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ADVOCAT INC

FORM 10-Q
(Quarterly Report)

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Industry	Healthcare Facilities
Sector	Healthcare
Fiscal Year	12/31

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

FORM 10-Q

CHECK ONE:

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

For the Quarterly Period Ended: September 30, 2011

OR

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

For the transition period from to .

Commission file No.: 1-12996

Advocat Inc.
(exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**62-1559667** **(IRS Employer Identification No.)**

1621 Galleria Boulevard, Brentwood, TN 37027
(Address of principal executive offices) (Zip Code)

(615) 771-7575
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report.)

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

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

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

Large accelerated filer ☐ Accelerated filer ☐

Non-accelerated filer ☐ Smaller reporting Company ☒

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

5,827,144

(Outstanding shares of the issuer's common stock as of October 28, 2011)

Part I. FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

ADVOCAT INC.

INTERIM CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2011 (Unaudited)	December 31, 2010
CURRENT ASSETS:		
Cash and cash equivalents	$ 7,748	$ 8,862
Receivables, less allowance for doubtful accounts of $3,022 and $2,822, respectively	25,573	23,801
Prepaid expenses and other current assets	4,986	4,526
Income tax refundable	1,789	1,439
Deferred income taxes	5,141	4,207
Total current assets	45,237	42,835
PROPERTY AND EQUIPMENT, at cost	89,342	78,690
Less accumulated depreciation	(45,740)	(41,563)
Discontinued operations, net	1,053	1,053
Property and equipment, net	44,655	38,180
OTHER ASSETS:		
Deferred income taxes	10,118	12,408
Deferred financing and other costs, net	1,382	834
Other assets	4,224	2,319
Acquired leasehold interest, net	9,092	9,380
Total other assets	24,816	24,941
	$ 114,708	$ 105,956

The accompanying notes are an integral part of these interim consolidated financial statements.

(Continued)

ADVOCAT INC.

INTERIM CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)
(continued)

	September 30, 2011 (Unaudited)	December 31, 2010
CURRENT LIABILITIES:		
Current portion of long-term debt and capitalized lease obligations	$ 677	$ 582
Trade accounts payable	4,556	3,120
Accrued expenses:		
Payroll and employee benefits	12,688	11,047
Current portion of self-insurance reserves	8,093	7,379
Other current liabilities	4,624	4,479
Total current liabilities	30,638	26,607
NONCURRENT LIABILITIES:		
Long-term debt and capitalized lease obligations, less current portion	25,874	23,819
Self-insurance reserves, less current portion	10,476	11,659
Other noncurrent liabilities	18,240	16,748
Total noncurrent liabilities	54,590	52,226
COMMITMENTS AND CONTINGENCIES		
SERIES C REDEEMABLE PREFERRED STOCK		
$.10 par value, 5,000 shares authorized, issued and outstanding	4,918	4,918
SHAREHOLDERS' EQUITY:		
Series A preferred stock, authorized 200,000 shares, $.10 par value, none issued and outstanding	—	—
Common stock, authorized 20,000,000 shares, $.01 par value, 6,059,000 and 5,976,000 shares issued, and 5,827,000 and 5,744,000 shares outstanding, respectively	61	60
Treasury stock at cost, 232,000 shares of common stock	(2,500)	(2,500)
Paid-in capital	18,299	17,896
Retained earnings	8,025	6,749
Accumulated other comprehensive loss	(950)	—
Total shareholders' equity of Advocat Inc.	22,935	22,205
Non-controlling interests	1,627	—
Total shareholders' equity	24,562	22,205
	$ 114,708	$ 105,956

The accompanying notes are an integral part of these interim consolidated financial statements.

ADVOCAT INC.

INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts, unaudited)

	Three Months Ended September 30,	
	2011	2010
PATIENT REVENUES, net	$ 80,644	$ 72,996
EXPENSES:		
Operating	61,871	58,534
Lease	5,737	5,661
Professional liability	4,610	1,684
General and administrative	7,185	4,954
Depreciation and amortization	1,636	1,453
Asset impairment	344	—
Total expenses	81,383	72,286
OPERATING INCOME (LOSS)	(739)	710
OTHER INCOME (EXPENSE):		
Interest expense, net	(683)	(413)
	(683)	(413)
INCOME (L0SS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(1,422)	297
(PROVISION) BENEFIT FOR INCOME TAXES	549	(68)
NET INCOME (LOSS) FROM CONTINUING OPERATIONS	(873)	229
NET LOSS FROM DISCONTINUED OPERATIONS:		
Operating loss, net of taxes of $0 and $(5), respectively	—	(9)
DISCONTINUED OPERATIONS	—	(9)
NET INCOME (LOSS)	(873)	220
PREFERRED STOCK DIVIDENDS	(86)	(86)
NET INCOME (LOSS) FOR COMMON STOCK	$ (959)	$ 134
NET INCOME (LOSS) PER COMMON SHARE:		
Per common share – basic		
Continuing operations	$ (0.17)	$ 0.02
Discontinued operations	—	—
	$ (0.17)	$ 0.02
Per common share – diluted		
Continuing operations	$ (0.17)	$ 0.02
Discontinued operations	—	—
	$ (0.17)	$ 0.02
COMMON STOCK DIVIDENDS DECLARED PER SHARE OF COMMON STOCK	$ 0.055	$ 0.055
WEIGHTED AVERAGE COMMON SHARES:		
Basic	5,779	5,742
Diluted	5,779	5,813

The accompanying notes are an integral part of these interim consolidated financial statements.

ADVOCAT INC.

INTERIM CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts, unaudited)

	Nine Months Ended September 30,	
	2011	2010
PATIENT REVENUES, net	$ 236,946	$ 214,640
EXPENSES:		
Operating	182,470	170,324
Lease	17,178	16,899
Professional liability	7,382	4,095
General and administrative	19,363	14,719
Depreciation and amortization	4,757	4,301
Asset impairment	344	—
Total expenses	231,494	210,338
OPERATING INCOME	5,452	4,302
OTHER INCOME (EXPENSE):		
Interest expense, net	(1,716)	(1,224)
Debt retirement costs	(112)	(127)
	(1,828)	(1,351)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	3,624	2,951
PROVISION FOR INCOME TAXES	(1,112)	(1,028)
NET INCOME FROM CONTINUING OPERATIONS	2,512	1,923
NET INCOME (LOSS) FROM DISCONTINUED OPERATIONS:		
Operating income (loss), net of taxes of $(6) and $207, respectively	(10)	359
Loss on disposal, net of taxes of $0 and $(96), respectively	—	(177)
DISCONTINUED OPERATIONS	(10)	182
NET INCOME	2,502	2,105
PREFERRED STOCK DIVIDENDS	(258)	(258)
NET INCOME FOR COMMON STOCK	$ 2,244	$ 1,847
NET INCOME PER COMMON SHARE:		
Per common share – basic		
Continuing operations	$ 0.39	$ 0.29
Discontinued operations	—	0.03
	$ 0.39	$ 0.32
Per common share – diluted		
Continuing operations	$ 0.38	$ 0.28
Discontinued operations	—	0.03
	$ 0.38	$ 0.31
COMMON STOCK DIVIDENDS DECLARED PER SHARE OF COMMON STOCK	$ 0.165	$ 0.16
WEIGHTED AVERAGE COMMON SHARES:		
Basic	5,770	5,729
Diluted	5,915	5,868

The accompanying notes are an integral part of these interim consolidated financial statements.

ADVOCAT INC.

INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands and unaudited)

	Nine Months Ended September 30, 2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 2,502	$ 2,105
Discontinued operations	(10)	182
Net income from continuing operations	2,512	1,923
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:		
Depreciation and amortization	4,757	4,301
Provision for doubtful accounts	1,702	1,617
Deferred income tax provision	1,938	488
Provision for (benefit from) self-insured professional liability, net of cash payments	(220)	(81)
Stock based compensation	546	487
Amortization of deferred balances	122	167
Provision for leases in excess of cash payments	336	669
Payment from lessor for leasehold improvement	—	120
Asset Impairment	344	—
Debt retirement costs	79	127
Changes in other assets and liabilities affecting operating activities:		
Receivables, net	(4,555)	(1,788)
Prepaid expenses and other assets	(1,405)	(1,076)
Trade accounts payable and accrued expenses	3,648	(574)
Net cash provided by continuing operations	9,804	6,380
Discontinued operations	592	1,135
Net cash provided by operating activities	10,396	7,515
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(9,311)	(4,400)
Increase in restricted cash	(1,733)	—
Deposit and other deferred balances	(31)	—
Net cash used by continuing operations	(11,075)	(4,400)
Discontinued operations	—	(45)
Net cash used in investing activities	(11,075)	(4,445)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of debt obligations	(24,302)	(4,119)
Proceeds from issuance of debt	26,000	3,810
Financing costs	(797)	(451)
Exercise of stock options	1	(47)
Proceeds from issuance of restricted share units	195	57
Payment of common stock dividends	(953)	(888)
Payment of preferred stock dividends	(258)	(258)
Contributions from noncontrolling interests	87	—
Payment for preferred stock restructuring	(408)	(395)
Net cash used in financing activities	(435)	(2,291)

(Continued)

ADVOCAT INC.

INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands and unaudited)
(continued)

	Nine Months Ended September 30,	
	2011	2010
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ (1,114)	$ 779
CASH AND CASH EQUIVALENTS, beginning of period	8,862	8,609
CASH AND CASH EQUIVALENTS, end of period	$ 7,748	$ 9,388
SUPPLEMENTAL INFORMATION:		
Cash payments of interest, net of amounts capitalized	$ 1,353	$ 1,037
Cash payments of income taxes	$ 617	$ 895

Non-cash transaction:

A capital lease obligation and capital lease asset of $452,000 was recorded when the Company entered into a lease for computer equipment during the third quarter of 2011. This non-cash transaction has been excluded from the interim consolidated statement of cash flows

The accompanying notes are an integral part of these interim consolidated financial statements.

ADVOCAT INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2011 AND 2010

1. BUSINESS

Advocat Inc. (together with its subsidiaries, “Advocat” or the “Company”) provides long-term care services to nursing center patients in eight states, primarily in the Southeast and Southwest. The Company’s centers provide a range of health care services to their patients and residents. In addition to the nursing, personal care and social services usually provided in long-term care centers, the Company’s nursing centers offer a variety of comprehensive rehabilitation services as well as nutritional support services.

As of September 30, 2011, the Company’s continuing operations consist of 46 nursing centers with 5,364 licensed nursing beds. The Company owns 9 and leases 37 of its nursing centers. The Company’s continuing operations include centers in Alabama, Arkansas, Florida, Kentucky, Ohio, Tennessee, Texas and West Virginia.

2. CONSOLIDATION AND BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

The interim consolidated financial statements include the operations and accounts of Advocat and its subsidiaries, all wholly-owned. All significant intercompany accounts and transactions have been eliminated in consolidation. Any variable interest entities (“VIEs”) in which the Company has an interest are consolidated when the Company identifies that it is the primary beneficiary. The Company has one variable interest entity and it relates to the facility under construction in West Virginia described in Note 8.

The interim consolidated financial statements for the three and nine month periods ended September 30, 2011 and 2010, included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management of the Company, the accompanying interim consolidated financial statements reflect all normal, recurring adjustments necessary to present fairly the Company’s financial position at September 30, 2011 and the results of operations and cash flows for the three and nine month periods ended September 30, 2011 and 2010. The Company’s consolidated balance sheet at December 31, 2010 was derived from its audited consolidated financial statements as of December 31, 2010. Certain amounts in the Company’s 2010 consolidated financial statements have been reclassified to conform to the 2011 presentation.

The results of operations for the three and nine month periods ended September 30, 2011 and 2010 are not necessarily indicative of the operating results that may be expected for a full year. These interim consolidated financial statements should be read in connection with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

3. LONG-TERM DEBT, INTEREST RATE SWAP AND CAPITALIZED LEASE OBLIGATIONS

On March 1, 2011, the Company entered into an agreement with a syndicate of banks to refinance the Company's mortgage loan that was scheduled to mature in August 2011 and to extend the maturity of the Company's revolving credit facility.

Under the terms of the new agreement, the syndicate of banks provided mortgage debt ("Mortgage Loan") of $23 million and the proceeds were used to retire the Company's previous mortgage loan and will fund approximately $2.4 million in capital improvements at the Company's owned centers. The Mortgage Loan has a term of five years, with principal and interest payable monthly based on a 25 year amortization. Interest is based on LIBOR plus 4.5%, but is fixed at 7.07% based on the interest rate swap transaction described below. The new mortgage loan is secured by four owned nursing centers, related equipment and a lien on the accounts receivable of these centers.

The new agreement extended the maturity of the Company's $15 million revolving credit facility ("Revolver") from March 2013 to March 2016. As amended, the Revolver has an interest rate of LIBOR plus 4.5%. The Revolver is secured by accounts receivable and is subject to limits on the maximum amount of loans that can be outstanding under the revolver based on borrowing base restrictions. As of September 30, 2011, the Company has no borrowings outstanding under the revolving credit facility. Annual fees for letters of credit issued under this revolver are 3.0% of the amount outstanding. The Company has a letter of credit of $4,551,000 to serve as a security deposit for certain of the Company's leases. Considering the balance of eligible accounts receivable at September 30, 2011, the letter of credit, the amounts outstanding under the revolving credit facility and the maximum loan amount of $15,000,000, the balance available for borrowing under the revolving credit facility is $10,449,000. The Mortgage Loan and the Revolver are cross-collateralized.

