

ROSETTA STONE INC  
Form 10-K  
March 06, 2019  
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2018

Commission file number: 1-34283

Rosetta Stone Inc.

(Exact name of registrant as specified in its charter)

Delaware  
(State of incorporation)

043837082  
(I.R.S. Employer

Identification No.)

1621 North Kent Street, Suite 1200  
Arlington, Virginia  
(Address of principal executive offices)

22209  
(Zip Code)

Registrant's telephone number, including area code: 703-387-5800

Securities Registered Pursuant to Section 12(b) of the Act:

Edgar Filing: ROSETTA STONE INC - Form 10-K

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value \$0.00005 per share	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Smaller reporting company
Accelerated filer (Do not check if a smaller reporting company)	Emerging growth company
Non-accelerated filer	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the common stock held by non-affiliates of the registrant was approximately \$ 267.9 million as of June 30, 2018 (based on the last sale price of such stock as quoted on the New York Stock Exchange). All executive officers and directors of the registrant and all persons filing a Schedule 13D with the Securities and Exchange Commission in respect of registrant's common stock have been deemed, solely for the purpose of the foregoing calculation, to be "affiliates" of the registrant.

As of February 27, 2019, there were 23,640,971 shares of common stock outstanding.

Edgar Filing: ROSETTA STONE INC - Form 10-K

Documents incorporated by reference: Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the 2019 Annual Meeting of Stockholders to be held on May 16, 2019 are incorporated by reference into Part III.

---

Table of Contents

TABLE OF CONTENTS

	Page
<u>PART I</u>	
Item 1. <u>Business</u>	4
Item 1A. <u>Risk Factors</u>	8
Item 1B. <u>Unresolved Staff Comments</u>	22
Item 2. <u>Properties</u>	23
Item 3. <u>Legal Proceedings</u>	23
Item 4. <u>Mine Safety Disclosures</u>	23
<u>PART II</u>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	24
Item 6. <u>Selected Financial Data</u>	26
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	47
Item 8. <u>Financial Statements and Supplementary Data</u>	47
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	47
Item 9A. <u>Controls and Procedures</u>	47
Item 9B. <u>Other Information</u>	48
<u>PART III</u>	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	49
Item 11. <u>Executive Compensation</u>	49
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	49
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence</u>	49
Item 14. <u>Principal Accounting Fees and Services</u>	49
<u>PART IV</u>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	50
Item 16. <u>Form 10-K Summary</u>	53

Table of Contents

PART I

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K (this "Report") and other statements or presentations made from time to time by the Company, including the documents incorporated by reference, contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by non-historical statements and often include words such as "outlook," "potential," "believes," "expects," "anticipates," "estimates," "intends," "plans," "seeks" or words of similar meaning, or future-looking or conditional verbs, such as "will," "should," "could," "may," "might," "aims," "intends," or "projects," or similar words or phrases. These statements may include, but are not limited to, statements related to: our business strategy; guidance or projections related to revenue, Adjusted EBITDA, sales, and other measures of future economic performance; the contributions and performance of our businesses, including acquired businesses and international operations; projections for future capital expenditures; and other guidance, projections, plans, objectives, and related estimates and assumptions. A forward-looking statement is neither a prediction nor a guarantee of future events or circumstances. In addition, forward-looking statements are based on the Company's current assumptions, expectations and beliefs and are subject to certain risks and uncertainties that could cause actual results to differ materially from our present expectations or projections. Some important factors that could cause actual results, performance or achievement to differ materially from those expressed or implied by these forward-looking statements include, but are not limited to: the risk that we are unable to execute our business strategy; declining demand for our language learning and literacy solutions; the risk that we are not able to manage and grow our business; the impact of any revisions to our pricing strategy; the risk that we might not succeed in introducing and producing new products and services; the impact of foreign exchange fluctuations; the adequacy of internally generated funds and existing sources of liquidity, such as bank financing, as well as our ability to raise additional funds; the risk that we cannot effectively adapt to and manage complex and numerous technologies; the risk that businesses acquired by us might not perform as expected; and the risk that we are not able to successfully expand internationally. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by law. These factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements risks and uncertainties that are more fully described in the Company's filings with the U.S. Securities and Exchange Commission (SEC), including those described below in this Annual Report on Form 10-K in Part I, Item 1A: "Risk Factors" and Part II, Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," those described elsewhere in this Annual Report on Form 10-K, and those described from time to time in our future reports filed with the Securities and Exchange Commission.

---

## Table of Contents

### Item 1. Business

#### Overview

Rosetta Stone Inc. (“Rosetta Stone,” “the Company,” “we” or “us”) is dedicated to changing people's lives through the power of language and literacy education. Our innovative digital solutions drive positive learning outcomes for the inspired learner at home or in schools and workplaces around the world.

Founded in 1992, Rosetta Stone's language division uses cloud-based solutions to help all types of learners read, write, and speak more than 30 languages. Lexia Learning, Rosetta Stone's literacy education division, was founded more than 30 years ago and is a leader in the literacy education space. Today, Lexia helps students build foundational reading skills through its rigorously researched, independently evaluated, and widely respected instruction and assessment programs. Rosetta Stone Inc. was incorporated in Delaware in 2005.

As our Company has evolved, we believe that our current portfolio of language and literacy products and transition to a SaaS-based delivery model provide multiple opportunities for long-term value creation. We believe the demand is growing for e-learning based literacy solutions in the U.S. and English language-learning around the globe, and we are uniquely positioned with the power of our global brand to meet the growing needs of global learners.

We continue to emphasize the development of products and solutions for learners who need to speak and read English. This focus extends to the Consumer Language segment, where we continue to make product investments serving the needs of passionate language-learners who are mobile, results-focused and value a quality language-learning experience.

To position the organization for success, our focus is on the following priorities:

1. Focus on growing our K-12 business;
2. Position ourselves as a leader in virtual blended learning; and
3. Accelerate growth and increase intrinsic value.

#### Business Segments

Our business is organized into three operating segments: Literacy, E&E Language, and Consumer Language. The Literacy segment derives revenue under a Software-as-a-Service ("SaaS") model from the sales of literacy solutions to educational institutions serving grades K through 12. The E&E Language segment derives language-learning revenues from sales to educational institutions, corporations, and government agencies worldwide under a SaaS model. The Consumer Language segment derives revenue from sales to individuals and retail partners worldwide and recently completed a SaaS migration from a packaged software business. For additional information regarding our segments, see Note 18 of Item 8, Financial Statements and Supplementary Data. Prior periods are presented consistently with our current operating segments and definition of segment contribution.

#### Products and Services

##### Literacy:

**Literacy Solutions:** Our Literacy segment is comprised solely of our Lexia business. The Lexia Learning suite of subscription-based English literacy-learning and assessment solutions provide explicit, systematic, personalized learning on foundational literacy skills for students of all abilities. This research-proven technology based approach

accelerates reading skills development, predicts students' year-end performance and provides teachers with data-driven action plans to help differentiate instruction. Lexia Reading Core5 is available for all abilities from pre-K through grade 5. PowerUp Literacy is designed for non-proficient readers in grades 6 and above. Lexia RAPID Assessment is a computer-adaptive screener and diagnostic tool for grades K-12 that identifies and monitors reading and language skills to provide actionable data for instructional planning. Lexia's solutions deliver performance data and analysis to enable teachers to monitor and modify their instruction to address specific student needs. These literacy solutions are provided under web-based subscriptions. Our service offerings provide schools with product implementation services to support strong educator and student use. These services are purchased through annual or multi-year service contracts.

E&E Language:

E&E Language-Learning Solutions: Rosetta Stone provides a series of web-based subscriptions to interactive language-learning solutions for schools, business and other organizations that are primarily available online. Our core language-learning suite offers courses and practice applications in multiple languages, each leveraging our proprietary context-based immersion methodology, speech recognition engine and innovative technology features. Available in 24 languages and designed for beginner to intermediate language learners, Rosetta Stone Foundations builds fundamental language skills. Rosetta Stone Advantage is available for all proficiency levels in 9 of the 24 languages and focuses on improving everyday and business language skills. Our Advanced English for Business solution

Table of Contents

serves multinational companies seeking to build their employees' English language proficiency so they are able to communicate and operate in a global business environment. Our Catalyst product consolidates and aligns our Foundations, Advantage and Advanced English for Business products into a single solution for our enterprise customers. Catalyst provides streamlined access and simplified pricing for the full suite of English and world language learning content, along with assessment, placement, ongoing reporting and demonstration of results, all of which address important customer needs to focus and demonstrate payback. Specifically designed for use with our language-learning solutions, our E&E Language customers may also purchase our audio practice products and live tutoring sessions to enhance the learning experience.

Rosetta Stone offers tailored solutions to help organizations maximize the success of their learning programs. Our current custom solutions include curriculum development, global collaboration programs that combine language education with business culture training, group and live tutoring, and language courses for mission-critical government programs.

Our E&E Language and Literacy customers can maximize their learning solutions with administrative tools, professional services and custom solutions.

**Administrative Tools:** Our E&E Language and Literacy learning programs come with a set of administrative tools for performance monitoring, and to measure and track learner progress. Administrators can use these tools to access real-time dynamic reports and identify each learner's strengths and weaknesses.

**Professional Services:** Professional services provide our customers with access to experienced training, implementation and support resources. Our team works directly with customers to plan, deploy, and promote the program for each organization, incorporate learning goals into implementation models, prepare and motivate learners, and integrate the E&E Language and Literacy solutions into technical infrastructure.

**Consumer Language:**

Rosetta Stone also offers a broad portfolio of technology-based learning products for personal use to the global consumer. Our interactive portfolio of language-learning solutions is powered by our widely recognized brand, and building on our more than 25-year heritage in language-learning.

Many of our consumer products and services are available in flexible and convenient formats for tablets and smartphones. Our mobile apps enable learners to continue their lessons on the go and extend the learning experience away from a computer. Progress is automatically synchronized across devices to meet our customers' lifestyles. These apps may be available for download through the Apple App Store, Google Play, Amazon App Store for Android and Samsung Galaxy App Store.

**Rosetta Stone Language-Learning Solutions:** Rosetta Stone provides intuitive, easy-to-use language-learning programs that can be purchased primarily as a software subscription via the web, mobile in-app purchase, or through retail channels.

Our language-learning suite offers courses and practice applications in multiple languages, each leveraging our proprietary immersion methodology, speech recognition engine and innovative technology features. Beginner to intermediate language-learning products are available in 30 languages to build fundamental language skills. More advanced language-learning products are available in 9 of the 30 languages. We also offer online services to enhance and augment our learners' capabilities. Our Online Tutoring is an online video service that provides either one-on-one



or group conversational coaching sessions with native speakers to practice skills and experience direct interactive dialogue. Our current suite of mobile language-learning apps includes companions to our computer-based language-learning apps which enables learners to access their language program anytime anywhere.

#### Software Development:

Our offering portfolio is a result of significant investment in software development. Our software development efforts include the design and build of software solutions across a variety of devices, pedagogy and curriculum development, and the creation of learning content. Our development teams build new solutions and enhance or maintain existing solutions. We have specific expertise in speech recognition technology, iterative and customer-focused software development, instructional design, and language acquisition. We continue to evaluate changes to our solutions to strengthen our brand and improve the relevance of our offering portfolio.

#### Customers and Distribution Channels

No customer accounted for more than 10% of consolidated revenue during the years ended December 31, 2018, 2017, and 2016. Most of our business is SaaS based; consequently, backlog is not significant.

Table of Contents

Literacy:

Our Literacy distribution channel in the United States utilizes a direct sales force as well as relationships with third-party resellers focused on the sale of Lexia solutions to K-12 schools. International distribution is primarily managed through independent resellers based in the United Kingdom, Australia and New Zealand.

E&E Language:

Our E&E Language distribution channel is focused on targeted sales activity primarily through a direct sales force in five markets: K-12 schools, colleges and universities, government agencies, not-for-profit organizations, and corporations. Our E&E Language-learning customers include the following:

**Educational Institutions.** These customers include primary and secondary schools and colleges and universities.

**Government Agencies and Not-for-Profit Organizations.** These customers include government agencies and organizations developing workforces that serve non-native speaking populations, offering literacy programs, and preparing members for overseas missions.

**Corporations.** We promote interest in this market with onsite visits, trade show and seminar attendance, speaking engagements, and direct mailings.

**Third-party Resellers and Partners.** We utilize third-party resellers and partners to provide our language-learning solutions to businesses, schools, and public-sector organizations in markets predominantly outside the U.S.

As part of our K-12 customer activities, our Literacy and E&E Language segments interact with employees of school districts including superintendents, procurement officers, principals and teachers. For instance, we participate in associations and events, including as a sponsor, at which such employees are present. We also invite these employees to events hosted by us, at which we discuss general educational developments as well as our products and services, and to serve on customer advisory boards to provide feedback on our products and services. We sometimes, and as permissible, pay the travel expenses of school district employees who attend company-sponsored events or serve on an advisory board.

Consumer Language:

Our Consumer Language distribution channel comprises a mix of our websites, third party e-commerce websites, app-stores, consignment distributors, select retailers, and call centers. We believe these channels complement each other, as consumers who have seen our direct-to-consumer advertising may purchase at our retailers, and vice versa.

**Direct to consumer (“DTC”).** Sales generated through our e-commerce website at [www.rosettastone.com](http://www.rosettastone.com), app stores such as Google Play and Apple App Store and our call centers.

**Indirect to consumer.** Sales generated through arrangements with third-party e-commerce websites and consignment distributors such as Software Packaging Associates.

**Retailers.** Our retailers enable us to provide additional points of contact to educate consumers about our solutions, expand our presence beyond our own websites, and further strengthen and enhance our brand image. Our retail relationships include Amazon.com, Barnes & Noble, Target, Best Buy, Staples, and others in and outside of the U.S.

We may also partner at times with daily deal and home shopping resellers.

Home School. We promote interest in the language-learning market through advertising in publications focused on home schooling and attending local trade shows.

#### Sourcing and Fulfillment

Consistent with the SaaS model in our Literacy and E&E Language segments, we have transitioned the Consumer Language segment away from CD-based product sales to a cloud-based software subscription in order to provide an improved learner experience with instant fulfillment and mobile availability, which has also allowed us to, over time, reduce costs associated with physical packaging and distribution. Consequently, physical inventory is not significant.

Our physical inventory utilizes a flexible and low-cost manufacturing base. We use a third-party logistics company to obtain substantially all of our packaging components, which primarily consist of boxes for our language learning product and audio practice products, and to manufacture and fulfill finished product. We believe that we have good relationships with our vendors and that there are alternative sources in the event that one or more of these vendors is not available. We continually review our manufacturing and supply needs against the capacity of our contract manufacturers and suppliers with a view to ensuring that we are able to meet our production goals, reduce costs and operate more efficiently.

## Table of Contents

### Competition

Rosetta Stone competes in several categories within the technology-based learning industry, including literacy, enterprise and educational language learning, and consumer language learning. With Lexia, we compete primarily in the K-12 digital literacy space in the U.S. The language-learning market is highly fragmented globally and consists of a variety of instructional and learning modes: classroom instruction utilizing the traditional approach of memorization, grammar and translation; immersion-based classroom instruction; self-study books, audio recordings and software that rely primarily on grammar and translation; and free online and mobile offerings that provide content and opportunities to practice writing and speaking.

### Seasonality

Our business is affected by variations in seasonal trends. Within our Literacy segment and K-12 Language education sales channel, sales are seasonally stronger in the second and third quarters of the calendar year corresponding to the end and beginning of school district budget years. E&E Language segment sales in our government and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Consumer Language sales are affected by seasonal trends associated with the holiday shopping season. In particular, we generate a large portion of our Consumer Language sales in the fourth quarter during the period beginning on Black Friday through the end of the calendar year.

Our operating segments are affected by different sales-to-cash patterns. Consumer Language sales typically turn to cash more quickly than E&E Language and Literacy sales, which tend to have longer collection cycles. Historically, in the first half of the year we have been a net user of cash and in the second half of the year we have been a net generator of cash.

### Intellectual Property

Our intellectual property is critical to our success. We rely on a combination of measures to protect our intellectual property, including patents, trade secrets, trademarks, trade dress, copyrights and non-disclosure and other contractual arrangements. In certain circumstances, we may sub-license our intellectual property including our trademarks and software for use in certain markets.

We have sixteen U.S. patents, thirteen foreign patents and several U.S. and foreign patent applications pending that cover various aspects of our language-learning and literacy technologies.

We have registered a variety of trademarks, including our primary or house marks, Rosetta Stone, The Blue Stone Logo, Lexia, Lexia PowerUP Literacy, TruAccent, and Catalyst. These trademarks are the subject of either registrations or pending applications in the U.S., as well as numerous countries worldwide where we do business. We have been issued trademark registrations for our yellow color from the U.S. Patent and Trademark Office. We intend to continue to strategically register, both domestically and internationally, trademarks we use today and those we develop in the future. We believe that the distinctive marks that we use in connection with our solutions are important in building our brand image and distinguishing our offerings from those of our competitors. These marks are among our most valuable assets.

In addition to our distinctive marks, we own numerous registered and unregistered copyrights, and trade dress rights, to our products and packaging. We intend to continue to strategically register copyrights in our various products. We also place significant value on our trade dress, which is the overall image and appearance of our products, as we

believe that our trade dress helps to distinguish our products in the marketplace from our competitors.

Since 2006, we have held a perpetual, irrevocable and worldwide license from the University of Colorado allowing us to use speech recognition technology for language-learning solutions. Since 2014, we have also held a commercial license from the Florida State University Research Foundation allowing us to use certain computer software and technology in our literacy offerings. These types of arrangements are often subject to royalty or license fees.

We diligently protect our intellectual property through the use of patents, trademarks and copyrights and through enforcement efforts in litigation. We routinely monitor for potential infringement in the countries where we do business. In addition, our employees, contractors and other parties with access to our confidential information are required to sign agreements that prohibit the unauthorized disclosure of our proprietary rights, information and technology.

#### Employees

As of December 31, 2018, we had 1,040 total employees, consisting of 723 full-time and 317 part-time employees. We have employees in France and Spain who benefit from a collective bargaining agreement. We believe that we have good relations with our employees.

Table of Contents

Available Information

This Annual Report on Form 10-K, along with our Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), are available free of charge through our website as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Our website address is [www.rosettastone.com](http://www.rosettastone.com). The information contained in, or that can be accessed through, our website is not part of, and is not incorporated into, this Annual Report on Form 10-K.

The SEC maintains a website that contains reports, proxy statements and other information regarding issuers that file electronically with the SEC. These materials may be obtained electronically by accessing the SEC's website at [www.sec.gov](http://www.sec.gov).

Item 1A. Risk Factors

The following description of risk factors includes any material changes to, and supersedes the description of, risk factors associated with our business previously disclosed in our Quarterly Report on Form 10-Q filed on November 6, 2018 with the SEC for the period ended September 30, 2018. An investment in our common stock involves a substantial risk of loss. Investors should carefully consider these risk factors, together with all of the other information included herewith, before deciding to purchase shares of our common stock. If any of the following risks actually occur, our business, financial condition, or results of operations could be materially adversely affected. In such case, the market price of our common stock could decline and all or part of an investment may be lost.

