

---

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

---

**FORM 10-Q**

---

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2011

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-50940

---

**ROTECH HEALTHCARE INC.**

(Exact name of registrant as specified in its charter)

---

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

**030408870**  
(IRS Employer  
Identification No.)

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

**32804**  
(Zip Code)

**(407) 822-4600**  
(Registrant's telephone number, including area code)

---

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of August 1, 2011, the registrant had 25,883,352 shares of common stock outstanding.

---

---

## TABLE OF CONTENTS

	<u>Page No.</u>
<b>PART I—FINANCIAL INFORMATION</b>	
<b><u>Item 1—Financial Statements (unaudited)</u></b>	3
<u>Condensed Consolidated Balance Sheets—June 30, 2011 and December 31, 2010</u>	3
<u>Condensed Consolidated Statements of Operations—Three and six months ended June 30, 2011 and 2010</u>	4
<u>Condensed Consolidated Statements of Cash Flows—Six months ended June 30, 2011 and 2010</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<b><u>Item 2—Management’s Discussion and Analysis of Financial Condition and Results of Operations</u></b>	13
<b><u>Item 3—Quantitative and Qualitative Disclosures About Market Risk</u></b>	26
<b><u>Item 4—Controls and Procedures</u></b>	26
<b>PART II—OTHER INFORMATION</b>	
<b><u>Item 1—Legal Proceedings</u></b>	27
<b><u>Item 1A—Risk Factors</u></b>	27
<b><u>Item 5—Other Information</u></b>	27
<b><u>Item 6—Exhibits</u></b>	27
<b><u>SIGNATURES</u></b>	28
<b><u>INDEX TO EXHIBITS</u></b>	29

**PART I—FINANCIAL INFORMATION**

**Item 1—Financial Statements**

**ROTECH HEALTHCARE INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share and per share data)

	June 30, 2011	December 31, 2010
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 40,496	\$ 63,046
Accounts receivable, net	79,814	68,042
Other receivables	6,008	2,480
Income taxes receivable	101	111
Inventories	10,206	10,020
Prepaid expenses	<u>3,578</u>	<u>3,390</u>
Total current assets	140,203	147,089
Property and equipment, net	102,117	105,290
Intangible assets (less accumulated amortization of \$11,942 at June 30, 2011 and \$9,600 at December 31, 2010)	18,974	14,434
Restricted cash	8,765	12,927
Other assets, including debt issue costs	<u>19,116</u>	<u>11,322</u>
	<u>\$ 289,175</u>	<u>\$ 291,062</u>
<b>Liabilities and Stockholders' Deficiency</b>		
Current liabilities:		
Accounts payable	\$ 22,294	\$ 19,637
Accrued expenses and other current liabilities	14,904	14,237
Accrued interest	14,130	13,159
Deferred revenue	9,240	9,058
Current portion of long-term debt	<u>508</u>	<u>502</u>
Total current liabilities	61,076	56,593
Deferred tax liabilities, net	513	614
Other long-term liabilities	496	515
Long-term debt, less current portion	509,414	510,909
Series A convertible redeemable preferred stock, stated value \$20 per share, 1,000,000 shares authorized, 239,496 shares issued and outstanding at June 30, 2011 and December 31, 2010	4,899	5,116
Commitments and contingencies		
Stockholders' deficiency:		
Common stock, par value \$.0001 per share, 50,000,000 shares authorized, 25,883,352 and 25,616,103 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively	3	3
Additional paid-in capital	507,299	506,960
Accumulated deficit	<u>(794,525)</u>	<u>(789,648)</u>
Total stockholders' deficiency	<u>(287,223)</u>	<u>(282,685)</u>
	<u>\$ 289,175</u>	<u>\$ 291,062</u>

See accompanying notes to unaudited condensed consolidated financial statements.

**ROTECH HEALTHCARE INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except share and per share data)

	Three months ended		Six months ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Net revenues	\$ 122,437	\$ 124,315	\$ 243,943	\$ 247,681
Costs and expenses:				
Cost of net revenues	35,931	40,005	75,029	80,848
Selling, general and administrative	62,994	66,779	125,625	133,187
Provision for doubtful accounts	7,109	4,484	12,348	13,815
Depreciation and amortization	2,261	1,984	4,635	3,989
Total costs and expenses	<u>108,295</u>	<u>113,252</u>	<u>217,637</u>	<u>231,839</u>
Operating income	14,142	11,063	26,306	15,842
Other expense (income):				
Interest expense, net	16,107	11,176	30,674	22,300
Other income, net	(18)	(3,497)	(880)	(3,484)
Loss on debt extinguishment	—	—	1,216	—
Total other expense	<u>16,089</u>	<u>7,679</u>	<u>31,010</u>	<u>18,816</u>
(Loss) earnings before income taxes	(1,947)	3,384	(4,704)	(2,974)
Income tax expense (benefit)	<u>23</u>	<u>(9)</u>	<u>(41)</u>	<u>141</u>
Net (loss) earnings	(1,970)	3,393	(4,663)	(3,115)
Accrued dividends on convertible redeemable preferred stock	<u>108</u>	<u>109</u>	<u>214</u>	<u>200</u>
Net (loss) earnings attributable to common stockholders	<u>\$ (2,078)</u>	<u>\$ 3,284</u>	<u>\$ (4,877)</u>	<u>\$ (3,315)</u>
Net (loss) earnings per common share:				
Basic	<u>\$ (0.08)</u>	<u>\$ 0.13</u>	<u>\$ (0.19)</u>	<u>\$ (0.13)</u>
Diluted	<u>\$ (0.08)</u>	<u>\$ 0.12</u>	<u>\$ (0.19)</u>	<u>\$ (0.13)</u>
Weighted average shares outstanding:				
Basic	<u>25,701,980</u>	<u>25,549,775</u>	<u>25,673,206</u>	<u>25,545,546</u>
Diluted	<u>25,701,980</u>	<u>27,407,984</u>	<u>25,673,206</u>	<u>25,545,546</u>

See accompanying notes to unaudited condensed consolidated financial statements.

**ROTECH HEALTHCARE INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Six months ended June 30,	
	2011	2010
Net loss	\$ (4,663)	\$ (3,115)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Provision for doubtful accounts	12,348	13,815
Depreciation and amortization	31,736	31,219
Loss on debt extinguishment	1,216	—
Deferred income taxes	(101)	76
Other	369	211
Changes in operating assets and liabilities:		
Accounts receivable	(24,120)	(21,453)
Other receivables	(3,528)	(584)
Income taxes receivable	10	(7)
Inventories	(140)	1,164
Prepaid expenses	(188)	(309)
Other assets	(1,293)	190
Accounts payable and accrued expenses	152	(1,182)
Other long-term liabilities	(19)	(23)
Accrued interest	971	(75)
Deferred revenue	182	168
Net cash provided by operating activities	<u>12,932</u>	<u>20,095</u>
Cash flows from investing activities:		
Purchases of property and equipment	(24,526)	(24,290)
Identifiable intangible assets associated with equipment purchases	(263)	—
Cash paid for asset purchases	(3,199)	—
Withdrawals from restricted cash	4,162	1,365
Net cash used in investing activities	<u>(23,826)</u>	<u>(22,925)</u>
Cash flows from financing activities:		
Payments on capital leases	(251)	(1,710)
Payments of other liabilities	—	(349)
Proceeds from long-term borrowing	284,771	—
Retirement of long-term borrowing	(287,000)	—
Debt issue costs	(8,845)	—
Net proceeds from stock option exercises	104	13
Payments of dividends on Series A convertible redeemable preferred stock	(435)	—
Net cash used in financing activities	<u>(11,656)</u>	<u>(2,046)</u>
Decrease in cash and cash equivalents	(22,550)	(4,876)
Cash and cash equivalents, beginning of period	63,046	58,904
Cash and cash equivalents, end of period	<u>\$ 40,496</u>	<u>\$ 54,028</u>

See accompanying notes to unaudited condensed consolidated financial statements.

**ROTECH HEALTHCARE INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**  
**(In thousands, except share and per share data)**

**(1) Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include the accounts of Rotech Healthcare Inc. and its subsidiaries and have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. In the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the results of operations for the interim periods presented have been reflected herein. Interim results are not necessarily indicative of results to be expected for the full year. 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. In general, management's estimates are based upon historical experience and various other assumptions that we believe to be reasonable under the facts and circumstances. Actual results could differ from those estimates made by management. For further information, refer to the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010. There have been no material changes to our significant accounting policies as disclosed in our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010.

The Company has evaluated significant events and transactions that occurred after June 30, 2011 through the date of filing this report on Form 10-Q.

As used in these notes, unless otherwise specified or the context otherwise requires, references to "the Company", "we", "our" and "us" refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries.

For all periods presented herein, there were no differences between net (loss) earnings and comprehensive (loss) earnings.

**(2) Liquidity**

We completed a refinancing of our former 9.5% Senior Subordinated Notes due 2012 (the "Senior Subordinated Notes") in March 2011 with the issuance of \$290,000 in aggregate principal amount of 10.5% Senior Second Lien Notes due 2018 (the "Senior Second Lien Notes"). We completed a refinancing of our former payment-in-kind term loan facility (the "Senior Facility") in October 2010 with the issuance of \$230,000 in aggregate principal amount of 10.75% Senior Secured Notes due 2015 (the "Senior Secured Notes").

We are highly leveraged. As of June 30, 2011, we had \$509,922 of long-term debt outstanding. Our Senior Secured Notes (\$224,298) mature in October 2015 and our Senior Second Lien Notes (\$284,921) mature in March 2018. Although we are highly leveraged, management believes, based upon our current cash projections that our current cash balances, cash generated from our operations and available credit under our revolving credit facility will be sufficient to meet our working capital, capital expenditure and other cash obligations for the next twelve months.

**(3) Earnings Per Common Share**

Basic earnings per share (EPS) are computed by dividing net earnings available to common stockholders by the weighted average number of common shares outstanding for the periods. Diluted EPS reflects the potential dilution of securities that could share in the earnings and are based upon the weighted average number of common and common equivalent shares outstanding during the three and six months ended June 30, 2011 and 2010. Common equivalent shares related to employee stock options and the Series A convertible redeemable preferred stock ("Series A Preferred") on an "if converted" basis totaled 3,312,228 and 708,241 for the three months ended June 30, 2011 and 2010, respectively, and 3,244,055 and 2,033,452 for the six months ended June 30, 2011 and 2010, respectively, are excluded from the computation of diluted EPS in periods where they have an anti-dilutive effect. We use the treasury stock method to compute the dilutive effects of common equivalent shares.

The reconciliations of net (loss) earnings attributable to common stockholders and shares outstanding for purposes of calculating basic and diluted EPS for the three and six months ended June 30, 2011 and 2010 are as follows:

	<u>Three months ended</u> <u>June 30,</u>		<u>Six months ended</u> <u>June 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
<b>Numerator:</b>				
Net (loss) earnings attributable to common stockholders (basic EPS)	\$ (2,078)	\$ 3,284	\$ (4,877)	\$ (3,315)
Accrued dividends on convertible redeemable preferred stock	—	109	—	—
Net (loss) earnings (diluted EPS)	<u>\$ (2,078)</u>	<u>\$ 3,393</u>	<u>\$ (4,877)</u>	<u>\$ (3,315)</u>
<b>Denominator:</b>				
Basic weighted-average shares outstanding	25,701,980	25,549,775	25,673,206	25,545,546
Dilutive stock options	—	1,665,033	—	—
Dilutive convertible redeemable preferred stock	—	193,176	—	—
Diluted weighted average shares outstanding	<u>25,701,980</u>	<u>27,407,984</u>	<u>25,673,206</u>	<u>25,545,546</u>
<b>Net (loss) earnings per common share:</b>				
Basic	<u>\$ (0.08)</u>	<u>\$ 0.13</u>	<u>\$ (0.19)</u>	<u>\$ (0.13)</u>
Diluted	<u>\$ (0.08)</u>	<u>\$ 0.12</u>	<u>\$ (0.19)</u>	<u>\$ (0.13)</u>

Each share of our Series A Preferred has a stated value of \$20 and entitles the holder to an annual cumulative dividend equal to 9% of its stated value, payable semi-annually at the discretion of our board of directors in cash or in additional shares of Series A Preferred. In the event dividends are declared by our board of directors but not paid for six consecutive periods, the holders of the Series A Preferred are entitled to vote as a separate class to elect one director to serve on our board of directors. Effective December 5, 2003, our board of directors adopted a policy of declaring dividends to the holders of the Series A Preferred under the Rotech Healthcare Inc. Employees Plan on an annual basis, with each such declaration to be made at the meeting of the board of directors following the annual meeting of the shareholders with respect to dividends payable for the preceding year. At the meeting of the board of directors held on June 22, 2010, dividends in the amount of \$435 were declared on our Series A Preferred and were paid in January 2011. At the meeting of the board of directors held on June 24, 2011, dividends in the amount of \$431 were declared on our Series A Preferred and are included in our accompanying consolidated balance sheet as of June 30, 2011 within “Accrued expenses and other current liabilities.”

