

OMEGA HEALTHCARE INVESTORS INC  
Form 10-Q  
December 15, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**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 September 30, 2006

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 1-11316

**OMEGA HEALTHCARE  
INVESTORS, INC.**

(Exact name of Registrant as specified in its charter)

**Maryland**  
(State of Incorporation)

**38-3041398**  
(I.R.S. Employer Identification No.)

**9690 Deereco Road, Suite 100, Timonium, MD 21093**  
(Address of principal executive offices)

**(410) 427-1700**  
(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 the filing requirements for the past 90 days.

Yes

No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or non-accelerated filer. See definition of accelerated filer and larger accelerated filer in Rule 12b-2 of the Exchange Act. (Check one:)

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes

No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as November 30, 2006.

**Common Stock, \$.10 par value**  
(Class)

**59,703,258**  
(Number of shares)

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OMEGA HEALTHCARE INVESTORS, INC.  
FORM 10-Q  
September 30, 2006

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**PART I FINANCIAL INFORMATION****Item 1 Financial Statements**

**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands)

|   | September 30,<br>2006<br>(Unaudited) | December 31,<br>2005<br>(Restated) |
|---|--------------------------------------|------------------------------------|
| <b>ASSETS</b>                               |                                      |                                    |
| Real estate properties                      |                                      |                                    |
| Land and buildings at cost                  | \$ 1,240,398                         | \$ 996,127                         |
| Less accumulated depreciation               | (180,270)                            | (157,255)                          |
| Real estate properties net                  | 1,060,128                            | 838,872                            |
| Mortgage notes receivable net               | 32,185                               | 104,522                            |
|   | 1,092,313                            | 943,394                            |
| Other investments net                       | 37,327                               | 28,918                             |
|   | 1,129,640                            | 972,312                            |
| Assets held for sale net                    | 737                                  | 1,243                              |
| Total investments                           | 1,130,377                            | 973,555                            |
| Cash and cash equivalents                   |                                      | 3,948                              |
| Accounts receivable net                     | 39,488                               | 15,018                             |
| Other assets                                | 13,189                               | 37,769                             |
| Total assets                                | \$ 1,183,054                         | \$ 1,030,290                       |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                                      |                                    |
| Revolving line of credit                    | \$ 157,500                           | \$ 58,000                          |
| Unsecured borrowings net                    | 484,735                              | 505,429                            |
| Other long term borrowings                  | 41,410                               | 2,800                              |
| Accrued expenses and other liabilities      | 27,813                               | 19,563                             |
| Income tax liabilities                      | 5,038                                | 3,299                              |
| Operating liabilities for owned properties  | 98                                   | 256                                |
| Total liabilities                           | 716,594                              | 589,347                            |
| Stockholders equity:                        |                                      |                                    |
| Preferred stock                             | 118,488                              | 118,488                            |
| Common stock and additional paid-in-capital | 695,948                              | 663,607                            |
| Cumulative net earnings                     | 279,357                              | 237,069                            |
| Cumulative dividends paid                   | (585,397)                            | (536,041)                          |
| Cumulative dividends redemption             | (43,067)                             | (43,067)                           |
| Unamortized restricted stock awards         |                                      | (1,167)                            |
| Accumulated other comprehensive income      | 1,131                                | 2,054                              |
| Total stockholders equity                   | 466,460                              | 440,943                            |
| Total liabilities and stockholders equity   | \$ 1,183,054                         | \$ 1,030,290                       |

**Note** The balance sheet at December 31, 2005 has been restated and derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See notes to consolidated financial statements.



**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Unaudited**  
**(in thousands, except per share amounts)**

|  | Three Months Ended<br>September 30, |                    | Nine Months Ended<br>September 30, |                    |
|--|-------------------------------------|--------------------|------------------------------------|--------------------|
|  | 2006                                | 2005<br>(Restated) | 2006                               | 2005<br>(Restated) |
| <b>Revenues</b>  |                                     |                    |                                    |                    |
| Rental income  | \$ 33,153                           | \$ 24,858          | \$ 93,056                          | \$ 70,329          |
| Mortgage interest income   | 1,054                               | 1,221              | 3,392                              | 4,417              |
| Other investment income net  | 994                                 | 867                | 2,878                              | 2,364              |
| Miscellaneous  | 42                                  | 141                | 483                                | 4,453              |
| Total operating revenues   | 35,243                              | 27,087             | 99,809                             | 81,563             |
| <b>Expenses</b>  |                                     |                    |                                    |                    |
| Depreciation and amortization  | 8,360                               | 6,182              | 23,414                             | 17,872             |
| General and administrative   | 5,669                               | 2,235              | 10,331                             | 6,470              |
| Provision for impairment on real estate properties                   |                                     | 3,072              |                                    | 3,072              |
| Provision for uncollectible mortgages, notes and accounts receivable | 179                                 |                    | 179                                | 83                 |
| Leasehold expiration expense   |                                     |                    |                                    | 750                |
| Total operating expenses   | 14,208                              | 11,489             | 33,924                             | 28,247             |
| <b>Income before other income and expense</b>                        | <b>21,035</b>                       | <b>15,598</b>      | <b>65,885</b>                      | <b>53,316</b>      |
| <b>Other income (expense):</b>                                       |                                     |                    |                                    |                    |
| Interest and other investment income                                 | 189                                 | 25                 | 371                                | 90                 |
| Interest   | (11,190 )                           | (7,709 )           | (30,246 )                          | (21,431 )          |
| Interest amortization of deferred financing costs                    | (439 )                              | (539 )             | (1,513 )                           | (1,570 )           |
| Interest refinancing costs   |                                     |                    | (3,485 )                           |                    |
| Provision for impairment on equity securities                        |                                     |                    |                                    | (3,360 )           |
| Gain on sale of equity securities                                    | 2,709                               |                    | 2,709                              |                    |
| Change in fair value of derivatives                                  | 1,764                               | (16 )              | 9,672                              | (427 )             |
| Total other expense  | (6,967 )                            | (8,239 )           | (22,492 )                          | (26,698 )          |
| <b>Income before gain on assets sold</b>                             | <b>14,068</b>                       | <b>7,359</b>       | <b>43,393</b>                      | <b>26,618</b>      |
| Gain on assets sold net  | 1,188                               |                    | 1,188                              |                    |
| <b>Income from continuing operations before income taxes</b>         | <b>15,256</b>                       | <b>7,359</b>       | <b>44,581</b>                      | <b>26,618</b>      |
| Provision for income taxes   | (600 )                              | (588 )             | (1,739 )                           | (1,776 )           |
| <b>Income from continuing operations</b>                             | <b>14,656</b>                       | <b>6,771</b>       | <b>42,842</b>                      | <b>24,842</b>      |
| (Loss) from discontinued operations                                  | (33 )                               | (1,087 )           | (554 )                             | (7,061 )           |
| <b>Net income</b>  | <b>14,623</b>                       | <b>5,684</b>       | <b>42,288</b>                      | <b>17,781</b>      |
| Preferred stock dividends  | (2,480 )                            | (2,481 )           | (7,442 )                           | (8,904 )           |
| Preferred stock conversion and redemption charges                    |                                     |                    |                                    | (2,013 )           |
| <b>Net income available to common</b>                                | <b>\$ 12,143</b>                    | <b>\$ 3,203</b>    | <b>\$ 34,846</b>                   | <b>\$ 6,864</b>    |
| <b>Income per common share:</b>                                      |                                     |                    |                                    |                    |
| <b>Basic:</b>  |                                     |                    |                                    |                    |
| Income from continuing operations                                    | \$ 0.21                             | \$ 0.08            | \$ 0.61                            | \$ 0.27            |
| Net income   | \$ 0.21                             | \$ 0.06            | \$ 0.60                            | \$ 0.13            |
| <b>Diluted:</b>  |                                     |                    |                                    |                    |
| Income from continuing operations                                    | \$ 0.20                             | \$ 0.08            | \$ 0.61                            | \$ 0.27            |
| Net income   | \$ 0.20                             | \$ 0.06            | \$ 0.60                            | \$ 0.13            |
| Dividends declared and paid per common share                         | \$ 0.24                             | \$ 0.22            | \$ 0.71                            | \$ 0.63            |
| Weighted-average shares outstanding, basic                           | 59,021                              | 51,187             | 58,203                             | 51,050             |
| Weighted-average shares outstanding, diluted                         | 59,446                              | 51,479             | 58,407                             | 51,386             |

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**Components of other comprehensive income:**

|   |           |          |           |           |
|---|-----------|----------|-----------|-----------|
| Net income  | \$ 14,623 | \$ 5,684 | \$ 42,288 | \$ 17,781 |
| Unrealized gain on common stock investment                      |           | 730      | 1,580     | 730       |
| Reclassification adjustment for gain on common stock investment | (1,740 )  |          | (1,740 )  |           |
| Unrealized loss on preferred stock investment                   | (172 )    | (332 )   | (763 )    | (959 )    |
| Total comprehensive income                                      | \$ 12,711 | \$ 6,082 | \$ 41,365 | \$ 17,552 |

See notes to consolidated financial statements.

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**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Unaudited (in thousands)**

|   | <b>Nine Months Ended<br/>September 30,</b> |                            |
|---|--|----------------------------|
|   | <b>2006</b>                                | <b>2005<br/>(Restated)</b> |
| <b>Operating activities</b>   |  |                            |
| Net income  | \$ 42,288                                  | \$ 17,781                  |
| Adjustment to reconcile net income to cash provided by operating activities:                      |  |                            |
| Depreciation and amortization (including amounts in discontinued operations)                      | 23,432                                     | 19,068                     |
| Provision for impairment on real estate properties (including amounts in discontinued operations) | 121  | 9,154                      |
| Provision for uncollectible mortgages, notes and accounts receivable                              | 179  | 83                         |
| Provision for impairment on equity securities   |  | 3,360                      |
| Refinancing costs   | 3,485                                      |                            |
| Amortization of deferred financing costs  | 1,513                                      | 1,570                      |
| (Gains) losses on assets sold and equity securities net   | (3,516 )                                   | 3,492                      |
| Restricted stock amortization expense   | 4,224                                      | 856                        |
| Change in fair value of derivatives   | (9,672 )                                   | 428                        |
| Income from accretion of marketable securities to redemption value                                | (1,155 )                                   | (1,225 )                   |
| Other   | (35 )                                      | (1,532 )                   |
| Net change in accounts receivable   | (24,650 )                                  | (1,276 )                   |
| Net change in other assets  | 1,941                                      | 2,087                      |
| Net change in tax liabilities   | 1,739                                      | 1,776                      |
| Net change in operating assets and liabilities  | 8,121                                      | (363 )                     |
| Net cash provided by operating activities   | 48,015                                     | 55,259                     |
| <b>Cash flows from investing activities</b>   |  |                            |
| Acquisition of real estate  | (178,906 )                                 | (120,696 )                 |
| Proceeds from sale of stock   | 7,573                                      |                            |
| Proceeds from sale of real estate investments   | 1,527                                      | 25,937                     |
| Capital improvements and funding of other investments   | (5,416 )                                   | (2,749 )                   |
| Proceeds from other investments   | 27,092                                     | 1,759                      |
| Investments in other investments  | (29,238 )                                  | (6,167 )                   |
| Collection of mortgage principal net  | 10,588                                     | 60,869                     |
| Net cash used in investing activities   | (166,780 )                                 | (41,047 )                  |
| <b>Cash flows from financing activities</b>   |  |                            |
| Proceeds from credit facility borrowings  | 234,200                                    | 180,200                    |
| Payments on credit facility borrowings  | (134,700 )                                 | (114,500 )                 |
| Receipts from other long-term borrowings  | 39,000                                     |                            |
| Payments of other long-term borrowings  | (390 )                                     | (370 )                     |
| Prepayment of re-financing penalty  | (755 )                                     |                            |
| Receipts from dividend reinvestment plan  | 29,161                                     | 2,415                      |
| Receipts/(payments) from exercised options net  | 225  | (984 )                     |
| Dividends paid  | (49,356 )                                  | (41,914 )                  |
| Redemption of preferred stock   |  | (50,013 )                  |
| Payment on common stock offering  | (178 )                                     | (28 )                      |
| Deferred financing costs paid   | (2,390 )                                   | (333 )                     |
| Net cash provided by (used in) financing activities   | 114,817                                    | (25,527 )                  |
| (Decrease) increase in cash and cash equivalents  | (3,948 )                                   | (11,315 )                  |
| Cash and cash equivalents at beginning of period  | 3,948                                      | 12,083                     |
| Cash and cash equivalents at end of period  | \$   | \$ 768                     |
| Interest paid during the period   | \$ 21,442                                  | \$ 18,949                  |

See notes to consolidated financial statements.





**OMEGA HEALTHCARE INVESTORS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Unaudited**  
**September 30, 2006**

**NOTE 1 BASIS OF PRESENTATION**

**Business Overview**

We have one reportable segment consisting of investments in real estate. Our business is to provide financing and capital to the long-term healthcare industry with a particular focus on skilled nursing facilities located in the United States. Our core portfolio consists of long-term lease and mortgage agreements. All of our leases are triple-net leases, which require the tenants to pay all property-related expenses. Our mortgage revenue derives from fixed-rate mortgage loans, which are secured by first mortgage liens on the underlying real estate and personal property of the mortgagor. Substantially all depreciation expenses reflected in the consolidated statements of operations relate to the ownership of our investment in real estate.

**Restated Financial Data**

We have restated certain historical results in the accompanying consolidated financial statements to correct errors in previously reported amounts related to income tax matters and certain debt and equity investments in Advocat Inc. ( Advocat ), as well as to record certain straight-line rental income. See Note 2 Restatement of Previously Issued Financial Statements.

**Basis of Presentation**

The accompanying unaudited consolidated financial statements for Omega Healthcare Investors, Inc. ( Omega or the Company ) have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain reclassifications have been made to the 2005 financial statements for consistency with the presentation adopted for 2006. Such reclassifications have no effect on previously reported earnings or equity.

Operating results for the three- and nine-month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the financial statements and footnotes included in our annual report on Form 10-K/A for the year ended December 31, 2005.

Our consolidated financial statements include the accounts of Omega, all direct and indirect wholly owned subsidiaries and one variable interest entity ( VIE ) for which we are the primary beneficiary. All inter-company accounts and transactions have been eliminated in consolidation of the financial statements.

*FAS 123R Adoption*

In December 2004, the Financial Accounting Standards Board ( FASB ) issued FAS No. 123 (revised 2004), *Share-Based Payment* ( FAS No. 123R ), which is a revision of FAS No. 123, *Accounting for Stock-Based Compensation*. FAS No. 123R supersedes Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FAS No. 95, *Statement of Cash Flows*. We adopted FAS No. 123R on January 1, 2006.

FIN 46R

Financial Accounting Standards Board Interpretation No. 46R, *Consolidation of Variable Interest Entities*, ( FIN 46R ), addresses the consolidation by business enterprises of VIEs. As a result of the adoption of FIN 46R, we consolidate all VIEs for which we are the primary beneficiary. Generally, a VIE is an entity with one or more of the following characteristics: (a) the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support; (b) as a group the holders of the equity investment at risk lack (i) the ability to make decisions about an entity's activities through voting or similar rights, (ii) the obligation to absorb the expected losses of the entity, or (iii) the right to receive the expected residual returns of the entity; or (c) the equity investors have voting rights that are not proportional to their economic interests, and substantially all of the entity's activities either involve, or are conducted on behalf of, an investor that has disproportionately few voting rights. FIN 46R requires a VIE to be consolidated in the financial statements of the entity that is determined to be the primary beneficiary of the VIE. The primary beneficiary generally is the entity that will receive a majority of the VIE's expected losses, receive a majority of the VIE's expected residual returns, or both.

In accordance with FIN 46R, we determined that we were the primary beneficiary of one VIE. This VIE is derived from a financing relationship entered into between Omega and one company that is engaged in the ownership and rental of six skilled nursing facilities ( SNFs ) and one assisted living facility ( ALF ). The consolidation of the VIE as of September 30, 2006 resulted in an increase in our consolidated total assets (primarily real estate) and liabilities (primarily indebtedness) of approximately \$37.8 million. The creditors of the VIE do not have recourse to our assets.

FIN 48 Evaluation

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ). FIN 48 is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes and is effective as of the beginning of our 2007 fiscal year. We are currently evaluating the impact, if any, that FIN 48 will have on our financial statements.

**NOTE 2 RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS**

**Summary of Restatement Items**

Our Board of Directors, including our Audit Committee, concluded on October 24, 2006, to restate our audited financial results as of December 31, 2005 and 2004 and for the three years ended December 31, 2005, 2004 and 2003 and for other periods affected, including our unaudited financial statements for each quarterly period in 2004, 2005 and 2006 as necessary. As a result, we have previously filed with the Securities and Exchange Commission ( SEC ) amendments to our Annual Report on Form 10-K for the period ending December 31, 2005 and our Quarterly Reports on Form 10-Q for the three-month periods ended March 31, 2006 and June 30, 2006, respectively, reflecting the restated matters (the Restatement ). The Restatement reflects the following adjustments that affect the three- and nine-months ended September 30, 2005.

1. We recorded asset values for securities received from Advocat (and the increases therein) since the completion of the restructuring of Advocat obligations pursuant to leases and mortgages for the facilities then operated by Advocat in 2000. These adjustments increased net income by \$0.4 million and \$0.8 million for the three and nine months ended September 30, 2005, respectively. These adjustments increased total assets by \$5.4 million as of December 31, 2005. Changes in the fair value of the securities not currently recognized in net income were reflected in other comprehensive income.

2. As a result of our holdings of Advocat securities, we recorded reserves related to a potential tax liability arising from our ownership of such securities. This tax liability along with related interest expense had not been previously accrued for and this adjustment decreased net income by \$0.6 million and \$1.8 million for the three and nine months ended September 30, 2005, respectively. The amount accrued represents the estimated liability, which remains subject to final resolution and therefore is subject to change.

3. Subsequent to October 25, 2006, we made a correction to our accounting for certain leases because these leases contain provisions (such as increases in rent based on the lesser of a fixed amount or two times the Consumer Price Index ( CPI )) that require us to record rental income on a straight-line basis subject to an appropriate evaluation of collectibility. We had not previously recorded rental income on these leases on a straight-line basis. As a result of this adjustment, our net income increased by \$0.8 million and \$2.1 million for the three and nine months ended September 30, 2005, respectively. In addition, net accounts receivable and retained earnings increased by \$9.1 million as of December 31, 2005, to reflect the effects of this adjustment from inception of the affected leases.

Additional information about the decision to restate these financial statements can be found in our Current Report on Form 8-K, filed with the SEC on October 25, 2006.

#### **Events Causing the Restatement    Advocat Restructuring**

In November 2000, Advocat, an operator of various skilled nursing facilities owned by or mortgaged to us, was in default on its obligations to us. As a result, we entered into an agreement with Advocat with respect to the restructuring of Advocat's obligations pursuant to leases and mortgages for the facilities then operated by Advocat (the Initial Advocat Restructuring ). As part of the Initial Advocat Restructuring in 2000, Advocat issued to us (i) 393,658 shares of Advocat's Series B non-voting, redeemable (on or after September 30, 2007), convertible preferred stock, which was convertible into up to 706,576 shares of Advocat's common stock (representing 9.9% of the outstanding shares of Advocat's common stock on a fully diluted, as-converted basis and accruing dividends at 7% per annum), and (ii) a secured convertible subordinated note in the amount of \$1.7 million bearing interest at 7% per annum with a September 30, 2007 maturity.