The risks described below are not the only ones facing us. Our business is also subject to the risks that affect many other companies, such as general economic conditions and geopolitical events. Further, additional risks not currently known to us or that we currently believe are immaterial could have a material adverse effect on our business, financial condition, cash flows and results of operations. In addition to the other information set forth in this annual report on Form 10-K, you should carefully consider the risk factors discussed below and in other documents we file with the SEC that could materially affect our business, financial condition, cash flows or future results.

We might not be successful in executing our strategy of focusing on learners who need to speak and read English and passionate language learners who are mobile.

We are continuing to implement our strategy to emphasize the development of products and solutions for learners who need to speak and read English. This focus extends to the Consumer Language segment, where we continue to make product investments serving the needs of passionate language learners who are mobile, results-focused and value a quality language-learning experience. If we do not successfully execute our strategy, our revenue and profitability could decline, which could have an adverse effect on our business and financial results.

Our actual operating results may differ significantly from our guidance.

Historically, our practice has been to release guidance regarding our future performance that represents management's estimates as of the date of release. This guidance, which includes forward-looking statements, is based on projections prepared by management. These projections are not prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party confirms or examines the projections and, accordingly, no such person expresses any opinion or any other form of assurance with respect thereto.

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We generally state possible outcomes as high and low ranges or as single point estimates, but actual results could differ materially. The principal reason that we release guidance is to provide a basis for management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such persons.

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions in the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results may vary from our guidance and the variations may be material. We expressly disclaim any obligations to update or revise any guidance, whether as a result of new information, future events or otherwise, except as required by law. In light of the foregoing, investors are urged not to rely upon, or otherwise consider, our guidance in making an investment decision in respect of our common stock.

Any failure to successfully implement our strategy or the occurrence of any of the events or circumstances set forth in these "Risk Factors" and elsewhere in this annual report on Form 10-K could result in the actual operating results being different from our guidance, and such differences may be adverse and material.

## Table of Contents

Intense competition in our industry may hinder our ability to attract and retain customers and generate revenue, and may diminish our margins.

The business environment in which we operate is rapidly evolving, highly fragmented and intensely competitive, and we expect competition to persist and intensify. Increased competition could adversely affect operating results by causing lower demand for our products and services, reduced revenue, more product returns, price reductions or concessions, reduced gross margins and loss of customers.

Many of the current and potential competitors in our Literacy and E&E Language segments have substantially greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition in some locations, as well as in some cases, lower costs. Some competitors offer more differentiated products (for example, online learning as well as physical classrooms and textbooks) that may allow them to more flexibly meet changing customer preferences. The resources of our competitors also may enable them to respond more rapidly to new or emerging technologies and changes in customer requirements and preferences and to offer lower prices than ours or to offer free language-learning software or online services. We may not be able to compete successfully against current or future competitors.

There are a number of free online language-learning opportunities to learn grammar, pronunciation, vocabulary (including specialties in areas such as medicine and business), reading, and conversation by means of podcasts and MP3s, mobile applications, audio courses and lessons, videos, games, stories, news, digital textbooks, and through other means, which compete with our Consumer Language segment. We estimate that there are thousands of free mobile applications on language-learning; free products are provided in at least 50 languages by private companies, universities, and government agencies. Low barriers to entry allow start-up companies with lower costs and less pressure for profitability to compete with us. Competitors that are focused more on user acquisition rather than profitability and funded by venture capital may be able to offer products at significantly lower prices or for free. As free online translation services improve and become more widely available and used, people may generally become less interested in language learning. Although we also offer free products such as mobile apps, if we cannot successfully attract users of these free products and convert a sufficient portion of these free users into paying customers, our business could be adversely affected. If free products become more engaging and competitive or gain widespread acceptance by the public, demand for our products could decline or we may have to lower our prices, which could adversely impact our revenue and other results.

Historically a substantial portion of our revenue has been generated from our Consumer Language business. If we fail to accurately anticipate consumer demand and trends in consumer preferences, our brands, sales and customer relationships may be harmed.

Demand for our consumer focused language-learning software products and related services is subject to rapidly changing consumer demand and trends in consumer preferences. Therefore, our success depends upon our ability to:

- identify, anticipate, understand and respond to these trends in a timely manner;
- introduce appealing new products and performance features on a timely basis;
- provide appealing solutions that engage our customers;
- adapt and offer our products and services using rapidly evolving, widely varying and complex technologies;
- anticipate and meet consumer demand for additional languages, learning levels and new platforms for delivery;
- effectively position and market our products and services;
- identify and secure cost-effective means of marketing our products to reach the appropriate consumers;

•



identify cost-effective sales distribution channels and other sales outlets where interested consumers will buy our products;

- anticipate and respond to consumer price sensitivity and pricing changes of competitive products; and

identify and successfully implement ways of building brand loyalty and reputation.

We anticipate having to make investments in new products in the future and we may incur significant expenses without achieving the anticipated benefits of our investment or preserving our brand and reputation. Investments in new products and technology are speculative, the development cycle for products may exceed planned estimates and commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Customers might not perceive our latest offerings as providing significant new value and may reduce their purchases of our offerings, unfavorably impacting revenue. We might not achieve significant revenue from new product and service investments for a number of years, if at all. We also might not be able to develop new solutions or enhancements in time to capture business opportunities or achieve sustainable acceptance in new or existing marketplaces. Furthermore, consumers may defer purchases of our solutions in anticipation of new products or new versions from us or our competitors. A decline in consumer demand for our solutions, or any failure on our part to satisfy such changing consumer preferences, could harm our business and profitability.

Table of Contents

If the recognition by schools and other organizations of the value of technology-based education does not continue to grow, our ability to generate revenue from organizations could be impaired.

Our success depends in part upon the continued adoption by organizations and potential customers of technology-based education initiatives. Some academics and educators oppose online education in principle and have expressed concerns regarding the perceived loss of control over the education process that could result from offering courses online. If the acceptance of technology-based education does not continue to grow, our ability to continue to grow our Literacy and E&E Language businesses could be impaired.

We depend on discretionary consumer spending in the Consumer Language segment of our business. Adverse trends in general economic conditions, including retail and online shopping patterns or consumer confidence, as well as other external consumer dynamics may compromise our ability to generate revenue.

The success of our business depends to a significant extent upon discretionary consumer spending, which is subject to a number of factors, including general economic conditions, consumer confidence, employment levels, business conditions, interest rates, availability of credit, inflation, and taxation. Adverse trends in any of these economic indicators may cause consumer spending to decline, which could adversely affect our sales and profitability.

Because a portion of our Consumer Language sales are made to or through retailers and distributors, none of which has any obligation to sell our products, the failure or inability of these parties to sell our products effectively could reduce our revenue and profitability.

We rely on retailers and distributors, together with our direct sales force, to sell our products. Our sales to retailers and distributors are concentrated on a key group that is comprised of a mix of websites, such as Amazon.com, app stores, such as the Apple App Store and the Google Play Store, select retail resellers, such as Barnes & Noble, Best Buy, Target, and Staples, and consignment distributors such as Software Packaging Associates.

We have no control over the quantity of products that retailers and distributors purchase from us or sell on our behalf, we do not have long-term contracts with any of them, and they have no obligation to offer or sell our products or to give us any particular shelf space or product placement within their stores. Thus, there is no guarantee that this source of revenue will continue at the same level as it has in the past or that these retailers and distributors will not promote competitors' products over our products or enter into exclusive relationships with our competitors. Any material adverse change in the principal commercial terms, material decrease in the volume of sales generated by our larger retailers or distributors or major disruption or termination of a relationship with these retailers and distributors could result in a significant decline in our revenue and profitability. Furthermore, product display locations and promotional activities that retailers, websites and app stores undertake can affect the sales of our products. The fact that we also sell our products directly could cause retailers, websites, app stores or distributors to reduce their efforts to promote our products or stop selling our products altogether.

Many traditional physical retailers are experiencing diminished foot traffic and sales. For our retail business, even though online sales have increased in popularity and are growing in importance, we continue to depend on sales that take place in physical stores and shopping malls. Reduced customer foot traffic in these stores and malls is likely to reduce their sales of our products. In addition, if one or more of these retailers or distributors are unable to meet their obligations with respect to accounts payable to us, we could be forced to write off accounts receivable with such accounts. Any bankruptcy, liquidation, insolvency or other failure of any of these retailers or distributors could result in significant financial loss and cause us to lose revenue in future periods.

Price changes and other concessions could reduce our revenue.

We continue to test and offer changes to the pricing of our products. If we reduce our prices in an effort to increase our sales, this could have an adverse impact on our revenue to the extent that unit sales do not increase in a sufficient amount to compensate for the lower pricing. Reducing our pricing to individual consumers could also cause us to have to lower pricing to our E&E Language customers. Any increase in the taxation of online sales could have the effect of a price increase to consumers and could cause us to have to lower our prices or could cause sales to decline. It is uncertain whether we will need to lower prices to effectively compete and what other short-term or long-term impacts could be.

In the U.S. and Canada, we offer consumers who purchase our web-based software, packaged software and audio practice products directly from us a 30-day, unconditional, full money-back refund. We also permit some of our retailers and distributors to return products, subject to certain limitations. We establish revenue reserves for product returns based on historical experience, estimated channel inventory levels, the timing of new product introductions and other factors. If product returns exceed our reserve estimates, the excess would offset reported revenue, which could adversely affect our reported financial results.

Table of Contents

Our future growth and profitability will depend in large part upon the effectiveness and efficiency of our marketing.

Our future growth and profitability will depend in large part upon the effectiveness and efficiency of our marketing, including our ability to:

- appropriately and efficiently allocate our marketing for multiple products;
- accurately identify, target and reach our audience of potential customers with our marketing messages;

	(e)	(f)	(g)	(h)				
	Number of Shares Beneficially Owned Prior to Offering	Number of Shares that may be Offered Hereby (1) (3)	Number of Shares to be Owned After Completion of the Offering (2)	Percent of Shares Beneficially Owned After the Offering (4)				
Elite Classic Convertible Arbitrage Ltd.	650	650	0	*	21,311	21,311	0	*
Argent LowLev Convertible Arbitrage Fund Ltd.	4,090	4,090	0	*	134,098	134,098	0	*
Argent Classic Convertible Arbitrage Fund L.P.	6,010	6,010	0	*	197,049	197,049	0	*
Xavex Convertible Arbitrage 2 Fund	290	290	0	*	9,508	9,508	0	*
Kamunting Street Master Fund, Ltd.	50,000	50,000	0	*	1,639,344	1,639,344	0	*
Highfields Capital I LP (5)	3,196	3,196	0	*	598,455	104,786	493,669	*
Highfields Capital II LP (5)	7,721	7,721	0	*	1,448,205	253,147	1,195,058	1.41%
Highfields Capital III L.P. (5)	33,083	33,083	0	*	5,646,041	1,084,689	4,561,352	5.38%
Partners Group Alternative Strategies PCC LTD	1,830	1,830	0	*	60,000	60,000	0	*
Dow Employees Pension Plan	1,350	1,350	0	*	44,262	44,262	0	*
Union Carbide Employees Pension Plan	600	600	0	*	19,672	19,672	0	*
Qwest Occupational Health Trust	250	250	0	*	8,196	8,196	0	*
Qwest Pension Trust	1,400	1,400	0	*	45,901	45,901	0	*
Virginia Retirement System	4,400	4,400	0	*	144,262	144,262	0	*
Zazove Convertible Securities Fund, Inc.	1,800	1,800	0	*	59,016	59,016	0	*
Zazove Aggressive Growth Fund, L.P.	3,700	3,700	0	*	121,311	121,311	0	*
Merrill, Lynch, Pierce, Fenner & Smith, Inc. (6)	3,000	3,000	0	*	98,360	98,360	0	*
Century National Insurance Company	900	900	0	*	29,508	29,508	0	*
Deerfield Partners, L.P.	3,519	3,519	0	*	115,377	115,377	0	*
Deerfield International Limited	5,481	5,481	0	*	179,704	179,704	0	*
ING Equity Income Fund	1,600	1,600	0	*	52,459	52,459	0	*
UIF Equity Income Fund	785	785	0	*	25,737	25,737	0	*
US Allianz Equity Income Fund	310	310	0	*	10,163	10,163	0	*
Van Kampen Equity Income Fund	27,000	27,000	0	*	885,245	885,245	0	*
Morgan Stanley Fundamental Value Fund	250	250	0	*	8,196	8,196	0	*
HFR CA Global Opportunity Master Trust	4,987	4,987	0	*	163,508	163,508	0	*
Forest Global Convertible Master Fund, L.P.	14,350	14,350	0	*	470,491	470,491	0	*
Institutional Benchmarks Master Fund Ltd.	3,076	3,076	0	*	100,852	100,852	0	*
LLT Limited	3,228	3,228	0	*	105,836	105,836	0	*
Alpine Partners, L.P.	1,406	1,406	0	*	46,098	46,098	0	*
Alpine Associates	9,837	9,837	0	*	322,524	322,524	0	*
Alpine Associates II, L.P.	780	780	0	*	25,573	25,573	0	*
Good Steward Trading Co., SPC Class F	213	213	0	*	6,983	6,983	0	*
Credit Suisse Securities (USA) LLC (7)	6,000	6,000	0	*	196,721	196,721	0	*
D.E. Shaw Valence Portfolios, L.L.C.	25,000	25,000	0	*	819,672	819,672	0	*

**Table of Contents**

	Series A Preferred Stock				Common Stock			
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Name	Number of Shares Beneficially Owned Prior to Offering	Number of Shares that may be Offered Hereby (1)	Number of Shares to be Owned After Completion of the Offering (2)	Percent of Shares Beneficially Owned After the Offering (2)	Number of Shares Beneficially Owned Prior to Offering	Number of Shares that may be Offered Hereby (1) (3)	Number of Shares to be Owned After Completion of the Offering (2)	Percent of Shares Beneficially Owned After the Offering (4)
Lyxor / Forest Fund Limited	17,819	17,819	0	*	584,229	584,229	0	*
Forest Multi Strategy Master Fund SPC	406	406	0	*	13,311	13,311	0	*
HFR RVA Select Performance Master Trust	634	634	0	*	20,786	20,786	0	*
Stark Master Fund Ltd.	10,000	10,000	0	*	327,868	327,868	0	*
All other holders of Series A Preferred Stock (and future transferees, distributees, pledges donees or successors of such holders) (8) (9)	139,049	139,049	0	*	4,558,983	4,558,983	0	*

\* Less than 1%

- (1) Unless otherwise indicated, each Preferred Selling Securityholder may offer any or all of the Series A Preferred Stock it beneficially owns and any of the Common Stock issuable upon conversion of the Series A Preferred Stock.
- (2) Assumes the sale of all shares of Series A Preferred Stock and Common Stock offered pursuant to this prospectus.
- (3) Assumes conversion of all of the Preferred Selling Securityholders' shares of Series A Preferred Stock at the conversion rate of 32.786885 shares of common stock per share of Series A Preferred Stock. This conversion rate is subject to certain adjustments as described in the Series A Preferred Stock certificate of designations. Accordingly, the number of shares of common stock that may be issued upon conversion of the Series A Preferred Stock may be adjusted from time to time. Fractional shares will not be issued upon conversion of the Series A Preferred Stock. Cash will be paid instead of fractional shares, if any. Assumes that no dividends on Series A Preferred Stock will be paid in shares of Common Stock.
- (4) This percentage is calculated using as the numerator the number of shares of Common Stock included in column (g) and as the denominator 78,684,549 shares of Common Stock issued and outstanding, net of treasury shares, on February 15, 2007, plus the number of shares of Common Stock issuable upon conversion of the Series A Preferred Stock held by the Preferred Selling Securityholders included in column (f).
- (5) Highfields Capital Management LP, Highfields GP LLC, Highfields Associates LLC, Mr. Jonathon S. Jacobson, and Mr. Richard L. Grubman, may be deemed to beneficially own 7,692,701 shares of our common stock and share the power to vote or direct the vote, and the power to dispose or direct the disposition of these shares. In addition, Highfields Capital I LP, Highfields Capital II LP and Highfields Capital III L.P. beneficially own \$4,177,000, \$10,107,000 and \$38,716,000 aggregate principal amount, respectively, of our 10.75% Senior Notes due 2016.
- (6) An affiliate of Merrill, Lynch, Pierce, Fenner & Smith, Inc. (Merrill) also served as an initial purchaser of our \$375 million aggregate principal amount floating rate senior notes due 2014 and \$625 million aggregate principal amount 10.75% senior notes due 2016. In addition, an affiliate of Merrill served as administrative agent for, and held borrowings under, our interim loan agreement dated March 10, 2006, which borrowings we repaid in full in June 2006. Merrill and certain of its affiliates also served as co-lead arranger and joint bookrunner in connection with our Credit Agreement, and receive customary fees and expense reimbursements. Merrill and its affiliates have performed investment banking, commercial banking and advisory services for the Company and its affiliates in the ordinary course of business, for which they have received customary fees and expense reimbursements. Merrill and its affiliates may, from time to time, engage in transactions with and perform services for the Company and its affiliates in the ordinary course of business. From time to time, Merrill and its affiliates may effect transactions for their own account or the account of customers, including hedging such positions, and hold on behalf of themselves or their customers, long or short positions in our debt or equity securities or loans.
- (7) Credit Suisse Securities (USA) LLC (Credit Suisse) is also a holder of 963,380 Warrants. In addition, Credit Suisse or one or more of its affiliates was the lender, administrative agent, syndication agent and arranger under our Senior Subordinated Credit Agreement, dated as of January 16, 2004 and also arranged

## Edgar Filing: ROSETTA STONE INC - Form 10-K

an amendment to this facility as administrative agent in 2005, and received customary fees in connection therewith. Credit Suisse has also acted as solicitation agent in soliciting consents related to various series of our senior notes, which are no longer outstanding, and received customary fees in connection therewith. Credit Suisse also served as a financial advisor to the Company during the period from July 2003 to June 2004, and received customary fees in connection therewith. Certain affiliates of Credit Suisse are also lenders under our Credit Agreement, dated as of March 10, 2006, as amended.

- (8) Information concerning other Preferred Selling Securityholders will be set forth in prospectus supplements or in an amendment to the registration statement of which this prospectus is a part if and when necessary. Totals in these columns may exceed the number of shares of Series A Preferred Stock and common stock offered by this prospectus as a result of the Preferred Selling Securityholders identified above having sold, transferred or otherwise disposed of some or all of their shares of Series A Preferred Stock since the date on which the information in the preceding table was provided to us without informing us of such sale(s). In no event will the number of shares of Series A Preferred Stock offered by this prospectus exceed 400,000 shares. Similarly, the total number of shares of our common stock

**Table of Contents**

issuable upon the conversion of all the Series A Preferred Stock may increase or decrease due to adjustments to the conversion rate. Pursuant to Rule 416 under the Securities Act, the registration statement of which this prospectus is a part also covers any additional shares of our common stock which become issuable in connection with such shares because of any stock dividend, stock split, recapitalization or other similar event or adjustment in the number of shares issuable as provided by the terms of the Series A Preferred Stock.