The Company's lending agreements contain various financial covenants, the most restrictive of which relate to minimum cash deposits, cash flow and debt service coverage ratios. The Company is in compliance with all such covenants at September 30, 2011.

Interest Rate Swap Transaction-

As part of the debt agreements entered into in March 2011, the Company entered into an interest rate swap agreement with a member of the bank syndicate as the counterparty. The interest rate swap agreement has the same effective date, maturity date and notional amounts as the Mortgage Loan. The interest rate swap agreement requires the Company to make fixed rate payments to the bank calculated on the applicable notional amount at an annual fixed rate of 7.07% while the bank is obligated to make payments to the Company based on LIBOR on the same notional amounts. The Company entered into the interest rate swap agreement to mitigate the variable interest rate risk on its outstanding mortgage borrowings. The applicable guidance requires companies to recognize all derivative instruments as either assets or liabilities at fair value in a company's balance sheets. In accordance with this guidance, the Company designated its interest rate swap as a cash flow hedge and the earnings component of the hedge, net of taxes, is reflected as a component of other comprehensive income.

The Company assesses the effectiveness of its interest rate swap on a quarterly basis and at September 30, 2011, the Company determined that the interest rate swap was effective. The interest rate swap valuation model indicated a net liability of $1,532,000 at September 30, 2011. The fair value of the interest rate swap is included in "other noncurrent liabilities" on the Company's interim consolidated balance sheet. The balance of accumulated other comprehensive loss at September 30, 2011, is $950,000 and reflects the liability related to the interest rate swap, net of the income tax benefit of $582,000. As the Company's interest rate swap is not traded on a market exchange, the fair value is determined using a valuation model based on a discounted cash flow analysis. This analysis reflects the contractual terms of the interest rate swap agreement and uses observable market-based inputs, including estimated future LIBOR interest rates. The fair value of the Company's interest rate

swap is the net difference in the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on the expectation of future interest rates and are observable inputs available to a market participant. The interest rate swap valuation is classified in Level 2 of the fair value hierarchy, in accordance with the Financial Accounting Standards Board's ("FASB") guidance on *Fair Value Measurements and Disclosures* .

Capitalized Lease Obligations

During the third quarter of 2011, the Company entered into a lease agreement to finance the purchase of certain equipment required for the implementation of Electronic Medical Records ("EMR") in its nursing centers. The Company determined the lease was capital in nature and has recorded both the asset and capitalized lease obligation of $452,000 as of September 30, 2011. The lease agreement provides a three year term.

In October 2011, the Company completed a sale and leaseback transaction for certain equipment purchased in the implementation of EMR in its nursing centers. The lease transaction, involving $1,219,000 in assets purchased by the Company during 2010 and 2011, is capital in nature, and the Company will record the cash from the sale and the capitalized lease obligation under the financing during the fourth quarter of 2011. The lease agreement provides a three year term.

4. INSURANCE MATTERS

Professional Liability and Other Liability Insurance-

For claims made after March 9, 2001, the Company has purchased professional liability insurance coverage for its nursing centers that, based on historical claims experience, is likely to be substantially less than the claims that are expected to be incurred. The Company has essentially exhausted all general and professional liability insurance available for claims asserted prior to July 1, 2011.

Effective June 1, 2010, the Company's nursing centers are covered by one of two professional liability insurance policies. The Company's 25 nursing centers in Arkansas, Kentucky, Tennessee, and West Virginia are currently covered by an insurance policy with coverage limits of $250,000 per medical incident and total annual aggregate policy limits of $750,000. This policy provides the only commercially affordable insurance coverage available for claims made during this period against these nursing centers. The Company's 21 nursing centers in Alabama, Florida, Ohio and Texas are currently covered by an insurance policy with coverage limits of $1,000,000 per medical incident, subject to a deductible of $495,000 per claim, with a total annual aggregate policy limit of $15,000,000 and a sublimit per center of $3,000,000.

Reserve for Estimated Self-Insured Professional Liability Claims-

Because the Company anticipates that its actual liability for existing and anticipated claims will exceed the Company's professional liability insurance coverage, the Company has recorded total liabilities for professional liability and other claims of $17,182,000 as of September 30, 2011. This accrual includes estimates of liability for incurred but not reported claims, estimates of liability for reported but unresolved claims, actual liabilities related to settlements, including settlements to be paid over time, and estimates of legal costs related to these claims. All losses are projected on an undiscounted basis. Amounts are added to the accrual for estimates of anticipated liability for claims incurred during each period, and amounts are deducted from the accrual for settlements paid on existing claims during each period.

Final determination of the Company's actual liability for claims incurred in any given period is a process that takes years. The Company evaluates the adequacy of this liability on a quarterly basis and engages a third-party actuarial firm to conduct an analysis semi-annually in the second and fourth quarters. The semi-annual actuarial analysis is prepared by the Actuarial Division of Willis of Tennessee, Inc. ("Willis") based on data furnished as of May 31 and November 30 each year.

These semi-annual actuarial analyses of the Company's liability are assessed and adjusted based on numerous factors, including claims actually reported, lawsuits filed, lawsuits resolved, changes in the Company's occupied beds and relevant claim development data. The Company records any revisions in estimates and differences between actual settlements and reserves, with changes in estimated losses being recorded in the consolidated statements of operations in the period identified. Any increase in the accrual decreases income in the period and any reduction in the accrual increases income during the period. In those quarters where Willis does not prepare an actuarial analysis, the Company evaluates its professional liability claims and settlements in order to determine whether there has been a material change in its anticipated liability for those claims.

Although the Company retains Willis to assist management in estimating the appropriate accrual for these claims, professional liability claims are inherently uncertain and the liability associated with anticipated claims is very difficult to estimate. As a result, the Company's actual liabilities may vary significantly from the accrual, and the amount of the accrual has and may continue to fluctuate by a material amount in any given period. Each change in the amount of this accrual will directly affect the Company's reported earnings and financial position for the period in which the change in accrual is made.

The Company's cash expenditures for self-insured professional liability costs from continuing operations were $6,733,000 and $3,512,000 for the nine months ended September 30, 2011 and 2010, respectively. In July 2011, the Company settled nine pending professional liability lawsuits for a total of $4,571,000, of which $742,000 will be paid from insurance proceeds. The majority of the Company's portion of these settlements was paid during the third quarter of 2011. In October 2011, the Company agreed to settle five pending professional liability lawsuits for a total of $3,200,000, none of which is expected to be paid from insurance proceeds. These settlements are expected to be paid in installments beginning in the fourth quarter of 2011 and extending through 2012. In the third quarter of 2011, the Company evaluated its accrual for professional liability claims, giving consideration to settlements of claims since June 30, 2011, and other factors affecting the remaining professional and general liability claims, including new lawsuits filed, lawsuits resolved, and the expected frequency and severity of claims during 2011 and prior periods. As a result of this evaluation, the Company recorded professional liability expense of $4,610,000 and $7,382,000 in the three and nine-month periods ended September 30, 2011, respectively.

Adoption of New Accounting Pronouncements - Self-Insured Professional Liability Claims-

In August 2010, the FASB issued updated guidance in the form of a FASB Accounting Standards Update on "Presentation of Insurance Claims and Related Insurance Recoveries" to clarify that a health care entity should not net insurance recoveries against a related professional liability claim and that the amount of the claim liability should be determined without consideration of insurance recoveries. The update is intended to improve accounting guidance by eliminating an existing industry exception and reduce diversity in practice by removing the ability to offset insurance recoveries against liabilities. The Company adopted this guidance effective January 1, 2011 and, as a result, recorded assets and equal liabilities of $188,000 at September 30, 2011 and $438,000 at December 31, 2010, respectively.

Other Insurance-

With respect to workers' compensation insurance, substantially all of the Company's employees became covered under either an indemnity insurance plan or state-sponsored programs in May 1997. The Company is completely self-insured for workers' compensation exposures prior to May 1997. The Company has been and remains a non-subscriber to the Texas workers' compensation system and is, therefore, completely self-insured for employee injuries with respect to its Texas operations. From June 30, 2003 until June 30, 2007, the Company's workers' compensation insurance programs provided coverage for claims incurred with premium adjustments depending on incurred losses. For

the period from July 1, 2008 through June 30, 2012, the Company is covered by a prefunded deductible policy. Under this policy, the Company is self-insured for the first $500,000 per claim, subject to an aggregate maximum of $3,000,000. The Company funds a loss fund account with the insurer to pay for claims below the deductible. The Company accounts for premium expense under this policy based on its estimate of the level of claims subject to the policy deductibles expected to be incurred. At September 30, 2011, there is a net asset of $192,000 recorded for the Company's workers' compensations policies.

As of September 30, 2011, the Company is self-insured for health insurance benefits for certain employees and dependents for amounts up to $175,000 per individual annually. The Company provides reserves for the settlement of outstanding self-insured health claims at amounts believed to be adequate. The liability for reported claims and estimates for incurred but unreported claims is $1,056,000 at September 30, 2011. The differences between actual settlements and reserves are included in expense in the period finalized.

5. STOCK-BASED COMPENSATION

During 2011, the Compensation Committee of the Board of Directors approved restricted common stock grants totaling 49,875 shares to certain employees and members of the Board of Directors. The restricted shares vest one-third on the first, second and third anniversaries of the grant date. Unvested shares may not be sold or transferred. During the vesting period, dividends accrue on the restricted shares, but are paid in additional shares of common stock upon vesting, subject to the vesting provisions of the underlying restricted shares. The restricted shares are entitled to the same voting rights as other common shares. Upon vesting, all restrictions are removed.

Stock-based compensation expense is non-cash and is included as a component of general and administrative expense or operating expense based upon the classification of cash compensation paid to the related employees. The Company recorded total stock-based compensation expense of $546,000 and $487,000 in the nine month periods ended September 30, 2011 and 2010, respectively.

6. DISCONTINUED OPERATIONS

Effective March 31, 2010, the Company terminated operations of four nursing centers in Florida under a lease that, as amended, would have expired in August 2010. These four homes contributed revenues of $6,835,000 and net income of $169,000 during the nine months ended September 30, 2010. The Company transitioned operations at these leased facilities to a new operator and has reclassified the operations of these facilities as discontinued operations for 2010 presented in the accompanying interim consolidated financial statements. The $177,000 net loss on lease termination primarily relates to severance, legal and other costs incurred to facilitate the transition as well as the transfer of inventory.

7. EARNINGS (LOSS) PER COMMON SHARE

Information with respect to basic and diluted net income per common share is presented below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income (loss) per common share:				
Per common share – basic				
Income (loss) from continuing operations	$(0.17)	$0.02	$0.39	$ 0.29
Income (loss) from discontinued operations				
Operating income, net of taxes	—	—	—	0.06
Loss on disposal, net of taxes	—	—	—	(0.03)
Discontinued operations, net of taxes	—	—	—	0.03
Net income (loss)	$(0.17)	$0.02	$0.39	$ 0.32
Per common share – diluted				
Income (loss) from continuing operations	$(0.17)	$0.02	$0.38	$ 0.28
Income (loss) from discontinued operations				
Operating income, net of taxes	—	—	—	0.06
Loss on disposal, net of taxes	—	—	—	(0.03)
Discontinued operations, net of taxes	—	—	—	0.03
Net income (loss)	$(0.17)	$0.02	$0.38	$ 0.31

The effects of 154,000 and 523,000 weighted average SOSARs and options outstanding were excluded from the computation of diluted earnings per common share in 2011 and 2010, respectively, because these securities would have been anti-dilutive.

8. WEST VIRGINIA FACILITY

On June 17, 2009, the Company completed the acquisition of certain assets of a skilled nursing facility in West Virginia. The Company had entered into an option agreement to purchase these assets for $850,000 during 2006 and the purchase price of $850,000 is included in other noncurrent assets in the Company's Interim Consolidated Balance Sheet. The Company did not agree to assume any liabilities or working capital in connection with the acquisition. The existing facility closed in February 2009.

The Company has an agreement with a real estate developer that will construct, furnish, and equip a 90 bed skilled nursing center near Milton, West Virginia, to replace the facility described above. The Company will lease the new facility upon completion. The initial lease term is 20 years from the date the center is completed and fit for occupancy as a skilled nursing center. The Company has the option to renew the lease for two additional five-year periods. Construction on the nursing center began in November 2010, and it is estimated the center will be completed in late 2011. The agreement provides the Company the right to purchase the center beginning at the end of the first year of the initial term of the lease and continuing through the fifth year for a purchase price ranging from 110% to 120% of the total project cost.

The Company has no equity interest in the entity constructing the new facility and does not guarantee any debt obligations of the entity. The owners of the facility have provided guarantees of the debt of the entity and, based on those guarantees, the entity is considered to be a variable interest entity ("VIE"). The Company owns the underlying Certificate of Need that is required for operation as a skilled nursing center. The Company is considered to be the primary beneficiary of the VIE based primarily on the ownership of the Certificate of Need, the fixed price purchase option described above, its ability to direct the activities that most significantly impact the economic performance of the VIE and the right to receive potentially significant benefits from the VIE.

