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# Richard Scrushy: The Rise and Fall of the “King of Health Care”

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STEVEN A. SOLIERI  
ANDREW J. FELO  
JOAN HODOWANITZ

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## Richard Scrushy: A Self-Made Man

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On his official Web site ([www.richardmscrushy.com](http://www.richardmscrushy.com)), Richard Marin Scrushy presents a self-aggrandizing account of his rags-to-riches life as the erstwhile king of health care. He was born into a middle-class family in the economically depressed city of Selma, Alabama, in 1952. The son of a cash register repairman and a nurse/respiratory therapist, Scrushy was an unusually precocious child who began teaching himself to play the piano and the guitar when he was only 8 years old. When he was 12, he was already earning pocket money by mowing lawns, flipping hamburgers, and working as a bellhop at a local hotel. Despite the promise of his early childhood, Scrushy dropped out of school to get married at the tender age of 17. Lacking a high school diploma, he lived in a Selma trailer park and took menial jobs to support his

family. But Scrusby soon realized that manual labor and trailer parks were not for him. One day when he was struggling to carry cement up a ladder, his boss chided him for his slowness. He quit that job on the spot and vowed to go back to school (Heylar 2003, 80).

With his mother's encouragement, Scrusby finished high school and earned his bachelor's degree in respiratory therapy from the University of Alabama at Birmingham (UAB) in 1974. He spent the next few years working as a UAB instructor and the director of a respiratory therapy program at a local community college. He got his first major career break in 1978 when he landed a position with Lifemark, a promising health care company in Houston, Texas. Scrusby's ambitious nature and persistent work ethic helped him race up the corporate ladder, and by 1980 he was in charge of operations valued at approximately \$100 million.

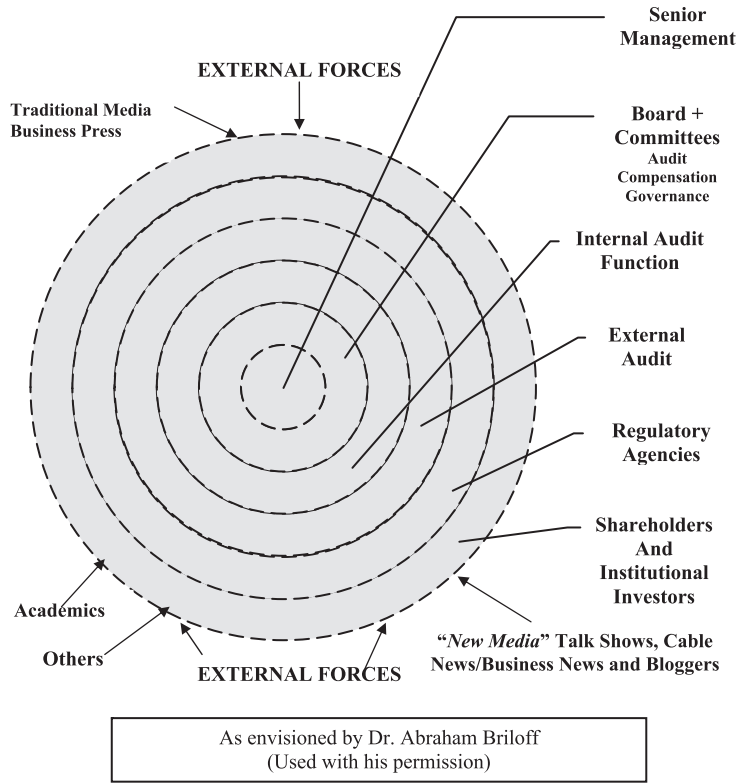
### **Scrusby as Visionary Leader: Opportunity Knocks**

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Scrusby's experiences at Lifemark convinced him that government-funded programs like Medicare and Medicaid offered unlimited opportunities for an ambitious entrepreneur (Heylar 2003, 80). The government was committed to underwriting the health care costs of the poor, the elderly, and the disabled at a time when demographic and lifestyle changes were increasing the number of patients requiring such care. There was certainly no shortage of poor people, and the number of elderly patients was rising steadily thanks to recent advances in health care. In addition, many young, health-conscious Americans were constantly seeking medical help for injuries sustained during exercise and sports activities. Fortunately, Medicare and Medicaid provided a guaranteed revenue stream for businesses specializing in health care services for these market segments. Health care, once the domain of not-for-profit hospitals and insurance companies, was rapidly being transformed into a highly profitable growth industry of the future.

