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**QUARTERLY REPORT**

**FOR THE QUARTERLY PERIOD ENDED  
SEPTEMBER 30, 2002**

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**(Substantial Equivalent of Form 10-Q)**

**ROTECH HEALTHCARE INC.**

(Exact name of company as specified in its charter)

**DELAWARE**  
(State or other  
jurisdiction of  
incorporation or  
organization)

**030408870**  
(I.R.S. Employer  
Identification  
Number)

**2600 Technology Drive, Suite 300**  
**Orlando, Florida 32804**  
(Address of principal executive offices, zip code)

**Telephone Number (407) 822-4600**  
(Company's telephone number, including area code)

As of November 1, 2002, there were 25,000,000 shares of the company's common stock outstanding.

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**ROTECH HEALTHCARE INC.**  
**Quarterly Report for the Period Ended September 30, 2002**

*Rotech Medical Corporation emerged from bankruptcy on March 26, 2002 and transferred to Rotech Healthcare Inc. substantially all of its assets in a restructuring transaction. As used in this quarterly report, unless otherwise specified or the context otherwise requires, references to the "Company" refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries for all periods subsequent to March 26, 2002 and to the business and operations of Rotech Medical Corporation and its subsidiaries for all periods prior to March 26, 2002. The financial statements included in this report reflect these transactions effective as of March 31, 2002. References to the "Predecessor" refer to Rotech Medical Corporation and its subsidiaries. References to the "Successor" refer to Rotech Healthcare Inc. and its subsidiaries. This quarterly report contains forward-looking statements based upon current expectations that involve risks and uncertainties. When used in this quarterly report, the words "intend," "anticipate," "believe," "estimate," "plan" and "expect" and similar expressions as they relate to Rotech Healthcare Inc. are included to identify forward-looking statements. Our actual results and the timing of certain events could differ materially from those anticipated in these forward-looking statements as a result of certain factors.*

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**PART I - FINANCIAL INFORMATION**

**ITEM 1 - Condensed Consolidated Financial Statements**

**ROTECH HEALTHCARE INC.**  
Condensed Consolidated Balance Sheets

(Dollars in Thousands)

	<u>Predecessor Company</u>	<u>Successor Company</u>
	<u>December 31, 2001</u>	<u>September 30, 2002 (unaudited)</u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 4,970	\$ 18,640
Accounts receivable, net	117,405	99,953
Other accounts receivable	2,283	1,677
Inventories	22,312	23,812
Prepaid expenses	2,955	3,258
Deferred income taxes	24,705	—
Total current assets	<u>174,630</u>	<u>147,340</u>
Property and equipment, net	257,338	217,180
Intangible assets	783,429	2,467
Reorganization value in excess of value of identifiable assets	—	677,533
Other assets	13,299	26,333
	<u>\$ 1,228,696</u>	<u>\$ 1,070,853</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 20,659	\$ 19,882
Accrued expenses	18,855	16,246
Accrued interest	—	3,207
Income taxes payable	—	4,645
Current portion of long term debt	—	2,000
Total current liabilities	<u>39,514</u>	<u>45,980</u>
Liabilities subject to compromise	48,373	—
Due to parent company, net	394,354	—
Deferred income taxes	58,359	7,065
Priority tax claim	—	14,000
Long term debt, less current portion	—	492,000
Commitments and contingencies		
Series A Convertible Redeemable Preferred Stock	—	5,233
Stockholders' equity:		
Common Stock	1	2
Additional paid-in capital	565,893	494,998
Retained earnings	122,202	11,575
Total stockholders' equity	<u>688,096</u>	<u>506,575</u>
	<u>\$ 1,228,696</u>	<u>\$ 1,070,853</u>

See accompanying notes to unaudited condensed consolidated financial statements.

**ROTECH HEALTHCARE INC.**  
Condensed Consolidated Statements of Operations  
(unaudited)  
(Dollars in Thousands)

	Predecessor Company			Successor Company	
	Three Months Ended September 30, 2001	Nine Months Ended September 30, 2001	Three Months Ended March 31, 2002	Three Months Ended September 30, 2002	Six Months Ended September 30, 2002
Net revenues	\$ 154,885	\$ 458,475	\$ 154,750	\$ 153,140	\$ 308,133
Costs and expenses:					
Cost of net revenues	23,262	72,141	22,513	22,416	45,557
Provision for doubtful accounts	6,889	17,218	3,661	4,596	8,407
Selling, general and administrative	82,016	244,609	84,996	92,659	179,705
Depreciation and amortization	26,518	77,171	14,986	15,086	30,823
Interest expense (income)	(187)	(251)	(17)	10,745	22,468
Provision for settlement of government claims	2,010	2,010	—	—	—
Provision for inventory losses	321	1,039	264	—	—
Total costs and expenses	<u>140,829</u>	<u>413,937</u>	<u>126,403</u>	<u>145,502</u>	<u>286,960</u>
Earnings before reorganization items, income taxes and extraordinary items	14,056	44,538	28,347	7,638	21,173
Reorganization items (note 3)	<u>7,740</u>	<u>9,825</u>	<u>29,094</u>	<u>250</u>	<u>1,494</u>
Earnings (loss) before income taxes and extraordinary items	6,316	34,713	(747)	7,388	19,679
Federal and state income taxes (benefit)	<u>4,784</u>	<u>26,295</u>	<u>(203)</u>	<u>2,955</u>	<u>7,871</u>
Earnings (loss) before extraordinary items	1,532	8,418	(544)	4,433	11,808
Extraordinary gain on debt discharge	<u>—</u>	<u>—</u>	<u>20,441</u>	<u>—</u>	<u>—</u>
Net earnings	1,532	8,418	19,897	4,433	11,808
Accrued dividends on redeemable preferred stock	<u>—</u>	<u>—</u>	<u>—</u>	<u>113</u>	<u>233</u>
Net earnings available for common stockholders	<u>\$ 1,532</u>	<u>\$ 8,418</u>	<u>\$ 19,897</u>	<u>\$ 4,320</u>	<u>\$ 11,575</u>

See accompanying notes to unaudited condensed consolidated financial statements.

**ROTECH HEALTHCARE INC.**  
**Condensed Consolidated Statements of Cash Flows**  
(unaudited)  
(Dollars in Thousands)

	<b>Predecessor Company</b>		<b>Successor Company</b>
	<b>Nine Months Ended September 30, 2001</b>	<b>Three Months Ended March 31, 2002</b>	<b>Six Months Ended September 30, 2002</b>
Net earnings	\$ 8,418	\$ 19,897	\$ 11,808
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Reorganization items	9,825	29,094	1,494
Depreciation and amortization	77,171	14,986	30,823
Deferred income taxes	1,995	—	(4,447)
Extraordinary gain on debt discharge	—	(20,441)	—
Net change in operating assets and liabilities	<u>(17,994)</u>	<u>(10,198)</u>	<u>19,000</u>
Net cash provided by operating activities	79,415	33,338	58,678
Net cash used by reorganization items	<u>(1,268)</u>	<u>(8,848)</u>	<u>(1,494)</u>
Net cash provided by operating activities and reorganization items	<u>78,147</u>	<u>24,490</u>	<u>57,184</u>
Cash flows from investing activities:			
Purchases of property and equipment	(62,630)	(15,299)	(30,965)
Business acquisitions	—	(100)	(2,903)
Decrease (increase) in other assets	<u>(4,793)</u>	<u>10,131</u>	<u>(363)</u>
Net cash used in investing activities	<u>(67,423)</u>	<u>(5,268)</u>	<u>(34,231)</u>
Cash flows from financing activities:			
Net proceeds from long term borrowings	—	483,040	—
Payments of long term borrowings	—	—	(6,000)
Payments of liabilities subject to compromise	—	(27,932)	—
Net proceeds from sale/lease back of vehicles	—	10,191	—
Distributions to parent company, net	<u>(19,156)</u>	<u>(487,804)</u>	<u>—</u>
Net cash used in financing activities	<u>(19,156)</u>	<u>(22,505)</u>	<u>(6,000)</u>
Increase (decrease) in cash and cash equivalents	(8,432)	(3,283)	16,953
Cash and cash equivalents, beginning of period	15,111	4,970	1,687
Cash and cash equivalents, end of period	<u>\$ 6,679</u>	<u>\$ 1,687</u>	<u>\$ 18,640</u>

See accompanying notes to unaudited condensed consolidated financial statements.