The following table summarizes the accounts and amounts included in the Company's Interim Consolidated Balance Sheet that are associated with the real estate developer's interests in the VIE. These assets can be used only to settle obligations of the VIE and none of these liabilities provide creditors with recourse to the general assets of the Company.

	September 30, 2011
Land	$ 787,000
Building and improvements	4,539,000
	$ 5,326,000
Current liabilities	$ 699,000
Notes payable	3,000,000
Non-controlling interests equity	1,627,000
	$ 5,326,000

9. RECENT ACCOUNTING GUIDANCE

In June 2011, the FASB issued updated guidance in the form of a FASB Accounting Standards Update on "Comprehensive Income - Presentation of Comprehensive Income," to require an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The update eliminates the option to present the components of other comprehensive income as part of the statement of equity. The Company will adopt this guidance effective January 1, 2012 and will apply it retrospectively. The Company currently believes there will be no significant impact on its consolidated financial statements.

In July 2011, the FASB issued updated guidance in the form of a FASB Accounting Standards Update on "Health Care Entities: Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities". This guidance impacts health care entities that recognize significant amounts of patient service revenue at the time the services are rendered even though they do not assess the patient's ability to pay. This updated guidance requires an impacted health care entity to present its provision for doubtful accounts as a deduction from revenue, similar to contractual discounts. Accordingly, patient service revenue for entities subject to this updated guidance will be required to be reported net of both contractual discounts and provision for doubtful accounts. The updated guidance also requires certain qualitative disclosures about the entity's policy for recognizing revenue and bad debt expense for patient service transactions. The Company will adopt this guidance effective January 1, 2012 and will apply it retrospectively. The Company is currently assessing the potential impact of the adoption and believes the adoption will not have a material impact on the Company's consolidated financial statements.

10. CHANGES IN COMPANY EXECUTIVES

William R. Council, III resigned as Chief Executive Officer and Director of the Company, effective September 30, 2011. In connection with his resignation, the Company and Mr. Council entered into a separation agreement effective September 30, 2011 for the severance under the terms of Mr. Council's employment agreement. The Company recorded $1,258,000 in severance and other expenses in the third quarter of 2011 related to Mr. Council's departure in accordance with his employment agreement, most of which will be paid on March 31, 2012. The Company and Mr. Council also entered into a six month consulting agreement effective October 1, 2011 to facilitate the transition of management. Under the consulting agreement, Mr. Council will receive $36,800 per month through March 2012. On September 16, 2011, the Board of Directors appointed the Company's Chief Operating Officer, Kelly J. Gill, as President of the Company and on November 4, 2011 promoted Mr. Gill to Chief Executive Officer of the Company and appointed him to the Board of Directors.

11. ASSET IMPAIRMENT

The Company routinely evaluates the recoverability of the carrying value of its long-lived assets, including when significant adverse changes in the general economic conditions and significant deteriorations of the underlying cash flows or fair values of the property indicate that the carrying amount of the property may not be recoverable. The need to recognize impairment is based on estimated future undiscounted cash flows from a property compared to the carrying value of that property. On July 29, 2011, the Centers for Medicare & Medicaid Services ("CMS") issued its final rule for skilled nursing facilities effective October 1, 2011, reducing Medicare reimbursement rates for skilled nursing facilities by 11.1% and also making changes to rehabilitation therapy regulations which will have a negative effect on the Company's revenue and costs in Medicare's fiscal year ending September 30, 2012 as compared to Medicare's fiscal year ended September 30, 2011. As a result of this negative impact, an interim impairment analysis was conducted as of August 31, 2011.

As of August 31, 2011, the Company determined that the carrying value of the long-lived assets of one of its leased nursing centers exceeded the fair value. As a result, the Company recorded a fixed asset impairment charge as of and for the period ended September 30, 2011 of $344,000 to reduce the carrying value of these assets.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Advocat Inc. provides long-term care services to nursing center patients in eight states, primarily in the Southeast and Southwest. Our centers provide a range of health care services to their patients and residents. In addition to the nursing, personal care and social services usually provided in long-term care centers, we offer a variety of comprehensive rehabilitation services as well as nutritional support services. As of September 30, 2011, our continuing operations consist of 46 nursing centers with 5,364 licensed nursing beds. We own 9 and lease 37 of our nursing centers included in continuing operations.

Strategic operating initiatives. In 2010, we completed a strategic planning process, and have identified several strategic operating initiatives to improve occupancy and skilled mix in our nursing centers by enhancing our registered nurse coverage and adding specialized clinical care. The investments in nursing and clinical care are being conducted in concert with additional investments in facility based marketing representatives to develop referral and managed care relationships. These investments are expected to better attract quality payor sources for patients covered by Medicare, managed care as well as certain private pay individuals. These marketing and nurse coverage efforts are also expected to enable us to improve our Medicare rate by becoming the preferred referral for higher acuity patients.

Another strategic operating initiative is to implement Electronic Medical Records ("EMR"). We believe we can improve operations, profitability and our quality programs in our nursing centers by implementing EMR. EMR provides the ability to electronically record the care provided to our patients and improves customer and employee satisfaction, improves facility regulatory compliance and provides real-time monitoring and scheduling of care delivery. It is anticipated that the improved documentation of care will also provide greater tracking and capture of services we provide to patients.

As part of our strategic operating initiatives we will accelerate our program for improving our physical plants. Since 2005, we have been completing strategic renovations of certain facilities that improve occupancy, quality of care and profitability. We plan to continue these facility renovation projects and accelerate this strategy using the knowledge obtained in the first few years of this program. Our strategic operating initiatives will also include pursuing and investigating opportunities to acquire, lease or develop new facilities, focusing primarily on opportunities within our existing areas of operation.

We are incurring expenses in connection with these initiatives, as described in "Results of Operations." These investments in business initiatives will increase our operating expenses for the next one or two years, and there is typically a time delay between incurring such expenses and attaining the revenues and cash flows expected from these initiatives and developments.

Divestitures . Effective March 31, 2010, we terminated operations of four nursing centers in Florida under a lease that, as amended, would have expired in August 2010. We have reclassified the operations of these facilities as discontinued operations in the accompanying interim consolidated financial statements for 2010.

Basis of Financial Statements. Our patient revenues consist of the fees charged for the care of patients in the nursing centers we own and lease. Our operating expenses include the costs, other than lease, professional liability, depreciation and amortization expenses, incurred in the operation of the nursing centers we own and lease. Our general and administrative expenses consist of the costs of the corporate office and regional support functions. Our interest, depreciation and amortization expenses include all such expenses across the range of our operations.

Critical Accounting Policies and Judgments

A "critical accounting policy" is one which is both important to the understanding of our financial condition and results of operations and requires management's most difficult, subjective or complex judgments often involving estimates of the effect of matters that are inherently uncertain. Actual results could differ from those estimates and cause our reported net income to vary significantly from period to period. Our critical accounting policies are more fully described in our 2010 Annual Report on Form 10-K.

Revenue Sources

We classify our revenues from patients and residents into four major categories: Medicaid, Medicare, managed care, and private pay and other. Medicaid revenues are composed of the traditional Medicaid program established to provide benefits to those in need of financial assistance in the securing of medical services. Medicare revenues include revenues received under both Part A and Part B of the Medicare program. Managed care revenues include payments for patients who are insured by a third-party entity, typically called a Health Maintenance Organization, often referred to as an HMO plan, or are Medicare beneficiaries who assign their Medicare benefits to a managed care replacement plan often referred to as Medicare replacement products. The private pay and other revenues are composed primarily of individuals or parties who directly pay for their services. Included in the private pay and other are patients who are hospice beneficiaries as well as the recipients of Veterans Administration benefits. Veterans Administration payments are made pursuant to renewable contracts negotiated with these payors.

The following table sets forth net patient and resident revenues related to our continuing operations by payor source for the periods presented (dollar amounts in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2011		2010		2011		2010	
Medicaid	$39,857	49.4%	$39,630	54.3%	$115,512	48.8%	$115,636	53.9%
Medicare	28,091	34.8	21,809	29.9	83,339	35.2	65,275	30.4
Managed care	3,234	4.0	1,825	2.5	9,375	4.0	6,052	2.8
Private Pay and other	9,462	11.8	9,732	13.3	28,720	12.0	27,677	12.9
Total	$80,644	100.0%	$72,996	100.0%	$236,946	100.0%	$214,640	100.0%

The following table sets forth average daily skilled nursing census by payor source for our continuing operations for the periods presented:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2011		2010		2011		2010	
Medicaid	2,828	67.9%	2,901	68.7%	2,793	67.3%	2,890	68.9%
Medicare	577	13.9	541	12.8	594	14.3	551	13.1
Managed care	83	2.0	48	1.1	80	1.9	56	1.3
Private Pay and other	673	16.2	733	17.4	684	16.5	699	16.7
Total	4,161	100.0%	4,223	100.0%	4,151	100.0%	4,196	100.0%

Consistent with the nursing home industry in general, changes in the mix of a facility's patient population among Medicaid, Medicare, managed care, and private pay and other can significantly affect the profitability of the facility's operations.

Health Care Industry

The health care industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, quality of resident care and Medicare and Medicaid fraud and abuse. Over the last several years, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations as well as laws and regulations governing quality of care issues in the skilled nursing profession in general. Violations of these laws and regulations could result in exclusion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with such laws and regulations is subject to ongoing government review and interpretation, as well as regulatory actions in which government agencies seek to impose fines and penalties. The Company is involved in regulatory actions of this type from time to time.

In March 2010, significant legislation concerning health care and health insurance was passed, including the “Patient Protection and Affordable Care Act” (“Patient Protection Act”) along with the “Health Care and Education Reconciliation Act of 2010” (“Reconciliation Act”) collectively defined as the “Legislation.” We expect this Legislation to impact our Company, our employees and our patients and residents in a variety of ways. Some aspects of these new laws are immediate while others will be phased in over the next ten years when all mandates become effective. This Legislation significantly changes the future responsibility of employers with respect to providing health care coverage to employees in the United States. Two of the main provisions of the Legislation become effective in 2014 whereby most individuals will be required to either have health insurance or pay a fine and employers with 50 or more employees will either have to provide minimum essential coverage or will be subject to additional taxes. We have not estimated the financial impact of the Legislation and the costs associated with complying with the increased levels of health insurance we will be required to provide our employees and their dependents in future years. We expect the Legislation will result in increased operating expenses.

We also expect for this Legislation to continue to impact our Medicaid and Medicare reimbursement as well, though the exact timing and level of that impact is currently unknown. We anticipate that many of the provisions of the Legislation may be subject to further clarification and modification through the rule making process. The Legislation expands the role of home based and community services, which may place downward pressure on our sustaining population of Medicaid residents.

Medicare and Medicaid Reimbursement

A significant portion of our revenues are derived from government-sponsored health insurance programs. Our nursing centers derive revenues under Medicaid, Medicare, managed care, private pay and other third party sources. We employ specialists in reimbursement at the corporate level to monitor regulatory developments, to comply with reporting requirements and to ensure that proper payments are made to our operated nursing centers. It is generally recognized that all government-funded programs have been and will continue to be under cost containment pressures, but the extent to which these pressures will affect our future reimbursement is unknown.

Medicare

Effective October 1, 2010, Medicare rates were increased by the Centers for Medicare & Medicaid Services (“CMS”) implementation of a market basket adjustment and the implementation of MDS 3.0 and Resource Utilization Group IV (“RUG IV”). The net impact of the market basket adjustment increased Medicare reimbursement to skilled nursing centers by approximately 1.7% compared to the fiscal year ending September 30, 2010. CMS also implemented MDS 3.0, a new patient assessment tool for the collection of clinical data to be used for classification into the RUG categories for all

Medicare patients and those Medicaid patients in RUG-based reimbursement states. In addition to the patient assessment tool, CMS expanded RUG categories to 66 under RUG IV up from 53 under RUG III. As discussed in our results of operations, these Medicare reimbursement changes increased our Medicare revenue and our Medicare rate per patient day. The new regulations have also resulted in an increase in costs to complete the patient assessments required by these new rules.

On July 29, 2011, CMS published its final rule providing for a net 11.1% reduction in payments to skilled nursing facilities effective October 1, 2011. The 11.1% reduction is on a net basis, after the application of a 2.7% market basket increase and a 1.0% productivity adjustment required by the Patient Protection Act. The final CMS rule also adjusts the method by which group therapy is counted for reimbursement purposes and, for patients receiving therapy, changes the timing of reassessment for purposes of determining patient RUG categories.

Therapy Services. There are annual Medicare Part B reimbursement limits on therapy services that can be provided to an individual. The limits effective January 1, 2011 impose a $1,870 per patient annual ceiling on physical and speech therapy services, and a separate $1,870 per patient annual ceiling on occupational therapy services. CMS established an exception process to permit therapy services in certain situations and as is standard within our industry, we provide services that are reimbursed under the exceptions process. The exceptions process has been extended several times, most recently by the Medicare and Medicaid Extenders Act of 2010 which extended this exception process through December 31, 2011. It is unknown if any further extension of the therapy cap exceptions will be included in future legislation. If the exception process is discontinued, it is expected that the reimbursement limitations will reduce therapy revenues and negatively impact our operating results and cash flows.