Subsequent to the Initial Advocat Restructuring, Advocat's operations and financial condition have improved and there has been a significant increase in the market value of Advocat's common stock from approximately \$0.31 per share at the time of the Initial Advocat Restructuring to the closing price on October 20, 2006 of \$18.84. As a result of the significant increase in the value of the common stock underlying the Series B preferred stock of Advocat held by us, on October 20, 2006 we again restructured our relationship with Advocat (the Second Advocat Restructuring ) by entering into a Restructuring Stock Issuance and Subscription Agreement with Advocat (the 2006 Advocat Agreement ). Pursuant to the 2006 Advocat Agreement, we exchanged the Advocat Series B preferred stock and subordinated note issued in the Initial Advocat Restructuring for 5,000 shares of Advocat's Series C non-convertible, redeemable (at our option after September 30, 2010) preferred stock with a face value of approximately \$4.9 million and a dividend rate of 7% payable quarterly, and a secured non-convertible subordinated note in the amount of \$2.5 million maturing September 30, 2007 and bearing interest at 7% per annum. As part of the Second Advocat Restructuring, we also amended our Consolidated Amended and Restated Master Lease by and between one of our subsidiaries, as lessor, and a subsidiary of Advocat, as lessee, to commence a new 12-year lease term through September 30, 2018 (with a renewal option for an additional 12 year term) and Advocat has agreed to increase the master lease annual rent by approximately \$687,000 to approximately \$14 million commencing on January 1, 2007.

Management believes that certain of the terms of the Advocat Series B preferred stock previously held by us could be interpreted as affecting our compliance with federal income tax rules applicable to real estate investment trusts ( REITs ) regarding related party tenant income as described below.

In 2000 at the time of the Initial Advocat Restructuring, we determined that no value should be ascribed to the Advocat preferred stock and subordinated note and, as a result, no value was recorded on our financial statements at that time or in any subsequent period. Management now believes that the accounting treatment in previous periods was incorrect and, in addition to the related party tenant issues described below, the Restatement reflects the appropriate carrying value (in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ( FAS No. 115 )) of the Advocat preferred stock of \$4.6 million and \$4.3 million and an embedded derivative (in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( FAS No. 133 )) of \$9.0 million and \$1.1 million on our restated balance sheets as of June 30, 2006 and December 31, 2005, respectively. In addition, in accordance with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* ( FAS No. 114 ), the Advocat subordinated note of \$1.7 million was fully reserved at September 30, 2006 and December 31, 2005, respectively.

The market value for Advocat's common stock has increased significantly since the completion of the Initial Advocat Restructuring. In connection with exploring the potential disposition of the Advocat Series B preferred stock as part of the Second Advocat Restructuring, we were advised by our tax counsel that due to the structure of the Initial Advocat Restructuring, Advocat may be deemed to be a related party tenant under applicable federal income tax rules and, in such event, rental income from Advocat would not be qualifying income under the gross income tests that are applicable to REITs.

In order to maintain qualification as a REIT, we annually must satisfy certain tests regarding the source of our gross income. The applicable federal income tax rules provide a savings clause for REITs that fail to satisfy the REIT gross income tests, if such failure is due to reasonable cause. A REIT that qualifies for the savings clause will retain its REIT status but will pay a tax under section 857(b)(5) and related interest.

We currently plan to submit to the IRS a request for a closing agreement to resolve the related party tenant issue. While we believe there are valid arguments that Advocat should not be deemed a related party tenant, the matter is not free from doubt, and we believe it is in our best interest to request a closing agreement in order to resolve the matter, minimize potential interest charges and obtain assurances regarding its continuing REIT status. By submitting a request for a closing agreement, we intend to establish that any failure to satisfy the gross income tests was due to reasonable cause. In the event that it is determined that the savings clause described above does not apply, we could be treated as having failed to qualify as a REIT for one or more taxable years. If we fail to qualify for taxation as a REIT for any taxable year, our income will be taxed at regular corporate rates, and we could be disqualified as a REIT for the following four taxable years.

As noted above, we have completed the Second Advocat Restructuring and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007. We will continue to accrue an income tax liability related to this matter during 2006.

#### **Recording of Rental Income**

During the course of preparing the Restatement due to the issues related to Advocat described above, we determined that we should correct our accounting for certain leases because these leases contain provisions (such as increases in rent based on the lesser of a fixed amount or two times CPI) that require us to record rental income on a straight-line basis subject to an appropriate evaluation of collectibility. Historically, we have recorded rental income for leases with these provisions based on

contractual scheduled rent payments, rather than on a straight-line basis. In accordance with Statement of Financial Accounting Standard ( SFAS ) No. 13, *Accounting for Leases* and Financial Accounting Standards Board Technical Bulletin No. 88-1 *Issues Related to Accounting for Leases*, we have determined that the recording of rental revenue associated with these leases should be on a straight-line basis. As a result of this adjustment, our net income will increase by \$1.1 million and \$3.0 million for the three and nine months ended September 30, 2005, respectively. In addition, accounts receivable and retained earnings will increase by \$9.1 million as of December 31, 2005, to reflect the effects of this adjustment from inception of the affected leases.

The following table sets forth the effects of the adjustments related to the Restatement on our consolidated balance sheet as of December 31, 2005:

**CONSOLIDATED BALANCE SHEETS**  
(Audited)  
(in thousands)

|   | As of December 31, 2005, |             |              |
|---|--------------------------|-------------|--------------|
|   | As Reported              | Adjustments | Restated     |
| <b>ASSETS</b>                               |                          |             |              |
| Real estate properties                      |                          |             |              |
| Land and buildings at cost                  | \$ 996,127               | \$          | \$ 996,127   |
| Less accumulated depreciation               | (157,255 )               |             | (157,255 )   |
| Real estate properties net                  | 838,872                  |             | 838,872      |
| Mortgage notes receivable net               | 104,522                  |             | 104,522      |
|   | 943,394                  |             | 943,394      |
| Other investments net                       | 23,490                   | 5,428       | 28,918       |
|   | 966,884                  | 5,428       | 972,312      |
| Assets held for sale net                    | 1,243                    |             | 1,243        |
| Total investments                           | 968,127                  | 5,428       | 973,555      |
| Cash and cash equivalents                   | 3,948                    |             | 3,948        |
| Accounts receivable net                     | 5,885                    | 9,133       | 15,018       |
| Other assets                                | 37,769                   |             | 37,769       |
| Total assets                                | \$ 1,015,729             | \$ 14,561   | \$ 1,030,290 |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                          |             |              |
| Revolving line of credit                    | \$ 58,000                | \$          | \$ 58,000    |
| Unsecured borrowings net                    | 505,429                  |             | 505,429      |
| Other long-term borrowings                  | 2,800                    |             | 2,800        |
| Accrued expenses and other liabilities      | 19,563                   |             | 19,563       |
| Income tax liabilities                      |                          | 3,299       | 3,299        |
| Operating liabilities for owned properties  | 256                      |             | 256          |
| Total liabilities                           | 586,048                  | 3,299       | 589,347      |
| Stockholders equity:                        |                          |             |              |
| Preferred stock                             | 118,488                  |             | 118,488      |
| Common stock and additional paid-in-capital | 663,607                  |             | 663,607      |
| Cumulative net earnings                     | 227,701                  | 9,368       | 237,069      |
| Cumulative dividends paid                   | (536,041 )               |             | (536,041 )   |
| Cumulative dividends redemption             | (43,067 )                |             | (43,067 )    |
| Unamortized restricted stock awards         | (1,167 )                 |             | (1,167 )     |
| Accumulated other comprehensive income      | 160                      | 1,894       | 2,054        |
| Total stockholders equity                   | 429,681                  | 11,262      | 440,943      |
| Total liabilities and stockholders equity   | \$ 1,015,729             | \$ 14,561   | \$ 1,030,290 |

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The effects of the adjustments related to the Restatement for the three and nine months ended September 30, 2005 are summarized below:

|  | Three Months Ended September 30, 2005 |               |                 |
|--|---------------------------------------|---------------|-----------------|
|  | As Reported(1)                        | Adjustments   | Restated        |
| <b>Revenues</b>  |                                       |               |                 |
| Rental income  | \$ 24,099                             | \$ 759        | \$ 24,858       |
| Mortgage interest income   | 1,221                                 |               | 1,221           |
| Other investment income net  | 457                                   | 410           | 867             |
| Miscellaneous  | 141                                   |               | 141             |
| Total operating revenues   | 25,918                                | 1,169         | 27,087          |
| <b>Expenses</b>  |                                       |               |                 |
| Depreciation and amortization  | 6,182                                 |               | 6,182           |
| General and administrative   | 2,235                                 |               | 2,235           |
| Provision for impairment on real estate properties                   | 3,072                                 |               | 3,072           |
| Provision for uncollectible mortgages, notes and accounts receivable |                                       |               |                 |
| Leasehold expiration expense   |                                       |               |                 |
| Total operating expenses   | 11,489                                |               | 11,489          |
| <b>Income before other income and expense</b>                        | <b>14,429</b>                         | <b>1,169</b>  | <b>15,598</b>   |
| <b>Other income (expense):</b>                                       |                                       |               |                 |
| Interest and other investment income                                 | 25                                    |               | 25              |
| Interest   | (7,709)                               | )             | (7,709)         |
| Interest amortization of deferred financing costs                    | (539)                                 | )             | (539)           |
| Provision for impairment on equity securities                        |                                       |               |                 |
| Change in fair value of derivatives                                  |                                       | (16)          | (16)            |
| Total other expense  | (8,223)                               | (16)          | (8,239)         |
| <b>Income from continuing operations before income taxes</b>         | <b>6,206</b>                          | <b>1,153</b>  | <b>7,359</b>    |
| Provision for income taxes   |                                       | (588)         | (588)           |
| <b>Income from continuing operations</b>                             | <b>6,206</b>                          | <b>565</b>    | <b>6,771</b>    |
| Loss from discontinued operations                                    | (1,087)                               | )             | (1,087)         |
| <b>Net income</b>  | <b>5,119</b>                          | <b>565</b>    | <b>5,684</b>    |
| Preferred stock dividends  | (2,481)                               | )             | (2,481)         |
| Preferred stock conversion and redemption charges                    |                                       |               |                 |
| <b>Net income available to common</b>                                | <b>\$ 2,638</b>                       | <b>\$ 565</b> | <b>\$ 3,203</b> |
| <b>Income per common share:</b>                                      |                                       |               |                 |
| <b>Basic:</b>  |                                       |               |                 |
| Income from continuing operations                                    | \$ 0.07                               | \$ 0.01       | \$ 0.08         |
| Net income   | \$ 0.05                               | \$ 0.01       | \$ 0.06         |
| <b>Diluted:</b>  |                                       |               |                 |
| Income from continuing operations                                    | \$ 0.07                               | \$ 0.01       | \$ 0.08         |
| Net income   | \$ 0.05                               | \$ 0.01       | \$ 0.06         |
| Dividends declared and paid per common share                         | \$ 0.22                               | \$            | \$ 0.22         |
| Weighted-average shares outstanding, basic                           | 51,187                                |               | 51,187          |
| Weighted-average shares outstanding, diluted                         | 51,479                                |               | 51,479          |
| <b>Components of other comprehensive income:</b>                     |                                       |               |                 |
| Net income   | \$ 5,119                              | \$ 565        | \$ 5,684        |
| Unrealized gain on common stock investment                           | 730                                   |               | 730             |
| Reclassification adjustment for gains on common stock investment     |                                       |               |                 |
| Unrealized (loss) on preferred stock investment                      |                                       | (332)         | (332)           |
| Total comprehensive income   | \$ 5,849                              | \$ 233        | \$ 6,082        |

(1) Includes current period reclassification for discontinued operations.





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|  | Nine Months Ended September 30, 2005 |                 |                 |
|--|--------------------------------------|-----------------|-----------------|
|  | As Reported (1)                      | Adjustments     | Restated        |
| <b>Revenues</b>  |                                      |                 |                 |
| Rental income  | \$ 68,251                            | \$ 2,078        | \$ 70,329       |
| Mortgage interest income   | 4,417                                |                 | 4,417           |
| Other investment income net  | 1,139                                | 1,225           | 2,364           |
| Miscellaneous  | 4,453                                |                 | 4,453           |
| Total operating revenues   | 78,260                               | 3,303           | 81,563          |
| <b>Expenses</b>  |                                      |                 |                 |
| Depreciation and amortization  | 17,872                               |                 | 17,872          |
| General and administrative   | 6,470                                |                 | 6,470           |
| Provision for impairment on real estate properties                   | 3,072                                |                 | 3,072           |
| Provision for uncollectible mortgages, notes and accounts receivable | 83                                   |                 | 83              |
| Leasehold expiration expense   | 750                                  |                 | 750             |
| Total operating expenses   | 28,247                               |                 | 28,247          |
| <b>Income before other income and expense</b>                        | <b>50,013</b>                        | <b>3,303</b>    | <b>53,316</b>   |
| <b>Other income (expense):</b>                                       |                                      |                 |                 |
| Interest and other investment income                                 | 90                                   |                 | 90              |
| Interest   | (21,431)                             | )               | (21,431)        |
| Interest amortization of deferred financing costs                    | (1,570)                              | )               | (1,570)         |
| Provision for impairment on equity securities                        | (3,360)                              | )               | (3,360)         |
| Change in fair value of derivatives                                  |                                      | (427)           | (427)           |
| Total other expense  | (26,271)                             | (427)           | (26,698)        |
| <b>Income from continuing operations before income taxes</b>         | <b>23,742</b>                        | <b>2,876</b>    | <b>26,618</b>   |
| Provision for income taxes   |                                      | (1,776)         | (1,776)         |
| <b>Income from continuing operations</b>                             | <b>23,742</b>                        | <b>1,100</b>    | <b>24,842</b>   |
| Loss from discontinued operations                                    | (7,061)                              | )               | (7,061)         |
| <b>Net income</b>  | <b>16,681</b>                        | <b>1,100</b>    | <b>17,781</b>   |
| Preferred stock dividends  | (8,904)                              | )               | (8,904)         |
| Preferred stock conversion and redemption charges                    | (2,013)                              | )               | (2,013)         |
| <b>Net income available to common</b>                                | <b>\$ 5,764</b>                      | <b>\$ 1,100</b> | <b>\$ 6,864</b> |
| <b>Income per common share:</b>                                      |                                      |                 |                 |
| <b>Basic:</b>  |                                      |                 |                 |
| Income from continuing operations                                    | \$ 0.25                              | \$ 0.02         | \$ 0.27         |
| Net income   | \$ 0.11                              | \$ 0.02         | \$ 0.13         |
| <b>Diluted:</b>  |                                      |                 |                 |
| Income from continuing operations                                    | \$ 0.25                              | \$ 0.02         | \$ 0.27         |
| Net income   | \$ 0.11                              | \$ 0.02         | \$ 0.13         |
| Dividends declared and paid per common share                         | \$ 0.63                              | \$              | \$ 0.63         |
| Weighted-average shares outstanding, basic                           | 51,050                               |                 | 51,050          |
| Weighted-average shares outstanding, diluted                         | 51,386                               |                 | 51,386          |
| <b>Components of other comprehensive income:</b>                     |                                      |                 |                 |
| Net income   | \$ 16,681                            | \$ 1,100        | \$ 17,781       |
| Unrealized gain (loss) on common stock investment                    | 730                                  |                 | 730             |
| Reclassification adjustment for gains on common stock investment     |                                      |                 |                 |
| Unrealized (loss) gain on preferred stock investment                 |                                      | (959)           | (959)           |
| Total comprehensive income   | \$ 17,411                            | \$ 141          | \$ 17,552       |

(1) Includes current period reclassification for discontinued operations.



**NOTE 3 PROPERTIES**

In the ordinary course of our business activities, we periodically evaluate investment opportunities and extend credit to customers. We also regularly engage in lease and loan extensions and modifications. Additionally, we actively monitor and manage our investment portfolio with the objectives of improving credit quality and increasing returns. In connection with portfolio management, we may engage in various collection and foreclosure activities.

If we acquire real estate pursuant to a foreclosure, lease termination or bankruptcy proceeding and do not immediately re-lease or sell the properties to new operators, the assets will be included on the balance sheet as foreclosed real estate properties, and the value of such assets is reported at the lower of cost or estimated fair value.

The table below summarizes our number of properties and investment by category for the nine months ended September 30, 2006:

| <b>Facility Count</b>                          | <b>Leased Property</b> | <b>Mortgage Notes Receivable</b> | <b>Facilities Held for Sale</b> | <b>Total Healthcare Facilities</b> |
|--|------------------------|----------------------------------|---------------------------------|------------------------------------|
| Balance at December 31, 2005                   | 192                    | 32                               | 3                               | 227                                |
| Properties sold/mortgages paid                 |                        | (15 )                            | (3 )                            | (18 )                              |
| Properties acquired                            | 32                     |                                  |                                 | 32                                 |
| Properties transferred to assets held for sale | (2 )                   |                                  | 2                               |                                    |
| Properties transferred to purchase/leaseback   | 7                      | (7 )                             |                                 |                                    |
| Balance at September 30, 2006                  | 229                    | 10                               | 2                               | 241                                |
| <b>Investment (\$000 s)</b>                    |                        |                                  |                                 |                                    |
| Balance at December 31, 2005                   | \$ 996,127             | \$ 104,522                       | \$ 1,243                        | \$ 1,101,892                       |
| Properties transferred to assets held for sale | (1,354 )               |                                  | 1,354                           |                                    |
| Properties sold/mortgages paid                 |                        | (48,990 )                        | (1,860 )                        | (50,850 )                          |
| Properties acquired                            | 178,906                |                                  |                                 | 178,906                            |
| Properties transferred to purchase/leaseback   | 61,750                 | (22,750 )                        |                                 | 39,000                             |
| Impairment on properties                       | (121 )                 |                                  |                                 | (121 )                             |
| Capital expenditures and other                 | 5,090                  | (597 )                           |                                 | 4,493                              |
| Balance at September 30, 2006                  | \$ 1,240,398           | \$ 32,185                        | \$ 737                          | \$ 1,273,320                       |

**Leased Property**

Our leased real estate properties, represented by 227 long-term care facilities and two rehabilitation hospitals at September 30, 2006, are leased under provisions of single leases and master leases with initial terms typically ranging from 5 to 15 years, plus renewal options. Substantially all of our leases contain provisions for specified annual increases over the rents of the prior year and are generally computed in one of three methods depending on specific provisions of each lease as follows: (i) a specific annual increase over the prior year's rent, generally 2.5%; (ii) an increase based on the change in pre-determined formulas from year to year (i.e., such as increases in the CPI); or (iii) specific dollar increases over prior years. Under the terms of the leases, the lessee is responsible for all maintenance, repairs, taxes and insurance on the leased properties.

Set forth below is a summary of the transactions that occurred in the nine months ended September 30, 2006.

*Litchfield Transaction*

On August 1, 2006, we completed a transaction with Litchfield Investment Company, LLC and its affiliates ( Litchfield ) to purchase 30 skilled nursing facilities and one independent living center for a total investment of approximately \$171 million. The facilities total 3,847 beds and are located in the states of Colorado (5), Florida (7), Idaho (1), Louisiana (13), and Texas (5). The facilities were subject to master leases with three national healthcare providers, which are existing tenants of the Company. The



tenants are Home Quality Management, Inc. ( *HQM* ), Nexion Health, Inc. ( *Nexion* ), and Peak Medical Corporation, which was acquired by Sun Healthcare Group, Inc. ( *Sun* ) in December of 2005. We used a combination of cash on hand and \$150 million of credit facility borrowings to finance the Litchfield transaction.

Simultaneously with the close of the purchase transaction, the seven *HQM* facilities were combined into an Amended and Restated Master Lease containing 13 facilities between us and *HQM*. In addition, the 18 *Nexion* facilities were combined into an Amended and Restated Master Lease containing 22 facilities between us and *Nexion*.

We entered into a Master Lease, Assignment and Assumption Agreement with Litchfield on the six *Sun* facilities. These six facilities are currently under a master lease that expires on September 30, 2007.