The profit potential of the health care industry was not lost on the charismatic Richard Scrusby. Working with Aaron Beam, the man who later became his first chief financial officer (CFO), and a handful of other Lifemark employees, Scrusby devised a new business model for a chain of health clinics specializing in outpatient diagnostic and rehabilitative services. Unlike traditional hospitals that incurred significant costs to provide 24-hour care, these clinics would function as low-cost providers of health care services, imitating as much as possible Wal-Mart's business model in the retail industry (Thomas 2003).

Scrusby shared his concept with Lifemark's management, hoping it would fund the first such clinics. Unfortunately, Lifemark was preparing to merge with another company and decided not to get involved (Mollenkamp



Note:  
 The order of the layers generally indicates that there are more interactions with Senior Management (the core of the model). The exact “order” can be debated, however, the general relationships of the entities (governance mechanisms) in the model should be fairly consistent. The key to the model is that each entity in corporate governance must perform its function and interact and communicate with the other entities, as required by various rules and conventions. If this communication does not occur, the chain is broken, and the chances of the model functioning “normally” are much less likely. A normally functioning model deters errors and irregularities and prevents fraud (as opposed to detecting fraud).

**CORPORATE GOVERNANCE MODEL – CONCENTRIC RING THEORY**

**Fig. 26.1**

and Moore 2003). Undaunted, Scrushy and his supporters left Lifemark to pursue their entrepreneurial vision. Investing \$55,000 of their own money (Abelson and Freudenheim 2003), they started a business named AmCare Inc. in a one-room office in Birmingham, Alabama, in January 1984 (Ward 2005). The company (renamed HealthSouth in May 1985) prospered virtually overnight. In September 1986, with \$20 million in annual revenues, HealthSouth became a publicly traded company (Heylar 2003, 81).

HealthSouth’s rise to the top of the health care industry was nothing less than meteoric, at least until 1997 (see table 26.1). Between 1987 and 1997, the

**Table 26.1 HealthSouth Timeline**

Date	Event
01/1984	HealthSouth begins operations in a one-room office in Birmingham, Alabama.
02/1984	HealthSouth incorporates in Delaware.
09/1986	HealthSouth completes its first public offering.
08/1997	President Clinton signs the Balanced Budget Act.
09/1998	HealthSouth issues its first profit warning.
05/14/2002	Scruschy sells personal stock for \$74 million.
05/17/2002	The Center for Medicare and Medicare Services (CMS) issues a clarification on existing billing procedures for health care providers.
07/31/2002	Scruschy sells personal stock for \$25 million.
08/14/2002	Scruschy and his CFO recertify HealthSouth's 2001 financial statements.
08/27/2002	HealthSouth issues its second profit warning based on its analysis of the CMS's change in billing procedures.
09/17/2002	The SEC announces an investigation of allegations of insider trading by Richard Scruschy.
10/01/2002	HealthSouth's institutional investors meet to discuss the company's bad corporate governance practices.
10/30/2002	HealthSouth issues a press release saying that the law firm of Fulbright & Jaworski LLP cleared Scruschy of all allegations of wrongdoing.
03/14/2003	Fulbright & Jaworski issues its final investigation report to HealthSouth's Board.
03/19/2003	HealthSouth fires Scruschy as CEO and chairman of the board of directors.
03/21/2003	Fulbright & Jaworski retracts its investigation report.
10/12/2003	Mike Wallace's interview with Richard Scruschy airs on 60 Minutes.
10/16/2003	Congress holds public hearings on the HealthSouth scandal.
11/04/2003	Scruschy is indicted on 85 criminal counts relating to the HealthSouth fraud.
11/05/2003	Congress concludes public hearing on the HealthSouth scandal.
06/28/2005	Scruschy is acquitted of all criminal charges related to the HealthSouth scandal.
09/15/2005	Scruschy claims he has the "clean numbers" (accurate financial information) for HealthSouth since the day he walked out of HealthSouth.
10/26/2005	Scruschy is indicted in federal court for paying former Alabama governor Dan Siegelman \$500,000 for a seat on the state's regulatory board for hospitals.
12/05/2005	Scruschy resigns his position as a HealthSouth director.
12/15/2005	Scruschy sues HealthSouth for more than \$70 million for breach of contract as CEO.
12/29/2005	HealthSouth countersues Scruschy for \$76 million.
01/03/2006	The courts order Scruschy to repay HealthSouth \$48 million in bonuses he had received as CEO. The bonuses were based on the fraudulent profit figures.
04/23/2006	Scruschy settles SEC civil suit by agreeing to pay \$81 million.

