandize their own status within the company.

Defense witnesses will establish that in fact Martin went to great pains to keep Mr. Scrushy out of the financial decisionmaking at HealthSouth and to underscore his own supremacy. One of these is Monzer Hourani, the Chief Executive Officer of Medistar Corporation.²³ Hourani and others at Medistar have reported that they observed a consistent

²³ Medistar, based in Houston, Texas, is a real estate development firm that specializes in the design, financing, and construction of medical office buildings and healthcare facilities. Monzer Hourani, in addition to being CEO, is the principal designer and architect for Medistar. Medistar developed many of HealthSouth's rehabilitation facilities around the United States, and was the developer for HealthSouth's state-of-the-art Digital Hospital being built in Birmingham. Hourani has been involved in developing facilities for HealthSouth since approximately 1994. Over the course of that time he has had significant contact with HealthSouth's senior management.

pattern by several senior HealthSouth officers to prevent information -- particularly financial information -- from getting to Richard Scrushy. Hourani and others also report that these senior managers, particularly the CFOs, readily proclaimed their view that they, and not Mr. Scrushy, ran the financial affairs at HealthSouth and that Mr. Scrushy did not know much of what was going on at the company.

For example, in approximately 1994 Hourani was retained to build HealthSouth's corporate headquarters in Birmingham. When Hourani completed the project on time and under budget, Mr. Scrushy asked him to formalize a relationship with HealthSouth by which Medistar would become HealthSouth's development arm. When HealthSouth and Medistar eventually agreed on the concept, Scrushy asked Hourani to meet with Mike Martin, HealthSouth's CFO at the time, to work out the details. As requested, Hourani and Gary Perryman, the President of Medistar, met with Martin. They told Martin about the understanding that Mr. Scrushy and Hourani had reached and that, pursuant to Mr. Scrushy's directions, they wanted to finalize an agreement. Martin became upset and rejected the proposal out-of-hand. Martin told Hourani and Perryman, "I am the guy who makes decisions here, not Richard." When Hourani protested and said he had an agreement with Mr. Scrushy, Martin told him flatly, "I run everything financial here, not Richard Scrushy." Hourani then threatened to go back to Mr. Scrushy and raise the issue with him. At that point, Martin told Hourani, "You are wasting your time, because I am the company. I run everything." Martin then advised that if Hourani informed Mr. Scrushy about the matter, Hourani would never earn another dollar from doing business with HealthSouth. The proposed merger never came about, just as Martin had predicted.

On several other occasions, Hourani and others met with Martin to discuss various financial issues between HealthSouth and Medistar. During these meetings Martin was

vehement about his role at HealthSouth. At one such meeting, Martin reportedly stated, "You cannot do anything here without telling me about it first, before you move one inch. Not Richard Scrushy, nobody. I am the Chief Financial Officer. Richard does not know a damn thing about the finances and the project here." On numerous other occasions, and in meetings with various other people, Martin made similar comments, both disparaging Mr. Scrushy and asserting his control over company finances. Witnesses are prepared to testify that Martin did not merely make such statements, he also arranged matters in such a way that his assertions became true.

Hourani also will testify that Owens, like Martin, actively kept financial information away from Mr. Scrushy. During 2000, when HealthSouth was in the process of building a parking deck adjacent to its hospital facility in Birmingham, Mr. Scrushy reviewed the construction plans and asked Hourani to review the plans to see whether the deck could be built for less money. Hourani reviewed the plans and was able to oversee the final construction of the deck. Hourani's revisions saved HealthSouth more than \$3 million in construction costs. At the conclusion of the project, Hourani prepared a letter to Rick Byrd, Manager of Leasing and Development at HealthSouth, detailing the final cost and the amount of savings realized from the modifications. Hourani copied Mr. Scrushy on the letter.

Shortly thereafter, Rick Byrd and another senior HealthSouth official called Hourani about the letter. Both were very upset and told Hourani that Bill Owens had intercepted the copy of the letter intended for Mr. Scrushy. Owens and Byrd were concerned and upset because Hourani's letter would have informed Mr. Scrushy about the final costs of the parking deck and the savings realized from Hourani's modifications. The men did not want Mr. Scrushy to know of the approximate \$3 million in savings and the fact that they had allowed the project to go forward with that type of unnecessary cost.

The men insisted that Hourani change the letter to say that they had been involved in the cost savings and had been cooperative in Hourani's efforts. Hourani and others were struck by the fact that the three men, apparently led by Bill Owens, would act to intercept financial information intended for the CEO. In fact, Owens told Hourani later not to send letters like that to Richard Scrushy and that in terms of the company's finances, "the buck stops here," referring to himself.

Similarly, Hourani will also verify the extent to which McVay another key Government witness concealed important financial matters from Mr. Scrushy. In late 2001, Medistar was asked by HealthSouth to acquire approximately \$80-90 million in properties from HealthSouth. Richard Scrushy approved the transaction in concept but left the details for Mr. Hourani to work out with Tad McVay, HealthSouth's then Treasurer. Unbeknownst to Hourani, McVay initiated discussions with Cambridge Company, a competitor of Medistar, based on McVay's longstanding personal relationship with certain senior managers at Cambridge. Ultimately, McVay rejected Medistar's proposal, notwithstanding Mr. Scrushy's prior approval, and instead did a deal with Cambridge, on considerably less favorable terms than if the sale had been to Medistar.

On or about December 2002, Cambridge concluded that it would not be able to repay the loan it received from HealthSouth to purchase the properties. McVay begged Hourani to help him out of this "desperate" situation and told Hourani that Mr. Scrushy was not aware of his dealings with Cambridge nor the predicament that his actions had created for HealthSouth. McVay pleaded with Hourani, "For God's Sake, don't let Richard Scrushy know about this. He

will fire me.”²⁴ Cambridge ultimately took all of the rental proceeds from the properties for one year (approximately \$8 million), and charged HealthSouth an additional \$5-7 million to allow HealthSouth to get the properties back in order to place them with an appropriate lending institution. Through all of these events, McVay kept the problems, which exposed HealthSouth to serious liability, and the payments to Cambridge to unwind the transaction (approaching \$13 million) totally secret from Mr. Scrushy.

D. Each of the Government’s Cooperating Witnesses Faces Serious Credibility Problems

The Government’s higher level cooperators have a clear track record of personal deception and a strong personal incentive to lie and point the finger upward. The Government will rely on such witnesses at its peril.²⁵

Aaron Beam’s overall reliability as a witness to events occurring during his tenure is subject to severe attack from multiple perspectives by numerous witnesses. His inability to oversee the financial affairs of HealthSouth was continuously remarked by subordinates. A long time figure of fun at the company, he devoted increasingly large amounts of time at night to supervising his bars and consuming their products. His night life and advanced consumption of alcohol increasingly impaired his ability to function. Whereas he was once viewed as an amiable figurehead who played no role in company operations, in his last year at the company he was

²⁴ Knowledge of this transaction was also concealed from Larry Taylor, President of HealthSouth’s Surgical Division. In fact, Taylor was shocked when he eventually learned of the transaction because it was such a bad deal for HealthSouth.

²⁵ Several cooperating witnesses are known to have engaged in unsavory conduct, such as sexual misconduct involving children, adultery, wife-swapping, drinking and drug use. In addition, at least one cooperator has defrauded members of his own family and committed a homicide. In a highly visible national case such backgrounds will inevitable surface in some form and thereby become a troublesome aspect of the Government’s case. Out of concern for the victims of this unacceptable conduct and because the Government already has most of this evidence, we will cover these matters orally with the Government if necessary.

seen as an acute embarrassment. This made Richard Scrushy more than willing to accept Beam's early separation from the company, which ended a year-long campaign by Martin to push him out of the company. These facts, coupled with the Government's knowledge of Beam's propensity to deceive others in order to carry on his preferred lifestyle, make his presence in this case surprising.

Michael Martin's credibility as a witness is similarly impaired by a variety of factors beyond his admission to a trusted associate. A domineering man of immense ambition who openly contested for power with Scrushy, Martin was a talented, but erratic performer who was finally defeated by his explosive temper, which was exacerbated by alcohol. By Martin's account, he eventually became unwilling to follow orders to falsify financial data and resigned from HealthSouth in February 2000. Martin Plea Tr. at 11. In fact, Martin was never in the least intimidated by Mr. Scrushy. As CFO he believed he controlled HealthSouth's access to money, and, in particular, its billion dollar credit line. In one fit of megalomania, he even demanded that Mr. Scrushy resign and permit him to become CEO.

Martin's increasingly frequent explosions created severe tensions within the company and even caused a Birmingham bar to ban him for life after an ugly fight. During an attempted power play in 1999, after having yelled at and cursed Mr. Scrushy on a conference call in front of his colleagues, Martin was told by Mr. Scrushy (1) to take him off speakerphone; (2) that both the call and his career at HealthSouth were over; and (3) that Mr. Scrushy was returning from California to Birmingham immediately, a day ahead of schedule, and wanted Martin in his office first thing in the morning in order to "deal with him." Mr. Scrushy specifically told Martin that his insubordination was unacceptable and that Martin was "finished" at HealthSouth. When Mr. Scrushy arrived in his office the next morning, Martin's resignation letter was on his chair.

These events, rather than any orders from Mr. Scrushy to commit fraud, were the true cause of Martin's resignation from HealthSouth. In short, Martin's demonstrative prior falsehoods, unstable character and centrality to the origin of the fraud make him a worthless witness for the Government.

Owens is similarly vulnerable to cross-examination based upon his obvious personal resentment of Mr. Scrushy as well as his clear willingness to do whatever is necessary to save himself.²⁶ The animus is amply demonstrated by Owens' secret and deceptive campaign, after he had attained the position of CEO in August 2002, to remove Mr. Scrushy from his position as the company's Chairman. This coup attempt is corroborated both by documents and Goodreau, who was summoned to meet with Owens to discuss it at the time. Freeze H'rg Tr. 804-06. Mr. Scrushy eventually learned of the plan, put an end to it, and in concert with the Board, demoted Owens to CFO in January 2003. The demotion was a huge blow to Owens. He dropped two executive levels, lost \$800,000 in annual salary, and was embarrassed in front of his friends and family. He would naturally seek to shift blame to Richard Scrushy, particularly if this would save him from incarceration. As Owens told Jim Goodreau when the fraud came to light, "there are some good people that are going to go down as a result of this. . . . I'm going to have to do whatever I have to do to look after my own self." *Id.* at 827. A jury will easily conclude that this would include falsely implicating Mr. Scrushy.

Weston Smith's longstanding friendship with and apparent dependence upon Bill Owens will undercut his credibility as will his minimal interaction with Mr. Scrushy. That Owens installed his protégé and best friend Smith as CFO under his control in order to continue concealing the fraud is the rather obvious explanation for Smith's promotion from Controller to

²⁶ See also *supra* n. 22 regarding Owens' desire to hack into HealthSouth's computerized accounting records.

CFO in the face of prior lackluster performance at the company. If Smith is called to the stand, he will have to explain what facts moved him to hire a lawyer in the summer of 2002 and then sign off on the Pitt certification, the second quarter financial statements, and the Sarbanes-Oxley §1350 certification. More importantly, he will need to explain what information he conveyed to others regarding the advice his counsel gave him. In signing these statements, Smith signaled to other responsible officers, including Mr. Scrushy, that there was nothing improper in HealthSouth's financials. On the witness stand, Smith also will have to explain the fact that his negotiations with the Government were heavily motivated by a successful desire to protect his second wife, Susan Smith, from prosecution for her role in handling HealthSouth's CMS/Medicare reimbursements. Combined with the fact that Smith never reported to Mr. Scrushy and never had any meetings with him, these facts will no doubt impair the credibility of Smith as an objective witness.

We also understand that Larry House, a former president of HealthSouth who was subsequently demoted by Mr. Scrushy for poor job performance, has been contacted regarding the possibility of his providing testimony in a potential criminal prosecution of Mr. Scrushy. If called to testify in this case, House's failed business career, his current financial and tax difficulties, and his personal animosity to Mr. Scrushy would combine to make reliance upon his testimony a hazardous undertaking.

In 1986, House approached Mr. Scrushy and requested a job at HealthSouth. House was desperate because the company he had created and run since 1975, American Intermedical Resources, Inc. ("AIR Inc."), had done poorly. AIR Inc. provided contract respiratory services to hospitals, but fell on hard times after Government reimbursement rates for these services were cut. It eventually became the target of numerous lawsuits and subsequent judgments, and Larry

House ultimately lost everything. As House testified in a suit brought by the IRS to collect back taxes, penalties, and interest, he “was broke . . . I lost my house, I lost everything I had. I was unable to make payroll . . . so it gradually went down the tubes.”²⁷ Mr. Scrusby took House in and he eventually rose to be Chief Operating Officer.

