KINDRED HEALTHCARE, INC
Form DEF 14A
April 01, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

SCHEDULE 14A INFORMATION

PROXY STATEMENT PURSUANT TO SECTION 14(a)

OF THE SECURITIES EXCHANGE ACT OF 1934

Filed by the Registrant x

Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨ Preliminary Proxy Statement
x Definitive Proxy Statement
¨ Definitive Additional Materials
¨ Soliciting Material Pursuant to Rule 14a-12

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KINDRED HEALTHCARE, INC.

(Name of Registrant as Specified in Its Charter)

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

Payment of Filing Fee (Check the appropriate box):

x No fee required.

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

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

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

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

(4) Proposed maximum aggregate value of transaction:

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(1) Amount Previously Paid:

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

(3) Filing Party:

(4) Date Filed:

KINDRED HEALTHCARE, INC.

April 1, 2009

Dear Shareholder:

You are cordially invited to attend the Annual Meeting of Shareholders of Kindred Healthcare, Inc., to be held at 10:00 a.m. (EDT) on Wednesday, May 20, 2009, at Kindred s principal office at 680 South Fourth Street, Louisville, Kentucky 40202-2412.

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

In accordance with rules adopted by the Securities and Exchange Commission, we are providing access to our proxy materials over the Internet. Accordingly, we are mailing to our shareholders a Notice of Internet Availability of Proxy Materials, which contains instructions on how to access our proxy materials over the Internet and vote online. If you received a Notice of Internet Availability of Proxy Materials, you will not receive a printed copy of our proxy materials by mail unless you request one. If you wish to receive a printed copy of our proxy materials for the 2009 Annual Meeting, please follow the instructions for requesting those materials set forth in the Notice of Internet Availability of Proxy Materials.

YOUR VOTE IS VERY IMPORTANT. Whether or not you plan to attend the meeting, it is important that your shares be represented. Therefore, we urge you to vote by submitting your proxy over the Internet, by telephone or by mail. Please refer to the Notice of Internet Availability of Proxy Materials for more detailed voting instructions. If you attend the meeting, you will, of course, have the right to vote in person.

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

Sincerely,

Paul J. Diaz

President and Chief Executive Officer

Kindred Healthcare, Inc.

680 South Fourth Street

Louisville, Kentucky 40202-2412

KINDRED HEALTHCARE, INC.

680 SOUTH FOURTH STREET

LOUISVILLE, KENTUCKY 40202-2412

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD ON MAY 20, 2009

To the Shareholders of Kindred Healthcare, Inc.:

The Annual Meeting of Shareholders of Kindred Healthcare, Inc. (Kindred) will be held at 10:00 a.m. (EDT) on Wednesday, May 20, 2009, at Kindred s principal office at 680 South Fourth Street, Louisville, Kentucky 40202-2412 for the following purposes:

(1) To elect a board of nine directors;

(2) To approve the Amended and Restated Kindred Healthcare, Inc. Short-Term Incentive Plan;

(3) To approve the Amended and Restated Kindred Healthcare, Inc. Long-Term Incentive Plan;

(4) To ratify the appointment of PricewaterhouseCoopers LLP as Kindred s independent registered public accounting firm for fiscal year 2009; and

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

Only shareholders of record at the close of business on March 24, 2009 will be entitled to notice of, and to vote at, the meeting and any adjournments thereof.

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

April 1, 2009

Paul J. Diaz

President and Chief Executive Officer

PROXY STATEMENT

FOR ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD ON MAY 20, 2009

GENERAL INFORMATION

This proxy statement and the accompanying form of proxy are furnished in connection with the solicitation of proxies by the Board of Directors (the Board or Board of Directors) of Kindred Healthcare, Inc. (Kindred or the Company) for use at the Annual Meeting of Shareholders (the Annual Meeting), to be held at 10:00 a.m. (EDT) on May 20, 2009, at the Company s principal office at 680 South Fourth Street, Louisville, Kentucky 40202-2412, and at any adjournment or postponement thereof. Only shareholders of record on the books of the Company at the close of business on March 24, 2009 will be entitled to notice of, and to vote at, the Annual Meeting. This proxy statement is dated April 1, 2009 and was first made available to shareholders on or about April 8, 2009.

Proxies are solicited by the Board of Directors in order to provide each shareholder with an opportunity to vote on all matters scheduled to come before the Annual Meeting, whether or not he or she attends the Annual Meeting in person. When your proxy is properly executed, the shares represented by the corresponding proxy card will be voted in accordance with your directions. If your proxy does not specify a choice, the shares will be voted as recommended by the Board of Directors.

The cost of preparing, assembling, posting and mailing the Notice of Internet Availability of Proxy Materials (including the notice of Annual Meeting), proxy statement and proxies will be paid by the Company. In addition to the use of the mail, proxies may be solicited by directors, officers and other employees of the Company, without additional compensation, in person, by telephone or other electronic means. Furthermore, the Company has retained Georgeson Inc., a proxy solicitation firm, to solicit proxies from brokers, banks and institutional holders by telephone or mail. The Company does not anticipate the fees paid to Georgeson, exclusive of reimbursement of costs, will exceed $25,000. Kindred will reimburse brokerage houses and other nominees for their expenses in forwarding proxy materials to beneficial owners of the Company s common stock.

In accordance with rules adopted by the Securities and Exchange Commission (the SEC), the Company is providing access to its proxy materials over the Internet. Accordingly, on or about April 8, 2009, the Company is mailing to its record and beneficial shareholders a Notice of Internet Availability of Proxy Materials, which contains instructions on how to access the Company s proxy materials over the Internet and vote online. If you received a Notice of Internet Availability of Proxy Materials, you will not receive a printed copy of the proxy materials by mail unless you request one. If you wish to receive a printed copy of the Company s proxy materials for the 2009 Annual Meeting, please follow the instructions for requesting those materials set forth in the Notice of Internet Availability of Proxy Materials.

Revocability of Proxy

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

Voting Rights and Outstanding Shares

Each share of common stock, $0.25 par value (Common Stock), of the Company outstanding at the close of business on March 24, 2009 is entitled to one vote at the Annual Meeting. As of March 24, 2009, there were 39,052,939 shares of Common Stock outstanding.

The presence at the Annual Meeting in person or by proxy of holders of record of a majority of the outstanding shares of Common Stock is required to constitute a quorum for the transaction of all business at the Annual Meeting. Each director-nominee listed in this proxy statement will be elected if the votes cast for such nominee s election exceed the votes cast against such nominee s election. As set forth in the Company s Corporate Governance Guidelines, the Board of Directors of the Company expects a director to tender his or her resignation for consideration by the Board if he or she fails to receive the requisite number of votes for re-election.

The affirmative vote of a majority of the outstanding shares of Common Stock present in person or by proxy will be necessary (1) to approve the Amended and Restated Kindred Healthcare, Inc. Short-Term Incentive Plan, (2) to approve the Amended and Restated Kindred Healthcare, Inc. Long-Term Incentive Plan, (3) to ratify the appointment of PricewaterhouseCoopers LLP as the Company s independent registered public accounting firm for fiscal year 2009, and (4) to approve any other matters that may properly come before the Annual Meeting for shareholder consideration. Abstentions and proxies relating to street name shares for which brokers have not received voting instructions from the beneficial owner (Broker Non-Votes) are counted in determining whether a quorum is present. In the election of directors, abstentions or Broker Non-Votes for a director-nominee will have no effect. With respect to any matters submitted to the shareholders for their consideration other than the election of directors, abstentions will be counted as shares present and entitled to vote on such proposals in determining whether the proposals have received the requisite number of favorable votes, but Broker Non-Votes will not be counted as shares present and entitled to vote on such proposals. Thus, abstentions will have the same effect as votes against any such proposal, but Broker Non-Votes will have no effect in determining whether any such proposal has been approved by the shareholders. Therefore, it is important that you complete and return your proxy early so that your vote may be recorded.

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

1. PROPOSAL TO ELECT DIRECTORS

The Board of Directors currently consists of 11 persons. The Board of Directors has nominated the nine persons listed below to be elected as directors at the Annual Meeting. Mr. John H. Klein and Mr. Garry N. Garrison, both current directors, have each notified the Company that he will resign from the Board effective at the conclusion of the Annual Meeting. Consistent with the Company s bylaws, the Board has unanimously adopted a resolution to reduce the size of the Board from 11 to nine members upon the effectiveness of the resignation of Mr. Klein and Mr. Garrison. Each director elected at the Annual Meeting will serve, subject to the provisions of the Company s bylaws, until the next annual meeting of shareholders or until his or her successor is duly elected and qualified. The names and ages of the nominees proposed for election as directors, all of whom are presently directors of the Company, together with certain information concerning the nominees, are set forth below.

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

Nominees For Director

EDWARD L. KUNTZ (63) has served as the Executive Chairman of the Board of Directors since January 1, 2004. He served as the Company s Chairman of the Board and Chief Executive Officer from January 1999 to December 31, 2003. He served as President of the Company from November 1998 until January 2002. He also served as Chief Operating Officer and a director of the Company from November 1998 to January 1999. Mr. Kuntz is a director of Rotech Healthcare, Inc., a provider of home medical equipment and related products and services.