Medicaid

Several states in which we operate face budget shortfalls, which could result in reductions in Medicaid funding for nursing centers. The federal government made an effort to address the financial challenges state Medicaid programs are facing by increasing the amount of Medicaid funding available to states. On February 17, 2009, the American Recovery and Reinvestment Act of 2009, (“ARRA”) was enacted. Among other provisions, ARRA provided $87 billion for a temporary period to assist states in maintaining and expanding Medicaid enrollment. Pressures on state budgets are expected to continue in the future and are expected to result in Medicaid rate reductions as the ARRA provisions that assist states in maintaining and expanding Medicaid ended on December 31, 2010. In August 2010, the federal government passed legislation that provided limited additional funding to assist states in matching Medicaid, similar to some of the ARRA provisions. The additional matching funds continued through June 2011. It is unclear what additional matching fund enhancements, if any, will continue in the future and the timing of changes to available matching funds will affect our Medicaid rates.

We receive the majority of our annual Medicaid rate increases during the third quarter of each year. The rate changes received in the third quarter of 2011 were the primary contributor to our 3.6% increase in average rate per day for Medicaid patients in the third quarter of 2011 compared to the third quarter of 2010.

We are unable to predict what, if any, reform proposals or reimbursement limitations will be implemented in the future, or the effect such changes would have on our operations. For the nine months ended September 30, 2011, we derived 35.2% and 48.8% of our total patient and resident revenues related to continuing operations from the Medicare and Medicaid programs, respectively. Any health care reforms that significantly limit rates of reimbursement under these programs could, therefore, have a material adverse effect on our profitability.

We will attempt to increase revenues from non-governmental sources to the extent capital is available to do so, if at all. However, private payors, including managed care payors, are increasingly demanding that providers accept discounted fees or assume all or a portion of the financial risk for the delivery of health care services. Such measures may include capitated payments, which can result in significant losses to health care providers if patients require expensive treatment not adequately covered by the capitated rate.

Licensure and other Health Care Laws

All our nursing centers must be licensed by the state in which they are located in order to accept patients, regardless of payor source. In most states, nursing centers are subject to certificate of need laws, which require us to obtain government approval for the construction of new nursing centers or the addition of new licensed beds to existing centers. Our nursing centers must comply with detailed statutory and regulatory requirements on an ongoing basis in order to qualify for licensure, as well as for certification as a provider eligible to receive payments from the Medicare and Medicaid programs. Generally, the requirements for licensure and Medicare/Medicaid certification are similar and relate to quality and adequacy of personnel, quality of medical care, record keeping, dietary services, resident rights, and the physical condition of the center and the adequacy of the equipment used therein. Each center is subject to periodic inspections, known as “surveys” by health care regulators, to determine compliance with all applicable licensure and certification standards. Such requirements are both subjective and subject to change. If the survey concludes that there are deficiencies in compliance, the center is subject to various sanctions, including but not limited to monetary fines and penalties, suspension of new admissions, non-payment for new admissions and loss of licensure or certification. Generally, however, once a center receives written notice of any compliance deficiencies, it may submit a written plan of correction and is given a reasonable opportunity to correct the deficiencies. There can be no assurance that, in the future, we will be able to maintain such licenses and certifications for our facilities or that we will not be required to expend significant sums in order to comply with regulatory requirements. Recently, we have experienced an increase in the severity of survey citations and the size of monetary penalties, consistent with industry trends.

Contractual Obligations and Commercial Commitments

We have certain contractual obligations of continuing operations as of September 30, 2011, summarized by the period in which payment is due, as follows (dollar amounts in thousands):

Contractual Obligations	Total	Less than 1 year	1 to 3 Years	3 to 5 Years	After 5 Years
Long-term debt obligations (1)	$ 33,795	$ 2,372	$ 4,625	$26,798	$ —
Settlement obligations (2)	$ 4,075	$ 4,075	$ —	$ —	$ —
Executive severance (3)	$ 1,903	$ 1,903	$ —	$ —	$ —
Series C Preferred Stock (4)	$ 4,918	$ 4,918	$ —	$ —	$ —
Elimination of Preferred Stock Conversion feature (5)	$ 4,808	$ 687	$ 1,374	$ 1,374	$ 1,373
Operating leases	$450,735	$18,199	$38,478	$40,194	$353,864
Required capital expenditures under operating leases (6)	$ 15,898	$ 273	$ 545	$ 545	$ 14,535
Total	$516,132	$32,427	$45,022	$68,911	$369,772

(1) Long-term debt obligations include scheduled future payments of principal and interest of long-term debt and amounts outstanding on our capital lease obligations.
(2) Settlement obligations relate to professional liability cases that will be paid within the next twelve months. The professional liabilities are included in our current portion of self insurance reserves.
(3) Executive severance includes separation payments to a former executive that will be paid within the next twelve months. The separation payments are included in our accrued payroll and employee benefits.
(4) Series C Preferred Stock equals the redemption value at the preferred shareholder's earliest redemption date.
(5) Payments to Omega for the elimination of the preferred stock conversion feature in connection with restructuring the preferred stock and master lease agreements. Monthly payments of approximately $57,000 will be made through the end of the initial lease period that ends in September 2018.
(6) Includes annual expenditure requirements under operating leases.

We have employment agreements with certain members of management that provide for the payment to these members amounts equal to their annual salary in the event of a termination without cause, a constructive discharge (as defined), or upon a change of control of the Company (as defined). Other than Mr. Council's payments described below, the maximum contingent liability under these agreements is approximately $1.2 million as of September 30, 2011. The terms of such agreements are from one to three years and automatically renew for one year if not terminated by us or the employee. In addition, upon the occurrence of any triggering event, those certain members of management may elect to require that we purchase equity awards granted to them for a purchase price equal to the difference in the fair market value of our common stock at the date of termination versus the stated equity award exercise price. Based on the closing price of our stock on September 30, 2011, the maximum contingent liability for the repurchase of the equity grants is approximately $0.2 million. No amounts have been accrued for these contingent liabilities for members of management we currently employ.

William R. Council, III resigned as Chief Executive Officer and Director of the Company, effective September 30, 2011. In connection with his resignation, we recorded approximately $1,258,000 in severance and other expenses in the third quarter of 2011 related to Mr. Council's departure in accordance with his employment agreement.

Results of Operations

The results of operations presented have been reclassified to present the effects of certain divestitures discussed in the overview to "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The following tables present the unaudited interim statements of income and related data for the three and nine month periods ended September 30, 2011 and 2010:

(in thousands)	Three Months Ended September 30,			
	2011	2010	Change	%
PATIENT REVENUES, net	$ 80,644	$ 72,996	$ 7,648	10.5
EXPENSES:				
Operating	61,871	58,534	3,337	5.7
Lease	5,737	5,661	76	1.3
Professional liability	4,610	1,684	2,926	173.8
General and administrative	7,185	4,954	2,231	45.0
Depreciation and amortization	1,636	1,453	183	12.6
Asset impairment	344	—	344	100.0
Total expenses	81,383	72,286	9,097	12.6
OPERATING INCOME (LOSS)	(739)	710	(1,449)	(204.1)
OTHER INCOME (EXPENSE):				
Interest expense, net	(683)	(413)	(270)	(65.4)
	(683)	(413)	(270)	(65.4)
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(1,422)	297	(1,719)	(578.8)
(PROVISION) BENEFIT FOR INCOME TAXES	549	(68)	617	907.4
NET INCOME (LOSS) FROM CONTINUING OPERATIONS	$ (873)	$ 229	$ (1,102)	$(481.2)

(in thousands)	Nine Months Ended September 30,			
	2011	2010	Change	%
PATIENT REVENUES, net	$236,946	$214,640	$22,306	10.4
EXPENSES:				
Operating	182,470	170,324	12,146	7.1
Lease	17,178	16,899	279	1.7
Professional liability	7,382	4,095	3,287	80.3
General and administrative	19,363	14,719	4,644	31.6
Depreciation and amortization	4,757	4,301	456	10.6
Asset impairment	344	—	344	100.0
Total expenses	231,494	210,338	21,156	10.1
OPERATING INCOME	5,452	4,302	1,150	26.7
OTHER INCOME (EXPENSE):				
Interest expense, net	(1,716)	(1,224)	(492)	(40.2)
Debt retirement costs	(112)	(127)	15	11.8
	(1,828)	(1,351)	(477)	(35.3)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	3,624	2,951	673	22.8
PROVISION FOR INCOME TAXES	(1,112)	(1,028)	(84)	(8.2)
NET INCOME FROM CONTINUING OPERATIONS	$ 2,512	$ 1,923	$ 589	30.6

Percentage of Net Revenues	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
PATIENT REVENUES, net	100.0%	100.0%	100.0%	100.0%
EXPENSES:				
Operating	76.7	80.2	77.0	79.4
Lease	7.1	7.7	7.2	7.9
Professional liability	5.7	2.3	3.1	1.9
General and administrative	8.9	6.8	8.2	6.8
Depreciation and amortization	2.0	2.0	2.0	2.0
Asset impairment	0.5	—	0.1	—
Total expenses	100.9	99.0	97.6	98.0
OPERATING INCOME (LOSS)	(0.9)	1.0	2.4	2.0
OTHER INCOME (EXPENSE):				
Interest expense	(0.9)	(0.6)	(0.8)	(0.6)
	(0.9)	(0.6)	(0.8)	(0.6)
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(1.8)	0.4	1.6	1.4
(PROVISION) BENEFIT FOR INCOME TAXES	0.7	(0.1)	(0.5)	(0.5)
NET INCOME (LOSS) FROM CONTINUING OPERATIONS	(1.1)%	0.3%	1.1%	0.9%

Three Months Ended September 30, 2011 Compared With Three Months Ended September 30, 2010

Patient Revenues

Patient revenues increased to $80.6 million in 2011 from $73.0 million in 2010, an increase of $7.6 million, or 10.5%.

The following table summarizes key revenue and census statistics for continuing operations for each period:

	Three Months Ended September 30,	
	2011	2010
Skilled nursing occupancy	77.6%	78.7%
As a percent of total census:		
Medicare census	13.9%	12.8%
Managed care census	2.0%	1.1%
As a percent of total revenues:		
Medicare revenues	34.8%	29.9%
Medicaid revenues	49.4%	54.3%
Managed care revenues	4.0%	2.5%
Average rate per day:		
Medicare	$473.98	$388.37
Medicaid	$153.55	$148.21
Managed care	$405.14	$394.11

Medicare census increased approximately 6.7% in 2011 and contributed approximately $1.3 million to the revenue increase experienced in the third quarter. This increase is primarily attributable to the investments we have made to improve our skilled care offerings. The average Medicare rate per patient day for 2011 increased 22.0% compared to 2010. On October 1, 2010, CMS implemented

RUG IV in connection with the MDS 3.0 patient assessment tool. RUG IV expanded RUG categories to 66 from 53 under RUG III. Also on October 1, 2010, CMS implemented a Medicare rate increase of 1.7% for the annual SNF market basket adjustment. The combined effect of these rate changes, together with changes in patient acuity levels, increased revenue by $4.5 million in the third quarter of 2011.

Medicaid average daily census was 2.5% lower in 2011, decreasing revenue by $1.0 million in the third quarter of 2011. The average Medicaid rate per patient day for 2011 increased 3.6% compared to 2010, and resulted in revenue increases of $1.4 million in 2011. This increase is the result of rate increases in certain states, partially funded by increased provider taxes, and increasing patient acuity levels. The decrease in Medicaid census reflects our focus on improving our skilled mix.

Managed care rates and census contributed approximately $1.4 million of the total revenue increase. The average managed care rate per patient day for 2011 increased 2.8% compared to 2010 and managed care average daily census increased 77%. The remaining revenue increases primarily resulted from increased Medicare Part B and private payors.

Operating expense

Operating expense increased to $61.9 million in 2011 from $58.5 million in 2010, an increase of $3.4 million, or 5.7%. The increase in operating expense is primarily attributable to cost increases associated with our increased revenue as well as investment in our operating initiatives focused on improving our skilled mix and occupancy. Operating expense decreased to 76.7% of revenue in 2011, compared to 80.2% of revenue in 2010.

The largest component of operating expense is wages, which increased to $39.2 million in 2011 from $36.3 million in 2010, an increase of $2.9 million, or 8.0%. The increase in wages was primarily due to labor costs associated with the 12.2% increase in Medicare and managed care patients, competitive labor markets in most of the areas in which we operate and regular merit and inflationary raises for personnel (increase of approximately 3.5% for the quarter). In accordance with our strategic initiatives to increase our high acuity patient care capabilities and grow our skilled mix and occupancy we have added additional registered nurses and therapists to attract and serve the needs of these patients, including approximately $1.2 million in therapy staffing costs, and $0.6 million in nursing center staffing costs to improve our ability to market and care for high acuity patients.

Provider taxes increased approximately $0.2 million in 2011, primarily due to increases in tax rates in certain states in which we operate.