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

**(1) Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include the accounts of Rotech Healthcare Inc. and its subsidiaries, and its predecessor, Rotech Medical Corporation and its subsidiaries, and have been prepared in accordance with generally accepted accounting principles for interim financial information as if the Company were a reporting company under the Securities Exchange Act of 1934, as amended. Interim results are not necessarily indicative of results to be expected for the full year. The unaudited condensed consolidated financial statements included in this report reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. All such adjustments are of a normal recurring nature.

Rotech Medical Corporation emerged from bankruptcy on March 26, 2002 and transferred to Rotech Healthcare Inc. substantially all of its assets in a restructuring transaction. As used in these notes, unless otherwise specified or the context otherwise requires, references to the "Company" refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries for all periods subsequent to March 26, 2002 and to the business and operations of Rotech Medical Corporation and its subsidiaries for all periods prior to March 26, 2002. The financial statements included herein reflect these transactions effective as of March 31, 2002. References to the "Predecessor" refer to Rotech Medical Corporation and its subsidiaries. References to the "Successor" refer to Rotech Healthcare Inc. and its subsidiaries.

Data have been presented for the six months ended September 30, 2002 rather than for the nine months ended on such date because we have had only six months of operating results since our Predecessor emerged from bankruptcy on March 26, 2002.

The unaudited condensed consolidated balance sheet of the Company as of March 31, 2002, gives effect to the consummation of the Predecessor's plan of reorganization discussed in Note 3 and the related restructuring transaction referred to above.

For all periods presented herein, there were no differences between net income and comprehensive income.

**(2) Reclassifications, Accounting Estimates and Recent Accounting Pronouncements**

Reclassifications: Certain amounts from prior periods have been reclassified to conform to the current period presentation.

Use of Accounting Estimates: The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Recent Accounting Pronouncements: In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ("SFAS No. 142"). SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of SFAS No. 142. SFAS No. 142 will also require that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

residual values, and reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. The Company adopted the provisions of SFAS No. 142 effective January 1, 2002. Had SFAS No. 142 been in effect for the three months and nine months ended September 30, 2001, amortization of goodwill would have been reduced by \$11,952 and \$35,856, respectively, and net earnings for such periods would have increased by \$10,552 and \$31,656, respectively.

**(3) Petitions for Reorganization under Chapter 11 and Other Information**

The Predecessor was incorporated on September 1, 1981. In 1997, the Predecessor entered into a definitive merger agreement pursuant to which the Predecessor became a wholly-owned subsidiary of Integrated Health Services, Inc. (“IHS”) effective as of October 21, 1997.

On February 2, 2000, IHS and substantially all of its subsidiaries, including the Predecessor and its subsidiaries, filed separate voluntary petitions for relief under Chapter 11 (“Chapter 11”) of the United States Bankruptcy Code (the “Bankruptcy Code”) with the United States Bankruptcy Court in the District of Delaware (the “Bankruptcy Court”). On November 23, 2001, IHS filed a plan of reorganization (the “Plan”) for the Predecessor and its subsidiaries, which was approved by the creditors and confirmed by the Bankruptcy Court on February 13, 2002. The Plan became effective on March 26, 2002. On the effective date, the Predecessor transferred to the Company substantially all of the assets used by it in connection with its businesses and operations (including the stock of substantially all of its subsidiaries).

In February 2002, the Predecessor settled all outstanding government litigation and pre-petition and certain post-petition claims arising from Medicare payments made to certain of the Company’s operating centers as well as claims in unliquidated amounts for a cash settlement of \$17 million. The settlement became effective on March 26, 2002, upon the effectiveness of the Plan.

In addition, on February 13, 2002, IHS and its subsidiaries, including the Predecessor, entered into a stipulation with the Centers for Medicare and Medicaid Services, or CMS, whereby CMS was permitted to set off certain underpayments to IHS with certain overpayments to the Predecessor in exchange for a full release of all CMS claims against IHS and its subsidiaries, including the Predecessor, to the effective date of the stipulation. The Bankruptcy Court signed the stipulation on April 12, 2002.

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

The Company recorded the following as reorganization items:

	Predecessor Company			Successor Company	
	Three Months Ended September 30, 2001	Nine Months Ended September 30, 2001	Three Months Ended March 31, 2002	Three Months Ended September 30, 2002	Six Months Ended September 30, 2002
Severance and terminations	\$ 357	\$ 776	\$ 837	\$ —	\$ —
Legal, accounting and consulting fees	400	981	175	—	497
Loss on sale/leaseback of vehicles	—	—	4,686	—	169
Priority tax claim allowed	—	—	14,000	—	—
Administrative expense claims allowed	—	—	7,800	—	—
Loss on closure of discontinued branch operations, long term incentive compensation and other charges resulting from reorganization and restructuring	6,983	8,068	1,596	250	828
	\$ 7,740	\$ 9,825	\$ 29,094	\$ 250	\$ 1,494

The Company has entered into an assumption, sale/leaseback and amendment to master lease agreement which became effective upon the Bankruptcy Court's final order of approval in March 2002. Vehicles purchased by the Company as debtor-in-possession were sold for \$10,191 and leased back along with other vehicles subject to the existing master operating lease. Among other things, the lease provides financial covenants for the maintenance of indebtedness to EBITDA (as defined in the agreement) not to exceed 4.0 to 1.0. The lease is renewable annually. The Company recorded a loss of approximately \$4,700 associated with the sale/leaseback transaction, which is classified as a reorganization item.

**(4) Other Commitments and Contingencies**

The Company is subject to workers' compensation and employee health benefit claims, which are primarily self-insured. The Company does, however, maintain certain stop-loss and other insurance coverage which management believes to be appropriate. Provisions for estimated settlements relating to the workers' compensation and health benefit plans are provided in the period of the related claim on a case-by-case basis plus an amount for incurred but not reported claims. Differences between the amounts accrued and subsequent settlements are recorded in operations in the period of settlement.

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

From time to time, the Company and its subsidiaries have been parties to various legal proceedings in the ordinary course of business. In the opinion of management, except with respect to the Chapter 11 proceedings described above, there are currently no proceedings which individually, after taking into account the insurance coverage maintained by the Company, would have a material adverse effect on the Company's financial position or results of operations.

**(5) Certain Significant Risks and Uncertainties**

The Company and others in the health care business are subject to certain inherent risks, including the following:

- Substantial dependence on revenues derived from reimbursement by the federal Medicare and state Medicaid programs which have been reduced in recent years and which entail exposure to various health care fraud statutes;
- Government regulations, government budgetary constraints and proposed legislative and regulatory changes; and
- Lawsuits alleging malpractice and related claims.

Such inherent risks require the use of certain management estimates in the preparation of the Company's financial statements and it is reasonably possible that a change in such estimates may occur.