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**Table 26.1 HealthSouth Timeline (Continued)**

Date	Event
06/29/2006	Scrushy is convicted of bribery and mail fraud for paying former Alabama governor Don Siegelman \$500,000 for a seat on the Alabama agency that regulates hospitals and other health facilities. He is sentenced to prison for 6 years and 10 months.

company’s stock price soared an average of 31% per year. In 1989, HealthSouth began acquiring potential competitors, and over the next decade, it grew at a fast and furious pace. HealthSouth’s revenues finally topped \$1 billion in 1994, making it the nation’s undisputed leader in the rehabilitative services sector of the health care industry (Heylar 2003, 84). In 1995 alone, the company’s share price, the basis for Scrushy’s compensation as chief executive officer (CEO), jumped 60%. Three years later, having met or exceeded Wall Street’s expectations for 48 consecutive quarters, HealthSouth became a Fortune 500 company, meaning it ranked among the 500 largest firms in the United States based on annual sales revenue. Almost everyone agreed that Scrushy had the Midas touch in an industry where most businesses struggled just to show a profit. The occasional critic who tried to question HealthSouth’s record-breaking growth and profitability was drowned out by the many voices praising the company and its talented founder. Scrushy was the “fair-haired” entrepreneur who could do no wrong even though many people regarded him as a colorful, if somewhat condescending, personality:

Flamboyant, natty, carefully tanned, Scrushy is almost a caricature of the modern swashbuckling CEO. He often pilots his company jet, he has cut a CD with his own honky-tonk band, and he promotes HealthSouth by hobnobbing with celebrity ex-jocks like Bo Jackson. In 1997, his pay, including cashed-in options, totaled \$106.8 million. When Scrushy married his third wife in 1997, he chartered a plane to fly 150 guests to Jamaica and hired Bob Marley’s widow to perform. (In a letter accompanying the invitation, he cast the occasion as a lesson in social consciousness, writing: “The poverty of this Third World country allows us to realize how blessed we are...”) In Birmingham, where he is often referred to as King Richard, Scrushy doomed his own scheme to build a big-league sports stadium by telling a journalist he had the backing of “the little people.” (Elkind 1999, 133)

Many of HealthSouth’s employees regarded Scrushy as a “hands-on” type of leader. Theresa Sanders, former head of the company’s Internal Audit Department, testified before Congress how Scrushy had directed her to develop a “pristine audit” checklist to ensure that every clinic in the chain maintained the same high standards of cleanliness, maintenance, and customer service. She complied, but she thought the project was a waste of

money. Scrushy paid Ernst & Young LLP, HealthSouth's independent auditor, to perform these pristine audits even though his own employees could have done the job at far less cost (U.S. House of Representatives 2003, part 1, 32). According to HealthSouth's 2000 and 2001 proxy statements, the company paid Ernst & Young more money for the pristine audits than it did for government-mandated financial audits. Whether the pristine audits reflected Scrushy's pursuit of excellence, his obsession with controlling every aspect of HealthSouth's operations, or some other agenda is a matter open for debate. At the end of the day, however, Ernst & Young must have been quite pleased with the additional revenue Scrushy sent its way.

### **Trouble in Paradise: The First Signs of Trouble**

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For HealthSouth, 1997 was a bittersweet year. Although the company recorded more than \$3 billion in sales revenues, it saw its future profits put in jeopardy when Congress passed the Balanced Budget Act (Haddad, Weintraub, and Grow 2003, 71). Among other provisions, the act called for a \$115 billion reduction in Medicare payments to health care providers over a 5-year period. This was certainly bad news for Scrushy since Medicare accounted for 37% of HealthSouth's revenues in 1997. If future revenues decreased significantly, so would Scrushy's compensation as CEO.

Scrushy became increasingly paranoid after the Balanced Budget Act became law. He surrounded himself with security guards and installed cameras and electronic surveillance devices throughout HealthSouth's Birmingham headquarters. According to one former employee, "the e-mail correspondence of employees suspected of being disloyal was routinely monitored. The company's surveillance methods were so thorough, he said, that he and other officers would go to restrooms at the corporate headquarters to have confidential conversations" (Romero and Abelson 2003). Scrushy even told his managers how "he received detailed financial reports every Friday and studied them at home to monitor the performance of individual facilities" (Shmukler and Morse 2005). Every Monday morning he grilled his division chiefs on the profits in their areas of responsibility and publicly berated any subordinate who failed to meet his expectations (Abelson and Freudenheim 2003). Shakespeare could have had Scrushy in mind when he penned the line: "Uneasy lies the head that wears a crown."

Even though many HealthSouth investors expressed concern that the Balanced Budget Act would limit future profits, Scrushy initially reassured them that the legislation would not hurt the company's bottom line. In September 1998, however, HealthSouth issued a profit warning informing investors that earnings for 1998 and 1999 would probably fall short of Wall Street's earlier estimates (Abelson and Freudenheim 2002). On October 7, 1998, the

company's stock price fell to \$8.31 from its record high of \$30.56 less than 6 months earlier (U.S. District Court 2004, 6, 8), and earnings plummeted a whopping 86.5% from \$343 million in 1997 to \$46 million in 1998. Despite the drop in HealthSouth's profits, Scrushy managed to become the third highest paid CEO in the nation in 1998 (Liu 2003).