- (9) Assumes that all other holders of Series A Preferred Stock (and future transferees, pledgees, donees or successors of such holders) do not beneficially own any shares of our common stock other than the shares issuable upon conversion of the Series A Preferred Stock.

**Warrants**

Pursuant to the terms of our former Senior Subordinated Credit Agreement, dated January 16, 2004, among the Company, Credit Suisse First Boston, and the lenders named therein, we agreed to issue to such lenders an aggregate of 10,000,000 Warrants, entitling the holder thereof to purchase 2,000,000 shares of common stock of the Company, par value \$0.01 per share, at an exercise price of \$32.50 per share, in each case, as applicable, adjusted on account of the one-for-five reverse stock split of our common stock effective October 25, 2006.

The selling securityholders listed below and their transferees, pledgees, donees or other successors, if not identified in this prospectus then so identified in supplements to this prospectus or in an amendment to the registration statement of which this prospectus forms a part, as required, are the Warrant Selling Securityholders under this prospectus, and, together with the Preferred Selling Securityholders, the Selling Securityholders. The following table sets forth for each Warrant Selling Securityholder, as of a recent practicable date prior to the effectiveness of the registration statement of which this prospectus forms a part:

the name of each Warrant Selling Securityholder;

the number of Warrants and the number of shares of our common stock issuable upon exercise that may be sold by the Warrant Selling Securityholders; and

the number and percent of shares of common stock to be beneficially owned by each Warrant Selling Securityholder before and after the offering.

The information is based on information provided by or on behalf of the Warrant Selling Securityholders to us in Warrant Selling Securityholder questionnaires and is as of the date specified by the holders of the questionnaires. We have not sought to verify the information contained in the table. Because the Warrant Selling Securityholders may offer all or some portion of these securities pursuant to this prospectus, and because we are not currently aware of any agreements, arrangements or understandings with respect to the sale of these securities, we cannot predict the number of shares or principal amount of the securities that will be held by the Warrant Selling Securityholders upon termination of this offering. In addition, some of the Warrant Selling Securityholders may have sold, transferred or otherwise disposed of all or a portion of their securities since the date on which they provided the information about themselves and the securities they were selling in transactions exempt from the registration requirements of the Securities Act. See Plan of Distribution.

Unless otherwise disclosed in the footnotes to the table below, no Warrant Selling Securityholder has, or within the past three years has had, any position, office or other material relationship with us or any of our predecessors or affiliates.

Name	Number of Warrants Beneficially Owned Prior to Offering	Number of Warrants that may be Offered Hereby (1)	Percentage of Outstanding Warrants	Shares of Common Stock Beneficially Owned Prior to Offering		Shares of Common Stock Beneficially Owned After Offering	
				Number	Percent (2)	Number	Percent (2)
Stanfield Offshore Leveraged Assets, Ltd.	84,507	84,507	*	0	*	0	*
King Street Capital, L.P	69,046	69,046	*	0	*	0	*
King Street Capital, Ltd.	146,722	146,722	1.47%	0	*	0	*
Concordia Distressed Debt Fund, L.P.	84,507	84,507	*	0	*	0	*





**Table of Contents**

Name	Number of Warrants Beneficially Owned Prior to Offering	Number of Warrants that may be Offered Hereby (1)	Percentage of Outstanding Warrants	Shares of Common Stock Beneficially Owned Prior to Offering		Shares of Common Stock Beneficially Owned After Offering	
				Number	Percent (2)	Number	Percent (2)
Credit Suisse Securities (USA) LLC (3)	963,380	963,380	9.6%	0	*	0	*
GSO Credit Opportunities Fund (Helios), LP	416,725	416,725	4.2%	0	*	0	*
Ore Hill Hub Fund Ltd.	488,380	488,380	4.9%				
All other holders of the Warrants (and future transferees, distributees, pledges donees or successors of such holders) (4) (5)	7,746,733	7,746,733	77.5%				

\* Less than 1%

- (1) Assumes exercise of the entire amount of Warrants held by the Warrant Selling Securityholder at a rate of one-fifth of a share of our Common Stock per Warrant. The number of shares of Common Stock issuable upon exercise of the Warrants may be adjusted under circumstances described under Description of Warrants Adjustments. Under the terms of the Warrants, cash will be paid instead of issuing any fractional shares.
- (2) This percentage is calculated using as the numerator the number of shares of Common Stock included in the previous column and as the denominator 78,684,549 shares of Common Stock issued and outstanding, net of treasury shares, on February 15, 2007.
- (3) Credit Suisse Securities (USA) LLC ( Credit Suisse ) is also a holder of 6,000 shares of our Series A Preferred Stock. In addition, Credit Suisse or one or more of its affiliates was the lender, administrative agent, syndication agent and arranger under our Senior Subordinated Credit Agreement, dated as of January 16, 2004 and also arranged an amendment to this facility as administrative agent in 2005, and received customary fees in connection therewith. Credit Suisse has also acted as solicitation agent in soliciting consents related to various series of our senior notes, which are no longer outstanding, and received customary fees in connection therewith. Credit Suisse also served as a financial advisor to the Company during the period from July 2003 to June 2004, and received customary fees in connection therewith. Certain affiliates of Credit Suisse are also lenders under our Credit Agreement, dated as of March 10, 2006, as amended.
- (4) Information concerning other Warrant Selling Securityholders will be set forth in prospectus supplements or in an amendment to the registration statement of which this prospectus is a part if and when necessary. Totals in these columns may exceed the number of Warrants and common stock offered by this prospectus as a result of the Warrant Selling Securityholders identified above having sold, transferred or otherwise disposed of some or all of their Warrants since the date on which the information in the preceding table was provided to us without informing us of such sale(s). In no event will the number of Warrants offered by this prospectus exceed 10,000,000. Similarly, the total number of shares of our common stock issuable upon the exercise of all the Warrants may increase or decrease due to adjustments to the exercise price and the number of shares issuable upon exercise of the Warrants. Pursuant to Rule 416 under the Securities Act, the registration statement of which this prospectus is a part also covers any additional shares of our common stock which become issuable in connection with the Warrants because of any stock dividend, stock split, recapitalization or other similar event or adjustment in the number of shares issuable upon exercise of the Warrants.
- (5) Assumes that all other holders of the Warrants (and future transferees, distributees, pledgees, donees or successors of such holders) do not beneficially own any shares of our common stock.

**Table of Contents**

**PLAN OF DISTRIBUTION**

The Series A Preferred Stock and the Warrants are being registered to permit public secondary trading of the offered securities by the holders thereof from time to time after the date of this prospectus. Under the terms of the registration rights agreement entered into with representatives of the holders of the Preferred Stock and the Warrants, we have agreed, among other things, to pay substantially all of the expenses incidental to the registration and sale of the securities covered by this prospectus.

We will not receive any of the proceeds from the offering by the selling securityholders of the Warrants, the Series A Preferred Stock or the shares of common stock into which the Series A Preferred Stock is convertible or for which the Warrants may be exercised, except with respect to the Warrants under certain circumstances described in greater detail under the heading **Use of Proceeds**.

We cannot assure you that any selling securityholder will sell all or any portion of the securities offered under this prospectus or that any selling securityholder will not transfer, devise or gift its securities by other means not described in this prospectus.

The selling securityholders and any brokers, dealers or agents who participate in the distribution of the securities covered by this prospectus may be deemed to be underwriters, and any profits on the sale of the securities by them and any discounts, commissions or concessions received by any brokers, dealers or agents may be deemed to be underwriting discounts and commissions under the Securities Act. To the extent the selling securityholders may be deemed to be underwriters, the selling securityholders may be subject to some statutory liabilities of the Securities Act, including, but not limited to, Sections 11, 12 and 17 of the Securities Act and Rule 10b-5 under the Exchange Act. If the selling securityholders are deemed to be underwriters, they will be subject to the prospectus delivery requirements of the Securities Act.

The securities offered hereby may be sold from time to time directly by the selling securityholders or, alternatively, through underwriters, broker-dealers or agents. If the securities covered by this prospectus are sold through underwriters or broker-dealers, the selling securityholder will be responsible for underwriting discounts or commissions or agent's commissions. Such securities may be sold in one or more transactions at fixed prices, at prevailing market prices at the time of sale, at varying prices determined at the time of sale, or at negotiated prices. Such sales may be effected in transactions (which may involve block transactions) (i) on any national securities exchange or quotation service on which the securities covered by this prospectus may be listed or quoted at the time of sale, (ii) in the over-the-counter market or (iii) in transactions otherwise than on such exchanges or services or in the over-the-counter market. The selling securityholders may also loan or pledge the securities offered hereby to broker-dealers that in turn may sell such securities.

The selling securityholders may use any one or more of the following methods when selling securities covered by this prospectus: (i) block trades in which the broker-dealer will attempt to sell the shares as agent but may position and resell a portion of the block as principal to facilitate the transaction; (ii) short sales; and (iii) any other method permitted pursuant to applicable law. The selling securityholders may also engage in short sales against the box, puts and calls and other transactions in our securities or derivatives of our securities and may sell or deliver shares in connection with these trades. In addition, the securities covered by this prospectus may be sold in private transactions or under Rule 144 under the Securities Act rather than under this prospectus.

The selling securityholders and any other person participating in the distribution will be subject to applicable provisions of the Exchange Act, including, without limitation, Regulation M, which may limit the timing of purchase and sales of any of the securities by the selling securityholders and any other person. Furthermore, under Regulation M, any person engaged in the distribution of the securities may not simultaneously engage in market-making activities with respect to the particular securities being distributed for particular periods prior to the commencement of the distribution. All of the foregoing may affect the marketability of these securities and the ability of any person or entity to engage in market-making activities with respect to the securities.

**Table of Contents**

Under the terms of the respective registration rights agreements relating to the Series A Preferred Stock and the Warrants, holders of the securities covered by this prospectus and we have agreed to indemnify each other against certain liabilities, including certain liabilities under the Securities Act and Exchange Act, or will be entitled to contribution in connection with those liabilities.

There is no public trading market for the shares of the Series A Preferred Stock or the Warrants and we have not applied and do not intend to apply for listing of the shares of the Series A Preferred Stock or the Warrants on any national securities exchange or for quotation of the shares on any automated quotation system. No assurances can be given as to the liquidity of the trading market for the shares of the Series A Preferred Stock or the Warrants or that an active public market for those shares will develop. If an active market for the Warrants or the shares of the Series A Preferred Stock does not develop, the market price and liquidity of those shares may be adversely affected. If the shares of the Series A Preferred Stock or the Warrants are traded, they may trade at a discount from their initial offering price, depending on the market for similar securities, our performance and other factors.

We have agreed, subject to certain rights to suspend use of the shelf registration statement, to use reasonable best efforts to keep the shelf registration statement effective until the earliest of (a) the sale of all registrable securities registered under the shelf registration statement; (b) two years from the last date of original issuance of the securities (or for such other period as shall be required by Rule 144(k) of the Securities Act of 1993, as amended, or any successor provision thereto); and (c) the date on which the Preferred Stock and the Warrants and any shares of common stock issued in conversion or upon exercise thereof (1) cease to be outstanding or (2) have been resold pursuant to Rule 144.

---

**Table of Contents**

**DESCRIPTION OF THE SERIES A PREFERRED STOCK**

The Series A Preferred Stock was issued under a certificate of designations in a private transaction that was not subject to the registration requirements of the Securities Act. The following is a summary of certain provisions of the certificate of designations for our Series A Preferred Stock. A copy of the certificate of designations and the form of Series A Preferred Stock share certificate is available upon request from us at the address set forth under the Section [Where to Find More Information](#) . The following summary of the terms of Series A Preferred Stock does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the certificate of designations. As used in this section, the terms the Company , us , we or our refer to HealthSouth Corporation and not any of its current or future subsidiaries.

**General**

Under our restated certificate of incorporation, our board of directors is authorized, without further stockholder action, to issue up to 1,500,000 shares of preferred stock, par value \$0.10 per share, in one or more series, with such voting powers, full or limited, or no voting powers, and such preferences and such relative, participating, optional or other special rights, with such qualifications, limitations or restrictions of such preferences or rights, as shall be set forth in the resolutions providing therefor.

When issued, the Series A Preferred Stock was, and any common stock issued upon the conversion of the Series A Preferred Stock will be, fully paid and nonassessable. The holders of the Series A Preferred Stock have no preemptive or preferential right to purchase or subscribe for stock, obligations, Warrants or other securities of the Company of any class. The transfer agent, registrar, conversion and dividend disbursing agent for shares of both the Series A Preferred Stock and common stock of the Company is Mellon Investor Services, LLC.

The Series A Preferred Stock is subject to forced conversion, as described below under the caption [Forced Conversion](#) .

Under Delaware law, we may pay dividends on our Series A Preferred Stock, whether in cash or in shares of our common stock, out of our surplus, which, under Delaware law, is the amount by which our total assets exceeds the sum of:

our total liabilities, including our contingent liabilities, and

the amount of our capital.

If there is no surplus, dividends may be paid out of our net profits for the fiscal year in which the payment occurs and/or the preceding fiscal year. When required to make a determination of availability of surplus, the amount of our total assets and liabilities and the amount of our capital will be determined by our board of directors in accordance with Delaware law.

**Ranking**

The Series A Preferred Stock, with respect to dividend rights or rights upon our liquidation, winding-up or dissolution, ranks:

senior to all classes of our common stock and each other class of capital stock or series of preferred stock established after the Issue Date of the Series A Preferred Stock, the terms of which do not expressly provide that such class or series ranks senior to or on a parity with the Series A Preferred Stock as to dividend rights or rights upon our liquidation, winding-up or dissolution (which we will refer to collectively as *Junior Stock* );

---

## **Table of Contents**

on a parity with any class of capital stock or series of preferred stock established after the Issue Date, the terms of which expressly provide that such class or series will rank on a parity with the Series A Preferred Stock as to dividend rights or rights upon our liquidation, winding-up or dissolution (which we will refer to collectively as *Parity Stock* );

junior to each class of capital stock or series of preferred stock established after the Issue Date, the terms of which expressly provide that such class or series will rank senior to the Series A Preferred Stock as to dividend rights or rights upon our liquidation, winding-up or dissolution (which we will refer to collectively as *Senior Stock* ); and

junior to all of our existing and future debt obligations and other liabilities, including claims of trade creditors.

While any shares of Series A Preferred Stock are outstanding, we may not authorize or issue any class or series of Senior Stock (or any security convertible into Senior Stock) without the affirmative vote or consent of the holders of at least two-thirds of the outstanding shares of Series A Preferred Stock, voting separately as a class with all other series of preferred stock upon which like voting rights have been conferred and are exercisable. Without the consent of any holder of Series A Preferred Stock, however, we may authorize, increase the authorized amount of, or issue any class or series of Parity Stock or Junior Stock. See *Voting Rights* below.

### **Dividends**

Holders of shares of Series A Preferred Stock are entitled to receive, when, as and if declared by our board of directors out of funds legally available for payment, and to the extent we are in compliance with our credit facilities, our debt indentures and our other then-existing debt instruments, cash dividends at the rate per annum of 6.50% per share on the liquidation preference thereof (the *Liquidation Preference* ), which, based upon the initial Liquidation Preference of \$1,000 per share of Series A Preferred Stock, is equivalent to \$65.00 per share annually. As further described below, the Liquidation Preference is subject to accretion in the event we do not pay accrued dividends on any Dividend Payment Date (as defined below).

Additional dividends will be payable under the circumstances described below under *Transfer Restrictions; Registration Rights* . All references to dividends shall be deemed to include such additional dividends if such additional dividends are then payable.

If we determine in good faith (which determination shall be conclusive) that we are prohibited by the terms of our credit facilities, our debt indentures or any of our other then-existing debt instruments from paying cash dividends on the Series A Preferred Stock, we may pay dividends in shares of common stock (or a combination of cash and shares of common stock), as described below (including with respect to the valuation of such common stock) under the caption *Method of Payment of Dividends*.

Dividends on the Series A Preferred Stock are payable quarterly in arrears on January 15, April 15, July 15 and October 15 of each year, or the following business day if such date is not a business day (each, a *Dividend Payment Date* ), at the annual rate set forth above, and shall accrue from the most recent date as to which dividends shall have been paid or, in the case of the initial dividend, from the Issue Date, whether or not in the relevant dividend period there have been funds legally available for the payment of such dividends.

Each dividend on our Series A Preferred Stock, if declared, based upon the initial Liquidation Preference of \$1,000 per share of Series A Preferred Stock, will be \$16.25 per share. Dividends will be payable to holders of record as they appear on our stock register on the immediately preceding January 1, April 1, July 1 and October 1, or the following business day if such date is not a business day (each, a *Record Date* ). Dividends payable on the Series A Preferred Stock for any period other than a full dividend period (based upon the number of days elapsed during the period) will be computed on the basis of a 360-day year consisting of twelve 30-day months.

---

**Table of Contents**

If we are unable to, or otherwise do not, pay accrued dividends in full on the Series A Preferred Stock on any Dividend Payment Date as described above, the Liquidation Preference will be increased as of the first day immediately following such Dividend Payment Date by the accretion amount in respect of the unpaid dividends. The accretion amount per share of Series A Preferred Stock for any Dividend Payment Date on which accrued dividends are not paid in full will be calculated by multiplying:

the accretion rate of 8.0% per year, calculated on a quarterly basis, by

the Liquidation Preference as of such Dividend Payment Date, by

the fraction of the accrued dividends that were not paid on the Dividend Payment Date.

The Liquidation Preference as of any date will equal the initial Liquidation Preference of \$1,000 per share increased, as described above, as the result of us not distributing dividends on prior Dividend Payment Dates and decreased to the extent we have made any payments described in the next paragraph. The amount of dividends payable for any period following a Dividend Payment Date on which there is a non-payment of dividends will be calculated on the basis of the accreted Liquidation Preference as of the first day of such period.

We may pay all or a portion of the amount by which the Liquidation Preference exceeds \$1,000 per share of Series A Preferred Stock on any Dividend Payment Date or on any other date in cash only. The Liquidation Preference per share of Series A Preferred Stock will be reduced by the amount of such payment. Accordingly, if we pay all of such excess in cash on any Dividend Payment Date or on any other date, the Liquidation Preference will return to the initial Liquidation Preference, and the amount of subsequent dividend payments will be calculated on the basis of the initial Liquidation Preference for the period of time from the date of such reduction until the applicable Dividend Payment Date.

The persons entitled to receive such payment will be holders of our Series A Preferred Stock as they appear on our stock register on a date selected by the board of directors or an authorized committee. That date must (1) not precede the date our board of directors or an authorized committee of our board declares such payment payable and (2) not be more than 60 days prior to the date such payment is paid.

If we pay a portion of the dividends payable on the Series A Preferred Stock on a Dividend Payment Date and accrete the unpaid portion as described above, we will pay the current portion equally and ratably to the holders of Series A Preferred Stock.