JOEL ACKERMAN (43) has served as a director of the Company since December 2008. Mr. Ackerman served as Managing Director and head of the Health Services Group at Warburg Pincus LLC, a global private equity firm, from January 1998 to September 2008. Mr. Ackerman is a director of Coventry Health Care, Inc., a national managed healthcare company, and Medical Staffing Network Holdings, Inc., a leading diversified temporary healthcare staffing company. (1)

ANN C. BERZIN (56) has served as a director of the Company since November 2006. Ms. Berzin served from 1992 to 2001 as Chairman and Chief Executive Officer of Financial Guaranty Insurance Company, then a subsidiary of General Electric Capital Corporation. Ms. Berzin is a director of Ingersoll-Rand Company, a worldwide climate control, industrial solutions, infrastructure development and security products company, and Constellation Energy Group, Inc., the largest wholesale power seller and competitive supplier of electricity to large commercial and industrial customers in the United States. (1)(2)(3)

JONATHAN D. BLUM (50) has served as a director of the Company since December 2008. Mr. Blum has served as the Senior Vice President Public Affairs for Yum! Brands, Inc., the world s largest restaurant company, since 1997. Mr. Blum is responsible for Yum s public policy, government relations, corporate social responsibility, internal and external communications, community relations/philanthropy, diversity, and its quality, food safety and nutrition initiatives. (2)(4)

THOMAS P. COOPER, M.D. (64) has served as a director of the Company since May 2003. Dr. Cooper is the founder and Chairman of Vericare, Inc., a provider of mental health services to patients in long-term care facilities, since 1991. Dr. Cooper also is an adjunct professor at the Columbia University School of Business. Dr. Cooper is a director of Hanger Orthopedic Group, Inc., the largest operator of orthotic and prosthetic patient care centers in the United States, and IPC The Hospitalist Company, Inc., a leading provider of hospitalist services in the United States. (2)(4)

PAUL J. DIAZ (47) has served as a director of the Company since May 2002, as Chief Executive Officer of the Company since January 1, 2004 and as President of the Company since January 2002. He served as the Chief Operating Officer of the Company from January 2002 to December 31, 2003. Mr. Diaz is a director of DaVita, Inc., a provider of dialysis services for patients suffering from chronic kidney failure.

ISAAC KAUFMAN (61), a certified public accountant, has served as a director of the Company since April 2001. Since September 1998, Mr. Kaufman has served as the Senior Vice President and Chief Financial Officer of Advanced Medical Management Inc., a manager of medical practices and an outpatient surgical center. Mr. Kaufman is a director of TransWorld Entertainment Corporation, a leading specialty retailer of music and video products, and Hanger Orthopedic Group, Inc., the largest operator of orthotic and prosthetic patient care centers in the United States. (1)(2)(3)

FREDERICK J. KLEISNER (64) has served as a director of the Company since March 20, 2009. Mr. Kleisner has served as President and Chief Executive Officer of Morgans Hotel Group Co., a hospitality company that operates, owns, acquires and redevelops boutique hotels in the United States and Europe, since September 2007, and as a director since February 2006. From March 2000 to August 2005, Mr. Kleisner was the Chief Executive Officer of Wyndham International, a hotel company that owned, leased, managed and franchised hotels and resorts in the U.S., Canada, Mexico, the Caribbean and Europe. (1)(4)

EDDY J. ROGERS, JR. (68) has served as a director of the Company since August 2003. Mr. Rogers has been a partner with the law firm of Andrews Kurth LLP since October 2001. (1)(2)(3)

(1) Member of the Audit Committee, of which Mr. Kaufman is Chairman.
(2) Member of the Executive Compensation Committee, of which Mr. Klein is Chairman.
(3) Member of the Nominating and Governance Committee, of which Mr. Rogers is Chairman.
(4) Member of the Compliance and Quality Committee, of which Dr. Cooper is Chairman.

The information contained in this proxy statement concerning the nominees is based upon statements made or confirmed to the Company by or on behalf of such nominees, except to the extent certain information appears in its records. Directors ages are given as of January 1, 2009.

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

CERTAIN INFORMATION CONCERNING THE BOARD OF DIRECTORS

The Board of Directors has determined that the following nine directors are independent, as defined under the listing standards of the New York Stock Exchange (NYSE): Mr. Joel Ackerman, Ms. Ann C. Berzin, Mr. Jonathan D. Blum, Thomas P. Cooper, M.D., Mr. Garry N. Garrison, Mr. Isaac Kaufman, Mr. John H. Klein, Mr. Frederick J. Kleisner and Mr. Eddy J. Rogers, Jr. The independent directors have regularly scheduled meetings at which members of management are not present. Mr. Klein presides as chairman of these meetings in his capacity as the Company s lead independent director. The Board of Directors intends to appoint a new lead independent director following the Annual Meeting to replace Mr. Klein. Mr. Michael J. Embler served as an independent director until his resignation from the Board of Directors, effective April 24, 2008.

The Board s independence determination was based on a review in which each director s independence was evaluated on a case-by-case basis. In performing the independence evaluations, the Board considers any matters that could affect the ability of each outside director to exercise independent judgment in discharging his or her responsibilities as a director, including all transactions and relationships between each such director, the director s family members and organizations with which the director or the director s family members have an affiliation and the Company, its subsidiaries and its management. Any such matters are evaluated both from the standpoint of the director and from that of persons or organizations with which the director has an affiliation. In addition, the Board also considers any other transactions, relationships or arrangements that could affect director independence.

In 2008, the Board reviewed relationships between the Company and other entities for which a director of the Company serves as a director. This review included analysis of ordinary course business transactions between the Company and (1) Coventry Health Care, Inc. and Medical Staffing Network Holdings, Inc. for which Mr. Ackerman serves as a non-employee director, (2) Constellation Energy Group, Inc. for which Ms. Berzin serves as a non-employee director, (3) Hanger Orthopedic Group, Inc. for which Dr. Cooper and Mr. Kaufman serve as non-employee directors, and (4) IPC The Hospitalist Company, Inc. for which Dr. Cooper serves as a non-employee director. In this review, the Board identified no transactions, relationships or arrangements in which a director of the Company had or will have a direct or indirect material interest or which otherwise adversely impacted the Board s independence evaluation of the applicable outside directors.

During 2008, the Board of Directors held 12 meetings, including six regular and six special meetings. For the time periods during which each director served on the Board, each director attended more than 75% of the total number of meetings held by the Board and the applicable committees.

The Board of Directors has established an Audit Committee, a Compliance and Quality Committee, an Executive Compensation Committee, and a Nominating and Governance Committee. Each committee has a written charter which is available on the Company s website at *www.kindredhealthcare.com*. The Company s

Corporate Governance Guidelines also are available on the Company s website at *www.kindredhealthcare.com*. Information on the Company s website is not part of this proxy statement. Shareholders may request a copy of the charters and the Corporate Governance Guidelines by contacting the Company, care of the Corporate Secretary, at the Company s principal office.

Audit Committee. The Audit Committee has five members consisting of Mr. Isaac Kaufman (Chairman), Mr. Joel Ackerman, Ms. Ann C. Berzin, Mr. Frederick J. Kleisner and Mr. Eddy J. Rogers, Jr. Each member of the Audit Committee is independent as defined under the listing standards of the NYSE. The Board of Directors has determined that Mr. Kaufman is the Audit Committee s financial expert as defined in Item 407 of Regulation S-K promulgated under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the Exchange Act). The Audit Committee held eight meetings during 2008. The Audit Committee assists the Board of Directors in monitoring (1) the adequacy of the Company s system of internal controls, accounting policies, financial reporting practices, and the quality and integrity of the Company s financial reporting; (2) the independent registered public accounting firm s qualifications and independence; and (3) the performance of the Company s internal audit function and independent registered public accounting firm.

Compliance and Quality Committee. The Compliance and Quality Committee has five members consisting of Thomas P. Cooper, M.D. (Chairman), Mr. Jonathan D. Blum, Mr. Garry N. Garrison, Mr. John H. Klein and Mr. Frederick J. Kleisner. Each member of the Compliance and Quality Committee is independent as defined under the listing standards of the NYSE. The Compliance and Quality Committee held four meetings in 2008. The Compliance and Quality Committee assists the Board of Directors in monitoring (1) the Company s compliance with applicable laws, regulations and policies; (2) the Company s compliance with its Code of Conduct; and (3) the Company s programs, policies and procedures that support and enhance the quality of care provided by the Company.

Executive Compensation Committee. The Executive Compensation Committee has seven members consisting of Mr. John H. Klein (Chairman), Ms. Ann C. Berzin, Mr. Jonathan D. Blum, Thomas P. Cooper, M.D., Mr. Garry N. Garrison, Mr. Isaac Kaufman and Mr. Eddy J. Rogers, Jr. Each member of the Executive Compensation Committee is independent as defined under the listing standards of the NYSE, and qualifies as an outside director within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended (the Code), and as a non-employee director within the meaning of Rule 16b-3 under the Exchange Act. The Executive Compensation Committee held seven meetings in 2008. The Executive Compensation Committee assists the Board of Directors in fulfilling its responsibility to the shareholders, potential shareholders and the investment community by ensuring that the Company s key executives, officers and Board members are compensated in accordance with the Company s overall compensation policies and executive compensation policy. The Executive Compensation Committee recommends and approves compensation policies, programs and pay levels that are necessary to support the Company s objectives and that are rational and reasonable to the value of the services rendered. The Executive Compensation Committee also reviews and discusses with management the Compensation Discussion and Analysis prepared for inclusion in the proxy statement and, based on such review, determines whether to recommend to the Board that the Compensation Discussion and Analysis be included in this proxy statement. Furthermore, the Executive Compensation Committee prepares the Compensation Committee Report that begins on page 51 of this proxy statement.