In approximately 1992, House approached Richard Scrusby about a new venture, MedPartners, to enter the market for physician-practice management or “PPM.” MedPartners grew rapidly and became a Fortune 500 company through numerous mergers which ultimately failed. All this abruptly came to an end in 1998, however, when a deal to sell MedPartners to its chief rival, PhyCor, collapsed amidst the discovery of substantial accounting irregularities within MedPartners. Mr. Scrusby was again confronted with a performance failure by House, whose resignation was forced by Mr. Scrusby and the board. After his forced resignation from MedPartners, House became embroiled in a host of federal and state lawsuits relating to the accounting irregularities discovered at MedPartners. House ultimately lost a substantial portion of his net worth, including a \$26 million mansion.²⁸ In addition, federal and state tax authorities determined that Larry House had extensive tax deficiencies, and placed liens on a number of his assets.²⁹ House’s clear motive for resentment of these adverse actions by Richard Scrusby, his contrasting failed business career, and his incentive to relieve Government pressure on himself, combine to make any testimony he might proffer against Richard Scrusby worthy of minimal belief.

²⁷ Peter Elkind, *Vulgarians at the Gate*, Fortune, June 21, 1999, at 132, available at LEXIS-NEXIS, News Group File.

²⁸ See Kathy Kemp, *Estate With 21 BR, 22BA For Sale: Shelby Mansion Will Be Auctioned*, B’ham News, Mar. 18, 2003, available at LEXIS-NEXIS, News Group File.

²⁹ Curiously, over \$7.8 million in Government liens placed on House’s properties were lifted in June of this year. Further examination may establish that this development relates to the Government’s investigation of Richard Scrusby.

E. The Recorded Conversation Between Owens And Mr. Scrusby On March 18, 2003 Is Exculpatory

Aside from its questionable witnesses, the one piece of hard evidence advanced so far by the Government is a recording secretly made by Bill Owens of a conversation with Mr. Scrusby on March 18, 2003, which the Government disclosed during the SEC asset freeze proceedings. The SEC argued -- to the court and to the press -- that the March 18 tape showed Mr. Scrusby's knowledge and direction of a conspiracy to falsify financial documents. In fact, this tape, together with other recordings which we believe to be in the Government's possession, provides evidence that he was not even aware of the elaborate conspiracy to manipulate financial data directed by Owens, much less the master orchestrator of it.

The March 18 conversation followed and continued a discussion initiated by Owens on the afternoon of March 17, which presumably was also recorded³⁰ -- though the Government has not disclosed this tape. The records of the conversations of March 17 and 18 will show that Owens did his best to elicit from Mr. Scrusby a direction to commit fraud, following a script dictated by the Government: "I did exactly what they told me to do, said exactly what they told me to say," Owens reported to his Government contact. Wire Tr. at 62. Apparently at the Government's instruction, Owens first initiated a tearful discussion with Mr. Scrusby on March 17, in which he stated that his wife had left him because she believed he had been signing "phony financial statements." Owens also declared that he had done something wrong in the third quarter financials, that he and Mr. Scrusby would both be required to sign an amendment to

³⁰ Remarks made by Owens in the March 18 tape suggest that this was not his first attempt to elicit and record incriminating comments from Mr. Scrusby:

Yeah, well we went to the different approach and now I actually have this thing in my belt and so I am going to make one last shot at it. We didn't get anything this morning so I am going to make one last shot at it this afternoon.

these third quarter financials in the next few days, and that he might refuse to sign this amendment. The Government presumably hoped that this portentous scenario would produce comments from Mr. Scrusby indicating awareness of ongoing accounting fraud and orders from Mr. Scrusby to ignore the law, sign the amendment and fix the problem with fraudulent devices. Instead, Mr. Scrusby showed through the course of both conversations that he had no knowledge of Owens' accounting fraud, that he relied on his CFO's judgment in dealing with these matters, and that he would support whatever needed to be done to address the problem properly, "trying to do the right thing." *Id.* at 30.

Disclosing only the March 18 tape, the Government argued in the SEC proceeding that it was remarkable that Mr. Scrusby did not react with shock to Owens' statement that his wife told him she feared that he would end up in jail "if you keep signing these phony financial statements -- and that was her terms." Wire Tr. at 29. The Government failed to inform the Court, however, that on the prior afternoon, when he was first told all of this, Mr. Scrusby reacted with surprise and disbelief, notwithstanding Owens' attempts to extract an admission of joint involvement in the wrongdoing. When it is finally disclosed, the March 17 recording will also show that Owens never explained what he had done wrong and cut off deeper inquiry by representing that Mr. Scrusby should not worry because he would get the problem resolved. We believe that another recording from the morning of March 18, which also has not been disclosed, will show that Mr. Scrusby attempted to reopen this conversation with Owens but was brushed off by Owens.

(continued...)

Transcript of March 18, 2003 Wire Recording ("Wire Tr.") at 1; *see also* Wire Tr. at 62 (referring to Mr. Scrusby having previously "poisoned" the tape).

The Government also argued in the SEC proceeding that the March 18 recording “cannot be interpreted as anything other than Mr. Scruschy urging Owens to commit a crime.” Freeze Hr’g Tr. at 1866. The transcript in fact shows that Mr. Scruschy urged Owens to work hard on solving the problem, notwithstanding his devastating personal problems with his wife, but by no means does Mr. Scruschy tell him to break the law:

I believe that once you get over your sadness and your depression here and what your wife is putting you through, you ought to be able to help us here. You ought to be able to engineer your way out of what you engineered your way into. Does that make sense? I don’t know how, but I think that your mind is not clear.

Wire Tr. at 30.

Though Owens never explained exactly what he believed to be wrong in the third quarter financials, the discussion focused on asset and write-off issues. HealthSouth had recently gone through an audit process in which Ernst & Young recommended \$680 million in write-offs to be implemented in the fourth quarter financials. This was a very large and surprising number. The evidence will show that Mr. Scruschy had no involvement in the process of developing these write-offs, and he did not know whether they placed the third quarter financials in question. Mr. Scruschy also had no knowledge of anything more that needed to be done to the balance sheet beyond what the Board had already approved. Ernst & Young had told the Board that they “cleaned the decks” with these write-offs, and Mr. Scruschy suggests to Owens that any balance sheet problem has been remedied: “We took a major write off last quarter. I think we’ve written off everything. People think the deck is clean.” Wire Tr. at 24.

The identification and approval of these write-offs required a great deal of effort and process, involving HealthSouth’s accounting personnel, Ernst & Young, the Audit Committee of the Board, and the full Board. As CFO, Owens was intimately involved in the entire affair. In light of all the corporate process that had gone into the formulation of this very large write-off,

Mr. Scrusby comments that Owens would “get killed” – *i.e.*, criticized by the Audit committee and the Board – if he raised up additional balance sheet issues now that should have been brought forward earlier, when the company was on the verge of filing its fourth quarter financials: “I think if there are other things that bother you about the balance sheet, that you need to fix them over time, or if there’s a way you could fix them now -- but I think you would get killed.” *Id.*

The SEC argued that Mr. Scrusby’s reference to fixing things “over time” amounts to a direction to commit fraud. But it is clear throughout the transcript that Mr. Scrusby is asking what should be done, that he cannot tell Owens what he must do in this situation, and that he relies on Owens, as his expert, to tell him what is permissible or required in the area of balance sheets. Far from directing his CFO to commit fraud, Mr. Scrusby constantly makes this clear: “what do you want to do, Bill? What would you like to do? I mean, I’m listening to you” (*id.*); “What do you want to do? Which route do you want to go?” (*id.* at 30); “Well, I don’t know what to tell you” (*id.*); “You know, only you can do what you feel like you need to do” (*id.*); “I’ll do whatever you want me to” (*id.* at 31); “But if you think that’s what we ought to do then tell me” (*id.* at 32). While Mr. Scrusby encourages Owens: “[t]rying to do the right thing, you ought to go down fighting” (*id.* at 30), there is no suggestion in this transcript that Mr. Scrusby wants Owens to engage in criminal fraud.

Finally, the SEC argued that some of Mr. Scrusby’s comments show knowledge of the past financial frauds at HealthSouth. The SEC focused on Mr. Scrusby’s comment to Owens that he is at the “Weston Smith juncture,” which it interpreted as a reference to Smith’s resignation as CFO caused by his “unwillingness to continue signing financial statements.” Freeze Hr’g Tr. at 1867-8. In fact, the “Weston Smith juncture” was a period prior to Smith’s

signing of the second quarter financials. Because of his concern over the impact of the Pitt certification requirement, Smith hired his own lawyer to consult on this issue. After receiving independent legal advice and apparently resolving his concerns, Smith signed off on the financials. Thus, Mr. Scruschy's remark means simply that Owens may be at a point where he has to go through a similar process (*i.e.*, consulting with legal counsel to gain adequate comfort with the Sarbanes-Oxley certification requirement), not that he now has to choose between fraud or resignation. This construction is consistent with the context of the remark:

You know, only you can do what you feel like you need to do. I think you are at that Weston Smith juncture, you know, that you had with him. I think if you aggressively work on trying to get where you want to get, you can probably get real close to it, you know?

Wire Tr. at 30. Thus, Mr. Scruschy's remark suggests that, through hard work and the help of counsel, Owens could "probably get real close" to an acceptable solution.

The SEC also suggested that Mr. Scruschy was referring to HealthSouth's accounting fraud when he told Owens "[w]e're so close to getting on the other side of this shit. I mean, I came out of that meeting today pumped." *Id.* at 32. But "this shit" is plainly not a reference to accounting fraud (which had not yet become an issue for HealthSouth), but to the business and legal problems associated with Transmittal 1753 and the SEC investigation of insider trading that had caused the collapse of HealthSouth's stock price. These were discussed at the conclusion of "that meeting" -- the HealthSouth officer's meeting -- a few hours before this conversation, where Mr. Scruschy states that "my goal will be to have all of these negative things that are aggravating the you know what out of us, get that put behind us and move on." *Id.* at 25.

Similarly, Mr. Scruschy's statement to Owens that "it seems to me that you are already in it, Bill. I don't see you getting out of it. Do you know what I mean?" (*id.* at 30), is not a dark allusion to the accounting conspiracy, as the SEC implied. The problem at issue in this

discussion was the need to execute an amendment to the third quarter financials, in which Owens said he had done something wrong. The third quarter financials were signed by Owens as President and CEO and McVay as CFO in November 2002. Though he remained Chairman, Mr. Scrusy had removed himself from day-to-day management by the third quarter of 2002 and did not sign the third quarter certification to those financials. Since Owens had signed the third quarter numbers (“I think you’ve already signed the documents” (*id.* at 29)), Owens was “already in it” and could not get out of the problem simply by not signing an amendment.

During this taped conversation, Owens’ entire approach, vague and manipulative at every turn, is inconsistent with the thesis that Mr. Scrusy was the conductor of a long-running accounting fraud at HealthSouth. In Owens’ attempt to “set up” Mr. Scrusy, Owens remarkably did not express his own concern about a history of false financials, which would have made sense if Mr. Scrusy had been, for years, orchestrating a fraud with Owens. He did not, for instance, tell Mr. Scrusy that “I am worried about what *we* have been doing here -- *we* could all end up in jail.” Owens knew that if he made a statement like that Mr. Scrusy would have rejected it and asked “what are you talking about?” -- as he had the day before. Instead, Owens puts the concern in the mouth of his wife (possibly at the suggestion of the FBI) -- whom he knows Mr. Scrusy would not consider knowledgeable. He says that his wife expressed concern about “phony financial statements -- and that was her terms,” which she derived from media reports about other companies. *Id.* Though he had said the previous day that he had done something wrong in the third quarter, Owens does not suggest that he thinks that he ever signed any other “phony” financial statements, much less that Mr. Scrusy should have known this.

If Mr. Scrusy and Owens had engaged in a history of conspiring to subvert accounting rules, the conversation would plainly have been very different. Mr. Scrusy would, in that case,

have been asking Owens not what he, as the accounting expert, wanted to do, but what they, together, could get away with. Indeed, if Mr. Scrushy and Owens had been “cooking the books” together for a long time, there would have been no reason for this intense concern over the third-quarter numbers, which had not been questioned by other parties. In short, the comments of Mr. Scrushy were those of a CEO who certainly did not want another potential SEC problem but knew that he must rely on his CFO to get the financial reports right and could not direct the resolution of these issues himself.

IV. AN OBJECTIVE REVIEW OF THE EVIDENCE SHOWS MARTIN AS THE ORIGINATOR AND OWENS AS THE ORCHESTRATOR OF THE FRAUDS

A. Richard Scrushy’s Activities At HealthSouth And As A Civic Leader Were Far Removed From These Events

In addition to the active efforts undertaken by several HealthSouth executives to prevent Richard Scrushy from receiving financial information, the Government also will have to deal with the fact that Mr. Scrushy had numerous positions and outside pursuits that distanced him -- both figuratively and geographically -- from HealthSouth’s daily and financial reporting operations. These facts will only make it more difficult to establish “knowing” and “willful” conduct on Mr. Scrushy’s part.

Mr. Scrushy served as Chairman and CEO of HealthSouth for most of its twenty year history. He was the company’s public face, and the individual who brought in the business and made the deals. Metaphorically speaking, Richard Scrushy was the company’s “rainmaker.” It was through his visionary leadership that HealthSouth grew into a Fortune 500 company. And it was under his direction that HealthSouth provided quality and affordable rehabilitation services to thousands of patients nationwide. As Jim Goodreau has already testified, Mr. Scrushy was “a working chairman,” but had very limited contact with the finance or accounting departments.