We will use our reasonable best efforts to provide notice to the holders of the Series A Preferred Stock not later than ten days prior to a Dividend Payment Date if we determine that we will not pay dividends on that Dividend Payment Date. We will provide such notice by notifying the transfer agent and by issuing a press release. If a development occurs less than ten days prior to a Dividend Payment Date that will prevent us from paying dividends on such date, and we have not already provided notice, we will provide prompt notice to the holders and the transfer agent as set forth above. The notice will indicate whether we will accrete all or a portion of the dividends, the amount of the dividends to be accreted and whether the portion of dividends to be paid, if any, will be paid in cash or in common stock. Notwithstanding the foregoing, our failure (if any) to deliver such notice will not impair our ability to accrete payment of dividends in any respect.

We are only obligated to pay a dividend on our Series A Preferred Stock if our board of directors or an authorized committee of our board declares the dividend payable and we have assets that legally can be used to pay the dividend. The terms of our senior credit facility and the terms of our debt indentures limit our ability to pay cash dividends on the Series A Preferred Stock. Dividends on the Series A Preferred Stock, if paid in cash, and based upon the initial Liquidation Preference of \$1,000 per share of Series A Preferred Stock, would amount to approximately \$26 million in the aggregate for each full four-quarter period. See Risk Factors Risks Related to the Series A Preferred Stock .

No dividends or other distributions (other than a dividend or distribution payable solely in shares of Parity Stock or Junior Stock (in the case of Parity Stock) or Junior Stock (in the case of Junior Stock) and cash in lieu of

---

## **Table of Contents**

fractional shares) may be declared, made or paid, or set apart for payment upon, any Parity Stock or Junior Stock, nor may any Parity Stock or Junior Stock be redeemed, purchased or otherwise acquired for any consideration (or any money paid to or made available for a sinking fund for the redemption of any Parity Stock or Junior Stock) by us or on our behalf (except by conversion into or exchange for shares of Parity Stock or Junior Stock (in the case of Parity Stock) or Junior Stock (in the case of Junior Stock)) unless all accrued and unpaid dividends (other than any accrued and unpaid dividends that have already resulted in accretion of the Liquidation Preference) have been or contemporaneously are declared and paid, or are declared and a sum of cash or number of shares of common stock sufficient for the payment thereof is set apart for such payment, on the Series A Preferred Stock and any Parity Stock for all dividend payment periods terminating on or prior to the date of such declaration, payment, redemption, purchase or acquisition. Notwithstanding the preceding, if full dividends have not been paid on the Series A Preferred Stock and any Parity Stock, dividends may be declared and paid on the Series A Preferred Stock and such Parity Stock so long as the dividends are declared and paid *pro rata* so that the aggregate amounts of dividends declared per share on, and the amounts of such dividends declared in cash per share on, the Series A Preferred Stock and such Parity Stock will in all cases bear to each other the same ratio that accrued and unpaid dividends per share on the shares of the Series A Preferred Stock and such Parity Stock bear to each other. Holders of shares of the Series A Preferred Stock will not be entitled to any dividend, whether payable in cash or stock, in excess of full accrued dividends.

### **Method of Payment of Dividends**

We will make each dividend payment on the Series A Preferred Stock in cash, except to the extent that we determine in good faith that we are prohibited by the terms of our credit facilities, our debt indentures or any of our other then-existing debt instruments from paying cash dividends on the Series A Preferred Stock, in which case we may elect to make all (or, if less than all, the prohibited portion) of such payment in shares of our common stock; *provided, however*, that during the period commencing on the Issue Date and ending on the second anniversary of the Issue Date, we may pay dividends by delivery of shares of our common stock only if (i) the common stock to be delivered as payment therefor is freely transferable by the recipient without further action on its behalf, other than by reason of the fact that such recipient is our affiliate or (ii) a shelf registration statement relating to that common stock has been filed with the SEC and is effective to permit the resale of that common stock by the holders thereof.

With respect to any delivery of shares of our common stock for which we rely on clause (ii) of the proviso to the preceding paragraph, we will use our reasonable best efforts to maintain the effectiveness of the registration statement for ten consecutive Trading Days immediately following the time of delivery of such shares. The resale of shares of our common stock delivered as a dividend will be subject to resale restrictions under the Securities Act.

If we elect to make any dividend payment, or any portion thereof, in shares of our common stock, such shares shall be valued for such purpose at 95% of the average of the daily Volume-Weighted Average Price (as defined below) per share of our common stock for each of the five consecutive Trading Days (as defined below) ending on the second Trading Day immediately prior to the Record Date for such dividend.

The term *Volume-Weighted Average Price* per share of our common stock on a Trading Day is the volume-weighted average price per share of our common stock on the NYSE for such Trading Day, as displayed by Bloomberg or such other comparable service determined in good faith by the Company that has replaced Bloomberg, or in the event that our shares are not traded on any securities exchange, an amount determined in good faith by our board of directors to be the fair value of the common stock, which determination shall be conclusive. Our common stock is currently traded on the NYSE under the ticker symbol *HLS*.

We will use our reasonable best efforts to give the holders of the Series A Preferred Stock notice of any election to make any dividend payment, or any portion thereof, in shares of our common stock. We will provide such notice by notifying the transfer agent and by issuing a press release. The notice will be given at least ten

## **Table of Contents**

Trading Days prior to the Record Date for such dividend and will set forth the portion of such payment that will be made in cash and the portion that will be made in common stock.

No fractional shares of common stock will be delivered to the holders of the Series A Preferred Stock, but we will instead pay a cash adjustment to each holder that would otherwise be entitled to a fraction of a share of common stock. Any portion of any such payment that is declared and not paid through the delivery of shares of common stock will be paid in cash.

## **Liquidation Preference**

In the event of our voluntary or involuntary liquidation, winding-up or dissolution, each holder of Series A Preferred Stock will be entitled to receive and to be paid out of our assets available for distribution to our stockholders, before any payment or distribution is made to holders of Junior Stock (including common stock), but after any distribution on any of our indebtedness or Senior Stock, an amount equal to the then-effective Liquidation Preference, plus accrued and unpaid dividends on the shares to the date fixed for liquidation, winding-up or dissolution. If, upon our voluntary or involuntary liquidation, winding-up or dissolution, the amounts payable with respect to the liquidation preference of the Series A Preferred Stock and all Parity Stock are not paid in full, the holders of the Series A Preferred Stock and the Parity Stock will share equally and ratably in any distribution of our assets in proportion to the full liquidation preference and accrued and unpaid dividends to which they are entitled. After payment of the full amount of the liquidation preference and accrued and unpaid dividends to which they are entitled, the holders of the Series A Preferred Stock will have no right or claim to any of our remaining assets. Neither the sale, conveyance, exchange or transfer of all or substantially all our assets, property or business (other than in connection with our liquidation, winding-up or dissolution), nor our merger or consolidation into or with any other person, will be deemed to be our voluntary or involuntary liquidation, winding-up or dissolution.

The certificate of designations does not contain any provision requiring funds to be set aside to protect the Liquidation Preference even though it is substantially in excess of the par value of the Series A Preferred Stock.

## **Voting Rights**

Each holder of Series A Preferred Stock will have one vote for each share held by the holder on all matters voted upon by the holders of our capital stock, as well as voting rights specifically required by Delaware law from time to time.

If we fail to repurchase the shares of Series A Preferred Stock as described below under the caption **Repurchase Upon a Fundamental Change**, then the number of directors constituting our board of directors will be increased by two and the holders of outstanding Series A Preferred Stock, voting separately as a class with all other series of preferred stock upon which like voting rights have been conferred and are exercisable, will have a right to elect those additional directors to our board until all such shares have been repurchased. To exercise this right, any holder of our Series A Preferred Stock may by written notice request that we call a special meeting of the holders of our Series A Preferred Stock (and any such other series of preferred stock) for the purpose of electing the additional directors and, if the failure to repurchase is continuing, we must call that meeting within 35 days of the date of such written request. If we fail to call such a meeting upon request, any holder at that time of our Series A Preferred Stock may call a meeting. Upon repurchase of all such shares, the holders of our outstanding Series A Preferred Stock will no longer have the right to vote on these additional directors, the term of office of each director so elected will terminate immediately upon such repurchase and the number of our directors will, without further action, be reduced by two.



---

## **Table of Contents**

In addition, we will not, without the approval of the holders of at least two-thirds of the shares of our Series A Preferred Stock then outstanding, voting separately as a class with all other series of preferred stock upon which like voting rights have been conferred and are exercisable:

amend our restated certificate of incorporation if the amendment would alter or change the powers, preferences, privileges or rights of the holders of shares of our Series A Preferred Stock so as to adversely affect them;

issue, authorize or increase the authorized amount of, or issue or authorize any obligation or security convertible into or evidencing a right to purchase, any Senior Stock; or

reclassify any of our authorized stock into any Senior Stock of any class, or any obligation or security convertible into or evidencing a right to purchase any Senior Stock;

*provided, however*, that no such vote will be required for us to take any of these actions to issue, authorize or increase the authorized amount of, or issue or authorize any obligation or security convertible into or evidencing a right to purchase, any Parity Stock or Junior Stock.

### **Conversion Rights**

Each share of Series A Preferred Stock will be convertible at any time at the option of the holder thereof into the number of shares of common stock (the *Conversion Rate* ) obtained by dividing (i) the then-effective Liquidation Preference by (ii) the Conversion Price (as defined below); *provided, however*, that we may elect to satisfy our conversion obligation with cash or a combination of cash and shares of common stock, as described below under the caption *Settlement Upon Conversion* . The *Conversion Price* is currently equal to \$30.50 per share, subject to adjustment as described below under the caption *Conversion Price Adjustment* . The resale of the common stock issuable upon conversion of the Series A Preferred Stock will be subject to resale restrictions under the Securities Act.

With respect to any shares of Series A Preferred Stock that are *restricted securities* on the date of conversion because the registration statement of which this prospectus forms a part covering such securities is not yet effective or for any other reason, the shares of common stock distributed upon conversion will be treated as *restricted securities* , will bear a legend to such effect and will not be transferable by the recipient thereof except pursuant to an effective registration statement or pursuant to an exemption from the registration requirements of the Securities Act. All such shares will be issued in physical certificated form and will not be eligible for receipt in global form through the facilities of The Depository Trust Company ( *DTC* ). With respect to shares of Series A Preferred Stock that are no longer *restricted securities* on a conversion date, either as a result of a resale of the Series A Preferred Stock pursuant to the registration statement of which this prospectus forms a part or otherwise, all shares of common stock distributed upon conversion will be freely transferable without restriction under the Securities Act (other than by our affiliates), and such shares will be eligible for receipt in global form through the facilities of *DTC*.

Holders of shares of Series A Preferred Stock who convert their shares on a day other than a Dividend Payment Date will not be entitled to any accrued dividends for the dividend period in which they convert their shares. Accordingly, shares of Series A Preferred Stock surrendered for conversion during the period between the close of business on any Record Date and the opening of business on the immediately succeeding Dividend Payment Date must be accompanied by payment in cash of an amount equal to the amount of the dividend payable on such shares on such Dividend Payment Date. Such holders will be entitled to receive the dividend payment on those shares on that Dividend Payment Date. A holder of shares of Series A Preferred Stock on a Record Date who (or whose transferee) tenders any shares for conversion on the corresponding Dividend Payment Date will receive the dividend payable by us on the Series A Preferred Stock on that date (and if we do not to pay such dividend, such holder's shares converted on such date will be converted at a Conversion Rate that reflects the accretion of the Liquidation Preference that results from such non-payment), and the converting holder need not include payment in the amount of such dividend upon surrender of shares of Series A Preferred

---

**Table of Contents**

Stock for conversion. Except as provided above with respect to any conversion described herein under *Conversion Rights*, we will make no payment or allowance for unpaid dividends, whether or not in arrears, on converted shares or for dividends on the shares of common stock issued upon conversion.

**Forced Conversion**

At any time on or after July 20, 2011, we may at our option cause the Series A Preferred Stock to be automatically converted at the Conversion Rate then in effect. We may exercise this right only if the Closing Sale Price (as defined below) of our common stock equals or exceeds 150% of the Conversion Price for at least 20 Trading Days in a period of 30 consecutive Trading Days, including the last Trading Day of such 30-day period, ending on the Trading Day prior to our issuance of a press release announcing the forced conversion as described below.

The term *Trading Day* means a day during which trading in securities generally occurs on the principal national securities exchange on which our common stock is listed.

The *Closing Sale Price* of common stock on any date means the closing sale price per share (or if no closing sale price is reported, the average of the closing bid and ask prices or, if more than one in either case, the average of the average closing bid and the average closing ask prices) on such date as reported on NYSE. In the absence of such a quotation, but only with respect to our common stock, the Closing Sale Price will be an amount determined in good faith by our board of directors to be the fair value of such common stock, and such determination shall be conclusive.

To exercise the forced conversion right described above, we will issue a press release prior to the close of business on the first Trading Day following any date on which the conditions described in the first paragraph of this *Forced Conversion* section are met, announcing such election to call a Forced Conversion. We will also give notice by mail or by publication (with subsequent prompt notice by mail) to the holders of the Series A Preferred Stock (not more than four business days after the date of the press release) of the election to call a Forced Conversion. The conversion date will be a date selected by us (which we will refer to as the *Forced Conversion Date*) and will be no more than 15 days after the date on which we issue such press release.

In addition to any information required by applicable law or regulation, the press release and notice of a forced conversion shall state, as appropriate:

the Forced Conversion Date;

the number of shares of common stock to be issued (and the amount of cash (other than cash in lieu of fractional shares) to be paid, if we so elect) upon conversion of each share of Series A Preferred Stock;

the number of shares of Series A Preferred Stock to be converted; and

that dividends on the Series A Preferred Stock to be converted will cease to accrue on the Forced Conversion Date.

On and after the Forced Conversion Date, dividends will cease to accrue on the Series A Preferred Stock called for a forced conversion, all rights of holders of such Series A Preferred Stock will terminate and all outstanding shares of Series A Preferred Stock will automatically convert into the common stock issuable (and cash payable, if we so elect) upon conversion thereof at the Conversion Rate then in effect. The dividend payment with respect to the Series A Preferred Stock for which the Forced Conversion Date occurs during the period between the close of business on any Record Date for the payment of dividends to the close of business on the corresponding Dividend Payment Date will be payable on such Dividend Payment Date to the record holder of such share on such Record Date. Except as provided in the immediately preceding sentence, with respect to a forced conversion, no payment or adjustment will be made upon conversion of Series A Preferred Stock for accrued and unpaid dividends or for dividends with respect to the common stock issued upon such conversion.

## **Table of Contents**

In addition to the forced conversion provision described above, if there are fewer than 15,000 shares of Series A Preferred Stock outstanding, we may, at any time on or after July 20, 2011, at our option, cause the Series A Preferred Stock to be automatically converted into that number of shares of common stock equal to the then-effective Liquidation Preference divided by the lesser of the Conversion Price then in effect and the Market Value (as defined below under the caption Conversion Price Adjustment ) as determined on the second Trading Day immediately prior to the Forced Conversion Date (which conversion obligation may be satisfied in cash or a combination of cash and common stock, if we so elect). The provisions of the immediately preceding three paragraphs shall apply to any such conversion; *provided, however*, that to exercise the right described in this paragraph, we must issue a press release at any time following satisfaction of the condition described in this paragraph.

### **Settlement Upon Conversion**

If a holder holds a beneficial interest in a global certificate representing shares of Series A Preferred Stock, to convert those shares of Series A Preferred Stock the holder must comply with DTC's procedures for converting a beneficial interest in a global certificate and, if required, pay funds equal to dividends payable on the next Dividend Payment Date to which the holder is not entitled and, if required, pay all taxes or duties, if any.

If a holder holds a certificate representing shares of Series A Preferred Stock, to convert those shares of Series A Preferred Stock the holder must:

complete and manually sign the conversion notice on the back of the certificate, or a facsimile of the conversion notice;

deliver the conversion notice, which is irrevocable, and the certificate to the conversion agent;

if required, furnish appropriate endorsements and transfer documents;

if required, pay all transfer or similar taxes; and

if required, pay funds equal to dividends payable on the next Dividend Payment Date to which the holder is not entitled.

In lieu of delivery of shares of common stock in satisfaction of our obligation upon conversion of the Series A Preferred Stock, we may elect to deliver cash or a combination of cash and shares of common stock. If we elect to do so, we will inform the holders of the method we choose to satisfy our obligation upon conversion of the Series A Preferred Stock no later than the second Trading Day immediately following the related conversion date.

If we choose to satisfy any portion of our conversion obligation in cash, we will specify the amount to be satisfied in cash as a fixed dollar amount. We will treat all holders converting on the same Trading Day in the same manner. We will not, however, have any obligation to settle our conversion obligations arising on different Trading Days in the same manner.

If we elect to satisfy any portion of our conversion obligation in cash (other than cash in lieu of fractional shares), the holders may retract their conversion notice at any time during the two Trading Day period beginning on the Trading Day after we have notified the holders of our method of settlement. We refer to this period as the Conversion Retraction Period, and we refer to the last Trading Day in the Conversion Retraction Period as the Retraction Date.

Settlement in shares of common stock only will occur as soon as practicable after the third Trading Day following the conversion date.

Settlements made entirely or partially in cash will occur on the third Trading Day following the final Trading Day of the Cash Settlement Averaging Period (as defined below).



**Table of Contents**

The settlement amount will be computed as follows:

1. If we elect to satisfy the entire conversion obligation in common stock, we will deliver to the holder a number of shares of our common stock equal to (i) the Conversion Rate then in effect multiplied by (ii) the number of shares of Series A Preferred Stock to be converted (*provided* that we will deliver cash in lieu of fractional shares).
2. If we elect to satisfy the entire conversion obligation in cash, we will deliver to the holder cash in an amount equal to the Conversion Value, as defined below.
3. If we elect to satisfy the conversion obligation in a combination of cash and common stock, we will deliver to the holder:

an amount in cash equal to the lesser of (i) the Conversion Value and (ii) the dollar amount per share of Series A Preferred Stock to be converted specified in the notice regarding our chosen method of settlement (the Specified Dollar Amount ); and

a number of whole shares per share of Series A Preferred Stock to be converted equal to the sum of the Daily Share Amounts, as defined below, for each of the trading days in the Cash Settlement Averaging Period (*provided* that we will deliver cash in lieu of fractional shares).

The *Cash Settlement Averaging Period* means, in respect of a conversion date, the twenty consecutive Trading Day period beginning on the Trading Day following the Retraction Date.

The *Conversion Value* per share of Series A Preferred Stock will be an amount equal to the sum of the Daily Conversion Value Amounts, as defined below, for each of the Trading Days in the Cash Settlement Averaging Period.

The *Daily Conversion Value Amount* means, for each Trading Day of the Cash Settlement Averaging Period and for each share of Series A Preferred Stock, the amount equal to the Closing Sale Price of our common stock on such Trading Day multiplied by the Conversion Rate in effect on such Trading Day divided by 20.

The *Daily Share Amount* means, for each Trading Day of the Cash Settlement Averaging Period and for each share of Series A Preferred Stock, a number of shares (but in no event less than zero) determined by the following formula:

$$\frac{(\text{Closing Sale Price on such Trading Day} \times \text{Applicable Conversion Rate}) - \text{Specified Dollar Amount}}{\text{Closing Sale Price on such Trading Day} \times 20}$$

If an event requiring an anti-dilution adjustment occurs subsequent to any Trading Day and prior to delivery of the Daily Share Amount for such share upon settlement, such Daily Share Amount will be appropriately adjusted.