The Executive Compensation Committee s processes and procedures for the consideration and determination of executive compensation, including the role of our Chief Executive Officer in making recommendations to the Executive Compensation Committee and the role of compensation consultants in assisting the Executive Compensation Committee in its functions, are more fully described in the Compensation Discussion and Analysis section that begins on page 12 of this proxy statement.

Nominating and Governance Committee. The Nominating and Governance Committee has three members consisting of Mr. Eddy J. Rogers, Jr. (Chairman), Ms. Ann C. Berzin and Mr. Isaac Kaufman. Each member of the Nominating and Governance Committee is independent as defined under the listing standards of the NYSE.

The Nominating and Governance Committee held five meetings in 2008. The Nominating and Governance Committee assists the Board of Directors by (1) identifying individuals qualified to become Board members, approving the director nominees for the next annual meeting of shareholders and approving nominees to fill vacancies on the Board; (2) recommending to the Board nominees for director and chairperson(s) for each committee; (3) leading the Board in its annual review of the Board s performance; and (4) recommending to the Board the Corporate Governance Guidelines applicable to the Company. The Nominating and Governance Committee also recommends to the Board of Directors whether or not to accept the expected resignation of any director who fails to receive the required vote for re-election in any uncontested election as set forth in the Company s bylaws and Corporate Governance Guidelines, or whether other action should be taken.

It is the policy of the Nominating and Governance Committee to consider director candidates recommended by shareholders in accordance with the procedures set forth below and who appear to be qualified to serve on the Company s Board of Directors. The Committee has not established any specific qualifications for directors. The Nominating and Governance Committee may choose not to consider an unsolicited recommendation if no vacancy exists on the Board of Directors. There have been no material changes to the procedures by which shareholders may recommend director candidates since the Company last disclosed such procedures.

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

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

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

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

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

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

In order for a director candidate to be considered for nomination at the Company s annual meeting of shareholders to be held in 2010, the recommendation must be received in accordance with the requirements for other shareholder proposals. See Shareholder Proposals and Director Nominations.

The Nominating and Governance Committee has generally identified director nominees based upon suggestions by outside directors, members of management and/or shareholders and outside search firms, and has interviewed and evaluated those persons on its own. On occasion, the Company engages outside search firms to identify and screen potential director candidates. Messrs. Ackerman and Blum were appointed to the Board of Directors on December 17, 2008. Mr. Kleisner was appointed to the Board of Directors on March 20, 2009. Mr. Ackerman was identified by two directors and his qualifications to serve as a director were further evaluated by an outside search firm. Mr. Blum was identified by a director and his qualifications to serve as a director were further evaluated by an outside search firm. Mr. Kleisner was originally identified for such position by an outside search firm. The Company seeks directors who possess integrity, a high level of education and business experience, broad-based business acumen, an understanding of the Company s business and the healthcare industry generally, strategic thinking and a willingness to share ideas, a network of contacts and diversity of experiences, expertise and backgrounds. The Nominating and Governance Committee uses these criteria to evaluate potential nominees, and does not evaluate proposed nominees differently depending upon who has made the proposal.

Attendance at the Annual Meeting. The Board of Directors does not require directors to attend the annual meeting of shareholders. Mr. Diaz and Dr. Cooper attended the 2008 annual meeting of shareholders.

CODE OF ETHICS AND RELATED PERSON TRANSACTIONS

Code of Ethics

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

The Company s Code of Conduct generally prohibits the Company s directors, executive officers and employees from engaging in activities that conflict with the interests of the Company and the residents and patients served by the Company. Unless otherwise approved in accordance with the requirements of the Code of Conduct, the Company s directors, executive officers and employees are prohibited, among other things, from (1) having a direct or indirect financial or business interest in any entity that does business with the Company, (2) having a direct or indirect financial or business interest in any transaction between the Company and a third party, and (3) serving as a director, officer, employee or consultant of an organization that does business with the Company.

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

During 2007 the Company spun off its institutional pharmacy business, Kindred Pharmacy Services (KPS), and simultaneously merged it with AmerisourceBergen Corporation s institutional pharmacy business, PharMerica Long-Term Care (the KPS Spin-off), to form a new, independent, publicly traded company, PharMerica Corporation (PharMerica). In connection with the KPS Spin-off, Messrs. Kuntz and Diaz were requested to serve on the PharMerica board of directors. Following the KPS Spin-off, PharMerica serves as the primary supplier of institutional pharmacy products and services to the Company s skilled nursing facilities and pharmacy management services to the Company s hospitals. In addition, the Company serves as PharMerica s exclusive provider of information services and support related to information technology infrastructure and financial systems. During 2008, the Company also provided certain corporate administrative services on a transitional basis to PharMerica. The independent directors of the Board reviewed the applicable standards under the Company s Code of Conduct with respect to such service and authorized Messrs. Kuntz and Diaz to become directors of PharMerica. Messrs. Kuntz and Diaz agreed to serve as directors through the 2008 annual meeting of PharMerica s shareholders unless such authority was re-approved by the Company s independent directors. Accordingly, Messrs. Kuntz and Diaz each resigned from PharMerica s board of directors effective July 24, 2008.

Related Person Transactions

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

Relevant factors include:

- the benefits of the transaction to the Company;
- the terms of the transaction and whether the terms have been negotiated at arm s-length and in the ordinary course of the Company s business;
- the direct or indirect nature of the related person s interest in the transaction;
- the amount involved and the expected term of the transaction; and
- other facts and circumstances that bear on the materiality of the related person transaction under applicable law and listing standards.

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

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

Based upon its review, the Audit Committee did not identify any related person transactions under Item 404 of Regulation S-K for 2008 or that are currently proposed.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding beneficial ownership of Common Stock as of January 1, 2009 by (1) each person who is a director or nominee for director, (2) each of the Company s Named Executive Officers (as defined herein), (3) all of the persons who are directors and executive officers of the Company, as a group, and (4) each shareholder known by the Company to be the beneficial owner of more than 5% of its outstanding shares of Common Stock.

Name of Beneficial Owner	Amount and Nature of Beneficial Ownership (1)	Percent of Class (1)
Directors, Nominees and Named Executive Officers		
Edward L. Kuntz	316,430	*
Paul J. Diaz	1,109,455	2.8%
Joel Ackerman		*
Ann C. Berzin	15,585	*
Jonathan D. Blum		*
Thomas P. Cooper, M.D.	44,699	*
Garry N. Garrison	66,944	*
Isaac Kaufman	66,944	*
John H. Klein	66,944	*
Frederick J. Kleisner (2)		*
Eddy J. Rogers, Jr.	51,242	*
Richard A. Lechleiter	257,605	*
Frank J. Battafarano	220,287	*
Lane M. Bowen	81,705	*
All Directors and Executive Officers as a Group (21 persons)	2,735,189	6.7%
Other Security Holders with More than 5% Ownership		
Dimensional Fund Advisors LP (3)	3,291,085	8.5%
Franklin Mutual Advisers, LLC (4)	7,618,871	19.6%

* Denotes less than 1%.

(1) Includes shares subject to stock options which are exercisable within 60 days from January 1, 2009. The number of shares of Common Stock that may be acquired through exercise of stock options, which are exercisable as of, or within 60 days after, January 1, 2009, are as follows: Mr. Kuntz 179,103 shares; Mr. Diaz 803,658 shares; Ms. Berzin 13,085 shares; Dr. Cooper 42,199 shares; Mr. Garrison 64,444 shares; Mr. Kaufman 64,444 shares; Mr. Klein 64,444 shares; Mr. Rogers 48,742 shares; Mr. Lechleiter 184,125 shares; Mr. Battafarano 122,476 shares; and Mr. Bowen 41,823 shares. Unless otherwise noted, the Company believes that all persons named in the table have sole voting and investment power with respect to all shares of Common Stock beneficially owned by them.

(2) Mr. Kleisner was appointed to the Board of Directors on March 20, 2009.

(3) Based on a Schedule 13G/A filed by Dimensional Fund Advisors LP (Dimensional) dated December 31, 2008 with the SEC. According to the Schedule 13G/A, Dimensional furnishes investment advice to four investment companies and serves as investment manager to certain other commingled group trusts and separate accounts (collectively, the Funds). According to the Schedule 13G/A, Dimensional, in its role as investment advisor or manager, possesses investment and/or voting power over these shares that are owned by the Funds. Dimensional disclaims beneficial ownership of these shares. The address of Dimensional is Palisades West, Building One, 6300 Bee Cave Road, Austin, Texas 78746.