#### (4) Equipment and Asset Purchases

During the six months ended June 30, 2011 and 2010, we completed \$5,809 and \$2,341, respectively, of purchases of new and used rental equipment and inventory from competitors exiting the home health care market which represents a limited subset of the assets and activities used in operating their respective businesses (“Equipment Purchases”).

	<u>Six months ended June 30,</u>	
	<u>2011</u>	<u>2010</u>
Property and equipment	\$ 5,103	\$ 2,274
Inventory	443	67
Identifiable intangible assets	263	—
Total	<u>\$ 5,809</u>	<u>\$ 2,341</u>

During the six months ended June 30, 2011, we completed purchases of new and used rental equipment, inventory and other additional assets, including identifiable intangible assets, from competitors exiting the home health care market representing a business combination (“Asset Purchases”) totaling \$3,199, the aggregate cost of which has been recorded as follows:

	<u>Six Months Ended June 30, 2011</u>
Property and equipment	\$ 2,219
Identifiable intangible assets	934
Inventory	46
Total	<u>\$ 3,199</u>

We did not have any Asset Purchases during the six months ended June 30, 2010. Pro forma results and other expanded disclosures required by the Financial Accounting Standards Board Accounting Standards Codification Topic 805, *Business Combinations*, have not been presented as these purchases individually and in the aggregate are not material.

**(5) Intangible Assets**

Intangible assets of a reporting unit will be tested for impairment if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

The following table reflects the components of identifiable intangible assets:

	<u>June 30, 2011</u>		<u>December 31, 2010</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
<b>Intangible assets subject to amortization:</b>				
Customer/physician relationship	\$ 12,000	\$ 5,550	\$ 12,000	\$ 5,250
Computer software	10,728	4,711	5,000	2,917
Other	6,188	1,681	5,034	1,433
Subtotal	<u>28,916</u>	<u>11,942</u>	<u>22,034</u>	<u>9,600</u>
<b>Intangible assets not subject to amortization:</b>				
Trade name	1,000	—	1,000	—
Medicare licenses	1,000	—	1,000	—
Subtotal	<u>2,000</u>	<u>—</u>	<u>2,000</u>	<u>—</u>
Total intangible assets	<u>\$ 30,916</u>	<u>\$ 11,942</u>	<u>\$ 24,034</u>	<u>\$ 9,600</u>

During 2011, we wrote off fully amortized intangibles in the amount of \$43. Amortization expense for the three and six months ended June 30, 2011 was approximately \$438 and \$800, respectively. Amortization expense for the three and six months ended June 30, 2010 was approximately \$316 and \$642, respectively. During 2011, we recorded \$6,925 of intangible assets subject to amortization, including reclassification of internally developed computer software from property and equipment, which have a weighted average remaining life of 8.3 years.

Estimated amortization expense for each of the fiscal years ending December 31 is as follows:

	<u>Amount</u>
2011	\$1,803
2012	1,999
2013	1,993
2014	1,692
2015	1,666

**(6) Segment Data**

We operate in one reportable segment with three primary product lines: respiratory therapy equipment and services, durable medical equipment, and other products and services. The following table presents net revenues from distribution by each of our three primary product lines:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Respiratory therapy equipment and services	\$107,160	\$107,698	\$213,216	\$214,099
Durable medical equipment	12,938	13,511	25,826	26,755
Other	2,339	3,106	4,901	6,827
Net revenue	<u>\$122,437</u>	<u>\$124,315</u>	<u>\$243,943</u>	<u>\$247,681</u>

**(7) Other Commitments and Contingencies**

We are subject to workers' compensation and employee health benefit claims, which are primarily self-insured. We do, however, maintain certain stop-loss and other insurance coverage which management believes to be appropriate.

Provisions for estimated settlements relating to workers' compensation are provided in the applicable period on a case-by-case basis. We review our estimated provisions on a quarterly basis and make changes when necessary. Differences between the amounts accrued and subsequent settlements are recorded in operations in the period of settlement. We estimate claim amounts incurred but not reported relating to health benefit plans in the applicable period and review such amounts on a quarterly basis.

We and our subsidiaries are parties to various legal proceedings in the ordinary course of business. For more information regarding our recent legal proceedings, see Note 8, "Certain Significant Risks and Uncertainties and Significant Events."

**(8) Certain Significant Risks and Uncertainties and Significant Events**

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

- Substantial dependence on revenues derived from reimbursement by various Federal health care programs (including Medicare) and State Medicaid programs, both of which have been significantly reduced in recent years, and which entail exposure to various health care fraud statutes;
- Inconsistent payment patterns from Centers for Medicare and Medicaid Services, its contractors and other third-party payors;
- Government regulations, government budgetary constraints and proposed legislative, reimbursement and regulatory changes; and
- Lawsuits alleging negligence in the provision of healthcare services and related claims.

Such inherent risks require the use of certain management estimates in the preparation of our financial statements and it is reasonably possible that changes in such estimates may occur.

We receive 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 (VA)) and from state governments under Medicaid. Revenue derived from Medicare, Medicaid and other federally funded programs represented 56.9% and 58.4% of our patient service revenue for the three months ended June 30, 2011 and 2010, respectively, and 57.0% and 58.1% for the six months ended June 30, 2011 and 2010, respectively.

We have recently signed an amendment to our provider participation agreement with Humana (the "Amendment"). The Amendment rescinds the termination notice received from Humana on May 2, 2011 and allows us to continue as a selected provider. The terms of the Amendment are effective September 1, 2011 with a four-year term.

(9) **Debt**

Our long-term debt consists of the following:

	<u>June 30, 2011</u>	<u>December 31, 2010</u>
Capital lease obligations with interest implied at fixed rates between 5.3% and 12.1%, due in equal monthly installments with terms expiring from July 2011 through April 2013, secured by equipment	\$ 703	\$ 629
10.75% Senior Secured Notes, due October 15, 2015, interest payable semi-annually on April 15 and October 15, net of \$5,702 and \$6,218 unamortized original issue discount at June 30, 2011 and December 31, 2010, respectively	224,298	223,782
10.5% Senior Second Lien Notes, due March 15, 2018, interest payable semi-annually on March 15 and September 15, net of \$5,079 unamortized original issue discount at June 30, 2011	284,921	—
9.5% senior subordinated notes, due April 1, 2012, interest payable semi-annually on April 1 and October 1, fully satisfied March 17, 2011	—	287,000
<b>Sub total</b>	<u>509,922</u>	<u>511,411</u>
Less current portion	508	502
<b>Total long-term debt</b>	<u>\$509,414</u>	<u>\$ 510,909</u>

On March 17, 2011, we issued \$290,000 in aggregate principal amount of Senior Second Lien Notes. The Senior Second Lien Notes were offered and sold in a private placement to Credit Suisse Securities (USA) LLC and Jefferies & Company, Inc. (the “Initial Purchasers”) in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended (the “Securities Act”), and resold by the Initial Purchasers to qualified buyers pursuant to exemptions from registration provided by Rule 144A and Regulation S of the Securities Act. The Senior Second Lien Notes were also offered and sold to certain directors of the Company who are accredited investors as defined in Rule 501(a) under the Securities Act.

The Senior Second Lien Notes were issued at a discount of \$5,229 and we incurred transaction costs of approximately \$8,823. The discount and transaction costs associated with the Senior Second Lien Notes will be amortized as interest expense over the term of these notes. Interest will be payable semi-annually on March 15 and September 15 commencing on September 15, 2011. We used the proceeds from the offering of the Senior Second Lien Notes, together with \$24,485 of cash on hand, to repay all of our outstanding Senior Subordinated Notes and pay associated fees and expenses. In conjunction with the closing of the Senior Second Lien Notes on March 17, 2011, we deposited \$301,920 with Bank of New York Mellon N.A., as trustee (the “Trustee”), to satisfy our obligation with respect to the Senior Subordinated Notes including the principal amount of \$287,000 and accrued interest through April 18, 2011 of \$14,920. We were legally released of our liability effective March 17, 2011. Upon completion of the 30-day notice period required under the indenture governing our Senior Subordinated Notes, on April 18, 2011, the Trustee redeemed and cancelled the Senior Subordinated Notes. As a result of the termination of the Senior Subordinated Notes we recorded a \$1,216 loss on extinguishment of debt related to unamortized debt issuance costs.

The Senior Second Lien Notes will mature on March 15, 2018. In connection with the issuance of the Senior Second Lien Notes, we entered into a registration rights agreement with the Initial Purchasers of the Senior Second Lien Notes, dated March 17, 2011 (the “Senior Second Lien Notes Registration Rights Agreement”). Pursuant to the Senior Second Lien Notes Registration Rights Agreement, we agreed to exchange the Senior Second Lien Notes for freely tradable notes with terms that are substantially identical to the Senior Second Lien Notes. We also agreed, in limited circumstances, to file a shelf registration statement with respect to the Senior Second Lien Notes. On July 12, 2011, we completed the registered exchange offer with respect to the Senior Second Lien Notes.

The indenture governing the Senior Second Lien Notes contains covenants that limit our ability and the ability of our restricted subsidiaries to, among other things: sell assets; pay dividends or make other distributions or repurchase or redeem our stock; incur or guarantee additional indebtedness; incur certain liens; make loans and investments; enter into agreements restricting our subsidiaries’ ability to pay dividends; consolidate, merge or sell all or substantially all of our assets, and enter into transactions with affiliates. The Senior Second Lien Notes are secured by a second priority security interest in substantially all of the Company’s assets. The Senior Second Line Notes are guaranteed by all of our wholly owned subsidiaries. Each guarantee is full and unconditional and joint and several. We hold all of our assets and conduct all of our operations through our wholly owned subsidiaries and we do not have independent assets and operations.

Additionally, on March 17, 2011 we entered into a credit agreement with Credit Suisse AG, as administrative agent, Credit Suisse Securities (USA) LLC and Jefferies Finance LLC, as joint bookrunners and joint lead arrangers, and Jefferies Finance LLC, as documentation agent. The credit agreement provides for a revolving credit facility commitment of up to \$10,000 provided that the maximum outstanding aggregate principal balance at any one time does not exceed \$10,000 (the “Revolving Credit Facility”). The Revolving Credit Facility expires on March 17, 2012. There was no debt outstanding under the Revolving Credit Facility as of June 30, 2011.

The Revolving Credit Facility contains customary covenants similar to those in our indentures governing our Senior Secured Notes and Senior Second Lien Notes. The Revolving Credit Facility also includes a maximum leverage ratio above which level we would be precluded from making any additional draws. As of June 30, 2011, we were below the maximum leverage ratio threshold, as defined therein.

All borrowings under the Revolving Credit Facility are secured by a first priority security interest in substantially all of the Company's assets. The interest rate per annum applicable to the Revolving Credit Facility is adjusted LIBOR or, at our option, the alternate base rate, which is the higher of (a) the prime rate, (b) the federal funds effective rate plus 0.50%, and (c) the adjusted LIBOR plus 1.0% in each case, plus the applicable margin (as defined below). The applicable margin in the case of LIBOR advances is 5.0% and in the case of alternate base rate advances is 4.0%. The default rate on the Revolving Credit Facility is 2.0% above the otherwise applicable interest rate. We are also obligated to pay a commitment fee of 0.75% on the unused portion of our Revolving Credit Facility.

On October 6, 2010, we issued \$230,000 in aggregate principal amount of Senior Secured Notes. The Senior Secured Notes were offered and sold in a private placement to Credit Suisse Securities (USA) LLC (the "Initial Purchaser") in reliance on the exemption from registration provided by the Securities Act, and resold by the Initial Purchaser to qualified buyers pursuant to exemptions from registration provided by Rule 144A and Regulation S of the Securities Act.

The Senior Secured Notes were issued at a discount of \$6,465 and we incurred transaction costs of approximately \$7,983. The discount and transaction costs associated with the Senior Secured Notes will be amortized as interest expense over the term of those notes. Interest will be payable semi-annually on April 15 and October 15 commencing on April 15, 2011. We used the proceeds from the offering of the Senior Secured Notes, together with \$13,698 of cash on hand, to repay all of the outstanding indebtedness including accrued interest of \$2,761 under our former Senior Facility and pay associated fees and expenses. As a result of the termination of the Senior Facility dated March 30, 2007, we recorded a \$4,401 loss on extinguishment of debt related to unamortized debt issuance costs of \$2,143 and prepayment premiums of \$2,258.