## Scrushy's Long Reach

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Also in 1998, many of HealthSouth's institutional investors (e.g., mutual funds, pension funds, and insurance companies) expressed concern over potential conflicts of interest between Scrushy and several directors on HealthSouth's board. According to HealthSouth's 1998 proxy statement, a shareholders' proposal submitted by the Iron Workers' Local No. 25 Pension Fund recommended that the company adopt the Council of Institutional Investors' (CII) criteria for director independence. The Iron Workers wanted to ensure that directors on HealthSouth's audit and compensation committee, the body responsible for overseeing financial reporting and recommending executive compensation, had no conflicts of interest with the company's senior management. These directors had to be completely independent of management to protect the shareholders' interests. But HealthSouth's board of directors, under Scrushy's leadership as chairman, opposed the Iron Workers' proposal because the directors already met the New York Stock Exchange (NYSE) and Internal Revenue Service (IRS) criteria for independence. The board also argued that the Iron Workers' proposal would reduce future profits by preventing HealthSouth from appointing the most qualified business leaders as directors. According to the company's second quarter report for 1998, the proposal was soundly defeated; it received less than 20% of voting shares during the annual shareholders' meeting.

HealthSouth's 1999 proxy statement contained a similar shareholder proposal by the Longview Collective Investment Fund, another institutional investor. Longview wanted at least 75% of HealthSouth's board members to be independent of HealthSouth's management as defined by the CII criteria. It argued that six of the twelve directors on the current board lacked independence. Five were company insiders (current or former HealthSouth executives), and the sixth was part of an interlocking directorate (that is, the director served on the board of another corporation). Longview also suggested that the board's overall lack of independence was responsible for the recent decline in HealthSouth's stock price and Scrushy's overly generous compensation package. In fact, Scrushy earned far more than most CEOs:

Our CEO was recently named as one of ten “executive pay anti-heroes” by Graef Crystal, an expert on executive pay, in a report prepared by the Coun-

cil of Institutional Investors. Crystal's conclusion was based in part on Mr. Scruschy's drawing a base salary 350% above the market; a salary and bonus 592% above the market; and a total direct compensation that is 225% above the market. (HealthSouth Corporation 1999, 10)

Once again, HealthSouth's board of directors (led by Scruschy) opposed the proposal, citing the same arguments used in 1998. The board also blamed the recent drop in the company's stock price on an industry-wide decline in earnings and dismissed complaints about Scruschy's compensation as "a gratuitous attack" on HealthSouth's founder. This time only 15% of the voting shares supported the Longview proposal.

Scruschy was clearly the dominant personality on HealthSouth's board, and his influence extended well beyond the boardroom. His ties with UBS Warburg, HealthSouth's banker, were so strong that UBS let him choose the person who would write future investment reports on his company, a practice unheard of in the investment banking business (Abelson 2004). Scruschy chose Howard Capek, an analyst who had always written glowing reports on HealthSouth. Capek continued to recommend HealthSouth's stock even after the government accused Scruschy of orchestrating a massive accounting fraud. In his private e-mails, however, Capek told his friends that the stock was really a pig.

When the auditors at Ernst & Young evaluated the risk of fraud at HealthSouth at the end of 2002, they concluded that Scruschy had "an overwhelming amount of control over the Company" (U.S. House of Representatives 2003, part 2, 490). Auditors regard such a concentration of power to be a potential red flag because of the increased risk of financial fraud. It seems, however, that Ernst & Young assumed that HealthSouth's board of directors could control its strong-willed chairman and CEO. In November 2003, the audit firm testified before Congress that its decision not to modify HealthSouth's financial audit to reflect an increased risk of fraud had nothing to do with the fact that the health care company was its highest paying client in the state of Alabama (U.S. House of Representatives 2003, part 2, 123). How much credence Congress gave to Ernst & Young's testimony is a matter of conjecture.

## **Weathering the Storm?**

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Unlike most of its business competitors, HealthSouth eventually reversed the financial losses it suffered in the late 90s following passage of the Balanced Budget Act (Haddad et al. 2003, 71-72). According to HealthSouth's 2000 Annual Report, net income rebounded to a respectable \$278 million, a feat the company attributed to cost reductions and an increased patient load. By 2001, Scruschy's cash compensation (\$3.96 million in salary plus a \$6.5 mil-

lion bonus) was 10 times the average compensation for health care CEOs (Abelson and Freudenheim 2002). Scrushy, however, was not content with his millions; he wanted to be highest paid CEO in the world (Hubbard 2003). According to Tom Winters, a Florida physician who knew him well, the self-proclaimed king of health care simply “didn’t know how much money was enough” (Abelson and Freudenheim 2003).