Freeze Tr. at 800.³¹ Monzer Hourani will similarly testify that since meeting Mr. Scrusby in 1994 he quickly concluded that Mr. Scrusby was an "idea man" who formulated strategies and broad goals, but left the details, financial and otherwise, to his subordinates. The testimony of the five CFO's themselves, if truthful, will confirm this.

During the latter part of Mr. Scrusby's twenty year tenure as CEO, however, it is well-publicized and widely known that he spent less and less time directly managing the company and more time on activities he believed would enhance its image and reputation. As a result of these marketing and philanthropic efforts, he was compelled to manage HealthSouth from a distance and to depend increasingly upon the financial knowledge and skills of HealthSouth's top executives, such as Owens, Weston Smith, McVay, and Martin, as well as the Operating Presidents of the three HealthSouth divisions all of whom had their own financial staff.

Blake
focused on
wife's health
increasing
health proble
to point of
relocating to AL
to be near her
D.F.'s.

Suffice it to say that Mr. Scrusby maintained an intense and busy travel schedule, a schedule that kept him away from HealthSouth for nearly four months out of the 2002 calendar year. In fact, in 2002, Mr. Scrusby flew over 120 times to and from Birmingham. In 2002, he spent approximately 50 days in Florida attending board meetings for Gibson Music, fulfilling speaking engagements and commitments, and fundraising for charities.

Clearly, Mr. Scrusby's numerous non-HealthSouth related business activities and personal pursuits compelled him to manage HealthSouth from a distance and created the opening for Owens to try to displace him. Had he been aware of a serious impending fraud problem at the beginning of this year, it is hardly likely he would have agreed with the Board to resume his CEO position and demote Owens. Even a cursory review of HealthSouth's documents reveal the

³¹ Mr. Scrusby's most sustained exposure to the numbers and financial reports were the briefings and discussions on the plane before the investor conference or investment banking presentations. *Id.* at 1311.

absence of Richard Scrushy from the day-in, day-out operations of the company. These facts alone raise serious doubts about the credibility of any allegations that he had knowledge of, and willfully executed intricate frauds -- frauds that even Ernst & Young and numerous corporate executives charged with detecting corporate fraud missed entirely.

B. The Evidence Gathered To Date Points Clearly To Accounting Fraud Originated By Mike Martin And Carried On By Bill Owens

The story of the frauds at HealthSouth is one involving Mike Martin and Bill Owens, not Richard Scrushy. The tale is not the simplistic one outlined in the Government's sterile and formulaic factual statements for Rule 11 purposes. The size of the fraud is not what the Government's plea outline alleges; its origins and purposes are not those which the Government has attempted to shoe horn into a plot which they did not fit. The full story is certainly not known to us or to the Government and may not be known for some time, if ever.

For present purposes it is sufficient to say that this fraud likely began small as most things do and was more than anything else a product of the ego of Mike Martin. Having been hired and elevated by Richard Scrushy, Mike Martin's ambitions rapidly grew along with the size of HealthSouth. As Richard Scrushy's unerring instinct identified expansion and acquisition opportunities, Mike Martin maneuvered to become the leader of his acquisition finance team, thereby succeeding in permanently sidelining the hapless Beam. Bill Owens, a man of considerably less energy, but of significant intellect, was constantly driven by the more energetic and compulsive Martin to keep up. The team of Martin and Owens did the financial due diligence on every HealthSouth acquisition during the 1990's -- more than 20 in total with a total value of \$6.5 billion.

During that period the Martin-Owens due diligence team inevitably made mistakes. Unfortunately for them, a number of the acquisitions that Martin and Owens investigated and

recommended to Mr. Scrushy and the Board did not perform as predicted. Martin knew that the poor performance of these acquisitions would negatively affect both his and Owens' compensation, and advancement within the company. Martin faced a choice several times. He could suppress his ego and face the music from Scrushy and the Board by admitting his faulty predictions, or he could try to cover up the problem and manipulate his way out.³² Since Martin knew that his subordinate Owens had the requisite accounting skills to manipulate the numbers to produce better outcomes and to cover up his mistakes, Martin ordered him to do so. Some of the early manipulations may have been simple examples of aggressive, but permissible, accounting. However, at some point, Martin and Owens crossed the line.

Bill Owens was always in a position within the company to implement the frauds alleged and ultimately to direct them. Unlike Richard Scrushy and Mike Martin, Bill Owens had the accounting education and training necessary to implement frauds so complex that they went undetected by other well-trained and well-intentioned individuals. The story of Mike Martin and Bill Owens as partners in and architects of intricate and carefully-hidden frauds in order to conceal from Mr. Scrushy and the Board their major financial mistakes will be far more credible than Martin and Owens' effort to depict Richard Scrushy as ordering the commission of crimes which would senselessly destroy the institution he worked so hard to build.

While the manipulations may have begun during the nominal watch of Aaron Beam, they became significant when Martin took over as CFO in October 1997. Martin had been the company's Treasurer prior to becoming CFO. It was as Treasurer that he first became involved in the due diligence for many of the company's acquisitions. In doing so, he worked closely

³² The difficulty Martin and Owens faced was that their due diligence determined the acquisition price for an acquired entity. When an acquisition did not perform as projected by them, this meant that HealthSouth overpaid for the acquisition, thereby costing the company hundreds of millions of dollars. If exposed, any such failures would lead to prompt termination of both Martin and Owens.

with Owens and the two of them shared responsibility for the success -- and failure -- of the acquisitions they recommended to the Board and Mr. Scrushy. When Martin became CFO, he willingly accepted Owens as the Controller with whom he was already closely working. Given Martin's hard-charging and demanding management style, he pushed Owens to use aggressive accounting techniques in preparing the financial statements in order to hide the true results of the poor-performing acquisitions he and Martin had recommended.

As HealthSouth exploded in size, the pressures for performance and the obstacles to that performance increased. Each quarter's reports were more and more complex and difficult to prepare as a result of the continuing poor performance of some of the acquisitions Martin and Owens had recommended to Mr. Scrushy and the Board.³³ However, Owens, a former Ernst & Young auditor with an intimate knowledge of HealthSouth's internal accounting controls, knew which strings could be safely pulled and which strings could not without alerting the external auditors (*e.g.*, the \$5,000 threshold for escaping Ernst & Young scrutiny). Martin was relentless in his pressure on Owens to insure good numbers so that neither he nor Owens would have to face critical scrutiny from above.

After Martin was forced to resign from the company in February 2000, Owens took over as CFO and ultimately reaped the whirlwind that Martin had originated. Owens moved his best friend, Weston Smith, into the Controller position.³⁴ With a loyal friend now in his prior position, Owens ensured his control over the past and any necessary future manipulations. This

³³ Ultimately, in 2002 Owens also needed to compensate for his drastic underestimation of the impact upon HealthSouth's finances of the new Medicare reimbursement policy set forth in Medicare Transmittal 1753. Even the drastic write off in the third quarter of 2002 apparently proved insufficient to cure the problem.

³⁴ Owens was even godfather to two of Smith's children.

partnership continued when Owens became President in August 2001, and Smith was promoted to CFO.

Whether due to blind ambition or some other motivation, Owens like Martin before him was not content to merely serve as President of HealthSouth. He had his eye upon the CEO position occupied by Mr. Scrushy and envied the money he had made. In fact, Owens openly questioned others as to whether he could make \$100 million and obtain admission to Augusta National if he were named CEO. In addition, Owens knew that Mr. Scrushy had become increasingly disengaged from the management of HealthSouth and that he was considering retirement from his CEO position. Owens also knew that if Mr. Scrushy retired, he would be one of the leading candidates for the CEO position, but only if HealthSouth continued to record strong financial performance and, most importantly, if the prior frauds remained hidden.

Owens' dreams of becoming the HealthSouth CEO were realized in August 2002. It was not long after his elevation, however, that things began to unravel at HealthSouth. Just days after he was formally installed as the CEO, the company released a press statement indicating that a new Medicare regulation would reduce HealthSouth's revenues by approximately \$175 million per year (the Transmittal "1753 issue"). Owens was personally criticized for his handling of the 1753 issue, and the stock price suffered for it. Not long after that, HealthSouth decided that it was abandoning its long-planned split into two separate companies. This was particularly disturbing to Owens because he had lost the opportunity to free himself from Mr. Scrushy's oversight.

Faced with the prospect of Chairman Scrushy overshadowing his leadership of the company and needing to implement an increasingly complicated cover-up for the various frauds, Owens decided to take matters into his own hands. Together with Tad McVay, he launched a

plan to persuade major investors in concert with the directors to oust Mr. Scrusby from his position as Chairman and get rid of him once and for all. As indicated, Mr. Scrusby eventually learned of this coup and exposed both Owens and McVay to the board of directors. Both were summarily demoted, and Mr. Scrusby was reinstated as CEO in January 2003.

Owens became withdrawn and despondent. Owens placed enormous importance on his title and position at HealthSouth, which he viewed as part of his social standing. His demotion from President and CEO back to CFO was both devastating and humiliating. His wife took it particularly personally and became embittered against Richard Scrusby.

Owens quickly came to the realization that he needed an exit strategy. The fraud and financial manipulation that he had inherited from Martin and had expanded were in danger of collapsing. Acquisitions which could cover up problems were unavailable given the depressed price of HealthSouth stock. He was no longer the CEO and was losing the control that he needed to continue concealing the fraud at HealthSouth.³⁵ In essence, he no longer had the power to postpone the day of reckoning for himself. All of the financial wealth that he had accumulated during his management of the frauds was in jeopardy. Acting in desperation, he even summoned his friend Jim Goodreau to a secret meeting to explore the possibility of breaking into the HealthSouth computer system in order to alter the financial data. *See supra* note 22.

In a last ditch effort to save some semblance of the lifestyle and good financial fortune that he had provided for his family, Owens developed a plan to pin the HealthSouth financial frauds on Richard Scrusby. He knew that the Government was investigating Richard Scrusby for alleged insider trading. He thus concluded that it would not be difficult to blame Mr. Scrusby --

³⁵ The possession of a huge uncashed check by one of the subordinates, a cooperating witness, (known to the Government) suggests that Owens (unlike Martin) may have compensated for his lack of energy by attempting to pay people to carry out his scheme.

someone whose ability was widely respected, but whose ostentation and flamboyance were widely resented -- for his and others' past criminal conduct. Owens knew that his only option was to turn himself in and cut the best deal for himself that he could by offering to serve up Mr. Scrushy, even if it meant lying about Mr. Scrushy's involvement. In his own words, he planned to take some "good people" down with him, and he was "going to have to do whatever I have to do to look after my own self." Freeze Hr'g Tr. at 827. Owens ultimately disclosed his orchestration of the frauds to the Government in early March 2003, and then falsely suggested that he performed them at the direction of Richard Scrushy in order to minimize his own punishment.

In apparent recompense for his cooperation, the Government permitted Owens to transfer one of the properties that he held jointly with his wife into her name alone in advance of his guilty plea. Similarly, the Government permitted Owens to transfer another property that he held jointly with his wife into his name alone, presumably with the understanding that that property would be the only one that he would be required to forfeit for the crimes he committed. In agreeing to these transfers, the Government effectively assisted Owens in shielding the proceeds of his crimes and provided additional inducement for his false testimony against Richard Scrushy.

Following the Government's execution of the search warrant on March 18, defense witnesses will testify that Owens provided further evidence of his current leadership of the HealthSouth fraud "family." Because he knew that the search would uncover evidence implicating all "family" members, Owens held a series of individual meetings with each one and recorded the names of their respective counsel. It also is likely that Owens wore a wire for the Government during these meetings -- a possibility which could explain the large number of rapid

guilty pleas by his subordinates.³⁶ Again, these were meetings and developments of which Richard Scrushy had no knowledge.

Owens' efforts to implicate Mr. Scrushy in his fraudulent activities have already fallen short in multiple respects. His most spectacular and costly failure was his inability to get Mr. Scrushy to incriminate himself during the day and a half he wore a wire preceding the HealthSouth raid on March 18. If the Government's theory were correct, this was a golden opportunity to obtain direct evidence that Mr. Scrushy was involved in these frauds. The effort failed completely, for the simple reason that Mr. Scrushy was not involved in the fraudulent activities.

As previously discussed, the Government introduced its "best" tape -- its purported "smoking gun" -- in the asset freeze hearing. It failed to establish the Government's case for a freeze on a far lesser standard of proof than beyond a reasonable doubt. While the identity of the Government's lawyers have changed, the strength of its evidence has not, even though more cooperators are now available. Owens' plea bargaining with the Government and the assets that he was apparently able to protect from forfeiture will only further undermine his personal credibility with any jury.