Employee health insurance costs were approximately $0.5 million lower in 2011 compared to 2010, a decrease of 33.1%. The Company is self insured for the first $175,000 in claims per employee each year, and we experienced a lower level of claims costs during 2011. Employee health insurance costs can vary significantly from year to year.

During the third quarter of 2011, we concluded a review of charges under pharmacy supply contracts, and reduced operating expenses by $0.3 million after reaching an agreement with a pharmacy provider for a refund of agreed upon overcharges.

Lease expense

Lease expense was approximately $5.7 million in both 2011 and 2010.

Professional liability

Professional liability expense was $4.6 million in the third quarter of 2011 compared to $1.7 million in the third quarter of 2010, an increase of $2.9 million. We recorded expense for the third quarter of 2011 after consideration of several factors affecting our estimate of professional and general liability claims, including an analysis of claims actually reported, new lawsuits filed, lawsuits resolved, and relevant claim development data during 2011 and prior periods. We were engaged in 32 professional liability lawsuits as of September 30, 2011, compared to 34 as of September 30, 2010. Our cash expenditures for professional liability costs of continuing operations were $4.5 million and $1.3 million for 2011 and 2010, respectively. Professional liability cash expenditures can fluctuate from year to year based respectively on the results of our third-party professional liability actuarial studies and on the costs incurred in defending and settling existing claims. See “Liquidity and Capital Resources” for further discussion of the accrual for professional liability.

General and administrative expense

General and administrative expenses were approximately $7.2 million in 2011, compared to $5.0 million in 2010, an increase of $2.2 million, or 45.0%. Costs of our strategic initiatives accounted for approximately $0.8 million, including compensation costs related to new positions of approximately $0.5 million and costs related to the continued implementation of electronic medical records of approximately $0.2 million, and other travel expenses of $0.1 million. Performance-based incentive expense was $0.2 million lower in 2011. We incurred approximately $1.3 million in separation costs in 2011 and experienced a $0.3 million increase in legal costs during 2011.

Depreciation and amortization

Depreciation and amortization expense was approximately $1.6 million and $1.5 million in 2011 and 2010, respectively.

Asset impairment

During the third quarter of 2011 we determined that the carrying value of the long-lived assets of one of our leased nursing centers exceeded the fair value. As a result, we recorded a fixed asset impairment charge as of and for the period ended September 30, 2011 of $0.3 million to reduce the carrying value of these assets.

Interest expense

Interest expense increased to $0.7 million in 2011 compared to $0.4 million in 2010. As discussed further in “Capital Resources” the increase in interest expense is due to the change in interest rates on our Mortgage Loan to a fixed rate of 7.07% from 4.01% at September 30, 2010, and the additional $2.4 million in borrowings for capital improvements at our owned homes.

Income (loss) from continuing operations before income taxes; income (loss) from continuing operations per common share

As a result of the above, continuing operations reported a loss before income taxes of $1.4 million in 2011 compared to income of $0.3 million in 2010. The benefit for income taxes was $0.5 million in 2011, an effective benefit rate of 38.6% and the provision for income taxes was $0.1 million in 2010, an effective expense rate of 22.9%. The basic and diluted income (loss) per common share from continuing operations were both $(0.17) in 2011 compared to $0.02 for both in 2010.

Nine Months Ended September 30, 2011 Compared With Nine Months Ended September 30, 2010

Patient Revenues

Patient revenues increased to $236.9 million in 2011 from $214.6 million in 2010, an increase of $22.3 million, or 10.4%.

The following table summarizes key revenue and census statistics for continuing operations for each period:

	Nine Months Ended September 30,	
	2011	2010
Skilled nursing occupancy	77.4%	78.2%
As a percent of total census:		
Medicare census	14.3%	13.1%
Managed care census	1.9%	1.3%
As a percent of total revenues:		
Medicare revenues	35.2%	30.4%
Medicaid revenues	48.8%	53.9%
Managed care revenues	4.0%	2.8%
Average rate per day:		
Medicare	$464.64	$390.35
Medicaid	$150.99	$146.27
Managed care	$407.45	$388.24

Medicare census increased approximately 7.8% in 2011, and contributed approximately $4.5 million to the revenue increase experienced in the nine month period. This increase is primarily attributable to the investments we have made to improve our skilled care offerings. The average Medicare rate per patient day for 2011 increased 19.0% compared to 2010. On October 1, 2010, CMS implemented RUG IV in connection with the MDS 3.0 patient assessment tool. RUG IV expanded RUG categories to 66 from 53 under RUG III. Also on October 1, 2010, CMS implemented a Medicare rate increase of 1.7% for the annual SNF market basket adjustment. The combined effect of these rate changes, together with changes in patient acuity levels, increased revenue by $12.0 million in the first nine months of 2011.

Medicaid average daily census was 3.4% lower in 2011, decreasing revenue by $3.8 million in the nine month period of 2011. The average Medicaid rate per patient day for 2011 increased 3.2% compared to 2010, and resulted in revenue increases of $3.6 million in 2011. This increase is the result of rate increases in certain states, partially funded by increased provider taxes, and increasing patient acuity levels. The decrease in Medicaid census reflects our focus on improving our skilled mix.

Managed care rates and census contributed approximately $3.1 million of the total revenue increase. The remaining revenue increases primarily resulted from increased Medicare Part B and private payors.

Operating expense

Operating expense increased to $182.5 million in 2011 from $170.3 million in 2010, an increase of $12.2 million, or 7.1%. The increase in operating expense is primarily attributable to cost increases associated with our increased revenue as well as investment in our operating initiatives focused on improving our skilled mix and occupancy. Operating expense decreased to 77.0% of revenue in 2011, compared to 79.4% of revenue in 2010.

The largest component of operating expense is wages, which increased to $113.7 million in 2011 from $104.5 million in 2010, an increase of $9.2 million, or 8.8%. The increase in wages was primarily due to labor costs associated with the 11.2% increase in Medicare and managed care patients, competitive labor markets in most of the areas in which we operate and regular merit and inflationary raises for personnel (increase of approximately 3.2% for the year). In accordance with our strategic initiatives to increase our high acuity patient care capabilities and grow our skilled mix and occupancy we have added additional registered nurses and therapists to attract and serve the needs of these patients, including approximately $3.6 million in therapy staffing costs, $1.7 million in nursing center staffing costs to improve our ability to market and care for high acuity patients and $0.7 million for increased wages that resulted from the transition to the new MDS 3.0 patient assessment tool in our facilities.

Provider taxes increased approximately $0.6 million in 2011, primarily due to increases in tax rates in certain states in which we operate.

Workers compensation insurance expense increased approximately $0.6 million in 2011 compared to 2010. The increase is the result of better claims experience in 2010 compared to 2011.

Employee health insurance costs were approximately $1.4 million lower in 2011 compared to 2010, a decrease of 26.5%. The Company is self insured for the first $175,000 in claims per employee each year, and we experienced a lower level of claims costs during 2011. Employee health insurance costs can vary significantly from year to year.

Lease expense

Lease expense increased to $17.2 million in 2011 from $16.9 million in 2010. The primary reason for the increase in lease expense was rent for lessor funded property renovations.

Professional liability

Professional liability expense was $7.4 million in 2011 compared to $4.1 million in 2010, an increase of $3.3 million. We were engaged in 32 professional liability lawsuits as of September 30, 2011, compared to 34 as of September 30, 2010. Our cash expenditures for professional liability costs of continuing operations were $6.7 million for 2011 and $3.5 million in 2010. Professional liability cash expenditures can fluctuate from year to year based respectively on the results of our third-party professional liability actuarial studies and on the costs incurred in defending and settling existing claims. See “Liquidity and Capital Resources” for further discussion of the accrual for professional liability.

General and administrative expense

General and administrative expenses were approximately $19.4 million in 2011, compared to $14.7 million in 2010, an increase of $4.7 million, or 31.6%. Costs of our strategic initiatives accounted for approximately $2.2 million, including compensation costs related to new positions of approximately $1.1 million, costs related to the continued implementation of electronic medical records of approximately $0.5 million, increased travel costs of $0.2 million, consulting services costs of $0.1 million and hiring and relocation cost increases of $0.3 million. Performance-based incentive expense was $0.1 million higher in 2011. We also experienced an increase of approximately $1.0 million in separation costs and experienced a $0.4 million increase in legal costs during 2011.

Depreciation and amortization

Depreciation and amortization expense was approximately $4.8 million and $4.3 million in 2011 and 2010, respectively.

Asset impairment

During the third quarter of 2011 we determined that the carrying value of the long-lived assets of one of our leased nursing centers exceeded the fair value. As a result, we recorded a fixed asset impairment charge as of and for the period ended September 30, 2011 of $0.3 million to reduce the carrying value of these assets.

Interest expense

Interest expense increased to $1.7 million in 2011 compared to $1.2 million in 2010. As discussed further in “Capital Resources” the increase in interest expense is due to the change in interest rates on our Mortgage Loan to a fixed rate of 7.07% from 4.01% at September 30, 2010 and the additional $2.4 million in borrowings for capital improvements at our owned homes.

Income from continuing operations before income taxes; income from continuing operations per common share

As a result of the above, continuing operations reported income before income taxes of $3.6 million in 2011 compared to income of $3.0 million in 2010. The provision for income taxes was $1.1 million in 2011, an effective rate of 30.7% and $1.0 million in 2010, an effective rate of 34.8%. The basic and diluted income per common share from continuing operations were $0.39 and $0.38 in 2011 compared to $0.29 and $0.28 in 2010.

Liquidity and Capital Resources

Liquidity

Our primary source of liquidity is the net cash flow provided by the operating activities of our facilities. We believe that these internally generated cash flows will be adequate to service existing debt obligations, fund required capital expenditures as well as provide cash flows for investing opportunities. In determining priorities for our cash flow, we evaluate alternatives available to us and select the ones that we believe will most benefit us over the long term. Options for our cash include, but are not limited to, capital improvements, dividends, purchase of additional shares of our common stock, acquisitions, payment of existing debt obligations, preferred stock redemptions as well as initiatives to improve facility performance. We review these potential uses and align them to our cash flows with a goal of achieving long term success. We plan to invest in business initiatives and development that will increase our operating expenses for the next one to two years as part of our plan to improve our high acuity offerings.

Net cash provided by operating activities of continuing operations totaled $9.8 million and $6.4 million in 2011 and 2010, respectively. Operating activities of discontinued operations provided cash of $0.6 million and $1.1 million in 2011 and 2010, respectively.

Investing activities of continuing operations used cash of $11.1 million and $4.4 million in 2011 and 2010, respectively. These amounts primarily represent cash used for purchases of property and equipment. We have used between $6.4 million and $9.4 million for capital expenditures of continuing operations in each of the three calendar years ended December 31, 2010. The $9.3 million in purchases of property and equipment during 2011 includes $3.7 million in assets added by the entity constructing the West Virginia facility that we are consolidating. We borrowed $2.4 million in our March 2011 mortgage refinancing to fund capital improvements at the four owned nursing centers that secure the mortgage loan, and have classified the unused portion of these funds as restricted cash. Investing activities of discontinued operations used cash of $45,000 during 2010.

Financing activities of continuing operations used cash of $0.4 million in 2011 and $2.3 million in 2010. Net cash used in 2011 primarily resulted from payment and refinancing of existing mortgage obligations of $20.6 million and paying $0.8 million in financing costs in connection with the new mortgage loan under which we borrowed $23.0 million, including approximately $2.4 million to fund capital improvements at our owned centers. We also paid the remaining $3.5 million outstanding on our revolving line of credit during 2011. Increased debt of $3.0 million was added by the entity constructing the West Virginia facility that we are consolidating. Net cash used in 2010 primarily resulted from payment and refinancing of existing debt obligations of $4.1 million and paying $0.5 million in financing costs in connection with the new revolving credit facility under which we borrowed $3.5 million. Financing activities reflect a total of $1.2 million in 2011 and $1.1 million in 2010 for common and preferred stock dividends.

Our cash expenditures related to self-insured professional liability costs from continuing operations were $6.7 million and $3.5 million for the nine months ended September 30, 2011 and 2010, respectively. In October 2011, we agreed to settle five pending professional liability cases for a total of $3.2 million, none of which is expected to be paid from insurance proceeds. These settlements are expected to be paid in installments beginning in the fourth quarter of 2011 and extending through 2012. Although we work diligently to limit the cash required to settle and defend professional liability claims, a significant judgment entered against us in one or more legal actions could have a material adverse impact on our cash flows and could result in our being unable to meet all of our cash needs as they become due.

Electronic Medical Records

During 2010, we developed a plan to introduce EMR to all our facilities. We have fully implemented EMR in 31 of our nursing centers and implemented at least one of three phases of EMR in all but two of our 46 nursing centers as of September 30, 2011. We expect to complete our EMR implementation plan during December 2011. It is anticipated that our investment in EMR will provide operational improvements through automation of record keeping and improvement in clinical records quality. Through September 30, 2011, we have capitalized $3.3 million related to our EMR initiative and expensed $1.3 million for training costs since we began this implementation. During the nine months ended September 30, 2011, we capitalized $1.5 million related to the EMR initiative and expensed $0.8 million in training costs. We expect to have total training expenses during 2010 and 2011 related to implementing our electronic medical record system of between $1.6 million and $1.7 million and total capital expenditures during this period of approximately $3.5 million.