**Fractional Shares**

No fractional shares of common stock or securities representing fractional shares of common stock will be issued upon conversion, whether voluntary or forced, or in respect of dividend payments made in common stock on Series A Preferred Stock. Any fractional interest in a share of common stock resulting from conversion will be paid in cash based on the Closing Sale Price at the close of business on the Trading Day next preceding the date of conversion.

---

## Table of Contents

### **Conversion Price Adjustment**

The Conversion Price is subject to adjustment (in accordance with formulas set forth in the certificate of designations) in certain events, including:

any payment of a dividend or other distribution to all holders of our common stock in shares of our common stock;

any issuance to all holders of shares of common stock of rights, options or Warrants entitling them to subscribe for or purchase shares of common stock or securities convertible into or exchangeable for shares of common stock for a period expiring within sixty (60) days from the date of issuance at less than the Market Value; *provided, however*, that no adjustment shall be made with respect to such a distribution if the holder of shares of Series A Preferred Stock would be entitled to receive such rights, options or Warrants upon conversion at any time of shares of Series A Preferred Stock into common stock; *provided, further, however*, that if such rights, options or Warrants are only exercisable upon the occurrence of certain triggering events, then the Conversion Price will not be adjusted until such triggering events occur;

any subdivision, split, combination or reclassification of the common stock;

any distribution by us consisting exclusively of cash to all holders of our common stock, in which event the Conversion Price will be adjusted by multiplying:

(1) the Conversion Price by:

(2) a fraction, the numerator of which will be the Market Value minus the amount per share of such dividend or distribution and the denominator of which will be the Market Value.

the successful completion of a tender or exchange offer made by us or any subsidiary of ours for outstanding shares of our common stock to the extent that the cash and the value of any other consideration included in the payment per share of our common stock exceeds the Closing Sale Price of our common stock on the Trading Day next succeeding the last date on which tenders or exchanges may be made pursuant to such tender or exchange offer; or

a distribution to all holders of common stock consisting of evidences of indebtedness, shares of capital stock other than our common stock, or assets (including securities, but excluding those dividends, rights, options, Warrants and distributions referred to above).

Notwithstanding the foregoing, in no event will the Conversion Price be less than \$24.45, subject to adjustment in accordance with the first, second, third, fifth and sixth bullet points above under this caption Conversion Price Adjustment .

No adjustment to the Conversion Price will be required unless such adjustment would result in an increase or decrease of at least 1.0% of the Conversion Rate then in effect. Any lesser adjustment shall be carried forward and shall be made at the time of and together with the next subsequent adjustment, if any, which, together with any adjustment or adjustments so carried forward, shall result in an increase or decrease of at least 1.0% of such Conversion Rate; *provided, however*, that we will make such adjustments no later than the earlier of (i) April 15 of each calendar year and (ii) the date on which we deliver any notice of a Forced Conversion. No adjustment to the Conversion Price will be made if such adjustment will result in a Conversion Price that is less than the par value of our common stock. We reserve the right to make such reductions in the Conversion Price in addition to those required in the foregoing provisions as we consider to be advisable in order that any event treated for federal income tax purposes as a dividend of stock or stock rights will not be taxable to the recipients. If we elect to make such a reduction in the Conversion Price, we will comply with the requirements of securities laws and regulations thereunder if and to the extent that such laws and regulations are applicable in connection with the reduction in the Conversion Price.

## Edgar Filing: ROSETTA STONE INC - Form 10-K

The term *Market Value* means the average Closing Sale Price of our common stock for a five consecutive Trading Day period on the NYSE, or if not traded on a principal national securities exchange or automated

---

**Table of Contents**

quotation system, an amount to be determined in good faith by our board of directors to be the fair value of the common stock, preceding the earlier of (i) the day preceding the date of determination and (ii) the day before the *ex date* with respect to the issuance or distribution requiring such computation. For purposes of this definition, the term *ex date* when used with respect to any issuance or distribution, means the first date on which our common stock trades on a principal national securities exchange or quotation system, without the right to receive the issuance or distribution.

On conversion, to the extent the holders of Series A Preferred Stock receive common stock, they will receive, in addition to shares of our common stock and any cash for fractional shares, the rights under any future stockholder rights plan (i.e., poison pill) we may establish, whether or not the rights are separated from our common stock prior to conversion. A distribution of rights pursuant to any such a stockholder rights plan will not trigger a Conversion Price adjustment pursuant to the second or sixth bullet points under this caption *Conversion Price Adjustment*, so long as we have made proper provision to provide that holders will receive such rights upon conversion in accordance with the terms of the certificate of designations. We currently do not have a stockholder rights plan.

The Conversion Price will not be adjusted:

upon the issuance of any shares of our common stock pursuant to any present or future plan providing for the reinvestment of dividends or interest payable on our securities and the investment of additional optional amounts in shares of our common stock under any plan;

upon the issuance of any shares of our common stock or options or rights to purchase those shares pursuant to any present or future employee, director or consultant benefit plan or program of or assumed by us or any of our subsidiaries;

upon the issuance of any shares of our common stock pursuant to any option, warrant, right or exercisable, exchangeable or convertible security outstanding as of the Issue Date;

for a change in the par value of the common stock; or

for accrued and unpaid dividends on the Series A Preferred Stock.

**Recapitalizations, Reclassifications and Changes in Our Common Stock**

Following any reclassification, consolidation or merger of our company with or into another person or any merger of another person with or into us (with certain exceptions), or any sale or other disposition of all or substantially all of our assets (computed on a consolidated basis), a holder of a share of Series A Preferred Stock then outstanding will, upon conversion of such Series A Preferred Stock, be entitled to receive the kind and amount of securities, cash and other property receivable upon such reclassification, consolidation, merger, sale or other disposition by a holder of the number of shares of common stock into which such Series A Preferred Stock was convertible immediately prior thereto, after giving effect to any adjustment event (or, if the transaction provides the holders of our common stock with the opportunity to elect the form of consideration to be received in such transaction, the weighted average of the forms and amounts of consideration received by the holders of our common stock that affirmatively make an election). This provision does not limit the rights of holders or our rights in the event of a Fundamental Change (as defined below under the caption *Adjustment to the Conversion Rate Upon a Fundamental Change*), including the adjustment to the Conversion Rate in the event of a Fundamental Change and the holders' right to require us to purchase any or all of their shares of Series A Preferred Stock.

**Adjustment to the Conversion Rate Upon a Fundamental Change**

We must give notice of each Fundamental Change (as defined below) to all record holders on a date (the *Fundamental Change Notice Date*) that is within ten Trading Days after the effective date of such Fundamental Change (the *Effective Date*) and, with respect to a Fundamental Change described in paragraph





**Table of Contents**

(2) of the definition of that term, at least ten Trading Days prior to the anticipated Effective Date of such Fundamental Change. The notice will state the events causing the Fundamental Change and the Effective Date or anticipated Effective Date thereof. If a holder converts its Series A Preferred Stock at any time beginning at the opening of business on the Trading Day immediately following the Effective Date of a Fundamental Change described in paragraph (2) of the definition of that term, and ending at the close of business on the 30th Trading Day immediately following such Effective Date, we will increase the Conversion Rate for such converted shares of Series A Preferred Stock by the amount described under *Determination of the Adjustment to the Conversion Rate Upon a Fundamental Change*. The additional shares described under the caption *Determination of the Adjustment to the Conversion Rate Upon a Fundamental Change* will be issued (or, if we so elect, the cash will be paid or the cash and additional shares will be paid and issued) after the later to occur of (i) the fifth business day following the Effective Date and (ii) the fifth business day following the relevant date of conversion, in each case subject to the provisions described under *Settlement Upon Conversion*.

A *Fundamental Change* will be deemed to have occurred upon the occurrence of any of the following:

1. a person or group within the meaning of Section 13(d) of the Exchange Act other than us, our subsidiaries or our or their employee benefit plans, files a Schedule TO or any schedule, form or report under the Exchange Act disclosing that the person or group has become the direct or indirect ultimate beneficial owner, as defined in Rule 13d-3 under the Exchange Act, of our voting stock representing more than 50% of the voting power of our voting stock;
2. consummation of any share exchange, consolidation or merger of us pursuant to which our common stock will be converted into cash, securities or other property or any sale, lease or other transfer in one transaction or a series of transactions of all or substantially all of the consolidated assets of us and our subsidiaries, taken as a whole, to any person other than one of our subsidiaries; *provided, however*, that a transaction where the holders of more than 50% of all classes of our voting stock immediately prior to the transaction own, directly or indirectly, more than 50% of all classes of voting stock of the continuing or surviving corporation or transferee immediately after the event shall not be a Fundamental Change;
3. continuing directors cease to constitute at least a majority of our board of directors;
4. we are liquidated or dissolved or holders of our capital stock approve any plan or proposal for our liquidation or dissolution; or
5. our common stock ceases to be listed on a national securities exchange or quoted on the Nasdaq National Market or another over-the-counter market in the United States.

However, a Fundamental Change will not be deemed to have occurred in the case of a share exchange, consolidation or merger, if (i) 100% of the consideration (excluding cash payments for fractional shares and cash payments pursuant to dissenters' appraisal rights) in such transaction consists of common stock of a United States company traded on a national securities exchange or quoted on the Nasdaq National Market (or which will be so traded or quoted when issued or exchanged in connection with such transaction) and (ii) as a result of such transaction or transactions the shares of Series A Preferred Stock become convertible solely into such common stock.

*Continuing director* means a director who either was a member of our board of directors on the date of this Prospectus or who becomes one of our directors subsequent to that date and whose election, appointment or nomination for election by our stockholders is duly approved by a majority of the continuing directors on our board of directors at the time of that approval, either by a specific vote or by approval of the proxy statement issued by us on behalf of our entire board of directors in which that individual is named as nominee for director.

The phrase *all or substantially all* of our assets is likely to be interpreted by reference to applicable state law at the relevant time, and will be dependent on the facts and circumstances existing at such time. As a result, there may be a degree of uncertainty in ascertaining whether a sale or transfer is of *all or substantially all* of our assets.

**Table of Contents****Determination of the Adjustment to the Conversion Rate Upon a Fundamental Change**

If a holder of Series A Preferred Stock elects to convert such stock upon the occurrence of a Fundamental Change described in paragraph (2) of the definition of that term within the time period described above under Adjustment to the Conversion Rate Upon a Fundamental Change, we will increase the Conversion Rate for such Series A Preferred Stock.

The increase in the Conversion Rate will be expressed as additional shares to be issued per \$1,000 Liquidation Preference of Series A Preferred Stock that is converted. The number of additional shares will be determined by reference to the table below, based on the Effective Date and the price of our common stock (the *Stock Price*). If the consideration (excluding cash payments for fractional shares or pursuant to statutory appraisal rights) for our common stock consists solely of cash, then the Stock Price will be the cash amount paid per share of our common stock. Otherwise the Stock Price will be the average of the Closing Sale Price per share of our common stock for the five consecutive Trading Days immediately preceding the Effective Date.

The following table sets forth the Stock Price paid, or deemed paid, per share of our common stock in a transaction that constitutes the Fundamental Change, the Effective Date and the number of additional shares to be added to the Conversion Rate for each \$1,000 of Liquidation Preference of Series A Preferred Stock converted:

**Number of Additional Shares**

Stock Price (1)	Effective Date						
	As of March 7, 2006	2007	2008	As of July 20, 2009	2010	2011	Thereafter
\$24.40	8.19654	8.19654	8.19654	8.19654	8.19654	8.19654	8.19654
\$26.25	7.23134	6.83950	6.57404	6.24606	6.3423	6.09884	6.09884
\$28.75	5.98122	5.93732	5.61906	5.28456	4.98024	4.7675	4.7675
\$31.25	5.22644	4.85376	4.53218	4.14976	4.14334	3.93436	3.93436
\$33.75	4.54480	4.12994	3.87816	3.47700	3.04082	2.8214	2.8214
\$38.75	3.53008	3.12150	2.88244	2.46094	1.90308	1.60204	1.60204
\$43.75	2.79796	2.40074	2.17584	1.74972	1.0882	0.6173	0.6173
\$50.00	2.12966	1.76746	1.53508	1.13354	0.38762	0.0000	0.0000
\$60.00	1.6283	1.24028	1.0753	0.74182	0.17906	0.0000	0.0000
\$75.00	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

(1) The Stock Prices set forth in the table have been adjusted since the initial offering pursuant to a one-for-five reverse stock split and will be further adjusted as of any date on which the Conversion Price of the Series A Preferred Stock is adjusted. The adjusted Stock Prices will equal the Stock Prices applicable immediately prior to the adjustment divided by a fraction, the numerator of which is the Conversion Price immediately prior to the adjustment to the Conversion Price and the denominator of which is the Conversion Price as so adjusted.

The exact Stock Price and Effective Date may not be set forth in the table, in which case:

if the Stock Price is between two Stock Prices in the table or the Effective Date is between two Effective Dates in the table, the number of additional shares will be determined by straight-line interpolation between the number of additional shares set forth for the higher and lower Stock Prices and the two Effective Dates, as applicable, based on a 365-day year;

if the Stock Price is in excess of \$75.00 per share (subject to adjustment in the same manner as the Stock Price) the payment corresponding to row \$75.00 will be paid; and

if the Stock Price is less than \$24.40 per share (subject to adjustment in the same manner as the Stock Price), there will be no increase in the Conversion Rate.



---

## **Table of Contents**

Notwithstanding the foregoing, in no event will the total number of shares of common stock issuable upon conversion exceed 40.8998 per \$1,000 Liquidation Preference, subject to adjustment in the same manner as the Conversion Price as described under the caption Conversion Price Adjustment .

Our obligation to increase the Conversion Rate as described in this section could be considered a penalty, in which case the enforceability thereof would be subject to general equitable principles of reasonableness of economic remedies.

### **Repurchase Upon a Fundamental Change**

In the event of a Fundamental Change, the holders will have the right, at their option, subject to the terms and conditions of the certificate of designations, to require us to purchase any or all of their shares of Series A Preferred Stock. We will purchase the Series A Preferred Stock with cash at a price equal to 100% of the Liquidation Preference of the shares to be purchased plus any accrued and unpaid dividends to, but excluding, the Fundamental Change Purchase Date (as defined below), unless such Fundamental Change Purchase Date falls after a Record Date and on or prior to the corresponding Dividend Payment Date, in which case (i) we will pay the full amount of accrued and unpaid dividends payable on such Dividend Payment Date only to the holder of record at the close of business on the corresponding Record Date and (ii) the purchase price payable on the Fundamental Change Purchase Date will include only the Liquidation Preference, but will not include any amount in respect of dividends declared and payable on such corresponding Dividend Payment Date. We will be required to purchase the Series A Preferred Stock as of a date that is not less than 30 or more than 60 business days after the occurrence of such Fundamental Change, which we refer to as a *Fundamental Change Purchase Date* . Our obligation to repurchase the Series A Preferred Stock will be subject to our compliance with all applicable securities laws at the time of repurchase, as determined by us in our sole discretion.

In addition, holders of Series A Preferred Stock will not have the right to require us to repurchase shares of Series A Preferred Stock upon a Fundamental Change (i) unless such purchase complies with our credit facilities, our debt indentures and our other debt instruments and (ii) unless and until our board of directors has approved such Fundamental Change or elected to take a neutral position with respect to such Fundamental Change.

Within 30 business days after the occurrence of a Fundamental Change, we will mail a written notice of the Fundamental Change to each holder of Series A Preferred Stock, containing the following:

the last day on which the Fundamental Change purchase right described hereunder may be exercised; the Fundamental Change purchase price;

the Fundamental Change Purchase Date;

the name and address of the transfer agent;

the Conversion Price and any adjustments to the Conversion Price;

a statement that the Series A Preferred Stock with respect to which a Fundamental Change Purchase Notice (as defined below) is given may be converted only if the Fundamental Change Purchase Notice has been withdrawn in accordance with the terms of the Series A Preferred Stock; and

the procedures that holders must follow to exercise these rights.

To exercise this right, holders must deliver a written notice (the *Fundamental Change Purchase Notice* ) to the transfer agent prior to the close of business on the business day immediately before the Fundamental Change Purchase Date. The Fundamental Change Purchase Notice must state:

if certificated shares of Series A Preferred Stock have been issued, the stock certificate numbers, or if not, such information as may be required under applicable DTC procedures;

the number of shares of Series A Preferred Stock to be purchased; and

that we are to purchase such shares of Series A Preferred Stock pursuant to the applicable provisions of the certificate of designations.

---

## **Table of Contents**

Holders may withdraw any Fundamental Change Purchase Notice by a written notice of withdrawal delivered to the transfer agent prior to the close of business on the business day before the Fundamental Change purchase date. The notice of withdrawal must state:

the number of the withdrawn shares of Series A Preferred Stock;

if certificated shares of Series A Preferred Stock have been issued, the stock certificate numbers, or if not, such information as may be required under applicable DTC procedures; and

the number, if any, of shares of Series A Preferred Stock that remain subject to the Fundamental Change Purchase Notice.

The Fundamental Change purchase feature of the Series A Preferred Stock may in certain circumstances make more difficult or discourage a takeover of the Company. The Fundamental Change purchase feature, however, is not the result of our knowledge of any specific effort to accumulate shares of our common stock, to obtain control of the Company by means of a merger, tender offer, solicitation or otherwise, or by management to adopt a series of anti-takeover provisions.

We could, in the future, enter into certain transactions, including certain recapitalizations, that would not constitute a Fundamental Change with respect to the Fundamental Change purchase feature of the Series A Preferred Stock but that would increase the amount of our (or our subsidiaries ) outstanding indebtedness.

Our ability to purchase shares of Series A Preferred Stock upon the occurrence of a Fundamental Change is subject to important limitations. Because a substantial amount of our operations is conducted through our subsidiaries, our ability to purchase the Series A Preferred Stock for cash may be limited by restrictions on our ability to obtain funds for such repurchase through dividends from our subsidiaries and the terms of our then existing borrowing agreements. If a Fundamental Change were to occur, we may not have sufficient legally available funds to pay the purchase price in cash for all tendered shares of Series A Preferred Stock. Our current credit agreements and debt indentures contain provisions prohibiting or restricting the purchase of the Series A Preferred Stock under certain circumstances. In addition, a Fundamental Change may constitute an event of default under those agreements or indentures. If a Fundamental Change occurs at a time when we are prohibited from purchasing Series A Preferred Stock for cash, we could seek the consent of our lenders to purchase the Series A Preferred Stock or attempt to refinance this debt. If we do not obtain consent, we would not be permitted to purchase the Series A Preferred Stock.

### **Consolidation, Merger and Sale of Assets**

The certificate of designations provides that we may, without the consent of the holders of any of the outstanding Series A Preferred Stock, consolidate with or merge into any other person or convey, transfer or lease all or substantially all our assets to any person or may permit any person to consolidate with or merge into, or transfer or lease all or substantially all its properties to, us; *provided, however*, that (a) the successor, transferee or lessee is organized under the laws of the United States or any political subdivision thereof; (b) the shares of Series A Preferred Stock will become shares of such successor, transferee or lessee, having in respect of such successor, transferee or lessee the same powers, preferences and relative participating, optional or other special rights and the qualification, limitations or restrictions thereon, the Series A Preferred Stock had immediately prior to such transaction; and (c) certain procedural conditions are met.

