# ADVOCAT INC

# FORM 10-Q
(Quarterly Report)

Filed 11/06/08 for the Period Ending 09/30/08

| | |
|---|---|
| Address | 1621 GALLERIA BLVD.<br>BRENTWOOD, TN 37027 |
| Telephone | 6157717575 |
| CIK | 0000919956 |
| Symbol | AVCA |
| SIC Code | 8051 - Skilled Nursing Care Facilities |
| 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, 2008**

**OR**

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

**For the transition period from _____ to _____.**

**Commission File Number: 1-12996**

# Advocat Inc.
**(Exact name of registrant as specified in its charter)**

| Delaware | 62-1559667 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):**

**Large accelerated filer ☐ Accelerated filer ☑ Non-accelerated filer ☐ Smaller reporting company ☑**
**(Do not check if a 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 ☑**

**5,670,987**
**(Outstanding shares of the issuer's common stock as of November 1, 2008)**

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## Part I. FINANCIAL INFORMATION

### ITEM 1 — FINANCIAL STATEMENTS

**ADVOCAT INC.**

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

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|---|---|---|
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 9,967 | $ 11,658 |
| Receivables, less allowance for doubtful accounts of $3,206 and $2,158, respectively | 23,585 | 26,444 |
| Current portion of note receivable | 4,685 | 629 |
| Prepaid expenses and other current assets | 2,178 | 2,130 |
| Insurance refunds receivable | — | 1,234 |
| Prepaid income taxes | 1,306 | — |
| Deferred income taxes | 2,298 | 2,110 |
| Total current assets | 44,019 | 44,205 |
| PROPERTY AND EQUIPMENT, at cost | 71,094 | 64,294 |
| Less accumulated depreciation | (37,280) | (34,091) |
| Discontinued operations, net | 1,455 | 1,455 |
| Property and equipment, net | 35,269 | 31,658 |
| OTHER ASSETS: | | |
| Deferred income taxes | 16,107 | 16,568 |
| Note receivable, net of current portion | — | 4,983 |
| Deferred financing and other costs, net | 994 | 1,239 |
| Other assets | 2,334 | 1,945 |
| Acquired leasehold interest, net | 10,245 | 9,492 |
| Total other assets | 29,680 | 34,227 |
| | $ 108,968 | $ 110,090 |

(Continued)

**ADVOCAT INC.**

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

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|---|---|---|
| CURRENT LIABILITIES: | | |
| Current portion of long-term debt | $ 4,122 | $ 1,942 |
| Trade accounts payable | 5,732 | 6,636 |
| Accrued expenses: | | |
| Payroll and employee benefits | 11,052 | 11,360 |
| Current portion of self-insurance reserves | 4,637 | 4,597 |
| Income taxes payable | — | 393 |
| Other current liabilities | 5,006 | 3,600 |
| Total current liabilities | 30,549 | 28,528 |
| NONCURRENT LIABILITIES: | | |
| Long-term debt, less current portion | 28,805 | 32,513 |
| Self-insurance reserves, less current portion | 13,755 | 17,578 |
| Other noncurrent liabilities | 11,411 | 9,137 |
| Total noncurrent liabilities | 53,971 | 59,228 |
| COMMITMENTS AND CONTINGENCIES | | |
| SERIES C REDEEMABLE PREFERRED STOCK | | |
| $.10 par value, 5,000 shares authorized, issued and outstanding, including premium of $3,398 and $4,672 at September 30, 2008 and December 31, 2007, respectively | 8,316 | 9,590 |
| 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, 5,903,000 and 5,878,000 shares issued, and 5,671,000 and 5,804,000 shares outstanding, respectively | 59 | 59 |
| Treasury stock at cost, 232,000 and 74,000 shares of common stock, respectively | (2,500) | (817) |
| Paid-in capital | 16,684 | 15,804 |
| Retained earnings (accumulated deficit) | 1,889 | (2,302) |
| Total shareholders' equity | 16,132 | 12,744 |
| | $ 108,968 | $ 110,090 |

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)**

| | Three Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| PATIENT REVENUES, net | $ 72,206 | $ 63,884 |
| EXPENSES: | | |
| Operating | 58,297 | 49,253 |
| Lease | 5,753 | 5,162 |
| Professional liability | 278 | (6) |
| General and administrative | 4,642 | 4,580 |
| Depreciation and amortization | 1,355 | 1,033 |
| Total expenses | 70,325 | 60,022 |
| OPERATING INCOME | 1,881 | 3,862 |
| OTHER INCOME (EXPENSE): | | |
| Foreign currency transaction gain (loss) | (126) | 330 |
| Interest income | 91 | 264 |
| Interest expense | (692) | (956) |
| Debt retirement costs | — | (116) |
| | (727) | (478) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 1,154 | 3,384 |
| PROVISION FOR INCOME TAXES | (480) | (1,363) |
| NET INCOME FROM CONTINUING OPERATIONS | 674 | 2,021 |
| NET LOSS FROM DISCONTINUED OPERATIONS: | | |
| Operating loss, net of taxes of $(4) and $(10), respectively | (4) | (100) |
| Gain on sale, net of taxes of $0 and $17, respectively | — | 28 |
| DISCONTINUED OPERATIONS | (4) | (72) |
| NET INCOME | 670 | 1,949 |
| PREFERRED STOCK DIVIDENDS | 86 | 86 |
| NET INCOME FOR COMMON STOCK | $ 584 | $ 1,863 |
| NET INCOME PER COMMON SHARE: | | |
| Per common share — basic | | |
| Continuing operations | $ 0.10 | $ 0.33 |
| Discontinued operations | — | (0.01) |
| | $ 0.10 | $ 0.32 |
| Per common share — diluted | | |
| Continuing operations | $ 0.10 | $ 0.32 |
| Discontinued operations | — | (0.02) |
| | $ 0.10 | $ 0.30 |
| WEIGHTED AVERAGE COMMON SHARES: | | |
| Basic | 5,671 | 5,877 |
| Diluted | 5,859 | 6,136 |

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, | |
|---|---|---|
| | 2008 | 2007 |
| PATIENT REVENUES, net | $ 214,517 | $ 173,857 |
| EXPENSES: | | |
| Operating | 169,832 | 132,903 |
| Lease | 17,203 | 14,369 |
| Professional liability | 636 | (2,961) |
| General and administrative | 13,848 | 12,920 |
| Depreciation and amortization | 3,914 | 2,874 |
| Total expenses | 205,433 | 160,105 |
| OPERATING INCOME | 9,084 | 13,752 |
| OTHER INCOME (EXPENSE): | | |
| Foreign currency transaction gain (loss) | (293) | 743 |
| Interest income | 371 | 771 |
| Interest expense | (2,226) | (2,548) |
| Debt retirement costs | — | (116) |
| | (2,148) | (1,150) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 6,936 | 12,602 |
| PROVISION FOR INCOME TAXES | (2,452) | (4,940) |
| NET INCOME FROM CONTINUING OPERATIONS | 4,484 | 7,662 |
| NET LOSS FROM DISCONTINUED OPERATIONS: | | |
| Operating loss, net of taxes of $(23) and $(10), respectively | (35) | (101) |
| Loss on sale, net of taxes of $0 and $(6), respectively | — | (7) |
| DISCONTINUED OPERATIONS | (35) | (108) |
| NET INCOME | 4,449 | 7,554 |
| PREFERRED STOCK DIVIDENDS | 258 | 258 |
| NET INCOME FOR COMMON STOCK | $ 4,191 | $ 7,296 |
| NET INCOME PER COMMON SHARE: | | |
| Per common share — basic | | |
| Continuing operations | $ 0.74 | $ 1.26 |
| Discontinued operations | — | (0.02) |
| | $ 0.74 | $ 1.24 |
| Per common share — diluted | | |
| Continuing operations | $ 0.71 | $ 1.21 |
| Discontinued operations | — | (0.02) |
| | $ 0.71 | $ 1.19 |
| WEIGHTED AVERAGE COMMON SHARES: | | |
| Basic | 5,700 | 5,874 |
| Diluted | 5,919 | 6,131 |