V. THE CIRCUMSTANTIAL EVIDENCE DOES NOT SUPPORT A CASE AGAINST RICHARD SCRUSHY

A. Richard Scrushy's Conduct Toward His Alleged Co-Conspirators Is Inconsistent With The Government's Proffered Theory

The notion that Richard Scrushy participated in the criminal frauds at HealthSouth is further contradicted by his conduct toward his supposed co-conspirators. If called to testify

³⁶ Of course, if it were to emerge at any trial that Owens as the Government's lead cooperator did in fact record his loyal subordinates in order to ensnare them on the Government's behalf, the impact of such a revelation on Owens' appeal to the jury as a witness would likely be significant.

against Mr. Scrushy, each of the last five CFOs at HealthSouth -- Owens, McVay, Smith, Martin and Beam -- will have to admit that they were either demoted, fired or encouraged to resign by Mr. Scrushy, at significant financial and personal cost to themselves. This is entirely inconsistent with the Government's case. Had Mr. Scrushy been involved with these men in a conspiracy, he would have done everything within his power to protect them from suspicion and to ensure their loyalty. Firing, demoting or encouraging early departure of all five during the period he is alleged to have been their partner in the crime, by contrast, would have been reckless at best. At trial, the Government would have to explain why a savvy and intelligent person like Mr. Scrushy would consistently create adversity and animosity on the part of those he most needed to protect himself from exposure as a criminal.

Perhaps no one suffered more professional and personal humiliation at the hand of Mr. Scrushy than Bill Owens. As discussed above, in late 2002, Mr. Scrushy uncovered a plot that had been launched by Owens to convince major investors and the Board to remove Mr. Scrushy as Chairman and drive him out of the company. After Owens' campaign fizzled, members of the Board as well as Scrushy himself became focused on his shortcomings including his failure to forewarn them about the impending Medicare Transmittal 1753 debacle. As a result, on January 6, 2003, Owens was formally demoted from CEO back to CFO. After just four months on the job, Owens' dream of becoming CEO of HealthSouth and a \$100 million dollar man crashed.

Tad McVay also was punished for his role in the attempt to oust Mr. Scrushy. A willing participant in Owens' plan, McVay was demoted from CFO to Treasurer. This should have come as no surprise to him. Throughout his brief career at HealthSouth, McVay repeatedly expressed an apprehension that Mr. Scrushy would punish him if some of his more reckless conduct was ever revealed. For instance, in late 2002, McVay pleaded with Hourani not to

inform Mr. Scruschy of the debacle that McVay had created surrounding the sale of HealthSouth assets to the Cambridge Company. Again, in late 2002 when Scruschy first discovered Owens' planned coup, McVay physically avoided Mr. Scruschy fearing that he was about to lose his job and asked Owens to intervene on his behalf. As indicated, these fears were well-founded.

Weston Smith likewise suffered a demotion and pay cut at Mr. Scruschy's direction during his career at HealthSouth. In August 2002, Smith was moved from CFO, a position he held for just one year and transferred by Owens (the CEO), to an operations position in the Inpatient Division with the same salary and hierarchical status. This transfer moved Smith from a position in which he wielded substantial power over the financial aspects of HealthSouth's entire operation to one in which he was involved with business development in a single division. Moreover, he no longer reported to the CEO nor supervised any employees. He reported to Pat Foster, the Inpatient Division president. While Foster would have been content to maintain Smith's salary and status, Mr. Scruschy believed that the change in function required Smith to take a \$130,000 pay cut -- commensurate with his reduced responsibilities. Scruschy requested Foster to implement this demotion and pay reduction. Thus, if Smith is to be believed, in August 2002 Mr. Scruschy not only intentionally removed one of his co-conspirators from a position in which he would have been most able to assist in the continuation of the fraud to one in which he could be of no assistance at all. Further, he insisted on doing so in a way that was sure to upset and alienate him. Obviously, the credibility of Smith's allegations are undercut by Mr. Scruschy's actions toward him which would have been suicidal if Mr. Scruschy knew that Smith could truthfully place him at the center of or even implicate him in these frauds. In contrast, Owens' contrasting initial action as CEO in transferring Smith while maintaining his

full pay and executive status is the action of one who is fully aware of Smith's sensitive role as a partner in crime who requires unusual and special treatment.

The adverse action of Mr. Scrusby in firing Mike Martin makes his allegations similarly suspect. Martin did not resign in late 1999 because of his unwillingness to continue with the fraud as he stated to Judge Clemon. Martin Plea Tr. at 11. As indicated, he resigned because it was "resign or be fired." When he hastily tendered his resignation by leaving it on Mr. Scrusby's desk, he knew that Mr. Scrusby was getting on an airplane to fire him -- because he was told that he was "finished" at HealthSouth -- as other witnesses will confirm. Thus, the Government will have to explain why Mr. Scrusby was willing to fire a colleague with whom he had been involved in a criminal conspiracy for more than seven years -- and who "had the goods" on Mr. Scrusby -- simply because Martin had publicly cursed him. Like the others, Martin failed to receive the protection or special consideration one would have expected from an alleged co-conspirator, vulnerable to crippling retaliation.

Finally, Mr. Scrusby actively encouraged Aaron Beam to resign from the company, which he did in 1996, when Beam came to him and contemplated retirement. Completely unfit for the duties and responsibilities of a company like HealthSouth, and unwilling to endure the constant criticism he received from subordinates such as Mike Martin, he solicited Mr. Scrusby's advice. Mr. Scrusby did not attempt to protect or comfort Beam. Quite the opposite, he suggested that it was time for Beam to leave the company. Beam resigned shortly thereafter.

Mr. Scrusby's principal accusers were all severely disciplined and demoted -- and in Martin's case run out of the company -- by Mr. Scrusby, in time.³⁷ But it would have been

³⁷ Mr. Scrusby also made the decision to fire HealthSouth's president, Jim Bennett, in 2000, who has also been targeted by the Government as a potential co-conspirator. We understand that Mr. Bennett does not accept the Government's allegations against him and is not cooperating with the Government's investigation. He has likewise rebuffed the Government's efforts to induce him to testify against Mr.

completely irrational for Mr. Scrusby to have pursued this course if they truly were acting as his lieutenants in a massive corporate fraud. The truth of the matter is that Mr. Scrusby was not interested in protecting Owens, Smith, McVay, or Martin. Nor was he reticent about disciplining them. In fact, his decisions to fire and demote these men would have been totally self-destructive if Mr. Scrusby were indeed relying on them to help carry out a long-term fraud, the details of which Mr. Scrusby would have been unable to fathom on his own. Clearly, Mr. Scrusby's personnel decisions were made with only one goal in mind: the legitimate one of ensuring the continued successful and proper operation of HealthSouth.

B. Richard Scrusby, In Contrast to His Accusers, Had No Motive To Commit the Fraud Alleged

Richard Scrusby had no motive to orchestrate or participate in the frauds alleged. By the late 1990s and early 2000s, Richard Scrusby was a wealthy and successful businessman and had no need to increase his wealth by running a numbers game that would place his career, his creation, and his entire investment in HealthSouth in jeopardy. The same cannot be said for the fourteen individuals that have admitted perpetrating the alleged frauds within HealthSouth. That Mr. Scrusby lacked the same incentives to commit the fraud as the Government's cooperating witnesses will undercut the Government's efforts to tie him to the scheme.

A simple analysis of the Government's disclosures regarding the timing and extent of fraud, how it relates to HealthSouth's performance, along with a corresponding analysis of Mr. Scrusby's interests shows that the Government's claim as to Mr. Scrusby's motive of self-enrichment are not supported. In fact, there analyses reveal the exact opposite. During much of

(continued...)

Scrusby, and has stated that it would constitute perjury for him to do so. Regardless, even if the Government's case against Mr. Bennett had any merit, which we do not believe it does, those circumstances would provide yet another example of someone whom Mr. Scrusby fired at great personal risk to himself if the government's potential claims against Mr. Scrusby were true.

the relevant period in which the Government has alleged improper conduct, Mr. Scrushy had no motive for fraud; and at other times, his financial interest stood directly contrary to the fraud undertaken. Indeed, if he had any knowledge of the timing, extent or nature of the financial overstatements at HealthSouth, Mr. Scrushy's stock transactions were particularly badly-timed and poorly-executed. The evidence simply does not support the Government's theory that Mr. Scrushy knew about, let alone orchestrated, the frauds. *See generally* Insider Trading Analysis at Appendix A.

1. Personal Financial Incentives

While the Government has asserted that greed was a motivation for Richard Scrushy's participation in the alleged frauds, we submit that his comparative wealth and his stake in HealthSouth is one of the central factors that distinguishes Richard Scrushy from the individuals that actually executed the alleged frauds.

Richard Scrushy is a man of significant financial means. His assets and lifestyle have been widely discussed, and often exaggerated, in the public media. However, until the Government executed its search warrant on HealthSouth on March 18, 2003, and then sought to freeze his assets, Richard Scrushy's financial strength was never threatened. He faced no margin calls or personal financial events that would have provided him with a motive to make a quick buck at the expense of HealthSouth's shareholders or the market as a whole.

In contrast, the individuals who have pled guilty to the alleged HealthSouth frauds do not maintain a high net worth. Some of them are young executives with modest incomes. Some of them, like Bill Owens and Weston Smith, were financially comfortable, but none of those individuals possessed the significant wealth that Richard Scrushy did. The lure of profiting from a short term run-up in HealthSouth's stock price was simply much greater for these individuals

than for Mr. Scrusby. This fact, alone, separates Mr. Scrusby from those that have admitted engaging in fraud.

Furthermore, in three of the years at issue -- 1998, 1999, and 2000 -- the company failed to meet internal budgetary targets, and, as a consequence, numerous executives, including Mr. Scrusby, failed to receive any performance bonuses.³⁸ This fact cannot be squared with the Government's theory that Mr. Scrusby acted for his own pecuniary gain and, therefore, seriously undermines the Government's burden of demonstrating criminal intent. If Mr. Scrusby were ordering his subordinates to "fix" HealthSouth's earnings so that he would earn his bonus, apparently -- and contrary to the Government's claim -- his instructions were highly ineffective, missing three years in a row. It would be senseless for a ringleader to concoct a grand scheme to manipulate earnings to achieve a bonus target and then repeatedly fail to hit the target triggering its bonus.

Mr. Scrusby also had no incentive to manipulate earnings in order to profit from stock transactions. Indeed, the evidence will show that Mr. Scrusby's sales and purchases of the HealthSouth stock generally mirrored that of the outside directors, none of whom have been implicated by the Government in any of the alleged frauds.

Perhaps even more significantly, Mr. Scrusby always maintained a substantial beneficial interest in HealthSouth following his sales of HealthSouth stock. True perpetrators of a fraud of the type alleged will typically inflate earnings so that they can sell out of a position when the underlying stock reaches a predetermined level. Therefore, and according to the Government's theory, one would expect to see Mr. Scrusby timing his trading to take advantage of the favorable effects of the fraud on the stock price. But Mr. Scrusby did not do that.

³⁸ Several executives, including Richard Scrusby, did, however, receive compensation in addition to their salary in the form of stock awards in 1999.

The most fundamental flaw with the Government's insider trading theory is that during the period of the alleged fraud, Mr. Scrusby was a net accumulator of stock in HealthSouth -- the opposite of what would be expected from someone who had knowledge that up to 20% of the company's balance sheet was falsely inflated. See Figure 1. If Mr. Scrusby's purchase and sale activity in HealthSouth stock is evidence of anything, it is that he was committed as a long term investor to the long run success of HealthSouth and not to any short term "pump, dump and then get out" scheme. Even today, Mr. Scrusby remains one of the largest shareholders in HealthSouth, and is thus a huge loser in the decline of HealthSouth's value due to these frauds and other factors.

**Richard Scrusby's Increase in Stock Ownership
During Alleged Fraud Period**

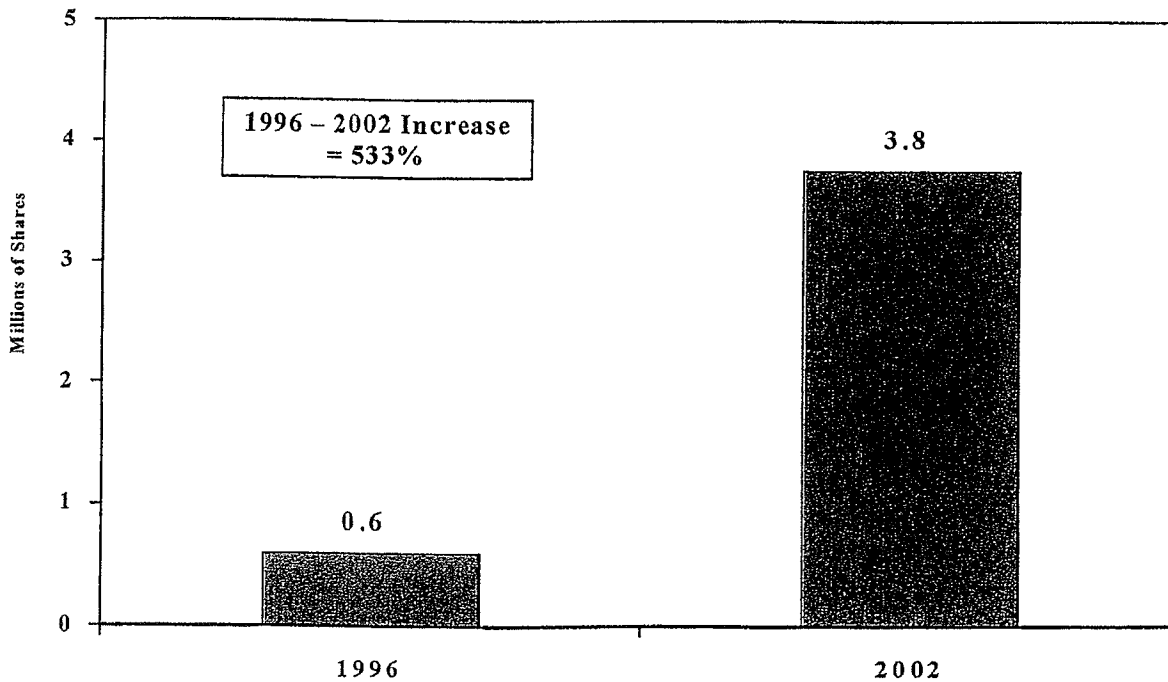


FIGURE 1

Finally, many of Richard Scrushy 's stock trades have already been subjected to intensive scrutiny, including an independent investigation by Fulbright & Jaworski (*see generally* Appendix D), and in the hearing before Judge Johnson. In both cases, it was concluded that Mr. Scrushy was innocent of any wrongdoing as to the trading examined.