Dividends

On November 4, 2011, the Board of Directors declared a quarterly dividend on common shares of $0.055 per share. We first began paying a quarterly common dividend in August 2009. While the Board of Directors intends to pay quarterly dividends, the Board will make the determination of the amount of future cash dividends, if any, to be declared and paid based on, among other things, our financial condition, funds from operations, the level of our capital expenditures and our future business prospects and opportunities.

Preferred Stock

At September 30, 2011, we have outstanding 5,000 shares of Series C Redeemable Preferred Stock (“Preferred Stock”) that has a stated value of approximately $4.9 million which pays an annual dividend rate of 7% of its stated value. Dividends on the Preferred Stock are paid quarterly in cash. The Preferred Stock was issued to Omega in 2006 and is not convertible, but has been redeemable at its stated value at Omega’s option since September 30, 2010, and since September 30, 2007, has been redeemable at its stated value at our option. Redemption under our option or Omega’s is subject to certain limitations. We believe we have adequate resources to redeem the Preferred Stock if Omega were to elect to redeem it.

Professional Liability

For claims made after March 9, 2001, we have purchased professional liability insurance coverage for our nursing centers that, based on historical claims experience, is likely to be substantially less than the amount required to satisfy claims that were incurred. We have essentially exhausted all of our general and professional liability insurance coverage for claims first asserted prior to July 1, 2011.

Effective June 1, 2010, our nursing centers are covered by one of two professional liability insurance policies. Our 25 nursing centers in Arkansas, Kentucky, Tennessee, and West Virginia are currently covered by an insurance policy with coverage limits of $250,000 per medical incident and total annual aggregate policy limits of $750,000. This policy provides the only commercially affordable insurance coverage available for claims made during this period against these nursing centers. Our 21 nursing centers in Alabama, Florida, Ohio and Texas are currently covered by an insurance policy with coverage limits of $1.0 million per medical incident, subject to a deductible of $0.5 million per claim, with a total annual aggregate policy limit of $15.0 million and a sublimit per center of $3.0 million.

As of September 30, 2011, we have recorded total liabilities for reported and settled professional liability claims and estimates for incurred but unreported claims of $17.2 million. A significant judgment entered against us in one or more of these legal actions could have a material adverse impact on our financial position and cash flows.

Capital Resources

As of September 30, 2011, we had $26.6 million of outstanding long term debt and capital lease obligations. The $26.6 million total includes $0.7 million in capital lease obligations and $3.0 million in a construction loan for the nursing center under construction in West Virginia. The balance of the long term debt is comprised of $22.9 million owed on our mortgage loan.

On March 1, 2011, we entered into an agreement with a syndicate of banks to refinance our mortgage loan that was scheduled to mature in August 2011 and extend the maturity of our revolving credit facility. Under the terms of the new agreement, the syndicate of banks provided mortgage debt of $23 million and the proceeds were used to retire our previous mortgage loan and will fund approximately $2.4 million in capital improvements at our owned centers. The Mortgage Loan has a term of five years, with principal and interest payable monthly based on a 25 year amortization. Interest is based on LIBOR plus 4.5%, but is fixed at 7.07% based on the interest rate swap transaction described below. The new mortgage loan is secured by four owned nursing centers, related equipment and a lien on the accounts receivable of these centers.

The new agreement extended the maturity of our $15 million revolving credit facility from March 2013 to March 2016. As amended, the Revolver has an interest rate of LIBOR plus 4.5%. The Revolver is secured by accounts receivable and is subject to limits on the maximum amount of loans that can be outstanding under the revolver based on borrowing base restrictions. As of September 30, 2011, we have no borrowings outstanding under the revolving credit facility. Annual fees for letters of credit issued under this revolver are 3.0% of the amount outstanding. We have a letter of credit of $4.6 million to serve as a security deposit for our leases. Considering the balance of eligible accounts receivable at September 30, 2011, the letter of credit, the amounts outstanding under the revolving credit facility and the maximum loan amount of $15.0 million, the balance available for borrowing under the revolving credit facility is approximately $10.4 million. The Mortgage Loan and the Revolver are cross-collateralized.

Our lending agreements contain various financial covenants, the most restrictive of which relate to minimum cash deposits, cash flow and debt service coverage ratios. We are in compliance with all such covenants at September 30, 2011.

Our calculated compliance with financial covenants is presented below:

	Requirement	Level at September 30, 2011
Minimum fixed charge coverage ratio	≥ 1.05:1.00	1.19:1.00
Minimum adjusted EBITDA	≥ $10.0 million	$16.0 million
EBITDAR (mortgaged facilities)	≥ $ 3.3 million	$ 5.3 million

As part of the debt agreements entered into in March 2011, we entered into an interest rate swap agreement with a member of the bank syndicate as the counterparty. The interest rate swap agreement has the same effective date, maturity date and notional amounts as the Mortgage Loan. The interest rate swap agreement requires us to make fixed rate payments to the bank calculated on the applicable notional amount at an annual fixed rate of 7.07% while the bank is obligated to make payments to us based on LIBOR on the same notional amounts. We entered into the interest rate swap agreement to mitigate the variable interest rate risk on our outstanding mortgage borrowings.

Capitalized Lease Obligations

During the third quarter of 2011, we entered into a lease agreement to finance the purchase of certain equipment required for the implementation of EMR in our nursing centers. We determined the lease was capital in nature and haves recorded both the asset and capitalized lease obligation of $0.5 million as of September 30, 2011.

In October 2011, we completed a sale and leaseback transaction for certain equipment purchased in the implementation of EMR in our nursing centers. The lease transaction, involving $1.2 million in assets we purchased during 2010 and 2011, is capital in nature, and we will record the cash from the sale and the capitalized lease obligation under the financing during the fourth quarter of 2011. The lease agreement provides a three year term.

Lease Agreement – West Virginia Nursing Center

On July 14, 2010, we entered into an agreement with a real estate developer that will construct, furnish, and equip a 90 bed skilled nursing center near Milton, West Virginia, which we will lease upon completion. The center will utilize a Certificate of Need we initially obtained in the June 2009 acquisition of certain assets of a skilled nursing center in Milton, West Virginia. The initial lease term is 20 years from the date the center is completed and fit for occupancy as a skilled nursing center. We have the option to renew the lease for two additional five-year periods. Construction on the nursing center began in November 2010 and it is estimated the center will be completed in late 2011. Annual lease costs will be based initially on 10.25% of the total project costs and provides for annual increases in lease payments equal to the increase in the Consumer Price Index, not to exceed 2.5%. The lease agreement grants us the right to purchase the center beginning at the end of the first year of the initial term of the lease and continuing through the fifth year for a purchase price ranging from 110% to 120% of the total project cost.

Center Renovations

During 2005, we began an initiative to complete strategic renovations of certain facilities to improve occupancy, quality of care and profitability. We developed a plan to begin with those facilities with the greatest potential for benefit and began the renovation program during the third quarter of 2005. As of September 30, 2011, we have completed renovations at fifteen facilities and currently expect to complete four other projects over the next several months in late 2011 and early 2012.

A total of $23.2 million has been spent on these renovation programs to date, with $15.9 million financed through Omega, $6.1 million financed with internally generated cash, and $1.2 million financed with long-term debt.

For the fifteen facilities with renovations completed as of the beginning of the third quarter 2011 compared to the last twelve months prior to the commencement of renovation, average occupancy increased from 69.8% to 77.7% and Medicare average daily census increased from a total of 177 to 210 for the period ended September 30, 2011.

In April 2011, we entered into an amendment to the Master lease with Omega under which Omega agreed to provide an additional $5.0 million to fund renovations to four nursing centers located in Arkansas, Kentucky, Ohio and Texas that are leased from Omega. The annual base rent related to these facilities will be increased to reflect the amount of capital improvements to the respective facilities as the related expenditures are made. The increase is based on a rate of 10.25% per year of the amount financed under this amendment. This arrangement is similar to amendments entered into in 2009, 2006 and 2005 that provided financing totaling $15.0 million that was used to fund renovations at twelve nursing centers leased from Omega.

Resignation of Chief Executive Officer

William R. Council, III resigned as Chief Executive Officer and Director of the Company effective September 30, 2011. In connection with his resignation, the Company and Mr. Council entered into a separation agreement effective September 30, 2011 for the severance under the terms of Mr. Council's employment agreement. The Company and Mr. Council also entered into a six month consulting agreement effective October 1, 2011, to facilitate the transition of management. Pursuant to the consulting agreement, Mr. Council will receive $36,800 per month through March 2012. Our cash expenditures related to the separation and consulting agreements will be approximately $0.3 million in the fourth quarter of 2011 and $1.6 million in the first quarter of 2012.

Receivables

Our operations could be adversely affected if we experience significant delays in reimbursement from Medicare, Medicaid and other third-party revenue sources. Our future liquidity will continue to be dependent upon the relative amounts of current assets (principally cash, accounts receivable and inventories) and current liabilities (principally accounts payable and accrued expenses). In that regard, accounts receivable can have a significant impact on our liquidity. Continued efforts by governmental and third-party payors to contain or reduce the acceleration of costs by monitoring reimbursement rates, by increasing medical review of bills for services, or by negotiating reduced contract rates, as well as any delay by us in the processing of our invoices, could adversely affect our liquidity and results of operations.

Accounts receivable attributable to patient services of continuing operations totaled $28.6 million at September 30, 2011 compared to $26.7 million at December 31, 2010, representing approximately 33 days and 34 days revenue in accounts receivable, respectively.

The allowance for bad debt was $3.0 million and $2.8 million at September 30, 2011 and December 31, 2010, respectively. We continually evaluate the adequacy of our bad debt reserves based on patient mix trends, aging of older balances, payment terms and delays with regard to third-party payors, collateral and deposit resources, as well as other factors. We continue to evaluate and implement additional procedures to strengthen our collection efforts and reduce the incidence of uncollectible accounts.

Inflation

Based on contract pricing for food and other supplies and recent market conditions, we expect cost increases in 2011 to be higher than the increases in 2010. We expect salary and wage increases for our skilled health care providers to continue to be higher than average salary and wage increases, as is common in the health care industry.

Off-Balance Sheet Arrangements

We have a letter of credit outstanding of approximately $4.6 million as of September 30, 2011, which serves as a security deposit for our facility lease with Omega. The letter of credit was issued under our revolving credit facility. Our accounts receivable serve as the collateral for this revolving credit facility.

Forward-Looking Statements

The foregoing discussion and analysis provides information deemed by management to be relevant to an assessment and understanding of our consolidated results of operations and financial condition. This discussion and analysis should be read in conjunction with our consolidated financial statements included herein. Certain statements made by or on behalf of us, including those contained in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere, are forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those contemplated by the forward-looking statements made herein. In addition to any assumptions and other factors referred to specifically in connection with such statements, other factors, many of which are beyond our ability to control or predict, could cause our actual results to differ materially from the results expressed or implied in any forward-looking statements including, but not limited to, our ability to successfully construct and operate the new nursing center in West Virginia, our ability to increase census at our renovated facilities, changes in governmental reimbursement, including the impact of the CMS final rule that is expected to result in an 11.1% reduction in Medicare reimbursement as of October 2011 and our ability to mitigate the impact of the reduction, government regulation, the impact of the recently adopted federal health care reform or any future health care reform, any increases in the cost of borrowing under our credit agreements, our ability to comply with covenants contained in those credit agreements, the outcome of professional liability lawsuits and claims, our ability to control ultimate professional liability costs, the accuracy of our estimate of our anticipated professional liability expense, the impact of future licensing surveys, the outcome of proceedings alleging violations of laws and regulations governing quality of care or violations of other laws and regulations applicable to our business, costs and impacts associated with the implementation of our electronic medical records plan, the costs of investing in our business initiatives and development, our ability to control costs, changes to our valuation of deferred tax assets, changes in occupancy rates in our facilities, changing economic and competitive conditions, changes in anticipated revenue and cost growth, changes in the anticipated results of operations, the effect of changes in accounting policies as well as others. Investors also should refer to the risks identified in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” as well as risks identified in “Risk Factors” in our annual report on Form 10-K for the year ended December 31, 2010 for a discussion of various risk factors of the Company and that are inherent in the health care industry. Given these risks and uncertainties, we can give no assurances that these forward-looking statements will, in fact, transpire and, therefore, caution investors not to place undue reliance on them. These assumptions may not materialize to the extent assumed, and risks and uncertainties may cause actual results to be different from anticipated results. These risks and uncertainties also may result in changes to the Company’s business plans and prospects. Such cautionary statements identify important factors that could cause our actual results to materially differ from those projected in forward-looking statements. In addition, we disclaim any intent or obligation to update these forward-looking statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The chief market risk factor affecting our financial condition and operating results is interest rate risk. As of September 30, 2011, we had outstanding borrowings of approximately $22.9 million that were subject to variable interest rates. In connection with our March 2011 financing agreement, we entered into an interest rate swap with respect to the mortgage loan to mitigate the floating interest rate risk of such borrowing. Therefore, we have no outstanding borrowings subject to variable interest rate risk after the March 1, 2011 refinancing transaction.