The Company receives payment for a significant portion of services rendered to patients from the federal government under Medicare and other federally funded programs (including the Veterans Administration) and from the states in which its facilities and/or services are located under Medicaid. Revenue derived from Medicare, Medicaid and other federally funded programs represented 66.6% of the Company's patient revenue for the nine months ended September 30, 2001, 67.2%, 67.9% and 69.1% of the Company's patient revenue for the three months ended September 30, 2001, March 31, 2002 and September 30, 2002, respectively, and 68.9% of the Company's patient revenue for the six months ended September 30, 2002. The Company's operations are subject to a variety of federal, state and local legal and regulatory risks, including, without limitation, federal Medicare and Medicaid fraud and abuse laws (sometimes referred to as the "Anti-Kickback Statute") and the federal Ethics in Patient Referral Act of 1989 ("Stark I") as amended by the Omnibus Budget and Reconciliation Act of 1993 ("Stark II" and together with Stark I, "Stark") many of which apply to virtually all companies engaged in the health care services industry. The Anti-Kickback Statute prohibits, among other things, the offer, payment, solicitation or receipt of any form of remuneration in return for the referral of Medicare and Medicaid patients. Stark prohibits, with limited exceptions, financial relationships between certain designated health service providers and referring physicians. Many states in which the Company operates have laws and regulations similar to Stark and the Anti-Kickback Statute with which the Company must comply. Other regulatory risks assumed by the Company and other companies engaged in the health care industry are as follows:

- False Claims — "Operation Restore Trust" is a major anti-fraud demonstration project of the Office of the Inspector General. The primary purpose for the project is to scrutinize the activities of health care providers which are reimbursed under the Medicare and Medicaid programs. False claims are prohibited pursuant to criminal and civil statutes and are punishable by imprisonment and monetary penalties.

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

- Regulatory Requirement Deficiencies — In the ordinary course of business, health care facilities receive notices of deficiencies for failure to comply with various regulatory requirements. In some cases, the reviewing agency may take adverse actions against a facility, including the imposition of fines, temporary suspension or decertification from participation in the Medicare and Medicaid programs and, in extreme cases, revocation of a facility's license.
- Changes in laws and regulations — Changes in laws and regulations could have a material adverse effect on licensure, eligibility for participation in government programs, permissible activities, operating costs and the levels of reimbursement from governmental and other sources.

The Company has formed a Corporate Compliance Department to help identify, prevent and deter instances of Medicare, Medicaid and other noncompliance. Although the Company strives to manage these regulatory risks, there can be no assurance that federal and/or state regulatory agencies that currently have jurisdiction over matters including, without limitation, Medicare, Medicaid and other government reimbursement programs, will take the position that the Company's business and operations are in compliance with applicable law or with the standards of such regulatory agencies.

While the Company believes it complies in all material respects with all applicable regulatory requirements, an adverse determination in a governmental investigation, whether currently asserted or arising in the future, could have a material adverse effect on the Company.

The Company is also subject to malpractice and related claims, which arise in the normal course of business and which could have a significant effect on the Company. As a result, the Company maintains occurrence based professional and general liability insurance with coverage and deductibles which management believes to be appropriate.

The Company is also subject to certain inherent risks related to the acquisition of businesses. Since its inception, the Company has grown through acquisitions, and realization of acquisition costs, including intangible assets of businesses acquired, is dependent initially upon the consummation of the acquisitions and subsequently upon the Company's ability to successfully integrate and manage acquired operations.

The Company believes that adequate provision for the aforementioned items has been made in the accompanying consolidated financial statements and that their ultimate resolution will not have a material effect on the consolidated financial statements.

**(6) Fresh-Start Reporting**

The Company adopted fresh-start reporting upon its emergence from Chapter 11, effective March 26, 2002. Under fresh-start reporting, the reorganization value of the Company is allocated to the Company's assets based on their respective fair values in conformity with the purchase method of accounting for business combinations; any portion not attributed to specific tangible or identified intangible assets are reported as an intangible asset referred to as "reorganization value in excess of value of identifiable assets." In adopting fresh-start reporting, the Company engaged an independent financial advisor to assist in the determination of the reorganization value or fair value of the entity.

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

Not all of the valuations required to determine the fair value of the Company's assets have been performed and, accordingly, the adjustments reflected in the data following are preliminary and subject to further revisions and adjustments. The Company has arranged to obtain valuations of significant assets and, upon completion of this process, the reorganization value will be allocated to specific assets. It is anticipated that there will be reductions in the carrying values of certain assets, and the fair value of certain other assets may exceed the carrying values. Accordingly, the final valuation could result in materially different amounts and allocations of reorganization value from the amount and allocations presented in the following data.

Subsequent to March 31, 2002, the following adjustments were made to reorganization value in excess of value of identifiable assets:

Reduction of property and equipment to estimated fair market value.....	\$ 4,683
Payment and accrual of taxes related to Internal Revenue Code Section 338(h)(10) election.....	16,036
Adjustment to reorganization value.....	<u>\$ 20,719</u>

In connection with the Company's adoption of fresh-start accounting, the Company has obtained valuations of the patient service equipment and has reconsidered the estimated useful lives for this equipment and its other fixed assets. The new basis of patient service equipment, furniture and office equipment, and vehicles at March 31, 2002 are being depreciated over their respective remaining useful lives at that date, using the weighted average life of the asset groups, which approximates four years. Purchases of such property and equipment since March 31, 2002 are being depreciated over five years for patient service equipment, three years for computer equipment and five years for vehicles; leasehold improvements and furniture and equipment are unchanged. The effect of this change in estimate for the three months and six months ended September 30, 2002 was to increase depreciation by \$421 and \$589, respectively.

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

A reconciliation of fresh-start reporting recorded as of March 31, 2002 follows (in thousands):

	<u>Predecessor Company</u>	<u>Reorganization Adjustments</u>	<u>Fresh-Start Adjustments</u>	<u>Successor Company</u>
<b>Assets</b>				
<b>Current assets:</b>				
Cash and cash equivalents	\$ 14,687	\$ (13,000) <sup>(1)</sup>	\$ —	\$ 1,687
Accounts receivable, net	121,742	—	—	121,742
Other accounts receivable	1,137	—	—	1,137
Inventories, net	23,908	—	—	23,908
Prepaid expenses	2,831	—	—	2,831
Deferred income taxes	24,705	(24,705) <sup>(2)</sup>	—	—
Total current assets	<u>189,010</u>	<u>(37,705)</u>	<u>—</u>	<u>151,305</u>
Property and equipment, net	242,774	—	(21,482) <sup>(7)</sup>	221,292
Intangible assets	783,529	—	(783,529) <sup>(8)</sup>	—
Reorganization value in excess of value of identifiable assets	—	—	656,814 <sup>(10)</sup>	656,814
Other assets	13,625	6,460 <sup>(3)</sup>	—	20,085
	<u>\$ 1,228,938</u>	<u>\$ (31,245)</u>	<u>\$ (148,197)</u>	<u>\$ 1,049,496</u>
<b>Liabilities and Stockholders' Equity</b>				
<b>Current liabilities:</b>				
Accounts payable	\$ 15,497	\$ —	\$ —	\$ 15,497
Accrued expenses	19,999	—	—	19,999
Current portion of long term debt	—	2,000 <sup>(5)</sup>	—	2,000
Total current liabilities	<u>35,496</u>	<u>2,000</u>	<u>—</u>	<u>37,496</u>
Liabilities subject to compromise	47,441	(47,441) <sup>(1)</sup>	—	—
Due to parent company, net	378,287	(438,086) <sup>(4)</sup>	59,799 <sup>(8)</sup>	—
Deferred income taxes	58,359	(58,359) <sup>(2)</sup>	—	—
Priority tax claim	—	14,000 <sup>(1)</sup>	—	14,000
Long-term debt, less current portion	—	498,000 <sup>(5)</sup>	—	498,000
Series A Convertible Redeemable Preferred Stock	—	—	5,000 <sup>(9)</sup>	5,000
Stockholders' equity:				
Common Stock	1	—	1 <sup>(9)</sup>	2
Additional paid-in capital predecessor	565,893	—	(565,893) <sup>(8)</sup>	—
Additional paid-in capital successor	—	—	494,998 <sup>(9)</sup>	494,998
Retained earnings	143,461	(1,359) <sup>(6)</sup>	(142,102) <sup>(8)</sup>	—
Total stockholders' equity	<u>709,355</u>	<u>(1,359)</u>	<u>(212,996)</u>	<u>495,000</u>
	<u>\$ 1,228,938</u>	<u>\$ (31,245)</u>	<u>\$ (148,197)</u>	<u>\$ 1,049,496</u>