*Guardian LTC Management, Inc.*

On September 1, 2006, we completed a \$25.0 million investment with subsidiaries of Guardian LTC Management, Inc. ( *Guardian* ), an existing operator of ours. The transaction involved the purchase and leaseback of a skilled nursing facility ( *SNF* ) in Pennsylvania and a termination of a purchase option on a combination *SNF* and rehabilitation hospital in West Virginia owned by us. The facilities were included in an existing master lease with *Guardian* with an increase in contractual annual rent of approximately \$2.6 million in the first year and the master lease now includes 17 facilities. In addition, the master lease term was extended from October 2014 through August 2016.

In accordance with FASB Statement No. 13, *Accounting Leases* ( *FAS No. 13* ) and FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases* ( *FASB TB No. 88-1* ), \$19.2 million of the \$25.0 million transaction amount will be accounted for as a lease inducement and is classified within accounts receivable net on our consolidated balance sheet. The lease inducement will be amortized as a reduction to rental income on a straight-line basis over the term of the new master lease. The remaining payment to *Guardian* of \$5.8 million will be allocated to the purchase of the Pennsylvania *SNF*.

*Advocat, Inc.*

On October 20, 2006, as part of the Second *Advocat* Restructuring, we amended our master lease with *Advocat* to commence a new 12-year lease term through September 30, 2018 (with a renewal option for an additional 12 year term) and *Advocat* agreed to increase the master lease annual rent by approximately \$687,000 to approximately \$14 million commencing on January 1, 2007. See Note 2 Restatement of Previously Issued Financial Statements.

The Second *Advocat* Restructuring will be accounted for as a new lease in accordance with *FAS No. 13* and *FASB TB No. 88-1*. The fair value of the assets exchanged in the restructuring (i.e., the Series B non-voting redeemable convertible preferred stock and the secured convertible subordinated note, with a fair value of \$14.9 million and \$2.5 million, respectively, at October 20, 2006) in excess of the fair value of the assets received (the Series C non-voting redeemable non-convertible preferred stock and the secured non-convertible subordinated note, with a fair value of \$4.1 million and \$2.5 million, respectively, at October 20, 2006) will be recorded as a lease inducement of approximately \$10.8 million in the fourth quarter of 2006. The \$10.8 million lease inducement asset will be amortized as a reduction to rental income on a straight-line basis over the term of the new master lease. The exchange of securities will also result in a gain in the fourth quarter of 2006 of approximately \$3.0 million representing: (i) the fair value of the secured convertible subordinated note of \$2.5 million, previously reserved; (ii) the realization of the gain on investments previously classified in other comprehensive income of approximately \$1.1 million relating to the Series B non-voting redeemable convertible preferred stock; and (iii) a loss of approximately

\$0.6 million resulting from the change in the fair value of the embedded derivative from September 30, 2006 to October 20, 2006. See also Note 8 Investments in Debt and Equity Securities.

*Haven Eldercare, LLC*

- During the three months ended March 31, 2006, Haven Eldercare, LLC ( Haven ), an existing operator of ours, entered into a \$39 million first mortgage loan with General Electric Capital Corporation ( GE Loan ). Haven used the \$39 million of proceeds to partially repay on a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of our remaining \$23 million of the mortgage note, due in October 2012, to that of the GE Loan. As a result of this transaction, the interest rate on our remaining mortgage note to Haven rose from 10% to approximately 15%, with annual escalators.

- In conjunction with the above transactions and the application of FIN 46R, we consolidated the financial statements and related real estate of this Haven entity into our financial statements. The consolidation resulted in the following changes to our consolidated balance sheet as of September 30, 2006: (1) an increase in total gross investments of \$39.0 million; (2) an increase in accumulated depreciation of \$1.2 million; (3) an increase in other long-term borrowings of \$39.0 million; and (4) a reduction of \$1.2 million in cumulative net earnings for the nine months ended September 30, 2006 due to the increased depreciation expense. General Electric Capital Corporation and Haven s other creditors do not have recourse to our assets. We have an option to purchase the mortgaged facilities for a fixed price in 2012. Our results of operations reflect the effects of the consolidation of this entity, which is being accounted for similarly to our other purchase-leaseback transactions.

**Acquisitions**

The table below summarizes the acquisitions completed during the nine months ended September 30, 2006. The purchase price includes estimated transaction costs.

| 100% Interest Acquired            | Acquisition Date  | Purchase Price (\$000 s) |
|-----------------------------------|-------------------|--------------------------|
| One facility in PA                | September 1, 2006 | \$ 5,800                 |
| Thirty-one facilities in 5 states | August 1, 2006    | 173,100                  |

The acquired properties are included in our results of operations from the respective date of acquisition. The following unaudited pro forma results of operations reflect these transactions as if each had occurred on January 1 of the year presented. According to management, all significant adjustments necessary to reflect the effects of the acquisitions have been made.

|                                   | Pro Forma<br>Three Months Ended<br>September 30, |                    | Nine Months Ended<br>September 30, |                    |
|-----------------------------------|--|--------------------|------------------------------------|--------------------|
|                                   | 2006   | 2005<br>(Restated) | 2006                               | 2005<br>(Restated) |
|                                   | (in thousands, except per share amounts)         |                    |                                    |                    |
| Revenues                          | \$ 36,854  | \$ 31,776          | \$ 110,797                         | \$ 95,629          |
| Net income                        | \$ 14,784  | \$ 6,184           | \$ 43,450                          | \$ 19,282          |
| Earnings (loss) per share Basic   | \$ 0.21  | \$ 0.07            | \$ 0.62                            | \$ 0.16            |
| Earnings (loss) per share Diluted | \$ 0.21  | \$ 0.07            | \$ 0.62                            | \$ 0.16            |

#### Assets Sold or Held for Sale

##### Assets Sold

- On June 30, 2006, we sold two SNFs in California resulting in an accounting loss of approximately \$0.1 million.
- On March 31, 2006, we sold a SNF in Illinois resulting in an accounting loss of approximately \$0.2 million.

##### Held for Sale

- At September 30, 2006, we had two assets held for sale with a net book value of approximately \$0.7 million.
- During the three months ended March 31, 2006, a \$0.1 million provision for impairment charge was recorded to reduce the carrying value to its sales price of one facility that was under contract to be sold that was subsequently sold during the second quarter of 2006.

#### Mortgage Notes Receivable

Mortgage notes receivable relate to ten long-term care facilities. The mortgage notes are secured by first mortgage liens on the borrowers underlying real estate and personal property. The mortgage notes receivable relate to facilities located in five states, operated by seven independent healthcare operating companies. We monitor compliance with mortgages and when necessary have initiated collection, foreclosure and other proceedings with respect to certain outstanding loans. As of September 30, 2006, we had no foreclosed property, and none of our mortgages were in foreclosure proceedings.

Mortgage interest income is recognized as earned over the terms of the related mortgage notes. Reserves are taken against earned revenues from mortgage interest when collection of amounts due becomes questionable or when negotiations for restructurings of troubled operators lead to lower expectations

regarding ultimate collection. When collection is uncertain, mortgage interest income on impaired mortgage loans is recognized as received after taking into account application of security deposits.

*Hickory Creek Healthcare Foundation, Inc.*

On June 16, 2006, we received approximately \$10 million in proceeds on a mortgage loan payoff. We held mortgages on 15 facilities located in Indiana, representing 619 beds.

*Haven Eldercare, LLC.*

During the three months ended March 31, 2006, Haven used the \$39 million of proceeds from the GE Loan to partially repay on a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of its remaining \$23 million on the mortgage note to that of the GE Loan (see Note 3 Properties; Leased Property, above).

#### **NOTE 4 CONCENTRATION OF RISK**

As of September 30, 2006, our portfolio of domestic investments consisted of 241 healthcare facilities, located in 27 states and operated by 33 third-party operators. Our gross investment in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$1.3 billion at September 30, 2006, with approximately 98% of our real estate investments related to long-term care facilities. This portfolio is made up of 227 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on 10 long-term healthcare facilities and two facilities held for sale. At September 30, 2006, we also held miscellaneous investments of approximately \$37 million, consisting primarily of secured loans to third-party operators of our facilities.

At September 30, 2006, approximately 25% of our real estate investments were operated by two public companies: Sun (17%) and Advocat (8%). Our largest private company operators (by investment) were CommuniCare Health Services, Inc. (CommuniCare) (15%), Haven (9%), HQM (8%), Guardian (7%), Nexion (6%) and Essex Healthcare Corporation (6%). No other operator represents more than 4% of our investments. The three states in which we had our highest concentration of investments were Ohio (22%), Florida (14%) and Pennsylvania (9%) at September 30, 2006.

For the three-month period ended September 30, 2006, our revenues from operations totaled \$35.2 million, of which approximately \$6.6 million were from Sun (19%), \$5.1 million from CommuniCare (14%) and \$3.7 million from Advocat (10%). For the nine-month period ended September 30, 2006, our revenues from operations totaled \$99.8 million, of which approximately \$18.2 million were from Sun (18%), \$15.2 million from CommuniCare (15%) and \$10.8 million from Advocat (11%). No other operator generated more than 10% of our revenues from operations for the three- and nine-month periods ended September 30, 2006.

Sun and Advocat are subject to the reporting requirements of the SEC and are required to file with the SEC annual reports containing audited financial information and quarterly reports containing unaudited interim financial information. Sun's and Advocat's filings with the SEC can be found at the SEC's website at [www.sec.gov](http://www.sec.gov). We are providing this data for information purposes only, and you are encouraged to obtain Sun's and Advocat's publicly available filings from the SEC.

#### **NOTE 5 DIVIDENDS**

In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our REIT taxable income (computed without regard to the dividends paid deduction and our net capital gain), and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of non-cash



income. In addition, if we dispose of any built-in gain asset during a recognition period, we will be required to distribute at least 90% of the built-in gain (after tax), if any, recognized on the disposition of such asset. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our REIT taxable income, as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates. In addition, our \$200 million revolving senior secured credit facility ( Credit Facility ) has certain financial covenants that limit the distribution of dividends paid during a fiscal quarter to no more than 95% of our aggregate cumulative funds from operations ( FFO ) as defined in the loan agreement governing the Credit Facility (the Loan Agreement ), unless a greater distribution is required to maintain REIT status. The Loan Agreement defines FFO as net income (or loss) plus depreciation and amortization and shall be adjusted for charges related to: (i) restructuring our debt; (ii) redemption of preferred stock; (iii) litigation charges up to \$5.0 million; (iv) non-cash charges for accounts and notes receivable up to \$5.0 million; (v) non-cash compensation related expenses; (vi) non-cash impairment charges; and (vii) tax liabilities in an amount not to exceed \$8.0 million.

#### ***Common Dividends***

On October 24, 2006, the Board of Directors announced a common stock dividend of \$0.25 per share, an increase of \$0.01 per common share compared to the prior quarter, which was paid November 15, 2006 to common stockholders of record on November 3, 2006.

On July 17, 2006, the Board of Directors declared a common stock dividend of \$0.24 per share. The common dividend was paid August 15, 2006 to common stockholders of record on July 31, 2006.

On April 18, 2006, the Board of Directors declared a common stock dividend of \$0.24 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid May 15, 2006 to common stockholders of record on April 28, 2006.

On January 17, 2006, the Board of Directors declared a common stock dividend of \$0.23 per share, an increase of \$0.01 per common share compared to the prior quarter. The common stock dividend was paid February 15, 2006 to common stockholders of record on January 31, 2006.

#### ***Series D Preferred Dividends***

On October 24, 2006, the Board of Directors declared the regular quarterly dividends for the 8.375% Series D Preferred Stock to stockholders of record on November 3, 2006. The stockholders of record of the Series D Preferred Stock on November 3, 2006 were paid dividends in the amount of \$0.52344 per preferred share on November 15, 2006. The liquidation preference for our Series D Preferred Stock is \$25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period August 1, 2006 through October 31, 2006.

On July 17, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid August 15, 2006 to preferred stockholders of record on April 28, 2006.

On April 18, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid May 15, 2006 to preferred stockholders of record on April 28, 2006.

On January 17, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid February 15, 2006 to preferred stockholders of record on January 31, 2006.

**NOTE 6 TAXES**

So long as we qualify as a REIT and, among other things, we distribute 90% of our taxable income, we will not be subject to Federal income taxes on our income, except as described below. We are permitted to own up to 100% of a taxable REIT subsidiary ( TRS ). Currently, we have two TRSs that are taxable as corporations and that pay federal, state and local income tax on their net income at the applicable corporate rates. These TRSs had net operating loss carry-forwards as of September 30, 2006 of \$11.6 million. These loss carry-forwards were fully reserved with a valuation allowance due to uncertainties regarding realization.

During the fourth quarter of 2006, we determined that certain terms of the Advocat Series B non-voting, redeemable convertible preferred stock could be interpreted as affecting our compliance with federal income tax rules applicable to REITs regarding related party tenant income. As such, Advocat, one of our lessees, may be deemed to be a related party tenant under applicable federal income tax rules. In such event, our rental income from Advocat would not be qualifying income under the gross income tests that are applicable to REITs. In order to maintain qualification as a REIT, we annually must satisfy certain tests regarding the source of our gross income. The applicable federal income tax rules provide a savings clause for REITs that fail to satisfy the REIT gross income tests if such failure is due to reasonable cause. A REIT that qualifies for the savings clause will retain its REIT status but will pay a tax under section 857(b)(5) and related interest. We currently plan to submit to the IRS a request for a closing agreement to resolve the related party tenant issue. While we believe there are valid arguments that Advocat should not be deemed a related party tenant, the matter is not free from doubt, and we believe it is in our best interest to request a closing agreement in order to resolve the matter, minimize potential interest charges and obtain assurances regarding our continuing REIT status. By submitting a request for a closing agreement, we intend to establish that any failure to satisfy the gross income tests was due to reasonable cause (see Note 2 Restatement of Previously Issued Financial Statements). In the event that it is determined that the savings clause described above does not apply, we could be treated as having failed to qualify as a REIT for one or more taxable years. If we fail to qualify for taxation as a REIT for any taxable year, our income will be taxed at regular corporate rates, and we could be disqualified as a REIT for the following four taxable years.

As a result of the potential related party tenant issue described above and further discussed in Note 2 Restatement of Previously Issued Financial Statements, we have recorded a \$0.6 million and \$1.7 million provision for income taxes, including related interest expense, for the three and nine months ended September 30, 2006, respectively, and \$0.6 million and \$1.8 million for the three and nine months ended September 30, 2005, respectively. The amount accrued represents the estimated liability and interest, which remains subject to final resolution and therefore is subject to change. In addition, in October 2006, we restructured our Advocat relationship and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007. We will continue to accrue an income tax liability related to this matter during 2006.

**NOTE 7 STOCK-BASED COMPENSATION**

*Stock Options*

Prior to January 1, 2006, we accounted for stock based compensation using the intrinsic value method as defined by APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Effective January 1, 2006, we adopted FAS No. 123R using the modified prospective method. Accordingly, we have not restated prior period amounts. The additional expense to be recorded in 2006 as a result of this adoption is approximately \$3 thousand. Under the provisions of FAS No. 123R, the Unamortized restricted stock awards line on our consolidated balance sheet, a contra-equity line representing the amount of unrecognized share-based compensation costs, is no longer presented. Accordingly, for the nine-month period ended September 30, 2006, the amount that had been on the Unamortized restricted stock awards

line was reversed through the Common stock and additional paid-in-capital line on our consolidated balance sheet.

Under the terms of our 2000 Stock Incentive Plan (the 2000 Plan), we reserved 3,500,000 shares of common stock. The exercise price per share of an option under the 2000 Plan cannot be reduced after the date of grant, nor can an option be cancelled in exchange for an option with a lower exercise price per share. The 2000 Plan provides for non-employee directors to receive options that vest over three years while other grants vest over the period required in the agreement applicable to the individual recipient. Directors, officers, employees and consultants are eligible to participate in the 2000 Plan. At September 30, 2006, there were outstanding options for 52,581 shares of common stock granted to eight eligible participants under the 2000 Plan. Additionally, 355,655 shares of restricted stock have been granted under the provisions of the 2000 Plan, and as of September 30, 2006, there were no shares of unvested restricted stock outstanding under the 2000 Plan.

At September 30, 2006, under the 2000 Plan, there were outstanding options for 50,912 shares of common stock granted to eight participants currently exercisable with a weighted-average exercise price of \$13.58, with exercise prices ranging from \$2.96 to \$37.20. There were 559,960 shares available for future grants as of September 30, 2006. A breakdown of the options outstanding under the 2000 Plan as of September 30, 2006, by price range, is presented below:

| Option Price Range | Number | Weighted Average Exercise Price | Weighted Average Remaining Life (Years) | Number Exercisable | Weighted Average Price on Options Exercisable |
|--------------------|--------|---------------------------------|---|--------------------|---|
| \$2.96 - \$3.81    | 11,918 | \$ 3.41                         | 5.26                                    | 11,918             | \$ 3.41                                       |
| \$6.02 - \$9.33    | 22,330 | \$ 6.67                         | 5.81                                    | 20,661             | \$ 6.46                                       |
| \$20.25 - \$37.20  | 18,333 | \$ 28.23                        | 1.79                                    | 18,333             | \$ 28.23                                      |

On April 20, 2004, our Board of Directors approved the 2004 Stock Incentive Plan (the 2004 Plan), which was subsequently approved by our stockholders at our annual meeting held on June 3, 2004. Under the terms of the 2004 Plan, we reserved 3,000,000 shares of common stock. The exercise price per share of an option under the 2004 Plan cannot be less than fair market value (as defined in the 2004 Plan) on the date of grant. The exercise price per share of an option under the 2004 Plan cannot be reduced after the date of grant, nor can an option be cancelled in exchange for an option with a lower exercise price per share. Directors, officers, employees and consultants are eligible to participate in the 2004 Plan. As of September 30, 2006, a total of 350,480 shares of restricted stock and 317,500 restricted stock units have been granted under the 2004 Plan, and as of September 30, 2006, there were no outstanding options to purchase shares of common stock under the 2004 Plan.

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At September 30, 2006, the only options outstanding to purchase shares of our common stock were options issued under our 2000 Plan for 52,581 shares of common stock. For the quarter ended September 30, 2006, no options were granted under any of our stock incentive plans. The following is a summary of option activity under the 2000 Plan:

| Stock Options                     | Number of Shares | Exercise Price      | Weighted-Average Price | Weighted-Average Remaining Contractual Term |
|-----------------------------------|------------------|---------------------|------------------------|---|
| Outstanding at December 31, 2005  | 227,440          | \$ 2.760 - \$37.205 | \$ 5.457               | 4.6   |
| Granted during 1st quarter 2006   |                  |                     |                        |   |
| Exercised                         | (174,191)        | ) 2.760 - 9.330     | 2.979                  |   |
| Cancelled                         | (668)            | ) 22.452 - 22.452   | 22.452                 |   |
| Outstanding at March 31, 2006     | 52,581           | \$ 2.960 - \$37.205 | \$ 13.448              | 4.4   |
| Granted during 2nd quarter 2006   |                  |                     |                        |   |
| Exercised                         |                  | -                   |                        |   |
| Cancelled                         |                  | -                   |                        |   |
| Outstanding at June 30, 2006      | 52,581           | \$ 2.960 - \$37.205 | \$ 13.448              | 4.2   |
| Granted during 3rd quarter 2006   |                  |                     |                        |   |
| Exercised                         |                  | -                   |                        |   |
| Cancelled                         |                  | -                   |                        |   |
| Outstanding at September 30, 2006 | 52,581           | \$ 2.960 - \$37.205 | \$ 13.448              | 4.0   |
| Vested at September 30, 2006      | 50,912           | \$ 2.960 - \$37.205 | \$ 13.583              | 3.8   |

| Non-Vested Options               | Number of Shares | Exercise Price     | Weighted-Average Price | Weighted-Average Remaining Contractual Term |
|----------------------------------|------------------|--------------------|------------------------|---|
| Non-vested at December 31, 2005  | 74,985           | \$ 2.760 - \$9.330 | \$ 3.200               | 7.0   |
| Vested during 1st quarter 2006   | (73,316)         | ) 2.760 - 9.330    | 3.059                  |   |
| Non-vested at March 31, 2006     | 1,669            | \$ 9.330 - \$9.330 | \$ 9.330               | 7.8   |
| Vested during 2nd quarter 2006   |                  | -                  |                        |   |
| Non-vested at June 30, 2006      | 1,669            | \$ 9.330 - \$9.330 | \$ 9.330               | 7.5   |
| Vested during 3rd quarter 2006   |                  | -                  |                        |   |
| Non-vested at September 30, 2006 | 1,669            | \$ 9.330 - \$9.330 | \$ 9.330               | 7.3   |

Cash received from exercise under all stock-based payment arrangements for the nine months ended September 30, 2006 and 2005 was \$0.9 million and \$0.2 million, respectively. Cash used to settle equity instruments granted under stock-based payment arrangements for the nine months ended September 30, 2006 and 2005 was \$0.7 million and \$1.2 million, respectively.