The Senior Secured Notes will mature on October 15, 2015. In connection with the issuance of the Senior Secured Notes, we entered into a registration rights agreement with the Initial Purchaser of the Senior Secured Notes, dated October 6, 2010 (the "Senior Secured Notes Registration Rights Agreement"). Pursuant to the Senior Secured Notes Registration Rights Agreement, we agreed to exchange the Senior Secured Notes for freely tradable notes with terms that are substantially identical to the Senior Secured Notes. We also agreed, in limited circumstances, to file a shelf registration statement with respect to the Senior Secured Notes. On January 14, 2011, we completed the registered exchange offer with respect to the Senior Secured Notes.

The indenture governing the Senior Secured Notes contains covenants that limit our ability and the ability of our restricted subsidiaries to, among other things: sell assets; pay dividends or make other distributions or repurchase or redeem our stock; incur or guarantee additional indebtedness; incur certain liens; make loans and investments; enter into agreements restricting our subsidiaries' ability to pay dividends; consolidate, merge or sell all or substantially all of our assets, and enter into transactions with affiliates. The Senior Secured Notes are secured by a first priority security interest in substantially all of the Company's assets. The Senior Secured Notes are guaranteed by all of our wholly owned subsidiaries. Each guarantee is full and unconditional and joint and several. We hold all of our assets and conduct all of our operations through our wholly owned subsidiaries and we do not have independent assets and operations.

During the six months ended June 30, 2010 we paid \$7,118 of interest in cash under our former Senior Facility.

We have outstanding letters of credit totaling \$8,765 as of June 30, 2011 and December 31, 2010. Our letters of credit were cash collateralized at 100% and 105% of their face amount, as of June 30, 2011 and December 31, 2010, respectively. The cash collateral for these outstanding letters of credit is included in restricted cash in our accompanying condensed consolidated balance sheet as of June 30, 2011 and December 31, 2010.

The fair value of our Senior Second Lien Notes at June 30, 2011 approximated carrying value because no public market existed until July 2011. The fair value of Senior Secured Notes at December 31, 2010 approximated carrying value because no public market existed until January 2011. The fair value of our Senior Secured Notes at June 30, 2011 and the Senior Subordinated Notes at December 31, 2010 are based on quoted market prices. The estimated fair value of the Senior Secured Notes at June 30, 2011 was \$252,822. The estimated fair value of the Senior Subordinated Notes at December 31, 2010 was \$277,054.

## **(10) Income Taxes**

We recorded a net tax expense of \$23 and a net tax benefit of \$9 for the three months ended June 30, 2011 and 2010, respectively and a net tax benefit of \$41 and a net tax expense of \$141 for the six months ended June 30, 2011 and 2010, respectively. The current year to date tax benefit is primarily the result of a decrease of \$101 in our liabilities recorded for uncertain tax positions and a current state tax expense of \$60. We have provided a full valuation allowance against our remaining net deferred tax assets as of June 30, 2011 because management's judgment is that it is more likely than not that the net deferred tax assets will not be realized based on cumulative book losses.

At June 30, 2011, we had available federal net operating loss (NOL) carryforwards of approximately \$189,164 net of the de-recognition recorded as a result of the change in ownership interest under Section 382 of the Internal Revenue Code that occurred on December 31, 2006. These remaining NOLs fully expire in 2031. NOL carryforwards and credits are subject to review and possible other adjustments by the Internal Revenue Service and may be further limited by the occurrence of certain events, including other significant changes in ownership interests as was the case in 2006. The effect of an ownership change is the imposition of an annual limitation on the use of the NOL carryforwards attributable to periods before the change.

We recorded a liability of \$442 and \$525 for unrecognized tax benefits related to various federal and state income tax matters as of June 30, 2011 and December 31, 2010, respectively. If recognized, all of these amounts would impact our effective tax rate. There is no difference between the total amount of unrecognized tax benefit and the amount that would impact the effective tax rate based on the current valuation of the deferred tax assets. We do not expect that the amounts of unrecognized tax benefits will change significantly within the next 12 months.

We are currently open to audit under the statute of limitations by the Internal Revenue Service for all years ended December 31, 2002 to present. However, we are only open to additional tax assessments under the Internal Revenue Code statute of limitations for the years ended December 31, 2007 to present. The IRS commenced examinations of the Company's U.S. income tax return for 2008 in the third quarter of 2010 and for 2009 in the first quarter of 2011. As of June 30, 2011, the IRS has closed the examinations and did not propose any adjustments. Our state income tax returns are open to audit and additional tax assessments for the years ended December 31, 2002 to present as applicable under the various state statutes of limitations.

There is \$71 and \$89 of accrued interest related to uncertain tax positions as of June 30, 2011 and December 31, 2010, respectively. No penalties have been accrued. We account for interest and penalties related to uncertain tax positions as part of our provision for federal and state income taxes.

#### (11) Supplemental Cash Flow and Non-cash Investing and Financing Information

	For the six months ended June 30,	
	2011	2010
Cash payments for:		
Interest	\$27,910	\$20,897
Income taxes, net of refunds	50	74
Non-cash investing and financing activities:		
Property and equipment unpaid and included in accounts payable	6,614	4,190
Property and equipment acquired through capital leases	333	227
Accrued debt issue costs	168	—

## Item 2—Management’s Discussion and Analysis of Financial Condition and Results of Operations

*The following discussion of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and our consolidated financial statements for the year ended December 31, 2010 and the notes thereto included in our Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. As used herein, unless otherwise specified or the context otherwise requires, references to the “Company”, “we”, “our” and “us” refer to the business and operations of Rotech Healthcare Inc. and its subsidiaries.*

### Introduction

#### *Background*

We are one of the largest providers of home medical equipment and related products and services in the United States, with a comprehensive offering of respiratory therapy and durable home medical equipment and related services. We provide home medical equipment and related products and services principally to older patients with breathing disorders, such as chronic obstructive pulmonary diseases (COPD), which include chronic bronchitis, emphysema, obstructive sleep apnea and other cardiopulmonary disorders. We provide equipment and services in 48 states through approximately 425 operating locations located primarily in non-urban markets.

Our revenues are principally derived from respiratory equipment rental and related services, which accounted for 87.5% and 86.6% of net revenues for the three months ended June 30, 2011 and 2010, respectively and 87.4% and 86.4% of net revenues for the six months ended June 30, 2011 and 2010, respectively. Revenues from respiratory equipment rental and related services include rental of oxygen concentrators, liquid oxygen systems, portable oxygen systems, ventilator therapy systems, nebulizer equipment and sleep disorder breathing therapy systems, and the sale of nebulizer medications. We also generate revenues through the rental and sale of durable medical equipment, which accounted for 10.6% and 10.9% of net revenues for the three months ended June 30, 2011 and 2010, respectively and 10.6% and 10.8% of net revenues for the six months ended June 30, 2011 and 2010, respectively. Revenues from rental and sale of durable medical equipment include hospital beds, wheelchairs, walkers, patient aids and ancillary supplies. We derive our revenues principally from reimbursement by third-party payors, including Medicare, Medicaid, the Veterans Administration (VA) and private insurers.

We are focused on specific initiatives to continue the growth in patient and product counts experienced over the past three years. During 2010, we substantially completed development of a new order intake system that will streamline our order intake processes and eliminate many of our current, paper-based processes. We have to date completed implementation of this system in approximately 10% of our operating locations and we expect full implementation by the end of 2011.

#### *Executive Summary*

We face significant financial and Medicare reimbursement related challenges that continue to negatively affect our financial position. We anticipate that we will continue to face such challenges in the near and long-term future. Most of these difficulties result from our highly leveraged capital structure, while others are the result of significant Medicare reimbursement reductions applicable to our industry, as well as current conditions in the capital markets.

In light of these challenges, our operational focus is on reducing our cost structure while maintaining internal growth and seeking opportunities to gain market share through selective asset and equipment purchases from competitors exiting the home medical equipment market. In particular:

- During the first six months of 2011, we purchased \$9.0 million of new and used rental equipment, inventory and certain identifiable intangible assets from competitors exiting the home medical equipment market. Some of the equipment purchased in these transactions is currently on rent and located in patients’ homes. We believe that we will be successful in continuing to identify additional asset and equipment purchase opportunities and that we will be able to successfully transition a high percentage of the associated patients onto service with our Company. During the six months ended June 30, 2011, we have recognized approximately \$11.7 million of revenues associated with patients transitioned onto service with our Company through asset and equipment purchases.
- During the first six months of 2010, we purchased \$2.3 million of new and used rental equipment and inventory from competitors exiting the home medical equipment market. Some of the equipment purchases in these transactions is currently on rent and located in patients’ homes. During the six months ended June 30, 2010, we have recognized approximately \$10.0 million of revenues associated with patients transitioned onto service with our Company through equipment purchases.
- During 2010, we implemented several new initiatives intended to streamline our workflows and further leverage new internally developed systems and system enhancements. These reductions, in addition to other cost savings initiatives, decreased our selling, general and administrative expenses as a percentage of net revenue to 51.5% for the six months ended June 30, 2011 as compared to 53.8% for the six months ended June 30, 2010.

These strategic and operational initiatives were implemented in order to improve our financial performance and thereby best position us to complete the refinancing of our 2011-2012 debt maturities and provide adequate cash flow to service our outstanding long-term debt and fund our strategic growth initiatives. We expect that we will continue to evaluate and explore strategic opportunities as they may arise, including potential acquisitions, business combination transactions, strategic partnerships or similar transactions. In addition, either in connection with or independent of such a transaction, we expect that we may engage in financing activities through public or private offerings of equity, debt or convertible securities, including common stock, preferred stock, warrants, convertible notes or other instruments. Our 2011 financial plan calls for continued improvements in financial performance compared to 2010.

On June 28, 2011, we submitted our application for relisting of our common stock on the NASDAQ Global Market. The listing application is subject to review and approval by NASDAQ's Listing Qualifications department for compliance with all NASDAQ Stock Market standards. We anticipate the NASDAQ review process to last approximately two months or longer before completion. While we intend to satisfy all of NASDAQ's requirements for relisting, there can be no assurance that our application will be approved, or of when or if our common shares will be listed on the NASDAQ Stock Market or another stock exchange. Our common stock will continue to trade on the OTC Bulletin Board under our current symbol, ROHI, during the NASDAQ review process.

#### *Reimbursement by Third-Party Payors*

We derive substantially all of our revenues from reimbursement by third-party payors, including Medicare, Medicaid, the VA and private insurers. Revenue derived from Medicare, Medicaid and other federally funded programs represented 56.9% and 58.4% of our patient service revenue for the three months ended June 30, 2011 and 2010, respectively and 57.0% and 58.1% of our patient service revenue for the six months ended June 30, 2011 and 2010, respectively. Our business has been, and may continue to be, significantly impacted by changes mandated by Medicare legislation.

Under existing Medicare laws and regulations, the sale and rental of our products generally are reimbursed by the Medicare program according to prescribed fee schedule amounts calculated using statutorily-prescribed formulas. Significant legislation affecting home medical equipment (HME) reimbursement has been signed into law, including the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Affordability Reconciliation Act (collectively, the "PPACA"), Medicare Improvement for Patients and Providers Act of 2008 (MIPPA), Medicare, Medicaid and State Children's Health Insurance Program Extension Act of 2007 ("SCHIP Extension Act"), the Deficit Reduction Act of 2005 (DRA) and the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), contain provisions that negatively impact reimbursement for the primary HME products that we provide. The PPACA, MIPPA, the SCHIP Extension Act, DRA and MMA provisions (each of which is discussed in more detail below), when fully implemented, could have a material adverse effect on our financial condition, revenues, profit margins, profitability, operating cash flows and results of operations.

- The PPACA includes, among other things, annual, non-deductible fees on any entity that manufactures or imports certain prescription drugs and biologics, beginning in 2011; a deductible excise tax on any entity that manufactures or imports medical devices offered for sale in the United States, with limited exceptions, beginning in 2013; new face to face encounter requirements for HME and home health services; and a requirement that by 2016, the competitive bidding process must be nationalized or prices in non-competitive bidding areas must be adjusted to match competitive bidding prices.
- MIPPA retroactively delayed the implementation of competitive bidding for eighteen months and decreased the 2009 fee schedule payment amounts by 9.5% for product categories included in competitive bidding.
- The SCHIP Extension Act reduced Medicare reimbursement amounts for covered Medicare Part B drugs, including inhalation drugs that we provide, which went into effect April 1, 2008.
- The DRA capped the Medicare rental period for oxygen equipment at 36 months of continuous use, after which time title of the equipment would transfer to the beneficiary. For purposes of this cap, the DRA provided for a new 36-month rental period that began January 1, 2006 for all oxygen equipment. With the passage of MIPPA, transfer of title of oxygen equipment at the end of the 36-month rental cap was repealed, although the rental cap remained in place.
- The MMA significantly reduced reimbursement for inhalation drug therapies beginning in 2005, reduced payment amounts for five categories of HME, including oxygen, beginning in 2005, froze payment amounts for other covered HME items through 2007, established a competitive acquisition program for HME and implemented quality standards and accreditation requirements for HME suppliers.