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

- (1) Represents estimated plan of reorganization claims allowed and paid.
- (2) Represents estimated effect of Internal Revenue Code Section 338(h)(10) election.
- (3) Represents the following:
- |  |                 |
|--|-----------------|
| Estimated value of non-core assets retained by predecessor | \$ (10,500)     |
| Deferred debt issue costs                                  | <u>16,960</u>   |
|  | <u>\$ 6,460</u> |
- (4) Represents settlement with IHS.
- (5) Represents the sale of senior secured term loan and senior subordinated notes.
- (6) Represents priority tax claim allowed of \$14,000, plus administrative expense claims allowed of \$7,800, less gain on debt discharge of \$20,441.
- (7) Represents reduction of property and equipment to estimated fair market value under fresh-start reporting.
- (8) Represents elimination of predecessor's intangible assets, equity accounts and retained earnings under fresh-start reporting.
- (9) Represents reorganization value of preferred and common stock as follows:
- |   |                   |
|---|-------------------|
| Series A Convertible Redeemable Preferred Stock | \$ 5,000          |
| Common Stock                                    | 2                 |
| Additional paid-in capital                      | <u>494,998</u>    |
|   | <u>\$ 500,000</u> |
- (10) Represents allocation of reorganization value under fresh-start reporting as follows:
- |  |                     |
|--|---------------------|
| Cash and cash equivalents                                      | \$ 1,687            |
| Accounts receivable  | 121,742             |
| Other current assets   | 27,876              |
| Property and equipment   | 221,292             |
| Other assets   | 20,085              |
| Accounts payable and accrued expenses                          | (35,496)            |
| Priority tax claim   | <u>(14,000)</u>     |
|  | 343,186             |
| Reorganization value in excess of value of identifiable assets | <u>656,814</u>      |
|  | <u>\$ 1,000,000</u> |

**ROTECH HEALTHCARE INC.**  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(Dollars in Thousands)

**(7) Long-Term Debt**

The Company's long-term debt consists of the following:

	<u>December 31, 2001</u>	<u>September 30, 2002</u>
Senior Secured Term Loan; \$487 payable quarterly through March 31, 2007 with remainder due quarterly through March 31, 2008, interest payable at LIBOR rate plus 3%, payable quarterly	\$ —	\$ 194,000
9 ½% Senior Subordinated Notes, due April 1, 2012, interest payable semi-annually on April 1 and October 1	—	300,000
Sub-total	—	494,000
Less current portion	—	2,000
Total long-term debt	<u>\$ —</u>	<u>\$ 492,000</u>

In addition to the above, as of September 30, 2002, the Company has a \$75 million five-year revolving credit facility available. No debt is outstanding under this facility at September 30, 2002, however, we have issued letters of credit totaling \$5 million under this facility.

## ITEM 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

The following management's discussion and analysis of financial condition and results of operations contains forward-looking statements based upon current expectations that involve risks and uncertainties. When used in this quarterly report, the words "intend," "anticipate," "believe," "estimate," "plan" and "expect" and similar expressions as they relate to Rotech Healthcare Inc. are included to identify forward-looking statements. Our actual results and the timing of certain events could differ materially from those anticipated in these forward-looking statements as a result of certain factors. As used herein, unless otherwise specified or the context otherwise requires, references to "we", "our" and "us" refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries for all periods subsequent to March 26, 2002 and to the business and operations of Rotech Medical Corporation and its subsidiaries for all periods prior to March 26, 2002.

The following table shows the results of operations for the Company as a percentage of its net revenues for the three months ended September 30, 2001 and 2002.

	<b>Three Months Ended</b>	
	<b>Predecessor Company</b>	<b>Successor Company</b>
	<b>September 30, 2001</b>	<b>September 30, 2002</b>
	<hr/>	<hr/>
Net revenues	100.0%	100.0%
Costs and expenses:		
Cost of net revenues	15.0%	14.6%
Provision for doubtful accounts	4.4%	3.0%
Selling, general and administrative	53.0%	60.5%
Depreciation and amortization	17.1%	9.9%
Interest expense (income)	(0.1%)	7.0%
Provision for settlement of government claims	1.3%	0.0%
Provision for inventory losses	0.2%	0.0%
Total costs and expenses	<hr/> 90.9%	<hr/> 95.0%
Earnings before reorganization items and income taxes	9.1%	5.0%
Reorganization items	5.0%	0.2%
Earnings before income taxes	<hr/> 4.1%	<hr/> 4.8%
Federal and state income taxes	<hr/> 3.1%	<hr/> 1.9%
Net earnings	<hr/> 1.0%	<hr/> 2.9%

Total net revenues for the three months ended September 30, 2002 decreased \$1.7 million, or 1.1%, to \$153.1 million, from the comparable period in 2001. The slight decrease was attributable to a 4.5% growth in our respiratory therapy equipment and services revenues, which was offset by a 15.5% decrease in our durable medical equipment revenues, and a 24.1% decline in our pharmacy related revenues (pharmacy related revenues represented 2.8% and 2.2% of the Company's revenues for the quarterly periods ended September 30, 2001 and September 30, 2002, respectively). The increase in respiratory equipment and services revenues

was primarily due to an increase in the number of rental units of oxygen concentrators. The decrease in durable medical equipment revenues was due to our efforts to focus our revenue growth on the more profitable respiratory therapy equipment rental and related services and provide durable medical equipment as a complementary offering to respiratory therapy services. The large decline in our pharmacy related revenues is a result of the closure of several non-nebulizer pharmacies. For the three months ended September 30, 2002, EBITDA was \$33.5 million as compared to \$42.7 million for the three months ended September 30, 2001. EBITDA is defined as earnings (loss) from continuing operations before interest, income taxes, depreciation and amortization and non-recurring items (including reorganization items, provision for settlement of government claims and provision for inventory losses). During the three months ended September 30, 2002, the Company incurred one-time charges of \$4.9 million for special investigation and severance costs. Had these one-time charges not been incurred, EBITDA for the three months ended September 30, 2002 would have been \$38.3 million.

Cost of net revenues for the three months ended September 30, 2002 decreased \$.8 million, or 3.6%, to \$22.4 million, from the comparable period in 2001. The decrease in cost of net revenues is attributable to the decline in our total net revenues for the period, as well as a change in the revenue composition from lower gross margin durable medical equipment to respiratory therapy equipment and services. We also experienced a price decrease in the cost of certain products. Cost of net revenues as a percentage of net revenue was 14.6% for the three months ended September 30, 2002 as compared to 15.0% for the comparable period in 2001.

The provision for doubtful accounts for the three months ended September 30, 2002 decreased by \$2.3 million, or 33.3%, from the comparable period in 2001. The provision for doubtful accounts expense as a percentage of net revenue decreased to 3.0% for the three months ended September 30, 2002 as compared to 4.4% for the same period in 2001. This improvement is attributed to a number of factors, including: (i) improved billing procedures and system enhancements; (ii) increased collections on our accounts receivable; and (iii) substantial improvement in our earned but unbilled receivables, which were \$18.3 million at September 30, 2002, versus \$28.3 million at September 30, 2001.

Selling, general and administrative expenses for the three months ended September 30, 2002 increased by \$10.6 million, or 13.0%, to \$92.7 million, from the comparable period in 2001. The increase in selling, general and administrative expenses resulted from the following: (i) \$4.9 million of special investigation costs related to a comprehensive internal investigation by special counsel and government contracting specialists (*see* Legal Proceedings—Recent Internal Investigation of Falsified Sales) as well as an estimate of the severance related costs resulting from recent changes in senior management; (ii) a \$3.0 million increase in salaries and benefits for company personnel; (iii) a \$1.4 million increase in legal, consulting and other services; and (iv) a \$1.4 million increase in insurance expense. Selling, general and administrative expenses as a percentage of net revenues increased to 60.5% for the three months ended September 30, 2002 from 53.0% for the three months ended September 30, 2001.

Depreciation and amortization for the three months ended September 30, 2002 decreased \$11.4 million, or 43.1%, to \$15.1 million, from the comparable period in 2001. The decrease was primarily due to the adoption of Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (“SFAS No. 142”). SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of SFAS No. 142. Accordingly, for the three months ended September 30, 2002, there was no amortization expense of intangible assets with indefinite lives. Had SFAS No. 142 been in effect for the three months ended September 30, 2001, amortization of goodwill would have been reduced by \$11,952 and net earnings for such periods would have increased by \$10,552.