In 2005, we accounted for our stock-based compensation arrangements in accordance with the intrinsic value method as defined by Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*. The following table presents the effect on net income and earnings per share if we had applied the fair value recognition provisions of FAS No. 123R to our stock-based compensation.

The reported and pro forma net income and earnings per share figures for 2006 in the table are the same because share-based compensation expense is calculated under the provisions of FAS No. 123R.

The 2006 amounts are included in the table below to provide detail for comparative purposes to the 2005 amounts.

|  | Three Months Ended<br>September 30,              |                    | Nine Months Ended<br>September 30, |                    |
|--|--|--------------------|------------------------------------|--------------------|
|  | 2006<br>(in thousands, except per share amounts) | 2005<br>(Restated) | 2006                               | 2005<br>(Restated) |
| Net income to common stockholders  | \$ 12,143  | \$ 3,203           | \$ 34,846                          | \$ 6,864           |
| Add: Stock-based compensation expense included in net income to common stockholders                | 3,639  | 285                | 4,224                              | 856                |
|  | 15,782   | 3,488              | 39,070                             | 7,720              |
| Less: Stock-based compensation expense determined under the fair value based method for all awards | 3,639  | 323                | 4,224                              | 1,013              |
| Pro forma net income to common stockholders  | \$ 12,143  | \$ 3,165           | \$ 34,846                          | \$ 6,707           |
| <b>Earnings per share:</b>   |  |                    |                                    |                    |
| Basic, as reported   | \$ 0.21  | \$ 0.06            | \$ 0.60                            | \$ 0.13            |
| Basic, pro forma   | \$ 0.21  | \$ 0.06            | \$ 0.60                            | \$ 0.13            |
| Diluted, as reported   | \$ 0.20  | \$ 0.06            | \$ 0.60                            | \$ 0.13            |
| Diluted, pro forma   | \$ 0.20  | \$ 0.06            | \$ 0.60                            | \$ 0.13            |

#### ***Restricted Stock***

On September 10, 2004, we entered into restricted stock agreements with four executive officers under the 2004 Plan. A total of 317,500 shares of restricted stock were granted, which equated to approximately \$3.3 million of deferred compensation. The shares vest thirty-three and one-third percent (33 1/3%) on each of January 1, 2005, January 1, 2006 and January 1, 2007 so long as the executive officer remains employed on the vesting date, with vesting accelerating upon a qualifying termination of employment or upon the occurrence of a change of control (as defined in the applicable restricted stock agreements). As a result of the grant, we recorded \$0.3 million and \$0.8 million of non-cash compensation expense for the three and nine-month periods ended September 30, 2006 and 2005, respectively.

For the nine-month period ended September 30, 2006, we issued 2,179 shares of restricted common stock to each non-employee director and an additional 2,000 shares of restricted common stock to the Chairman of the Board under the 2004 Plan for a total of 12,895 shares. These shares represent a payment of the portion of the directors' annual retainer that is payable in shares of our common stock.

As of September 30, 2006, there was \$377 thousand of total unrecognized compensation cost related to these restricted stock awards.

#### ***Performance Restricted Stock Units***

On September 10, 2004, we entered into performance restricted stock unit agreements with our four executive officers under the 2004 Plan. A total of 317,500 restricted stock units were issued under the 2004 Plan and will fully vest into shares of common stock when our company attains \$0.30 per share of adjusted funds from operations (as defined in the applicable restricted stock unit agreements), ( AFFO ) for two (2) consecutive quarters, with vesting accelerating upon a qualifying termination of employment or upon the occurrence of a change of control (as defined in the applicable restricted stock unit agreements). The performance restricted stock units expire on December 31, 2007 if the performance criteria has not been met. Under our current method of accounting for stock-based

compensation, the expense related to the restricted stock units will be recognized when it becomes probable that the vesting requirements will be met.

As of September 30, 2006, we have achieved the vesting target as defined in the 2004 Plan, and therefore, in accordance with FAS No. 123R (i.e., compensation expense for a performance-based stock award shall be recognized when the satisfaction of the performance conditions that cause the award to vest are probable to occur), we have recorded approximately \$3.3 million for the three and nine months ending September 30, 2006 as compensation expense associated with the performance restricted stock units.

In accordance with FASB Statement No. 128, *Earnings per Share*, ( FAS No. 128 ), the restricted stock unit shares are included in the computation of basic EPS on a weighted-average basis. In addition, in accordance with FAS No. 128, all of the 317,500 restricted stock units are included in diluted EPS as of September 30, 2006, as we have achieved all necessary conditions for the vesting of the restricted units for the quarter ended September 30, 2006. See Note 12 Earnings per Share.

#### **NOTE 8 INVESTMENTS IN DEBT AND EQUITY SECURITIES**

Marketable securities classified as available-for-sale are stated at fair value with unrealized gains and losses recorded in accumulated other comprehensive income. Realized gains and losses and declines in value judged to be other-than-temporary on securities held as available-for-sale are included in investment income. The cost of securities sold is based on the specific identification method. If events or circumstances indicate that the fair value of an investment has declined below its carrying value and we consider the decline to be other than temporary, the investment is written down to fair value and an impairment loss is recognized.

At September 30, 2006, we had the following marketable security:

##### *Advocat Subordinated Debt and Convertible Preferred Stock Investments*

- Under our 2000 restructuring agreement with Advocat, we received the following: (i) 393,658 shares of Advocat's Series B non-voting, redeemable (on or after September 30, 2007), convertible preferred stock, which was convertible into up to 706,576 shares of Advocat's common stock (representing 9.9% of the outstanding shares of Advocat's common stock on a fully diluted, as-converted basis and accruing dividends at 7% per annum); and (ii) a secured convertible subordinated note in the amount of \$1.7 million bearing interest at 7% per annum with a September 30, 2007 maturity (see Note 2 Restatement of Previously Issued Financial Statements).
- In accordance with FAS No. 115, the Advocat Series B security is a compound financial instrument. The embedded derivative value of the conversion feature is recorded separately at fair market value in accordance with FAS No. 133. The non-derivative portion of the security is classified as an available-for-sale investment and is stated at its fair value with unrealized gains or losses recorded in accumulated other comprehensive income. For the three- and nine-month periods ended September 30, 2006, we recorded an adjustment of \$0.2 million and \$0.8 million to other comprehensive income, respectively, and for the three- and nine-month periods ended September 30, 2005, we recorded an adjustment of \$0.3 million and \$1.0 million to other comprehensive income, respectively, to adjust the non-derivative portion of the Advocat security to its then current fair market value.
- In accordance with FASB No. 114 and FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*, the Advocat secured convertible subordinated note is fully reserved and accounted for using the cost-recovery

method applying cash received against the outstanding principal balance prior to recording interest income.

*Sun Healthcare Common Stock Investment*

- Under our 2004 restructuring agreement with Sun, we received the right to convert deferred base rent owed to us, totaling approximately \$7.8 million, into 800,000 shares of Sun's common stock, subject to certain non-dilution provisions and the right of Sun to pay cash in an amount equal to the value of that stock in lieu of issuing stock to us.
- On March 30, 2004, we notified Sun of our intention to exercise our right to convert the deferred base rent into fully paid and non-assessable shares of Sun's common stock. On April 16, 2004, we received a stock certificate for 760,000 restricted shares of Sun's common stock and cash in the amount of approximately \$0.5 million in exchange for the remaining 40,000 shares of Sun's common stock. On July 23, 2004, Sun registered these shares with the SEC. We are accounting for the 760,000 shares received as available for sale marketable securities with changes in market value recorded in other comprehensive income.
- During the three months ended September 30, 2006, we sold our remaining 760,000 share of Sun's common stock for approximately \$7.6 million, realizing a gain on the sale of these securities of approximately \$2.7 million.

**NOTE 9 FINANCING ACTIVITIES AND BORROWING ARRANGEMENTS**

**Bank Credit Agreements**

At September 30, 2006, we had \$157.5 million outstanding under our \$200 million revolving senior secured credit facility (the New Credit Facility) and \$2.5 million was utilized for the issuance of letters of credit, leaving availability of \$40.0 million. The \$157.5 million of outstanding borrowings had a blended interest rate of 6.57% at September 30, 2006. The New Credit Facility, entered into on March 31, 2006, is being provided by Bank of America, N.A., as Administrative Agent, Deutsche Bank Trust Company Americas, UBS Securities LLC, General Electric Capital Corporation, LaSalle Bank N.A., and Citicorp North America, Inc. and will be used for acquisitions and general corporate purposes.

The New Credit Facility replaced our previous \$200 million senior secured credit facility (the Prior Credit Facility), that was terminated on March 31, 2006. We will realize a 125 basis point savings on LIBOR-based loans under the New Credit Facility, as compared to LIBOR-based loans under our Prior Credit Facility. The New Credit Facility matures on March 31, 2010, and includes an accordion feature that permits us to expand our borrowing capacity to \$300 million during our first two years.

For the three-month period ending March 31, 2006, we recorded a one-time, non-cash charge of approximately \$2.7 million relating to the write-off of deferred financing costs associated with the termination of our Prior Credit Facility.

Our long-term borrowings require us to meet certain property level financial covenants and corporate financial covenants, including prescribed leverage, fixed charge coverage, minimum net worth, limitations on additional indebtedness and limitations on dividend payouts. As of September 30, 2006, we were in compliance with all property level and corporate financial covenants.

On October 23, 2006, we entered into a Second Amendment, Waiver and Consent to Credit Agreement (the Second Amendment) pursuant to which the lenders under the New Credit Facility waived any potential misrepresentations and events of default that could have been caused by the

Restatement.

**\$100 Million Aggregate Principal Amount of 6.95% Unsecured Notes Tender and Redemption**

On December 16, 2005, we initiated a tender offer and consent solicitation for all of our outstanding \$100 million aggregate principal amount 6.95% notes due 2007 (the 2007 Notes ). On December 30, 2005, we accepted for purchase 79.3% of the aggregate principal amount of the 2007 Notes outstanding that were tendered. On December 30, 2005, our Board of Directors also authorized the redemption of all outstanding 2007 Notes that were not otherwise tendered. On December 30, 2005, upon our irrevocable funding of the full redemption price for the 2007 Notes and certain other acts required by the Indenture governing the 2007 Notes, the Trustee of the 2007 Notes certified in writing to us (the Certificate of Satisfaction and Discharge ) that the Indenture was satisfied and discharged as of December 30, 2005, except for certain administrative provisions. In accordance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, ( FAS No. 140 ) we removed 79.3% of the aggregate principal amount of the 2007 Notes, which were tendered in our tender offer and consent solicitation, and the corresponding portion of the funds held in trust by the Trustee to pay the tender price from our balance sheet and recognized \$2.8 million of additional interest expense associated with the tender offer. On January 18, 2006, we completed the redemption of the remaining 2007 Notes not otherwise tendered. Accordingly, we reduced other assets, representing the funds deposited with the Trustee, and unsecured borrowings by \$21 million. In connection with the redemption and in accordance with FAS No. 140, we recognized \$0.8 million of additional interest expense in the first quarter of 2006. As of January 18, 2006, none of the 2007 Notes remained outstanding.

**Other Long-Term Borrowings**

During the three months ended March 31, 2006, Haven used the \$39 million of proceeds from the GE Loan to partially repay a portion of a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of its remaining \$23 million on the mortgage note to that of the GE Loan. In conjunction with the above transactions and the application of FIN 46R, we consolidated the financial statements of this Haven entity into our financial statements, which contained the long-term borrowings with General Electric Capital Corporation of \$39.0 million. The loan has an interest rate of approximately seven percent and is due in 2012. The lender of the \$39.0 million does not have recourse to our assets (see Note 3 Properties; Leased Property).

**NOTE 10 LITIGATION**

We are subject to various legal proceedings, claims and other actions arising out of the normal course of business. While any legal proceeding or claim has an element of uncertainty, management believes that the outcome of each lawsuit, claim or legal proceeding that is pending or threatened, or all of them combined, will not have a material adverse effect on our consolidated financial position or results of operations.

We and several of our wholly-owned subsidiaries have been named as defendants in professional liability claims related to our former owned and operated facilities. Other third-party managers responsible for the day-to-day operations of these facilities have also been named as defendants in these claims. In these suits, patients of certain previously owned and operated facilities have alleged significant damages, including punitive damages against the defendants. The majority of these lawsuits representing the most significant amount of exposure were settled in 2004. There currently is one lawsuit pending that is in the discovery stage, and we are unable to predict the likely outcome of this lawsuit at this time.



**NOTE 11 DISCONTINUED OPERATIONS**

Statement of Financial Accounting Standards ( SFAS ) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires the presentation of the net operating results of facilities sold during 2006 or currently classified as held-for-sale as income from discontinued operations for all periods presented. We incurred a net loss from discontinued operations of approximately \$33 thousand and \$0.6 million for the three- and nine-month periods ended September 30, 2006, respectively, in the accompanying consolidated statements of operations.

The following table summarizes the results of operations of facilities sold or held-for-sale during the three and nine months ended September 30, 2006 and 2005, respectively.

|   | Three Months Ended<br>September 30,<br>2006 |                    | Nine Months Ended<br>September 30,<br>2006 |                    |
|---|---|--------------------|--|--------------------|
|   | 2006  | 2005               | 2006                                       | 2005               |
|   | (in thousands)                              |                    |  |                    |
| <b>Revenues</b>                             |   |                    |  |                    |
| Rental income                               | \$  | \$ 678             | \$   | \$ 3,685           |
| Other income                                |   |                    |  | 24                 |
| Subtotal revenues                           |   | 678                |  | 3,709              |
| <b>Expenses</b>                             |   |                    |  |                    |
| Depreciation and amortization               | 2   | 93                 | 18   | 1,196              |
| General and administrative                  | 31  |                    | 34   |                    |
| Provision for impairment                    |   | 2,382              | 121  | 6,082              |
| Subtotal expenses                           | 33  | 2,475              | 173  | 7,278              |
| Income (loss) before loss on sale of assets | (33 )                                       | (1,797 )           | (173 )                                     | (3,569 )           |
| Gain (loss) on assets sold net              |   | 710                | (381 )                                     | (3,492 )           |
| <b>(Loss) from discontinued operations</b>  | <b>\$ (33 )</b>                             | <b>\$ (1,087 )</b> | <b>\$ (554 )</b>                           | <b>\$ (7,061 )</b> |

**NOTE 12 EARNINGS PER SHARE**

We calculate basic and diluted earnings per common share ( EPS ) in accordance with FAS No. 128. The computation of basic EPS is computed by dividing net income available to common stockholders by the weighted-average number of shares of common stock outstanding during the relevant period. Diluted EPS is computed using the treasury stock method, which is net income divided by the total weighted-average number of common outstanding shares plus the effect of dilutive common equivalent shares during the respective period. Dilutive common shares reflect the assumed issuance of additional common shares pursuant to certain of our share-based compensation plans, including stock options, restricted stock and restrictive stock units.

For the three- and nine-month periods ended September 30, 2006 and 2005, the dilutive effect from stock options was immaterial.

**Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Forward-looking Statements, Reimbursement Issues and Other Factors Affecting Future Results**

*The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this document. This document contains forward-looking statements within the meaning of the federal securities laws, including statements regarding potential financings and potential future changes in reimbursement. These statements relate to our expectations, beliefs, intentions, plans, objectives, goals, strategies, future events, performance and underlying assumptions and other statements other than statements of historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology including, but not limited to, terms such as may, will, anticipates, expects, believes, intends, should or comparable terms or the negative thereof. These statements are based on information available on the date of this filing and only speak as to the date hereof and no obligation to update such forward-looking statements should be assumed. Our actual results may differ materially from those reflected in the forward-looking statements contained herein as a result of a variety of factors, including, among other things:*

- (i) those items discussed under Risk Factors in Item 1A to our annual report on Form 10-K/A for the year ended December 31, 2005;
- (ii) uncertainties relating to the business operations of the operators of our assets, including those relating to reimbursement by third-party payors, regulatory matters and occupancy levels;
- (iii) the ability of any operators in bankruptcy to reject unexpired lease obligations, modify the terms of our mortgages and impede our ability to collect unpaid rent or interest during the process of a bankruptcy proceeding and retain security deposits for the debtors' obligations;
- (iv) our ability to sell closed assets on a timely basis and on terms that allow us to realize the carrying value of these assets;
- (v) our ability to negotiate appropriate modifications to the terms of our credit facility;
- (vi) our ability to manage, re-lease or sell any owned and operated facilities;
- (vii) the availability and cost of capital;
- (viii) competition in the financing of healthcare facilities;
- (ix) regulatory and other changes in the healthcare sector;
- (x) the effect of economic and market conditions generally and, particularly, in the healthcare industry;
- (xi) changes in interest rates;
- (xii) the amount and yield of any additional investments;
- (xiii) changes in tax laws and regulations affecting real estate investment trusts;
- (xiv) our ability to maintain our status as a real estate investment trust; and
- (xv) changes in the ratings of our debt and preferred securities.

**Overview**

At September 30, 2006, our portfolio of domestic investments consisted of 241 healthcare facilities, located in 27 states and operated by 33 third-party operators. Our gross investment in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$1.3 billion at September 30, 2006, with approximately 98% of our real estate investments related to long-term care facilities. This portfolio is made up of 227 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on 10 long-term healthcare facilities and two long-term healthcare facilities that are currently held for sale. At September 30, 2006, we also held other investments of approximately \$37 million, consisting primarily of secured loans to third-party operators of our facilities.

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## Medicare Reimbursement

All of our properties are used as healthcare facilities; therefore, we are directly affected by the risk associated with the healthcare industry. Our lessees and mortgagors, as well as any facilities that may be owned and operated for our own account from time to time, derive a substantial portion of their net operating revenues from third-party payors, including the Medicare and Medicaid programs. These programs are highly regulated by federal, state and local laws, rules and regulations and are subject to frequent and substantial change.

In 1997, the Balanced Budget Act significantly reduced spending levels for the Medicare and Medicaid programs, in part because the legislation modified the payment methodology for skilled nursing facilities ( SNFs ) by shifting payments for services provided to Medicare beneficiaries from a reasonable cost basis to a prospective payment system. Under the prospective payment system, SNFs are paid on a per diem prospective case-mix adjusted basis for all covered services. Implementation of the prospective payment system has affected each long-term care facility to a different degree, depending upon the amount of revenue such facility derives from Medicare patients.