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, | |
|---|---|---|
| | 2008 | 2007 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 4,449 | $ 7,554 |
| Discontinued operations | (35) | (108) |
| Net income from continuing operations | 4,484 | 7,662 |
| Adjustments to reconcile net income from continuing operations to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,914 | 2,874 |
| Provision for doubtful accounts | 1,684 | 809 |
| Deferred income tax provision | 273 | 3,713 |
| Provision for (benefit from) self-insured professional liability, net of cash payments | (3,636) | (6,010) |
| Stock-based compensation | 645 | 454 |
| Amortization of deferred balances | 335 | 221 |
| Provision for leases in excess of cash payments | 1,371 | 1,753 |
| Foreign currency transaction (gain) loss | 293 | (743) |
| Debt retirement costs | — | 116 |
| Non-cash interest income | (96) | (99) |
| Changes in other assets and liabilities affecting operating activities: | | |
| Receivables, net | 1,140 | (7,520) |
| Prepaid expenses and other assets | (133) | 872 |
| Trade accounts payable and accrued expenses | (1,365) | 2,965 |
| Net cash provided by continuing operations | 8,909 | 7,067 |
| Discontinued operations | (35) | (21) |
| Net cash provided by operating activities | 8,874 | 7,046 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (7,259) | (4,015) |
| Acquisition of leasehold interest | — | (9,218) |
| Proceeds from sale of discontinued operations and bed license | — | 180 |
| Decrease (increase) in restricted cash deposits | — | 247 |
| Note receivable issued | — | (1,800) |
| Notes receivable collection | 765 | 2,500 |
| Decrease in cash restricted for capital expenditures | — | 864 |
| Deposits and other deferred balances | (413) | (6) |
| Net cash used by continuing operations | (6,907) | (11,248) |
| Discontinued operations | (49) | — |
| Net cash used in investing activities | (6,956) | (11,248) |

(Continued)

**ADVOCAT INC.**

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Repayment of debt obligations | $ (1,528) | $ (9,353) |
| Proceeds from issuance of debt | — | 16,500 |
| Financing costs | (4) | (826) |
| Repurchase of common stock | (1,683) | — |
| Proceeds from exercise of stock options | 235 | 60 |
| Payment of preferred stock dividends | (258) | (258) |
| Payment for preferred stock restructuring | (371) | (326) |
| Net cash provided by (used in) financing activities | (3,609) | 5,797 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (1,691) | 1,595 |
| CASH AND CASH EQUIVALENTS, beginning of period | 11,658 | 12,344 |
| CASH AND CASH EQUIVALENTS, end of period | $ 9,967 | $ 13,939 |
| SUPPLEMENTAL INFORMATION: | | |
| Cash payments of interest | $ 1,938 | $ 2,294 |
| Cash payments of income taxes | $ 3,848 | $ 838 |

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

**ADVOCAT INC.**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2008 and 2007**

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 offers a variety of comprehensive rehabilitation services as well as nutritional support services.

As of September 30, 2008, the Company’s continuing operations consist of 50 nursing centers with 5,773 licensed nursing beds and 31 assisted living units. The Company’s continuing operations include nine owned nursing centers and 41 leased nursing centers located in Alabama, Arkansas, Florida, Kentucky, Ohio, Tennessee, Texas and West Virginia.

2. BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

The interim consolidated financial statements for the three and nine month periods ended September 30, 2008 and 2007 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, 2008 and the results of operations and cash flows for the three and nine month periods ended September 30, 2008 and 2007. The Company’s consolidated balance sheet at December 31, 2007 was derived from the Company’s audited consolidated financial statements as of December 31, 2007.

The results of operations for the three and nine month periods ended September 30, 2008 and 2007 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, 2007.

3. ACQUISITION

Effective August 11, 2007, the Company purchased the leasehold interests and operations of seven skilled nursing facilities from Senior Management Services of America North Texas, Inc. (“SMSA” or “SMSA Acquisition”) for an initial purchase price of approximately $9,957,000, including approximately $8,570,000 in cash, the assumption of approximately $862,000 in liabilities, and transaction costs of $525,000. These facilities include 1,266 licensed nursing beds, with 1,105 nursing beds currently available for use. The SMSA facilities had unaudited revenues of approximately $52.1 million for the year ended December 31, 2006. The SMSA facilities are in the Company’s existing geographic and operational footprint and are expected to contribute to the Company’s growth strategy and existing base of operations.

The facilities were part of a larger organization that had been in bankruptcy since January 2007. Under the terms of the purchase agreement, the Company acquired the leases and leasehold

interests in the facilities, inventory and certain equipment, but did not acquire working capital or assume liabilities, apart from certain obligations for employee paid-time-off benefits, specified lease related obligations and 2007 property taxes.

The facilities are leased from a subsidiary of Omega Healthcare Investors, Inc. ("Omega"). Prior to the SMSA Acquisition, the Company leased 28 facilities from Omega under a master lease agreement (the "Master Lease"). In connection with this acquisition, the Company amended the Master Lease to include the seven SMSA facilities. The substantive terms of the SMSA lease, including payment provisions and lease period including renewal options, were not changed by this amendment. The lease terms for the seven SMSA facilities provide for an initial term and renewal periods at the Company's option through May 31, 2035. The lease provides for annual increases in lease payments equal to the increase in the consumer price index, not to exceed 2.5%.

The SMSA Acquisition is accounted for using the purchase method of accounting. The purchase price of this transaction was allocated to the identifiable assets acquired based upon their respective fair values, and the liabilities assumed are based on the expected or paid settlement amounts. The purchase price allocation was subject to change during the twelve month period subsequent to the acquisition date for items including actual settlement of the assumed liabilities and is now final. The operating results have been included in the Company's consolidated financial statements since the date of the acquisition.

During the three months ended June 30, 2008, the Company received notification of payments due to the Centers for Medicare and Medicaid Services ("CMS") related to Medicare reimbursement for 1997 and earlier periods for one of the acquired facilities. The total amount of the payments requested by CMS as of September 30, 2008 was approximately $1,436,000, including accrued interest of approximately $807,000. The Company intends to seek relief for this assessment from CMS, and is seeking to have the assessment declared to be the responsibility of previous owners of the facility in litigation pending in the United States Bankruptcy Court for the Northern District of Texas, which is the court in which SMSA's bankruptcy case was filed. In the second quarter of 2008, the Company recorded a liability of $1,022,000 for its estimate of its ultimate liability for this assessment and defense costs, resulting in an increase in the acquired leasehold interest intangible asset. The Company's estimate of the liability takes into consideration the facts and circumstances, including the number of operators of the property in the intervening period since the original assessment and delays by CMS in seeking collection.