2. Supposed Desire to Meet Wall Street Expectations

The Government alleges that HealthSouth officials, acting pursuant to Mr. Scrushy's direction, fraudulently manipulated HealthSouth's financial books and records in order to beat Wall Street earnings estimates, to achieve gains in stock transactions, and to earn management bonuses. A review of the periods in question, however, reveal that the facts provide no support for these motives or any theory of Mr. Scrushy's orchestration of a fraud to achieve these goals. In fact, HealthSouth often failed to meet the earnings estimates issued by Wall Street analysts during the relevant time period. The Government alleges that HealthSouth officials fraudulently manipulated HealthSouth's earnings per share ("EPS") in order to meet or beat Wall Street analysts' expectations. The evidence, however, refutes this allegation. In fact, a comparison of HealthSouth's reported EPS³⁹ to a consensus estimate of analyst expectations indicates that HealthSouth consistently failed to meet market expectations. *See* Figures 2 & 3.

³⁹ This EPS is reported in accordance with GAAP. Obviously, to the extent a quarter's EPS was infected by fraud, the earnings would not be reported in accordance with GAAP. This caveat applies to all references to "GAAP-reported" earnings.

**Earnings Per Share: Reported v. Analyst Consensus
(1995-2002 by Year)**

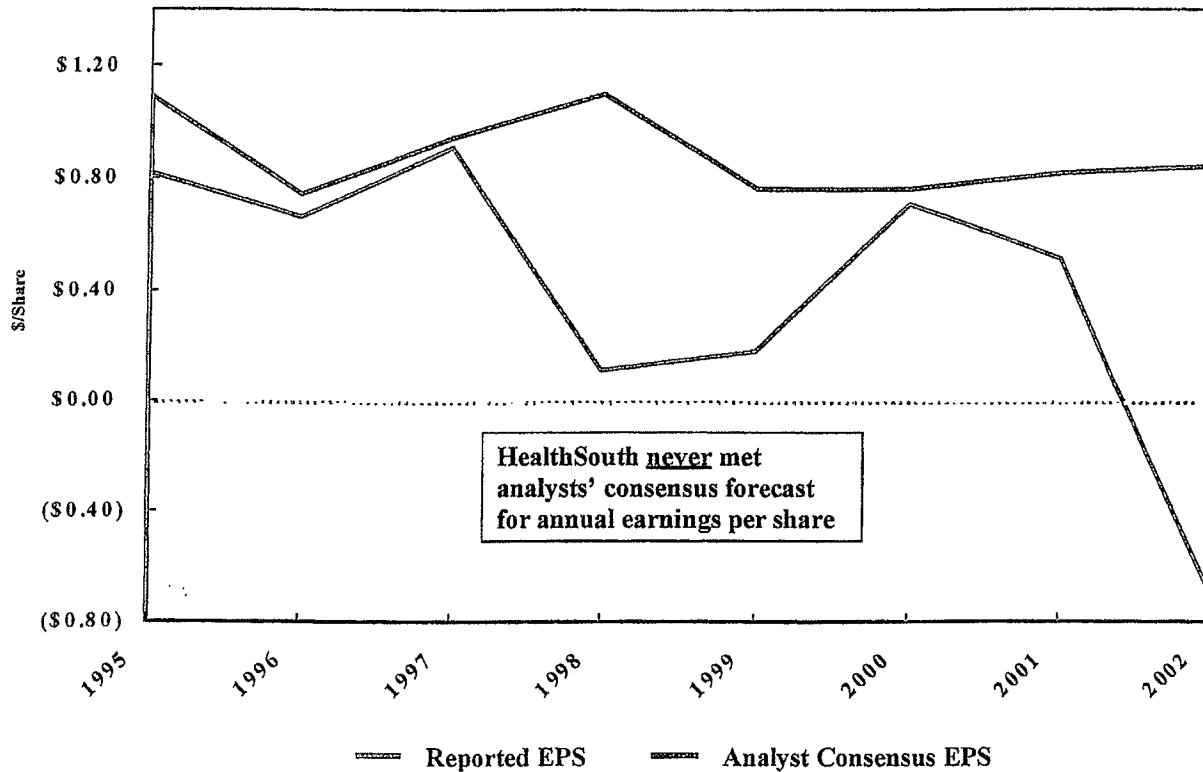


FIGURE 2

The only year in which HealthSouth's annual reported earnings exceeded the consensus estimate of "Wall Street" analysts was 1987. Indeed, from 1987 to 2002 HealthSouth missed analyst expectations in four of these years by more than fifty cents per share.⁴⁰ Most significantly, between 1995 and 2002, HealthSouth beat the markets' earnings expectations in only three out of thirty-one quarters, and met quarterly expectations only eleven times.⁴¹ In other

⁴⁰ HealthSouth missed analyst estimates of EPS by \$1.08 in 1993, \$0.99 in 1998, \$0.58 in 1999, and \$1.51 in 2002. In addition, the calculated correlation coefficient between analysts' annual consensus estimate and HealthSouth's annual reported earnings for the period 1995 to 2002 is 0.08. A coefficient this close to zero indicates that actual reported EPS relative to analysts' expected EPS was widely divergent.

⁴¹ While we currently have annual GAAP and analyst EPS data from 1995 through 2002, we do not have GAAP EPS data for the fourth quarter of 2002. Thus, statements concerning quarterly

words, over the eight-year period during which the frauds are alleged to have occurred, HealthSouth failed to meet analysts' quarterly EPS estimates more than 50 percent of the time. If meeting or beating Wall Street expectations was the object of these financial frauds, the perpetrators spectacularly failed to achieve their goal.

Earnings Per Share: Reported v. Analyst Consensus (1995-2002 by Quarter)

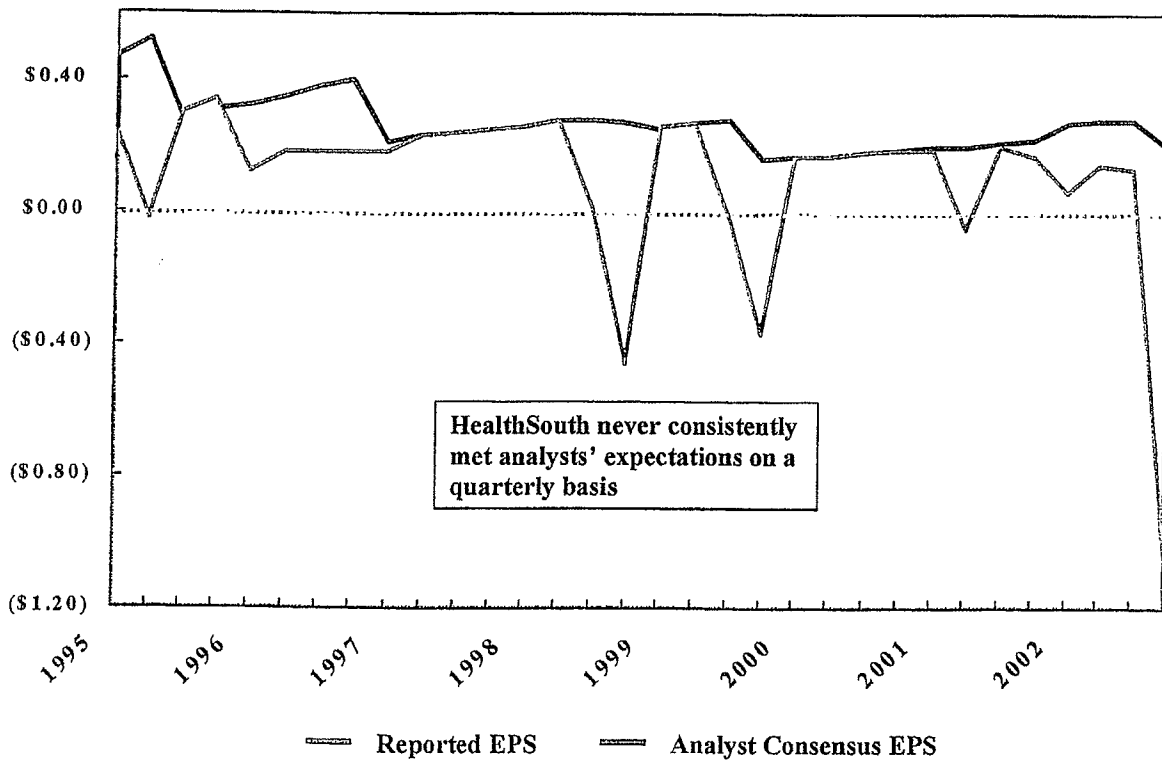


FIGURE 3

(continued...)

performance are based on only 31 quarters of data. During this period, the calculated correlation between the quarterly analysts' consensus expected earnings and HealthSouth's annual reported earnings is 0.16, this again reveals that there was no predictable pattern or link between analysts' expected EPS and the actual EPS reported by HealthSouth.

Moreover, HealthSouth's financial performance during the period that it allegedly overstated its income undercuts the logic and coherence of the alleged manipulative scheme. For example, in 1998 and 1999 HealthSouth fell far short of analysts' estimates due to enormous write-offs in the third and fourth quarters of both years. Third and fourth quarter charges in 1998 and 1999 were approximately \$448 million and \$587 million, respectively. See Figure 4 below. In essence, the Government's allegation is that Mr. Scrushy, at the helm of an organization taking enormous judgmental write-offs, was simultaneously ordering the falsification of financial information to create \$610 and \$421 million of false profits in 1998 and 1999, respectively.

HealthSouth Quarterly Financial Performance (1998-99)

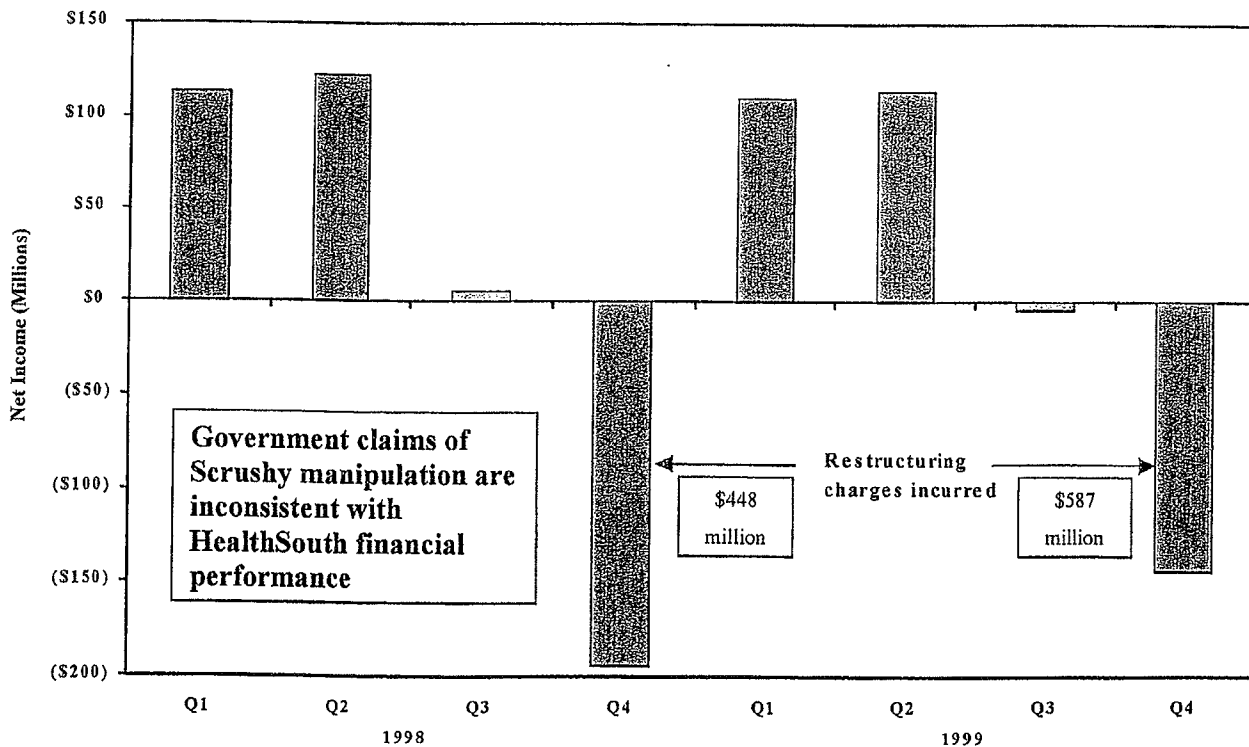


FIGURE 4

Contrary to the Government's theory -- but consistent with any other financial overstatement fraud of the type it has alleged -- the logical course for Mr. Scrushy, if he were truly motivated by monetary self-interest would have been to cause the company to *understate* earnings in 1998 and 1999. By causing the *understatement* of income in years of poor performance, he could not only have purchased shares of HealthSouth at a lower price, but he could also have cleared out costs that would have improved future operating results. This would have ensured that when he sold the stock in future periods he would achieve large gains. Thus, as far as Mr. Scrushy was concerned, the results alleged by the Government -- *overstatements* of earnings in 1998 and 1999 would have made absolutely no personal economic sense whatsoever.