Although HealthSouth eventually reduced the number of company insiders on its board of directors in response to investor pressure, it never completely eliminated the close financial ties between its directors and HealthSouth or Scrushy (Lublin and Carrns 2003). For example, the company paid Director Joel Gordon \$250,000 a year for his services as a health consultant. Phillip Watkins, a director on HealthSouth’s compensation committee, not only bought property in Florida with Scrushy, he invested in MedCenterDirect, one of HealthSouth’s many corporate ventures. Charles Newhall III served as a director at MedCenterDirect and HealthSouth at the same time. The company even awarded a \$5 million contract to Larry Stripplin, a director on HealthSouth’s compensation and audit committee, to install glass at one of the company’s Birmingham facilities. This contract accounted for 77% of the revenues at Stripplin’s company in 2001. Several media analysts questioned the independence of these directors because they profited from their association with HealthSouth or Scrushy.

## Another Profit Warning

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During the 90s, HealthSouth attributed its leadership position in the health care industry to cost controls and its acquisition of potential competitors. By 2002, however, there were no more costs to cut or rivals to acquire. HealthSouth reluctantly changed its business strategy and started divesting itself of facilities that were unable to meet profit goals. As it turned out, this was just the beginning of the biggest crisis in the company’s history.

On May 17, 2002, the Center for Medicare and Medicaid Services (CMS) issued a statement clarifying existing billing procedures for health care providers. HealthSouth, however, insisted that the CMS had issued a major policy change. Although the CMS and HealthSouth argued about the significance of this statement, everyone agreed that Scrushy sold a portion of his personal holdings of HealthSouth stock in May and July 2002 for a total of \$99 million (Freudenheim, August 28, 2002).

On July 30, 2002, President George W. Bush signed the Sarbanes-Oxley (SOX) Act into law to protect the investing public’s interests and hold corporate executives and directors accountable for their actions (see [table 26.2](#)). A direct response to the accounting frauds at Enron, WorldCom, Tyco, and other corporations, this landmark legislation functioned as a wake-up call

**Table 26.2 The Sarbanes-Oxley (SOX) Act**

SOX section	Description	Mgmt	Marketing	MBA	Accounting	Finance	HR
I	PCAOB				X	X	
II	Auditor independence				X	X	
III	Corporate responsibilities	X	X	X			
IV	Enhanced financial disclosures	X	X	X	X	X	X
V	Analysts' conflicts of interest	X		X	X	X	
VI	SEC resources and authority				X	X	
VII	Studies and reports		X	X	X	X	
VIII	Corporate and criminal fraud accountability	X	X	X	X	X	X
IX	White-collar crime penalty enhancements	X	X	X	X	X	X
X	Corporate tax returns				X	X	
XI	Corporate fraud and accountability	X	X	X	X	X	X

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to the CEOs and CFOs of publicly traded companies. The act requires these officers to certify the accuracy of their companies' annual financial statements, thereby holding them personally responsible for the actions of their subordinates. CEOs and CFOs can no longer shift responsibility for corporate fraud to subordinates who actually crunch the numbers on which financial statements are based. In addition, any person convicted of making a false certification under the provisions of the SOX Act can be sentenced to up to 20 years in prison, fined \$5 million, or both.

On August 7, 2002, Scrushy held a conference call with investors and market analysts, but he never mentioned a potential problem with future earnings. One week later, he and his CFO, Weston Smith, recertified the company's 2001 annual financial statements as required by the SOX Act. On August 27, however, HealthSouth issued a press statement claiming that the CMS's recent billing guidance would reduce the company's pretax earnings by \$175 million per year. The company also announced that Smith was resigning as CFO and Scrushy was resigning as CEO, but not as chairman of the board. One Credit Suisse analyst, John Hindelong, described the company's profit warning as "discouraging, given the fact that management reiterated its confidence in guidance for analysts just a few weeks ago" (Freudenheim, September 6, 2002). Naturally, people began asking why future profits should drop so dramatically if the CMS had merely clarified

existing billing procedures. More importantly, how reliable were HealthSouth's 2001 financial statements if the company had not used the correct billing procedures? At the same time, the Securities and Exchange Commission (SEC) expressed interest in the fortuitous timing of Scrushy's 2002 stock sales. Fearing future shareholder lawsuits, Scrushy's lawyers advised him not to answer any questions about HealthSouth's reduced earnings forecast or his stock trades.