Legislation adopted in 1999 and 2000 provided for a few temporary increases to Medicare payment rates, but these temporary increases have since expired. Specifically, in 1999 the Balanced Budget Refinement Act included a 4% across-the-board increase of the adjusted federal per diem payment rates for all patient acuity categories (known as Resource Utilization Groups or RUGs ) that were in effect from April 2000 through September 30, 2002. In 2000, the Benefits Improvement and Protection Act included a 16.7% increase in the nursing component of the case-mix adjusted federal periodic payment rate, which was implemented in April 2000 and also expired October 1, 2002. The October 1, 2002 expiration of these temporary increases has had an adverse impact on the revenues of the operators of SNFs and has negatively impacted some operators' ability to satisfy their monthly lease or debt payments to us.

The Balanced Budget Refinement Act and the Benefits Improvement and Protection Act also established temporary increases, beginning in April 2001, to Medicare payment rates to SNFs that were designated to remain in place until the Centers for Medicare and Medicaid Services ( CMS ) implemented refinements to the existing RUG case-mix classification system to more accurately estimate the cost of non-therapy ancillary services. The Balanced Budget Refinement Act provided for a 20% increase for 15 RUG categories until CMS modified the RUG case-mix classification system. The Benefits Improvement and Protection Act modified this payment increase by reducing the 20% increase for three of the 15 RUGs to a 6.7% increase and instituting an additional 6.7% increase for eleven other RUGs.

On August 4, 2005, CMS published a final rule, effective October 1, 2005, establishing Medicare payments for SNFs under the prospective payment system for federal fiscal year 2006 (October 1, 2005 to September 30, 2006). The final rule modified the RUG case-mix classification system and added nine new categories to the system, expanding the number of RUGs from 44 to 53. The implementation of the RUG refinements triggered the expiration of the temporary payment increases of 20% and 6.7% established by the Balanced Budget Refinement Act and the Benefits Improvement and Protection Act, respectively.

Additionally, CMS announced updates in the final rule to reimbursement rates for SNFs in federal fiscal year 2006 based on an increase in the full market-basket of 3.1%. In the August 4, 2005 notice, CMS estimated that the increases in Medicare reimbursements to SNFs arising from the refinements to the prospective payment system and the market basket update under the final rule would offset the reductions stemming from the elimination of the temporary increases during federal fiscal year 2006. CMS estimated that there would be an overall increase in Medicare payments to SNFs totaling \$20 million in fiscal year 2006 compared to 2005.

On July 27, 2006, CMS posted a notice updating the payment rates to SNFs for fiscal year 2007 (October 1, 2006 to September 30, 2007). The market basket increase factor is 3.1% for 2007. CMS estimates that the payment update will increase aggregate payments to SNFs nationwide by approximately \$560 million in fiscal year 2007 compared to 2006.

Nonetheless, we cannot accurately predict what effect, if any, these changes will have on our lessees and mortgagors in 2006 and beyond. These changes to the Medicare prospective payment system for SNFs, including the elimination of temporary increases, could adversely impact the revenues of the operators of nursing facilities and could negatively impact the ability of some of our lessees and mortgagors to satisfy their monthly lease or debt payments to us.

A 128% temporary increase in the per diem amount paid to SNFs for residents who have AIDS took effect on October 1, 2004. This temporary payment increase arose from the Medicare Prescription Drug Improvement and Modernization Act of 2003 ( Medicare Modernization Act ). Although CMS also noted that the AIDS add-on was not intended to be permanent, the July 2006 notice updating payment rates for SNFs for fiscal year 2007 indicated that the increase will continue to remain in effect for fiscal year 2007.

A significant change enacted under the Medicare Modernization Act is the creation of a new prescription drug benefit, Medicare Part D, which went into effect January 1, 2006. The significant expansion of benefits for Medicare beneficiaries arising under the expanded prescription drug benefit could result in financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts for our operators. As part of this new program, the prescription drug benefits for patients who are dually eligible for both Medicare and Medicaid are being transitioned from Medicaid to Medicare, and many of these patients reside in long-term care facilities. The Medicare program experienced significant operational difficulties in transitioning prescription drug coverage for this population when the benefit went into effect on January 1, 2006, although it is unclear whether or how issues involving Medicare Part D might have any direct financial impacts on our operators.

On February 8, 2006, the President signed into law a \$39.7 billion budget reconciliation package called the Deficit Reduction Act of 2005 ( Deficit Reduction Act ) to lower the federal budget deficit. The Deficit Reduction Act included estimated net savings of \$8.3 billion from the Medicare program over 5 years.

The Deficit Reduction Act contained a provision reducing payments to SNFs for allowable bad debts. Previously, Medicare reimbursed SNFs for 100% of beneficiary bad debt arising from unpaid deductibles and coinsurance amounts. In 2003, CMS released a proposed rule seeking to reduce bad debt reimbursement rates for certain providers, including SNFs, by 30% over a three-year period. CMS never finalized its 2003 proposal. The Deficit Reduction Act reduced payments to SNFs for allowable bad debts by 30% effective October 1, 2005 for those individuals not dually eligible for Medicare and Medicaid. Bad debt payments for the dually eligible population will remain at 100%. These reductions in Medicare payments for bad debt could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

The Deficit Reduction Act also contained a provision governing the therapy caps that went into place under Medicare on January 1, 2006. The therapy caps limit the physical therapy, speech-language therapy and occupation therapy services that a Medicare beneficiary can receive during a calendar year. The therapy caps were in effect for calendar year 1999 and then suspended by Congress for three years. An inflation-adjusted therapy limit (\$1,590 per year) was implemented in September of 2002, but then once again suspended in December of 2003 by the Medicare Modernization Act. Under the Medicare Modernization Act, Congress placed a two-year moratorium on implementation of the caps, which expired at the end of 2005.

The inflation-adjusted therapy caps are set at \$1,740 for calendar year 2006. These caps do not apply to therapy services covered under Medicare Part A in a SNF, although the caps apply in most other instances involving patients in SNFs or long-term care facilities who receive therapy services covered under Medicare Part B. The Deficit Reduction Act permitted exceptions in 2006 for therapy services to exceed the caps when the therapy services are deemed medically necessary by the Medicare program, but there will be no such exceptions permitted beginning in calendar year 2007. The implementation of the therapy caps could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

In general, we cannot be assured that federal reimbursement will remain at levels comparable to present levels or that such reimbursement will be sufficient for our lessees or mortgagors to cover all operating and fixed costs necessary to care for Medicare and Medicaid patients. We also cannot be assured that there will be any future legislation to increase Medicare payment rates for SNFs, and if such payment rates for SNFs are not increased in the future, some of our lessees and mortgagors may have difficulty meeting their payment obligations to us.

### **Medicaid and Other Third-Party Reimbursement**

Each state has its own Medicaid program that is funded jointly by the state and federal government. Federal law governs how each state manages its Medicaid program, but there is wide latitude for states to customize Medicaid programs to fit the needs and resources of their citizens. Currently, Medicaid is the single largest source of financing for long-term care in the United States. Rising Medicaid costs and decreasing state revenues caused by recent economic conditions have prompted an increasing number of states to cut or consider reductions in Medicaid funding as a means of balancing their respective state budgets. Existing and future initiatives affecting Medicaid reimbursement may reduce utilization of (and reimbursement for) services offered by the operators of our properties.

In recent years, many states have announced actual or potential budget shortfalls, and many budget forecasts in 2007 could be similar. As a result of these budget shortfalls, many states have announced that they are implementing or considering implementing freezes or cuts in Medicaid reimbursement rates, including rates paid to SNF and long-term care providers, or reductions in Medicaid enrollee benefits, including long-term care benefits. We cannot predict the extent to which Medicaid rate freezes, cuts or benefit reductions ultimately will be adopted, the number of states that will adopt them or the impact of such adoption on our operators. However, extensive Medicaid rate cuts, freezes or benefit reductions could have a material adverse effect on our operators' liquidity, financial condition and operations, which could adversely affect their ability to make lease or mortgage payments to us.

The Deficit Reduction Act included \$4.7 billion in estimated savings from Medicaid and the State Children's Health Insurance Program over five years. The Deficit Reduction Act gave states the option to increase Medicaid cost-sharing and reduce Medicaid benefits, accounting for an estimated \$3.2 billion in federal savings over five years. The remainder of the Medicaid savings under the Deficit Reduction Act comes primarily from changes to prescription drug reimbursement (\$3.9 billion in savings over five years) and tightened policies governing asset transfers (\$2.4 billion in savings over five years).

Asset transfer policies, which determine Medicaid eligibility based on whether a Medicaid applicant has transferred assets for less than fair value, became more restrictive under the Deficit Reduction Act, which extended the look-back period to five years, moved the start of the penalty period and made individuals with more than \$500,000 in home equity ineligible for nursing home benefits (previously, the home was excluded as a countable asset for purposes of Medicaid eligibility). These changes could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

Additional reductions in federal funding are expected for some state Medicaid programs as a result of changes in the percentage rates used for determining federal assistance on a state-by-state basis.

Legislation has been introduced in Congress that would partially mitigate the reductions for some states that would experience significant reductions in federal funding, although whether Congress will enact this or other legislation remains uncertain.

Finally, private payors, including managed care payors, increasingly are demanding discounted fee structures and the assumption by healthcare providers of all or a portion of the financial risk of operating a healthcare facility. Efforts to impose greater discounts and more stringent cost controls are expected to continue. Any changes in reimbursement policies that reduce reimbursement levels could adversely affect the revenues of our lessees and mortgagors, thereby adversely affecting those lessees' and mortgagors' abilities to make their monthly lease or debt payments to us.

### **Fraud and Abuse Laws and Regulations**

There are various extremely complex and largely uninterpreted federal and state laws governing a wide array of referrals, relationships and arrangements and prohibiting fraud by healthcare providers, including criminal provisions that prohibit filing false claims or making false statements to receive payment or certification under Medicare and Medicaid, and failing to refund overpayments or improper payments. The federal and state governments are devoting increasing attention and resources to anti-fraud initiatives against healthcare providers. Penalties for healthcare fraud have been increased and expanded over recent years, including broader provisions for the exclusion of providers from the Medicare and Medicaid programs. The Office of the Inspector General for the U.S. Department of Health and Human Services (OIG-HHS) has described a number of ongoing and new initiatives for 2007 to study instances of potential overbilling and/or fraud in SNFs and nursing homes under both Medicare and Medicaid. The OIG-HHS, in cooperation with other federal and state agencies, also continues to focus on the activities of SNFs in certain states in which we have properties.

In addition, the federal False Claims Act allows a private individual with knowledge of fraud to bring a claim on behalf of the federal government and earn a percentage of the federal government's recovery. Because of these monetary incentives, these so-called whistleblower suits have become more frequent. Some states currently have statutes that are analogous to the federal False Claims Act. The Deficit Reduction Act encourages additional states to enact such legislation and may encourage increased enforcement activity by permitting states to retain 10% of any recovery for that state's Medicaid program if the enacted legislation is at least as rigorous as the federal False Claims Act. The violation of any of these laws or regulations by an operator may result in the imposition of fines or other penalties that could jeopardize that operator's ability to make lease or mortgage payments to us or to continue operating its facility.

### **Legislative and Regulatory Developments**

Each year, legislative and regulatory proposals are introduced or proposed in Congress and state legislatures as well as by federal and state agencies that, if implemented, could result in major changes in the healthcare system, either nationally or at the state level. In addition, regulatory proposals and rules are released on an ongoing basis that may have major impacts on the healthcare system generally and the industries in which our operators do business. Legislative and regulatory developments can be expected to occur on an ongoing basis at the local, state and federal levels that have direct or indirect impacts on the policies governing the reimbursement levels paid to our facilities by public and private third-party payors, the costs of doing business and the threshold requirements that must be met for facilities to continue operation or to expand.

The Medicare Modernization Act, which is one example of such legislation, was enacted in December 2003. The significant expansion of other benefits for Medicare beneficiaries under this Act, such as the prescription drug benefit, could create financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts on our operators. Although the creation of a prescription drug benefit for Medicare beneficiaries was expected to generate fiscal relief for state

Medicaid programs, the structure of the benefit and costs associated with its implementation may mitigate the relief for states that originally was anticipated.

The Deficit Reduction Act is another example of such legislation. The provisions in the legislation designed to create cost savings from both Medicare and Medicaid could diminish reimbursement for our operators under both Medicare and Medicaid.

CMS also launched the Nursing Home Quality Initiative program in 2002, which requires nursing homes participating in Medicare to provide consumers with comparative information about the quality of care at the facility. In the fall of 2007, CMS plans to initiate a new quality campaign, Advancing Excellence for America's Nursing Home Residents, to be conducted over the next two years with the ultimate goal being improvement in quality of life and efficiency of care delivery. In the event any of our operators do not maintain the same or superior levels of quality care as their competitors, patients could choose alternate facilities, which could adversely impact our operators' revenues. In addition, the reporting of such information could lead in the future to reimbursement policies that reward or penalize facilities on the basis of the reported quality of care parameters.

In late 2005, CMS began soliciting public comments regarding a demonstration to examine pay-for-performance approaches in the nursing home setting that would offer financial incentives for facilities to deliver high quality care. In June 2006, Abt Associates published recommendations for CMS on how to design this demonstration project. The proposed three-year demonstration could begin as early as late 2006 or early 2007, with CMS inviting state agencies to participate in the project. Other proposals under consideration include efforts by individual states to control costs by decreasing state Medicaid reimbursements in the current or future fiscal years and federal legislation addressing various issues, such as improving quality of care and reducing medical errors throughout the health care industry. We cannot accurately predict whether specific proposals will be adopted or, if adopted, what effect, if any, these proposals would have on operators and, thus, our business.

## **Taxation**

The following is a general summary of the material U.S. federal income tax considerations applicable to us and to the holders of our securities and our election to be taxed as a real estate investment trust ( REIT ). It is not tax advice. The summary is not intended to represent a detailed description of the U.S. federal income tax consequences applicable to a particular stockholder in view of any person's particular circumstances, nor is it intended to represent a detailed description of the U.S. federal income tax consequences applicable to stockholders subject to special treatment under the federal income tax laws such as insurance companies, tax-exempt organizations, financial institutions, securities broker-dealers, investors in pass-through entities, expatriates and taxpayers subject to alternative minimum taxation.

The following discussion, to the extent it constitutes matters of law or legal conclusions (assuming the facts, representations, and assumptions upon which the discussion is based are accurate), accurately represents some of the material U.S. federal income tax considerations relevant to our securities. The sections of the Internal Revenue Code (the Code ) relating to the qualification and operation as a REIT are highly technical and complex. The following discussion sets forth the material aspects of the Code sections that govern the federal income tax treatment of a REIT and its stockholders. The information in this section is based on the Code; current, temporary, and proposed Treasury regulations promulgated under the Code; the legislative history of the Code; current administrative interpretations and practices of the Internal Revenue Service ( IRS ); and court decisions, in each case, as of the date of this report. In addition, the administrative interpretations and practices of the IRS include its practices and policies as expressed in private letter rulings, which are not binding on the IRS, except with respect to the particular taxpayers who requested and received those rulings.



*Taxation of Omega*

*General.* We have elected to be taxed as a REIT, under Sections 856 through 860 of the Code, beginning with our taxable year ended December 31, 1992. Except with respect to the Advocat Inc. ( Advocat ) related party tenant issue described elsewhere in this report, we believe that we have been organized and operated in such a manner as to qualify for taxation as a REIT under the Code and we intend to continue to operate in such a manner, but no assurance can be given that we have operated or will be able to continue to operate in a manner so as to qualify or remain qualified as a REIT.

The sections of the Code that govern the federal income tax treatment of a REIT are highly technical and complex. The following sets forth the material aspects of those sections. This summary is qualified in its entirety by the applicable Code provisions, rules and regulations promulgated thereunder, and administrative and judicial interpretations thereof.

If we qualify for taxation as a REIT, we generally will not be subject to federal corporate income taxes on our net income that is currently distributed to stockholders. However, we will be subject to federal income tax as follows: First, we will be taxed at regular corporate rates on any undistributed REIT taxable income, including undistributed net capital gains; provided, however, that if we have a net capital gain, we will be taxed at regular corporate rates on our undistributed REIT taxable income, computed without regard to net capital gain and the deduction for capital gains dividends, plus a 35% tax on undistributed net capital gain, if our tax as thus computed is less than the tax computed in the regular manner. Second, under certain circumstances, we may be subject to the alternative minimum tax on our items of tax preference that we do not distribute or allocate to our stockholders. Third, if we have (i) net income from the sale or other disposition of foreclosure property, which is held primarily for sale to customers in the ordinary course of business, or (ii) other nonqualifying income from foreclosure property, we will be subject to tax at the highest regular corporate rate on such income. Fourth, if we have net income from prohibited transactions (which are, in general, certain sales or other dispositions of property (other than foreclosure property) held primarily for sale to customers in the ordinary course of business by us, (i.e., when we are acting as a dealer)), such income will be subject to a 100% tax. Fifth, if we should fail to satisfy the 75% gross income test or the 95% gross income test (as discussed below), but have nonetheless maintained our qualification as a REIT because certain other requirements have been met, we will be subject to a 100% tax on an amount equal to (a) the gross income attributable to the greater of the amount by which we fail the 75% or 95% test, multiplied by (b) a fraction intended to reflect our profitability. Sixth, if we should fail to distribute by the end of each year at least the sum of (i) 85% of our REIT ordinary income for such year, (ii) 95% of our REIT capital gain net income for such year, and (iii) any undistributed taxable income from prior periods, we will be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed. Seventh, we will be subject to a 100% excise tax on transactions with a taxable REIT subsidiary, or TRS, that are not conducted on an arm's-length basis. Eighth, if we acquire any asset, which is defined as a built-in gain asset from a C corporation that is not a REIT (i.e., generally a corporation subject to full corporate-level tax) in a transaction in which the basis of the built-in gain asset in our hands is determined by reference to the basis of the asset (or any other property) in the hands of the C corporation, and we recognize gain on the disposition of such asset during the 10-year period, which is defined as the recognition period, beginning on the date on which such asset was acquired by us, then, to the extent of the built-in gain (i.e., the excess of (a) the fair market value of such asset on the date such asset was acquired by us over (b) our adjusted basis in such asset on such date), our recognized gain will be subject to tax at the highest regular corporate rate. The results described above with respect to the recognition of built-in gain assume that we will not make an election pursuant to Treasury Regulations Section 1.337(d)-7(c)(5).

*Requirements for qualification.* The Code defines a REIT as a corporation, trust or association: (1) which is managed by one or more trustees or directors; (2) the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest; (3) which would be taxable as a domestic corporation, but for Sections 856 through 859 of the Code; (4) which is neither a financial institution nor an insurance company subject to the provisions of the Code; (5) the beneficial ownership of which is held by 100 or more persons; (6) during the last half year of each taxable year not

more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals (as defined in the Code to include certain entities); and (7) which meets certain other tests, described below, regarding the nature of its income and assets and the amount of its annual distributions to stockholders. The Code provides that conditions (1) to (4), inclusive, must be met during the entire taxable year and that condition (5) must be met during at least 335 days of a taxable year of twelve months, or during a proportionate part of a taxable year of less than twelve months. For purposes of conditions (5) and (6), pension funds and certain other tax-exempt entities are treated as individuals, subject to a look-through exception in the case of condition (6).

*Income tests.* In order to maintain our qualification as a REIT, we annually must satisfy two gross income requirements. First, at least 75% of our gross income (excluding gross income from prohibited transactions) for each taxable year must be derived directly or indirectly from investments relating to real property or mortgages on real property (including generally rents from real property, interest on mortgages on real property and gains on sale of real property and real property mortgages, other than property described in Section 1221 of the Code) and income derived from certain types of temporary investments. Second, at least 95% of our gross income (excluding gross income from prohibited transactions) for each taxable year must be derived from such real property investments, dividends, interest and gain from the sale or disposition of stock or securities other than property held for sale to customers in the ordinary course of business.