(4) Based on a Schedule 13G/A filed by Franklin Mutual Advisers, LLC (FMA) dated June 25, 2008 with the SEC. According to the Schedule 13G/A, these shares are beneficially owned by one or more open-end investment companies or other management accounts of FMA. Under its investment management contracts, FMA has sole voting and investment power over these securities owned by its clients which FMA manages. FMA disclaims beneficial ownership of these shares. The address of FMA is 101 John F. Kennedy Parkway, Short Hills, New Jersey 07078.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company s directors and executive officers and persons who own more than 10% of the Common Stock to file initial stock ownership reports and reports of changes in ownership with the SEC. Based on a review of these reports and on written representations from the reporting persons that no other reports were required, the Company believes that the applicable Section 16(a) reporting requirements were complied with for all transactions which occurred in 2008, except as noted below.

On March 4, 2008, Paul J. Diaz, President and Chief Executive Officer, filed a Form 4/A that amended the amount of restricted stock and stock options beneficially owned by him that were reflected in separate Form 4 filings on February 20, 2008 and February 26, 2008, respectively.

COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS

COMPENSATION DISCUSSION AND ANALYSIS

Overview

The Company s executive compensation program is designed to (1) motivate and retain executive officers, (2) award the achievement of short-term and long-term performance goals, (3) establish a reasonable and appropriate relationship between executive pay and short-term and long-term performance and (4) align executive officers interests with those of the Company s shareholders. The primary elements of the Company s compensation program are base salary, annual cash incentive awards, long-term cash incentive awards, equity-based compensation and retirement and other perquisites and benefits. The Company believes that each element supports one or more of the objectives of the Company s executive compensation program and provides sufficient flexibility to the Executive Compensation Committee (the Committee) to structure future awards to address new issues and challenges facing the Company. The Company s executive compensation program generally attempts to target total direct compensation for the Named Executive Officers (as defined herein) between the 50^{th} and 75^{th} percentiles of the healthcare industry, depending upon the individual performance of the Named Executive Officer, his level of responsibility, and the performance of the Company. While the Committee uses this range as a measure of competitiveness, it ultimately uses its discretion to provide appropriate compensation to attract and retain qualified and experienced healthcare executives. The Committee believes that the total direct compensation awarded to each Named Executive Officer for 2008, except for Mr. Battafarano, was below the 50^{th} percentile primarily as a result of the Company failing to achieve a number of incentive compensation performance targets in 2008. The Committee believes that the total direct compensation awarded to Mr. Battafarano for 2008 was between the 50^{th} and 75^{th} percentiles of the healthcare industry, primarily due to his promotion to Chief Operating Officer, effective March 1, 2008.

Performance Measures

The primary elements of the Company s executive compensation program are designed to promote the achievement of financial and quality goals established annually by the Committee and to increase shareholder value. The Company uses two cash incentive plans an annual short-term incentive plan and a long-term incentive plan. These plans provide certain of the Named Executive Officers with the opportunity to earn cash awards for achieving financial goals and measures such as:

(1) achieving targeted levels of earnings before interest, income taxes, depreciation, amortization and rent (EBITDAR),

(2) collecting accounts receivable,

(3) achieving patient admission and census goals,

(4) managing costs and improving operating efficiencies,

(5) achieving targeted levels of earnings per share,

(6) attaining targeted stock price appreciation, and

(7) implementing strategic goals.

The Company believes that several of these financial goals are measures generally used by investors to value the Company s Common Stock.

As a healthcare provider, the Company also focuses a substantial portion of its short-term cash incentive awards on achieving measurable quality and customer service goals. The goals for 2008 were based upon:

(1) operational and clinical measures of quality care,

(2) customer satisfaction measures obtained from customer satisfaction surveys, and

(3) achieving targeted employee retention rates.

The Company believes that measurable quality and customer service goals are critical to promoting a culture of quality throughout the Company which enhances the services offered by the Company. Moreover, the Company believes that there is a direct link between providing quality services and achieving favorable financial results.

The Company also believes that the performance measures it has chosen appropriately reward performance without encouraging unnecessary and excessive risk taking on the part of its executive officers.

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

The Executive Compensation Process

During 2008, the Committee was comprised of either five or six independent directors. On April 24, 2008, one of the independent directors resigned from the Board and the Committee. Each director that served on the Committee during 2008 is independent as defined under the NYSE listing standards and qualifies as an outside director within the meaning of Section 162(m) of the Code and as a non-employee director within the meaning of Rule 16b-3 under the Exchange Act. The Committee meets regularly to review and oversee the Company s executive compensation program. The Committee reviews all components of, and makes all decisions regarding, the compensation of the Named Executive Officers.

During the period commencing in December of the prior fiscal year and ending in February of the upcoming fiscal year, the Committee reviews base salaries and incentive compensation targets for the upcoming fiscal year for the Company s key employees, including the Named Executive Officers. During this time, the Committee also determines whether performance targets under each of the cash incentive plans were achieved for the prior fiscal year. The Committee may consider other executive compensation issues and discusses trends and current topics in executive compensation at various times throughout the year.

The 2008 base salaries for the Named Executive Officers were established in February 2008. The 2008 performance targets under the Company s short-term and long-term cash incentive plans were established in December 2007 after review of the Company s 2008 operating budget. As discussed below, the awards under these plans are formulaic, based upon the achievement of measurable financial and quality goals established annually by the Committee. Nevertheless, the Committee retains the right to administer these plans in its discretion, including the ability to decrease cash incentive awards otherwise payable to a Named Executive Officer for unforeseen events or circumstances, such as restatements of the Company s financial statements.

The Committee generally grants equity-based awards to the Named Executive Officers to coincide with the Committee s evaluation of the performance of the Company and the Named Executive Officers. Considering equity-based awards at or after the cash incentive plan awards have been determined allows the Committee to consider the value of the equity-based award in relation to the total direct compensation for the Named Executive Officers, thus enabling the Committee to award total direct compensation that is competitive within the healthcare industry (and, in particular, the Company s peer group) and relative to the performance of the Company and the Named Executive Officer. From time to time, the Committee may grant equity-based awards at other times, particularly in connection with promotions, exceptional performance or changes in a Named Executive Officer s level of responsibility.

As Chief Executive Officer, Mr. Diaz participates frequently in a portion of the meetings of the Committee, and the Committee also regularly holds executive sessions not attended by any members of management or the non-independent directors. The Committee discusses Mr. Diaz s compensation with him and then makes decisions with respect to Mr. Diaz s compensation without him present. Mr. Diaz provides written evaluations related to the performance of the Company s other executive officers and discusses the roles and responsibilities of such executive officers with the Committee. Members of the Committee also frequently interact with the Company s executive officers and thereby gain an appreciation of the roles and level of responsibility of the executive officers. Mr. Diaz also makes recommendations for the Committee s consideration regarding executive compensation, including base salary, incentive targets, performance measures and equity compensation for the Company s executive officers other than Messrs. Kuntz and Diaz. The Committee is not obligated to accept Mr. Diaz s recommendations with respect to executive compensation. The other Named Executive Officers do not make recommendations on incentive compensation or otherwise significantly participate in the process.

During 2008, the Committee addressed two significant compensation issues outside of its normal review cycle. In February 2008, the Committee considered and approved changes to the employment agreement for Mr. Battafarano in connection with his promotion to Chief Operating Officer. In addition, the Committee considered and approved modifications to the employment and change in control agreements of the Company s officers to ensure such agreements were in compliance with Section 409A of the Code. These matters are described in more detail under Employment and Other Agreements.

In December 2008, the Committee began its annual executive compensation review process. In February 2009, the Committee elected not to increase the base salaries of the Named Executive Officers for 2009. At that time, the Committee also determined, as discussed below, which performance targets were achieved in 2008 by the Named Executive Officers under the short-term incentive plan, the long-term incentive plan and performance-based restricted stock, and established the 2009 goals under the cash incentive plans. In March 2009, the Committee considered and approved annual equity awards for the officers of the Company, including the Named Executive Officers and the independent directors. Also in March 2009, the Committee considered and approved a new employment agreement with Mr. Kuntz in connection with his new role as Chairman of the Board and terminated his previous employment agreement and change in control severance agreement effective May 20, 2009. These matters are described in more detail under Employment and Other Agreements Mr. Kuntz.

In connection with its review of executive compensation, the Committee considered the challenges faced by the Company in connection with the current credit crises and stock market disruptions. During 2008, the value of the Company s Common Stock declined substantially. While management was successful in improving its liquidity and financial flexibility, it was not successful in improving the Company s stock price. The Committee noted that the stock price decline negatively impacted the value of the Common Stock held by the Named Executive Officers and has resulted in a substantial number of stock options having an exercise price above the current market price. The reduced stock price also negatively impacted the 2008 performance under the Company s long-term incentive plan. The Company, like many other healthcare providers, will face significant challenges in 2009 and beyond. Nevertheless, the Committee believes that its existing executive compensation program provides sufficient flexibility to retain and motivate management during these difficult times. As such, the Committee does not believe it is necessary to deviate from its customary compensation practices at this time.

Use of Consultants

During 2008, Mercer, a global human resources consulting firm, was engaged by management to assist management and the Committee in evaluating the Company s executive compensation program. Mercer regularly seeks input from Mr. Diaz to assist it in analyzing the effectiveness of the Company s executive compensation strategy. Mercer reviewed the Company s executive compensation strategy and provided compensation benchmarks to the Committee for each Named Executive Officer, including comparisons of base salary, cash incentives, equity-based compensation and total direct compensation. Mercer also provided the Committee with other relevant market data and made recommendations on potential executive compensation alternatives. In addition, Mercer assisted the Committee in developing a compensation package for Mr. Battafarano in connection with his promotion to Chief Operating Officer. The Company also engages Mercer to advise it on various other employee benefit and compensation matters impacting the Company and its employees such as strategic analysis and actuarial support related to the Company s benefit plans. During 2008, Mercer also assisted the Company in the analysis and design of revised benefit plans for the Company s employees and on other human resources issues. The Company paid Mercer approximately $2.1 million in 2008 for services unrelated to executive compensation.