ITEM 4. CONTROLS AND PROCEDURES

Advocat, with the participation of our principal executive and financial officers has evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of September 30, 2011. Based on this evaluation, the principal executive and financial officers have determined that such disclosure controls and procedures are effective to ensure that information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There has been no change (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal control over financial reporting that has occurred during our fiscal quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

The provision of health care services entails an inherent risk of liability. Participants in the health care industry are subject to lawsuits alleging malpractice, product liability, or related legal theories, many of which involve large claims and significant defense costs. Like many other companies engaged in the long-term care profession in the United States, we have numerous pending liability claims, disputes and legal actions for professional liability and other related issues. It is expected that we will continue to be subject to such suits as a result of the nature of our business. Further, as with all health care providers, we are periodically subject to regulatory actions seeking fines and penalties for alleged violations of health care laws and are potentially subject to the increased scrutiny of regulators for issues related to compliance with health care fraud and abuse laws and with respect to the quality of care provided to residents of our facility. Like other health care providers, in the ordinary course of our business, we are also subject to claims made by employees and other disputes and litigation arising from the conduct of our business.

As of September 30, 2011, we are engaged in 32 professional liability lawsuits. Five lawsuits are currently scheduled for trial or mediation during the next eleven months and it is expected that additional cases will be set for trial. Our cash expenditures for professional liability costs of continuing operations were $4.5 million in the third quarter of 2011, which included the settlement of nine professional liability cases in July 2011 for a total of $4.6 million, of which $0.7 million is expected to be paid from insurance proceeds. The majority of our portion of these settlements was paid during the third quarter of 2011. In October 2011, we agreed to settle five of these outstanding professional liability cases for a total of $3.2 million. These settlements are expected to be paid in quarterly installments beginning in the fourth quarter of 2011 and extending through 2012. In addition to the settlement payments described above, we will have additional cash expenditures in the ordinary course of business for other settlements and self-insured professional liability costs throughout the year. The ultimate results of any of our professional liability claims and disputes cannot be predicted. We have limited, and sometimes no, professional liability insurance with regard to most of these claims. A significant judgment entered against us in one or more of these legal actions could have a material adverse impact on our financial position and cash flows.

In January 2009, a purported class action complaint was filed in the Circuit Court of Garland County, Arkansas against us and certain of our subsidiaries and Garland Nursing & Rehabilitation Center (the “Facility”). The complaint alleges that the defendants breached their statutory and contractual obligations to the residents of the Facility over the past five years. The lawsuit has not been certified as a class action, and no motion to certify the class has been filed by Plaintiffs’ counsel to date. We intend to defend the lawsuit vigorously.

We cannot currently predict with certainty the ultimate impact of any of the above cases on our financial condition, cash flows or results of operations. An unfavorable outcome in any of the lawsuits, any regulatory action, any investigation or lawsuit alleging violations of fraud and abuse laws or of elderly abuse laws or any state or Federal False Claims Act case could subject us to fines, penalties and damages, including exclusion from the Medicare or Medicaid programs, and could have a material adverse impact on our financial condition, cash flows or results of operations.

ITEM 6. EXHIBITS

The exhibits filed as part of this report on Form 10-Q are listed in the Exhibit Index immediately following the signature page.

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.

ADVOCAT INC.

November 7, 2011

By: /s/ Kelly J. Gill
Kelly J. Gill
President and Chief Executive Officer,
Principal Executive Officer and
An Officer Duly Authorized to Sign on Behalf of the Registrant

By: /s/ L. Glynn Riddle, Jr.
L. Glynn Riddle, Jr.
Executive Vice President and Chief Financial Officer,
Secretary,
Principal Accounting Officer and
An Officer Duly Authorized to Sign on Behalf of the Registrant

Exhibit Number	Description of Exhibits
3.1	Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement No. 33-76150 on Form S-1).
3.2	Certificate of Designation of Registrant (incorporated by reference to Exhibit 3.5 to the Company's quarterly report on Form 10-Q for the quarter ended September 30, 2006).
3.3	Bylaws of the Company (incorporated by reference to Exhibit 3.2 to the Company's Registration Statement No. 33-76150 on Form S-1).
3.4	Bylaw Amendment adopted November 5, 2007 (incorporated by reference to Exhibit 3.4 to the Company's annual report on Form 10-K for the year ended December 31, 2007).
3.5	Amendment to Certificate of Incorporation dated March 23, 1995 (incorporated by reference to Exhibit A of Exhibit 1 to the Company's Form 8-A filed March 30, 1995).
3.6	Certificate of Designation of Registrant (incorporated by reference to Exhibit 3.4 to the Company's quarterly report on Form 10-Q for the quarter ended March 31, 2001).
4.1	Form of Common Stock Certificate (incorporated by reference to Exhibit 4 to the Company's Registration Statement No. 33-76150 on Form S-1).
4.2	Amended and Restated Rights Agreement dated as of December 7, 1998 (incorporated by reference to Exhibit 1 to Form 8-A/A filed December 7, 1998).
4.3	Amendment No. 1 to the Amended and Restated Rights Agreement, dated March 19, 2005, by and between Advocat Inc. and SunTrust Bank, as Rights Agent (incorporated by reference to Exhibit 2 to Form 8-A/A filed on March 24, 2005).
4.4	Second Amendment to the Amended and Restated Rights Agreement, dated August 15, 2008, by and between Advocat Inc. and ComputerShare Trust Company, N.A., as successor to SunTrust Bank (incorporated by reference to Exhibit 3 to Form 8-A/A filed on August 18, 2008).
4.5	Third Amendment to Amended and Restated Rights Agreement, dated August 14, 2009, between Advocat, Inc. and Computershare Trust Company, N.A, as successor to SunTrust Bank, (incorporated by reference to Exhibit 4 to the Company's Registration Statement on Form 8-A/A filed on August 14, 2009).
*10.1	Separation Agreement dated September 27, 2011 between William R. Council, III and Advocat Inc.
*10.2	Consulting Agreement dated October 1, 2011 between William R. Council, III and Advocat Inc.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a).
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a).
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b).
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

* Indicates management contract or compensatory plan or arrangement.

Exhibit 10.1

September 27, 2011

Via Hand Delivery
William R. Council, III
9533 Thoroughbred Way
Brentwood, TN 37027,

Re: Termination of Employment

Dear Will:

This letter will confirm the terms of the agreement (the "Agreement") between William R. Council, III ("Council") and Advocat Inc. and/or any of its wholly-owned subsidiaries (collectively the "Company"). Capitalized terms used in this letter but not defined herein shall have the meaning ascribed to them in the Employment Agreement between Council and the Company dated March 31, 2006 ("Employment Agreement").

1. Council has submitted, and the Company has accepted, a notice of termination of employment with the Company pursuant to the Without Cause Termination provisions effective as of the close of business on September 30, 2011 ("Date of Termination"). Council has also submitted his resignation as a member of the Board of Directors of the Company.

2. Council shall be entitled to the following payments, which the parties have determined are subject to Section 409A of the Internal Revenue Code ("Section 409A") and will be made or begin to be made on the Delayed Payment Date in accordance with Section 4:

(a) A lump sum payment from the Company to Council in the amount of $1,105,000.

(b) The Incentive Compensation Award for the current year, payable on a pro rata basis in a lump sum amount of $331,500.

(c) Delivery to Council by Company of unrestricted shares of common stock of the Company equal to the number of Restricted Shares Units held by Council under the 2008 Stock Purchase Plan For Key Personnel ("2008 Stock Plan"), adjusted for dividends through the Delayed Payment Date, rounded down to the nearest whole share, and will make a payment to Council in amount representing the value of any remaining fractional Restricted Share Units held by Council using the value per share as determined under Section 2(p) of the 2008 Stock Plan.

(d) Each month for a period of eighteen months following the Date of Termination, the Company shall reimburse Council for the cost of disability premiums, subject to any required withholding, provided that Council has furnished to the Company evidence, as reasonable required by the Company, of his payment of disability insurance premiums.

(e) Payment to Council an amount equal to the Company's matching contributions to the EIRP in the total amount of $39,780, payable in equal quarterly installments of $6,630 for six quarters.

3. Council shall be entitled to the following payments and benefits, which the parties have determined are **not** subject to Section 409A of the Internal Revenue Code ("Section 409A") and will be made or begin to be made on the Effective Date, except as otherwise provided below:

(a) Earned, but unpaid, Base Salary and accrued, but unused, vacation time.

(b) If Council elects to continue COBRA benefits, each month for the earlier of the period of time that Council has coverage through the Company's group health plan or eighteen months following the Date of Termination, the Company shall reimburse Council for the cost of group health insurance premiums under COBRA, subject to any required withholding.

(c) Council's outstanding stock options and stock appreciation rights ("SARs") shall be deemed vested, and the Company shall purchase from Council all of such options and SARs for an amount equal to the difference between the fair market value of a share of the Company's common stock on the Date of Termination and the per share exercise price of such option or SAR. All restrictions on his Restricted Stock shall terminate as of the Date of Termination and Council shall receive unrestricted shares of Stock, including all dividends paid on such Restricted Stock through the Date of Termination.

4. Payments made pursuant Section 2 hereof shall be made on the date which is the six months from the Date of Termination (the "Delayed Payment Date" or "Delay Period"). Upon the expiration of the Delay Period, all payments delayed pursuant to the immediately preceding sentence (whether they otherwise would have been payable in a single sum or in installments in the absence of such delay) shall be paid to Council in a lump sum, and all remaining payments due under this Agreement, that would have otherwise been payable after the Delay Period, shall be paid or provided in accordance with the payment dates otherwise specified herein.

5. Council will return any Company property in his possession, custody, or control including, without limitation, all records, memoranda, etc. relating to the business of the Company whether made by Council or otherwise coming into his possession. Council acknowledges that all such property is confidential and will remain the property of the Company.

6. On behalf of Council and his heirs, representatives, and assigns, Council discharges and releases the Company and its affiliates and agents (collectively the "Released Parties") from all claims, obligations, and demands that Council had, has, or may have arising out of or related to his employment and/or the termination of his employment. Without limiting the generality of the foregoing, Council discharges and releases any claims, causes of action,

liabilities, covenants, agreements, obligations, damages, and/or demands of every nature, character, and description under Title VII of the Civil Rights Act of 1964, the Fair Labor Standards Act, the Americans with Disabilities Act, the Family and Medical Leave Act, the Tennessee Human Rights Act, the Civil Rights Act of 1991, the Age Discrimination in Employment Act, the Older Worker Benefit Protection Act, the Employee Retirement Income Security Act of 1974 (except with respect to benefits to which Council has a vested entitlement), and all other federal, state, and local laws including any laws regarding wrongful discharge, breach of contract, retaliation, infliction of emotional distress (collectively, the "Released Claims"). Notwithstanding the foregoing, Released Claims does not include any claim for breach of this Agreement or any claim for any payment or benefit provided for under this Agreement.

7. Council agrees and understands that the effect of this Agreement is to waive and release any and all claims, causes of action, liabilities, covenants, agreements, obligations, damages and/or demands of every nature, character, and description, without limitation in law, equity, or otherwise, that Council had, has, or may have, whether known or unknown, against any of the Released Parties for any liability, whether vicarious, derivative, direct, or indirect. The foregoing includes, without limitation, any claims for damages (actual or punitive), back wages, future wages, commission payments, bonuses, reinstatement, past and future employee benefits (except to which there is vested entitlement) including contributions to the Company's employee benefit plans, compensatory damages, penalties, equitable relief, attorneys' fees, costs of court, interest, and any and all other loss, expense, or detriment of whatever kind arising out of or related in any way to your employment by the Company and/or the termination of such employment, except for any vested benefit or for any payment or benefit provided for pursuant to this Agreement. However, Council does not by virtue of this Agreement waive or release any claims that arise after his signature below.

8. Council will not initiate, or cause to be initiated, any lawsuit based on the Released Claims. Except as prohibited by law, Council will indemnify the Company and all other Released Parties for any sum of money that any of them may hereafter be compelled to pay Council, his heirs, representatives, or assigns and any of the Company's legal fees and/or costs associated therewith on account Council bringing or allowing to be brought on his behalf legal action based upon the Released Claims. Furthermore, Council understands and agrees that this Agreement does not constitute any admission by the Company of any liability or of any violation of any federal, state, or local laws.

9. Council and the Company will treat the terms, conditions, amount, and circumstances relating to this Agreement as confidential, except as disclosure may be required by applicable law. Council may disclose the terms of this Agreement to his tax advisor or counsel, provided that they agree to maintain the confidentiality of this Agreement. If Council is required to make any disclosure required by law, Council agrees to inform the Company immediately and prior to any such disclosure. Obligations under this paragraph shall terminate to the extent that information contained herein is made public by the Company in the course of its compliance with public disclosure obligations.

10. Council shall have a period of up to 21 calendar days in which to consider entering into this Agreement. Council acknowledges that he has had the opportunity to read and review this Agreement and seek legal advice. Council freely and voluntarily, and without coercion, agrees to and understands the significance and consequences of the terms of this Agreement. Council agrees not to sign this Agreement prior to the Date of Termination. Following the date of Council's signature below, Council shall have a period of 7 calendar days within which to revoke his acceptance of this Agreement, in which case this Agreement shall be null and void. If Council does not exercise his right to revoke this Agreement within 7 calendar days of Council's signature, this Agreement shall be held in full force and effect as of the 8 th calendar day (the "Effective Date") and each party shall be obligated to comply with its requirements. The parties agree that any changes made to this Agreement (whether material or immaterial) as a result of the negotiation of the parties do not restart the running of the 21-day period noted above.