Under any consolidation by us with, or merger by us into, any other person or any conveyance, transfer or lease of all or substantially all our assets as described in the preceding paragraph, the successor resulting from such consolidation or into which we are merged or the transferee or lessee to which such conveyance, transfer or lease is made, will succeed to, and be substituted for, and may exercise every right and power of, ours under the shares of Series A Preferred Stock, and thereafter, except in the case of a lease, the predecessor (if still in existence) will be released from its obligations and covenants with respect to the Series A Preferred Stock. This provision does not limit the rights of holders in the event of a Fundamental Change.

## **Table of Contents**

### **SEC Reports**

If, during the period beginning on July 1, 2006 (the first day of the second full fiscal quarter following the Issue Date) and ending on the second anniversary of the Issue Date, we fail to file any annual or quarterly reports with the SEC within 15 days after the time periods prescribed under the Exchange Act or the related rules and regulations under the Exchange Act, then the dividend rate per annum shall increase by 0.50% until all such reports have been filed with the SEC.

### **Notices**

When we are required to give notice to holders of our Series A Preferred Stock by issuing a press release, rather than directly to holders, we will do so in a public medium that is customary for such press release. In such cases, however, publication of a press release through the Dow Jones News Service will be considered sufficient to comply with such notice obligation.

When we are required to give notice to holders of our Series A Preferred Stock within a specified number of Trading Days prior to a specified event, we will identify such Trading Days in good faith based on the definition of Trading Days set forth above. Any notice issued in reliance on such identification will satisfy our obligation with respect to the timing of such notice, notwithstanding any subsequent events that may cause such days to fail to be Trading Days.

### **Miscellaneous**

We will at all times reserve and keep available out of our authorized and unissued common stock, solely for issuance upon the conversion of the Series A Preferred Stock, that number of shares of common stock as shall from time to time be issuable upon the conversion of all the shares of the Series A Preferred Stock then outstanding. The Series A Preferred Stock converted into our common stock or otherwise reacquired by us shall resume the status of authorized and unissued shares of our preferred stock, undesignated as to series, and shall be available for subsequent issuance. Before the delivery of any common stock that we will be obligated to deliver upon conversion of the Series A Preferred Stock, we will comply with all applicable federal and state laws and regulations which require action to be taken by us. All shares of common stock delivered upon conversion of the Series A Preferred Stock will upon delivery be duly and validly issued and fully paid and nonassessable, free of all liens and charges and not subject to any preemptive rights.

### **Book-Entry, Delivery and Form**

We initially issued the Series A Preferred Stock in the form of global securities. The global securities were deposited with, or on behalf of, the Depositary and registered in the name of the Depositary or its nominee. Except as set forth below, the global securities may be transferred, in whole and not in part, only to the Depositary or another nominee of the Depositary. Investors may hold their beneficial interests in the global securities directly through the Depositary if they have an account with the Depositary or indirectly through organizations which have accounts with the Depositary.

Shares of Series A Preferred Stock that are issued as described below under the caption **Certificated Series A Preferred Stock** will be issued in definitive form. Upon the transfer of Series A Preferred Stock in definitive form, such Series A Preferred Stock will, unless the global securities have previously been exchanged for Series A Preferred Stock in definitive form, be exchanged for an interest in the global securities representing the Liquidation Preference being transferred.

The Depositary has advised us as follows: The Depositary is a limited-purpose trust company organized under the laws of the State of New York, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code, and a clearing agency registered pursuant to the provisions of Section 17A of the Exchange Act. The Depositary was created to hold securities of institutions



---

**Table of Contents**

that have accounts with the Depository ( *participants* ) and to facilitate the clearance and settlement of securities transactions among its participants in such securities through electronic book-entry changes in accounts of the participants, thereby eliminating the need for physical movement of securities certificates. The Depository's participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. Access to the Depository's book-entry system is also available to others such as banks, brokers, dealers and trust companies ( *indirect participants* ) that clear through or maintain a custodial relationship with a participant, whether directly or indirectly.

Pursuant to procedures established by the Depository, upon the deposit of the global securities with, or on behalf of, the Depository, the Depository credited, on its book-entry registration and transfer system, the Liquidation Preference represented by such global securities to the accounts of participants. The accounts to be credited shall be designated by us. Ownership of beneficial interests in the global securities will be limited to participants or persons that may hold interests through participants. Ownership of beneficial interests in the global securities will be shown on, and the transfer of those ownership interests will be effected only through, records maintained by the Depository (with respect to participants' interests) and such participants and indirect participants (with respect to the owners of beneficial interests in the global securities other than participants). The laws of some jurisdictions may require that certain purchasers of securities take physical delivery of such securities in definitive form. Such limits and laws may impair the ability to transfer or pledge beneficial interests in the global securities.

So long as the Depository, or its nominee, is the registered holder and owner of the global securities, the Depository or such nominee, as the case may be, will be considered the sole legal owner and holder of the Series A Preferred Stock evidenced by the global certificates for all purposes of such Series A Preferred Stock and the certificate of designations. Except as set forth below as an owner of a beneficial interest in the global certificates, you will not be entitled to have the Series A Preferred Stock represented by the global securities registered in your name, will not receive or be entitled to receive physical delivery of certificated Series A Preferred Stock in definitive form and will not be considered to be the owner or holder of any Series A Preferred Stock under the global securities. We understand that under existing industry practice, in the event an owner of a beneficial interest in the global securities desires to take any action that the Depository, as the holder of the global securities, is entitled to take, the Depository will authorize the participants to take such action, and that the participants will authorize beneficial owners owning through such participants to take such action or would otherwise act upon the instructions of beneficial owners owning through them.

All payments on Series A Preferred Stock represented by the global securities registered in the name of and held by the Depository or its nominee will be made to the Depository or its nominee, as the case may be, as the registered owner and holder of the global securities. We expect that the Depository or its nominee, upon receipt of any payment on the global securities, credited participants' accounts with payments in amounts proportionate to their respective beneficial interests in the Liquidation Preference of the global securities as shown on the records of the Depository or its nominee. We also expect that payments by participants or indirect participants to owners of beneficial interests in the global securities held through such participants or indirect participants will be governed by standing instructions and customary practices and will be the responsibility of such participants or indirect participants. We will not have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the global securities for any Series A Preferred Stock or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests or for any other aspect of the relationship between the Depository and its participants or indirect participants or the relationship between such participants or indirect participants and the owners of beneficial interests in the global securities owning through such participants or indirect participants.

Although the Depository has agreed to the foregoing procedures in order to facilitate transfers of interests in the global securities among participants or indirect participants of the Depository, it is under no obligation to perform or continue to perform such procedures, and such procedures may be discontinued at any time. Neither we nor the transfer agent will have any responsibility or liability for the performance by the Depository or its participants or indirect participants of their respective obligations under the rules and procedures governing their operations.

## Table of Contents

The share of Series A Preferred Stock will be subject to certain restrictions on transfer set forth on the shares and the certificates evidencing the shares will bear the legend regarding such transfer restrictions set forth under Notice to Investors; Transfer Restrictions .

## **Registration Rights**

Under the terms of a registration rights agreement that we entered into with the holders of the Series A Preferred Stock, we are required to:

file the registration statement of which this prospectus forms a part with the SEC on or prior to the day (the *Filing Date* ) that is 30 days after the Company is required to file its Report on Form 10-K with the SEC for the fiscal year ending December 31, 2006 (giving effect to any extensions under the Exchange Act);

use our reasonable best efforts to cause the shelf registration statement to be declared effective under the Securities Act no later than 180 days after the Filing Date; and

use our reasonable best efforts to keep the shelf registration statement effective after its effective date until the earlier of (1) the sale pursuant to the shelf registration statement of all of the Series A Preferred Stock and any of the common stock issued upon conversion of the Series A Preferred Stock; (2) the expiration of the holding period applicable to the Series A Preferred Stock and the common stock issuable upon conversion of the Series A Preferred Stock held by non-affiliates of the Company under Rule 144(k) under the Securities Act; and (3) the date on which all of the Series A Preferred Stock and any of the common stock issued upon conversion of the Series A Preferred Stock (i) cease to be outstanding or (ii) have been resold pursuant to Rule 144 under the Securities Act.

We have the right to suspend use of the shelf registration statement during specified periods of time for any bona fide reason, including pending corporate developments and public filings with the SEC and similar events for a period not to exceed 30 days in any three-month period and not to exceed an aggregate of 120 days in any 12-month period. If we fail to file the shelf registration statement on or prior to the Filing Date, the shelf registration statement is not declared effective on or prior to the 180th day after the Filing Date or, after the shelf registration statement has been declared effective, we fail to keep the shelf registration statement effective or usable in accordance with and during the periods specified in the registration rights agreement, other than the periods during which we are permitted to suspend use of the registration statement (any of the foregoing, a *registration default* ), then, in each case, we will pay additional dividends to all holders of Series A Preferred Stock equal to the applicable dividend rate or accretion rate for the relevant period plus (i) 0.25% per annum for the first 90 days after such registration default and (ii) thereafter, 0.50% per annum. So long as the failure to file or become effective or such unavailability continues, we will pay additional dividends on each Dividend Payment Date to the person who is the holder of record of the Series A Preferred Stock on the applicable Record Date. When such registration default is cured, additional dividends through the date of cure will be paid in cash on the subsequent Dividend Payment Date to the record holder.

We filed the registration statement of which this prospectus forms a part with the SEC pursuant to the registration rights granted in connection with the original issuance of the Series A Preferred Stock.

A holder who elects to sell any Series A Preferred Stock or common stock pursuant to the shelf registration statement:

will be required to be named as selling securityholder;

will be required to deliver to purchasers a prospectus or an effective notice under Rule 173 under the Securities Act to the effect that such sale was made pursuant to a registration statement;

will be subject to the civil liability provisions under the Securities Act in connection with any sales; and

will be bound by the applicable provisions of the registration rights agreement, including indemnification obligations.

**Table of Contents**

We refer to the Series A Preferred Stock and common stock issuable upon conversion of the Series A Preferred Stock as registrable securities . Promptly upon request from any holder of registrable securities, we will provide a form of notice and questionnaire, which must be completed and delivered by that holder to us before any intended distribution of registrable securities under the registration statement of which this prospectus forms a part. To be named as a selling security holder in the registration statement of which this prospectus forms a part when it first becomes effective, holders must complete and deliver a selling securityholder questionnaire at least five business days before the effectiveness of the registration statement of which this prospectus forms a part. Any holder that does not complete and deliver a questionnaire or provide such other information will not be named as a selling security holder in the prospectus and therefore will not be permitted to sell any registrable securities under the registration statement.

The description of the registration rights agreement appearing above is a summary of the material provisions of the registration rights agreement. It does not purport to be complete. This summary is subject to and is qualified by reference to all the provisions of the registration rights agreement, a copy of which was filed as Exhibit 4.8 to our Annual Report of Form 10-K for the year ended December 31, 2005, filed with the SEC on March 29, 2006.

**Certificated Series A Preferred Stock**

Subject to certain conditions, the Series A Preferred Stock represented by the global securities is exchangeable for certificated Series A Preferred Stock in definitive form if (1) the Depositary notifies us that it is unwilling or unable to continue as Depositary for the global securities or if at any time the Depositary ceases to be a clearing agency registered under the Exchange Act and, in either case, a successor is not appointed within 90 days or (2) we in our discretion at any time determine not to have all of the Series A Preferred Stock represented by the global securities. Any Series A Preferred Stock that is exchangeable pursuant to the preceding sentence is exchangeable for certificated Series A Preferred Stock issuable for such number of shares and registered in such names as the Depositary shall direct. Subject to the foregoing, the global securities are not exchangeable, except for global securities representing the same aggregate number of shares and registered in the name of the Depositary or its nominee.

## **Table of Contents**

### **DESCRIPTION OF THE WARRANTS**

On January 16, 2004, we entered into a warrant agreement (the "Warrant Agreement") with Wells Fargo Bank Northwest, N.A. (the "Warrant Agent") pursuant to which we issued to the lenders named therein 10,000,000 Warrants. The issuance of the Warrants satisfied an existing obligation we had to such lenders in connection with the repayment of our 3.25% Convertible Debentures on January 16, 2004. Each of the Warrants issued under the Warrant Agreement initially entitled the holder thereof to purchase one share of our common stock at an exercise price of \$6.50. On October 25, 2006, we effected a one-for-five reverse stock split of our common stock. As such, the exercise price of the Warrants increased from \$6.50 to \$32.50 per share, and as a result, the aggregate number of shares of common stock issuable upon exercise of the Warrants decreased from 10,000,000 to 2,000,000. The following is a summary of certain provisions of the Warrant Agreement and the Warrants. The following summary of the Warrant Agreement and the Warrants does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the Warrant Agreement and the Warrants, copies of which have been filed as exhibits to our current report on Form 8-K filed with the SEC on January 20, 2004. The Warrants expire on January 16, 2014.

#### **Exercise of Warrants**

Each warrant entitles its holder to purchase one-fifth of a share of common stock at an exercise price of \$32.50 per share, subject to adjustment in accordance with the anti-dilution and other adjustment provisions described below. The holder of each warrant will be able to exercise the warrant, in whole or part, by delivering to the Warrant Agent the certificate representing the warrant, the exercise notice properly completed and executed and payment of the aggregate exercise price for the number of shares of common stock as to which the warrant is being exercised. The exercise price will be payable to the Warrant Agent at the option of each warrant holder, (a) in cash or by certified or official bank or bank cashier's check payable to the order of HealthSouth Corporation; or (b) by cashless exercise, pursuant to which the exercise price would be paid by surrendering additional Warrants to the Warrant Agent having an aggregate spread (generally, with respect to any Warrant, the current market value of the shares of common stock subject to such Warrant, less the exercise price of such Warrant) equal to the aggregate exercise price of the Warrants being exercised.

Each Warrant is exercisable at any time on or prior to January 16, 2014. Each warrant may be exercised at any time in whole or in part at the applicable exercise price until the expiration date. No fractional shares of our common stock will be issued upon the exercise of the Warrants. Instead, we will pay cash in an amount equal to the product resulting from multiplying the fractional amount by the market price per share determined averaging the daily market price for the 20 trading days ending on the last trading day before the date of exercise.

Upon exercise of each Warrant and as soon as practicable thereafter, we will issue and deliver a stock certificate representing the number of shares that were exercised under the Warrant. If the Warrant is not fully exercised, we will execute and deliver a new Warrant exercisable for the remaining shares at the same time we deliver the stock certificate for the exercised shares.

#### **Repurchase Offers**

The Company shall offer to repurchase all outstanding Warrants in the event: (1) the Company merges or consolidates with another person or entity pursuant to which the holders of common stock receive consideration for such common stock and the common stock thereafter issuable upon exercise of the Warrants is not registered; (2) the Company sells all or substantially all of its assets to another person or entity and the common stock thereafter issuable upon exercise of the Warrants is not registered; or (3) the Company or any of its subsidiaries purchases common stock pursuant to a tender offer or exchange offer for a price that is greater than the current market value of the common stock. Each holder may, but is not obligated to, accept such repurchase offer, and may do so either in part or in whole. The repurchase price for each warrant properly tendered, except in the case of a repurchase pursuant to a tender offer or exchange offer, as described above, will be equal to the value of the

## **Table of Contents**

common stock on the date five business days before notice of the repurchase offer is given (measured by the daily market price of the common stock for the 20 consecutive trading days immediately preceding such valuation date), less the exercise price in effect on the date on which notice of repurchase is given. The repurchase price for each warrant properly tendered pursuant to a tender offer or exchange offer, as described above shall be equal to the price that would have been paid for the shares of common stock represented by such warrant had such warrant been exercised and such shares of common stock tendered or exchanged in the relevant tender offer or exchange offer. The Company is required to give notice of a repurchase offer within two business days of any repurchase event described above.

## **Adjustments**

The exercise price of each Warrant and the number of shares of our common stock issuable upon the exercise of each Warrant will be subject to adjustment upon the occurrence of certain events. No adjustment in the number of shares of common stock, in each case, shall be required unless such adjustment would require an increase or decrease of at least one percent (1%) in the number of shares of common stock purchasable upon the exercise of each Warrant; provided, however, that any adjustment which is not required to be made because it falls below the one percent (1%) threshold will be taken into account with respect to any subsequent adjustment. The exercise price of each Warrant may be adjusted under the following circumstances:

in the event that we, on or before January 16, 2014, (a) issue any shares of our common stock in payment of a dividend or distribution with respect to our common stock or other shares of capital stock, (b) subdivide our issued and outstanding shares of common stock, (c) consolidate our issued and outstanding shares of common stock into a smaller number of shares, or (d) reclassify or convert the shares of our common stock (other than a reclassification in connection with a business combination transaction);

in the event that we issue any rights, options, warrants or convertible or exchangeable securities (other than as described above) to all holders of shares of our common stock, entitling them to subscribe for or purchase shares of common stock at a price per share which is lower than the then-current market value per share;

in the event that we decrease the purchase price per share of any outstanding rights, options, warrants or convertible or exchangeable securities (other than under a provision designed to protect against dilution);

in the event that we increase the number of shares of common stock which may be purchased or subscribed for upon exercise, exchange or conversion of any outstanding rights, options, warrants or convertible or exchangeable securities (other than under a provision designed to protect against dilution);

in the event that we sell and issue any shares of our common stock or rights related thereto (other than as described above or in connection with a merger or certain other business combination transactions) at a price per share that is lower than the current market value per share in effect immediately prior to the date of such sale or issuance;

in the event that we make a distribution to holders of shares of our common stock of (i) evidences of our indebtedness, or assets, or other dividends or distributions, or (ii) any options, warrants or other rights to subscribe for or purchase any of the foregoing (other than (A) any issuance of common shares pursuant to adjustment for payment of a dividend, subdivision, consolidation or reclassification, (B) distributions in connection with the dissolution, liquidation or winding-up of the Company and (C) distributions of securities as described above);

upon the expiration of any rights, options, warrants or conversion or exchange privileges that have previously resulted in an adjustment, if any thereof shall not have been exercised, exchanged or converted;

---

## **Table of Contents**

In case of a merger or certain other business combination transactions for which consideration is payable to holders of shares of common stock, the Warrants will remain subject to the terms and conditions set forth in the Warrant Agreement and each warrant will, after such transaction, entitle the holder to receive upon exercise, the number of shares in the capital or other securities or property of or from the person or entity resulting from such transaction (or, in the case of a sale of assets, to whom the assets were sold) that would have been distributable or payable on account of the shares of common stock if such holder's Warrants had been exercised immediately prior to such transaction; and the rights and interests of the holders will be appropriately adjusted by our board of directors in good faith so as to be applicable, as nearly as may reasonably be, to any shares, other securities or any property thereafter deliverable on the exercise of the Warrants. Notwithstanding the above, if we merge or consolidate with, or sell all or substantially all of our property and assets to, another person or entity (other than an affiliate of the Company) and consideration is payable to holders of shares of common stock in exchange for their shares of common stock in connection with such merger, consolidation or sale consists solely of cash, or in the event of the dissolution, liquidation or winding up of the Company, the holders of Warrants shall be entitled to receive distributions on the date of such event on an equal basis with holders of shares of common stock (or other securities issuable upon exercise of the Warrants) as if the Warrants had been exercised immediately prior to such event, less the exercise price.