The following table summarizes the final purchase price allocation of the net assets acquired, including the adjustment described above:

| | |
|---|---|
| Current assets | $ 70,000 |
| Property and equipment | 145,000 |
| Deferred tax asset | 116,000 |
| Acquired leasehold interest intangible | 10,653,000 |
| Total assets acquired | 10,984,000 |
| Current liabilities | 1,889,000 |
| Total net assets acquired | $ 9,095,000 |

The purchase price allocation resulted in an acquired leasehold interest intangible asset of approximately $10,653,000. The intangible asset is subject to full amortization over the remaining life of the lease, including renewal periods, a period of approximately 28 years. Amortization expense of approximately $278,000 related to this intangible asset was recorded during the nine month period ended September 30, 2008.

4. AMENDMENT TO MASTER LEASE AGREEMENT FOR REPLACEMENT FACILITY

In November 2007, the Company entered into a short-term, single facility lease with Omega for an existing 102 bed skilled nursing center in Paris, Texas, and undertook an evaluation of the feasibility of entering into an agreement with Omega for the construction of a replacement facility. On March 14, 2008, the Company entered into an amendment to its master lease with Omega to provide for the construction and lease of a replacement facility. Upon the completion of the construction of the replacement facility, the existing building will be closed and the single facility lease terminated.

Under the terms of the lease amendment, Omega will provide funding and the Company will supervise the construction of the facility. Construction began during the second quarter of 2008, with completion expected in mid-2009. Rent will commence upon completion of the project, but no later than August 2009. Once construction is completed, annual rent will be equal to 10.25% of the total cost of the replacement facility, including direct costs of construction, carrying costs during the construction period, furnishings and equipment, land cost and the value of the related skilled nursing facility license. The total cost of the replacement facility was originally expected to be approximately $7.0 million and is currently expected to be approximately $7.9 million. Under the terms of the March 14, 2008 lease amendment and an October 24, 2008 lease amendment, costs incurred in excess of the current estimated cost of $7.9 million would be borne by the Company. The lease amendment provides for renewal options with respect to the new facility through 2035.

The replacement facility will be subject to the requirements of the Company's current master lease, with certain exceptions for capital spending requirements. At the fifth anniversary of rent commencement for the replacement facility, the Company may terminate the lease with respect to this facility. Beginning 18 months after the facility commences operations and continuing until the fifth anniversary of rent commencement, Omega may terminate the lease for this facility if the cash flow of the facility (as defined in the lease amendment) is less than 1.2 times the then existing rent. If the Company elects to continue the lease, annual rentals for this facility may be increased by an amount equal to one half of the amount of the cash flow of the facility (as defined in the lease amendment) in excess of 1.2 times the then existing rent, effective as of the start of the sixth year after the completion of the building. If at any time beginning 18 months after the completion of the building the average annual cash flow of the facility exceeds 1.3 times the then existing rent, the termination options of both Omega and the Company are eliminated, and the rent reset provisions described above are eliminated.

5. INSURANCE MATTERS

*Professional Liability and Other Liability Insurance-*

Due to the Company's past claims experience and increasing cost of claims throughout the long-term care industry, the premiums paid by the Company for professional liability and other liability insurance to cover future periods exceeds the coverage purchased so that it costs more than $1 to purchase $1 of insurance coverage. For this reason, effective March 9, 2001, the Company has purchased professional liability insurance coverage for its facilities that, based on historical claims experience, is likely to be substantially less than the claims that are expected to be incurred. As a result, the Company is effectively self-insured and expects to remain so for the foreseeable future.

The Company has essentially exhausted all general and professional liability insurance available for claims asserted prior to March 10, 2007. For claims made during the period from March 10, 2007 through March 9, 2009, the Company maintains insurance with coverage limits of $100,000 per medical incident and total annual aggregate policy coverage limits of $500,000. As of September 30, 2008, payments already made by the insurance provider for the period from March 10, 2007 through March 9, 2009 have reduced the remaining aggregate coverage amount in the policy period, but coverage has not been exhausted.

*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 limited professional liability insurance coverage, the Company has recorded total liabilities for professional liability and other claims of $17,038,000 as of September 30, 2008. 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.

The Company records its estimated liability for these professional liability claims based on the results of a third-party actuarial analysis prepared by the Actuarial Division of Willis of Tennessee, Inc. ("Willis"). Each quarter, amounts are added to the accrual for estimates of anticipated liability for claims incurred during that period. These estimates are assessed and adjusted quarterly as claims are actually reported, as lawsuits are filed, and as those actions are actually resolved. As indicated by the chart of reserves by policy year set forth below, final determination of the Company's actual liability for claims incurred in any given period is a process that takes years. At each quarter end, 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 income 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.

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 quarter. 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. A significant judgment entered against the Company in one or more legal actions could have a material adverse impact on the Company's financial position and cash flows.

The following summarizes the Company's accrual for professional liability and other claims for each policy year as of the end of the period:

| | September 30, 2008 | December 31, 2007 |
|---|---|---|
| Policy Year End March 9, | | |
| 2009 | $ 2,992,000 | $ — |
| 2008 | 6,252,000 | 5,134,000 |
| 2007 | 4,664,000 | 7,625,000 |
| 2006 | 1,731,000 | 4,757,000 |
| 2005 | 999,000 | 2,339,000 |
| 2004 and earlier | 400,000 | 820,000 |
| | $17,038,000 | $20,675,000 |

The Company's cash expenditures for self-insured professional liability costs were $3,806,000 and $2,589,000 for the nine months ended September 30, 2008 and 2007, respectively. In April 2008, the Company entered into individual agreements to settle eight professional liability cases for a total of $4,950,000, including $200,000 paid from insurance proceeds. The settlements will be paid in installments from April 2008 through January 2009. As of September 30, 2008, the Company is obligated to pay installments that total $2,050,000 related to these settlements. The remaining obligation for these claims is fully accrued and included in the accrual for professional liability claims. In addition to these settlement payments, the Company will have throughout the year additional cash expenditures for other settlements and self-insured professional liability costs.

*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. The Company has provided reserves for the settlement of outstanding self-insured claims at amounts believed to be adequate. The liability recorded by the Company for the self-insured obligations under these plans is $380,000 as of September 30, 2008.

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. The Company accounts for premium expense under these policies based on its estimate of the level of claims expected to be incurred, and had recorded insurance refunds receivable of $1,234,000 as of December 31, 2007. During the nine months ended September 30, 2008, the Company received the proceeds of these insurance refunds. Any adjustments of future premiums for workers' compensation policies and differences between actual settlements and reserves for self-insured obligations are included in expense in the period finalized.

From July 1, 2007 through June 30, 2008, the Company had a guaranteed cost policy for workers' compensation insurance, under which expense was equal to the premiums paid. As a result, there will be no premium refunds for this policy period.

For the period from July 1, 2008 through June 30, 2009, the Company entered into a prefunded deductible workers' compensation 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. Any differences in estimated claims costs and actual amounts are included in expense in the period finalized.