Rents received by us will qualify as rents from real property in satisfying the gross income requirements for a REIT described above only if several conditions are met. First, the amount of the rent must not be based in whole or in part on the income or profits of any person. However, any amount received or accrued generally will not be excluded from the term rents from real property solely by reason of being based on a fixed percentage or percentages of receipts or sales. Second, the Code provides that rents received from a tenant will not qualify as rents from real property in satisfying the gross income tests if we, or an owner (actually or constructively) of 10% or more of the value of our stock, actually or constructively owns 10% or more of such tenant, which is defined as a related party tenant. Third, if rent attributable to personal property, leased in connection with a lease of real property, is greater than 15% of the total rent received under the lease, then the portion of rent attributable to such personal property will not qualify as rents from real property. Finally, for rents received to qualify as rents from real property, we generally must not operate or manage the property or furnish or render services to the tenants of such property, other than through an independent contractor from which we derive no revenue. We, however, directly perform certain services that are usually or customarily rendered in connection with the rental of space for occupancy only and are not otherwise considered rendered to the occupant of the property. In addition, we may provide a minimal amount of non-customary services to the tenants of a property, other than through an independent contractor, as long as our income from the services does not exceed 1% of our income from the related property. Furthermore, we may own up to 100% of the stock of a taxable REIT subsidiary ( TRS ), which may provide customary and non-customary services to our tenants without tainting our rental income from the related properties. For our tax years beginning after 2004, rents for customary services performed by a TRS or that are received from a TRS and are described in Code Section 512(b)(3) no longer meet the 100% excise tax safe harbor. Instead, such payments avoid the excise tax if we pay the TRS at least 150% of its direct cost of furnishing such services.

The term interest generally does not include any amount received or accrued (directly or indirectly) if the determination of such amount depends in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from the term interest solely by reason of being based on a fixed percentage or percentages of gross receipts or sales. In addition, an amount that is based on the income or profits of a debtor will be qualifying interest income as long as the debtor derives substantially all of its income from the real property securing the debt from leasing substantially all of its interest in the property, but only to the extent that the amounts received by the debtor would be qualifying rents from real property if received directly by a REIT.

If a loan contains a provision that entitles us to a percentage of the borrower's gain upon the sale of the real property securing the loan or a percentage of the appreciation in the property's value as of a specific date, income attributable to that loan provision will be treated as gain from the sale of the property securing the loan, which generally is qualifying income for purposes of both gross income tests.

Interest on debt secured by mortgages on real property or on interests in real property generally is qualifying income for purposes of the 75% gross income test. However, if the highest principal amount of a loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan as of the date we agreed to originate or acquire the loan, a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test, but will be qualifying income for purposes of the 95% gross income test. The portion of the interest income that will not be qualifying income for purposes of the 75% gross income test will be equal to the portion of the principal amount of the loan that is not secured by real property.

*Prohibited transactions.* We will incur a 100% tax on the net income derived from any sale or other disposition of property, other than foreclosure property, that we hold primarily for sale to customers in the ordinary course of a trade or business. We believe that none of our assets is primarily held for sale to customers and that a sale of any of our assets would not be in the ordinary course of our business. Whether a REIT holds an asset primarily for sale to customers in the ordinary course of a trade or business depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. Nevertheless, we will attempt to comply with the terms of safe-harbor provisions in the federal income tax laws prescribing when an asset sale will not be characterized as a prohibited transaction. We cannot assure you, however, that we can comply with the safe-harbor provisions or that we will avoid owning property that may be characterized as property that we hold primarily for sale to customers in the ordinary course of a trade or business.

*Foreclosure property.* We will be subject to tax at the maximum corporate rate on any income from foreclosure property, other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. However, gross income from foreclosure property will qualify for purposes of the 75% and 95% gross income tests. Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

- that is acquired by a REIT as the result of the REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;
- for which the related loan or lease was acquired by the REIT at a time when the default was not imminent or anticipated; and
- for which the REIT makes a proper election to treat the property as foreclosure property.

Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property, or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

- on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test, or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;



- on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or
- which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT, other than through an independent contractor from whom the REIT itself does not derive or receive any income.

After the year 2000, the definition of foreclosure property was amended to include any qualified health care property, as defined in Code Section 856(e)(6) acquired by us as the result of the termination or expiration of a lease of such property. We have operated qualified healthcare facilities acquired in this manner for up to two years (or longer if an extension was granted). However, we do not currently own any property with respect to which we have made foreclosure property elections. Properties that we had taken back in a foreclosure or bankruptcy and operated for our own account were treated as foreclosure properties for income tax purposes, pursuant to Internal Revenue Code Section 856(e). Gross income from foreclosure properties was classified as good income for purposes of the annual REIT income tests upon making the election on the tax return. Once made, the income was classified as good for a period of three years, or until the properties were no longer operated for our own account. In all cases of foreclosure property, we utilized an independent contractor to conduct day-to-day operations in order to maintain REIT status. In certain cases we operated these facilities through a taxable REIT subsidiary. For those properties operated through the taxable REIT subsidiary, we utilized an eligible independent contractor to conduct day-to-day operations to maintain REIT status. As a result of the foregoing, we do not believe that our participation in the operation of nursing homes increased the risk that we will fail to qualify as a REIT. Through our 2005 taxable year, we had not paid any tax on our foreclosure property because those properties had been producing losses. We cannot predict whether, in the future, our income from foreclosure property will be significant and/or whether we could be required to pay a significant amount of tax on that income.

*Hedging transactions.* From time to time, we enter into hedging transactions with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps, and floors, options to purchase these items, and futures and forward contracts. To the extent that we enter into an interest rate swap or cap contract, option, futures contract, forward rate agreement, or any similar financial instrument to hedge our indebtedness incurred to acquire or carry real estate assets, any periodic income or gain from the disposition of that contract should be qualifying income for purposes of the 95% gross income test, but not the 75% gross income test. Accordingly, our income and gain from our interest rate swap agreements generally is qualifying income for purposes of the 95% gross income test, but not the 75% gross income test. To the extent that we hedge with other types of financial instruments, or in other situations, it is not entirely clear how the income from those transactions will be treated for purposes of the gross income tests. We have structured and intend to continue to structure any hedging transactions in a manner that does not jeopardize our status as a REIT. For tax years beginning after 2004, we will no longer include income from hedging transactions in gross income (i.e., not included in either the numerator or the denominator) for purposes of the 95% gross income test.

*TRS income.* A TRS may earn income that would not be qualifying income if earned directly by the parent REIT. Both the subsidiary and the REIT must jointly elect to treat the subsidiary as a TRS. A corporation of which a TRS directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a TRS. Overall, no more than 20% of the value of a REIT's assets may consist of securities of one or more TRSs. However, a TRS does not include a corporation which directly or indirectly (i) operates or manages a health care (or lodging) facility, or (ii) provides to any other person (under a franchise, license, or otherwise) rights to any brand name under which a health care (or lodging) facility is operated. A TRS will pay income tax at regular corporate rates on any income that it earns. In addition, the new rules limit the deductibility of interest paid or accrued by a TRS to its parent REIT to assure that the TRS is subject to an appropriate level of corporate taxation. The rules also impose a 100% excise tax on transactions between a TRS and its parent REIT or the REIT's tenants that

are not conducted on an arm's-length basis. We have made a TRS election with respect to Bayside Street II, Inc. That entity will pay corporate income tax on its taxable income and its after-tax net income will be available for distribution to us.

*Failure to satisfy income tests.* If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for such year if we are entitled to relief under certain provisions of the Code. These relief provisions will be generally available if our failure to meet such tests was due to reasonable cause and not due to willful neglect, we attach a schedule of the sources of our income to our tax return, and any incorrect information on the schedule was not due to fraud with intent to evade tax. It is not possible, however, to state whether in all circumstances we would be entitled to the benefit of these relief provisions. Even if these relief provisions apply, we would incur a 100% tax on the gross income attributable to the greater of the amounts by which we fail the 75% and 95% gross income tests, multiplied by a fraction intended to reflect our profitability and we would file a schedule with descriptions of each item of gross income that caused the failure.

*Asset tests.* At the close of each quarter of our taxable year, we must also satisfy the following tests relating to the nature of our assets. First, at least 75% of the value of our total assets must be represented by real estate assets (including (i) our allocable share of real estate assets held by partnerships in which we own an interest and (ii) stock or debt instruments held for not more than one year purchased with the proceeds of a stock offering or long-term (at least five years) debt offering of our company), cash, cash items and government securities. Second, of our investments not included in the 75% asset class, the value of our interest in any one issuer's securities may not exceed 5% of the value of our total assets. Third, we may not own more than 10% of the voting power or value of any one issuer's outstanding securities. Fourth, no more than 20% of the value of our total assets may consist of the securities of one or more TRSs. Fifth, no more than 25% of the value of our total assets may consist of the securities of TRSs and other non-TRS taxable subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test.

For purposes of the second and third asset tests the term "securities" does not include our equity or debt securities of a qualified REIT subsidiary or TRS or our equity interest in any partnership, since we are deemed to own our proportionate share of each asset of any partnership of which we are a partner. Furthermore, for purposes of determining whether we own more than 10% of the value of only one issuer's outstanding securities, the term "securities" does not include: (i) any loan to an individual or an estate; (ii) any Code Section 467 rental agreement; (iii) any obligation to pay rents from real property; (iv) certain government issued securities; (v) any security issued by another REIT; and (vi) our debt securities in any partnership, not otherwise excepted under (i) through (v) above, (A) to the extent of our interest as a partner in the partnership or (B) if 75% of the partnership's gross income is derived from sources described in the 75% income test set forth above.

We may own up to 100% of the stock of one or more TRSs. However, overall, no more than 20% of the value of our assets may consist of securities of one or more TRSs, and no more than 25% of the value of our assets may consist of the securities of TRSs and other non-TRS taxable subsidiaries (including stock in non-REIT C corporations) and other assets that are not qualifying assets for purposes of the 75% asset test. If the outstanding principal balance of a mortgage loan exceeds the fair market value of the real property securing the loan, a portion of such loan likely will not be a qualifying real estate asset under the federal income tax laws. The nonqualifying portion of that mortgage loan will be equal to the portion of the loan amount that exceeds the value of the associated real property.

After initially meeting the asset tests at the close of any quarter, we will not lose our status as a REIT for failure to satisfy any of the asset tests at the end of a later quarter solely by reason of changes in asset values. If the failure to satisfy the asset tests results from an acquisition of securities or other property during a quarter, the failure can be cured by disposition of sufficient nonqualifying assets within 30 days after the close of that quarter.

For our tax years beginning after 2004, subject to certain *de minimis* exceptions, we may avoid REIT disqualification in the event of certain failures under the asset tests, provided that (i) we file a schedule with a description of each asset that caused the failure, (ii) the failure was due to reasonable cause and not willful neglect, (iii) we dispose of the assets within 6 months after the last day of the quarter in which the identification of the failure occurred (or the requirements of the rules are otherwise met within such period), and (iv) we pay a tax on the failure equal to the greater of (A) \$50,000 per failure, and (B) the product of the net income generated by the assets that caused the failure for the period beginning on the date of the failure and ending on the date we dispose of the asset (or otherwise satisfy the requirements) multiplied by the highest applicable corporate tax rate.

*Annual distribution requirements.* In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our REIT taxable income (computed without regard to the dividends paid deduction and our net capital gain) and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of noncash income. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our REIT taxable income, as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates.

Furthermore, if we fail to distribute during a calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

- 85% of our REIT ordinary income for such year;
- 95% of our REIT capital gain income for such year; and
- any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% excise tax described above. We have made, and we intend to continue to make, timely distributions sufficient to satisfy the annual distribution requirements. We may also be entitled to pay and deduct deficiency dividends in later years as a relief measure to correct errors in determining our taxable income. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

The availability to us of, among other things, depreciation deductions with respect to our owned facilities depends upon the treatment by us as the owner of such facilities for federal income tax purposes, and the classification of the leases with respect to such facilities as true leases rather than financing arrangements for federal income tax purposes. The questions of whether we are the owner of such facilities and whether the leases are true leases for federal tax purposes are essentially factual matters. We believe that we will be treated as the owner of each of the facilities that we lease, and such leases will be treated as true leases for federal income tax purposes. However, no assurances can be given that the IRS will not successfully challenge our status as the owner of our facilities subject to leases, and the status of such leases as true leases, asserting that the purchase of the facilities by us and the leasing of such facilities merely constitute steps in secured financing transactions in which the lessees are owners of the facilities and we are merely a secured creditor. In such event, we would not be entitled to claim

depreciation deductions with respect to any of the affected facilities. As a result, we might fail to meet the 90% distribution requirement or, if such requirement is met, we might be subject to corporate income tax or the 4% excise tax.

*Other Failures.* We may avoid disqualification in the event of a failure to meet certain requirements for REIT qualification, other than the 95% and 75% gross income tests, the rules with respect to ownership of securities of more than 10% of a single issuer, and the new rules provided for failures of the asset tests, if the failures are due to reasonable cause and not willful neglect, and if the REIT pays a penalty of \$50,000 for each such failure.

#### ***Failure to Qualify***

If we fail to qualify as a REIT in any taxable year, and the relief provisions do not apply, we will be subject to tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Distributions to stockholders in any year in which we fail to qualify will not be deductible and our failure to qualify as a REIT would reduce the cash available for distribution by us to our stockholders. In addition, if we fail to qualify as a REIT, all distributions to stockholders will be taxable as ordinary income, to the extent of current and accumulated earnings and profits, and, subject to certain limitations of the Code, corporate distributees may be eligible for the dividends received deduction. Unless entitled to relief under specific statutory provisions, we would also be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. It is not possible to state whether in all circumstances we would be entitled to such statutory relief. Failure to qualify could result in our incurring indebtedness or liquidating investments in order to pay the resulting taxes.

#### ***Other Tax Matters***

We own and operate a number of properties through qualified REIT subsidiaries, ( QRSs ). The QRSs are treated as qualified REIT subsidiaries under the Code. Code Section 856(i) provides that a corporation which is a qualified REIT subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a qualified REIT subsidiary shall be treated as assets, liabilities and such items (as the case may be) of the REIT. Thus, in applying the tests for REIT qualification described in this prospectus under the heading Taxation of Omega, the QRSs will be ignored, and all assets, liabilities and items of income, deduction, and credit of such QRSs will be treated as our assets, liabilities and items of income, deduction, and credit.

In the case of a REIT that is a partner in a partnership, the REIT is treated as owning its proportionate share of the assets of the partnership and as earning its allocable share of the gross income of the partnership for purposes of the applicable REIT qualification tests. Thus, our proportionate share of the assets, liabilities, and items of income of any partnership, joint venture, or limited liability company that is treated as a partnership for federal income tax purposes in which we own an interest, directly or indirectly, will be treated as our assets and gross income for purposes of applying the various REIT qualification requirements.

#### **Critical Accounting Policies and Estimates**

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and a summary of our significant accounting policies is included in Note 2 to our annual report on Form 10-K/A for the year ended December 31, 2005. Our preparation of the financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period.



We have identified five significant accounting policies that we believe are critical accounting policies. These critical accounting policies are those that have the most impact on the reporting of our financial condition and those requiring significant assumptions, judgments and estimates. With respect to these critical accounting policies, we believe the application of judgments and assessments is consistently applied and produces financial information that fairly presents the results of operations for all periods presented. The five critical accounting policies are:

***Revenue Recognition***

With the exception of certain master leases, rental income and mortgage interest income are recognized as earned over the terms of the related master leases and mortgage notes, respectively. Substantially all of our leases contain provisions for specified annual increases over the rents of the prior year and are generally computed in one of three methods depending on specific provisions of each lease as follows: (i) a specific annual increase over the prior year's rent, generally 2.5%; (ii) an increase based on the change in pre-determined formulas from year to year (i.e., such as increases in the Consumer Price Index (CPI)); or (iii) specific dollar increases over prior years. Revenue under lease arrangements with specific determinable increases is recognized over the term of the lease on a straight-line basis. SEC Staff Accounting Bulletin No. 101 *Revenue Recognition in Financial Statements* (SAB 101) does not provide for the recognition of contingent revenue until all possible contingencies have been eliminated. We consider the operating history of the lessee, the general condition of the industry and various other factors when evaluating whether all possible contingencies have been eliminated. We have historically not included, and generally expect in the future not to include, contingent rents as income until received. We follow a policy related to rental income whereby we typically consider a lease to be non-performing after 90 days of non-payment of past due amounts and do not recognize unpaid rental income from that lease until the amounts have been received.

In the case of rental revenue recognized on a straight-line basis, we will generally discontinue recording rent on a straight-line basis if the lessee becomes delinquent in rent owed under the terms of the lease. Reserves are taken against earned revenues from leases when collection becomes questionable or when negotiations for restructurings of troubled operators result in significant uncertainty regarding ultimate collection. The amount of the reserve is estimated based on what management believes will likely be collected. Once the recording of straight-line rent is suspended, we will evaluate the collectibility of the related straight-line rent asset. If it is determined that the delinquency is temporary, we will resume booking rent on a straight-line basis once payment is received for past due rents, after taking into account application of security deposits. If it appears that we will not collect future rent due under our leases, we will record a provision for loss related to the straight-line rent asset.

Recognizing rental income on a straight-line basis results in recognized revenue exceeding contractual amounts due from our tenants. Such cumulative excess amounts are included in accounts receivable and were \$18.4 million and \$13.8 million, net of allowances, at September 30, 2006 and December 31, 2005, respectively. See Note 2 *Restatement of Previously Issued Financial Statements*. In the case of a lease recognized on a straight-line basis, we will generally provide an allowance for straight-line accounts receivable when certain conditions or indicators of collectibility are present (e.g., among other things, lessee payment delinquencies, bankruptcy indicators, etc.). At September 30, 2006 and December 31, 2005, the allowance for straight-line accounts receivable was \$6.5 million and \$6.7 million, respectively.

Gains on sales of real estate assets are recognized pursuant to the provisions of SFAS No. 66, *Accounting for Sales of Real Estate*. The specific timing of the recognition of the sale and the related gain is measured against the various criteria in SFAS No. 66 related to the terms of the transactions and any continuing involvement associated with the assets sold. To the extent the sales criteria are not met, we defer gain recognition until the sales criteria are met.

***Depreciation and Asset Impairment***

Under GAAP, real estate assets are stated at the lower of depreciated cost or fair value, if deemed impaired. Depreciation is computed on a straight-line basis over the estimated useful lives of 20 to 40 years for buildings and improvements and three to ten years for furniture, fixtures and equipment. Management periodically, but not less than annually, evaluates our real estate investments for impairment indicators, including the evaluation of our assets' useful lives. The judgment regarding the existence of impairment indicators is based on factors such as, but not limited to, market conditions, operator performance and legal structure. If indicators of impairment are present, management evaluates the carrying value of the related real estate investments in relation to the future undiscounted cash flows of the underlying facilities. Provisions for impairment losses related to long-lived assets are recognized when expected future undiscounted cash flows are determined to be permanently less than the carrying values of the assets. An adjustment is made to the net carrying value of the leased properties and other long-lived assets for the excess of historical cost over fair value. The fair value of the real estate investment is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses. All impairments are taken as a period cost at that time, and depreciation is adjusted going forward to reflect the new value assigned to the asset.

If we decide to sell rental properties or land holdings, we evaluate the recoverability of the carrying amounts of the assets. If the evaluation indicates that the carrying value is not recoverable from estimated net sales proceeds, the property is written down to estimated fair value less costs to sell. Our estimates of cash flows and fair values of the properties are based on current market conditions and consider matters such as rental rates and occupancies for comparable properties, recent sales data for comparable properties, and, where applicable, contracts or the results of negotiations with purchasers or prospective purchasers.