### **Warrant Holder Not A Stockholder**

The Warrants do not entitle the holders to any voting or other rights as are accorded to our stockholders nor are the holders subject to any liability for the exercise price or as a stockholder whether asserted by us or our creditors.

### **Registration Rights**

We agreed to file the registration statement of which this prospectus forms a part with respect to the Warrants and the shares of common stock issuable upon exercise of the Warrants. The following is a summary of certain provisions of the registration rights agreement. The following summary of the registration rights agreement does not purport to be complete and is subject to, and qualified in its entirety by reference to, the provisions of the registration rights agreement, a copy of which has been filed as an exhibit to our report on Form 8-K filed with the SEC on January 20, 2004.

We filed the registration statement of which this prospectus forms a part with the SEC pursuant to the registration rights granted in connection with the original issuance of the Warrants.

The holders of the Warrants and the common stock issuable upon exercise of the Warrants are entitled to the benefits of a registration rights agreement. This prospectus is part of a registration statement that we filed to meet our obligations to register after the issuance of the Warrants:

resale of the Warrants by the selling security holder; and

resales of the shares of common stock issuable upon exercise of the Warrants by the selling security holder.

Pursuant to the registration rights agreement, we are required to file a registration statement with the SEC on or before ninety (90) days from the earlier of the date on which (a) we give notice to the holders that our audited financial statements for periods required to be included in a registration statement on Form S-1 are available, or (b) such audited financial statements are filed with the SEC.

We will use our best efforts to have this shelf registration statement declared effective as soon as reasonably practicable following the filing thereof, and to keep it effective until the earlier of:

- (1) the date on which the Warrants expire;
- (2) the date on which the Warrants have been exercised pursuant to a registration statement; or
- (3) the date on which the underlying common stock has been disposed of in accordance with a registration statement or distributed to the public pursuant to Rule 144.

**Table of Contents**

We further agree to use our reasonable best efforts to keep this registration statement continually effective for the above-specified period. Upon the occurrence of an event or circumstance that makes the material in the registration statement misleading, we will promptly file all requisite supplements and amendments to cure such defect.

We will be permitted to suspend the use of this prospectus for a period not to exceed sixty (60) consecutive days and no more than two times in any calendar year, in the event that (i) a circumstance exists which makes the registration statement or related documents misleading because of misstatement or omission of a material fact and (ii) (A) we determine in good faith that the disclosure would have a material adverse effect on our business or (B) the disclosure otherwise relates to material non-public information. However, no such period may be in effect during the three months prior to the expiration of the Warrants.

No holder of registrable securities may include such securities in any registration statement pursuant to the registration rights agreement unless and until such holder furnishes to us in writing, within twenty days after the receipt of a request therefor, information about itself and the specifics of the sale. The holders of the Warrants further agree to be named as a selling security holder in the related prospectus, deliver a prospectus to purchasers, be subject to relevant civil liability provisions under the Securities Act in connection with such sales and be bound by the provisions of the registration rights agreements which are applicable to such holder.

We will pay all registration expenses of the shelf registration, provide each holder that is selling registrable securities pursuant to the registration statement copies of the related prospectus and take other actions as are required to permit, subject to the foregoing, unrestricted resales of the registrable securities. Warrant Selling Securityholders remain responsible for all selling expenses, such as commissions and discounts.



---

**Table of Contents**

**CERTAIN U.S. FEDERAL INCOME TAX CONSIDERATIONS**

The following is a summary of certain material U.S. federal income tax consequences to holders who purchase Series A Preferred Stock or Warrants in this offering. This summary is based upon the Internal Revenue Code of 1986, as amended (the Code), Treasury regulations, judicial and administrative authorities, including published positions of the Internal Revenue Service (the IRS) and other applicable authorities, all as in effect on the date hereof (the Tax Authorities). The Tax Authorities may change, perhaps retroactively, or be subject to differing interpretations, so as to result in U.S. federal tax considerations different from those summarized below. We cannot assure you that a change in U.S. federal tax law will not alter significantly the tax considerations that we describe in this summary. This summary does not address any taxes other than U.S. federal income taxes and does not discuss any aspect of U.S. federal alternative minimum tax, state, local or non-U.S. taxation. This summary does not address all of the tax consequences that may be relevant to a particular holder of Series A Preferred Stock or Warrants or to holders of the Series A Preferred Stock or Warrants subject to special treatment under U.S. federal income tax laws such as:

certain financial institutions;

insurance companies;

dealers in securities or foreign currencies;

U.S. holders whose functional currency is not the U.S. dollar;

partnerships or other entities classified as partnerships for U.S. federal income tax purposes;

persons who own 10% or more of our voting stock;

persons subject to the alternative minimum tax; or

tax-exempt organizations.

This summary is limited to holders of the Series A Preferred Stock or Warrants who hold our Series A Preferred Stock or Warrants as a capital asset. No ruling has been or will be sought from the IRS regarding any matter discussed herein. Our counsel has not rendered any legal opinion regarding any tax consequences relating to an investment in the Series A Preferred Stock or Warrants. No assurance can be given that the IRS would not assert, or that a court would not sustain, a position contrary to any of the tax consequences set forth below. This summary is for general information only and is not tax advice. Prospective purchasers should consult their tax advisors as to the U.S. federal income tax consequences of acquiring, holding and disposing of the Series A Preferred Stock or Warrants, as well the effects of state, local and non-U.S. tax laws.

As used herein, the term U.S. holder means a beneficial owner of Series A Preferred Stock or Warrants that is for U.S. federal income tax purposes:

a citizen or resident of the United States;

## Edgar Filing: ROSETTA STONE INC - Form 10-K

a corporation or other entity taxed as a corporation created or organized in or under the laws of the United States, any state thereof or the District of Columbia;

an estate the income of which is subject to U.S. federal income taxation regardless of its source; or

a trust if:

(i) a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons has the authority to control all substantial decisions of the trust or

(ii) the trust was in existence on August 20, 1996 and properly elected to continue to be treated as a U.S. person.

A partnership (or other entity treated as a partnership for U.S. federal income tax purposes) holding Series A Preferred Stock or Warrants or a partner in a partnership (or other such entity) holding Series A Preferred Stock or Warrants should consult its tax advisor because the tax treatment of a partner generally depends upon the status of the partner and the partnership's activities.

---

**Table of Contents**

A non-U.S. holder means a beneficial owner of Series A Preferred Stock or Warrants that is an individual, corporation, estate or trust for U.S. federal income tax purposes and is not a U.S. Holder.

**Summary of Tax Consequences With Respect to our Series A Preferred Stock**

**U.S. Holders**

**Distributions.** Except as discussed below, the distributions received on shares of our Series A Preferred Stock will be treated as follows: first, as a dividend, taxable as ordinary income, to the extent of our current or accumulated earnings and profits, as calculated for U.S. federal income tax purposes; next, as a tax-free return of capital to the extent of your adjusted tax basis in such stock, and thereafter, as capital gain from the sale of such stock (which capital gain will be long-term if your holding period for the stock is more than one year). The amount of any distribution of property other than cash (including common stock distributed to holders of Series A Preferred Stock) will be the fair market value of such property on the date of distribution. Distributions of property will be taxable in the same manner as distributions of cash and therefore may result in tax liability even though no cash is received in the distribution. Distributions on our Series A Preferred Stock generally will be taxable when received, either by you, or by the transfer agent upon our distribution of our common stock.

Distributions taxable as dividends to corporate holders of the Series A Preferred Stock will be eligible for the dividends received deduction, subject to applicable limitations. The benefits of any dividends received deduction to a corporate holder of Series A Preferred Stock may, in effect, be reduced or eliminated by various exceptions and restrictions, including restrictions relating to the holding period of stock on which the dividends are received, debt-financed portfolio stock, taxpayers that pay alternative minimum tax and the so-called extraordinary dividend provisions of Section 1059 of the Code.

**Deemed Distributions.** Certain adjustments to, or failure to adjust, the conversion rate of our Series A Preferred Stock may cause the holders of such stock to be treated as having received a distribution with respect to their Series A Preferred Stock, to the extent any such adjustment or failure to adjust results in an increase in the proportionate interest of such holders in our company. Such a distribution would be taxable to the holders of Series A Preferred Stock as a dividend, return of capital or capital gain in accordance with the rules discussed above for Distributions. In addition, if we are unable to pay dividends on the Series A Preferred Stock, the accreted liquidation preference of the Series A Preferred Stock will be increased and may give rise to a deemed distribution, at the time of such increase, to the holders of the Series A Preferred Stock in the amount of all, or a portion of, the increase in liquidation preference. Any deemed distribution would be taxable in the same manner as a cash distribution of equal amount, as explained above in Distributions, and therefore may result in tax liability even though no cash is received.

**Conversion.** A holder of Series A Preferred Stock who converts Series A Preferred Stock into our common stock generally will not recognize gain or loss. The tax basis of common stock received on conversion generally will equal the tax basis of the Series A Preferred Stock converted, and the holding period for the common stock received generally will include the holding period of the Series A Preferred Stock converted. A holder of Series A Preferred Stock who exchanges Series A Preferred Stock solely for cash generally will recognize capital gain or loss on the receipt of the cash, provided that the payment meets at least one of the following requirements:

the payment is not essentially equivalent to a dividend as determined for U.S. federal income tax purposes;

the payment results in a complete termination of the holder's interest in our stock (preferred and common); or

the payment is substantially disproportionate with respect to the holder of Series A Preferred Stock for U.S. federal income tax purposes.

If the payment satisfies any of these requirements, such capital gain or loss generally will equal the difference between the amount of cash received by the holder of Series A Preferred Stock and the holder's tax

---

**Table of Contents**

basis in the Series A Preferred Stock redeemed. This capital gain or loss will be long term if the holding period for the Series A Preferred Stock is more than one year. In determining whether any of the above requirements apply, shares considered to be owned by the holder of Series A Preferred Stock by reason of certain attribution rules must be taken into account. It may be more difficult for a person who owns, actually or constructively by operation of the attribution rules, any of our stock to satisfy any of the above requirements.

If the payment does not satisfy any of the above requirements, then the entire amount received (i.e., without any offset for the holder's tax basis in the Series A Preferred Stock redeemed) will be treated as a distribution taxable as described in "Distributions" above. In such case, the holder's tax basis in the Series A Preferred Stock that is redeemed will be allocated to the holder's remaining stock, if any, or possibly to stock owned by him constructively if the holder of Series A Preferred Stock does not continue to directly own any of our stock.

A holder of Series A Preferred Stock who receives a combination of our common stock and cash upon a conversion of Series A Preferred Stock generally will recognize gain (but not loss) in an amount equal to the lesser of (i) the excess of the sum of the amount of cash and the fair market value of the common stock received pursuant to the conversion over that holder's adjusted tax basis in its shares of Series A Preferred Stock surrendered or (ii) the amount of cash received pursuant to the conversion. Any recognized gain generally will be long-term capital gain if the holder's holding period with respect to the shares of Series A Preferred Stock surrendered is more than one year at the time of the conversion, and otherwise will be short-term capital gain. If, however, the cash received has the effect of the distribution of a dividend, the gain will be treated as a dividend to the extent of the holder's ratable share of our accumulated earnings and profits, as calculated for U.S. federal income tax purposes, and the remainder as capital gain. In determining whether a holder's gain should be characterized as capital gain or dividend income, a holder will be treated as having received solely common stock upon the conversion followed immediately by our redemption of a number of shares of common stock equal in value to the cash consideration the holder actually receives. The receipt of cash should not have the effect of a distribution of a dividend under this analysis if the receipt of cash in this hypothetical redemption satisfies at least one of the requirements set forth above for capital gain treatment.

Notwithstanding the foregoing, the amount of cash and the fair market value of any shares of common stock received and attributable to any dividends in arrears at the time of the conversion will be treated for U.S. holders as a distribution as described above under "Distributions".

PROSPECTIVE PURCHASERS SHOULD CONSULT THEIR TAX ADVISORS AS TO THE U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE RECEIPT OF CASH, OR CASH AND COMMON STOCK, IN EXCHANGE FOR OUR SERIES A PREFERRED STOCK.

***Fundamental Change Put Right.*** If, as a result of a fundamental change, a holder of Series A Preferred Stock exercises the right to put Series A Preferred Stock to us, the holder will be taxed under the rules described with respect to cash payments in "Conversion" above.

***Other Sales or Dispositions.*** Except as set forth above, a holder of Series A Preferred Stock who sells or otherwise disposes of Series A Preferred Stock generally will recognize capital gain or loss equal to the difference between the sum of the amount of cash and fair market value of any property received on the sale or other disposition and the tax basis in the shares sold or disposed.

***Backup Withholding and Information Reporting.*** Information returns may be filed with the IRS in connection with payments of dividends on the Series A Preferred Stock and the proceeds from a sale or other disposition of the Series A Preferred Stock. You will not be subject to U.S. backup withholding tax on these payments if you provide your taxpayer identification number to the paying agent and comply with certain certification procedures or otherwise establish an exemption from backup withholding. The amount of any backup withholding from a payment to you will be allowed as a credit against your U.S. federal income tax liability and may entitle you to a refund, provided that the required information is furnished to the IRS.

---

**Table of Contents**

**Non-U.S. Holders**

The character for U.S. income tax purposes of any payment received by a non-U.S. holder as a distribution, in exchange for our Series A Preferred Stock pursuant to a conversion or exercise of a put right or from a third party pursuant to a sale or disposition of our Series A Preferred Stock, generally will be determined by applying the principles set forth above with respect to U.S. holders. Dividends paid on our Series A Preferred Stock held by a non-U.S. holder, which dividends are not effectively connected with a trade or business conducted by such non-U.S. holder in the United States, generally will be subject to a U.S. withholding tax at a rate of 30% or at such lower rate as may be provided by an applicable treaty, if any.

Non-U.S. holders generally will not be subject to U.S. federal income tax in respect of gain realized on a sale, exchange or other disposition (including a redemption that is not treated as a dividend) of our Series A Preferred Stock unless (i) the gain is effectively connected with a trade or business conducted by the non-U.S. holder within the United States, and, if a tax treaty applies, attributable to a U.S. permanent establishment maintained by the non-U.S. holder, (ii) in the case of an individual non-U.S. holder, such holder is present in the United States for a least 183 days in the taxable year of the disposition and meets certain other requirements or (iii) we are or have been during certain periods preceding the disposition a U.S. real property holding corporation for U.S. federal income tax purposes (which we believe we are not and are not likely to become).

If you hold your shares of our Series A Preferred Stock in connection with a trade or business that you are conducting in the United States, any dividends on the shares, and any gain from disposing of the shares, generally will be subject to tax in the manner and at the rates generally applicable to U.S. persons. In addition, if you are a corporation, you may be subject to the branch profits tax on your earnings that are connected with your U.S. trade or business, including earnings from the shares. The branch profits tax generally is assessed at a rate of 30%, but may be reduced or eliminated by an applicable treaty, if any.

Information returns may be filed with the IRS in connection with the payment to non-U.S. holders of dividends on the Series A Preferred Stock and the proceeds from the sale or other disposition of the Series A Preferred Stock. You may be subject to U.S. backup withholding on these payments unless you comply with certification procedures to establish an exemption from backup withholding. The amount of backup withholding from a payment to you will be allowed as a credit against your U.S. federal income tax liability and may entitle you to a refund, provided that the required information is furnished to the IRS.

PROSPECTIVE PURCHASERS OF THE SERIES A PREFERRED STOCK SHOULD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

**Summary of Tax Consequences With Respect to the Warrants**

This discussion assumes that the Warrants are treated as such, and not as common stock, for U.S. federal income tax purposes. No assurances can be made in this regard. The tax considerations discussed below would be different if the Warrants were treated as common stock.

**U.S. Holders**

**Exercise of Warrants**

***Cash Exercise***

A U.S. holder generally will not recognize income, gain or loss when paying cash to exercise a Warrant, except with respect to the receipt of cash in lieu of fractional shares, as described below. A U.S. holder's tax basis in common stock received upon the exercise of a Warrant will equal the sum of (i) the U.S. holder's adjusted tax basis in the Warrant at the time of exercise and (ii) the exercise price of the Warrant (reduced by any tax basis allocable to a fractional share, as described below). A U.S. holder's holding period for such common stock will begin on the date the Warrant is exercised.

## **Table of Contents**

### ***Cashless Exercise***

The tax treatment of a cashless exercise of a Warrant (i.e., where a portion of the holder's Warrants are surrendered as the exercise price for other Warrants) is uncertain. A cashless exercise may, for example, be treated as a tax-free recapitalization, in which case a holder's tax basis in the common stock received would equal the tax basis in the surrendered Warrants (reduced by any tax basis allocable to a fractional share, as described below). Alternatively, a cashless exercise may be treated similarly to a cash exercise. It is also possible that a cashless exercise could be treated as a taxable exchange in which gain or loss should be recognized.

The holding period for common stock acquired in a cashless exercise will depend on the U.S. federal income tax treatment of a cashless exercise. Accordingly, the holding period for a share of common stock acquired in a cashless exercise generally should include the holder's holding period for the exercised Warrant if the cashless exercise is treated as a recapitalization, or the holding period generally should begin on the date the Warrant is exercised if the cashless exercise is treated similarly to a cash exercise, or the holding period generally should begin on the day following the date of exercise if the cashless exercise is treated as a taxable exchange. Due to the absence of authority on the U.S. federal income tax treatment of a cashless exercise, there can be no assurance which, if any, of the alternative tax consequences and holding periods described above would be adopted by the IRS or a court of law. Accordingly, holders are urged to consult their tax advisors as to the tax consequences of a cashless exercise.

### ***Cash Received In Lieu of Fractional Shares***

Cash received in lieu of a fractional share of common stock upon exercise of a Warrant will be treated as a payment in exchange for such fractional share deemed to be received by the holder on conversion, and generally should result in capital gain or loss measured by the difference between the cash received for such fractional share and the holder's adjusted tax basis allocable to the fractional share. The utilization of capital losses is subject to certain limitations.

### **Lapse of Warrants**

Upon a lapse or expiration of an unexercised Warrant, a U.S. holder will recognize a capital loss equal to the Warrant holder's tax basis in the Warrant. This capital loss will be a long-term capital loss if the holding period with respect to such Warrant is more than one year. The utilization of capital losses is subject to certain limitations.

### **Sale or Disposition of Warrants**

Upon a sale or other taxable disposition of a Warrant other than by exercise as described above, a U.S. holder generally will recognize capital gain or loss in an amount equal to the difference between the amount realized on the disposition and the U.S. holder's tax basis in such Warrant. A U.S. holder's tax basis in a Warrant generally will equal the cost of the Warrant to such U.S. holder. Any such capital gain or loss will be long-term capital gain or loss if the holder's holding period for the Warrant is more than one year at the time of disposition. The utilization of capital losses is subject to certain limitations.