Interest expense for the three months ended September 30, 2002 increased \$10.9 million from the comparable period in 2001. The increase is attributable to interest costs incurred on the \$200 million senior secured term

loan and the \$300 million 9½% Senior Subordinated Notes due 2012 that relate to our emergence from bankruptcy. In addition, because we were delayed in filing the registration statement relating to our 9½% Senior Subordinated Notes due 2012, we have incurred approximately \$315,000 of liquidated damages as of the filing date of the registration statement. The registration statement was filed with the Securities and Exchange Commission on October 25, 2002 but is not yet effective. We will continue to incur additional liquidated damages until the registration statement is declared effective by the Securities and Exchange Commission.

We adopted fresh-start reporting upon our emergence from bankruptcy, effective as of March 31, 2002. Under fresh-start reporting, the reorganization value of the Company is allocated to our assets based on their respective fair values in conformity with the purchase method of accounting for business combinations; any portion not attributed to specific tangible or identified intangible assets will be reported as an intangible asset referred to as “reorganization value in excess of value of identifiable assets.”

Not all of the valuations required to determine the fair value of our assets have been performed and, accordingly, the adjustments reflected in the September 30, 2002 financial statements are preliminary and subject to further revisions and adjustments. We have arranged to obtain valuations of significant assets and, upon completion of this process, the reorganization value will be allocated to specific assets. It is anticipated that there will be reductions in the carrying values of certain assets, and the fair value of certain other assets may exceed the carrying values. Accordingly, the final valuation could result in materially different amounts and allocations of reorganization value from the amounts and allocations presented in the September 30, 2002 financial statements.

Reorganization expenses related to Rotech Medical Corporation’s bankruptcy for the three months ended September 30, 2002, decreased \$7.5 million from the comparable period in 2001.

Federal and state income taxes for the three months ended September 30, 2002 decreased \$1.8 million to \$3.0 million from the comparable period in 2001. The decrease in federal and state income taxes was due to an unusually high effective tax rate of 76% for the three months ended September 30, 2001. This high effective tax rate resulted from the non-deductible amortization of goodwill.

Net earnings were \$4.4 million for the three months ended September 30, 2002 as compared to \$1.5 million for the same period in 2001. The increase in net earnings was primarily due to a decline in depreciation and amortization expense and a decline in reorganization items. These items were offset by increases in interest expense and selling, general and administrative expenses.

### **Liquidity and capital resources**

Rotech Medical Corporation was acquired by and became a wholly-owned subsidiary of IHS in October 1997. From that time until its emergence from bankruptcy, Rotech Medical Corporation had an integrated cash management system with IHS under which any cash in the consolidated bank account at the end of each day in excess of amounts needed by Rotech Medical Corporation for its operations was transferred to IHS. During the bankruptcy proceeding, Rotech Medical Corporation operated as a debtor-in-possession under the jurisdiction of the United States Bankruptcy Court for the District of Delaware. IHS was also in bankruptcy and had a debtor-in-possession financing facility. Rotech Medical Corporation continued to operate pursuant to the integrated cash management system previously in place. Upon emergence from bankruptcy, Rotech Medical Corporation is no longer a subsidiary of IHS and we, as the successor to Rotech Medical Corporation, are not a subsidiary of IHS. We now have a separate independent cash management system. We have entered into the credit facilities described below.

Net cash provided by operating activities and reorganization items was \$57.2 million for the six months ended September 30, 2002, and \$24.5 million for the three months ended March 31, 2002. For the nine months

ended September 30, 2001, net cash provided by operating activities and reorganization items was \$78.1 million. Cash flows in both years were sufficient to fund capital expenditures and required repayments of debt.

Accounts receivable before allowance for doubtful accounts decreased \$19.8 million from \$142.0 million at December 31, 2001 to \$122.2 million at September 30, 2002. Accounts receivable decreased as a result of an increase in cash collections for the period. Days sales outstanding (calculated as of each period end by dividing accounts receivable, less allowance for doubtful accounts, by the 90-day rolling average of net revenue) were 59 days at September 30, 2002 compared to 68 days at December 31, 2001.

Included in accounts receivable are earned but unbilled receivables of \$18.3 million at September 30, 2002 and \$24.9 million at December 31, 2001. Delays, ranging from a day to several weeks, between the date of service and billing can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources. Earned but unbilled receivables are aged from date of service and are considered in our analysis of historical performance and collectibility.

Due to the nature of the industry and the reimbursement environment in which the Company operates, certain estimates are required to record net revenues and accounts receivable at their net realizable values. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available. Specifically, the complexity of many third-party billing arrangements and the uncertainty of reimbursement amounts for certain services from certain payors may result in adjustments to amounts originally recorded. Such adjustments are typically identified and recorded at the point of cash application, claim denial or account review.

Management performs analyses to evaluate the net realizable value of accounts receivable. Specifically, management considers historical realization data, accounts receivable aging trends, other operating trends and relevant business conditions. Because of continuing changes in the health care industry and third-party reimbursement, it is possible that management's estimates could change, which could have an impact on operations and cash flows.

Capital expenditures totaled \$31.0 million for the six months ended September 30, 2002, and \$15.3 million for the three months ended March 31, 2002. For the nine months ended September 30, 2001, capital expenditures were \$62.6 million. The decrease in 2002 is attributed to a decline in the purchase of vehicles (which are now leased under a master operating lease).

Cash flows from financing activities primarily relate to the Company's emergence from bankruptcy, which was reflected in the three months ended March 31, 2002. We entered into:

- A five-year \$75 million senior secured revolving credit facility that will constitute a working capital facility for general corporate purposes including working capital, capital expenditures and acquisitions. There are no immediate plans to draw on this revolver other than issuance of letters of credit. Interest is payable based upon a consolidated leverage ratio grid with an option of a margin plus the Eurodollar rate or a margin plus a Base prime rate. The range of margin rates based on the Eurodollar rate is 3.25% to 2.25%. The range of margin rates based on the prime rate is 2.25% to 1.25%.
- A six-year \$200 million senior secured term loan, the proceeds of which were used to repay certain pre-petition claims owed to Rotech Medical Corporation's creditors as part of its plan of reorganization. The term loan is repayable in an aggregate annual amount equal to 1% of the principal amount each year for the first five years with the balance due in year six. Interest is payable based on the election of either the Eurodollar rate plus 3.00% or the Base prime rate plus 2.00%. On September 30, 2002, we made an optional prepayment on the term loan in the

amount of \$5 million, which, together with scheduled amortization payments, reduced the outstanding principal amount of the term loan to \$194 million.

- 9½% Senior Subordinated Notes due 2012 in an aggregate principal amount of \$300 million, the proceeds of which were used to repay certain pre-petition claims owed to Rotech Medical Corporation's creditors as part of its plan of reorganization. The notes mature on April 1, 2012. Interest of 9½% is payable semi-annually in arrears on April 1 and October 1 of each year.

Borrowings under the revolving credit facility and term loan are secured by substantially all of our assets and the agreements impose numerous restrictions, including, but not limited to, covenants requiring the maintenance of certain financial ratios, limitations on additional borrowing, capital expenditures, acquisitions and investments.

Upon Rotech Medical Corporation's emergence from bankruptcy, settlement agreements that it had entered into with IHS and with the United States Government became effective. Pursuant to the settlement agreement with IHS, Rotech Medical Corporation and IHS have fully and finally satisfied the claims they have against each other by an allocation of \$40 million in cash and a \$5 million promissory note and the remainder of the cash on hand (approximately \$40 million) was retained by IHS. Pursuant to the terms of the settlement agreement with the United States Government, Rotech Medical Corporation paid to the federal government \$17 million in cash, in full settlement and satisfaction of its claims against Rotech Medical Corporation and us for the conduct covered in the agreement.