In short, the Government's allegation that HealthSouth, at Mr. Scrushy's direction, fraudulently manipulated its earnings in order to meet or beat analyst expectations fails in light of the empirical evidence. HealthSouth's reported earnings repeatedly failed to meet Wall Street's expectations. This simple fact alone undercuts any theory that Mr. Scrushy could have directed his CFOs or anyone else to make fraudulent alterations in order to "hit the numbers," -- numbers it seems HealthSouth repeatedly failed to "hit."

C. Richard Scrushy's Accusers Had Motives Other than Financial Gain to Commit Fraud.

1. Desire To Vindicate Under-Performing Acquisitions For Which They Had Performed Due Diligence

Another motive factor that separates Richard Scrushy from those who actually committed the frauds is their desire and necessity to justify and vindicate past business combinations. HealthSouth grew exponentially during the 1990s due to numerous corporate mergers and acquisitions. The CFOs and Controllers were responsible for analyzing the value of these acquisitions and determining a purchase price. It now appears in hindsight that certain of those business combinations failed to produce the value that these individuals who recommended the

transactions had predicted. Significantly, the very individuals that recommended the execution of those transactions to Richard Scrushy and the Board of Directors were the same individuals that controlled the presentation of the company's financial results to Wall Street -- the cooperators -- most notably Bill Owens, Weston Smith, Mike Martin and Tad McVay.

These individuals, fully cognizant of the fact that their compensation and advancement in the company was predicated in part on the success of their recommendations, had the means and ability to make the impact of the acquisitions on HealthSouth's financials appear to be better than they truly were. For example, if a transaction that Mike Martin and Bill Owens had recommended to the Board and Mr. Scrushy did not perform as they had predicted, Bill Owens had the means at his disposal to make that transaction look more accretive to the company than it truly was through a manipulation of HealthSouth accounts. This was a clear personal survival motivation for the execution of the frauds that Richard Scrushy did not share.

2. Misguided Desire To Please Superiors

By most accounts, Richard Scrushy is an intense and demanding executive. He expected best efforts from HealthSouth employees, and strongly encouraged the development of a team environment that would achieve corporate growth and success. It was this challenging environment and these leadership qualities that helped HealthSouth grow into a multi-billion dollar company. However, these same challenges may have caused certain executives (discussed elsewhere) -- in a misguided desire to satisfy their colleagues, bosses, or Richard Scrushy to take the "easy way" out. Rather than face reality or confess failure, they began to fudge results. They could have thought that this preserved their jobs and their bonuses and that their misjudgments in a rapidly growing company would never be discovered.

Richard Scrusby did not share these incentives. Richard Scrusby stood at the pinnacle of the HealthSouth corporate structure. This absence of a desire or need to impress others, or create a personal track record of success dramatically separates him those who committed the frauds.

3. Owens' Ambition To Succeed Richard Scrusby

Bill Owens was a top executive at HealthSouth for over 15 years. As described above, he rose from Controller to CFO to President, and for a short time, served as HealthSouth's CEO. While his former superior and predecessor Mike Martin had staged various fights with Scrusby internally for control of certain activities, Martin only once in a fit of megalomania attempted to persuade Scrusby to step down in favor of himself. When Martin was forced out in 2000 and Scrusby thereafter displayed a willingness to disengage, for Owens the Martin fantasy was a near reality. Bill Owens could now think of taking over HealthSouth and making it his own. Whether motivated by a genuine belief that he could do a better job than Richard Scrusby, his \$100 million fantasy, or an overriding desire to gain entrance to Augusta National, Bill Owens knew that two things were required for him to take over HealthSouth: (1) top financial performance by HealthSouth largely attributable to his efforts; and (2) the complete removal of Richard Scrusby from positions of control and authority within the company.

Owens knew that his ability to remove Mr. Scrusby from his position of control would depend in large part on the continued financial growth and success of the company. Any marked decrease in the reported financials of the company would have to be explained by Owens, and any such excuses would impair his ultimate goal of gaining Board support. This was a strong motivation for Owens to manipulate or falsify the company's financial statements, and certainly not one that Richard Scrusby shared. This stark difference in motivation and ambition clearly distinguishes Mr. Scrusby from Bill Owens, the long-term linchpin of the HealthSouth frauds.

4. Loyalty To Owens

Another motivation that Richard Scrushy did not share with many of the conspirators was a “loyalty” to Bill Owens. Some of the conspirators were “loyal” to Owens because he apparently provided them fraudulent payments in exchange for their participation in the fraud. The evidence will show, for example, that Owens -- the individual with operating power over the company’s checkbook -- gave Kay Morgan a \$1 million check in exchange for her participation in the fraud. Kay Morgan apparently was so troubled by her own conduct that she could not bring herself to cash it.

Other conspirators were “loyal” to Owens because of a strong personal friendship with him. As previously discussed, Weston Smith and Owens were close friends for many years. And the latest individual to plead guilty to the conspiracy, Richard Botts, was a good friend of Owens from their hometown, high school and fraternity brother days at Troy State. In contrast, Mr. Scrushy had only a business relationship with all of the co-conspirators, and demoted, fired or caused the early departure of all five principal ones.

VI. CONVICTION WILL BE VIRTUALLY IMPOSSIBLE GIVEN THE INHERENT FLEXIBILITY IN FINANCIAL MANAGEMENT AND RICHARD SCRUSHY’S GOOD FAITH RELIANCE ON ACCOUNTING PROFESSIONALS AND INTERNAL CONTROLS

Financial management, reporting and accounting are disciplines replete with judgmental questions, the answers to which can have a dramatic impact on a company’s final results. Never was this more apparent than during the rapid economic expansion of the 1990s. These facts will make it difficult for the Government to establish that Richard Scrushy had the requisite criminal intent to commit the crimes it plans to allege, and that he did not justifiably and in good faith rely on the expert judgments of Ernst & Young, his CFOs, his general counsel, and other finance professionals. The flexibility and judgment inherent in accounting standards will compel a battle

of experts at trial which will be virtually impossible for the Government to win beyond a reasonable doubt.

A. Proper Accounting Is Inherently Discretionary And Flexible

Certain areas of accounting are black and white, but there are other substantial areas of accounting that are not based on hard and fast rules. They rely instead upon the discretion and judgment of highly-trained and skilled accountants.

HealthSouth was by no means immune to these accounting uncertainties. Indeed, the presentation of HealthSouth's financials depended to a large extent on the discretionary answers that its accountants gave to the many and varied accounting questions they faced. Many of these answers related to the treatment of items that the Government has alleged were used to orchestrate the accounting fraud in question: the capitalization of expenditures; a change in contractual adjustments; and the use of reserves obtained from mergers and acquisitions. However, as discussed below, these items are capable of differing, and perfectly proper, treatments depending upon the individual facts and circumstances. Because of this variability, there will inevitably be a battle of the experts over what approaches are reasonable. In the end, it will be difficult to establish beyond a reasonable doubt that anyone "willfully" engaged in the alleged frauds absent concrete, irrefutable evidence establishing criminal intent, which is lacking here.

1. The Proper Capitalization Of Expenditures

The Government has alleged that one of the schemes used to falsely inflate the net income and earnings per share of HealthSouth was the improper capitalization of certain

expenditures. However, it is perfectly proper to capitalize an expenditure if it creates an “asset” for the company.⁴²

The determination of whether an “asset” has been created is governed by Financial Accounting Standards Board (“FASB”) Concept Statement 6. Under that guideline, an “asset” exists if there is a “probable, future economic benefit obtained or controlled by a particular entity as a result of past transactions or events.” Although most accountants agree in principle that expenditures for a “probable, future economic benefit” should be capitalized, they vary in the application of this principle.

a. The Proper Capitalization Of Expenditures Related To Property, Plant & Equipment

Most accountants agree that the cost of painting a building should typically be treated as a non-capitalizable repair and maintenance expense. But if the painting is done in order to project a corporate image say, for example, a certain color that would assist in identifying the facility in question for the public -- such as the red roof on a “Red Roof Inn” or the red exterior of a McDonald’s restaurant -- many accountants would agree that this expenditure should be capitalized in a property, plant and equipment (“PP&E”) account because it will yield a “probable, future economic benefit” to the company.⁴³ However, the application of these principles may substantially vary as the probability of the “future economic benefit” becomes less clear.

Some of the governing accounting associations have issued statements in an effort to clarify the subject. The Accounting Standards Executive Committee for the American Institute of Certified Public Accountants (“AICPA”) published an exposure draft, dated June 29, 2001,

⁴² See Stephen M. Bragg, *Accounting Reference Desktop* 184 (2002).

entitled "Accounting for Certain Costs and Activities Related to Property Plant and Equipment."⁴⁴ On the same date, the FASB issued a draft of a Proposed Statement of Financial Accounting Standards entitled "Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant and Equipment."⁴⁵ Both of these drafts "address diversity in accounting for expenditures related to PP&E including improvements, replacements, betterments, additions and repairs and maintenance." Although the full impact of these drafts is still unknown, it is fair to say that both recognize that it is common and understandable for accountants to differ in their handling of expenditures relating to PP&E.

This is perhaps an unsurprising conclusion to the accounting community, but its application to this case is significant. Absent substantial, direct proof of Richard Scruschy's criminal intent and involvement in the frauds alleged, it will be difficult for the Government to establish that Mr. Scruschy "willfully" participated in a fraud with respect to the capitalization of PP&E expenditures. Mr. Scruschy neither had the ability nor the knowledge to determine what was improper in this discretionary area of accounting.

b. The Proper Capitalization Of Expenditures Related To Internet and Software Development

Specific allegations also have been made with respect to HealthSouth's characterization of certain costs as internet or software development capital. However, like the capitalization of

(continued...)

⁴⁵ *Id.* at 185. If the expenditure will have "an incremental impact on the asset in future periods, rather than solely in the current period," the expenditure should be capitalized. *Id.*

⁴⁴ See American Institute of Certified Public Accountants, Inc., *Exposure Draft: Proposed Statement of Position: Accounting for Certain Costs and Activities Related to Property, Plant and Equipment*, June 29, 2001, at <http://ftp.aicpa.org/public/download/members/div/acctstd/edo/aicpaed.pdf>.

⁴⁵ See Financial Accounting Standards Board, *Exposure Draft: Proposed Statement of Financial Accounting Standards: Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant and Equipment*, June 29, 2001, at <http://ftp.aicpa.org/public/download/members/div/acctstd/edo/fasbed.pdf>.

expenditures relating to PP&E, there is nothing improper about the capitalization of costs relating to the internal development of software or internet-related items if it is reasonably determined that the expenditures will lead to a probable “future economic benefit” for the company.⁴⁶

During much of the relevant period, the accounting treatment for expenditures related to software and internet development was governed by the AICPA’s Statement of Position (“SOP”) 98-1. Under this standard, expenditures may be capitalized only after management has completed conceptual formulation of the project, approved its funding, and concluded that the success of the project is probable. At that point, costs that would otherwise be expensed -- such as payroll costs, service costs, and even interest costs after technological feasibility is established -- may be capitalized.

To illustrate, suppose HealthSouth was interested in developing a new, high-tech patient diagnostic and records sharing system. There would be an initial period of time during which management explored the feasibility of the project. During that period, all costs associated with the project -- including payroll, interest costs and external service costs -- would be deemed research and development charges and expensed as period costs. At some point, however, management may become convinced of the feasibility of the project and authorize further development (such as was the case with the Digital Hospital). At that point, all of the costs that were initially listed as expenses could be appropriately capitalized pursuant to SOP 98-1. These costs would then be held in a “construction-in-progress” account until the new billing program is put in service. At that point, the capitalized costs could be depreciated or amortized.