While HealthSouth's August profit warning was, by itself, no proof of wrongdoing, the SEC and several angry investors demanded an explanation from Scrushy and HealthSouth's board of directors, especially its audit committee. In August 2002, HealthSouth's audit committee consisted of three directors: Chairman George Strong, Larry Striplin, and C. Sage Givens. Only Strong was truly independent of Scrushy and HealthSouth. As mentioned earlier, Striplin's glass company reaped 77% of its revenues in 2001 from a HealthSouth contract. Givens owed her success as a venture capitalist to Scrushy. Under his leadership, HealthSouth invested \$3.5 million in her company. In addition, she invested heavily in MedCenterDirect, one of HealthSouth's many corporate ventures (Thomas 2003). The audit committee's apparent lack of independence fed the public perception that Scrushy influenced the very people who were supposed to oversee his actions as CEO.

The media, eager to exploit another juicy corporate scandal, released several titillating stories about Scrushy's extravagant lifestyle, his flawed leadership style and abuses of power, and the Federal Bureau of Investigation's (FBI) secret recordings of his private conversations. Meanwhile investors, dissatisfied with the CEO's constant reassurances that everything was fine, began filing lawsuits against Scrushy and the company he founded.

## **The Board's Special Litigation Committee**

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In September 2002, the SEC notified HealthSouth that it was investigating allegations of insider trading by Richard Scrushy and other unspecified problems. At the same time, HealthSouth's board appointed Directors Jon Hanson, Larry Striplin, and Robert May to a Special Litigation Committee to look into the SEC's allegations (Roth and Michaels, March 29, 2003). The company also engaged the law firm of Fulbright & Jaworski LLP to conduct an "impartial investigation" (Terhune and Mollenkamp 2003).

The independence of the Special Litigation Committee came under fire almost immediately. One member, Jon Hanson, joined HealthSouth's board in September 2002 at Scrushy's personal request. He and Scrushy were both directors on the boards of the National Football Foundation and the College Football Hall of Fame. A few months before Hanson became a Health-

South director, HealthSouth donated \$425,000 to the foundation to endow a trophy and scholarship. Another member, Larry Striplin, resigned from the committee within 1 month even though he insisted that his glass company's \$5 million contract with HealthSouth would not impair his objectivity. The third member, Robert May, had "publicly and prematurely" exonerated Mr. Scrushy while his own committee's investigation had just started" according to Judge Strine of the Delaware Court of Chancery. If the Special Litigation Committee were to later clear Scrushy, "there will always linger a reasonable doubt that its investigation was designed to paper a decision that had already been made." Strine also believed it was unlikely the committee could be impartial if its members had "compromising ties to the key officials who are suspected of malfeasance" (Roth and Michaels, March 29, 2003).

## Scrushy Goes on the Offense

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By October 2002, Scrushy had launched a major public relations campaign to defend himself against the government's allegations of misconduct. He reinvented himself as a born-again Christian who was being unfairly persecuted by an out-of-control judicial system (Grow 2004, 87). In addition to setting up his own Web site to publicize his version of events, Scrushy and his wife hosted *Viewpoint*, a religious television show that gave him much needed positive publicity in the Birmingham area (Terhune and Shmukler 2005). Meanwhile, approximately 160 institutional investors angrily confronted him about HealthSouth's lapses in corporate governance, specifically the board of directors' apparent lack of independence and financial conflicts of interest. They were also disturbed by Scrushy's apparent greed as demonstrated by the timing of his 2002 stock trades (Roth and Michaels, April 15, 2003). Instead of addressing their specific concerns, Scrushy reassured them that HealthSouth was taking the initiative to improve its corporate governance. This approach, however, failed to convince a growing number of skeptics inside and outside the company.

On October 30, 2002, before the investigation was complete, HealthSouth issued a statement claiming that Fulbright & Jaworski had "cleared" Scrushy of all allegations of wrongdoing (Terhune and Mollenkamp 2003). Given Scrushy's controlling nature, it is highly unlikely that this information would have been released to the press without his personal approval as chairman of the board. Unfortunately for HealthSouth and Scrushy, the statement did not have the intended effect of restoring investor confidence. Fulbright & Jaworski immediately challenged HealthSouth's characterization of its preliminary findings. HealthSouth was forced to issue a second statement explaining that the investigation failed to uncover any evidence of wrongdo-

ing by Scrushy. In other words, the investigation failed to find evidence of guilt; it did not exonerate Scrushy.