We cannot predict the impact that any federal legislation enacted in the future will have on our financial condition, revenues, profit margins, profitability, operating cash flows and results of operations.

Further, changes in the law or new interpretations of existing laws could have a dramatic effect on permissible activities, the relative costs associated with doing business and the amount of reimbursement by government and other third-party payors. Reimbursement from Medicare and other government programs is subject to federal and state statutory and regulatory requirements, administrative rulings, interpretations of policy, implementation of reimbursement procedures, renewal of VA contracts, retroactive payment adjustments and governmental funding restrictions. Our levels of revenue and profitability, like those of other health care companies, are affected by the continuing efforts of government payors to contain or reduce the costs of health care, including competitive bidding initiatives, measures that impose quality standards as a prerequisite to payment, policies reducing certain HME payment rates and restricting coverage and payment for inhalation drugs, and refinements to payments for oxygen and oxygen equipment.

(1) **Competitive Bidding Program for HME.** On April 2, 2007, the Centers for Medicare & Medicaid Services (CMS), the agency responsible for administering the Medicare program, issued its final rule implementing a competitive bidding program for certain HME products under Medicare Part B. This nationwide competitive bidding program is designed to replace the existing fee schedule payment methodology. Under the competitive bidding program, suppliers compete for the right to provide items to beneficiaries in a defined geographic region. CMS selects contract suppliers that agree to receive as payment the “single payment amount” calculated by CMS after bids are submitted. Round one of the competitive bidding program began on July 1, 2008 in ten high-population competitive bidding areas (CBAs). As a winning bidder in nine of the ten competitive bidding areas, we signed contracts with CMS to become a contracted supplier for the round one contract period of July 1, 2008 through June 30, 2011. The competitive bidding program was scheduled to expand to 70 additional CBAs for a total of 80 CBAs in 2009 and additional areas thereafter.

However, on July 15, 2008, the United States Congress, following an override of a Presidential veto, enacted MIPPA. MIPPA retroactively delayed the implementation of competitive bidding for eighteen months, and terminated all existing contracts previously awarded. MIPPA included a 9.5% nationwide reduction in reimbursement effective January 1, 2009 for the product categories included in competitive bidding, as a budget-neutrality offset for the eighteen month delay.

On January 16, 2009, CMS published an interim final rule with comment period (IFC) addressing the MIPPA provisions that affect round one of the competitive bidding program. This IFC announced the delay of round one of the program from 2007 to 2009. The round one competition, also known as the round one rebid, occurred in the same CBAs as the 2007 round one bidding, excluding Puerto Rico. The product categories for 2009 were the same as those selected for the 2007 round one bidding, with the exception of negative pressure wound therapy and Group 3 complex rehabilitative wheelchairs. The IFC also announced the delay of round two of the program from 2009 to 2011, the national mail order program until after 2010 and competition in additional areas, other than mail order, until after 2011. Suppliers are required to meet all applicable eligibility, financial, quality and accreditation standards. The MIPPA changes that were addressed in this IFC did not alter the fundamental requirements of the final regulation for the competitive bidding program published on April 10, 2007.

On July 2, 2010, CMS announced the single payment amount for each of the respective round one rebid CBAs and product categories and began offering contracts to certain bidders in the CBAs. We were awarded and accepted 17 contracts. In addition, on July 1, 2011, we completed an acquisition in one of the round one rebid CBAs. As part of this acquisition, we assumed two additional competitive bid contracts, for a total of 19, as follows:

- 6 CBAs for oxygen supplies and equipment;
- 6 CBAs for enteral nutrients, equipment and supplies;
- 4 CBAs for continuous positive airway pressure, respiratory assist devices and related supplies and accessories;
- 1 CBA for walkers; and
- 2 CBAs for standard power wheelchairs, scooters and related accessories.

CMS announced the participating providers in November 2010. The contracts became effective on January 1, 2011 and have a term of three years. The average reduction from current Medicare payment rates in this round of competitive bidding across the CBAs is 32%. Suppliers that were not contracted by CMS may continue to provide certain capped rental and oxygen equipment for those beneficiaries that were patients at the time the program began and are known as “grandfathered suppliers”. In the CBAs and product categories where we are not a contracted supplier, we continue to service our Medicare patients as grandfathered suppliers under applicable guidelines. Based upon CMS release information, it appears that approximately 70% of existing providers across the Round 1 Rebid CBAs were not awarded competitive bidding contracts and are therefore not able to provide competitive bid products to new Medicare patients during the term of these contracts in the respective CBAs. Although we do not have specific market share data relative to the 70% of providers not awarded competitive bidding contracts, we believe that contracted providers within these CBAs have experienced significant volume increases since the competitive bidding contracts became effective on January 1, 2011. The application of the new competitive bid rates in the Round 1 Rebid CBAs reduced our net revenue by approximately \$0.9 million and \$2.0 million for the three and six months ended June 30, 2011, respectively. We have experienced volume increases in the CBAs where we were awarded contracts, which we attribute to an increase in market share, during the three and six months ended June 30, 2011, and we believe that these volume increases will more than offset the reductions in reimbursement over time.

(2) **Certain Clinical Conditions, Accreditation Requirements and Quality Standards.** The MMA required establishment and implementation of new clinical conditions of coverage for HME products and quality standards for HME suppliers. Some clinical conditions have been implemented, such as the requirement for a face-to-face visit by treating physicians for beneficiaries seeking power mobility devices. CMS published its quality standards and criteria for accrediting organizations for HME suppliers in 2006 and revised some of these standards in October 2008. As an entity that bills Medicare and receives payment from the program, we are subject to these standards. We have revised our policies and procedures to ensure compliance in all material respects with the quality standards. These standards, which are applied by independent accreditation organizations, include business-related standards, such as financial and human resources management requirements, which would be applicable to all HME suppliers, and product-specific quality standards, which focus on product specialization and service standards. The product specific standards address several of our products, including oxygen and oxygen equipment, CPAP and power and manual wheelchairs and other mobility equipment.

Currently, all of our operating locations are accredited by the Joint Commission (formerly referred to as the Joint Commission on Accreditation of Healthcare Organizations). The Joint Commission is a CMS recognized accrediting organization. Round 1 re-bid competitive bid suppliers were required to be accredited by September 30, 2009.

On January 2, 2009, CMS published its final rule on surety bond requirements for HME suppliers, effective March 3, 2009. For each National Provider Identifier (NPI) number subject to Medicare billing privileges, suppliers must obtain a surety bond in the amount of \$50,000. Each of our 425 operating locations is required to have its own NPI number. There may be an upward adjustment for suppliers that have had adverse legal actions imposed on them in the past. HME suppliers already enrolled in Medicare were required to obtain a surety bond by October 2, 2009, and newly enrolled suppliers or those changing ownership were subject to the provisions of the new rule on May 4, 2009. We maintain surety bonds covering all of our NPI numbers at each of our operating locations.

(3) **Reduction in Payments for HME and Inhalation Drugs.** The MMA changes also included a reduction in reimbursement rates beginning in January 2005 for oxygen equipment and certain other HME items (including wheelchairs, nebulizers, hospital beds and air mattresses) based on the percentage difference between the amount of payment otherwise determined for 2002 and the 2002 median reimbursement amount under the Federal Employee Health Benefits Program (FEHBP) as determined by the Office of the Inspector General of the Department of Health and Human Services (OIG). The FEHBP adjusted payments remained “frozen” through 2008. With limited exceptions, items that were not included in competitive bidding received a 5% update for 2009. As discussed above, for 2009, MIPPA included a 9.5% nationwide reduction in reimbursement for the product categories included in competitive bidding, as a budget neutrality offset for the eighteen month delay.

The MMA also revised the payment methodology for certain drugs, including inhalation drugs dispensed through nebulizers. Historically, prescription drug coverage under Medicare has been limited to drugs furnished incident to a physician’s services and certain self-administered drugs, including inhalation drug therapies. Prior to MMA, Medicare reimbursement for covered drugs, including the inhalation drugs that we provide, was limited to 95 percent of the published average wholesale price (AWP) for the drug. MMA established new payment limits and procedures for drugs reimbursed under Medicare Part B. Beginning in 2005, inhalation drugs furnished to Medicare beneficiaries are reimbursed at 106 percent of the volume-weighted average selling price (ASP) of the drug, as determined from data provided each quarter by drug manufacturers under a specific formula described in MMA. Implementation of the ASP-based reimbursement formula resulted in a significant reduction in payment rates for inhalation drugs. Given the overall reduction in payment for inhalation drugs dispensed through nebulizers, CMS established a dispensing fee for inhalation drugs shipped to a beneficiary beginning in 2005. The current dispensing fee is \$57 for the first 30-day period in which a Medicare beneficiary uses inhalation drugs and \$33 for each subsequent 30-day period. The dispensing fee for a 90-day supply of inhalation drugs is \$66. The dispensing fee has remained unchanged since 2006. Future changes from quarterly updates to ASP pricing, as well as any future dispensing fee reductions or eliminations, if they occur, could have a material adverse effect on our financial condition, revenues, profit margins, profitability, operating cash flows and results of operations.

Furthermore, because the ASP amounts vary from quarter to quarter, changes in market forces influence the Medicare payment rate. In late 2006, the US Food and Drug Administration approved a first-time generic formulation for DuoNeb. The introduction of this generic product into the market has contributed to the reduction of the ASP for DuoNeb from \$1.079 in the fourth quarter of 2007 to \$0.275 in the third quarter 2011. The impact of this reduction to our profit margins, profitability, operating cash flows and results of operations was partially mitigated through the dispensing of generic DuoNeb and changes in nebulizer product mix.

(4) **Reduction in Payments for Oxygen and Oxygen Equipment.** The DRA which was signed into law on February 8, 2006, made certain changes to the way Medicare Part B pays for certain of our HME products, including oxygen and oxygen equipment. For oxygen equipment, prior to the DRA, Medicare made monthly rental payments indefinitely, provided medical

need continued. The DRA capped the Medicare rental period for oxygen equipment at 36 months of continuous use, after which time ownership of the equipment would transfer to the beneficiary. For purposes of this cap, the DRA provided for a new 36-month rental period that began January 1, 2006 for all oxygen equipment. In addition to the changes in the duration of the rental period for capped rental items and oxygen equipment, the DRA permitted payments for servicing and maintenance of the products after ownership transfers to the beneficiary.

On November 1, 2006, CMS released a final rule to implement the DRA changes, which went into effect January 1, 2007. Under the rule, CMS clarified the DRA's 36-month rental cap on oxygen equipment. CMS also revised categories and payment amounts for the oxygen equipment and contents during the rental period and for oxygen contents after equipment ownership by the beneficiary as described below. With the passage of MIPPA on July 15, 2008, transfer of title to oxygen equipment at the end of the 36-month rental cap was repealed, although the rental cap remained in place. Effective January 1, 2009, after the 36th continuous month during which payment is made for the oxygen equipment, the equipment is to continue to be furnished during any period of medical need for the remainder of the reasonable useful lifetime of the equipment. The reasonable useful lifetime for stationary or portable oxygen equipment begins when the oxygen equipment is first delivered to the beneficiary and continues until the point at which the stationary or portable oxygen equipment has been used by the beneficiary on a continuous basis for five years (60 months) provided there are no breaks in service due to medical necessity. Computation of the reasonable useful lifetime is not based on the age of the equipment. During the capped rental period from months 37 through 60 of continuous use, payment is made only for oxygen and for certain reasonable and necessary maintenance and servicing (for parts and labor not covered by the supplier's or manufacturer's warranty) (as discussed in more detail below).

- *Payment for Rental Period.* The 2011 and 2010 rate for stationary oxygen equipment is \$173.31 and \$173.17, respectively. The 2011 and 2010 monthly portable oxygen add-on amount is \$28.74 and \$28.77, respectively. The 2011 monthly payment amount for oxygen-generating portable oxygen equipment remains unchanged at \$51.63 from 2010. The oxygen-generating portable oxygen equipment payments were unaffected by MIPPA.
- *Payment for Contents after 36-Month Rental Cap.* Payment is based on the type of equipment owned and whether it is oxygen-generating. Previously, CMS paid a combined average monthly payment amount of \$154.90 for furnishing oxygen contents for stationary and portable systems after the 36-month rental cap. This amount included payment for both stationary contents and portable contents. CMS split this payment into a separate monthly payment amount for stationary oxygen content of \$77.45 and a separate monthly payment amount for portable oxygen content of \$77.45. This payment amount is for oxygen contents for equipment that is not oxygen-generating. If the beneficiary uses both stationary and portable equipment that is not oxygen-generating, the monthly payment amount for oxygen contents is \$154.90. For stationary or portable oxygen equipment that is oxygen-generating, there will be no monthly payment for contents.