Our working capital requirements relate primarily to the working capital needed for general corporate purposes and our plans to grow through internal growth supplemented by acquisitions primarily in non-urban markets. Rotech Medical Corporation has historically satisfied its working capital requirements and capital expenditures from its operating cash flow, except with respect to acquisitions during the time Rotech Medical Corporation was a subsidiary of IHS, which were principally funded by IHS.

We currently have no commitments for capital expenditures over the next twelve months other than to acquire equipment as needed to supply our patients. Although we contemplate consummating acquisitions in the next twelve months, including several acquisitions for which we have entered into non-binding letters of intent, we are not a party to any definitive agreement regarding any material acquisition. We believe that the cash generated from our operations, together with amounts available under the \$75 million revolving credit facility, will be sufficient to meet our working capital, capital expenditure and other cash needs for the foreseeable future.

### **ITEM 3 - Quantitative and Qualitative Disclosures about Market Risk**

Concurrently with our emergence from bankruptcy and the transfer to us of Rotech Medical Corporation's business and operations, we entered into (i) a five-year \$75 million senior secured revolving credit facility and (ii) a six-year \$200 million senior secured term loan. Our earnings may be affected by changes in interest rates relating to these debt facilities. Variable interest rates may rise, which could increase the amount of interest expense. We did not incur any interest expense in the year ended December 31, 2001. In March 2002, in consideration for the transfer of the assets of Rotech Medical Corporation to us in connection with the restructuring described under the heading "Restructuring transaction and related transactions," we borrowed the entire amount of the \$200 million term loan and transferred the proceeds of that loan to Rotech

Medical Corporation to fund a portion of the cash distributions made by Rotech Medical Corporation in connection with its plan of reorganization. As of November 1, 2002, the \$75 million senior secured revolving credit facility had not been drawn upon, although standby Letters of Credit totaling \$5 million have been issued under this credit facility. Assuming a hypothetical increase of one percentage point for the variable interest rate applicable to the \$200 million term loan, we would incur approximately \$1.5 million in additional interest expense for the period March 27, 2002 through December 31, 2002.

## **PART II - OTHER INFORMATION**

### **ITEM 1 - Legal Proceedings**

Due to the nature of our business, we are involved from time to time in lawsuits that arise in the ordinary course of our business. We do not believe that any lawsuit that our predecessor, Rotech Medical Corporation, or we are a party to, if resolved adversely, would have a material adverse effect on our financial condition or results of operations.

#### *Recent Internal Investigation of Falsified Sales*

In late June 2002, we discovered that an independent contractor (who was also a former employee) had falsified certain bulk sales to the Department of Veterans Affairs ("VA") by fabricating documentation for nonexistent sales of medical equipment in bulk to the VA. Upon learning of these falsified sales, we promptly:

- brought the matter to the attention of the relevant government authorities;
- terminated the independent contractor;
- retained the national law firm of Latham & Watkins and the government contracts consulting firm Navigant Consulting, Inc., to conduct a comprehensive internal investigation; and
- commenced working with KPMG LLP to determine the appropriate accounting treatment.

The investigation confirmed the existence of a pattern of falsified bulk sales of equipment to the VA, as well as certain improperly recorded revenues from non-bulk VA service contracts. The total of the falsified sales was originally recorded to our books and records as net revenue of \$30.4 million. Of this amount, \$14.8 million was recorded during the six-month period from October 1, 2001 to March 31, 2002. In addition, \$8.1 million of receivables associated with non-bulk VA service contracts have been written off. As a result of the investigation, we have restated our consolidated financial statements for each of the years ended December 31, 1999, 2000 and 2001. The restatement reflects a net after-tax charge of \$14.1 million over a three-year period. The principal adjustments comprising the restatements are summarized in the footnotes to the unaudited financial statements included in the amended and restated quarterly report for the period ended March 31, 2002, as well as in our restated audited financial statements for 1999, 2000 and 2001, copies of which have been provided to our principal creditors and the holders of our 9½% Senior Subordinated Notes due 2012. Additional copies of our restated audited financial statements and our quarterly reports are available upon request.

#### *The bankruptcy of our predecessor*

On February 2, 2000, our predecessor, Rotech Medical Corporation, and its parent company, Integrated Health Services, Inc. ("IHS"), filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code with the United States Bankruptcy Court in the District of Delaware. Rotech Medical Corporation's plan of reorganization was confirmed on February 13, 2002 and became effective on March 26, 2002.

#### *Events leading to the commencement of the Chapter 11 cases*

The principal reason for the commencement of Rotech Medical Corporation's Chapter 11 case was that Rotech Medical Corporation had jointly guaranteed approximately \$2.3 billion of obligations of IHS, under

credit agreements with IHS' senior creditors. IHS defaulted on its obligations under those agreements in 1999. As a result, IHS and substantially all of its subsidiaries, including Rotech Medical Corporation, filed voluntary bankruptcy petitions under Chapter 11 on February 2, 2000.

### *The Rotech plan of reorganization*

On February 13, 2002, the Bankruptcy Court issued an order confirming Rotech Medical Corporation's plan of reorganization, which became final on February 25, 2002. The plan of reorganization became effective on March 26, 2002. As a result of the reorganization, Rotech Medical Corporation (and consequently we, as its successor) is no longer a subsidiary of IHS.

Pursuant to the plan of reorganization, we have distributed to Rotech Medical Corporation all of our outstanding common stock for further distribution to Rotech Medical Corporation's creditors. Rotech Medical Corporation has agreed to pay approximately \$532 million in cash (including a \$14 million priority tax claim that will be paid out over six years at an interest rate of 6% per year) to creditors and claimants in full satisfaction, release and discharge of claims asserted against Rotech Medical Corporation with respect to the period prior to February 2, 2000 plus certain claims which arose during the bankruptcy cases. These creditors and claimants also received all of the common stock of Rotech Medical Corporation. The plan of reorganization also provided for payment of certain expenses related to Rotech Medical Corporation's operation during the pendency of its bankruptcy case, for expenses incurred in connection with its restructuring described under the heading "Restructuring transaction and related transactions" below and for our entry into (a) a five-year \$75 million senior secured revolving credit facility and (b) a six-year \$200 million senior secured term loan (together, the "Senior Secured Credit Facilities").

The foregoing description of certain material terms of the plan of reorganization is subject to and qualified in its entirety by reference to the detailed provisions of the plan, which is available for review upon request.

The plan of reorganization effected a recapitalization and did not result in a reduction in the scope of our operations. As a result of the plan of reorganization becoming effective:

- substantially all of Rotech Medical Corporation's business and operations were transferred to us;
- certain claims and expenses were satisfied, including the guarantee claims against Rotech Medical Corporation by the senior creditors of IHS of approximately \$2.3 billion, unsecured trade debt of which our liability is capped at \$10 million, government claims arising out of Medicare billings asserted to be \$48 million (plus claims in unliquidated amounts), subordinated debt claims of approximately \$2 million, tax claims of approximately \$14 million and other expenses related to the case; and
- we issued an aggregate principal amount of \$300 million of our 9½% Senior Subordinated Notes due 2012 (the "Notes") in transactions in reliance on Rule 144A and Regulation S under the Securities Act of 1933, as amended (the "Securities Act"), we established the Senior Secured Credit Facilities and we distributed the net proceeds of the offering of the Notes and the proceeds of a \$200 million term loan under the Senior Secured Credit Facilities to our predecessor, Rotech Medical Corporation, for distribution to certain of its creditors under its plan of reorganization.

In addition, as a result of the plan of reorganization and the restructuring described below under the heading "Restructuring transaction and related transactions," as of September 30, 2002:

- our total consolidated debt is approximately \$500 million, including the Notes and \$194 million of senior debt;

- stockholders' equity is approximately \$500 million;
- any liabilities of Rotech Medical Corporation existing on the date it filed for bankruptcy protection have been substantially eliminated from our financial statements and reserves have been established for any remaining liabilities; and
- we have up to \$70 million of available borrowings under a five-year \$75 million senior secured revolving credit facility. We have issued letters of credit totaling \$5 million under this facility.