During the nine months ended September 30, 2006, we recognized an impairment loss associated with one facility of approximately \$0.1 million.

***Loan Impairment***

Management, periodically but not less than annually, evaluates our outstanding loans and notes receivable. When management identifies potential loan impairment indicators, such as non-payment under the loan documents, impairment of the underlying collateral, financial difficulty of the operator or other circumstances that may impair full execution of the loan documents, and management believes these indicators are permanent, then the loan is written down to the present value of the expected future cash flows. In cases where expected future cash flows cannot be estimated, the loan is written down to the fair value of the collateral. The fair value of the loan is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses.

In accordance with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* and FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*, we currently account for impaired loans using the cost-recovery method applying cash received against the outstanding principal balance prior to recording interest income (see Note 8 - Investments in Debt and Equity Securities).

***Assets Held for Sale and Discontinued Operations***

Pursuant to the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the operating results of specified real estate assets that have been sold, or otherwise qualify as held for disposition (as defined by SFAS No. 144), are reflected as discontinued operations in the consolidated statements of operations for all periods presented.

### *Consolidation of Variable Interest Entities*

Financial Accounting Standards Board Interpretation No. 46R, *Consolidation of Variable Interest Entities*, or FIN 46R, addresses the consolidation by business enterprises of variable interest entities ( VIEs ). FIN 46R provides criteria that, if met, would create a VIE, which would then be subject to consolidation. If an entity is determined to be a VIE, the party deemed to be the primary beneficiary is required to consolidate the VIE. The primary beneficiary is the party that has the most variability in expected gains or losses of the VIE.

In order to determine which party is the primary beneficiary, we must calculate the expected losses and expected residual returns of the VIE. The analysis requires a projection of expected cash flows and the assignment of probabilities to each possible cash flow outcome. Estimating expected cash flows and assigning probabilities of each outcome of the VIE requires us to use significant judgment. If assumptions used to estimate the expected cash flows prove to be inaccurate, our conclusions regarding which party is the VIE's primary beneficiary could be incorrect, resulting in us improperly consolidating the VIE when we are not the primary beneficiary or not consolidating the VIE when we are the primary beneficiary.

### **Results of Operations**

The following is our discussion of the consolidated results of operations, financial position and liquidity and capital resources, which should be read in conjunction with our audited consolidated financial statements and accompanying notes.

Our Board of Directors, including our Audit Committee, concluded on October 24, 2006, to restate our audited financial results as of December 31, 2005 and 2004 and for the three years ended December 31, 2005, 2004 and 2003 and for other periods affected, including our unaudited financial statements for each quarterly period in 2004, 2005 and 2006 as necessary. As a result, we have previously filed with the Securities and Exchange Commission ( SEC ) amendments to our Annual Report on Form 10-K for the period ending December 31, 2005 and our Quarterly Reports on Form 10-Q for the three-month periods ended March 31, 2006 and June 30, 2006, respectively, reflecting the restated matters (the Restatement ). The Restatement reflects the following adjustments that affect the three- and nine-month periods ended September 30, 2005:

1. We recorded asset values for securities received from Advocat (and the increases therein) since the completion of the restructuring of Advocat obligations pursuant to leases and mortgages for the facilities then operated by Advocat in 2000. These adjustments increased net income by \$0.4 million and \$0.8 million for the three and nine months ended September 30, 2005, respectively. These adjustments also increased total assets by \$5.4 million as of December 31, 2005. Changes in the fair value of the securities not currently recognized in net income were reflected in other comprehensive income.
2. As a result of our holdings of Advocat securities, we recorded reserves related to a potential tax liability arising from our ownership of such securities. This tax liability along with related interest expense had not been previously accrued for and this adjustment decreased net income by \$0.6 million and \$1.8 million for the three and nine months ended September 30, 2005, respectively. The amount accrued represents the estimated liability, which remains subject to final resolution and therefore is subject to change.
3. Subsequent to October 25, 2006, we made a correction to our accounting for certain leases because these leases contain provisions (such as increases in rent based on the lesser of a fixed amount or two times the CPI) that require us to record rental income on a straight-line basis subject to an appropriate evaluation of collectibility. We had not previously recorded rental income on these leases on a straight-line basis. As a result of this adjustment, our net income increased by \$0.8 million and \$2.1 million for the three and nine months ended September 30, 2005, respectively. In addition, net accounts receivable and retained earnings increased by \$9.1 million as of December 31, 2005, to reflect the effects of this adjustment from inception of the affected leases.



*Three Months Ended September 30, 2006 and 2005*

*Operating Revenues*

Our operating revenues for the three months ended September 30, 2006 totaled \$35.2 million, an increase of \$8.1 million, over the same period in 2005. The \$8.1 million increase was primarily a result of new investments made throughout 2005 and 2006. The increase in operating revenues from new investments was partially offset by a reduction in mortgage interest income.

Detailed changes in operating revenues for the three months ended September 30, 2006 are as follows:

- Rental income was \$33.2 million, an increase of \$8.3 million over the same period in 2005. The increase was primarily due to new leases entered into throughout 2005 and during the third quarter of 2006, as well as from the consolidation of a VIE.
- Mortgage interest income totaled \$1.1 million, a decrease of \$0.2 million over the same period in 2005. The decrease was primarily the result of normal amortization and a \$10 million loan payoff that occurred in the second quarter of 2006.
- Other investment income totaled \$1.0 million, an increase of \$0.1 million over the same period in 2005. The primary reason for the increase was due to dividends and accretion income associated with the Advocat securities.

*Operating Expenses*

Operating expenses for the three months ended September 30, 2006 totaled \$14.2 million, an increase of approximately \$2.7 million over the same period in 2005. The increase was primarily due to \$2.2 million of increased depreciation expense and \$3.6 million of restricted stock expense, partially offset by a 2005 provision for impairment on real estate properties.

Detailed changes in our operating expenses for the three months ended September 30, 2006 versus the same period in 2005 are as follows:

- Our depreciation and amortization expense was \$8.4 million, compared to \$6.2 million for the same period in 2005. The increase is due to new investments placed throughout 2005 and during the third quarter of 2006, as well as the consolidation of a VIE in 2006.
- Our general and administrative expense, when excluding restricted stock amortization expense and compensation expense related to the performance restricted stock units, was \$2.0 million, compared to \$2.0 million for the same period in 2005.
- For the three months ended September 30, 2006, in accordance with FAS No. 123R, we recorded approximately \$3.3 million (included in general and administrative expense) of compensation expense associated with the performance restricted stock units (see Note 7 Stock Based Compensation).
- In 2005, we recorded a \$3.1 million provision for impairment charge to reduce the carrying value of two facilities to their estimated fair value.

*Other Income (Expense)*

For the three months ended September 30, 2006, our total other net expenses were \$7.0 million as compared to \$8.2 million for the same period in 2005. The significant changes are as follows:

- Our interest expense, excluding amortization of deferred costs and refinancing related interest expenses, for the three months ended September 30, 2006 was \$11.2 million, compared to \$7.7 million

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for the same period 2005. The increase of \$3.5 million was primarily due to higher debt on our balance sheet versus the same period in 2005 and from consolidation of a VIE in 2006.

- For the three months ended September 30, 2006, we sold our remaining 760,000 shares of Sun's common stock for approximately \$7.6 million, realizing a gain on the sale of these securities of approximately \$2.7 million.
- For the three months ended September 30, 2006, in accordance with FASB No. 133, we recorded a \$1.8 million mark-to-market adjustment to reflect the fair value of our derivative instrument (i.e., the conversion feature of a redeemable convertible preferred stock security in Advocat, a publicly traded company; see Note 2 Restatement of Previously Issued Financial Statements and Note 8 Investments in Debt and Equity Securities).

#### *Nine Months Ended September 30, 2006 and 2005*

##### *Operating Revenues*

Our operating revenues for the nine months ended September 30, 2006 totaled \$99.8 million, an increase of \$18.2 million, over the same period in 2005. The \$18.2 million increase was primarily a result of new investments made throughout 2005 and 2006. The increase in operating revenues from new investments was partially offset by a reduction in mortgage interest income and one-time contractual interest revenue associated with the payoff of a mortgage during the first quarter of 2005.

Detailed changes in operating revenues for the nine months ended September 30, 2006 are as follows:

- Rental income was \$93.1 million, an increase of \$22.7 million over the same period in 2005. The increase was due to new leases entered into throughout 2005 and during the third quarter of 2006, as well as from the consolidation of a VIE.
- Mortgage interest income totaled \$3.4 million, a decrease of \$1.0 million over the same period in 2005. The decrease was primarily the result of normal amortization, a \$60 million loan payoff that occurred in the first quarter of 2005 and a \$10 million loan payoff that occurred in the second quarter of 2006.
- Other investment income totaled \$2.9 million, an increase of \$0.5 million over the same period in 2005. The primary reason for the increase was due to dividends and accretion income associated with the Advocat securities.
- Miscellaneous revenue was \$0.5 million, a decrease of \$4.0 million over the same period in 2005. The decrease was due to contractual revenue owed to us and received in the second quarter of 2005 resulting from a mortgage note prepayment that occurred in the first quarter of 2005.

##### *Operating Expenses*

Operating expenses for the nine months ended September 30, 2006 totaled \$33.9 million, an increase of approximately \$5.7 million over the same period in 2005. The increase was primarily due to \$5.5 million of increased depreciation expense and \$4.2 million of restricted stock expense, partially offset by a 2005 provision for impairment on real estate properties and by a 2005 leasehold termination expense.

Detailed changes in our operating expenses for the nine months ended September 30, 2006 versus the same period in 2005 are as follows:

- Our depreciation and amortization expense was \$23.4 million, compared to \$17.9 million for the same period in 2005. The increase is due to new investments placed throughout 2005 and during the third quarter of 2006, as well as from the consolidation of a VIE.





- Our general and administrative expense, when excluding restricted stock amortization expense and compensation expense related to the performance restricted stock units, was \$6.1 million, compared to \$5.6 million for the same period in 2005. The increase was primarily due to normal inflationary increases in goods and services.
- For the nine months ended September 30, 2006, in accordance with FAS No. 123R, we recorded approximately \$3.3 million (included in general and administrative expense) of compensation expense associated with the performance restricted stock units (see Note 7 Stock Based Compensation).
- In 2006, we recorded a \$0.2 million provision for uncollectible notes receivable.
- In 2005, we recorded a \$3.1 million provision for impairment charge to reduce the carrying value of two facilities to their estimated fair value.
- In 2005, we recorded a \$0.8 million lease expiration accrual relating to disputed capital improvement requirements associated with a lease that expired June 30, 2005.

*Other Income (Expense)*

For the nine months ended September 30, 2006, our total other net expenses were \$22.5 million as compared to \$26.7 million for the same period in 2005. The significant changes are as follows:

- Our interest expense, excluding amortization of deferred costs and refinancing related interest expenses, for the nine months ended September 30, 2006 was \$30.2 million, compared to \$21.4 million for the same period 2005. The increase of \$8.8 million was primarily due to higher debt on our balance sheet versus the same period in 2005 and from consolidation of a VIE in 2006.
- For the nine months ended September 30, 2006, we sold our remaining 760,000 shares of Sun's common stock for approximately \$7.6 million, realizing a gain on the sale of these securities of approximately \$2.7 million.
- For the nine months ended September 30, 2006, in accordance with FAS No. 133, we recorded a \$9.7 million mark-to-market adjustment to reflect the fair value of our derivative instrument (i.e., the conversion feature of a redeemable convertible preferred stock security in Advocat, a publicly traded company; see Note 2 Restatement of Previously Issued Financial Statements and Note 8 Investments in Debt and Equity Securities).
- For the nine months ended September 30, 2006, we recorded a \$0.8 million non-cash charge associated with the redemption of the remaining 20.7% of our \$100 million aggregate principal amount of 6.95% unsecured notes due 2007 not otherwise tendered in 2005.
- For the nine months ended September 30, 2006, we recorded a one time, non-cash charge of approximately \$2.7 million relating to the write-off of deferred financing costs associated with the termination of our prior credit facility.
- During the nine months ended September 30, 2005, we recorded a \$3.4 million provision for impairment of an equity security. In accordance with FASB No. 115, the \$3.4 million provision for impairment was to write-down our 760,000 share investment in Sun's common stock to its then current fair market value.

*Taxes*

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So long as we qualify as a REIT and, among other things, we distribute 90% of our taxable income, we will not be subject to Federal income taxes on our income, except as described below. We are permitted to own up to 100% of a taxable REIT subsidiary ( TRS ). Currently, we have two TRSs that are taxable as corporations and that pay federal, state and local income tax on their net income at the applicable corporate rates. See Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations Taxation.

During the fourth quarter of 2006, we determined that certain terms of the Advocat Series B non-voting, redeemable convertible preferred stock held by us could be interpreted as affecting our compliance with federal income tax rules applicable to REITs regarding related party tenant income. As such, Advocat,

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one of our lessees, may be deemed to be a related party tenant under applicable federal income tax rules. In such event, our rental income from Advocat would not be qualifying income under the gross income tests that are applicable to REITs. In order to maintain qualification as a REIT, we annually must satisfy certain tests regarding the source of our gross income. The applicable federal income tax rules provide a savings clause for REITs that fail to satisfy the REIT gross income tests if such failure is due to reasonable cause. A REIT that qualifies for the savings clause will retain its REIT status but will pay a tax under section 857(b)(5) and related interest. We currently plan to submit to the IRS a request for a closing agreement to resolve the related party tenant issue. While we believe there are valid arguments that Advocat should not be deemed a related party tenant, the matter is not free from doubt, and we believe it is in our best interest to request a closing agreement in order to resolve the matter, minimize potential interest charges and obtain assurances regarding our continuing REIT status. By submitting a request for a closing agreement, we intend to establish that any failure to satisfy the gross income tests was due to reasonable cause (see Note 2 Restatement of Previously Issued Financial Statements). In the event that it is determined that the savings clause described above does not apply, we could be treated as having failed to qualify as a REIT for one or more taxable years. If we fail to qualify for taxation as a REIT for any taxable year, our income will be taxed at regular corporate rates, and we could be disqualified as a REIT for the following four taxable years.

As a result of the potential related party tenant issue described above and further discussed in Note 2 Restatement of Previously Issued Financial Statements, we have recorded a \$0.6 million and \$1.7 million provision for income taxes, including related interest expense, for the three and nine months ended September 30, 2006, respectively, and \$0.6 million and \$1.8 million for the three and nine months ended September 30, 2005, respectively. The amount accrued represents the estimated liability and interest, which remains subject to final resolution and therefore is subject to change. In addition, in October 2006, we restructured our Advocat relationship and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007. We will continue to accrue an income tax liability related to this matter during 2006.

#### ***Loss from Discontinued Operations***

Discontinued operations relate to properties we disposed of in 2006 or are currently held-for-sale and are accounted for as discontinued operations under SFAS No. 144. For the nine months ended September 30, 2006, we sold two SNFs in California and one in Illinois resulting in an accounting loss of approximately \$0.4 million.

At September 30, 2006, we had two assets held for sale with a net book value of approximately \$0.7 million.

During the three months ended March 31, 2006, a \$0.1 million provision for impairment charge was recorded to reduce the carrying value to its sales price of one facility that was under contract to be sold that was subsequently sold during the second quarter of 2006.

In accordance with SFAS No. 144, the \$0.4 million realized net loss is reflected in our consolidated statements of operations as discontinued operations. See Note 11 Discontinued Operations.

#### ***Funds From Operations***

Our funds from operations available to common stockholders ( FFO ), for the three months ended September 30, 2006, was \$19.3 million, compared to \$8.8 million, for the same period in 2005.

We calculate and report FFO in accordance with the definition and interpretive guidelines issued by the National Association of Real Estate Investment Trusts ( NAREIT ), and, consequently, FFO is defined as net income available to common stockholders, adjusted for the effects of asset dispositions and

certain non-cash items, primarily depreciation and amortization. We believe that FFO is an important supplemental measure of our operating performance. Because the historical cost accounting convention used for real estate assets requires depreciation (except on land), such accounting presentation implies that the value of real estate assets diminishes predictably over time, while real estate values instead have historically risen or fallen with market conditions. The term FFO was designed by the real estate industry to address this issue. FFO herein is not necessarily comparable to FFO of other real estate investment trusts ( REITs ) that do not use the same definition or implementation guidelines or interpret the standards differently from us.

We use FFO as one of several criteria to measure operating performance of our business. We further believe that by excluding the effect of depreciation, amortization and gains or losses from sales of real estate, all of which are based on historical costs and which may be of limited relevance in evaluating current performance, FFO can facilitate comparisons of operating performance between periods and between other REITs. We offer this measure to assist the users of our financial statements in evaluating our financial performance under GAAP, and FFO should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. Investors and potential investors in our securities should not rely on this measure as a substitute for any GAAP measure, including net income.

In February 2004, NAREIT informed its member companies that it was adopting the position of the Securities and Exchange Commission ( SEC ) with respect to asset impairment charges and would no longer recommend that impairment write-downs be excluded from FFO. In the tables included in this disclosure, we have applied this interpretation and have not excluded asset impairment charges in calculating our FFO. As a result, our FFO may not be comparable to similar measures reported in previous disclosures. According to NAREIT, there is inconsistency among NAREIT member companies as to the adoption of this interpretation of FFO. Therefore, a comparison of our FFO results to another company s FFO results may not be meaningful.

The following table presents our FFO results reflecting the impact of asset impairment charges (the SEC s interpretation) for the three and nine months ended September 30, 2006 and 2005:

|   | Three Months Ended<br>September 30,<br>2006 |          | 2005 |        | Nine Months Ended<br>September 30,<br>2006 |        | 2005 |        |
|---|---|----------|------|--------|--|--------|------|--------|
|   | (in thousands)                              |          |      |        |  |        |      |        |
| <b>Net income available to common</b>                         | \$  | 12,143   | \$   | 3,203  | \$   | 34,846 | \$   | 6,864  |
| Add back loss (deduct gain) from real estate dispositions     |   | (1,188 ) |      | (710 ) |  | (807 ) |      | 3,492  |
| Sub-total   |   | 10,955   |      | 2,493  |  | 34,039 |      | 10,356 |
| Elimination of non-cash items included in net income:         |   |          |      |        |  |        |      |        |
| Depreciation and amortization                                 |   | 8,362    |      | 6,275  |  | 23,432 |      | 19,068 |
| <b>Funds from operations available to common stockholders</b> | \$  | 19,317   | \$   | 8,768  | \$   | 57,471 | \$   | 29,424 |

#### Portfolio Developments, New Investments and Recent Developments

Below is a brief description, by third-party operator, of our re-leasing, restructuring or new investment transactions that occurred during the nine months ended September 30, 2006.

*Litchfield Transaction*

On August 1, 2006, we completed a transaction with Litchfield Investment Company, LLC and its affiliates ( Litchfield ) to purchase 30 skilled nursing facilities and one independent living center for a total investment of approximately \$171 million. The facilities total 3,847 beds and are located in the states of Colorado (5), Florida (7), Idaho (1), Louisiana (13), and Texas (5). The facilities were subject to master leases with three national healthcare providers, which are existing tenants of the Company. The tenants are Home Quality Management, Inc. ( HQM ), Nexion Health, Inc. ( Nexion ), and Peak Medical Corporation, which was acquired by Sun Healthcare Group, Inc. ( Sun ) in December of 2005. We used a combination of cash on hand and \$150 million of credit facility borrowings to finance the Litchfield transaction.

Simultaneously with the close of the purchase transaction, the seven HQM facilities were combined into an Amended and Restated Master Lease containing 13 facilities between us and HQM. In addition, the 18 Nexion facilities were combined into an Amended and Restated Master Lease containing 22 facilities between us and Nexion.