In its November 1, 2006 final rule, CMS also acknowledged certain other payments after the 36-month rental cap, including payment for supplies such as tubing and masks. In addition, CMS detailed several requirements regarding a supplier's responsibility to maintain and service capped rental items and provided for a general maintenance and servicing payment for certain oxygen-generating equipment beginning six months after the 36-month rental cap. On October 30, 2008, CMS issued new oxygen payment rules and supplier responsibilities to address changes to the transfer of title under MIPPA. In the final rule, CMS determined that for liquid or gaseous oxygen (stationary or portable), after the 36-month rental cap, there would be no additional Medicare payment for the maintenance and servicing of such equipment for the remainder of the useful lifetime of the equipment. CMS also determined that for 2009 only, Medicare would pay for in-home, maintenance and servicing visits for oxygen concentrators and transfilling equipment every six months, beginning six months after the end of the 36-month rental cap. This payment would be made if the supplier visited the beneficiary's home, performed any necessary maintenance and servicing, and inspected the equipment to ensure that it would function safely for the next six months. In its final CY 2010 rule, CMS stated that it will continue to pay for such in-home maintenance and servicing visits every six months until medical necessity ends or the beneficiary elects to obtain new equipment. Beginning July 1, 2010, the payment rate is capped at 10% of the cost of acquiring a stationary oxygen concentrator increased by the consumer price index, or \$66 for calendar year 2010. On February 5, 2010, CMS issued program instruction on this new provision.

Finally, CMS clarified that though it retains title to the equipment, a supplier is required to continue to furnish needed oxygen equipment and contents for liquid or gaseous equipment after the 36-month rental cap until the end of the equipment's reasonable useful lifetime. CMS determined the reasonable useful lifetime for oxygen equipment to be five years provided there are no breaks in service due to medical necessity, computed based on the date the equipment is delivered to the beneficiary. On January 27, 2009, CMS posted further instructions on the implementation of the 36-month rental cap, including guidance on payment for oxygen contents after month 36 and the replacement of oxygen equipment that has been in continuous use by the patient for the equipment's reasonable useful lifetime (as defined above). In accordance with the instructions, and consistent with the final rule published on October 30, 2008, suppliers may bill for oxygen contents on a monthly basis after the 36-month rental cap, and the supplier can deliver up to a maximum of three months of oxygen contents at one time. Additionally, in accordance with these instruction, and consistent with the final rule published on October 30, 2008, we now provide replacement equipment to our patients that exceed five years of continuous use.

The ongoing financial impact of the 36-month rental cap will depend upon a number of variables, including, (i) the number of Medicare oxygen customers reaching 36 months of continuous service, (ii) the number of patients receiving oxygen contents beyond the 36-month rental period and the coverage and billing requirements established by CMS for suppliers to receive payment for such oxygen contents, (iii) the mortality rates of patients on service beyond 36 months, (iv) the incidence of patients with equipment deemed to be beyond its reasonable useful life that may be eligible for new equipment and therefore a new rental episode and the coverage and billing requirements established by CMS for suppliers to receive payment for a new rental period, (v) any breaks in continuous use due to medical necessity, and (vi) payment amounts established by CMS to reimburse suppliers for maintenance of oxygen equipment. We cannot predict the impact that any future rulemaking by CMS will have on our business. If payment amounts for oxygen equipment and contents are further reduced in the future, this could have a material adverse effect on our financial condition, revenues, profit margins, profitability, operating cash flows and results of operations.

CMS also has authority to make other adjustments to reimbursement for HME. With the passage of the Balanced Budget Act of 1997, CMS may determine to increase or reduce the reimbursement for HME, including oxygen, by up to 15% each year under an inherent reasonableness procedure. The regulation implementing the inherent reasonableness authority establishes a process for adjusting payments for certain items and services covered by Medicare Part B when the existing payment amount is determined to be grossly excessive or deficient. The regulation lists factors that may be used by CMS and its Medicare contractors to determine whether an existing reimbursement rate is grossly excessive or deficient and to determine what a realistic and equitable payment amount is. Also, under the regulation, CMS and its contractors will not consider a payment amount to be grossly excessive or deficient and make an adjustment if they determine that an overall payment adjustment of less than 15% is necessary to produce a realistic and equitable payment amount. The implementation of the inherent reasonableness procedure itself does not trigger payment adjustments for any items or services and to date, no payment adjustments have occurred or been proposed under this inherent reasonableness procedure.

Though the inherent reasonableness authority has not been exercised, in past years, CMS historically has reduced the published Medicare reimbursement rates for HME to an amount based on the payment amount for the least costly alternative (LCA) treatment that meets the Medicare beneficiary's medical needs. LCA determinations have been applied to particular products and services by CMS and its contractors through the notice and comment process used in establishing local coverage policies for HME. With respect to its LCA policies, on October 16, 2008, a U.S. District Court in the District of Columbia held that CMS did not have the authority to implement LCA determinations in setting payment amounts for an inhalation drug. This decision was upheld by the U.S. Court of Appeals and, as a result, CMS and its contractors withdrew their LCA policy for the inhalation drug. In addition, CMS instructed its contractors that they may no longer apply LCA policies to any HME. Effective February 4, 2011, all coverage policies have been revised to eliminate their LCA provisions.

## Results of Operations

The following table shows our results of operations for the three and six months ended June 30, 2011 and 2010.

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Net revenues	\$122,437	\$124,315	\$243,943	\$247,681
Costs and expenses:				
Cost of net revenues	35,931	40,005	75,029	80,848
Selling, general and administrative	62,994	66,779	125,625	133,187
Provision for doubtful accounts	7,109	4,484	12,348	13,815
Depreciation and amortization	2,261	1,984	4,635	3,989
Total costs and expenses	108,295	113,252	217,637	231,839
Operating income	14,142	11,063	26,306	15,842
Other expense (income):				
Interest expense, net	16,107	11,176	30,674	22,300
Other income, net	(18)	(3,497)	(880)	(3,484)
Loss on debt extinguishment	—	—	1,216	—
Total other expense	16,089	7,679	31,010	18,816
(Loss) earnings before income taxes	(1,947)	3,384	(4,704)	(2,974)
Income tax expense (benefit)	23	(9)	(41)	141
Net (loss) earnings	(1,970)	3,393	(4,663)	(3,115)
Accrued dividends on convertible redeemable preferred stock	108	109	214	200
Net (loss) earnings attributable to common stockholders	<u>\$ (2,078)</u>	<u>\$ 3,284</u>	<u>\$ (4,877)</u>	<u>\$ (3,315)</u>

The following table shows our results of operations as a percentage of our net revenues for the three and six months ended June 30, 2011 and 2010.

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Net revenues	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Cost of net revenues	29.3%	32.2%	30.8%	32.6%
Selling, general and administrative	51.5%	53.7%	51.5%	53.8%
Provision for doubtful accounts	5.8%	3.6%	5.1%	5.6%
Depreciation and amortization	1.8%	1.6%	1.9%	1.6%
Total costs and expenses	88.4%	91.1%	89.3%	93.6%
Operating income	11.6%	8.9%	10.7%	6.4%
Other expense (income):				
Interest expense, net	13.2%	9.0%	12.6%	9.0%
Other income, net	— %	(2.8)%	(0.4)%	(1.4)%
Loss on debt extinguishment	— %	— %	0.5%	— %
Total other expenses	13.2%	6.2%	12.7%	7.6%
(Loss) earnings before income taxes	(1.6)%	2.7%	(2.0)%	(1.2)%
Income tax expense (benefit)	— %	— %	— %	0.1%
Net (loss) earnings	(1.6)%	2.7%	(2.0)%	(1.3)%
Accrued dividends on convertible redeemable preferred stock	0.1%	0.1%	0.1%	0.1%
Net (loss) earnings attributable to common stockholders	<u>(1.7)%</u>	<u>2.6%</u>	<u>(2.1)%</u>	<u>(1.4)%</u>

### Three months ended June 30, 2011 as compared to the three months ended June 30, 2010

Total net revenues for the three months ended June 30, 2011 were \$122.4 million as compared to \$124.3 million for the comparable period in 2010. This net decrease of \$1.9 million from the comparable period in 2010 is primarily attributable to a \$4.6 million reduction in nebulizer medication reimbursement and volume, a \$0.9 million reduction from competitive bidding, and a \$0.9 million reduction associated with non-patient service revenue and other changes in Medicare reimbursement. These decreases were partially offset by \$2.6 million from organic growth in our core oxygen and CPAP product lines and approximately \$2.1 million associated with patients transitioned onto service with us through equipment purchases.

Cost of net revenues totaled \$35.9 million for the three months ended June 30, 2011, a decrease of \$4.1 million, or 10.2%, from the comparable period in 2010. Cost of net revenues for the three months ended June 30, 2011 and 2010 was comprised of the following:

	Three months ended June 30,	
	2011	2010
<b>Cost of net revenues:</b>		
Product and supply costs	\$21,342	\$25,247
Patient service equipment depreciation	12,425	12,578
Operating costs	2,164	2,180
	<u>\$35,931</u>	<u>\$40,005</u>

The decrease in product and supply costs is primarily attributable to the reduced volume in our nebulizer medication business. In addition, our CPAP supply product costs have decreased as a result of lower pricing associated with achievement of higher purchase volume tiers with certain of our vendors. Cost of net revenues as a percentage of net revenues was 29.3% for the three months ended June 30, 2011 as compared to 32.2% for the comparable period in 2010.

Selling, general and administrative expenses for the three months ended June 30, 2011 totaled \$63.0 million, a decrease of \$3.8 million, or 5.7%, from the comparable period in 2010. The decrease in selling, general and administrative expenses was primarily attributable to a \$2.4 million decrease in insurance costs as a result of lower claims incurrence and design changes to our health insurance plans, a \$1.3 million reduction in salary-related costs primarily from a 2% reduction in full-time equivalent employee count compared to the comparable period in 2010, and a \$1.2 million reduction in fleet costs associated with the buy-out of our vehicle leases during 2010. These decreases were partially offset by increased fuel costs as a result of higher gas prices. Selling, general and administrative expenses as a percentage of net revenues decreased to 51.5% for the three months ended June 30, 2011 from 53.7% for the three months ended June 30, 2010.

The provision for doubtful accounts for the three months ended June 30, 2011 totaled \$7.1 million, a \$2.6 million increase from the comparable period in 2010. As a percentage of net revenues, the provision for doubtful accounts was 5.8% and 3.6% for the three months ended June 30, 2011 and 2010, respectively. This increase is attributable to the factors described below under the heading "Liquidity and Capital Resources."

Depreciation and amortization for the three months ended June 30, 2011 totaled \$2.3 million, an increase of \$0.3 million from the comparable period in 2010. This increase was mainly the result of purchased vehicles, including those acquired in conjunction with certain equipment and asset purchase transactions. Depreciation and amortization as a percentage of net revenues increased to 1.8% as compared to 1.6% for the comparable period in 2010.

Net interest expense for the three months ended June 30, 2011 totaled \$16.1 million, an increase of \$4.9 million from the comparable period in 2010. This increase is primarily the result of the refinancing of the Senior Facility with our Senior Secured Notes in October 2010 and the refinancing of the Senior Subordinated Notes with our Senior Second Lien Notes in March 2011. The Senior Secured Notes bear interest at 10.75% and the Senior Second Lien Notes bear interest at 10.5% while the Senior Facility had an average variable interest rate of 6.3% and the Senior Subordinated Notes bore interest at 9.5%.

Other income for the three months ended June 30, 2011 totaled \$0.02 million, a decrease of \$3.5 million from the comparable period in 2010. During the month of April 2010, we settled a commercial arbitration proceeding related to previously unpaid claims and associated interest, fees, expenses and legal costs. The net amount received as a result of this settlement, after consideration of all legal costs and expenses incurred was approximately \$2.9 million. The settlement is the primary difference in other income for the three months ended June 30, 2011 compared to the comparable period in 2010.

Net loss for the three months ended June 30, 2011 was \$2.0 million compared to net earnings of \$3.4 million for the comparable period in 2010. This difference is attributable to the changes in revenue, costs and expenses and other income described above.

#### **Six months ended June 30, 2011 as compared to the six months ended June 30, 2010**

Total net revenues for the six months ended June 30, 2011 were \$243.9 million as compared to \$247.7 million for the comparable period in 2010. This net decrease of \$3.7 million from the comparable period in 2010 is primarily attributable to a \$6.5 million reduction in nebulizer medication reimbursement and volume, a \$2.0 million reduction from competitive bidding, and a \$2.1 million reduction associated with non-patient service revenue and other changes in Medicare reimbursement. These decreases were partially offset by \$5.2 million from organic growth in our core oxygen and CPAP product lines and approximately \$1.7 million of net increase associated with patients transitioned onto service with us through equipment purchases.