The Company is self-insured for health insurance benefits for certain employees and dependents for amounts up to $150,000 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 $974,000 at September 30, 2008. The differences between actual settlements and reserves are included in expense in the period finalized.

## 6. STOCK-BASED COMPENSATION

The Company's Board of Directors adopted and the shareholders approved at the Annual Meeting in June 2008 the Advocat Inc. 2008 Stock Purchase Plan for Key Personnel ("Stock Purchase Plan"). The Stock Purchase Plan provides for the granting of rights to purchase shares of the Company's common stock to directors and officers and is administered by the compensation committee of the board of directors. The maximum number of shares of the Company's common stock to be authorized and reserved for issuance under the Stock Purchase Plan is 150,000 shares, subject to equitable adjustment as set forth in the Stock Purchase Plan.

The plan allows participants to elect to utilize a specified portion of base salary, annual cash bonus, or director compensation to purchase restricted shares or restricted share units at a price equal to 85% of the fair market value of a share of the Company's common stock on the date on which such restricted shares or restricted share units are purchased.

The restricted period for restricted shares or restricted share units issued under the Stock Purchase Plan is generally two years from the date of purchase. During the restricted period the shares will have all rights of other shares including voting rights and the rights to receive dividends, however, the restricted share certificates will not be delivered to the shareholder and the shares cannot be sold, assigned or disposed of during the restricted period. No grants of restricted shares or restricted share units can be made under the Stock Purchase Plan after April 25, 2018.

During the nine month period ended September 30, 2008, the Compensation Committee of the Board of Directors approved grants of 110,700 Stock only Stock Appreciation Rights ("SOSARs") at a weighted average exercise price of $10.90. The SOSARs will vest one-third on the first, second, and third anniversaries of the grant date. As a result of the SOSARs granted the Company recorded an additional $151,000 and $325,000 in stock-based compensation expense for the three and nine month periods ended September 30, 2008. As of September 30, 2008, there was approximately $673,000 of remaining compensation costs related to these 2008 SOSARs to be recognized over the remaining vesting period. The Company estimated the total recognized and unrecognized compensation using the Black-Scholes-Merton ("BSM") option valuation model.

This non-cash expense 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 $645,000 and $454,000 in the nine month periods ended September 30, 2008 and 2007, respectively.

In computing the fair value of these SOSARs, the Company estimated the SOSARs expected term based on the average of the vesting term and the original contractual terms of the grants, consistent with the interpretive guidance in Securities and Exchange Commission Staff Accounting Bulletin ("SAB") 107 and SAB 110 (the "Simplified Method"). The Company continues to use the Simplified Method since the Company's exercise history is not representative of the expected term of the SOSARs granted in 2008. The Company's recent exercise history is primarily from options granted in 2005 that were vested at grant date and were significantly in-the-money due to an increase in stock price during the period between grant date and formal approval by shareholders, and from older options granted several years ago that had fully vested.

## 7. RECLASSIFICATIONS

Certain amounts in the Company's 2007 consolidated financial statements have been reclassified to conform to the 2008 presentation.

## 8. DISCONTINUED OPERATIONS

Effective March 31, 2007 the Company terminated operations at its leased facility in Eureka Springs, Arkansas. The owner of the property, a subsidiary of Omega Healthcare Investors, Inc., sold the property and the Company cooperated in an orderly transition to the new owner.

The facility had low occupancy and operated at a loss. The facility had been leased subject to the Omega master lease. Under the terms of that lease, the master lease rental payment was not reduced. This facility accounted for revenues of approximately $575,000 in the nine month period ended September 30, 2007.

The Company owns real estate related to an assisted living facility it closed in 2006 that is held for sale.

In accordance with the provisions of Financial Accounting Standards Board ("FASB") Statements of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the Company has reclassified the operations of this facility and the real estate

described above as discontinued operations for all periods presented in the Company's consolidated financial statements.

9. EARNINGS 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, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Net income per common share: | | | | |
| Per common share — basic | | | | |
| Income from continuing operations | $ 0.10 | $ 0.33 | $ 0.74 | $ 1.26 |
| Income (loss) from discontinued operations | | | | |
| Operating income, net of taxes | — | (0.02) | — | (0.02) |
| Loss on sale, net of taxes | — | 0.01 | — | — |
| Discontinued operations, net of taxes | — | (0.01) | — | (0.02) |
| Net income | $ 0.10 | $ 0.32 | $ 0.74 | $ 1.24 |
| Per common share — diluted | | | | |
| Income from continuing operations | $ 0.10 | $ 0.32 | $ 0.71 | $ 1.21 |
| Income (loss) from discontinued operations | | | | |
| Operating income, net of taxes | — | (0.02) | — | (0.02) |
| Loss on sale, net of taxes | — | — | — | — |
| Discontinued operations, net of taxes | — | (0.02) | — | (0.02) |
| Net income | $ 0.10 | $ 0.30 | $ 0.71 | $ 1.19 |

The impact of the weighted average SOSARs outstanding were not included in the computation of diluted earnings per common share because these securities would have been anti-dilutive.

10. LONG-TERM DEBT

The Company has a $15,000,000 revolving credit facility that provides for revolving credit loans as well as the issuance of letters of credit. There are limits on the maximum amount of loans that may be outstanding under the revolver based on borrowing base restrictions. The revolver has a term of three years, expiring August 2010 and bears interest at the Company's option of LIBOR plus 2.25% or the bank's prime lending rate. Annual fees for letters of credit issued under this revolver are 2.25% of the amount outstanding. The Company has a letter of credit of approximately $8,117,000 to serve as a security deposit for the Company's leases with Omega. Considering the balance of eligible accounts receivable at September 30, 2008, the letter of credit and the current maximum loan amount of $15,000,000, the balance available for revolving credit loans as of September 30, 2008 was $6,467,000. As of September 30, 2008, the Company had no borrowings outstanding under the revolving credit facility.

The Company's debt agreements require additional payments from proceeds received upon certain asset dispositions and excess cash flows, as defined in the debt agreements. In addition, the Company's debt agreements allow for voluntary prepayments of principal outstanding, and during 2007, the Company made voluntary prepayments of $3,000,000. These prepayments reduce the required amounts that must be paid in the future from excess cash flows and asset dispositions.

The Company's debt agreements contain various financial covenants, the most restrictive of which relate to cash flow, debt service coverage ratios, liquidity and limits on the payment of dividends to shareholders. The Company is in compliance with all such covenants at September 30, 2008, with the exception of the Minimum Fixed Charge Coverage Covenant related to the Company's term loan. The Minimum Fixed Charge Coverage Covenant was impacted by a combination of the decline in the Company's operating performance and increased capital expenditures. On November 3, 2008 the Company received a covenant waiver from the bank effective for the period ending September 30, 2008 through the earlier of October 1, 2009 or the date the

Company amends the Minimum Fixed Charge Coverage Covenant. The Company and the bank are currently in discussions to amend the provisions of the Minimum Fixed Charge Coverage Covenant, and the terms of the waiver require that this amendment be completed by December 31, 2008. It is anticipated that the amendment will be completed in the fourth quarter of 2008 and that the Company would be in compliance with the proposed covenant for at least the next twelve months.