⁴⁶ See AICPA’s Statement of Position (“SOP”) 98-1.

As this example illustrates, the reversal of expense entries relating to a software or internet project is highly judgmental, by no means abnormal, and in most instances fully anticipated. Consequently, the existence of documentation in HealthSouth's files evidencing the reversal of certain expense accounts and related debiting of certain capital internet accounts is even less remarkable than the reversal of accounts related to the capitalization of certain PP&E expenditures. This fact, along with Mr. Scrushy's lack of expertise in accounting matters and lack of connection to any of the allegedly fraudulent acts, will again make it difficult for the Government to establish that Mr. Scrushy "willfully" orchestrated a fraud in the handling of these accounts.

c. The Proper Reassessment Of Expenditures For Capital Treatment

Given the large amount of discretion that is involved in the capitalization of expenditures, it is not uncommon and entirely proper for senior accountants to reassess the assumptions made by lower level accountants in determining the corporate expenditures that should be capitalized prior to the final issuance of the company's financial statements.⁴⁷ In other words, a senior accountant may properly decide that a lower level accountant mistakenly treated a painting expenditure as a "repair and maintenance" expense and reverse the entry so that it is properly listed as capital. Some would even suggest that a failure to perform such a reassessment would evidence a weakness in a company's internal controls.⁴⁸

Reassessments by senior accountants are often precipitated by a company's performance being better or worse than expected.⁴⁹ Variances in the company's performance will typically

⁴⁷ See Bragg, *supra* note 42, at 297 (referring to "Closing Activities Subsequent to Period-End.").

⁴⁸ See The Bizmanualz Accounting Policies, Procedures and Forms. *G&A 105 Period-End Review & Closing*, (2002).

⁴⁹ *Id.*

cause senior accountants to review their accounting staff's work to determine whether mistakes have been made or whether there should be any changes in the treatment of the accounts. Types of reassessments include (1) lowering the threshold of expenditures that potentially qualify for capitalization, particularly if the company has purchased a large number of relatively small items such as durable equipment; (2) reassessment of the assets' useful lives to determine whether the assets are lasting longer than the useful lives originally assigned; and (3) reassessment of individual items for which upper management may have a different perspective with respect to the likelihood of future economic benefit. There is nothing improper about these reassessments provided they are supported by GAAP, executed consistently, and properly disclosed.⁵⁰

Given these facts, the capitalization of expenditures about which the Government complains could as easily be a legitimate management reassessment of the nature of the expenditures as it is a component of the alleged fraud. Indeed, it was this very type of explanation that evidently satisfied Ernst & Young when it became aware of some instances of the allegedly improper capitalization of expenditures in the Summer of 2002.⁵¹

If Ernst & Young considered management's reassessment and capitalization of expenses proper after they became aware of allegations of impropriety with respect to the practice, there is no reason to believe that Richard Scrushy would or should have considered it improper. Absent direct evidence of complicity, there is no reason why Mr. Scrushy, with his lack of sophistication in accounting matters, would have any reason to come to a conclusion different from the expert accounting view of Ernst & Young on which he necessarily relied.

⁵⁰ *Id.* at 5.3.5 indicates that the controller of the company should establish a minimum threshold amount for capitalization of expenditures of the company: *see also* Bragg, *supra* note 42, at 183 (recommending that the Board of Directors establish a capitalization threshold under which no assets are capitalized).

⁵¹ *See* Freeze Hr'g Tr. 1549-50 (Testimony of James Lamphron, Ernst & Young Partner).

2. Accounting For Contractual Adjustments

Another focus of the Government's allegations to date has been HealthSouth's treatment of contractual adjustments as an offset to the company's revenue. Like the capitalization of expenditures discussed above, the accounting treatment for contractual adjustments is inherently judgmental, and any change in the accounting treatment applied will likely have a significant and material effect on the amount recorded. These facts will again make it difficult for the Government to establish that Richard Scrushy "willfully" engaged in a fraud with respect to these accounts or even suspected it absent evidence of direct, illicit communications regarding the alleged fraud's execution.

The accounting for contractual adjustments is inherently judgmental because it involves significant estimation regarding the amount of patient billings that will remain outstanding following collection efforts from both the third party payors and the patients. The estimation is complicated by numerous other factors, including but not limited to, conflicting and differing third party payor arrangements; special provider policies and practices (such as courtesy discounts to medical staff members and other administrative adjustments); prospective rate-setting that allows for retrospective adjustments; state waiver contingencies that allow the federal government to recoup certain excess state payments; poorly or improperly-documented medical and billing records; and numerous legislative, quasi-legislative and regulatory initiatives that change the amounts that can be recovered. As a result, the amount listed in the contractual adjustment account is always subject to change based upon a change in accounting assumptions.

The fact that Ernst & Young failed to detect any fraud in this account is particularly significant. The AICPA Audit and Accounting Guide for Health Care Organizations states the following with respect to the contractual adjustment account:

2.23 Although management is responsible for making estimates, the independent auditor is responsible for evaluating the reasonableness of estimates and should consider appropriate procedures in planning and performing the audit.⁵²

Richard Scrushy justifiably relied on Ernst & Young's evaluation of the reasonableness of HealthSouth's assessment, and absent direct proof that Richard Scrushy directed a fraud with respect to these accounts, it will be difficult to establish any "willful" criminal act on his part.

3. Accounting For Mergers And Acquisitions

Prior to 2001, few areas of accounting allowed more discretion for a company to change the presentation of its financial position than business combinations. By structuring mergers and acquisitions in different ways, and by changing the method by which they are accounted for, management could dramatically change the presentation of the company's financial results. As was the case with the capitalization of expenditures and statement of contractual adjustments discussed above, the flexibility inherent in this area of accounting will make it difficult for the Government to establish that Richard Scrushy had the requisite intent to commit the crimes alleged.

HealthSouth grew exponentially through its acquisition of several companies during the 1990s. For example, from 1995 through the year 2000, HealthSouth engaged in over twenty separate business acquisitions and paid in total approximately \$6.5 billion in consideration. Not surprisingly, these acquisitions had a significant impact on HealthSouth's financial statements during that period. The precise impact, however, depended largely upon the accounting method chosen to record the acquisition.

Prior to January 1, 2001, there were two methods by which a company could properly record an acquisition or business combination: "pooling" or "purchase." Under the pooling

⁵² AICPA Audit and Accounting Guide - Health Care Organizations 2.23 (May 1, 1997).

method, the newly-formed entity presented its financial results as a combination of the financial results of the two pre-existing entities.⁵³ Not only were the financial reports for the current year amalgamated, but the financial results for the prior years were also hypothetically combined so that they could serve as a benchmark for the current year's results. When both companies are and have been profitable, both the historical and post-transaction income statements will show higher earnings under the pooling method.⁵⁴

Under the purchase method, which as of January 1, 2001 is now the only proper and acceptable method to account for a business combination, the acquiring company treats the acquired company as an asset. After closing, the acquiring company conducts its own valuation of the assets of the acquired company, lists those assets on the books, and then applies the appropriate amortization or depreciation schedule depending on the use the acquiring company gives the assets.⁵⁵ The acquiring company also has the ability to revalue the assets acquired under the purchase method for up to one year after the effective date of the acquisition.⁵⁶

HealthSouth utilized both methods of acquisition accounting. HealthSouth apparently chose the method that was consistent with its transaction terms, or alternatively modified the transaction terms so that the method of accounting would have a positive effect on its financial reporting. Regardless of the presentation chosen, both methods were proper and whichever method was chosen often had a significant and material effect on the company's financial statements. Thus, any change in the financial statements observed by someone not steeped in

⁵³ See Accounting Principles Board ("APB") Opinion No. 16.

⁵⁴ *Id.*

⁵⁵ APB Opinion No. 16, ¶ 12.

⁵⁶ Accounting For Preacquisition Contingencies of Purchase Enterprises, SFAS 38.

accounting could reasonably be viewed as having been caused by a legitimate change in the application of proper accounting methods.

4. Pro Forma Financial Statements

Like many companies throughout the 1980's and 1990's, HealthSouth commonly used pro forma financial statements in the presentation of their financial results. Pro forma statements are designed to present a more accurate picture of a company's financial position by accounting for certain non-recurring events that occurred during the period in question. For example, a large, one-time expenditure may be characterized as non-recurring and thus be excluded from a calculation of the company's net income. This, of course, also has the effect of improving a company's bottom-line earnings and related better earnings per share. Non-recurring items such as this are then accounted for and explained in the Management, Discussion and Analysis (or "MD&A") section of the company's financial statements.

Although pro forma statements are commonly used, there are no concrete accounting principles or guidelines that govern their creation and presentation. For this reason, the presentation of pro forma statements is another area of accounting that is highly judgmental and dependent upon preparer discretion. This fact, as well as the lack of any evidence indicating that Richard Scrusby was involved in the preparation of any pro forma financial statement or the determination of what constituted a non-recurring item for any relevant period, will again make it difficult to establish that he "knowingly" and "willfully" engaged in any criminal act relating to the reporting of HealthSouth's financial statements.

B. Richard Scrusby Justifiably Relied On His CFOs And Other Executive Officers

As CEO of HealthSouth, it was Richard Scrusby's job to give HealthSouth direction and vision. Accordingly, Mr. Scrusby spent much of his time managing the company and pursuing

new strategic growth opportunities. SEC Investigative Testimony of Richard Scrusby (“Scrusby Test.”) at 52:22-25 (March 14, 2003). In contrast, it was the CFO’s job, with the assistance of the Controller, to prepare HealthSouth’s financial reports and estimates of financial results. Richard Scrusby, like most founding CEOs, neither had the training nor the technical expertise to ensure the accuracy and veracity of HealthSouth’s financial reports. He thus necessarily and justifiably relied on his CFOs and their staff to prepare the reports.

Prior to March 2003, Richard Scrusby had no reason to question the performance of HealthSouth’s various CFOs. While Mr. Scrusby had no training or experience in accounting or finance, he had every reason to believe that HealthSouth’s CFOs were competent. In particular, he was entitled to rely on Bill Owens, who had originally served as an outside auditor, and Mike Martin, an experienced banker. Ironically, it now appears that Owens and Martin betrayed Scrusby’s reliance on them in order to cover up their own mistakes.

Richard Scrusby also was never involved in the structuring of HealthSouth’s accounting systems and policies. For example, he had no involvement in determining how HealthSouth would calculate third-party payor contractual adjustments, whether HealthSouth would capitalize certain expenses, or whether HealthSouth would utilize the pooling or purchase method accounting with respect to its various acquisitions. He relied instead on the expertise of HealthSouth’s CFOs, its Audit Committee, and Ernst & Young to ensure such determinations were properly made and the financial results properly presented.⁵⁷

⁵⁷ To the extent Sarbanes-Oxley now requires CEOs to play a more intimate role in the presentation of a company’s financial statements, that was not the case during the relevant time period.

C. Richard Scrushy Justifiably Relied On Ernst & Young And HealthSouth's Audit Committee

It cannot reasonably be disputed that Ernst & Young is one of the top accounting firms in the world. It audits hundreds, if not thousands, of public and private companies a year, many of which are in the health care business. Ernst & Young, moreover, audited HealthSouth from its inception, and provided HealthSouth numerous other accounting services. For nearly 20 years, Ernst & Young ably and expertly assisted HealthSouth in numerous aspects of its business: financial, accounting and otherwise. And every year Ernst & Young certified the financial results as presented and that it had found no material weaknesses in HealthSouth's accounting controls. These conclusions were reported by Ernst & Young auditors personally and directly to the Board of Directors and to the Audit Committee.

In addition to employing expert outside auditors, HealthSouth had an Audit Committee whose job it was to work with, assist and monitor Ernst & Young in the preparation of HealthSouth's financial statements and other related accounting tasks. The Audit Committee met regularly with Ernst & Young along with the CFO, Controller and other HealthSouth executives including the Group Vice Presidents and members of HealthSouth's accounting staff. Freeze Hr'g Tr. at 553.

The members of HealthSouth's Audit Committee changed over the years, but during the most recent relevant period it was comprised of George Strong, Sage Givens and Larry Striplin. *Id.* at 556. Since the passage of the Sarbanes-Oxley Act, at least one director on the Audit Committee is required to have financial expertise. George Strong, who also served as the chair of the Committee, served as the director with the "financial expertise." *Id.* at 1476.⁵⁸ Richard

⁵⁸ George Strong began his career with Smith Barney where he was a vice president and shareholder. After 15 years at Smith Barney, Strong participated in the creation of Norlin Industries, and

Scruschy was not a member of the Audit Committee, nor could he be under rules and regulations governing companies listed on the New York Stock Exchange. He also never attended an Audit Committee meeting. Significantly, not a single member of the Audit Committee has admitted guilt in this matter, nor been charged by the Government with personal wrongdoing in connection with any of the frauds that allegedly took place right under their noses.