Cost of net revenues totaled \$75.0 million for the six months ended June 30, 2011, a decrease of \$5.8 million, or 7.2%, from the comparable period in 2010. Cost of net revenues for the three months ended June 30, 2011 and 2010 was comprised of the following:

	Six months ended June 30,	
	2011	2010
<b>Cost of net revenues:</b>		
Product and supply costs	\$45,570	\$50,899
Patient service equipment depreciation	25,140	25,718
Operating costs	4,319	4,231
	<u>\$75,029</u>	<u>\$80,848</u>

The decrease in product and supply costs is primarily attributable to the reduced volume in our nebulizer medication business. In addition, our CPAP supply product costs have decreased as a result of lower pricing associated with achievement of higher purchase volume tiers with certain of our vendors. Cost of net revenues as a percentage of net revenue was 30.8% for the six months ended June 30, 2011 as compared to 32.6% for the comparable period in 2010.

Selling, general and administrative expenses for the six months ended June 30, 2011 totaled \$125.6 million, a decrease of \$7.6 million, or 5.7%, from the comparable period in 2010. The decrease in selling, general and administrative expenses was primarily attributable to a \$3.5 million decrease in insurance costs as a result of lower claims incurrence and design changes to our health insurance plans, a \$2.5 million reduction in fleet costs associated with the buy-out of our vehicle leases during 2010, a \$1.9 million reduction in salary-related costs primarily from a 2% reduction in full-time equivalent employee count compared to the comparable period in 2010, and a \$1.2 million decrease in telecom expenses associated with an excise tax refund (\$0.6 million, net of associated fees) and renegotiated telecom contracts. These decreases were partially offset by increased fuel costs as a result of higher gas prices, and increased contract and temporary labor costs as a result of increased utilization of respiratory therapists and transition costs associated with equipment purchases. Selling, general and administrative expenses as a percentage of net revenues decreased to 51.5% for the six months ended June 30, 2011 from 53.8% for the six months ended June 30, 2010.

The provision for doubtful accounts for the six months ended June 30, 2011 totaled \$12.3 million, a \$1.5 million decrease from the comparable period in 2010. During 2009, we transitioned all patient-related collection activities to a third-party vendor. We experienced extended delays and implementation issues associated with this transition. During the quarter ended March 31, 2010, we completed the initial collection phases associated with the early patient balances most impacted by these transition issues and determined that an additional provision for doubtful accounts in the amount of \$5.0 million was required to allow for a lower percentage of collection on patient receivables resulting from these transition issues. Management believes that these transition issues have been fully resolved and the associated increase in the provision for doubtful accounts recorded during the three months ended March 31, 2010 is not expected to recur. As a percentage of net revenue, excluding the \$5.0 million additional provision for the three months ended March 31, 2010, the provision for doubtful accounts increased from 3.6% for the six months ended June 30, 2010 to 5.1% for the six months ended June 30, 2011. This increase is attributable to the factors described below under the heading "Liquidity and Capital Resources."

Depreciation and amortization for the six months ended June 30, 2011 totaled \$4.6 million, an increase of \$0.6 million from the comparable period in 2010. This increase was mainly the result of purchased vehicles, including those acquired in conjunction with certain equipment and asset purchase transactions. Depreciation and amortization as a percentage of net revenues increased to 1.9% as compared to 1.6% for the comparable period in 2010.

Net interest expense for the six months ended June 30, 2011 totaled \$30.7 million, an increase of \$8.4 million from the comparable period in 2010. This increase is primarily the result of the refinancing of the Senior Facility in October 2010 with our Senior Secured Notes and the refinancing of the Senior Subordinated Notes with our Senior Second Lien Notes in March 2011. The Senior Secured Notes bear interest at 10.75% and the Senior Second Lien Notes bear interest at 10.5% while the Senior Facility had an average variable interest rate of 6.3% and the Senior Subordinated Notes bore interest at 9.5%.

Other income for the six months ended June 30, 2011 totaled \$0.9 million, a decrease of \$2.6 million from the comparable period in 2010. During the month of April 2010, we settled a commercial arbitration proceeding related to previously unpaid claims and associated interest, fees, expenses and legal costs. The net amount received as a result of this settlement, after consideration of all legal costs and expenses incurred, was approximately \$2.9 million. The settlement is the primary difference in other income for the six months ended June 30, 2011 compared to the comparable period in 2010.

As a result of the redemption of the 9.5% Senior Subordinated Notes due 2012 (the “Senior Subordinated Notes”), we recorded a \$1.2 million loss on extinguishment of debt related to unamortized debt issuance costs.

Net loss for the six months ended June 30, 2011 was \$4.7 million compared to a net loss of \$3.1 million for the six months ended June 30, 2010. This difference is attributable to the changes in revenue, costs and expenses and other income described above.

### Non-GAAP Financial Measure

We present Adjusted EBITDA as a supplemental measure of our performance that is not required by, or presented in accordance with, generally accepted accounting principles (GAAP) in the United States of America. We define Adjusted EBITDA as net earnings (loss) adjusted for (i) income tax (benefit) expense, (ii) interest expense and (iii) depreciation and amortization, as further adjusted to eliminate the impact of certain items, consistent with definitions provided under our former Senior Facility, that we do not consider indicative of our ongoing operating performance. These further adjustments are itemized below. You are encouraged to evaluate these adjustments and the reasons we consider them appropriate for supplemental analysis. We believe Adjusted EBITDA assists investors and securities analysts in comparing our performance across reporting periods on a consistent basis by excluding items, consistent with definitions provided under our former Senior Facility, that we do not believe are indicative of our core operating performance. However, there may be additional items which are non-recurring as set forth above in Management’s Discussion and Analysis of Financial Condition and Results of Operations. We use Adjusted EBITDA to evaluate the effectiveness of our business strategies. In evaluating Adjusted EBITDA, you should be aware that in the future we may incur expenses that are the same as or similar to some of the adjustments in this presentation. Our presentation of Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

The following table is a reconciliation of Adjusted EBITDA to net (loss) earnings (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Net (loss) earnings	\$ (1,970)	\$ 3,393	\$ (4,663)	\$ (3,115)
Income tax expense (benefit)	23	(9)	(41)	141
Interest expense	16,120	11,185	30,838	22,348
Depreciation and amortization, including patient service equipment depreciation	14,685	14,562	29,775	29,708
Accounts receivable adjustment <sup>(1)</sup>	—	—	—	5,000
Non-cash equity-based compensation expense	160	80	193	167
Restructuring related costs <sup>(2)</sup>	16	33	22	99
Settlement costs <sup>(3)</sup>	—	—	18	21
Loss on extinguishment of debt <sup>(4)</sup>	—	—	1,216	—
	<u>\$29,034</u>	<u>\$29,244</u>	<u>\$57,358</u>	<u>\$54,369</u>

<sup>(1)</sup> Accounts receivable adjustments associated with specific collection issues that are not considered indicative of our ongoing operation performance. During 2009, we transitioned all patient-related collection activities to a third-party vendor. We experienced extended delays and implementation issues associated with this transition. During the quarter ended March 31, 2010, we completed the initial collection phases associated with the early patient balances most impacted by these transition issues and determined that an additional provision for doubtful accounts in the amount of \$5.0 million was required to allow for a lower percentage of collection on patient receivables resulting from these transition issues. Management believes that these transition issues have been fully resolved and the associated increase in the provision for doubtful accounts recorded during the three months ended March 31, 2010 is not expected to recur.

<sup>(2)</sup> Restructuring related costs generally consist of severance and location closure costs.

<sup>(3)</sup> Settlement costs incurred outside our ordinary course of business which we do not believe reflect the current and ongoing cash charges related to our operating cost structure.

<sup>(4)</sup> We redeemed our 9.5% Senior Subordinated Notes due April 2012 on March 17, 2011, and recorded a \$1.2 million loss on extinguishment of debt related to unamortized debt issue costs.

Adjusted EBITDA should not be considered as a measure of financial performance under GAAP, and the items excluded from EBITDA are significant components in understanding and assessing financial performance. Adjusted EBITDA has limitations as an analytical tool. Some of these limitations are:

- Adjusted EBITDA does not reflect our cash expenditures, future requirements for capital expenditures or contractual commitments;
- Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- Adjusted EBITDA does not reflect significant interest expense, or the cash requirements necessary to service interest or principal payments on our debts;

- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements;
- non-cash compensation is and will remain a key element of our overall long-term incentive compensation package, although we exclude it as an expense when evaluating our ongoing operating performance for a particular period;
- Adjusted EBITDA does not reflect the impact of certain cash charges resulting from matters we consider not to be indicative of our ongoing operations; and
- other companies in our industry may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

Because of these limitations, Adjusted EBITDA should not be considered in isolation or as a substitute for performance measures calculated in accordance with GAAP. We compensate for these limitations by relying primarily on our GAAP results and using Adjusted EBITDA only supplementally.

### **Liquidity and Capital Resources**

Net cash provided by operating activities was \$12.9 million for the six months ended June 30, 2011, as compared to \$20.1 million for the same period in 2010. Our working capital requirements relate primarily to the working capital needed for general corporate purposes. Cash flows and cash on hand were sufficient to fund operations, capital expenditures and required repayments of debt during the six months ended June 30, 2011. Based on current conditions, we believe that the cash generated from our operations and cash balances will be sufficient to meet our working capital, capital expenditure and other cash needs during the next twelve months, including payment of interest amounts on our Senior Secured Notes and Senior Second Lien Notes when due. In addition, we have \$10.0 million available under our revolving credit facility which expires March 17, 2012.

Accounts receivable before allowance for doubtful accounts increased to \$91.1 million at June 30, 2011 from \$78.5 million at December 31, 2010. Allowances for contractual adjustments and doubtful accounts as a percentage of accounts receivable totaled 30.3% and 31.6% as of June 30, 2011 and December 31, 2010, respectively. Days sales outstanding (DSO) in accounts receivable (calculated as of each period end by dividing net accounts receivable by the 90-day rolling average of net revenue) were 58.5 days at June 30, 2011, compared to 49.5 days at December 31, 2010 and 54.6 days at June 30, 2010. There are several factors that continue to impact our DSO, including, but not limited to:

- Lengthened initial collection cycles for patients transitioned onto service with us through equipment purchases. When we purchase equipment from competitors and transition their patients onto service with us, we are required to obtain revised documentation from the patient's physician, which requires additional resources and time to obtain and thereby extends the collection cycle during the transition period.
- Managed care business. As a result of our increases in managed care volumes, we have experienced increases in our DSO as a result of comparatively longer collections cycles from managed care payors, as well as increased patient copayment obligations which likewise have a longer collection cycle.
- Increased patient responsibility. We continue to see increased patient responsibility for healthcare costs. These increases include the impact of high deductible insurance plans, increased deductible and copayment levels under employer sponsored plans and increased levels of patients without insurance coverage due to job loss (or job change). We have implemented more stringent collection standards with respect to balances due directly from patients including enhanced internal collection efforts and utilization of a third-party collection resource. While these changes have increased our DSO, we believe that our efforts will ultimately result in greater collection of amounts due from patients.

During 2009, we transitioned all patient-related collection activities to a third-party vendor. We experienced extended delays and implementation issues associated with this transition. During the quarter ended March 31, 2010, we completed the initial collection phases associated with the early patient balances most impacted by these transition issues and determined that an additional provision for doubtful accounts in the amount of \$5.0 million was required to allow for a lower percentage of collection on patient receivables resulting from these transition issues. Management believes that these transition issues have been fully resolved and the associated increase in the provision for doubtful accounts recorded during the three months ended March 31, 2010 is not expected to recur.