In addition, the Committee from time to time engages consultants to advise it on various compensation issues and trends. In 2007, the Committee engaged Towers, Perrin, Forster & Crosby, Inc. (Towers Perrin), a global human resources consulting firm, to advise the Committee with respect to the Company s executive compensation program and in connection with setting compensation for the Named Executive Officers. At the Committee s request, Towers Perrin advised the Committee on the development of the overall executive compensation strategy, the evaluation of competitive pay levels, the design of incentive compensation plans, the development of performance metrics and appropriate performance measures, and identifying best practices in executive compensation. In December 2007, Towers Perrin reported to the Committee on its independent assessment of the Company s executive compensation practices, including a review of comparable peer groups and a comparison of healthcare industry executive pay and the pay levels of companies of comparable size in general industries. Towers Perrin was engaged directly by the Committee as an independent advisor. Towers Perrin provides no other services to the Company and did not interact with senior management in performing its services for the Committee.

In November 2008, the Committee engaged Frederic W. Cook & Co. (Cook), a national executive compensation consulting firm, to review the Company s employment and change in control severance agreements with its officers, and compare the agreements to best practices and competitive practices of companies within its peer group. For the study, Cook used a subset of the Company s peer group for the comparisons. Cook was engaged directly by the Committee as an independent advisor. Cook provides no other services to the Company and did not interact with senior management in performing its services for the Committee.

Peer Group

During 2008, the Committee revised its peer group of companies. Following consultation with Mercer, three companies used in the 2007 peer group were removed since they are no longer publicly traded. Seven new companies were added to maintain a meaningful number of comparable companies. The Committee compares each component of compensation for the Named Executive Officers with peer group data assembled by Mercer. The Company used the following companies for compensation benchmarking purposes for 2008:

Brookdale Senior Living, Inc.	Healthsouth Corporation	Quest Diagnostics, Inc.
Universal Health Services, Inc.	Lifepoint Hospitals, Inc.	Lincare Holdings, Inc.
Community Health Systems, Inc.	Tenet Healthcare Corp.	Psychiatric Solutions, Inc.
Health Management Associates, Inc.	Sun Healthcare Group, Inc.	DaVita, Inc.
Laboratory Corp of America		

This peer group is periodically reviewed and updated by the Committee based upon organic changes in the peer companies and upon recommendations from Mercer. The Committee believes that these peer companies compete for executives with similar talents and expertise to those of the Named Executive Officers and also reflect the diversified nature of the Company s businesses and the healthcare industry. The Committee also considers, to a lesser extent, comparisons of compensation from companies outside the healthcare industry and published compensation surveys.

Components of Executive Compensation

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

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

The Company believes that the combination of these elements enables the Committee to award total direct compensation that is competitive within the healthcare industry and that promotes the goals of the executive compensation program.

The Committee does not have a pre-established policy for the allocation between fixed compensation, such as base salary, and variable or at risk compensation, such as short-term and long-term cash incentives and equity. However, the Committee generally places a significant portion of total direct compensation for the Named Executive Officers at risk. The following chart reflects the mix of fixed and at risk compensation comprising the total direct compensation earned by the Named Executive Officers for 2008.

Percent of Total Direct Compensation Earned in 2008 (1)

	Fixed	At Risk		
	Base Salary	Short-term Incentive Plan	Long-term Incentive Plan	Equity Awards (2)
Mr. Diaz	25.3%	24.1%	3.4%	47.2%
Mr. Lechleiter	41.1%	23.4%	5.0%	30.5%
Mr. Kuntz	53.8%			46.2%
Mr. Battafarano	24.0%	18.2%	3.1%	54.7%
Mr. Bowen	33.3%	23.3%	4.1%	39.3%

(1) This chart reflects all compensation earned by the respective Named Executive Officer except for the amounts reported as Changes in Pension Value and Non-qualified Deferred Compensation Earnings and All Other Compensation in the Summary Compensation Table on page 33.

(2) These amounts reflect a grant date fair value of $25.83 per share for each share of service-based and performance-based restricted stock granted in 2008 and a Black-Scholes fair value of $9.44 per share for each stock option granted in 2008 to the Named Executive Officer.

At risk compensation under the Company s cash incentive plans incentivizes the Named Executive Officers to reach or exceed the financial and quality goals established by the Committee. Moreover, at risk compensation under the Company s equity incentive plans incentivizes the Named Executive Officers to grow the value of the Common Stock to enhance the benefit of the equity-based compensation. These incentives also promote the retention of the Named Executive Officers and align the interests of the Named Executive Officers with those of the Company s shareholders.

In establishing performance goals, the Committee considers the allocation of the potential compensation among financial and quality goals. The Committee believes that continued emphasis on maintaining or improving the quality of the Company s services is a key driver in reaching desired financial results. With respect to the financial goals, the Committee aligns these goals with the Company s operating budgets that have been reviewed and approved by the Board of Directors. The Committee does not believe that these goals encourage or promote the Named Executive Officers to take undue risks in the Company s businesses.

The Committee generally structures base salaries to be at or below the 50th percentile of the healthcare industry because it believes generally that a greater portion of total direct compensation should be subject to the attainment of performance goals. The Company s annual short-term and long-term incentive plans provide certain of the Named Executive Officers with the ability to achieve significant additional cash compensation, typically above the median level of the peer group for such awards based upon industry benchmarks, provided targeted levels of performance or higher are achieved. As discussed below, Mr. Kuntz does not participate in the Company s annual short-term and long-term incentive plans. The Named Executive Officers are generally awarded equity-based compensation below the median level of the peer group. The Committee considers the amount of total cash compensation earned by the Named Executive Officers in determining the amount of the equity-based compensation. While the Committee does not have a set allocation between cash and equity compensation, the Committee generally provides for a greater percentage of cash compensation than its peers since the equity awards have a greater dilutive impact on shareholders given the Company s relatively low number of outstanding shares. The Committee uses a mixture of these components so that total direct compensation to the Named Executive Officers awards performance and is competitive within its peer group.

Mr. Diaz s compensation is higher than the compensation of the other Named Executive Officers. The Committee believes that higher compensation for the Chief Executive Officer is consistent with the practices of other healthcare companies. In addition, Mr. Diaz s compensation reflects the unique nature and scope of his leadership responsibilities, the level of accountability for the Company s overall performance and the competitive market for attracting and retaining talented chief executive officers.

Base Salary

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

At its February 2008 meeting, the Committee increased the base salaries for 2008 for the Named Executive Officers as follows:

	2007 Base Salary	**2008 Base Salary**
Mr. Diaz	$ 950,019	$ 1,002,290
Mr. Lechleiter	$ 414,024	$ 434,741
Mr. Kuntz	$ 855,000	$ 902,025
Mr. Battafarano	$ 434,720	$ 650,000
Mr. Bowen	$ 400,005	$ 426,026

The Committee has elected not to increase the base salaries of the Named Executive Officers for 2009 due to the current economic conditions.

The 2008 increase provided to Mr. Diaz was made primarily to move his base salary closer to the market median of the peer group and to reflect the efforts associated with a very successful 2007 for the Company. The increases for the other Named Executive Officers, other than Mr. Battafarano, reflect standard cost of living adjustments provided to most employees in the Company and reflect a successful 2007 operating year. For Mr. Lechleiter and Mr. Bowen, the increases also helped to maintain their base salaries close to the market median.

Effective March 1, 2008, the Committee considered and approved changes to the employment agreement for Mr. Battafarano in connection with his promotion to Chief Operating Officer. The base salary for Mr. Battafarano was determined as part of his overall compensation package associated with his promotion. For additional information regarding Mr. Battafarano s base salary and employment agreement, see Employment and Other Agreements Mr. Battafarano.

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

Cash Incentives

Under the Company s executive compensation program, a significant portion of total cash compensation for the Named Executive Officers is subject to the attainment of measurable financial and quality goals. This approach creates a direct incentive for the Named Executive Officers to achieve pre-established performance objectives and places a significant percentage of each Named Executive Officer s total direct cash compensation at risk. The Company uses two cash incentive plans an annual short-term incentive plan and a long-term incentive plan. The Company s cash incentive plans also provide sufficient flexibility to allow the Committee to establish non-routine goals that may be integral to the success of the Company over the short-term or long-term.

During 2008, Mr. Kuntz s areas of responsibility fell outside of the day-to-day operations of the Company and primarily related to coordinating Board matters, participating in the Company s lobbying efforts and advising senior management. As a result, Mr. Kuntz does not participate in the Company s cash incentive plans. See Employment and Other Agreements Mr. Kuntz for a discussion of Mr. Kuntz s areas of responsibility.