The Company is subject to a covenant under its mortgage loan that requires the Company to maintain a combined occupancy for seven owned homes that serve as collateral for the mortgage loan. The Company is in compliance with the covenant at September 30, 2008, however, the covenant becomes more restrictive as of December 31, 2008, and based on occupancy at September 30, 2008, the Company would not be in compliance with the more restrictive covenant. The Company is currently in discussions with its mortgage lender to amend these covenants, and based on these discussions with the lender and forecasted occupancy at these facilities, it is anticipated that the Company will remain in compliance with the revised covenant for at least the next twelve months.

## 11. INCOME TAXES

In periods prior to 2001, the Company generated tax credits under the Work Opportunity Tax Credit program totaling approximately $328,000. As the Company was incurring taxable losses in those years the Company did not record tax assets related to these credits. During the three months ending March 31, 2008, the Company recorded these carryforward credits as deferred tax assets, as the Company anticipates using them to reduce its taxes payable in 2008. The impact of recording these assets reduced the effective tax rate for the nine months ending September 30, 2008.

The Canada Customs and Revenue Agency (“CCRA”) audited the 2003 and 2002 Canadian federal tax returns of Diversicare Canada Management Services Co., Inc. (“DCMS”), the Company’s Canadian subsidiary sold in 2004, and proposed certain adjustments to the DCMS tax returns. The adjustments related to deductions for the allocation of overhead charges of United States management to DCMS. Under the terms of the sale of DCMS, the Company is liable for any liability that arises from these adjustments. In 2005, the Company recorded a charge for its estimated liability for additional tax, interest and professional fees resulting from these proposed adjustments. During 2008, the Company paid $234,000 to settle the remaining tax liability with CCRA. The payment decreased the unrecognized tax benefits accrued in accordance with FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109.”

## 12. AMENDMENT TO SHAREHOLDERS’ RIGHTS PLAN

On August 1, 2008, the Company’s Board of Directors approved amending its current Amended and Restated Rights Agreement (the “Rights Agreement”). The amendment provides for an increase of the exercise price of the rights under the Rights Agreement (the “Rights”) to $50 from $15 and for the extension of the Expiration Date of the Rights to August 2, 2018. In addition, the amendment includes a share exchange feature that provides the Company’s Board of Directors the option of exchanging, in whole or in part, each Right, other than those of the hostile acquiring holder, for one share of the Company’s common stock. This provision is intended to avoid requiring Rights holders to pay cash to exercise their Rights and to alleviate the uncertainty as to whether holders will exercise their Rights.

## 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, 2008, our continuing operations consisted of 50 nursing centers with 5,773 licensed nursing beds and 31 assisted living units. As of September 30, 2008, our continuing operations included nine owned nursing centers and 41 leased nursing centers.

*Acquisitions and New Lease* . Effective August 11, 2007, we purchased the leasehold interests and operations of seven skilled nursing facilities from SMSA for a price of approximately $11.0 million. Effective November 1, 2007, we entered into an agreement to lease a single facility in Texas from a subsidiary of Omega. Together, these facilities are referred to as the "New Texas Facilities."

*Divestitures.* Effective March 31, 2007, we terminated operations at a leased facility in Arkansas that had low occupancy and operated at a loss. The owner of the facility sold the property and we cooperated in an orderly transition to the new owner. In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," our consolidated financial statements have been reclassified to reflect this divestiture as discontinued operations.

*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 of the need to make estimates about 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 accounting policies that fit this definition include the following:

#### Revenues

***Patient Revenues***

The fees we charge patients in our nursing centers are recorded on an accrual basis. These rates are contractually adjusted with respect to individuals receiving benefits under federal and state-funded programs and other third-party payors. Our net revenues are derived substantially from Medicare, Medicaid and other government programs (approximately 85.0% and 87.4% for the nine month periods ended September 30, 2008 and 2007, respectively). Medicare intermediaries make retroactive adjustments based on changes in allowed claims. In addition, certain of the states in which we operate require

complicated and detailed cost reports which are subject to review and adjustments. In the opinion of management, adequate provision has been made for adjustments that may result from such reviews. Retroactive adjustments, if any, are recorded when objectively determinable, generally within three years of the close of a reimbursement year depending upon the timing of appeals and third-party settlement reviews or audits.

***Allowance for Doubtful Accounts***

We evaluate the collectability of our accounts receivable by reviewing current agings of accounts receivable, historical collections data and other factors. As a percentage of revenue, our provision for doubtful accounts was approximately 0.8% and 0.5% for the nine month periods ended September 30, 2008 and 2007, respectively. During 2007, bad debt expense was lower due to better than expected collections experience. On a full year basis, our provision for doubtful accounts was approximately 0.4%, 0.8% and 0.8% for 2007, 2006 and 2005, respectively. Historical bad debts have generally resulted from uncollectible private pay balances, some uncollectible coinsurance and deductibles and other factors. Receivables that are deemed to be uncollectible are written off.

**Professional Liability and Other Self-Insurance Reserves**

***Accrual for Professional and General Liability Claims*** -

Because our actual liability for existing and anticipated professional liability and general liability claims will exceed our limited insurance coverage, we have recorded total liabilities for reported professional liability claims and estimates for incurred but unreported claims of $17.0 million as of September 30, 2008. 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 related legal costs incurred and expected to be incurred. All losses are projected on an undiscounted basis.

We retain Willis, a third-party actuarial firm, to estimate the appropriate accrual for incurred general and professional liability claims. The actuary, Willis, primarily uses historical data regarding the frequency and cost of our past claims over a multi-year period and information regarding our number of occupied beds to develop its estimates of our ultimate professional liability cost for current periods. The actuary estimates our professional liability accrual for past periods by using currently-known information to adjust the initial reserve that was created for that period.

On a quarterly basis, we obtain reports of claims and lawsuits that we have incurred from insurers and a third party claims administrator. These reports contain information relevant to the liability actually incurred to date with that claim as well as the third-party administrator's estimate of the anticipated total cost of the claim. This information is reviewed by us and provided to the actuary. The actuary uses this information to determine the timing of claims reporting and the development of reserves, and compares the information obtained to its original estimates of liability. Based on the actual claim information obtained and on estimates regarding the number and cost of additional claims anticipated in the future, the reserve estimate for a particular prior period may be revised upward or downward on a quarterly basis. Final determination of our actual liability for claims incurred in any given period is a process that takes years. The following summarizes the Company's accrual for professional liability and other claims for each policy year as of the end of the period:

| | September 30, 2008 | December 31, 2007 |
|---|---|---|
| Policy Year End March 9, | | |
| 2009 | $ 2,992,000 | $ — |
| 2008 | 6,252,000 | 5,134,000 |
| 2007 | 4,664,000 | 7,625,000 |
| 2006 | 1,731,000 | 4,757,000 |
| 2005 | 999,000 | 2,339,000 |
| 2004 and earlier | 400,000 | 820,000 |
| | $17,038,000 | $20,675,000 |

The Company's cash expenditures for self-insured professional liability costs were $3.8 million and $2.6 million for the nine months ended September 30, 2008 and 2007, respectively. In April 2008, the Company entered into individual agreements to settle eight professional liability cases for a total of $5.0 million, including $200,000 paid from insurance proceeds. The settlements will be paid in installments from April 2008 through January 2009. As of September 30, 2008, we are obligated to pay installments that total $2.1 million related to these settlements. The remaining obligation for these claims is fully accrued and is included in the accrual for professional liability claims. In addition to these settlement payments, we will have additional cash expenditures throughout the year for other settlements and self-insured professional liability costs.