## The SEC Files Suit

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Scrushy resumed his position as CEO in January 2003, but events quickly spun out of control. Former CFO William Owens became an informant for the FBI and wore a hidden wire to record his conversations with Scrushy. During one conversation, Scrushy discussed the importance of keeping the HealthSouth family together, a reference to senior management including all five CFOs in the company’s 19-year history. Scrushy also reminded Owens that if the CFO chose to expose the fraud, Scrushy would blame him and the rest of the “family” (Shaw and Cook 2005).

In March 2003, the SEC filed a civil suit against HealthSouth and Scrushy in which it accused the CEO of directing his staff to overstate the company’s earnings by at least \$1.4 billion since 1999 (Terhune, Mollenkamp, and Carrns 2003). On March 14, 2003, Fulbright & Jaworski issued its final report to HealthSouth’s board of directors and the SEC. Seven days later, however, the law firm notified the board that it should not rely on the report’s findings because, as the firm later learned, HealthSouth had withheld information during the investigation (Terhune and Mollenkamp 2003). Unfortunately, it was a little too late for Scrushy to put a positive spin on this latest development. The SEC had already filed suit against him, and HealthSouth quickly followed up by firing him as CEO and chairman of the board of directors. Scrushy, however, retained his seat as a director. His contract as CEO ensured that only the company’s stockholders could vote him out as a director.

## The American Dream?

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Scrushy not only lacked a sense of humility about his success, he had his own version of the American dream. In October 2003, Mike Wallace interviewed him for the CBS show *60 Minutes*. When Wallace brought up the subject of the 2002 stock sales that led to the SEC’s allegations of insider trading, Scrushy explained that he was forced to exercise his stock options because they were about to expire. Not content to leave the matter alone, he went on to say, “When you build something from nothing, you should have the right at some point to have some liquidity. That’s what every young MBA in America is working toward. So what I did was, you know, the American dream” (CBSNews.com 2004). But for Scrushy, the American dream went far beyond mere financial security for himself and his family. It meant making

more money than anyone else and enjoying perks that were reserved for only the richest men.

## **Criminal Charges Are Filed**

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In November 2003, the U.S. Department of Justice (DOJ) indicted Scrushy on 85 criminal counts for allegedly orchestrating a \$2.7 billion accounting fraud between 1996 and 2003 (U.S. Department of Justice 2003). The DOJ was convinced that the HealthSouth fraud started long before 1996, but it could not prove such a charge. The most serious charges in the indictment involved allegations of conspiracy, securities fraud (based on Scrushy's 2002 stock sales), wire fraud, mail fraud, money laundering, and violation of the SOX Act's certification provisions. Thus, Scrushy made corporate history by becoming the first CEO to be charged under the provisions of the SOX Act.

According to the DOJ's indictment, Scrushy and his alleged partners in crime had developed a special vocabulary to help carry out the fraud. For example, a "hole" was defined as the difference between HealthSouth's earnings estimates (usually inflated) and actual earning. If Scrushy detected a hole in HealthSouth's earnings, he would order his subordinates ("the family") to fill it with "dirt" (fictitious sales revenue). The family hid the bogus sales from public view by improperly adjusting the balances in accounts such as estimated insurance reimbursements and fixed assets (i.e., buildings and equipment). The perpetrators of the fraud were quite familiar with Ernst & Young's financial audit procedures (two of HealthSouth's CFOs had worked as auditors in Ernst & Young's Birmingham office). They knew several tricks to prevent the auditors from detecting the fraud. For example, they knew that Ernst & Young's auditors ignored most transactions below \$5,000 (Mollenkamp 2003). As it turned out, most of the \$1 billion in fictitious assets recorded on HealthSouth's balance sheet were based on bogus accounting entries that fell below the magic \$5,000 threshold.

## **The Criminal Trial**

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Scrushy's criminal trial began on January 25, 2005, in Birmingham, Alabama, the city where HealthSouth's corporate headquarters were located. The presiding judge dismissed all but 58 counts of the original 85 counts, but she refused to throw out 3 counts accusing Scrushy of violating the certification provisions of the SOX Act (MSNBC.com 2005).

Scrushy's penchant for controlling people and organizations continued during his trial. Shortly after his indictment by the DOJ, Scrushy left his affluent Birmingham church and joined an African-American congrega-

tion on the other side of town. His son-in-law's local television station began broadcasting *The Scrushy Trial with Nikki Preede* twice a day. Donald Watkins, Scrushy's lead attorney, used the show to give the defense team's spin on each day's testimony. Herman Henderson, a local black pastor, claimed that Scrushy paid him to encourage other pastors, many of whom were also black, to attend the trial as part of "Scrushy's Amen Corner" (Grow 2006). Henderson also alleged that Scrushy paid his assistant, Audrey Lewis, to write a series of prodefense articles that ran on page 1 of the *Birmingham Times*, a newspaper targeting the local black community.