*Major settlements and other motions approved by the bankruptcy court*

Subsequent to the filing of the bankruptcy case on February 2, 2000, Rotech Medical Corporation was required to seek approval of the Bankruptcy Court for certain material decisions regarding its continued operations. The following summarizes the major matters approved during the bankruptcy case:

- *Settlement with the United States Government.* The United States Government filed a \$48 million claim against Rotech Medical Corporation claiming trebled damages with respect to an underlying \$16 million claim relating to, among other things, claims arising from Medicare billings as well as claims in unliquidated amounts. Although Rotech Medical Corporation disputed the validity of the claims and the allowability of a trebled damage claim, in an effort to compromise this and other issues, Rotech Medical Corporation and the Department of Justice, or DOJ, entered into a settlement agreement dated on or about February 11, 2002. Pursuant to the terms of the settlement agreement, which was approved by the Bankruptcy Court on February 13, 2002, Rotech Medical Corporation has paid the federal government \$17 million in cash in full settlement and satisfaction of the aforementioned claims and certain claims which arose during the bankruptcy cases.

The parties to the settlement agreement are Rotech Medical Corporation and its subsidiaries and affiliates, the DOJ and the Office of Inspector General for the Department of Health and Human Services, or DHHS. On March 26, 2002, the effective date of the plan of reorganization, the DOJ provided a release of all administrative and civil monetary claims under the False Claims Act, Civil Monetary Penalties Law, Program Fraud Civil Remedies Act, common law theories of payment by mistake, unjust enrichment, breach of contract, and fraud for the covered conduct in the agreement. The Office of Inspector General also provided Rotech Medical Corporation with a release of its right to, with respect to covered conduct in the agreement, permissively exclude us from participating in federal health care programs.

In connection with the settlement agreement, Rotech Medical Corporation entered into a Corporate Integrity Agreement with the Office of Inspector General for the DHHS. As the successor to Rotech Medical Corporation, we are subject to the terms of the Corporate Integrity Agreement. Under the Corporate Integrity Agreement, Rotech Medical Corporation agreed to implement procedures designed to ensure compliance with the requirements of Medicare, Medicaid and all other federal health care programs. The Corporate Integrity Agreement will be effective for five years.

- *Settlement with IHS.* During the pendency of the Chapter 11 case, Rotech Medical Corporation and IHS operated pursuant to an integrated cash management system controlled by IHS. Pursuant to the settlement agreement with IHS, Rotech Medical Corporation and IHS have fully and finally satisfied the claims they have against each other by an allocation of \$40 million in cash and a \$5 million promissory note and the remainder of the cash on hand (approximately \$40 million) was retained by IHS. Rotech Medical Corporation and IHS exchanged, effective as of the effective date of the plan of reorganization, general releases, which cover all intercompany

claims against each other. As the successor to Rotech Medical Corporation, we are subject to the terms of the settlement agreement.

- *Settlement with CMS.* IHS and its subsidiaries, including Rotech Medical Corporation, receive reimbursement under Part B of Medicare. The Centers for Medicare and Medicaid Services, or CMS, had asserted that it overpaid IHS Part B Providers, including Rotech Medical Corporation, approximately \$1.1 million in the aggregate for certain services and underpaid approximately \$2.5 million in the aggregate for certain services. CMS was holding the underpayments in administrative freeze pending a resolution of its right to set them off against the overpayments. As part of a stipulation filed with the Bankruptcy Court, the parties agreed that CMS is permitted to set off the underpayments against the overpayments and hold in administrative freeze the balance remaining after the setoff, subject to (A) mutual agreement by the parties or (B) an order from the Court concerning the disposition of said funds. Effective March 26, 2002, all of (A) CMS's claims against IHS and its subsidiaries, including Rotech Medical Corporation, and (B) all of IHS's and its subsidiaries', including Rotech Medical Corporation's, claims against CMS for underpayments arising under Medicare Part B before the February 13, 2002 settlement date have been released, subject to limited exceptions, including insurance obligations retained by IHS. The Bankruptcy Court signed the stipulation on April 12, 2002.
- *Key Employee and Executive Retention Programs.* To encourage certain key employees to remain with Rotech Medical Corporation during the reorganization process and after emergence from bankruptcy, Rotech Medical Corporation proposed, and the Bankruptcy Court approved key employee and executive retention programs by orders dated June 21, 2000 and January 22, 2001, respectively. Under these programs, three executives and 82 other key employees became entitled to quarterly bonuses throughout the pendency of the bankruptcy proceeding, up to a maximum aggregate of approximately \$5 million annually in retention bonus payments. Each key employee received annual bonuses generally ranging from 25% to 100% of each such employee's salary. As a condition to participation in the programs, each key employee agreed to a six-month non-compete obligation. Payments under this bonus plan ceased upon emergence from bankruptcy.
- *Settlement Agreement with a Former Executive.* On July 26, 2000, the Bankruptcy Court approved a separation agreement with Stephen P. Griggs, Rotech Medical Corporation's former president, under which IHS agreed to pay to Mr. Griggs \$3 million in the following manner: \$1 million in September 2000, which was paid, and \$2 million payable in equal monthly installments over a period of three years beginning in September 2000. The agreement imposes upon Mr. Griggs various post-termination obligations, including non-competition, non-solicitation and confidentiality obligations. As part of the agreement, Mr. Griggs also waived all claims against Rotech Medical Corporation and its subsidiaries and relinquished certain equity rights he had in IHS.
- *Rejection of Executory Contracts and Unexpired Leases.* At the commencement of the bankruptcy case, Rotech Medical Corporation was party to numerous nonresidential real property leases, equipment leases and other "executory" contracts. (Although there is no precise definition of what constitutes an executory contract, the term generally includes contracts with respect to which performance remains due to some extent on both sides.) Since the commencement of its bankruptcy case, Rotech Medical Corporation has continually reviewed its portfolio of leases and contracts in order to identify those which it wished to reject and which could be rejected in connection with the bankruptcy proceeding. Rotech Medical Corporation rejected more than 425 leases and contracts, each of which it believed would not be important to its future operations. Under the Bankruptcy Code, the other party to the lease or contract which

has been terminated has the right to receive damages arising from such termination. These parties became unsecured creditors of Rotech Medical Corporation with respect to their claims and their claims have been satisfied under the plan of reorganization. All leases and contracts that continued after emergence from bankruptcy were assigned to us in connection with the restructuring described below under the heading “Restructuring transaction and related transactions.”

#### *Restructuring transaction and related transactions*

Pursuant to its plan of reorganization, on March 26, 2002, Rotech Medical Corporation transferred to us substantially all of the assets it uses in connection with its businesses and operations (including the stock of substantially all of its subsidiaries). Rotech Medical Corporation has retained certain assets that are not material to the continuation of the businesses and operations as they were conducted immediately prior to the restructuring. The assets transferred to us are subject to, and we assumed sole and exclusive responsibility for, (a) all claims, liabilities and obligations of Rotech Medical Corporation and its subsidiaries incurred after February 2, 2000 to the extent not paid on or prior to the effective date of the plan of reorganization, other than any claims, liabilities and obligations directly relating to assets retained by Rotech Medical Corporation, and (b) any tax liabilities of Rotech Medical Corporation and its subsidiaries for periods ending on or before the effective date of the plan of reorganization to the extent payable after such date (whether or not relating to the transferred assets), including, without limitation, any taxes incurred in connection with the transfer of the assets.

In consideration for the transfer of the assets from Rotech Medical Corporation to us we transferred to Rotech Medical Corporation (a) 25,000,000 shares of our common stock which represents all of our outstanding shares of common stock, (b) the net proceeds from the offering of the Notes and the proceeds of the \$200 million term loan, which has been used to fund a portion of the cash distributions made by Rotech Medical Corporation on the effective date of its plan of reorganization, and (c) a promissory note payable by IHS in the principal amount of \$5 million.