Although we retain a third-party actuarial firm to assist us, professional and general liability claims are inherently uncertain, and the liability associated with anticipated claims is very difficult to estimate. As a result, our 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 quarter.

Professional liability costs are material to our financial position, and changes in estimates as well as differences between estimates and the ultimate amount of loss may cause a material fluctuation in our reported results of operations. Our professional liability expense was $0.6 million for the nine month period ended September 30, 2008, compared to negative $3.0 million for the nine months ended September 30, 2007, with negative amounts representing net benefits resulting from downward revisions in previous estimates. These amounts are material in relation to our reported net income from continuing operations for the related periods of $4.5 million and $7.7 million, respectively. The total liability recorded at September 30, 2008, was $17.0 million, compared to current assets of $44.0 million and total assets of $109.0 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.

***Accrual for Other Self-Insured Claim* s-**

From June 30, 2003 until June 30, 2007, our workers' compensation insurance programs provided coverage for claims incurred with premium adjustments on incurred losses. We account for premium expense under these policies based on our estimate of the level of claims expected to be incurred and had recorded insurance refunds receivable of $1.2 million as of December 31, 2007. During the nine months ended September 30, 2008, we received the proceeds of these insurance refunds. Any adjustments of future premiums for workers' compensation policies and differences between actual settlements and reserves for self-insured obligations are included in expense in the period finalized.

From July 1, 2007 through June 30, 2008, we had a guaranteed cost policy for workers' compensation insurance, under which expense was equal to the premiums paid. As a result, there will be no premium refunds for this policy period.

For the period from July 1, 2008 through June 30, 2009, we entered into a prefunded deductible workers' compensation policy. Under this policy, we are self insured for the first $500,000 per claim, subject to an aggregate maximum of $3,000,000. We fund a loss fund account with the insurer to pay for claims below the deductible. We account for premium expense under this policy based on our estimate of the level of claims subject to the policy deductibles expected to be incurred. Any differences in estimated claims costs and actual amounts are included in expense in the period finalized.

We are self-insured for health insurance benefits for certain employees and dependents for amounts up to $150,000 per individual annually under a self-insurance plan. We provide reserves for the settlement of outstanding self-insured health claims at amounts believed to be adequate, based on known claims and estimates of unknown claims based on historical information. The liability for reported claims and estimates for incurred but unreported claims is $1.0 million at September 30, 2008. The differences between actual settlements and reserves are included in expense in the period finalized. Our reserves for health insurance benefits can fluctuate materially from one year to the next depending on the number of significant health issues of our covered employees and their dependants.

**Asset Impairment**

We evaluate our property and equipment on a quarterly basis to determine if facts and circumstances suggest that the assets may be impaired or that the estimated depreciable life of the asset may need to be changed such as significant physical changes in the property, significant adverse changes in general economic conditions, and significant deteriorations of the underlying cash flows of the property. The need to recognize an impairment is based on estimated undiscounted future cash flows from a property compared to the carrying value of that property. If recognition of an impairment is necessary, it is measured as the amount by which the carrying amount of the property exceeds the fair value of the property. We did not record any asset impairments in the nine month periods ended September 30, 2008 and 2007. If our estimates or assumptions with respect to a property change in the future, we may be required to record additional impairment charges for our assets.

**Business Combinations**

We account for our acquisitions in accordance with SFAS No. 141, "Business Combinations" and related interpretations. The SMSA Acquisition in 2007 has been accounted for as a purchase business combination. Purchase accounting requires that we make certain valuations based on our experience, including determining the fair value and useful lives of assets acquired and the expected settlement amount of liabilities assumed based upon their respective fair values. These valuations are subject to change during the twelve month period subsequent to the acquisition date. Such valuations require us to make significant estimates, judgments and assumptions, including projections of future events and operating performance.

**Stock-Based Compensation**

We recognize compensation cost for all share-based payments granted after January 1, 2006 on a straight-line basis over the vesting period. We calculated the recognized and unrecognized stock-based compensation using the BSM option valuation method, which requires us to use certain key assumptions to develop the fair value estimates. These key assumptions include expected volatility, risk-free interest rate, expected dividends and expected term. During the nine month periods ended September 30, 2008 and 2007, we recorded charges of approximately $0.6 million and $0.5 million, respectively, in stock-based compensation. Stock-based compensation expense is a non-cash expense, and such amounts are included as a component of general and administrative expense or

operating expense based upon the classification of cash compensation paid to the related employees.

**Income Taxes**

We determine deferred tax assets and liabilities based upon differences between financial reporting and tax bases of assets and liabilities and measure them using the enacted tax laws that will be in effect when the differences are expected to reverse. We maintain a valuation allowance of approximately $0.9 million to reduce deferred tax assets by the amount we believe is more likely than not to not be utilized through the turnaround of existing temporary differences, future earnings, or a combination thereof. In future periods, we will continue to assess the need for and adequacy of the remaining valuation allowance.

**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 laws 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 the requirement to make 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. We are involved in regulatory actions of this type from time to time. Additionally, changes in these laws and regulations, such as reimbursement policies of Medicare and Medicaid programs as a result of budget cuts by federal and state governments or other legislative and regulatory actions, have had a material adverse effect on the industry and our consolidated financial position, results of operations, and cash flows. Future federal budget legislation and federal and state regulatory changes may further negatively impact us.

**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, 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.

Certain per person annual Medicare Part B reimbursement limits on therapy services became effective January 1, 2006. Subject to certain exceptions, the current limits impose a $1,810 per patient annual ceiling on physical and speech therapy services, and a separate $1,810 per patient annual ceiling on occupational therapy services. CMS established an exception process to permit therapy services in certain situations, and the majority of services provided by us are reimbursed under the exceptions. In July 2008, Congress passed the Medicare Improvements for Patients and Providers Act of 2008, which extends the exceptions process through December 31, 2009. If the exception process is discontinued after December 31, 2009, it is expected that the reimbursement limitations will reduce therapy revenues and negatively impact our operating results and cash flows.

In December 2006, Congress passed the Tax Relief and Health Care Act of 2006 (TRHCA). The TRHCA reduces the maximum federal matching under Medicare provider assessments to 5.5% of aggregate Medicaid outlays. This reduction in funding became effective for fiscal years beginning after January 1, 2008. This change has not had a material impact on our results of operations.

The Federal Deficit Reduction Act of 2005 mandates reducing by 30% the amount that Medicare reimburses nursing centers and other non-hospital providers for bad debts arising from uncollectible Medicare coinsurance and deductibles for those individuals that are not dually eligible for Medicare and Medicaid. This provision has not had a material impact on the Company.

Reduction in health care spending has become a national priority in the United States, and the field of health care regulation and reimbursement is a rapidly evolving one. As discussed previously, on May 1, 2008, CMS issued a draft regulation that would have reduced Medicare payments to skilled nursing facilities by approximately 0.3% effective October 1, 2008. The decrease was the net effect of a 3.3% decrease intended to correct CMS forecasting errors that resulted when the current Resource Utilization Group (“RUG”) system went into effect in 2006, partially offset by an inflation increase as measured by the SNF “market basket.” However, on July 31, 2008, CMS issued its final rule, providing for a 3.4% market basket increase, and indefinitely deferring the discussion of possible decreases related to any CMS perceived forecasting errors.