Short-term Incentive Plan

Under the short-term incentive plan, the Committee establishes annual financial and quality goals for the Company s key employees, including certain of the Named Executive Officers. These goals are based on similar financial and quality measures but the actual goals vary depending upon the operational responsibilities of the Named Executive Officer. As such, the goals are tailored for the corporate support office or operating division to which the Named Executive Officer is assigned. Messrs. Diaz, Lechleiter and Battafarano are assigned to the corporate support office and as such, the goals under the short-term incentive plan applicable to them and all other corporate support office participants in the plan are generally based on company-wide measures and aggregated financial and quality goals from each of the operating divisions. Mr. Bowen leads the Company s health services division and as such, his short-term incentive goals are based primarily on measures tailored to that operating division and its financial and quality objectives.

For 2008, the financial measures for the participating Named Executive Officers were based upon:

(1) achieving targeted levels of EBITDAR,

(2) collecting accounts receivable,

(3) achieving patient admission and census goals, and

(4) managing costs and operating efficiencies.

These goals are established based on the historic operating results of the Company and its operating divisions and are the key drivers necessary for the Company to achieve its 2008 operating budget.

For 2008, the quality goals under the short-term incentive plan were based upon:

(1) operational and clinical measures of quality care,

(2) customer satisfaction measures obtained from customer satisfaction surveys, and

(3) achieving targeted employee retention rates.

These goals are established based on the historic clinical results achieved by the operating divisions and new initiatives to improve the quality of care. These quality goals often include various sub-components. The goals are established with a view to be challenging but achievable with good operational focus on the Company s businesses.

Annual cash bonuses under the short-term incentive plan are based upon a percentage of the participating Named Executive Officer s base salary. No awards are granted under the short-term incentive plan until certain minimum levels of performance are achieved.

The following chart reflects the potential award levels for the Named Executive Officers as a percentage of their base salary for 2008:

Short-Term Incentive Plan Table A

	Percentage of Base Salary		
	Minimum	**Target**	**Maximum**
Mr. Diaz	40%	100%	125%
Mr. Lechleiter	24%	60%	75%
Mr. Kuntz			
Mr. Battafarano	30%	75%	94%
Mr. Bowen	24%	60%	75%

The following chart sets forth the minimum, target and maximum goals for 2008 under the short-term incentive plan, as well as the actual levels achieved for 2008. The Committee exercised no discretion in 2008 to adjust these awards. Notwithstanding the foregoing, the Committee retains the right to administer the short-term incentive plan in its discretion, including the ability to reduce awards otherwise payable to a Named Executive Officer for unforeseen events or circumstances, such as restatements of the Company s financial statements.

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Short-Term Incentive Plan Table B

	2008 Incentive Goals										
	Minimum		Target		Maximum (1)		Actual	% of Target	Award % of Base Salary		
	Goal	% of Bonus	Goal	% of Bonus	Goal	% of Bonus	Performance Achieved	Bonus Achieved	Diaz	Lechleiter	Battafarano
Goals applicable for Messrs. Diaz, Lechleiter and Battafarano:											
Financial goals:											
EBITDAR (2) (dollars in millions)	$ 509.0	12.0%	$ 565.6	30.0%	$ 593.9	45.0%	$ 527.1	17.14%	17.14%	10.28%	12.86%
Accounts receivable days outstanding	58.6	6.0%	55.7	15.0%	53.0	22.5%	56.4	12.90%	12.90%	7.74%	9.68%
Hospital admissions	43,202	1.33%	45,476	3.33%	47,750	5.0%	43,936	1.73%	1.73%	1.04%	1.30%
Level of nursing center private pay, managed care and Medicare census	33.1%	1.0%	34.8%	2.5%	36.5%	3.75%	34.2%	1.90%	1.90%	1.14%	1.42%
Total nursing center census	24,051	.33%	25,317	.83%	26,583	1.25%	25,058	.63%	.63%	.38%	.47%
New rehabilitation contracts	67	1.33%	70	3.33%	74	5.0%	67	1.33%	1.33%	.80%	1.00%
Hospital operating costs per patient day	$ 1,111	1.0%	$ 1,055	2.5%	$ 1,005	3.75%	$ 1,081	1.60%	1.60%	.96%	1.20%
Hospital labor cost per patient day	$ 532	1.0%	$ 506	2.5%	$ 482	3.75%	$ 519	1.60%	1.60%	.96%	1.20%
Total nursing hours per patient day nursing centers	3.22	.67%	3.31	1.67%	3.39	2.5%	3.33	1.87%	1.87%	1.12%	1.40%
Percentage acceptance of alternative dispute resolution process	66.5%	1.33%	70.0%	3.33%	72.1%	5.0%	87.1%	5.00%	5.00%	3.00%	3.75%
Hospital therapist productivity	77.4%	.50%	79.0%	1.25%	79.8%	1.88%	79.0%	1.25%	1.25%	.75%	.94%
Nursing center therapist productivity affiliated	77.9%	.75%	79.5%	1.88%	81.1%	2.81%	82.4%	2.81%	2.81%	1.69%	2.11%
Nursing center therapist productivity unaffiliated	76.0%	.75%	77.5%	1.88%	79.8%	2.81%	80.2%	2.81%	2.81%	1.69%	2.11%
Quality goals:											
Wound care improvement hospitals	76.0%	.40%	80.0%	1.0%	82.4%	1.5%	100.0%	1.50%	1.50%	.90%	1.13%
Clinical quality service index hospitals	3.01	.80%	2.86	2.0%	2.78	3.0%	2.50	3.00%	3.00%	1.80%	2.25%
Hospital customer satisfaction index	4.09	.80%	4.30	2.0%	4.43	3.0%	4.37	2.40%	2.40%	1.44%	1.80%
Clinical competency admission grid nursing centers	85.5%	.44%	90.0%	1.11%	92.7%	1.67%	100.0%	1.67%	1.67%	1.00%	1.25%
Average health deficiencies index per standard survey	1.165	.45%	1.130	1.13%	1.097	1.69%	1.140	.85%	.85%	.51%	.64%
Clearing of health deficiencies during first follow-up survey	67.9%	.44%	70.0%	1.11%	72.1%	1.67%	93.2%	1.67%	1.67%	1.00%	1.25%
Customer service recommendations nursing centers	67.9%	.44%	70.0%	1.11%	72.1%	1.67%	72.9%	1.67%	1.67%	1.00%	1.25%
Consistent staffing assignment nursing centers	72.8%	.22%	75.0%	.56%	77.3%	.83%	95.5%	.83%	.83%	.50%	.62%
Rehabilitation clinical compliance	92.6%	1.0%	97.5%	2.5%	100%	3.75%	96.5%	2.20%	2.20%	1.32%	1.65%
Customer service index rehabilitation	2.85	1.0%	3.00	2.5%	3.09	3.75%	3.42	3.75%	3.75%	2.25%	2.81%
Aggregate employee turnover	47.0%	6.0%	44.7%	15.0%	43.4%	22.5%	37.8%	22.50%	22.50%	13.50%	16.87%

Total:	94.61%	94.61%	56.77%	70.96%

Short-Term Incentive Plan Table B (continued)

	2008 Incentive Goals								
	Minimum		Target		Maximum (1)		Actual	% of Target	Award %
	Goal	% of Bonus	Goal	% of Bonus	Goal	% of Bonus	Performance Achieved	Bonus Achieved	of Base Salary
Goals applicable for Mr. Bowen:									
Financial goals:									
Health Services Division EBITDARM (dollars in millions) (3)	$ 272.25	9%	$ 302.50	22.5%	$ 317.63	33.75%	$ 333.1	33.75%	20.25%
Kindred Consolidated EBITDAR (dollars in millions) (2)	$ 509.04	3%	$ 565.60	7.5%	$ 593.88	11.25%	$ 527.1	4.29%	2.57%
Accounts receivable days outstanding	37.4	4%	35.5	10%	33.8	15%	36.4	7.30%	4.38%
Level of private pay, managed care and Medicare census	33.1%	6%	34.8%	15%	36.5%	22.5%	34.2%	11.40%	6.84%
Total nursing center census	24,051	2%	25,317	5%	26,583	7.5%	25,058	3.80%	2.28%
Total nursing hours per patient day	3.22	1%	3.31	2.5%	3.39	3.75%	3.33	2.81%	1.69%
Percentage acceptance of alternative dispute resolution process	66.5%	2%	70.0%	5%	72.1%	7.5%	87.1%	7.50%	4.50%
Quality goals:									
Clinical competency admission grid	85.5%	2%	90.0%	5%	92.7%	7.5%	100.0%	7.50%	4.50%
Average health deficiencies index per standard survey	1.165	2%	1.130	5%	1.097	7.5%	1.140	3.80%	2.28%
Clearing of health deficiencies during first follow-up survey	67.9%	2%	70.0%	5%	72.1%	7.5%	93.2%	7.50%	4.50%
Customer service recommendations	67.9%	2%	70.0%	5%	72.1%	7.5%	72.9%	7.50%	4.50%
Consistent staffing assignment	72.8%	1%	75.0%	2.5%	77.3%	3.75%	95.5%	3.75%	2.25%
Aggregate employee turnover	60.4%	4%	58.6%	10%	56.9%	15%	49.0%	15.00%	9.00%
Total:								115.9%	69.54%

(1) The maximum award level is capped in the aggregate at 125% of the target award for the participating Named Executive Officers.