The following tables set forth the percentage breakdown of our accounts receivable by payor and aging category as of June 30, 2011 and December 31, 2010:

### June 30, 2011

<u>Accounts receivable by payor and aging category:</u>	<u>Government</u>	<u>Managed Care and Other</u>	<u>Patient Responsibility</u>	<u>Total</u>
Aged 0-90 days	38%	19%	9%	66%
Aged 91-180 days	7%	5%	10%	22%
Aged 181-360 days	3%	2%	6%	11%
Aged over 360 days	1%	0%	0%	1%
<b>Total</b>	<b>49%</b>	<b>26%</b>	<b>25%</b>	<b>100%</b>

### December 31, 2010

<u>Accounts receivable by payor and aging category:</u>	<u>Government</u>	<u>Managed Care and Other</u>	<u>Patient Responsibility</u>	<u>Total</u>
Aged 0-90 days	38%	21%	8%	67%
Aged 91-180 days	5%	5%	7%	17%
Aged 181-360 days	4%	4%	7%	15%
Aged over 360 days	0%	1%	0%	1%
<b>Total</b>	<b>47%</b>	<b>31%</b>	<b>22%</b>	<b>100%</b>

Included in accounts receivable are earned but unbilled receivables of \$21.7 million at June 30, 2011 and \$18.9 million at December 31, 2010. These amounts include \$5.1 million at June 30, 2011 and \$3.6 million at December 31, 2010 of receivables for which a prior authorization is required but has not yet been received. 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. In addition to the aforementioned delays, we are required to obtain revised documentation for patients transitioned onto service with us through equipment purchases which results in increased initial billing cycles for these patients. Earned but unbilled receivables are aged from the date of service and are considered in our analysis of historical performance and collectability.

Due to the nature of the industry and the reimbursement environment in which we operate, 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 our financial condition, revenues, profit margins, profitability, operating cash flows and results of operations.

We derive a significant portion of our revenues from the Medicare and Medicaid programs and from managed care health plans. Payments for services rendered to patients covered by these programs may be less than billed charges. Revenue is recognized at net realizable amounts estimated to be paid by customers and third-party payors. Our billing system contains payor-specific price tables that reflect the fee schedule amounts in effect or contractually agreed upon by various government and commercial payors for each item of equipment or supply provided to a customer. For Medicare and Medicaid revenues, as well as most other managed care and private payors, final payment is subject to administrative review and audit. Management makes estimated provisions for adjustments, which may result from administrative review and audit, based upon historical experience. Management closely monitors its historical collection rates as well as changes in applicable laws, rules and regulations and contract terms to help assure that provisions are made using the most accurate information management believes to be available. However, due to the complexities involved in these estimations, actual payments we receive could be different from the amounts we estimate and record.

Collection of receivables from third-party payors and patients is our primary source of cash and is critical to our operating performance. We manage billing and collection of accounts receivable through our own billing and collection centers. In addition, we utilize third-party collection resources to manage collection of amounts due from patients. Our primary collection risks relate to patient accounts for which the primary insurance payor has paid, but patient responsibility amounts (generally deductibles and co-payments) remain outstanding. We record bad debt expense based on a percentage of revenue using historical Company-specific data. The percentage and amounts used to record bad debt expense and the allowance for doubtful accounts are supported by various

methods including current and historical cash collections, bad debt write-offs, and aging of accounts receivable. Accounts are written off against the allowance when all collection efforts (including payor appeals processes) have been exhausted. We routinely review accounts receivable balances in conjunction with our historical contractual adjustment and bad debt rates and other economic conditions which might ultimately affect the collectability of patient accounts when we consider the adequacy of the amounts we record as provision for doubtful accounts. Significant changes in payor mix, business office operations, economic conditions or trends in federal and state governmental health care coverage could affect our collection of accounts receivable, cash flows and results of operations. Further, even if our billing procedures comply with all third-party payor requirements, some of our payors may experience financial difficulties, may delay payments or may otherwise not pay accounts receivable when due, which would result in increased write-offs or provisions for doubtful accounts. If we are unable to collect our accounts receivable on a timely basis, our revenues, profitability and cash flow likely will significantly decline.

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 revenues, profit margins, profitability, operating cash flows and results of operations. Our future liquidity may be materially adversely impacted by health care reform.

Net cash used in investing activities was \$23.8 million for the six months ended June 30, 2011, as compared to \$22.9 million for the same period in 2010. We currently have no contractual commitments for capital expenditures over the next twelve months other than to acquire equipment as needed to supply our patients. Our business requires us to make significant capital expenditures relating to the purchase and maintenance of the medical equipment used in our business. Cash paid for capital expenditures totaled approximately \$24.5 million for the six months ended June 30, 2011 as compared to \$24.3 million for the same period in 2010, including \$6.1 million and \$2.3 million paid for equipment purchases from competitors exiting the home health care market, respectively. Some of the equipment purchased in these transactions is currently on rent and located in a patient's home. As such, we have the opportunity to transition such patients onto service with our Company. We also paid \$3.2 million for the six months ended June 30, 2011 for asset purchases from competitors. These increases in cash used in investing activities were partially offset by a \$4.2 million reduction in our surety bond and letter of credit collateral included in restricted cash.

Refer to the "Notes to Condensed Consolidated Financial Statements—(9) Debt" included herein in Item 1, "Financial Statements," for a complete description of our outstanding indebtedness.

We have outstanding letters of credit totaling \$8.8 million as of June 30, 2011 and December 31, 2010. Our letters of credit were cash collateralized at 100% and 105% of their face amount, as of June 30, 2011 and December 31, 2010, respectively. The cash collateral for these outstanding letters of credit is included in restricted cash in our consolidated balance sheet as of June 30, 2011 and December 31, 2010.

Cash flows from financing activities primarily relate to our debt facilities and outstanding debt. Our outstanding debt includes the following:

- \$224.3 million in aggregate principal amount of Senior Secured Notes, the proceeds of which were used to repay our Senior Facility. The notes mature on October 15, 2015. Interest of 10.75% is payable semi-annually in arrears on April 15 and October 15 of each year. We made our regularly scheduled April 15 interest payment of \$13.0 million during the six months ended June 30, 2011. Accrued interest on the Senior Secured Notes totaled \$5.2 million and \$6.2 million at June 30, 2011 and December 31, 2010, respectively.
- \$284.9 million aggregate principal amount of Senior Second Lien Notes, the proceeds of which were used to repay our Senior Subordinated Notes. The notes mature on March 15, 2018. Interest of 10.5% is payable semi-annually in arrears on March 15 and September 15 of each year. Accrued interest on the Senior Second Lien Notes totaled \$8.9 million at June 30, 2011.

### **Off-balance Sheet Arrangements and Contractual Obligations**

We do not have off-balance sheet arrangements (as that term is defined in Item 303(a)(4)(ii) of Regulation S-K) that have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### **Critical Accounting Policies**

Refer to Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," as presented in our Annual Report on Form 10-K for the year ended December 31, 2010 regarding our critical accounting policies.

## **Forward-Looking Statements**

This report contains certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and the provisions of section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act) and section 27A of the Securities Act of 1933, as amended. These forward-looking statements include all statements regarding the intent, belief or current expectations regarding the matters discussed in this report and all statements which are not statements of historical fact. Words such as “expects,” “anticipates,” “intends,” “plans,” “believes,” “estimates,” “projects,” “may,” “will”, “could”, “should”, “would”, variations of such words and similar expressions are intended to identify such forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties, contingencies and other factors that could cause results, performance or achievements to differ materially from those stated in this report. The following are some but not all of such risks, uncertainties, contingencies, assumptions and other factors, many of which are beyond our control, that could cause results, performance or achievements to differ materially from those anticipated: general economic, financial and business conditions; setting of new reimbursement rates and other changes in reimbursement policies, the timing of reimbursements and other legislative initiatives aimed at reducing health care costs associated with Medicare and Medicaid; issues relating to reimbursement by government and third-party payors for our products and services generally; the impact of competitive bidding on Medicare volume in the impacted competitive bidding areas; the costs associated with government regulation of the health care industry; health care reform and the effect of changes in federal and state health care regulations generally; whether we will be subject to additional regulatory restrictions or penalties; issues relating to our ability to maintain effective internal control over financial reporting and disclosure controls and procedures; compliance with federal and state regulatory agencies, as well as accreditation standards and confidentiality requirements with respect to patient information; the effects of competition, industry consolidation and referral sources; recruiting, hiring and retaining qualified employees and directors; compliance with various settlement agreements and corporate compliance programs; the costs and effects of legal proceedings; our ability to meet our working capital, capital expenditures and other liquidity needs; our ability to maintain compliance with the covenants contained in our indentures for our senior secured notes and our senior second lien notes; our ability to successfully transition and retain patients associated with equipment and asset purchases; our ability to maintain current levels of collectability on our accounts receivable; the risks and uncertainties discussed under the heading “Certain Significant Risks and Uncertainties and Significant Events” in Note 8 of the Condensed Consolidated Financial Statements in Part I, Item 1 of this Form 10-Q and other factors described in our filings with the Securities and Exchange Commission. Readers should refer to the discussion under “Risk Factors” in Part II, Item 1A contained in our Annual Report on Form 10-K for the year ended December 31, 2010 for a description of additional risks and uncertainties. Should one or more of these risks or uncertainties materialize or should underlying assumptions prove incorrect, our actual results, performance or achievements could differ materially from those expressed in, or implied by, such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date thereof. When you consider these forward-looking statements, you should keep in mind these risk factors and other cautionary statements in this report. We do not undertake any obligation to release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

## **Item 3—Quantitative and Qualitative Disclosures About Market Risk**

We are a smaller reporting company as defined by Rule 12b-2 of the Securities Exchange Act of 1934 and are not required to provide the information under this Item.

## **Item 4—Controls and Procedures**

### **Disclosure Controls and Procedures**

As required by Rule 13a-15(b) of the Exchange Act, our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our principal executive officer and principal financial officer have concluded, as of the end of such period, that our disclosure controls and procedures are effective.

### **Internal Control over Financial Reporting**

As required by Rule 13a-15(d) of the Exchange Act, our management with the participation of our principal executive officer and principal financial officer, has evaluated any changes in our internal control over financial reporting that occurred during the fiscal quarter covered by this report.

In connection with this evaluation, there were no changes identified during the second quarter of fiscal year 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II—OTHER INFORMATION

### Item 1—Legal Proceedings

Information required for Part II, Item 1 is incorporated herein by reference to the discussion under the heading “Certain Significant Risks and Uncertainties and Significant Events” in Note 8 of the Condensed Consolidated Financial Statements in Part I, Item 1 of this Form 10-Q. See also Part I, Item 3 “Legal Proceedings” of our 2010 Annual Report on Form 10-K, filed on February 28, 2011.

### Item 1A—Risk Factors

There have been no material changes from the risk factors previously disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010 and the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2011, except for the following:

*A significant percentage of our business is derived from patients with primary health coverage under Medicare Part B, and as such, any decreases in Medicare Part B reimbursement rates are likely to have a material adverse effect on our financial condition, revenues, profit margins, profitability, operating cash flows and results of operations.*

As a home medical equipment (HME) provider, we are heavily dependent on Medicare reimbursement with approximately 40% of our revenue reimbursed under Medicare Part B. There are increasing pressures on Medicare to control health care costs and to reduce or limit reimbursement rates for home medical equipment and services. Medicare reimbursement is subject to statutory and regulatory changes, retroactive rate adjustments, administrative and executive orders and governmental funding restrictions, all of which could materially decrease payments to us for the services and equipment we provide.

Recent legislation containing provisions that directly impact reimbursement for the primary HME products that we provide have had a material adverse effect on our financial condition, revenues, profitability, profit margins, operating cash flows and results of operations. The most recent health care reform enacted in March 2010 is discussed in more detail below. Prior legislation with continued impact on our business includes, but is not limited to:

- **Medicare Improvements for Patients and Providers Act of 2008 (MIPPA).** MIPPA delayed the implementation of a Medicare competitive bidding program for oxygen equipment and certain other HME items that was scheduled to begin on July 1, 2008 and instituted a 9.5% price reduction nationwide for these items as of January 1, 2009.
- **Medicare, Medicaid and SCHIP Extension Act of 2007 (“SCHIP Extension Act”).** The SCHIP Extension Act reduced Medicare reimbursement amounts for covered Part B drugs, including inhalation drugs that we provide, beginning April 1, 2008.
- **Deficit Reduction Act of 2005 (DRA).** DRA provisions negatively impacted reimbursement for oxygen equipment beginning in 2009 and negatively impacted reimbursement for HME items subject to capped rental payments beginning in 2007.
- **Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA).** MMA significantly reduced reimbursement for inhalation drug therapies beginning in 2005, reduced payment amounts for certain categories of durable medical equipment (DME), including oxygen, beginning in 2005, froze payment amounts for other covered HME items through 2007, established a competitive acquisition program for HME and implemented quality standards and accreditation requirements for HME suppliers.

These legislative provisions, as currently in effect and when fully implemented, have had and will have a material adverse effect on our financial condition, revenues, profit margins, profitability, operating cash flows and results of operations. In addition, Medicare reimbursement may be reduced in connection with recently proposed, currently pending and future legislation relating to the federal government’s ability to incur or pay interest on its indebtedness. The impact of recent reimbursement changes are discussed in more detail under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operation” in Part I, Item 2.

### Item 5—Other Information

On August 8, 2011, in order to provide for an orderly succession plan, Rotech Healthcare, Inc. (the “Company”) entered into an amendment (the “Amendment”) to the Second Amended and Restated Employment Agreement, originally dated October 6, 2008, between the Company and Philip L. Carter, the Company’s Chief Executive Officer (the “Executive”).