The 3.4% market basket increase is effective October 1, 2008. The actual amount of the market basket increase is based on several factors and varies for each individual center. It is estimated that the market basket adjustment will result in an average increase of approximately 3.5% for our facilities as a group, increasing the Company’s revenue by approximately $0.2 million per month.

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, 2008, we derived 31.7% and 53.3% 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 homes are subject to certificate of need laws, which require us to obtain government approval for the construction of new nursing homes or the addition of new licensed beds to existing homes. 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 facility and the adequacy of the equipment used therein. Each facility 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 facility 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 facility 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.

**Contractual Obligations and Commercial Commitments**

We have certain contractual obligations of continuing operations as of September 30, 2008, summarized by the period in which payment is due, as follows (dollar amounts in thousands):

| Contractual Obligations | Total | 1 year or less | 2 to 3 Years | 4 to 5 Years | After 5 Years |
|---|---|---|---|---|---|
| Long-term debt obligations [1] | $ 38,436 | $ 6,083 | $28,071 | $ 4,282 | $ — |
| Settlement Obligations [2] | $ 2,050 | $ 2,050 | $ — | $ — | $ — |
| Series C Preferred Stock [3] | $ 5,607 | $ 344 | $ 5,263 | $ — | $ — |
| Elimination of Preferred Stock Conversion feature [4] | $ 6,868 | $ 687 | $ 1,374 | $ 1,374 | $ 3,433 |
| Operating leases | $608,864 | $21,799 | $43,645 | $45,027 | $498,393 |
| Required capital expenditures under mortgage loans [5] | $ 694 | $ 245 | $ 449 | $ — | $ — |
| Required capital expenditures under operating leases [6] | $ 28,980 | $ 854 | $ 1,708 | $ 1,713 | $ 24,705 |
| Total | $691,499 | $32,062 | $80,510 | $52,396 | $526,531 |

(1) Long-term debt obligations include scheduled future payments of principal and interest of long-term debt.

(2) Settlement obligations relate to professional liability cases settled in 2008 that will be paid in installments through January 2009. The liabilities are included in our current portion of self insurance reserves.

(3) Series C Preferred Stock includes quarterly dividend payments and redemption value at preferred shareholder's earliest redemption date.

(4) Payments for the elimination of preferred stock conversion feature.

(5) Includes annual expenditure requirements for capital maintenance under mortgage loan covenants.

(6) Includes annual capital expenditure requirements under operating leases.

We have employment agreements with certain members of management that provide for the payment to these members of amounts up to 2.5 times their annual salary in the event of a termination without cause, a constructive discharge (as defined in each employment agreement), or upon a change of control of the Company (as defined in each employment agreement). The maximum contingent liability under these agreements is approximately $2.0 million as of September 30, 2008. 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, 2008, the maximum contingent liability for the repurchase of the equity grants is approximately $0.3 million. No amounts have been accrued for this contingent liability.

## 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, 2008 and 2007:

| (in thousands) | Three Months Ended September 30, 2008 | 2007 | Change | % |
|---|---|---|---|---|
| PATIENT REVENUES, net | $72,206 | $63,884 | $ 8,322 | 13.0 |
| EXPENSES: | | | | |
| Operating | 58,297 | 49,253 | 9,044 | 18.4 |
| Lease | 5,753 | 5,162 | 591 | 11.4 |
| Professional liability | 278 | (6) | 284 | 4,733.3 |
| General and administrative | 4,642 | 4,580 | 62 | 1.4 |
| Depreciation and amortization | 1,355 | 1,033 | 322 | 31.2 |
| Total expenses | 70,325 | 60,022 | 10,303 | 17.2 |
| OPERATING INCOME | 1,881 | 3,862 | (1,981) | (51.3) |
| OTHER INCOME (EXPENSE): | | | | |
| Foreign currency transaction gain (loss) | (126) | 330 | (456) | (138.2) |
| Interest income | 91 | 264 | (173) | (65.5) |
| Interest expense | (692) | (956) | 264 | 27.6 |
| Debt retirement costs | — | (116) | 116 | 100.0 |
| | (727) | (478) | (249) | (52.1) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 1,154 | 3,384 | (2,230) | (65.9) |
| PROVISION FOR INCOME TAXES | (480) | (1,363) | (883) | (64.8) |
| NET INCOME FROM CONTINUING OPERATIONS | $ 674 | $ 2,021 | $ (1,347) | (66.7) |

| (in thousands) | Nine Months Ended September 30, 2008 | 2007 | Change | % |
|---|---|---|---|---|
| PATIENT REVENUES, net | $214,517 | $173,857 | $40,660 | 23.4 |
| EXPENSES: | | | | |
| Operating | 169,832 | 132,903 | 36,929 | 27.8 |
| Lease | 17,203 | 14,369 | 2,834 | 19.7 |
| Professional liability | 636 | (2,961) | 3,597 | 121.5 |
| General and administrative | 13,848 | 12,920 | 928 | 7.2 |
| Depreciation and amortization | 3,914 | 2,874 | 1,040 | 36.2 |
| Total expenses | 205,433 | 160,105 | 45,328 | 28.3 |
| OPERATING INCOME | 9,084 | 13,752 | (4,668) | (33.9) |
| OTHER INCOME (EXPENSE): | | | | |
| Foreign currency transaction gain (loss) | (293) | 743 | (1,036) | (139.4) |
| Interest income | 371 | 771 | (400) | (51.9) |
| Interest expense | (2,226) | (2,548) | 322 | 12.6 |
| Debt retirement costs | — | (116) | 116 | 100.0 |
| | (2,148) | (1,150) | (998) | (86.8) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 6,936 | 12,602 | (5,666) | (45.0) |
| PROVISION FOR INCOME TAXES | (2,452) | (4,940) | (2,488) | (50.4) |
| NET INCOME FROM CONTINUING OPERATIONS | $ 4,484 | $ 7,662 | $ (3,178) | (41.5) |

| *Percentage of Net Revenues* | Three Months Ended September 30, 2008 | Three Months Ended September 30, 2007 | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
|---|---|---|---|---|
| PATIENT REVENUES, net | 100.0% | 100.0% | 100.0% | 100.0% |
| EXPENSES: | | | | |
| Operating | 80.7 | 77.1 | 79.2 | 76.4 |
| Lease | 8.0 | 8.1 | 8.0 | 8.3 |
| Professional liability | 0.4 | — | 0.3 | (1.7) |
| General and administrative | 6.4 | 7.2 | 6.5 | 7.4 |
| Depreciation and amortization | 1.9 | 1.6 | 1.8 | 1.7 |
| Total expenses | 97.4 | 94.0 | 95.8 | 92.1 |
| OPERATING INCOME | 2.6 | 6.0 | 4.2 | 7.9 |
| OTHER INCOME (EXPENSE): | | | | |
| Foreign currency transaction gain (loss) | (0.2) | 0.5 | (0.1) | 0.4 |
| Interest income | 0.1 | 0.4 | 0.1 | 0.4 |
| Interest expense | (0.9) | (1.4) | (1.0) | (1.4) |
| Debt retirement costs | — | (0.2) | — | (0.1) |
| | (1.0) | (0.7) | (1.0) | (0.7) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 1.6 | 5.3 | 3.2 | 7.2 |
| PROVISION FOR INCOME TAXES | 0.7 | 2.1 | 1.1 | 2.8 |
| NET INCOME FROM CONTINUING OPERATIONS | 0.9% | 3.2% | 2.1% | 4.4% |