### **Distributions on Our Common Stock**

Distributions on our common stock will be treated as a dividend, return of capital or capital gain as described in [Summary of the Consequences with respect to our Series A Preferred Stock](#) U.S. Holders' Distributions.

### **Adjustment of the Conversion Rate**

Certain adjustments to, or failure to adjust, the conversion rate of the Warrants may cause holders of Warrants or shares of common stock to be treated as having received a distribution on the Warrants or common

---

## **Table of Contents**

stock, to the extent any such adjustment or failure to adjust results in an increase in the proportionate interest of such holders in our company. Such a distribution would be taxable to holders as a dividend, return of capital or capital gain in accordance with rules discussed above under Summary of the Consequences with respect to our Series A Preferred Stock U.S. Holders Distributions.

### **Disposition of Common Stock**

Upon a taxable disposition of shares issued upon exercise of Warrants, a holder generally will recognize capital gain or loss equal to the difference, if any, between (i) the amount of cash and the fair market value of other property received, and (ii) the holder's adjusted tax basis in the shares. Such gain or loss generally will be long-term capital gain or loss if the holding period with respect to such shares is more than one year. The utilization of capital losses is subject to certain limitations.

### **Non-U.S. Holders**

#### **Distributions and Adjustments to Conversion Rate**

Distributions paid to a non-U.S. holder on our common stock generally will be subject to U.S. withholding tax at a rate of 30%, subject to reduction by an applicable tax treaty. Certain adjustments to, or failure to adjust, the conversion rate of the Warrants may cause holders of Warrants or shares of common stock to be treated as having received a distribution on the Warrants or common stock, to the extent any such adjustment or failure to adjust results in an increase in the proportionate interest of such holders in our company.

#### **Exercise or Sale of Warrants or Common Stock**

A non-U.S. holder generally will not be subject to U.S. federal income tax on the gain, if any, resulting from the exercise of a Warrant or the sale or disposition of a Warrant or a share of our common stock unless (i) the gain is effectively connected with a trade or business conducted by the non-U.S. holder within the United States, and, if a tax treaty applies, attributable to a U.S. permanent establishment maintained by the non-U.S. holder, (ii) in the case of an individual non-U.S. holder, such holder is present in the United States for a least 183 days in the taxable year of the disposition and meets certain other requirements or (iii) we are or have been during certain periods preceding the disposition a U.S. real property holding corporation, for U.S. federal income tax purposes (which we believe we are not and are not likely to become).

If you hold the Warrants or our common stock in connection with a trade or business that you are conducting in the United States, any dividends on the shares, and any gain from disposing of the shares, generally will be subject to tax in the manner and at the rates generally applicable to U.S. persons. In addition, if you are a corporation, you may be subject to the branch profits tax on your earnings that are connected with your U.S. trade or business, including earnings from the shares. The branch profits tax generally is assessed at a rate of 30%, but may be reduced or eliminated by an applicable treaty, if any.

### **Information Reporting**

Information returns may be filed with the IRS in connection with payments of dividends on our common stock and the proceeds from a sale or other disposition of the Warrants or the common stock. You will not be subject to U.S. backup withholding tax on these payments unless you comply with certain certification procedures to establish an exemption from backup withholding. The amount of any backup withholding from a payment to you will be allowed as a credit against your U.S. federal income tax liability and may entitle you to a refund, provided that the required information is furnished to the IRS.

PROSPECTIVE PURCHASERS OF WARRANTS SHOULD SEEK ADVICE BASED UPON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

**Table of Contents**

**WHERE YOU CAN FIND MORE INFORMATION**

We are subject to the information reporting requirements of the Exchange Act, and, in accordance with these requirements, we are required to file periodic reports and other information with the SEC. The reports and other information filed by us with the SEC may be inspected and copied at the public reference facilities maintained by the SEC as described below.

We have filed with the SEC a registration statement on Form S-3 (the Registration Statement, which term shall encompass all amendments, exhibits, annexes and schedules thereto and all documents incorporated by reference therein) pursuant to the Securities Act, and the rules and regulations promulgated thereunder, with respect to the Shares offered hereby. This prospectus, which constitutes a part of the registration statement, does not contain all the information contained in the registration statement, parts of which are omitted in accordance with the rules and regulations of the SEC. For further information with respect to us and the securities offered hereby, reference is made to the Registration Statement.

You may copy and inspect the Registration Statement, including the exhibits thereto, and the periodic reports and information referred to above at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549 at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. Our public filings are also available to the public from commercial document retrieval services and at the Internet worldwide website maintained by the SEC at <http://www.sec.gov>.

In addition, you may obtain these materials on our website. Our Internet website address is [www.healthsouth.com](http://www.healthsouth.com). Information on our website does not constitute part of this prospectus and should not be relied upon in connection with making any investment decision with respect to our common stock.

You may also request a copy of any SEC filings, and any information required by Rule 144A(d)(4) under the Securities Act during any period in which we are not subject to Section 13 or 15(d) of the Exchange Act, at no cost, by contacting:

HealthSouth Corporation

One HealthSouth Parkway

Birmingham, Alabama 35243

Attention: General Counsel



**Table of Contents**

**INCORPORATION OF CERTAIN INFORMATION BY REFERENCE**

This prospectus incorporates by reference information that we have filed with the SEC under the Securities Exchange Act of 1934, as amended (the Exchange Act), which means that we are disclosing important information to you by referring you to those documents. Any statement contained in this prospectus or in any document incorporated or deemed to be incorporated by reference into this prospectus will be deemed modified or superseded for the purposes of this prospectus to the extent that a statement contained in this prospectus or any subsequently filed document which also is, or is deemed to be, incorporated by reference into this prospectus modifies or supersedes that statement. Any statement so modified or superseded will not be deemed, except as so modified or superseded, to constitute a part of this prospectus. Accordingly, we incorporate by reference the specific documents listed below and any future filings made with the SEC after the date hereof under Section 13(a), 13(c), 14, or 15(d) of the Exchange Act which will be deemed to be incorporated by reference into this prospectus and to be part of this prospectus from the date we subsequently file such reports and documents until the termination of this offering:

Our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, filed with the SEC on March 1, 2007, as amended by our Form 10-K/A filed with the SEC on March 22, 2007 (the financial statements included therein have been superceded by the financial statements filed as Exhibit 99.2 to our Current Report on Form 8-K filed with the SEC on March 30, 2007),

Our Current Report on Form 8-K that was filed with the SEC on January 12, 2007;

Our Current Report on Form 8-K that was filed with the SEC on January 30, 2007;

Our Current Report on Form 8-K that was filed with the SEC on February 9, 2007;

Our Current Report on Form 8-K that was filed with the SEC on February 20, 2007;

Our Current Report on Form 8-K that was filed with the SEC on March 1, 2007;

Our Current Report on Form 8-K that was filed with the SEC on March 5, 2007;

Our Current Report on Form 8-K that was filed with the SEC on March 14, 2007;

Our Current Report on Form 8-K that was filed with the SEC on March 26, 2007;

Our Current Reports on Form 8-K that were filed with the SEC on March 30, 2007;

Our Current Report on Form 8-K that was filed with the SEC on April 19, 2007;

Our Current Report on Form 8-K that was filed with the SEC pursuant to Items 8.01 and 9.01 on May 2, 2007; and

## Edgar Filing: ROSETTA STONE INC - Form 10-K

Our Registration Statement on Form 8-A, filed with the SEC on September 13, 2006, describing our common stock, and any amendment or report filed with the SEC for the purpose of updating the description.

We will provide without charge to each person to whom a copy of this prospectus has been delivered a copy of any and all of these filings. You may request a copy of these filings by writing or telephoning us at:

HealthSouth Corporation

General Counsel

One HealthSouth Parkway

Birmingham, Alabama 35243

(205) 967-7116

**Table of Contents**

**LEGAL MATTERS**

The validity of the securities being offered hereby will be passed upon for us by Skadden, Arps, Slate, Meagher & Flom LLP.

**EXPERTS**

The financial statements incorporated in this prospectus by reference to HealthSouth Corporation's Current Report on Form 8-K dated March 30, 2007, and management's assessment of the effectiveness of internal control over financial reporting (which is included in Management's Report on Internal Control over Financial Reporting), incorporated in this prospectus by reference to the Annual Report on Form 10-K of HealthSouth Corporation for the year ended December 31, 2006, have been so incorporated in reliance on the report (which contains an adverse opinion on the effectiveness of internal control over financial reporting) of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

Table of Contents

---

# HealthSouth Corporation

400,000 SHARES OF 6.50% SERIES A

CONVERTIBLE PERPETUAL PREFERRED STOCK

10,000,000 WARRANTS TO PURCHASE

SHARES OF COMMON STOCK

AND

15,114,760 SHARES OF COMMON STOCK ISSUABLE

UPON EXERCISE OF THE WARRANTS

AND

CONVERSION OF THE SERIES A PREFERRED STOCK

---

PROSPECTUS

---

MAY 3, 2007

---

**Table of Contents****PART II****INFORMATION NOT REQUIRED IN PROSPECTUS****Item 14. Other Expenses of Issuance and Distribution.**

The expenses relating to the registration of the securities registered hereby will be borne by the registrant. Such expenses are estimated to be as follows:

Securities and Exchange Commission Registration Fee	\$ 13,656
Accounting Fees and Expenses	\$ 10,000
Legal Fees	\$ 35,000
Printing Fees	\$ 50,000
Total	\$ 108,656

**Item 15. Indemnification of Directors and Officers.**

The following summary is qualified in its entirety by reference to the complete text of any statutes referred to below and the restated certificate of incorporation, as amended and the amended and restated bylaws of HealthSouth Corporation, a Delaware corporation (the Registrant). Article VI or the Registrant's amended and restated bylaws provides that, to the full extent permitted by applicable law, the Registrant will indemnify any person (and the heirs, executors and administrators of such person) who, by reason of the fact that he is or was a director, officer, employee or agent of the Registrant was or is a party or is threatened to be a party to (a) any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the Corporation), against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with any such action, suit or proceeding, or, (b) any threatened, pending or completed action or suit by or in the right of the Registrant to procure a judgment in its favor, against expenses (including attorneys' fees) actually and reasonably incurred by him in connection with the defense or settlement of such action or suit. Moreover, any indemnification by the Registrant pursuant thereto will not be deemed exclusive of any other rights to which those seeking indemnification may otherwise be entitled.

Section 145 of the Delaware General Corporation Law (the DGCL) provides that a corporation may indemnify any persons, including officers and directors, who are, or are threatened to be made, parties to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of such corporation), by reason of the fact that such person is or was a director, officer, employee or agent of such corporation or is or was serving at the request of such corporation as a director, officer, employee or agent of another corporation or enterprise. The indemnity may include expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such action, suit or proceeding, provided such director, officer, employee or agent acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable cause to believe that the person's conduct was unlawful. A Delaware corporation may indemnify officers and directors in an action by or in the right of the corporation under the same conditions, except that no indemnification is permitted without judicial approval if the officer or director is adjudged to be liable to the corporation. Where an officer or director is successful on the merits or otherwise in the defense of any action referred to above, the corporation must indemnify him against the expenses that such officer or director actually and reasonably incurred.

The indemnification permitted under the DGCL is not exclusive, and pursuant to Section 145 of the DGCL, a corporation is empowered to purchase and maintain insurance against liabilities whether or not indemnification would be permitted by statute. Article VI of the Registrant's amended and restated bylaws provides that it has the power to purchase and maintain insurance on behalf of any person who is or was a Director, officer, employee or agent of the Registrant, or is or was serving at the request of the Registrant as a Director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability

---

## **Table of Contents**

asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the Registrant would have the power to indemnify him against such liability under applicable law. The Registrant presently has an insurance policy for its directors and officers in the amount of \$200 million, which includes \$50 million in coverage for individual directors and officers in circumstances where we are legally or financially unable to indemnify these individuals.

Section 102(b)(7) of the DGCL allows a Delaware corporation to eliminate or limit the personal liability of directors to a corporation or its stockholders for monetary damages for a breach of fiduciary duty as a director, except where the director breached his duty of loyalty, failed to act in good faith, engaged in intentional misconduct or knowingly violated a law, authorized the payment of a dividend or approved a stock repurchase or redemption in violation of Delaware corporate law or obtained an improper personal benefit.

Pursuant to Section 102(b)(7) of the DGCL, Article NINTH of The Registrant's restated certificate of incorporation provides that no director shall be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a Director except (a) for any breach of the Director's duty of loyalty to the Corporation or its stockholders, (b) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (c) under Section 174 of the DGCL (providing for liability of directors for unlawful payment of dividends or unlawful stock purchases or redemptions), or (d) for any transaction from which the Director derived an improper personal benefit.

Under separate indemnification agreements with HealthSouth Corporation, each director and certain officers of the Registrant are indemnified against all liabilities relating to his or her position as a director or officer of HealthSouth Corporation, to the fullest extent permitted under applicable laws.

### **Item 16. *List of Exhibits.***

The Exhibits to this registration statement are listed in the Index to Exhibits.

### **Item 17. *Undertakings.***

(a) The undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) To include any prospectus required by section 10(a)(3) of the Securities Act of 1933;

(ii) To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than a 20 percent change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement;

(iii) To include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement;

*provided, however*, that paragraphs (a)(1)(i), (a)(1)(ii) and (a)(1)(iii) above do not apply if the information required to be included in a post-effective amendment by those paragraphs is contained in reports filed with or furnished to the Commission by the registrant pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934, as amended, that are incorporated by reference in the registration statement, or is contained in a form of prospectus filed pursuant to Rule 424(b) that is part of the registration statement.

**Table of Contents**

(2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(4) That, for the purpose of determining liability under the Securities Act of 1933 to any purchaser:

(i) Each prospectus filed by the registrant pursuant to Rule 424(b)(3) shall be deemed to be part of the registration statement as of the date the filed prospectus was deemed part of and included in the registration statement; and

(ii) Each prospectus required to be filed pursuant to Rule 424(b)(2), (b)(5), or (b)(7) as part of a registration statement in reliance on Rule 430B relating to an offering made pursuant to Rule 415(a)(1)(i), (vii), or (x) for the purpose of providing the information required by section 10(a) of the Securities Act of 1933 shall be deemed to be part of and included in the registration statement as of the earlier of the date such form of prospectus is first used after effectiveness or the date of the first contract of sale of securities in the offering described in the prospectus. As provided in Rule 430B, for liability purposes of the issuer and any person that is at that date an underwriter, such date shall be deemed to be a new effective date of the registration statement relating to the securities in the registration statement to which that prospectus relates, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof, provided, however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such effective date, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such effective date.

(b) The undersigned registrant hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant's annual report pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, (and, where applicable, each filing of an employee benefit plan's annual report pursuant to Section 15(d) of the Securities Exchange Act of 1934, as amended) that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(c) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers, and controlling persons of each Registrant pursuant to the foregoing provisions, or otherwise, each Registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act of 1933 and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by a Registrant of expenses incurred or paid by a director, officer or controlling person of a Registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, that Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act of 1933 and will be governed by the final adjudication of such issue.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, the registrant certifies that it has reasonable grounds to believe that it meets all of the requirements for filing on Form S-3 and has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Birmingham, State of Alabama on May 3, 2007.

**HEALTHSOUTH CORPORATION**

By: /s/ JOHN P. WHITTINGTON  
 Name: **John P. Whittington**  
 Title: **Executive Vice President,**

**General Counsel and Corporate Secretary**

Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the dates indicated.

Signature	Title	Date
*	President, Chief Executive	May 3, 2007
<b>Jay Grinney</b>	Officer and Director	
	(Principal Executive Officer)	
*	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	May 3, 2007
<b>John L. Workman</b>		
*	Chairman of the Board of Directors	May 3, 2007
<b>Jon F. Hanson</b>		
*	Director	May 3, 2007
<b>Edward A. Blechschmidt</b>		
*	Director	May 3, 2007
<b>Donald L. Correll</b>		
*	Director	May 3, 2007
<b>Yvonne M. Curl</b>		
*	Director	May 3, 2007
<b>Charles M. Elson</b>		
*	Director	May 3, 2007
<b>Leo I. Higdon, Jr.</b>		
*	Director	May 3, 2007
<b>John E. Maupin, Jr.</b>		
*	Director	May 3, 2007
<b>L. Edward Shaw, Jr.</b>		

\*By: /s/ JOHN P. WHITTINGTON  
**John P. Whittington**  
 Attorney-in-fact



**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit Numbers</b>	<b>Description</b>
3.1	Restated Certificate of Incorporation of HealthSouth Corporation, as filed in the Office of the Secretary of State of the State of Delaware on May 21, 1998 (incorporated by reference to Exhibit 3.1 to HealthSouth's Annual Report on Form 10-K filed with the SEC on June 27, 2005).
3.2	Certificate of Amendment to the Restated Certificate of Incorporation of HealthSouth Corporation, as filed in the Office of the Secretary of State of the State of Delaware on October 25, 2006 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed with the SEC on October 31, 2006).
3.3	Amended and Restated By-Laws of HealthSouth Corporation, effective as of September 21, 2006 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed with the SEC on September 27, 2006).
3.4	Amendments to Amended and Restated By-Laws of HealthSouth Corporation, effective as of February 28, 2007 (incorporated by reference to Exhibit 3.1 to HealthSouth's Current Report on Form 8-K filed with the SEC on March 5, 2007).
4.1	Certificate of Designations of 400,000 Shares of 6.50% Series A Convertible Perpetual Preferred Stock of HealthSouth Corporation, (incorporated by reference to Exhibit 3.1 of HealthSouth's Current Report on Form 8-K filed on March 9, 2006).
4.2	Warrant Agreement, dated as of January 16, 2004, by and between HealthSouth Corporation and Wells Fargo Bank Northwest, N.A., as Warrant Agent (incorporated by reference to HealthSouth's Current Report on Form 8-K filed with the SEC on January 20, 2004).
4.3	Registration Rights Agreement, dated as of January 16, 2004, among HealthSouth Corporation and the entities listed on the signature pages thereto as Holders of Warrants and Transfer Restricted Securities (incorporated by reference to Exhibit 10.3 to HealthSouth's Current Report on Form 8-K filed with the SEC on January 20, 2004).
4.4	Registration Rights Agreement, dated February 28, 2006, between HealthSouth and the purchasers party to the Securities Purchase Agreement, dated February 28, 2006, re: HealthSouth's sale of 400,000 shares of 6.50% Series A Convertible Perpetual Preferred Stock (incorporated by reference to Exhibit 4.8 of HealthSouth's Annual Report on Form 10-K filed with the SEC on March 29, 2006).
5.1	Opinion of Skadden, Arps, Slate, Meagher & Flom LLP regarding the validity of the securities being registered.
12.1	Computation of Ratios (incorporated by reference to Exhibit 12 to our Form 10-K/A filed with the SEC on March 22, 2007).
23.1	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm.*
23.2	Consent of Skadden, Arps, Slate, Meagher & Flom LLP (included in the opinion of Skadden, Arps, Slate, Meagher & Flom LLP filed as Exhibit 5.1 hereto).
24.1	Power of Attorney (previously filed on signature page hereto).

---

\* Filed herewith.