The Amendment provides that after December 31, 2011 (the “Transition Date”), the board of directors of the Company may take any action reasonably necessary in furtherance of planning for the hiring of a new Chief Executive Officer and that following the Transition Date, the Executive will assist with the orderly transition of his duties to his successor.

As amended by the Amendment, the Agreement provides that if at any time following the Transition Date, the Company

terminates the Executive's employment without Cause (as defined in the Agreement) or the Executive voluntarily resigns his employment with the Company, the Executive will receive retirement benefits from the Company consisting of the following, subject to his signing and not revoking a general release of claims in favor of the Company: (i) a lump sum cash payment equal to one times the Executive's then current annual base salary, plus the full amount of the Executive's target bonus for the year in which the termination occurs and \$10,000 in lieu of outplacement services, (ii) accelerated vesting of any of the Executive's then-unvested stock options, and (iii) certain benefit continuation amounts and other in-kind benefits. In addition, the Executive will receive all payments and benefits accrued through the date of termination, including a pro rata portion of the current year's target bonus amount, but not including the discretionary portion of any unpaid bonus earned for the prior year, whether or not previously accrued. The Company and the Executive are required to provide six months' notice before any such termination.

The retirement benefits described above are provided in lieu of any other severance entitlements, such that following the Transition Date the Executive will not be entitled to the severance benefits other than the retirement benefits described above, including the severance benefits previously provided under the Agreement, which previously provided for a severance upon a termination of the Executive's employment by the Company without Cause or by the Executive for Good Reason (as such terms are defined in the Agreement) in the amount of three times the Executive's base salary and target bonus amount, in addition to other benefits. The Amendment does not change the payments or benefits the Executive would receive upon a change in control of the Company. The Executive will also remain subject to the non-competition, non-solicitation and confidentiality covenants contained in the Agreement.

The foregoing summary is qualified in its entirety by reference to the full text of the Amendment, a copy of which is attached as Exhibit 10.2 to this Quarterly Report on Form 10-Q and incorporated herein by reference.

#### **Item 6—Exhibits**

##### (a) Exhibits:

- 10.1 Rotech Healthcare Inc. Equity Award Plan (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K, filed on June 22, 2011).
- 10.2 Employment Agreement Amendment to the Second Amended and Restated Employment Agreement with Philip L. Carter dated August 8, 2011.
- 31.1 Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following materials from the Quarterly Report on Form 10-Q for Rotech Healthcare Inc. for the quarter ended June 30, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at June 30, 2011 and December 31, 2010; (ii) Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2011 and 2010; (iii) Condensed Consolidated Statement of Cash Flows for the six months ended June 30, 2011 and 2010; and (iv) Notes to Condensed Consolidated Financial Statements\*.

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.



## Index to Exhibits

<u>Exhibit No.</u>	<u>Description</u>
10.1	Rotech Healthcare Inc. Equity Award Plan (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K, filed on June 22, 2011).
10.2	Employment Agreement Amendment to the Second Amended and Restated Employment Agreement with Philip L. Carter dated August 8, 2011.
31.1	Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following materials from the Quarterly Report on Form 10-Q for Rotech Healthcare Inc. for the quarter ended June 30, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at June 30, 2011 and December 31, 2010; (ii) Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2011 and 2010; (iii) Condensed Consolidated Statement of Cash Flows for the six months ended June 30, 2011 and 2010; and (iv) Notes to Condensed Consolidated Financial Statements*.
*	Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**EMPLOYMENT AGREEMENT AMENDMENT**

This Employment Agreement Amendment (the "Amendment") to that certain Second Amended and Restated Employment Agreement dated October 6, 2008 (the "Employment Agreement") is made and entered into on August 8, 2011 (the "Effective Date"), by and between Rotech Healthcare Inc., a Delaware corporation (the "Company") and Philip L. Carter (the "Executive").

WHEREAS, Executive is currently employed as the President and Chief Executive Officer of the Company pursuant to the Employment Agreement;

WHEREAS, the Board of Directors of the Company and the Executive believe that it is in the best interest of the Company to provide for an orderly succession plan;

WHEREAS, the Board of Directors of the Company wishes to recognize the service and contributions of the Executive over this tenure as Chief Executive officer;

NOW, THEREFORE, for good and valuable consideration, the receipt of which is hereby acknowledged, the Company and the Executive hereby agree to amend the Employment Agreement as follows:

1. The Employment Agreement is hereby amended to add a new Section 4.5 to read as follows:

"4.5 The Board and the Executive desire to provide for additional terms related to President and Chief Executive Officer succession planning.

(a) Retirement Award. If at any time following December 31, 2011 (the "**Transition Date**"), the Company terminates the Executive without Cause pursuant to Section 3.1.5 or the Executive ends his employment relationship with the Company pursuant to Section 3.1.7, then, in addition to the payments provided in Section 4.1, which payments shall include the pro rata bonus in Section 4.1(d), whether or not the termination is voluntary by the Executive without Good Reason:

(i) the Company shall pay to the Executive a lump-sum retirement payment equal to one (1) times (1X) the sum of (A) the Executive's then current Base Salary, (B) \$10,000 in lieu of outplacement services, plus (C) the full amount of the Target Bonus for the year in which the termination occurs, which amount shall be payable on the first Company payroll date occurring on or following the first day of the seventh (7th) month following the date of termination of employment;

(ii) the Company shall continue to provide for a period of twelve (12) months following the date of termination of employment (or until such earlier date that substantially the same or better benefits are provided by a successor employer) (the "**Retirement Continuation Period**") medical, life, dental and vision insurance benefits provided pursuant to Section 2.5 (for the Executive and his spouse and dependents, if applicable), pursuant and subject to the paragraph below that further discusses health benefits;

(iv) the Company shall continue to provide for a period of twelve (12) months following the date of termination of employment, the benefits provided in Section 2.4 regarding use of a Company vehicle, which vehicle shall be the vehicle that the Executive is using immediately prior to the date of termination;

(v) the Executive shall be entitled to retain his Company computer, iPad, cellular phone and other similar communications equipment; provided, that the Company may remove from such devices any Company confidential information; and

(vi) subject to the effectiveness of the release described in this Section 4.5, all of Executive's stock options to purchase shares of the Company's common stock that are outstanding immediately prior to the date of the Executive's termination shall fully vest on the date of the Executive's termination (collectively the compensation and benefits under clauses (i), (ii) and (iii), the "**Retirement Benefits**").

With respect to the health benefits under Section 4.5(a)(ii), the Executive (and, if applicable, his dependents) shall timely elect COBRA continuation of group medical, dental and vision coverage following the termination of the Executive's employment. Provided that the Executive timely elects COBRA coverage, the Company shall pay for or reimburse the Executive for, during the Retirement Continuation Period, the monthly premium for such COBRA coverage in an amount equal to 100% of such premium, less any applicable tax withholding. Subject to the Executive timely electing COBRA, payment of monthly premiums shall apply to all medical, dental and vision plans under which the Executive participates while the Executive is an active employee of the Company, including, without limitation, the executive benefit program.

Notwithstanding anything in to the contrary in this Agreement or any bonus plan, in the event the Executive becomes entitled to any compensation or benefits pursuant to this Section 4.5(a), the Executive shall not be entitled to the discretionary portion of any bonus otherwise payable under Section 4.1(c), whether or not previously accrued.

(b) Other Provisions and Benefits. Following the Transition Date, the Executive shall no longer be eligible to receive any compensation or benefits pursuant to Sections 4.2 or 4.3. Instead, the Executive shall only be eligible to receive retirement compensation and benefits pursuant and subject to this Section 4.5. In addition, Section 5 shall apply following the Transition Date but shall not apply after end of the Employment Period. In the event the Executive is entitled to receive any payment pursuant to Section 4.2 or Section 5, the Executive shall not be entitled to any payments or benefits pursuant to this Section 4.5. In the event the Executive's employment is terminated or otherwise ends during the Employment Period and prior to the Transition Date pursuant to Section 3.1.1, 3.1.2, 3.1.3, 3.1.4, 3.1.5 or 3.1.6, the Executive shall not be entitled to any payments or benefits pursuant to this Section 4.5. Notwithstanding anything in to the contrary in this Agreement, in the event the Executive becomes entitled to any compensation or benefits pursuant to Section 4.5(a), the Executive shall not be entitled to continue to participate in any employee benefit plans, programs or arrangements following the end of the Employment Period, except to the extent provided in this Section 4.5 or explicitly provided in any such plans, programs or arrangements.

(c) Succession Planning; Board Seat; Non-compete.

- (i) Following the Transition Date, the Board may, in its discretion, take any action reasonably necessary in furtherance of planning for the hiring or appointing of a new Chief Executive Officer of the Company, including, but not limited to, hiring consultants and other contractors, hiring and firing employees, changing reporting relationships, promoting and demoting employees and making other personnel related decisions.
- (ii) Following the Transition Date and ending on the date of Executive's termination of employment, the Executive shall, in addition to his other duties and responsibilities to the Company, assist with the orderly transition of his duties and responsibilities to his successor and the Board may, in its discretion, reduce the Executive's title, duties, positions and/or responsibilities.
- (iii) On the termination date, the Executive shall remain eligible to serve on the Board as a non-employee member. While the Executive serves as a non-employee member of the Board, he will be subject to the standard terms and conditions applicable to non-employee members of the Board.

(d) Release; Notice Period; Full Satisfaction.

- (i) Notwithstanding anything to the contrary in this Section 4.5, the Executive shall not be entitled to any Retirement Benefits unless (A) as of, or within twenty-one (21) days following, the date of termination, the Executive executes and delivers a full release of any and all claims the Executive may have against the Releasees arising through the date the release is executed and a covenant not to sue the Releasees and (ii) any revocation period provided for in the release must have expired, (B) the Executive is and remains in full compliance with his obligations under Section 6 of this Agreement, (C) to the extent termination of the Executive's employment is effectuated pursuant to Section 3.1.7, the Executive provides, on or following the Transition Date and prior to the Executive's termination of employment with the Company, not less than six (6) months' prior written notice to the Company of his voluntary resignation pursuant to Section 3.1.7, which the Board may, in its discretion, shorten to no less than one (1) month, and (D) the Executive does not breach the Agreement prior to the end of the Employment Period.
- (ii) Following the Transition Date, the Company agrees to provide the Executive with not less than six (6) months' prior notice in the event it decides to terminate the Executive without Cause pursuant to Section 3.1.5.
- (iii) In the event the Executive's employment is terminated or otherwise ends during the Employment Period and the Executive is entitled to any of the Retirement Benefits pursuant to this Section 4.5, then the Retirement Benefits shall constitute liquidated damages and shall be deemed to satisfy and be in full and final settlement of all obligations to the Executive under this Agreement."

2. No Other Amendment. Except as expressly set forth in this Amendment, the Employment Agreement shall remain unchanged and shall continue in full force and effect according to its terms.

3. Acknowledgement. The Executive acknowledges and agrees that he has carefully read this Amendment in its entirety, fully understands and agrees to its terms and provisions and intends and agrees that it be final and legally binding on the Executive and the Company.

4. Governing Law; Counterparts. This Amendment shall be construed in accordance with the laws of the State of Delaware without reference to principles of conflicts of law and may be executed in several counterparts by the parties.

IN WITNESS WHEREOF, the Company and the Executive have executed this Amendment as of the date first written above.

ROTECH HEALTHCARE INC.

By: /s/ Arthur Reimers

Name: Arthur J. Reimers

Title: Chairman of the Board of Directors

/s/ Philip Carter

Philip L. Carter

**CERTIFICATION**

I, Philip L. Carter, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended June 30, 2011 of Rotech Healthcare Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2011

/s/ PHILIP L. CARTER

---

**Philip L. Carter**  
**President and Chief Executive Officer**

**CERTIFICATION**

I, Steven P. Alsene, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended June 30, 2011 of Rotech Healthcare Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2011

/s/ STEVEN P. ALSENE

---

**Steven P. Alsene**  
**Chief Financial Officer**

**Certification Pursuant to  
18 U.S.C. Section 1350,  
as Adopted Pursuant to  
Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report on Form 10-Q of Rotech Healthcare Inc. (the "Company") for the quarterly period ended June 30, 2011, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Philip L. Carter, as President and Chief Executive Officer of the Company, and Steven P. Alsene, as Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. §1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to the best of each such officer's knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ PHILIP L. CARTER

Name: Philip L. Carter  
Title: **President and Chief Executive Officer**  
Date: **August 9, 2011**

/s/ STEVEN P. ALSENE

Name: Steven P. Alsene  
Title: **Chief Financial Officer**  
Date: **August 9, 2011**

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

A signed original of this written statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.