Our certificate of incorporation authorizes us to issue up to 250,000 shares of Series A Convertible Redeemable Preferred Stock with an aggregate face value of \$5 million. Concurrently with the effectiveness of the plan of reorganization, we issued all of the shares of Series A Convertible Redeemable Preferred Stock to our employee profit sharing plan as partial compensation for future services to be rendered by employees to us and our subsidiaries.

Pursuant to the plan of reorganization, we distributed all of our common stock to Rotech Medical Corporation. The plan of reorganization provided for the further distribution to the creditors of Rotech Medical Corporation of our common stock (which was to be distributed only to the senior bank creditors), the common stock of Rotech Medical Corporation and the cash and any term notes transferred by us to Rotech Medical Corporation in consideration for the assets transferred to us. After giving effect to the distribution by Rotech Medical Corporation in accordance with its plan of reorganization, all of the issued and outstanding shares of our common stock were initially owned by Rotech Medical Corporation’s senior bank creditors.

After giving effect to the restructuring, we have no continuing relationship with Rotech Medical Corporation except that, immediately following the restructuring, its Board of Directors consisted of certain of our executive officers and we were owned by the same stockholders.

#### *Other information*

- *Fresh-start Reporting.* Upon emergence from bankruptcy, completion of the restructuring and the transfer of substantially all of Rotech Medical Corporation’s assets to us, we implemented “fresh-start” reporting. Under fresh-start reporting, assets have been revalued and certain

accounting adjustments have been made in accordance with generally accepted accounting principles. As a result of adopting “fresh-start” reporting and emerging from bankruptcy, historical financial information may not be comparable with financial information for those periods after emergence from bankruptcy. Not all of the valuations required to determine the fair value of our assets have been performed and, accordingly, the fresh-start adjustments are preliminary and subject to further revisions and adjustments.

- *Recent Changes in Management.* Effective August 19, 2002, Stephen D. Linehan, our then-President and Chief Executive Officer, resigned his employment with us. Mr. Linehan also resigned as a member of our Board of Directors. Mr. Linehan has agreed that he will continue to provide us with advice and assistance at our request. On August 20, 2002, we also announced that we will not renew the employment contract of our Chief Operating Officer, Scott Novell, when it expires in December 2002. On November 7, 2002, we announced the appointment of Philip L. Carter as Chief Executive Officer and President of our company, effective December 9, 2002. Mr. Carter, age 54, replaces Guy P. Sansone, who has served as our interim President and Co-Chief Executive Officer since August 2002. William Wallace Abbott, who remains Chairman of our Board of Directors, will also step down as Co-Chief Executive Officer.
- *Board of Directors.* As of March 31, 2002, our Board of Directors consisted of seven directors, including Stephen D. Linehan, our then-President and Chief Executive Officer. As noted above, Mr. Linehan resigned his position as an officer and director of the Company effective August 19, 2002. In addition, on May 15, 2002, John H. Klein resigned as a member of our Board of Directors. Our Board of Directors consists of the following six individuals as of the date of this report, five of whom were selected by Rotech Medical Corporation’s senior creditors (who received 100% of our outstanding common stock pursuant to the plan of reorganization), to serve as directors of the Company: William Wallace Abbott, Guy P. Sansone, Edward L. Kuntz, William J. Mercer, Arthur J. Reimers and Arthur Siegel. In compliance with our by-laws, effective October 21, 2002, Mr. Siegel was appointed by a unanimous vote of our Board of Directors to fill one of the vacancies on our board. Philip L. Carter, who will become Chief Executive Officer and President of our company effective December 9, 2002, will also become a member of our Board of Directors effective December 9, 2002.
- *Agreement Related to Taxes.* In connection with the plan of reorganization, we entered into a Tax Sharing Agreement with Rotech Medical Corporation and IHS which sets forth our respective rights and obligations with respect to taxes arising from and in connection with the implementation of the plan of reorganization. The Tax Sharing Agreement sets forth that the parties to the agreement will, for tax purposes, treat the transfer of Rotech Medical Corporation’s assets to us as a taxable event rather than as a tax-free reorganization. If it is decided that an election should be made under Section 338(h)(10) of the Internal Revenue Code of 1986, as amended, and under any analogous state and local law, with respect to the transfer of Rotech Medical Corporation’s assets to us, it is expected that the parties to the Tax Sharing Agreement will agree to jointly make, or cause to be made, such election on a timely basis. If an election under Section 338(h)(10) is made, then we will be able to account for the acquisition of the stock of all of the subsidiaries as if we had acquired the assets of those subsidiaries for income tax purposes. This deemed asset purchase agreement will result in some increase in the immediate tax cost of the restructuring, but our tax basis used in calculating depreciation and amortization deductions for these assets will increase substantially, resulting in future tax savings. We believe that the present value of such future tax savings will be significantly greater than the increase in current tax costs.

The parties have agreed to provide assistance to each other in the preparation and filing of tax returns, defending audits and related matters. We have agreed to indemnify Rotech Medical

Corporation and IHS for all taxes attributable to us and incurred in connection with the implementation of the plan of reorganization and will indemnify Rotech Medical Corporation and IHS for all taxes that they incur as a result of the Section 338(h)(10) and similar elections described above, other than up to \$2 million of certain specified taxes. Also, IHS has agreed to indemnify us and Rotech Medical Corporation for all taxes attributable to IHS and its subsidiaries that are not also subsidiaries of us or Rotech Medical Corporation.

**ITEM 2 - Changes in Securities and Use of Proceeds**

Not applicable.

**ITEM 3 - Defaults upon Senior Securities**

Not applicable.

**ITEM 4 - Submission of Matters to Vote of Security Holders**

Not applicable.

**ITEM 5 - Other Information**

As a result of the plan of reorganization and subsequent restructuring transactions, as of March 31, 2002, our Board of Directors consisted of seven directors, including Stephen D. Linehan, our former President and Chief Executive Officer and John H. Klein. As noted above, Mr. Linehan resigned his position as an officer and director of the Company effective August 19, 2002. In addition, Mr. Klein resigned his position as a director of the Company effective as of May 15, 2002. The following six individuals, five of whom were selected by our senior creditors, serve as directors of the Company as of the date of this report: William Wallace Abbott, Guy P. Sansone, Edward L. Kuntz, William J. Mercer, Arthur J. Reimers and Arthur Siegel. All of such individuals, with the exception of Mr. Siegel, have served as directors of the Company since March 2002. Mr. Siegel was appointed to the Board of Directors, effective October 21, 2002. As noted below, Philip L. Carter will become a member of the Board of Directors effective December 9, 2002.

On November 7, 2002, we announced the appointment of Philip L. Carter as Chief Executive Officer and President of our company and as a member of our Board of Directors effective December 9, 2002. Mr. Carter, age 54, replaces Mr. Sansone, who has served as interim President and Co-Chief Executive Officer since August 2002. Mr. Abbott, who remains Chairman of our Board of Directors, will also step down as Co-Chief Executive Officer. Mr. Carter previously served as chief executive officer of Apria Healthcare Group, Inc. from 1998 to 2002. From 1995 to 1998, Mr. Carter served as president and chief executive officer of MacFrugal's Bargains-Closeouts, a Los Angeles based retail company.

Upon his resignation as an officer of the Company, we entered into a separation agreement with Stephen D. Linehan pursuant to which we agreed to pay Mr. Linehan a cash payment in the amount of \$1.5 million, as well as the earned but unpaid portion of his long-term incentive compensation. In addition, Mr. Linehan is entitled until ninety days after the effective date of his resignation to exercise the portion of all outstanding stock options granted to him that became exercisable prior to his resignation.

## **SIGNATURES**

The Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: November 8, 2002

### **ROTECH HEALTHCARE INC.**

/s/ William Wallace Abbott  
William Wallace Abbott  
Co-Chief Executive Officer and  
Chairman of the Board of Directors

/s/ Guy P. Sansone  
Guy P. Sansone  
President and Co-Chief Executive Officer

/s/ Janet L. Ziomek  
Janet L. Ziomek  
Chief Financial Officer