We entered into a Master Lease, Assignment and Assumption Agreement with Litchfield on the six Sun facilities. These six facilities are currently under a master lease that expires on September 30, 2007.

*Guardian LTC Management, Inc.*

On September 1, 2006, we completed a \$25.0 million investment with subsidiaries of Guardian LTC Management, Inc. ( Guardian ), an existing operator of ours. The transaction involved the purchase and leaseback of a skilled nursing facility ( SNF ) in Pennsylvania and termination of a purchase option on a combination SNF and rehabilitation hospital in West Virginia owned by us. The facilities were included in an existing master lease with Guardian with an increase in contractual annual rent of approximately \$2.6 million in the first year and the master lease now includes 17 facilities. In addition, the master lease term was extended from October 2014 through August 2016.

In accordance with FASB Statement No. 13, *Accounting Leases* ( FAS No. 13 ) and FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases* ( FASB TB No. 88-1 ), \$19.2 million of the \$25.0 million transaction amount will be accounted for as a lease inducement and is classified within accounts receivable net on our consolidated balance sheets. The lease inducement will be amortized as a reduction to rental income on a straight-line basis over the term of the new master lease. The remaining payment to Guardian of \$5.8 million will be allocated to the purchase of the Pennsylvania SNF.

*Advocat, Inc.*

On October 20, 2006, as part of the Second Advocat Restructuring, we amended our master lease with Advocat to commence a new 12-year lease term through September 30, 2018 (with a renewal option for an additional 12 year term) and Advocat agreed to increase the master lease annual rent by approximately \$687,000 to approximately \$14 million commencing on January 1, 2007. See Note 2 Restatement of Previously Issued Financial Statements.

The Second Advocat Restructuring will be accounted for as a new lease in accordance with FAS No. 13 and FASB TB No. 88-1. The fair value of the assets exchanged in the restructuring (i.e., the Series B non-voting redeemable convertible preferred stock and the secured convertible subordinated note, with a fair value of \$14.9 million and \$2.5 million, respectively, at October 20, 2006) in excess of the fair value of the assets received (the Series C non-voting redeemable non-convertible preferred stock and the secured non-convertible subordinated note, with a fair value of \$4.1 million and \$2.5 million, respectively, at October 20, 2006) will be recorded as a lease inducement of approximately \$10.8 million in the fourth quarter of 2006. The \$10.8 million lease inducement asset will be amortized as a reduction to rental income on a straight-line basis over the term of the new master lease. The exchange of securities will also result in a gain in

the fourth quarter of 2006 of approximately \$3.0 million representing: (i) the fair value of the secured convertible subordinated note of \$2.5 million, previously reserved; (ii) the realization of the gain on investments previously classified in other comprehensive income of approximately \$1.1 million relating to the Series B non-voting redeemable convertible preferred stock; and (iii) a loss of approximately \$0.6 million resulting from the change in the fair value of the embedded derivative from September 30, 2006 to October 20, 2006. See also Note 8 Investments in Debt and Equity Securities.

*Hickory Creek Healthcare Foundation, Inc.*

On June 16, 2006, we received approximately \$10 million in proceeds on a mortgage loan payoff. We held mortgages on 15 facilities located in Indiana, representing 619 beds.

*Haven Eldercare, LLC*

- During the three months ending March 31, 2006, Haven Eldercare, LLC ( Haven ), an existing operator of ours, entered into a \$39 million first mortgage loan with General Electric Capital Corporation ( GE Loan ). Haven used the \$39 million of proceeds to partially repay on a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of our remaining \$23 million on the mortgage note, due in October 2012, to that of the GE Loan. As a result of this transaction, the interest rate on our remaining mortgage note to Haven rose from 10% to approximately 15%, with annual escalators.

- In conjunction with the above transactions and the application of FIN 46R, we consolidated the financial statements and related real estate of this Haven entity into our financial statements. The consolidation resulted in the following changes to our consolidated balance sheet as of September 30, 2006: (1) an increase in total gross investments of \$39.0 million; (2) an increase in accumulated depreciation of \$1.2 million; (3) an increase in other long-term borrowings of \$39.0 million; and (4) a reduction of \$1.2 million in cumulative net earnings for the nine months ended September 30, 2006 due to the increased depreciation expense. General Electric Capital Corporation and Haven s other creditors do not have recourse to our assets. We have an option to purchase the mortgaged facilities for a fixed price in 2012. Our results of operations reflect the effects of the consolidation of this entity, which is being accounted for similarly to our other purchase-leaseback transactions.

*Assets Sold*

- On June 30, 2006, we sold two SNFs in California resulting in an accounting loss of approximately \$0.1 million.
- On March 31, 2006, we sold a SNF in Illinois resulting in an accounting loss of approximately \$0.2 million.

*Held for Sale*

- We had two assets held for sale as of September 30, 2006 with a net book value of approximately \$0.7 million.
- During the three months ended March 31, 2006, a \$0.1 million provision for impairment charge was recorded to reduce the carrying value to its sales price of one facility that was under contract to be sold, which was subsequently sold during the second quarter of 2006.

The partial expiration of certain Medicare rate increases has had an adverse impact on the revenues of the operators of nursing home facilities and has negatively impacted some operators ability to satisfy their monthly lease or debt payment to us. In several instances, we hold security deposits that can be



applied in the event of lease and loan defaults, subject to applicable limitations under bankruptcy law with respect to operators seeking protection under Chapter 11 of the Bankruptcy Code.

### Liquidity and Capital Resources

At September 30, 2006, we had total assets of \$1.2 billion, stockholders' equity of \$466.5 million and debt of \$683.6 million, which represents approximately 59.4% of our total capitalization.

The following table shows the amounts due in connection with the contractual obligations described below as of September 30, 2006.

|                             | Payments due by period  |                     |                 |                   |                      |
|-----------------------------|-------------------------|---------------------|-----------------|-------------------|----------------------|
|                             | Total<br>(In thousands) | Less than<br>1 year | 1-3 years       | 3-5 years         | More than<br>5 years |
| Long-term debt(1)           | \$ 683,910              | \$ 415              | \$ 900          | \$ 158,285        | \$ 524,310           |
| Other long-term liabilities | 559                     | 231                 | 328             |                   |                      |
| <b>Total</b>                | <b>\$ 684,469</b>       | <b>\$ 646</b>       | <b>\$ 1,228</b> | <b>\$ 158,285</b> | <b>\$ 524,310</b>    |

(1) The \$683.9 million includes \$310 million aggregate principal amount of 7% Senior Notes due 2014, \$175 million aggregate principal amount of 7% Senior Notes due 2016, \$157.5 million in borrowings under the \$200 million revolving senior secured credit facility that matures in March 2010 and Haven's \$39 million first mortgage with General Electric Capital Corporation that expires in 2012.

### Financing Activities and Borrowing Arrangements

#### Bank Credit Agreements

At September 30, 2006, we had \$157.5 million outstanding under our \$200 million revolving senior secured credit facility (the New Credit Facility) and \$2.5 million was utilized for the issuance of letters of credit, leaving availability of \$40.0 million. The \$157.5 million of outstanding borrowings had a blended interest rate of 6.57% at September 30, 2006. The New Credit Facility, entered into on March 31, 2006, is being provided by Bank of America, N.A., as Administrative Agent, Deutsche Bank Trust Company Americas, UBS Securities LLC, General Electric Capital Corporation, LaSalle Bank N.A., and Citicorp North America, Inc. and will be used for acquisitions and general corporate purposes.

The New Credit Facility replaced our previous \$200 million senior secured credit facility (the Prior Credit Facility), that was terminated on March 31, 2006. We will realize a 125 basis point savings on LIBOR-based loans under the New Credit Facility, as compared to LIBOR-based loans under our Prior Credit Facility. The New Credit Facility matures on March 31, 2010, and includes an accordion feature that permits us to expand our borrowing capacity to \$300 million during our first two years.

For the three-month period ending March 31, 2006, we recorded a one-time, non-cash charge of approximately \$2.7 million relating to the write-off of deferred financing costs associated with the termination of our Prior Credit Facility.

Our long-term borrowings require us to meet certain property level financial covenants and corporate financial covenants, including prescribed leverage, fixed charge coverage, minimum net worth, limitations on additional indebtedness and limitations on dividend payouts. As of September 30, 2006, we were in compliance with all property level and corporate financial covenants.

On October 23, 2006, we entered into a Second Amendment, Waiver and Consent to Credit Agreement (the Second Amendment) pursuant to which the lenders under the New Credit Facility





waived any potential misrepresentations and events of default that could have been caused by the Restatement.

*\$100 Million Aggregate Principal Amount of 6.95% Unsecured Notes Tender and Redemption*

On December 16, 2005, we initiated a tender offer and consent solicitation for all of our outstanding \$100 million aggregate principal amount 6.95% notes due 2007 (the 2007 Notes ). On December 30, 2005, we accepted for purchase the 79.3% of the aggregate principal amount of the 2007 Notes outstanding that were tendered. On December 30, 2005, our Board of Directors also authorized the redemption of all outstanding 2007 Notes that were not otherwise tendered. On December 30, 2005, upon our irrevocable funding of the full redemption price for the 2007 Notes and certain other acts required by the Indenture governing the 2007 Notes, the Trustee of the 2007 Notes certified in writing to us (the Certificate of Satisfaction and Discharge ) that the Indenture was satisfied and discharged as of December 30, 2005, except for certain administrative provisions. In accordance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, ( FAS 140 ) we removed 79.3% of the aggregate principal amount of the 2007 Notes, which were tendered in our tender offer and consent solicitation, and the corresponding portion of the funds held in trust by the Trustee to pay the tender price from our balance sheet and recognized \$2.8 million of additional interest expense associated with the tender offer. On January 18, 2006, we completed the redemption of the remaining 2007 Notes not otherwise tendered. Accordingly, we reduced other assets, representing the funds deposited with the Trustee, and unsecured borrowings by \$21 million. In connection with the redemption and in accordance with FAS 140, we recognized \$0.8 million of additional interest expense in the first quarter of 2006. As of January 18, 2006, none of the 2007 Notes remained outstanding.

*Other Long-Term Borrowings*

During the three months ended March 31, 2006, Haven used the \$39 million of proceeds from the GE Loan to partially repay a portion of a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of its remaining \$23 million on the mortgage note to that of the GE Loan. In conjunction with the above transactions and the application of FIN 46R, we consolidated the financial statements of this Haven entity into our financial statements, which contained the long-term borrowings with General Electric Capital Corporation of \$39.0 million. The loan has an interest rate of approximately seven percent and is due in 2012. The lender of the \$39.0 million does not have recourse to our assets. See Note 3 Properties; Leased Property.

*Dividends*

In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our REIT taxable income (computed without regard to the dividends paid deduction and our net capital gain), and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of non-cash income. In addition, if we dispose of any built-in gain asset during a recognition period, we will be required to distribute at least 90% of the built-in gain (after tax), if any, recognized on the disposition of such asset. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our REIT taxable income, as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates. In addition, our New Credit Facility has certain financial covenants that limit the distribution of dividends paid during a fiscal quarter to no more than 95% of our aggregate cumulative funds from operations ( FFO ) as defined in the loan agreement governing the New

Credit Facility (the Loan Agreement), unless a greater distribution is required to maintain REIT status. The Loan Agreement defines FFO as net income (or loss) plus depreciation and amortization and shall be adjusted for charges related to: (i) restructuring our debt; (ii) redemption of preferred stock; (iii) litigation charges up to \$5.0 million; (iv) non-cash charges for accounts and notes receivable up to \$5.0 million; (v) non-cash compensation related expenses; (vi) non-cash impairment charges; and (vii) tax liabilities in an amount not to exceed \$8.0 million.

#### *Common Dividends*

On October 24, 2006, the Board of Directors announced a common stock dividend of \$0.25 per share, an increase of \$0.01 per common share compared to the prior quarter, which was paid November 15, 2006 to common stockholders of record on November 3, 2006.

On July 17, 2006, the Board of Directors declared a common stock dividend of \$0.24 per share. The common dividend was paid August 15, 2006 to common stockholders of record on July 31, 2006.

On April 18, 2006, the Board of Directors declared a common stock dividend of \$0.24 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid May 15, 2006 to common stockholders of record on April 28, 2006.

On January 17, 2006, the Board of Directors declared a common stock dividend of \$0.23 per share, an increase of \$0.01 per common share compared to the prior quarter. The common stock dividend was paid February 15, 2006 to common stockholders of record on January 31, 2006.

#### *Series D Preferred Dividends*

On October 24, 2006, the Board of Directors declared the regular quarterly dividends for the 8.375% Series D Preferred Stock to stockholders of record on November 3, 2006. The stockholders of record of the Series D Preferred Stock on November 3, 2006 were paid dividends in the amount of \$0.52344 per preferred share on November 15, 2006. The liquidation preference for our Series D Preferred Stock is \$25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period August 1, 2006 through October 31, 2006.

On July 17, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid August 15, 2006 to preferred stockholders of record on April 28, 2006.

On April 18, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid May 15, 2006 to preferred stockholders of record on April 28, 2006.

On January 17, 2006, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid February 15, 2006 to preferred stockholders of record on January 31, 2006.

#### *Liquidity*

We believe our liquidity and various sources of available capital, including cash from operations, our existing availability under our New Credit Facility and expected proceeds from mortgage payoffs are more than adequate to finance operations, meet recurring debt service requirements and fund future investments through the next twelve months.

We regularly review our liquidity needs, the adequacy of cash flow from operations, and other expected liquidity sources to meet these needs. We believe our principal short-term liquidity needs are to fund:

- normal recurring expenses;
- debt service payments;
- preferred stock dividends;
- common stock dividends; and
- growth through acquisitions of additional properties.

The primary source of liquidity is our cash flows from operations. Operating cash flows have historically been determined by: (i) the number of facilities we lease or have mortgages on; (ii) rental and mortgage rates; (iii) our debt service obligations; and (iv) general and administrative expenses. The timing, source and amount of cash flows provided by financing activities and used in investing activities are sensitive to the capital markets environment, especially to changes in interest rates. Changes in the capital markets environment may impact the availability of cost-effective capital and affect our plans for acquisition and disposition activity.

Cash and cash equivalents totaled \$0.0 million as of September 30, 2006, a decrease of \$3.9 million as compared to the balance at December 31, 2005. The following is a discussion of changes in cash and cash equivalents due to operating, investing and financing activities, which are presented in our Consolidated Statements of Cash Flows.

Operating Activities Net cash flow from operating activities generated \$48.0 million for the nine months ended September 30, 2006, as compared to \$55.3 million for the same period in 2005. The \$7.2 million decrease is due primarily to: a \$19.2 million lease inducement with Guardian; partially offset by (i) incremental revenue associated with acquisitions completed throughout 2005 and 2006 and (ii) normal working capital fluctuations during the period.

Investing Activities Net cash flow from investing activities was an outflow of \$166.8 million for the nine months ended September 30, 2006, as compared to an outflow of \$41.0 million for the same period in 2005. The \$125.7 million change in investing cash outflow was primarily due to: (i) an outflow of \$178.9 million for acquisitions completed during the nine months of 2006 as compared to \$120.7 million for the same period in 2005, (ii) a \$60.0 million mortgage payoff in 2005 as compared to a \$10.0 million mortgage payoff in 2006, (iii) \$1.5 million collected from the sale of real estate for the nine months ended September 30, 2006 as compared to \$25.9 million in 2005 and (iv) \$7.6 million of proceeds from the sale of Sun common stock in 2006.

Financing Activities Net cash flow from financing activities was an inflow of \$114.8 million for the nine months ended September 30, 2006 as compared to an outflow of \$25.5 million for the same period in 2005. The increase in financing cash inflow of \$140.3 million was primarily a result of: (i) net borrowings of \$99.5 million on our New Credit Facility in 2006 versus net borrowings of \$65.7 million on our Prior Credit Facility in 2005; (ii) \$39.0 million of proceeds received in a Haven transaction; (iii) \$26.8 million of incremental optional cash purchases of our common stock through our dividend reinvestment for the nine months ended September 30, 2006 as compared to the same time period in 2005. The increase was partially offset by \$50.0 million redemption of the outstanding shares of Series B preferred stock in 2005.

### **Item 3 Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to various market risks, including the potential loss arising from adverse changes in interest rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes, but we seek to mitigate the effects of fluctuations in interest rates by matching the term of new investments with new long-term fixed rate borrowing to the extent possible.



The fair value of our embedded derivative (i.e., the conversion feature of a preferred stock investment) is subject to change due to fluctuations primarily resulting from the market value of Advocat's common stock. A ten percent increase in the value of Advocat's common stock as of September 30, 2006 to \$21.65 per common share would have resulted in a \$1.4 million or 12.9% increase in the value of this derivative as of September 30, 2006. A ten percent decrease in the value of Advocat's common stock as of September 30, 2006 to \$17.71 per common share would have resulted in a \$1.4 million or 12.9% decrease in the value of this derivative as of September 30, 2006.

For additional information, refer to Item 7A as presented in our annual report on Form 10-K/A for the year ended December 31, 2005.

#### **Item 4 Controls and Procedures**

##### *Evaluation of Disclosure Controls and Procedures*

Disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) are controls and other procedures that are designed to provide reasonable assurance that the information that we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

In connection with the preparation of this Form 10-Q, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2006. In making this evaluation, our management considered the matters relating to the restatement of our financial statements and the material weakness discussed below. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of September 30, 2006.

##### *Changes in Internal Control Over Financial Reporting*

As noted under Item 9A in Management's Report on Internal Control over Financial Reporting in our Form 10-K/A for the year ended December 31, 2005, management determined that a material weakness in our internal control over financial reporting existed as of December 31, 2005. Management determined that as of December 31, 2005, we lacked sufficient internal control processes, procedures and personnel resources necessary to address accounting for certain complex and/or non-routine transactions. This material weakness resulted in errors in accounting for financial instruments, income taxes and straight-line rental revenue and could result in a material misstatement to the interim consolidated financial statements that would not be prevented or detected on a timely basis. In the course of management's evaluation of our disclosure controls and procedures as of September 30, 2006, no changes in our internal control over financial reporting were identified as having occurred during the quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the our internal control over financial reporting.

In light of the material weakness described above, we performed additional analyses and other procedures to ensure that our consolidated financial statements included in this Form 10-Q were prepared in accordance with GAAP. These measures included, among other things, expansion of our document review procedures and dedication of significant internal resources to scrutinize account analyses. As a result, we concluded that the consolidated financial statements included in this Form 10-Q present fairly, in all material respects, our financial position, results of operations and cash flows for the periods presented in conformity with GAAP.

**PART II OTHER INFORMATION**

**Item 1 Legal Proceedings**

See Note 10 Litigation to the Consolidated Financial Statements in PART I, Item 1 hereto, which is hereby incorporated by reference in response to this item.

**Item 1A Risk Factors**

We amended our Annual Report on Form 10-K/A for the year ended December 31, 2005 with the Securities and Exchange Commission on December 14, 2006, which sets forth our risk factors in Item 1A therein. We have not experienced any material changes from the risk factors previously described therein.

**Item 5 Other Information**

None

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**Item 6 Exhibits**

Exhibit

| No.  | Description  |
|------|--|
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer. |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer. |
| 32.1 | Section 1350 Certification of the Chief Executive Officer.             |
| 32.2 | Section 1350 Certification of the Chief Financial Officer.             |

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OMEGA HEALTHCARE INVESTORS, INC.

Registrant

Date: December 14, 2006

By: /S/ C. TAYLOR PICKETT  
C. Taylor Pickett  
Chief Executive Officer

Date: December 14, 2006

By: /S/ ROBERT O. STEPHENSON  
Robert O. Stephenson  
Chief Financial Officer

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