11. Neither Council nor the Company, nor any equity owner, officer, director, employee or agent of either shall at any time communicate negative statements or implications regarding, or in any other way disparage, or imply any improper conduct regarding any other party to this Agreement, whether orally, in writing, by action or inaction or by any other means, neither shall any party or any equity owner, officer, director, employee or agent of a party engage in any communication(s) with any third person that might reflect poorly upon a party to this Agreement. Each of Council and the Company acknowledges respectively that it has no basis for any negative statement against the other party. Nothing contained in this Agreement shall be deemed to release either party from liability for any disparaging statement that has the purpose or effect of adversely impacting the professional reputation or standing of the other party. Should a court of competent jurisdiction determine that either party, either directly or through its agent(s), has violated this provision, then the waivers of a right to sue contained in this Agreement shall be void and of no further effect, and the disparaged party shall be free to pursue all available remedies under the law for breach of this provision.

12. Council will at all times maintain strict confidentiality of, and will not give to any person, firm, association, corporation or governmental agency any information concerning the affairs, business, clients, customers or other relationships of the Company except as required by law. Council will not make use of this type of information for his own purposes or for the benefit of any person or organization other than the Company. Council will also use his best efforts to prevent the disclosure of this information by others.

13. For a period of Twelve (12) months following the termination of his employment, Council will not use his status with the Company to obtain loans, goods or services from another organization on terms that would not be available to Council in the absence of his relationship to the Company.

14. For a period of Twelve (12) months following the termination of his employment, Council will not (and Council will not assist others to) directly or indirectly, hire any employee of the Company or solicit or encourage any such employee to leave the employ of the Company.

15. As part of his employment, Council acknowledges and agrees that he has obtained knowledge, information, and expertise regarding the operations of the Company that may be useful to the Company in prosecuting, defending and otherwise managing current and future

litigation matters by or against the Company. Therefore, Council will, with reasonable notice after the Date of Termination, furnish information as may be in his possession and cooperate with the Company as may reasonably be requested in connection with any claims or legal actions in which the Company is or may become a party.

16. In response to inquiries from his prospective employers, Council agrees that the Company may provide his dates of employment with the Company, job titles while employed by the Company, and final salary. Council agrees to advise any prospective employers to contact the Human Resources Department of the Company with regard to any references or other inquiries.

17. Council acknowledges that his breach or threatened or attempted breach of any provision of this Agreement would cause irreparable harm to the Company not compensable in monetary damages. Notwithstanding the parties' agreement to arbitrate disputes, Council consents to the issuance of a temporary restraining order and preliminary injunction by a court of competent jurisdiction to prohibit and enjoin any breach of a provision of this Agreement.

18. Except with respect to the release of claims provided for above, the provisions of this Agreement shall be severable, and the invalidity of any provisions or portion thereof shall not affect the validity of the other provisions. To the extent that a court of competent jurisdiction deems any provision of this Agreement unenforceable (except the release of claims), such court shall modify the terms of the Agreement by adding, deleting, or changing in its discretion any language necessary to make such provision enforceable to the maximum extent permitted by law, and the parties expressly agree to be bound by any such provision as reformed by such court. If this Agreement is not enforceable in whole or in part after such severance or reformation, the Company shall have a contractual right of restitution, recoupment, and set-off to recover from Council any consideration paid to him under this Agreement.

19. Section 409A Compliance.

(a) This Agreement and any payments or benefits provided pursuant to the Employment Agreement shall be interpreted, operated and administered in a manner intended to avoid the imposition of additional taxes under Section 409A of the Code. Further, the parties acknowledge and agree that the form and timing of the payments and benefits to be provided pursuant to this Agreement are intended comply with Section 409A of the Code or to be exempt from, or to comply with, one or more exceptions to the requirements of Section 409A of the Code. Notwithstanding any provision of this Agreement to the contrary, the Company, its affiliates, subsidiaries, successors, and each of their respective officers, directors, employees and representatives, neither represent nor warrant the tax treatment under any federal, state, local, or foreign laws or regulations thereunder (individually and collectively referred to as the "Tax Laws") of any payment or benefits contemplated by this Agreement including, but not limited to, when and to what extent such payments or benefits may be subject to tax, penalties and interest under the Tax Laws.

(b) The parties agree that the termination of employment of Council constitutes a separation from service as defined by the default provisions of Treas. Reg. section 1.409A-1(h)(ii).

20. This Agreement constitutes the entire agreement between the parties with respect to its subject matter and, except as expressly set forth above, supersedes all previous agreements and understandings between the parties. This Agreement may not be modified except in a writing signed by both parties. This Agreement shall be governed by and construed in accordance with the laws of the State of Tennessee and without regard to any rule of construction under which an agreement may be construed against the drafter or any rule regarding conflicts of law. Any dispute among the parties hereto shall be settled by arbitration in Nashville, Tennessee, in accordance with the rules then obtaining of the American Arbitration Association and judgment upon the award rendered may be entered in any court having jurisdiction thereof.

Council has carefully read this Agreement. Council hereby accepts and agrees to all of the terms and conditions of this Agreement.

Advocat Inc.

/s/ Kelly Gill

By: Kelly Gill
Title: President
Date: September 27, 2011

/s/ William R. Council, III

William R. Council, III
Date: September 30, 2011

Exhibit 10.2

CONSULTING AGREEMENT

THIS CONSULTING AGREEMENT (" **Agreement** ") is effective October 1, 2011, and is between Advocat Inc. a Delaware corporation (" **Company** "), and William R. Council, III (" **Consultant** ").

WITNESSETH:

WHEREAS, as prior to September 30, 2011, Consultant was an employee of the Company in accordance with the terms of that certain Employment Agreement between the Company and Consultant dated March 31, 2006 (the "Employment Agreement")

WHEREAS, the Company and Consultant have agreed to the termination Consultant's employment with the Company as of September 30, 2011 (the "Employment Termination Date") and have entered into a Separation Agreement effective September 30, 2011; and

WHEREAS, after the Employment Termination Date, Consultant's employment with the Company shall terminate and cease, and Consultant's continuing relationship with the Company shall be as an independent contractor rather than as an employee and shall be governed by the terms contained in this Agreement;

NOW, THEREFORE, the parties agree as follows:

1. **Term of Consulting Engagement** . The consulting arrangement between Consultant and the Company shall commence on October 1, 2011, the day immediately following the Employment Termination Date, and shall continue in effect until March 31, 2012. This Agreement may be terminated (i) by either party upon failure of the other party to comply with the terms hereof following written notice thereof and a ten (10) day period to remedy such noncompliance, or (ii) upon mutually written consent. In the event of any early termination of this Agreement, the compensation payable to Consultant hereunder shall be payable only through the effective date of the termination unless the Agreement is terminated by Consultant for cause, in which case the Company's obligations to Consultant shall continue until March 31, 2012; provided that Company shall not be relieved of its obligation to compensate Consultant for fees earned and expenses incurred prior to the effective date of any termination.

2. **Consultant's Duties** . Consultant will reasonably cooperate with the management employees of the Company in an effort to effectively transition the management of the Company. Consultant shall have such additional reasonable related responsibilities as may be requested of him, from time to time, by the Company. Consultant's duties shall be on a part-time basis whereby he will be expected to work no more than eight (8) hours a week during the term of this Agreement. The parties understand and agree that the termination of employment of Consultant constitutes a separation from service as defined by the default provisions of Treas. Reg. Section 1.409A-1(h)(ii) and that nothing in this Agreement requires Consultant to work more than nor do the parties hereto expect that under any circumstances Consultant's service hereunder will exceed twenty (20%) percent of the level of service performed by Consultant for the Company during the 36-month period immediately preceding the Employment Termination Date.

3. **Compensation and Benefits** . During the term of this Agreement, for all services rendered by Consultant hereunder on behalf of Company and its affiliates, Company agrees to pay and Consultant agrees to accept an amount equal to Thirty-Six Thousand Eight Hundred Thirty-Three and 33/100 ($36,833.33) per month, plus reimbursement for reasonable, documented expenses incurred in providing the services, including but not limited to long distance and cellular telephone charges and mileage or automobile expenses computed at the reimbursement rate established by the Internal Revenue Service from time to time.

4. **Confidential Information** . Consultant recognizes and acknowledges that all information pertaining to the affairs, business, clients, customers or other relationships of the Company, as hereinafter defined, is confidential and is a unique and valuable asset of the Company. Access to and knowledge of this information are essential to the performance of the Executive's duties under this Agreement. Consultant will not during the term of this Agreement or after except to the extent reasonably necessary in performance of the duties under this Agreement, give to any person, firm, association, corporation or governmental agency any information concerning the affairs, business, clients, customers or other relationships of the Company except as required by law. Consultant will not make use of this type of information for his own purposes or for the benefit of any person or organization other than the Company. Consultant will also use his best efforts to prevent the disclosure of this information by others.

5. **Return of Company Property** . Upon termination or expiration of this Agreement, Consultant shall immediately return and deliver to Company and shall not retain any originals or copies of any books, papers, price lists, customer contracts, bids, customer lists, files, notebooks, computer files, computer hardware or software, or any other documents or computer records which are company property, which contain Confidential Information, or which otherwise relate to Consultant's performance of duties under this Agreement. Consultant further acknowledges and agrees that all such documents and computer records are Company's sole and exclusive property.

6. **Successors and Assigns** . The provisions hereof shall inure to the benefit of and be binding upon the permitted successors and assigns of the parties hereto.

7. **Non-Assignability by Consultant** . The rights and obligations of Consultant hereunder are not assignable and any prohibited assignment will be null and void. Company may assign this Agreement.

8. **Governing Law** . This Agreement shall be interpreted under, subject to and governed by the substantive laws of the State of Tennessee, and all questions concerning its validity, construction, and administration shall be determined in accordance thereby.

9. **Relationship** . The Company and Consultant agree that Consultant will serve as a consultant and independent contractor to the Company. Consultant will not be deemed for any purposes to be an employee or agent of the Company or any of its affiliates, and Consultant shall have no authority to bind, obligate, or act on behalf of the Company or its affiliates. Consultant agrees that the Company will not be responsible for, or pay, any employment taxes for him with respect to payments made under this Agreement including, but not limited to, social security, FUTA, federal and state withholding, and worker's compensation insurance. Consultant understands that he will be solely responsible for the payment of any taxes or other charges

related to the payments made under this Agreement. Consultant understands that as an independent contractor he will not be eligible for any benefits the Company might provide to its employees, including health insurance, retirement, vacation, and paid holidays; provided, however, that nothing herein shall affect Consultant's rights or entitlement to benefits accrued during his employment with the Company prior to October 1, 2011.

10. **Notice** . Any notice or other communication provided for or required by this Agreement shall be in writing and shall be deemed to have been duly given when personally delivered or sent via electronic mail, or three (3) days following its being sent by certified mail, return receipt requested, postage prepaid, addressed to the parties' respective principal business address or to such other address as either party may have furnished to the other in writing.

11. **Modification** . No provision of this Agreement may be modified, waived or discharged unless such modification, waiver or discharge is agreed to in writing and signed by Consultant, the Company.

12. **Severability** . The provisions of this Agreement shall be deemed severable and the invalidity or unenforceability of any provision shall not affect the validity or enforceability of the other provisions hereof.

13. **Counterparts** . This Agreement may be executed in several counterparts, each of which shall be deemed to be an original but all of which together will constitute one and the same instrument.

EXECUTED as of September 30, 2011.

CONSULTANT :

/s/ William R. Council, III
William R. Council, III

COMPANY:
Advocat Inc.

/s/ Kelly Gill
By: Kelly Gill
Its: President

Exhibit 31.1

CERTIFICATIONS PURSUANT TO SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002

(i) CERTIFICATION

I, Kelly J. Gill, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Advocat Inc.;

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

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

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

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

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

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

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

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

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

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

Date: November 7, 2011

/s/ Kelly J. Gill
Kelly J. Gill
President and Chief Executive Officer

Exhibit 31.2

CERTIFICATIONS PURSUANT TO SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002

(ii) CERTIFICATION

I, L. Glynn Riddle, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Advocat Inc.;

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

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

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

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

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

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

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

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

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

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

Date: November 7, 2011

/s/ L. Glynn Riddle, Jr.
L. Glynn Riddle, Jr.
Chief Financial Officer

Exhibit 32

CERTIFICATION OF QUARTERLY REPORT ON FORM 10-Q
OF ADVOCAT INC.
FOR THE QUARTER ENDED SEPTEMBER 30, 2011

The undersigned hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the undersigned's best knowledge and belief, the Quarterly Report on Form 10-Q for Advocat Inc. (the "Company") for the period ending September 30, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"):

(a) fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

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

This Certification is executed as of November 7, 2011.

/s/ Kelly J. Gill
Kelly J. Gill
President and Chief Executive Officer

/s/ L. Glynn Riddle, Jr.
L. Glynn Riddle, Jr.
Chief Financial Officer

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