The prosecution called an impressive list of witnesses including all five men who had at one time served as Scrushy's CFO. In addition to admitting their roles in the fraud, all five testified that Scrushy directed them to make, or knew they were making, improper accounting entries to cover up the fraud. Scrushy's lawyers argued that he was unaware that the numbers presented in HealthSouth's annual financial reports were fraudulent. (This is known as the "Sergeant Schultz" defense, after the character in the television show *Hogan's Heroes*.) Scrushy's lawyers also portrayed the five CFOs as criminals hoping to lighten their own sentences by testifying for the prosecution. By the time the case went to the jury on May 19, 2005, the presiding judge had dismissed all but 36 counts of the original 85 counts (Morse and Terhune 2005).

On June 28, 2005, after 21 days of deliberations, the jury acquitted Richard Scrushy on all 36 counts. Several media pundits accused him of playing the religion and race cards, but the jurors insisted that he was acquitted because the prosecution failed to present a "smoking gun" linking him to the fraud (Farrell 2005). Some legal analysts, however, concluded that Scrushy was only acquitted because the prosecution's case was just too complicated for the jury to understand (Squeo 2005).

According to his official Web site, Scrushy resigned his position as a HealthSouth director in December 2005 and then sued his former company for more than \$70 million. He argued that HealthSouth breached his contract as CEO because he was fired even though he was never convicted of wrongdoing in a court of law. Not surprisingly, HealthSouth filed a \$76 million countersuit blaming Scrushy for the fraud (FOXNews.com 2005b). In January 2006, a court ordered Scrushy to pay HealthSouth approximately \$48 million for bonuses he received based on fraudulent profit figures (Dade 2006).

## Other Legal Issues

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In April 2006, Scrushy settled the SEC's civil suit by agreeing to pay \$81 million (Reeves 2007). This figure was divided into \$77.5 million of ill-gotten gains and \$3.5 million in civil penalties as required under the provisions of

the SOX Act. HealthSouth's founder was also barred from serving as an officer or director of a public company anytime in the future. Despite the multi-million dollar settlement, Scrushy dodged yet another bullet. If the SEC had won in court, Scrushy could have been fined as much as \$786 million (plus interest) (Taub 2005). Having received credit for \$71.5 million paid in other HealthSouth cases, Scrushy may not even pay the remaining \$9.5 million if the court accepts his claim of poverty.

On June 29, 2006, Scrushy was found guilty of bribery and mail fraud. He was accused of paying former Alabama governor Don Siegelman \$500,000 for a seat on the state board that licenses hospitals and other medical facilities (FOXNews.com 2005a). Scrushy's position on the board enabled him to influence state approval of HealthSouth's facilities throughout Alabama. Despite his felony conviction, Scrushy's luck seems to have held. He was sentenced to only 6 years and 10 months in prison, not the 30 years recommended by prosecutors (Lattman 2007). Perhaps he will use his time in prison to prepare for the pending class action suits by HealthSouth's investors and bondholders.

## Conclusion

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Even though Scrushy was not found criminally liable for the HealthSouth fraud, some critics have convicted him of serious ethical lapses as the leader of a multinational corporation (Steffy 2006). As HealthSouth's founder and CEO for nearly two decades, he created a culture that valued profits over ethical business conduct and entitlement over corporate responsibility. He undermined HealthSouth's internal corporate governance safeguards against fraud and used his connections as a business mogul to further his personal ambitions and greed. Having founded a Fortune 500 company, he was unwilling to relinquish even a small part of his control to internal or external parties. If he was not a participant in the fraud, he should have been aware of it since he controlled everything that happened at HealthSouth. He was a slave to Wall Street's earnings estimates and a hands-on CEO who micromanaged his company's financial performance at every level. Scrushy's word was law, but there were no effective checks and balances on his actions as HealthSouth's CEO.

Aaron Beam, one of the Lifemark employees who helped Scrushy start HealthSouth, recalled his impression of Scrushy after meeting him for the first time in the early 80s: "I told my wife that I just interviewed either the biggest con artist I ever met or the most brilliant young man" (Roth, Liu, and Michaels 2003). What Beam did not realize at that time was that Scrushy was both. He led the company he founded to the pinnacle of success, but he was also responsible for the corporate culture that nurtured one of the worst accounting frauds in American history. Scrushy's acquittal in the Health-

South trial and his settlement with the SEC have angered critics who are convinced he masterminded a multibillion dollar fraud. But he lost more than his bank account. Richard Scrushy's reputation is largely in tatters, and he can look forward to several years in prison reminiscing about the good old days when he really was the king of health care.

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