(2) The Company s performance goals include the financial measure EBITDAR. The Company uses EBITDAR as a meaningful measure of operating performance in addition to other measures. The Company believes that income from continuing operations is the most comparable measure, in relation to generally accepted accounting principles, to EBITDAR. EBITDAR should be considered in addition to, not as a substitute for, or superior to, financial measures based upon generally accepted accounting principles as an indicator of operating performance.

(3) EBITDARM is defined as divisional earnings before interest, income taxes, depreciation, amortization, rent and corporate overhead. The Company uses EBITDARM as a meaningful measure of operating performance in addition to other measures. The Company believes that operating income is the most comparable measure, in relation to generally accepted accounting principles, to EBITDARM. EBITDARM should be considered in addition to, not as a substitute for, or superior to, financial measures based upon generally accepted accounting principles as an indicator of operating performance.

To calculate the final awards under the short-term incentive plan, the Committee multiplies the target bonus percentage for the Named Executive Officer with the percentage of target achieved and the Named Executive Officer s base salary. The calculations for 2008 were as follows:

Short-Term Incentive Plan 2008 Bonus Calculation

	Target Bonus % (Table A)	x	% of Target Bonus Achieved (Table B)	x	2008 Base Salary	=	2008 Actual Award
Mr. Diaz	100%		94.61%		$ 1,002,290		$ 948,266
Mr. Lechleiter	60%		94.61%		$ 434,741		$ 246,785
Mr. Kuntz							
Mr. Battafarano	75%		94.61%		$ 650,000		$ 461,224
Mr. Bowen	60%		115.90%		$ 426,026		$ 296,258

As noted previously, the Committee has established performance goals for 2009 under the short-term incentive plan. These goals are similar to the 2008 goals but reflect certain changes to focus the Named Executive Officers and management on the operational and financial challenges the Company expects to face in 2009.

Long-term Incentive Plan

The Company s long-term incentive plan provides cash awards to the Company s key employees, including certain of the Named Executive Officers, upon the attainment of specified performance objectives. For 2008, the performance period under the long-term incentive plan covered one year. For each performance period, the Committee selects participants who are in a position to contribute materially to the success of the Company and establishes the performance goal or goals to be measured under the plan. For 2008, the performance goals for the participating Named Executive Officers were based upon:

(1) achieving various levels of EBITDAR,

(2) achieving various levels of earnings per share,

(3) achieving various levels of stock price appreciation, and

(4) successfully implementing specified components of the Company s strategic plan.

These goals were the same for each participant in the long-term incentive plan, including each Named Executive Officer, and reflected company-wide measures. These goals are established with a view to be challenging but achievable with good operational focus on the Company s businesses.

Under the long-term incentive plan, participants are eligible to receive cash awards based upon a percentage of their base salary. These percentages vary depending upon the participant s position within the Company and the extent to which the performance goals established by the Committee are attained. The maximum awards available under the long-term incentive plan as a percentage of base salary are 100% for the Chief Executive Officer and 90% for the other participating Named Executive Officers.

The following chart reflects the potential award levels for the Named Executive Officers as a percentage of base salary for 2008:

	Long-Term Incentive Plan Percentage of Base Salary		
	Minimum	Target	Maximum
Mr. Diaz	10%	50%	100%
Mr. Lechleiter	9%	45%	90%
Mr. Kuntz			
Mr. Battafarano	9%	45%	90%
Mr. Bowen	9%	45%	90%

No awards are granted under the long-term incentive plan until certain minimum levels of performance are achieved. The Committee exercised no discretion in 2008 to adjust these awards. Notwithstanding the foregoing, the Committee retains the right to administer the long-term incentive plan in its discretion, including the ability to reduce awards otherwise payable to a Named Executive Officer for unforeseen events or circumstances, such as restatements of the Company s financial statements. The following chart depicts the minimum, target and maximum goals that were achievable under the long-term incentive plan, as well as the actual levels achieved for 2008 for Mr. Diaz and the other participating Named Executive Officers.

Long-Term Incentive Plan

	2008 Incentive Goals							
	Minimum		Target		Maximum			
	Goal	Award % of Salary	Goal	Award % of Salary	Goal	Award % of Salary (1)	Actual Achieved	Award as a % of Base Salary
Mr. Diaz:								
EBITDAR (dollars in millions) (2)	$ 548.6	3.5%	$ 565.6	17.5%	$ 582.6	47.3%	$ 527.1	0
Earnings per share	$ 1.00	3.5%	$ 1.27	17.5%	$ 1.53	47.3%	$ 0.76	0
Stock price appreciation	5.0%	2.0%	10%	10.0%	20%	27.0%	$ 13.02	0
Strategic plan (3)	Level I	1.0%	Level II	5.0%	Level III	13.5%	Level III	13.5%
Total								13.5%
Other Named Executive Officers:								
EBITDAR (dollars in millions) (2)	$ 548.6	3.2%	$ 565.6	15.8%	$ 582.6	42.5%	$ 527.1	0
Earnings per share	$ 1.00	3.2%	$ 1.27	15.8%	$ 1.53	42.5%	$ 0.76	0
Stock price appreciation	5.0%	1.8%	10%	9.0%	20%	24.3%	$ 13.02	0
Strategic plan (3)	Level I	0.9%	Level II	4.5%	Level III	12.2%	Level III	12.2%
Total								12.2%

(1) The maximum award level is capped in the aggregate at 100% of base salary for Mr. Diaz and 90% of base salary for the other participating Named Executive Officers.

(2) The Company s performance goals include the financial measure EBITDAR. The Company uses EBITDAR as a meaningful measure of operating performance in addition to other measures. The Company believes that income from continuing operations is the most comparable measure, in relation to generally accepted

accounting principles, to EBITDAR. EBITDAR should be considered in addition to, not as a substitute for, or superior to, financial measures based upon generally accepted accounting principles as an indicator of operating performance.

(3) The strategic planning goals are approved by the Committee and are based upon the achievement of specified levels of the Company s strategic plan. The minimum target is achieved by satisfying level I objectives, the target goal is achieved by satisfying level I and level II objectives and the maximum goal is achieved by satisfying level I, level II and level III objectives.

As noted previously, the Committee has established performance goals for 2009 under the long-term incentive plan. These goals are similar to the 2008 goals but reflect certain changes to focus the Named Executive Officers and management on the operational and financial challenges the Company expects to face in 2009.

Cash awards under the long-term incentive plan are payable in three equal annual installments on or about each of the first, second, and third anniversaries of the end of the relevant performance period, provided generally that the participant is employed by the Company at the time payments are due. This delayed payment feature serves as a significant retention vehicle for the Company. The awards earned in 2008 will be paid in three equal annual installments commencing on or about December 15, 2009.

Equity-Based Compensation

Consideration of Annual Equity Awards

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

Historically, the Committee has awarded both stock options and restricted stock to the Named Executive Officers. Generally, the Committee believes that a mixture of equity awards between stock options and restricted stock is the most appropriate method to achieve the Company s compensation strategies in relation to the total cost to the Company and is consistent with the equity allocation trends of the peer group. The Committee believes that such equity awards provide incentives to the Named Executive Officers to grow the Company s stock price since the full benefit of these awards cannot be achieved unless the value of the Common Stock increases. When evaluating equity-based compensation, the Committee also considers the accounting costs associated with the form of equity award.

In 2008, the Committee continued the historical practice of granting stock options and service-based restricted stock, which vest over several years, to promote retention of the Named Executive Officers and to build their ownership stake in the Company. In addition, for the reasons discussed below, the Committee also began the practice of granting performance-based restricted stock that vests only upon satisfaction of certain performance measures.

The Committee allocated the value of the 2008 equity awards equally among stock options, service-based restricted stock and performance-based restricted stock. The Committee believes that the stock options provide a strong link between executive compensation and the long-term performance of the Company. The service-based restricted stock promotes retention of the Named Executive Officers and builds their ownership stake in the

Company. The performance-based restricted stock further enhances the Company s pay for performance strategies by linking the vesting of the performance-based restricted stock to the Company s financial performance during the applicable performance period.

While the Committee does not have a formal policy with respect to the timing of grants of equity-based awards in connection with the release of material non-public information, the Committee generally considers issues raised by the timing of award grants when making such awards. Stock options are awarded at the closing price of the Company s Common Stock on the NYSE on the date of grant. The Committee does not grant options with an exercise price that is less than the closing price of the Common Stock on the NYSE on the grant date and it does not grant stock options that are priced on a date other than the grant date.

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

Following the establishment of the aggregate pool of potential equity awards, the Committee considers benchmarks by position from the peer group in evaluating potential awards to the Named Executive Officers. The Chief Executive Officer also provides an assessment to the Committee of the overall level of performance for the other Named Executive Officers. The Committee then considers the overall performance of the Named Executive Officer and his actual and potential contribution to the Company s growth and long-term performance in determining individual awards. The assessment of actual and potential contribution is based upon the Committee s subjective evaluation of each Named Executive Officer in light of various operational and strategic challenges and opportunities facing the Named Executive Officer during the relevant year. The Committee also considers how the potential equity award impacts a Named Executive Officer s total direct compensation. Based on these assessments, the Committee ranks each Named Executive Officer in one of three award levels high, middle or low. These award levels are converted to a multiple of base salary, generally within the relevant benchmark, and awards are made from the Company s aggregate pool of available equity awards established by the Committee.