Richard Scruschy had a good faith basis to rely on Ernst & Young and HealthSouth's Audit Committee to oversee financial operations at HealthSouth and to raise with him and other HealthSouth management any financial or accounting problems that they observed or suspected. Richard Scruschy acted reasonably and justifiably in relying upon Ernst & Young's signed audit report of HealthSouth's financial statements every year without qualification. And Richard Scruschy was reasonable and justified in accepting Ernst & Young's representation every year that it found no material weakness in HealthSouth's internal accounting controls. These facts will make a conviction of Richard Scruschy very difficult.

D. Richard Scruschy Justifiably Relied On HealthSouth's Internal Controls

HealthSouth has had internal accounting controls in place since at least 1989 when it became a member of the New York Stock Exchange. *See* 15 U.S.C. § 78m(b)(2). As the testimony from the SEC asset freeze hearing revealed, these controls are extensive and provide numerous checks and balances to prevent corporate fraud. Freeze Hr'g Tr. at 195-96.

The preparation of HealthSouth's monthly, quarterly and annual financial statements during the relevant period involved several steps. It commenced with HealthSouth's 1800 individual facilities submitting "financial packages" to the corporate accounting department. *Id.*

(continued...)

later served as senior vice president and CFO of American Medicorp before joining HealthSouth as a director. "Directorship Names New Advisory Board Member," www.directorship.com.

at 194. These “financial packages” were a collection of financial information pre-selected by the corporate accounting department. *Id.* at 193. Upon receipt of the financial packages, the staff accountants in corporate accounting booked the entries, and then prepared a preliminary financial statement or “greenstripe.” *Id.* at 194, 195. These preliminary financial statements were then sent to the individual facilities for review. *Id.* at 195, 954-55. The individual facility’s accounting staff and administrator would then review the statements for errors, and inform corporate accounting of any necessary adjustments. *Id.* at 955-59. After the necessary adjustments were made, the financial statements would be generated again and the facility accounting staff and administrator would give the financial statements a second review. *Id.* at 195, 954. Once approved by the individual facilities, corporate accounting would consolidate the financial statements and prepare financial statements by region and ultimately division. *See generally: id.* at 951-55.

Following consolidation at the region and division level, the Regional Vice Presidents, Division Vice Presidents and responsible Senior Vice Presidents, as well as their finance and accounting staffs, would review their respective financial statements for errors. *Id.* at 920. Once approved, the three division-level statements would be consolidated and reviewed by the corporate accounting staff, including by the Controller and CFO. *Id.* at 88. In the end, approximately 2,500 HealthSouth employees played some part in the preparation and review of HealthSouth’s financial statements before they reached Richard Scrushy.⁵⁹ As these facts reveal, and as one witness called by the Government at the SEC asset freeze hearing agreed,

⁵⁹ HealthSouth’s budgeting process went through a similar level of detailed preparation and review. Indeed, the evidence will show that HealthSouth’s budgeted vs. actual revenues rarely, if ever, exceed a variance of one percent.

HealthSouth's internal controls were "elaborate" and had "several levels of review." *Id.* at 195-96.

As elaborate as these internal accounting controls were, they were by no means the only controls on which Mr. Scrusy could justifiably rely to detect and prevent corporate fraud. HealthSouth also had detailed procedures governing capital expenditures which involved "multiple layers of review and approval and sign-off." *Id.* at 938. Corporate accounting also handled the cutting of all checks for all of the approximately 1800 HealthSouth facilities, thereby ensuring consistency and control in the handling of all cash disbursements. *Id.* at 209-10.

HealthSouth also had a Corporate Compliance Department whose job was to monitor such fraud prevention controls as the "1-800" fraud hotline and internal corporate compliance audits. *Id.* at 542-44. The hotline was a phone number that allowed a HealthSouth employee to report suspected fraud or impropriety within the company. Each HealthSouth employee was informed of the hotline, and Mr. Scrusy himself was known to encourage HealthSouth employees on a regular basis to utilize the hotline if they saw or suspected any illegality or impropriety within the corporation. *Id.* at 545. The employee could identify him or herself or call anonymously. *Id.* at 544. The employees even received a "card" for their wallet to ensure that the number was not forgotten. *Id.* On more than one occasion, Mr. Scrusy even asked his executive team at Monday morning meetings to hold their cards up in the air to prove they carried them. *Id.* at 797.

In addition to the fraud hotline, the Corporate Compliance Department also monitored HealthSouth's "Clinical and Administrative Reviews" or "HCAR's." *Id.* at 548-49. In an HCAR, one HealthSouth facility would do a "cross-audit" of another HealthSouth facility to

ensure that they met the requirements for Medicare certification, including recordation and billing. *Id.*

Finally, Mr. Scrushy justifiably relied upon HealthSouth's Internal Audit Division. The Internal Audit Division reviewed HealthSouth's financial records to ensure that the company was being operated according to the policies and procedures established by management. *Id.* at 163. The Division had a staff of ten auditors that conducted random audits of HealthSouth facilities located throughout the country. *Id.* at 211. The results of these audits were thoroughly reviewed annually by an Ernst & Young audit team. *Id.* at 1481-82. The Director of the Internal Audit Division also reported directly to the CEO, and made quarterly reports to the Audit Committee which were attended by Ernst & Young representatives. *Id.* at 164, 551, 760.

E. Richard Scrushy Justifiably Relied on His General Counsel and Legal Staff.

Finally, Mr. Scrushy appropriately relied on his general counsel and legal staff to prepare truthful and accurate financial reports that complied with all necessary laws and regulations. Mr. Scrushy's background did not provide him with the financial and legal expertise necessary to navigate many of the disclosures and calculations that were required under the various SEC and other reporting schemes. *See, e.g.,* Scrushy Test. at 28, 32, 38, 66-67. Mr. Scrushy nevertheless routinely signed HealthSouth's financials because he trusted that those responsible for preparing such reports, including his general counsel, Bill Horton, were not lying when they indicated to him that the reports were truthful and accurate. *See, e.g.,* Scrushy Test. at 34-35, 43, 50, 52-53, 55-56. In fact, Mr. Scrushy made it a practice never to sign the company's financial statements without the explicit advice of his general counsel.

Mr. Scrushy continued to depend on the honesty, expertise and hard work of his general counsel after Sarbanes-Oxley became effective. Mr. Scrushy specifically consulted with Horton before he signed the August 14, 2002 SEC submissions, which included the second quarter Form

10-Q, the Pitt certification letter, and the first Sarbanes-Oxley certification. *See, e.g.*, Scrusby Test. at 64-65. Mr. Scrusby asked Horton if Mr. Scrusby should hire a personal attorney to get him comfortable with the new Sarbanes-Oxley requirements, as Weston Smith had already done. Horton told Mr. Scrusby that it was not necessary because he was his lawyer. Mr. Scrusby then specifically asked Horton if there was anything wrong or improper in the financial statements. After being told by Horton that there was not, Mr. Scrusby signed the documents. That Horton indicated that it was both necessary and appropriate for Mr. Scrusby to sign such documents makes his willingness to do so eminently reasonable. The Government will be hard-pressed to show criminal intent in the face of such assurances from counsel.

VII. THE GOVERNMENT SHOULD NOT PROSECUTE RICHARD SCRUSHY FOR PUBLIC POLICY REASONS

A. A Loss Would Be a Substantial Setback For The Government And Would Jeopardize The Deterrent Effect That The Pleas To Date Have Created

1. The Absence of Evidence of Personal Misconduct Against Richard Scrusby Makes This A Poor Test Case for the Government

As the first major criminal trial of a corporate CEO since the enactment of Sarbanes-Oxley, it would be watched very closely by the legal and financial communities. Any case brought against Mr. Scrusby would be one which the Government would be expected to win overwhelmingly, particularly in light of the skewed reporting in the press for many months. However, as the hearing on the SEC's asset freeze effort initially demonstrated, and subsequent investigation has confirmed, the true facts in this case are far different from and more complex than the initial simplistic accounts suggested in the press.

While the Government appears to have several cooperating witnesses who are willing to testify against Mr. Scrusby, we do not believe that there is any documentary or other tangible evidence that will corroborate their stories. The Government not only lacks -- because there does

not exist -- a “smoking gun” that would be expected in such a high-profile case, but also lacks the routine documentary evidence that a jury would typically expect of it in order to substantiate the testimony of Government witnesses who possess minimal credibility or jury appeal. Indeed, as the Government undertakes the forensic efforts it outlined in its July 9 filing before Judge Johnson, and takes each cooperating witness through the massive number of documents, we expect that any criminal prosecution against Richard Scrushy will become increasingly difficult.

Were the Government to lose a case of such national visibility, it would also lose the positive and corrective enforcement benefits from the large number of guilty pleas it has already obtained in this case. A loss in a case against Mr. Scrushy would drown out the enforcement success and set the stage for a flood of critical commentary about the clear damage sustained by HealthSouth, its employees, its shareholders and the Birmingham economy as a whole from the Government’s failed enforcement efforts. A fickle press likely would ignore that the Government had previously brought to justice smaller fish -- even though they are the real guilty parties in the case. The lesson that would be drawn by many from an unsuccessful trial would be simply that defendants should never plead guilty in such cases, because the Government cannot win at trial. The Government’s legacy would be that it tried to convict Mr. Scrushy and lost, demonstrating its inability to apply criminal law to accounting fraud, while damaging an otherwise strong public company critical to the reputation and economic health of the Birmingham community.

2. Criminal Accounting Fraud Cases Present Challenging Issues of Proof

While it is apparent that a number of individuals were involved in illegal accounting and financial practices at HealthSouth, these acts were not the result of a master plan designed by Mr. Scrushy. If they had been, it is very likely that the strategy of wiring an informant-accomplice

would have succeeded. Since it did not, the Government is now faced with having to discover and prove the motivation and orchestration of a fraud by the CEO through the testimony of flawed, self-interested conspirators.

Historically, these cases have not been easy to prove given the rigorous standards required to be met for a criminal conviction. Proof of guilt “beyond a reasonable doubt” in the complex and ambiguous area of corporate accounting has never been easy. The SEC has always had a far less difficult time convincing a fact-finder in a civil action that it was “more probable than not” that a particular practice violated the securities laws. This is particularly true where the sanctions at stake are merely economic rather than potentially lengthy imprisonment. For this reason, we respectfully submit that there are adequate non-criminal alternatives to criminal prosecution and that the Government should attempt to resolve on a civil basis any issues it has regarding Mr. Scrushy’s actions as CEO of HealthSouth. If an agreed settlement could be reached, such a resolution would allow the Government to declare the HealthSouth investigation a success on all fronts and avoid the risky and potential downside of pushing forward on a criminal prosecution with insufficient evidence to convict.

3. A Failed Prosecution Will Reinforce Critics of the Government’s Criminal Enforcement Tactics

The Enron, WorldCom and similar corporate scandals following the crash in the stock market inflicted a body blow to public confidence in the integrity and effectiveness of American business. The media gave the matter tremendous attention and the public placed intense pressure for the Government to “do something” to protect against further economic loss. The administration responded with major initiatives designed to detect, expose and prosecute corporate fraud, most notably the Corporate Fraud Task Force led by the Justice Department. Congress responded by passing the Sarbanes-Oxley Act.

Inspired by this new emphasis, the Government employed extremely aggressive law enforcement tactics, which included wire tapping, wiring of a key informant, and the lightning quick execution of a search warrant this past spring. The Government attempted to make a “real time” arrest in the HealthSouth frauds and a highly visible example of alleged ringleader, Richard Scrushy. The Government coupled its criminal investigation with a civil attempt to freeze Richard Scrushy’s assets – which would have disabled his defense -- prior to any indictment or finding of criminal culpability.

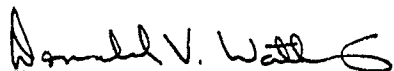
The credibility of the Government’s overall investigation has been sustained by the array of guilty pleas obtained by the Government from various HealthSouth employees involved in various aspects of its financial and accounting operations. An acquittal of Mr. Scrushy will suggest that the Government’s aggressive tactics in this case were inappropriate and raise new questions concerning the appropriate application of the criminal law to highly judgmental aspects of operating a public corporation.

B. Negative Publicity from Prosecution May Force HealthSouth Into Bankruptcy

Finally, the decision to prosecute Richard Scrushy may result in additional financial losses for HealthSouth and its remaining investors and creditors. It is no secret that HealthSouth is in financial distress and has, for the moment, staved off bankruptcy. But HealthSouth is not Enron. It is a real company, with real revenues and real profits. What has hurt the company so badly in recent months has much less to do with its sustainability as an ongoing business and much more to do with the cloud of bad publicity hanging over it in connection with this investigation. Nevertheless, HealthSouth has more than a fighting chance to emerge from this ordeal intact. If the company is again placed at risk by a massive round of negative national publicity from an unwinnable criminal trial, it is hard to see how anyone will benefit.

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Respectfully submitted,



Donald V. Watkins
Donald V. Watkins, P.C.
2170 Highland Avenue
Birmingham, AL 35209
(205) 558-4665
(205) 558-46750 (Fax)



Jonathan C. Rose
JONES DAY
51 Louisiana Avenue, N.W.
Washington, DC 20001
(202) 879-3939
(202) 626-1700 (Fax)