In February 2008, after evaluating the performance of the Company for 2007, the Committee established an aggregate pool of approximately 599,000 shares for potential equity awards to all participants, which represented between the 25^{th} and 50^{th} percentile of the peer group. The Committee determined that the Company s performance supported an aggregate pool at the 50^{th} percentile but elected to reduce the size of the pool by approximately 45% due to the cost of the awards, the dilutive effect of the awards on stockholders equity given the Company s relatively low number of outstanding shares, and the high level of total cash compensation awarded in 2007. The equity pool also included the equity awarded to Mr. Battafarano in connection with his promotion to Chief Operating Officer.

In February 2008, the Committee granted annual equity awards to the Named Executive Officers from the aggregate pool as follows:

	2008 Equity Grant		
	Stock Options	Service-based Restricted Stock	Performance-based Restricted Stock
Mr. Diaz	62,889	24,527	24,527
Mr. Lechleiter	10,874	4,241	4,241
Mr. Kuntz	26,078	10,171	10,171
Mr. Battafarano	26,418	24,453	19,453
Mr. Bowen	16,945	6,608	6,608

The stock options vest in equal annual installments over three years and have a seven year life. Except as noted below, the service-based restricted stock vests in equal annual installments over four years. For Mr. Battafarano, 20,000 shares of his service-based restricted stock vest in equal annual installments over three years. The performance-based restricted stock is divided into three equal annual tranches. The Committee will establish performance goals annually for the current year s tranche. If the performance goals are not satisfied in a given year, then some or all of the performance-based restricted stock in such year s tranche will be forfeited by the Named Executive Officer. The following chart depicts the minimum, target and maximum goals established for 2008 for the first tranche of performance-based restricted stock.

	Minimum		**Target**		**Maximum**			
	Goal	**% of Award**	**Goal**	**% of Award**	**Goal**	**% of Award (1)**	**Actual Performance Achieved**	**% of Award Achieved**
EBITDAR (dollars in millions) (2)	$ 548.6	10.0%	$ 565.6	50.0%	$ 582.6	67.5%	$ 527.1	0%
Earnings per share	$ 1.00	10.0%	$ 1.27	50.0%	$ 1.53	67.5%	$ 0.76	0%
Total								0%

(1) The maximum award level is capped in the aggregate at 100% of the target award.

(2) The Company s performance goals include the financial measure EBITDAR. The Company uses EBITDAR as a meaningful measure of operating performance in addition to other measures. The Company believes that income from continuing operations is the most comparable measure, in relation to generally accepted accounting principles, to EBITDAR. EBITDAR should be considered in addition to, not as a substitute for, or superior to, financial measures based upon generally accepted accounting principles as an indicator of operating performance.

The Committee has established performance goals for 2009 for the performance-based restricted stock. These goals are similar to the 2008 goals but reflect certain changes to focus the Named Executive Officers and management on the operational and financial challenges the Company expects to face in 2009.

As noted above, the individual awards also are based on the Committee s subjective evaluation of the Named Executive Officer s performance. The Committee determined that Messrs. Diaz, Lechleiter, Kuntz and Battafarano had performed at the middle range. The Committee determined that Mr. Bowen had performed at the high range.

In making these grants, the Committee considered the performance of Mr. Diaz in successfully operating the Company s three businesses and improving several employee, patient and resident satisfaction and quality metrics. The Committee also noted Mr. Diaz s efforts to position the Company for further growth by completing a transaction with Ventas, Inc. that permitted the Company to dispose of 22 under-performing facilities. Mr. Diaz also facilitated additional external growth as the Company added four hospitals, nine nursing centers and a rehabilitation services company in 2007. Likewise, Messrs. Lechleiter and Kuntz also assisted in the Company s growth through acquisitions and organic development projects. Mr. Lechleiter also was instrumental in the Company successfully amending its revolving credit facility to provide more flexibility and better pricing.

With respect to Mr. Battafarano, the Committee believed that the Company s hospital division continued to perform well despite a difficult reimbursement environment. In addition, Mr. Battafarano continued the hospital division s growth in patient admissions while maintaining high levels of quality and customer satisfaction and achieved meaningful reductions in overhead. Mr. Battafarano s equity award also includes awards that were made in connection with his promotion to Chief Operating Officer. See Employment and Other Agreements Mr. Battafarano.

In evaluating Mr. Bowen s performance, the Committee noted that the health services division continued to make significant improvements in quality and customer service. Mr. Bowen s leadership has produced better financial results as well. He also has successfully guided the division through additional growth and new program development.

As described above, the Committee granted these equity awards based upon its subjective evaluation that the equity awards were appropriate and desirable considering the foregoing contributions of the Named Executive Officers to the Company and the Committee s desire to award total direct compensation that is competitive within its peer group. The Committee also considered the retention benefits of awarding stock options and service-based restricted stock as well as the link between the Company s financial performance and the compensation provided to the Named Executive Officers created by awarding performance-based restricted stock.

Stock Ownership Guidelines

In 2008, the Company adopted stock ownership guidelines for its executive officers, including the Named Executive Officers. The Committee believes that the guidelines ensure that the Named Executive Officers hold a sufficient amount of Common Stock to further strengthen the long-term link between the results achieved for the Company s shareholders and the compensation provided to the Named Executive Officers.

The stock ownership guidelines for the Named Executive Officers are determined as a multiple of the Named Executive Officer s base salary as follows:

	Multiple of Base Salary
Mr. Diaz	2.5x
Mr. Lechleiter	1.5x
Mr. Kuntz	1x
Mr. Battafarano	1.5x
Mr. Bowen	1x

The Named Executive Officers have until June 30, 2012 to attain the required level of ownership. The minimum number of shares to be held by the Named Executive Officers will be calculated on each June 30 based on the average of the high and low price of the Common Stock on the NYSE on that date.

If the applicable guideline is not achieved, the Named Executive Officer is required to retain an amount equal to 60% of net shares received under any equity awards. The Board of Directors may, at its discretion, waive the stock ownership guidelines if compliance would create a substantial hardship or prevent a Named Executive Officer from complying with a court order.

In determining whether a Named Executive Officer satisfies the required ownership level, the calculation will include stock held directly by the Named Executive Officer or owned either jointly with, or separately by, his immediate family members residing in the same household and shares held in trust for the benefit of the Named Executive Officer or his immediate family members. Stock ownership does not include unexercised stock options, stock appreciation rights, or the non-vested portion of any service-based or performance-based restricted stock awards.

Section 401(k) Plan and Other Perquisites and Benefits

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

In addition, the Named Executive Officers may participate in the Kindred Deferred Compensation Plan (the DCP), which is available to certain highly compensated employees. A participant in the DCP may elect to defer up to 25% of his or her base salary and up to 100% of his or her annual short-term incentive award into the DCP during each plan year. In addition, the Company will credit such participant s account balance with an amount equal to (1) the 401(k) Plan contribution that would be calculated using the matching contribution formula in effect for such plan year, less (2) the amount such participant would receive during the plan year as a matching contribution under the 401(k) Plan if such participant had contributed the maximum amount of elective deferral contribution permissible under the administrative provisions of the 401(k) Plan for persons of such participant s status. The DCP is discussed in further detail under the heading Non-Qualified Deferred Compensation Table Fiscal Year 2008.

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

Employment and Other Agreements

For several years, the Company has maintained employment agreements with its executive officers, including the Named Executive Officers. The Committee has provided employment agreements to its Named Executive Officers since it believes that these arrangements are typical in healthcare companies and to ease the consequences of an unexpected termination of employment. The Committee believes that severance terms and benefits under these agreements generally are competitive within the healthcare industry and are important factors in attracting and retaining executive talent. These agreements also support the retention of key employees during periods of uncertainty.

Regulatory Compliance

New tax requirements for deferred compensation under Section 409A of the Code and related regulations (Section 409A) became effective on January 1, 2009. These new requirements are very broad and apply to certain compensation benefits payable under the Company s employment agreements and change in control severance agreements with executive officers and certain of the Company s benefit plans, including the short-term incentive plan and long-term incentive plan. Accordingly, in 2008 the Company, with Committee oversight and approval, performed a regulatory compliance review of its employment agreements and change in control severance agreements and other employee benefit plans to ensure documentary compliance with Section 409A and other provisions of the Code by the December 31, 2008 compliance deadline.

As a result of this regulatory compliance review, on December 18, 2008, the Committee approved revised employment agreements and revised change in control severance agreements for the Named Executive Officers in order to comply with Section 409A. The revised employment agreements other than for Mr. Kuntz also provide for the immediate vesting of restricted shares in the event of certain involuntary terminations in order to facilitate the payment of tax obligations that may accelerate under Section 83 of the Code. The revised employment agreements other than for Mr. Kuntz, as well as the change in control severance agreements, also include changes related to compliance with recent interpretations under Section 162(m) of the Code to clarify that performance-based bonuses payable upon an involuntary termination are calculated based upon the performance objectives actually achieved by the Company. Except for the changes adopted in order to comply with Section 409A, Section 83 and Section 162(m), the revised employment agreements and revised change in control severance agreements did not change in any material manner the financial and other significant terms of the agreements as described below.

Mr. Diaz

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

Mr. Diaz s employment agreement also provides for severance payments if his employment is terminated under certain circum