As a supplement to the tables above, the following tables present the unaudited statements of income from continuing operations before income taxes and related data for the three and nine month periods ended September 30, 2008 and 2007 on a same center basis, excluding the effects of the New Texas Facilities and discontinued operations.

| SAME CENTER (in thousands) | Three Months Ended September 30, 2008 | 2007 | Change | % |
|---|---|---|---|---|
| PATIENT REVENUES, net | $58,919 | $57,289 | $ 1,630 | 2.8 |
| EXPENSES: | | | | |
| Operating | 46,139 | 43,313 | 2,826 | 6.5 |
| Lease | 4,731 | 4,634 | 97 | 2.1 |
| Professional liability | 139 | (90) | 229 | 254.4 |
| General and administrative | 4,412 | 4,174 | 238 | 5.7 |
| Depreciation and amortization | 1,065 | 944 | 121 | 12.8 |
| Total expenses | 56,486 | 52,975 | 3,511 | 6.6 |
| OPERATING INCOME | 2,433 | 4,314 | (1,881) | (43.6) |
| OTHER INCOME (EXPENSE): | | | | |
| Foreign currency transaction gain (loss) | (126) | 330 | (456) | (138.2) |
| Interest income | 91 | 264 | (173) | (65.5) |
| Interest expense | (560) | (819) | 259 | 31.6 |
| Debt retirement costs | — | (116) | 116 | 100.0 |
| | (595) | (341) | (254) | (74.5) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | $ 1,838 | $ 3,973 | $(2,135) | (53.7) |

| SAME CENTER (in thousands) | Nine Months Ended September 30, 2008 | 2007 | Change | % |
|---|---|---|---|---|
| PATIENT REVENUES, net | $175,744 | $167,262 | $ 8,482 | 5.1 |
| EXPENSES: | | | | |
| Operating | 134,767 | 126,964 | 7,803 | 6.1 |
| Lease | 14,168 | 13,841 | 327 | 2.4 |
| Professional liability | 556 | (3,045) | 3,601 | 118.3 |
| General and administrative | 13,177 | 12,513 | 664 | 5.3 |
| Depreciation and amortization | 3,093 | 2,785 | 308 | 11.1 |
| Total expenses | 165,761 | 153,058 | 12,703 | 8.3 |
| OPERATING INCOME | 9,983 | 14,204 | (4,221) | (29.7) |
| OTHER INCOME (EXPENSE): | | | | |
| Foreign currency transaction gain (loss) | (293) | 743 | (1,036) | (139.4) |
| Interest income | 371 | 771 | (400) | (51.9) |
| Interest expense | (1,784) | (2,411) | 627 | 26.0 |
| Debt retirement costs | — | (116) | 116 | 100.0 |
| | (1,706) | (1,013) | (693) | (68.4) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | $ 8,277 | $ 13,191 | $ (4,914) | (37.3) |

**Three Months Ended September 30, 2008 Compared With Three Months Ended September 30, 2007**

As noted in the overview, during 2007 we completed the SMSA Acquisition and entered into a lease for an additional facility in Texas (together, the “New Texas Facilities”). All results for the New Texas Facilities are included from the effective date of acquisition or inception of lease. Accordingly, the third quarter data referenced in the comparisons below for the New Texas Facilities is comparing the full quarter of 2008 to a partial quarter in 2007.

In addition, we have entered into certain divestiture transactions in recent periods, and our consolidated financial statements have been reclassified to present such transactions as discontinued operations. Accordingly, the related revenue, expenses, assets, liabilities and cash flows have been reported separately, and the discussion below addresses principally the results of our continuing operations.

*Patient Revenues* . Patient revenues increased to $72.2 million in 2008 from $63.9 million in 2007, an increase of $8.3 million, or 13.0%. Revenues related to the New Texas Facilities were $13.3 million in 2008 and $6.6 million in 2007. Same center patient revenues increased to $58.9 million in 2008 from $57.3 million in 2007, an increase of $1.6 million, or 2.8%. This increase is primarily due to Medicare rate increases, increased Medicaid rates in certain states and increased private pay and managed care rates and census, partially offset by the effects of lower Medicaid and Medicare census.

The following table summarizes key revenue and census statistics for continuing operations for each period and segregates effects of the New Texas Facilities:

| | Three Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| Skilled nursing occupancy: | | |
| Same center | 77.7% | 79.1% |
| New Texas Facilities | 67.8% | 68.4% |
| Total continuing operations | 75.3% | 77.6% |
| Medicare census as percent of total: | | |
| Same center | 13.0% | 13.3% |
| New Texas Facilities | 11.4% | 12.0% |
| Total continuing operations | 12.6% | 13.1% |
| Medicare revenues as percent of total: | | |
| Same center | 30.1% | 29.7% |
| New Texas Facilities | 31.6% | 33.1% |
| Total continuing operations | 30.4% | 30.0% |
| Medicaid revenues as percent of total: | | |
| Same center | 55.9% | 57.9% |
| New Texas Facilities | 47.9% | 46.0% |
| Total continuing operations | 54.5% | 56.7% |
| Medicare average rate per day: | | |
| Same center | $382.96 | $351.51 |
| New Texas Facilities | $398.02 | $375.13 |
| Total continuing operations | $385.86 | $354.12 |
| Medicaid average rate per day: | | |
| Same center | $146.66 | $142.04 |
| New Texas Facilities | $113.91 | $109.62 |
| Total continuing operations | $140.19 | $138.59 |

On a same center basis, the Company's average rate per day for Medicare Part A patients increased 8.9% in 2008 compared to 2007 as a result of annual inflation adjustments and increased acuity levels of Medicare patients in our nursing centers, as indicated by RUG level scores, which were higher in 2008 than in 2007. Our average rate per day for Medicaid patients increased 3.3% in 2008 compared to 2007 as a result of increasing patient acuity levels and other rate increases in certain states.

*Operating expense* . Operating expense increased to $58.3 million in 2008 from $49.3 million in 2007, an increase of $9.0 million, or 18.4%. Operating expense related to the New Texas Facilities was $12.2 million in 2008 and $5.9 million in 2007. Same center operating expense increased to $46.1 million in 2008 from $43.3 million in 2007, an increase of $2.8 million, or 6.5%. This increase is primarily attributable to cost increases related to wages and benefits and other cost increases as discussed below. On a same center basis, operating expense increased to 78.3% of revenue in 2008, compared to 75.6% of revenue in 2007.

The largest component of operating expenses is wages, which increased to $34.6 million in 2008 from $29.4 million in 2007, an increase of $5.2 million, or 17.8%. Wages related to the New Texas Facilities were approximately $7.4 million in 2008 and $3.4 million in 2007. Same center wages increased approximately $1.2 million, or 4.6%, primarily due to increases in wages as a result of competitive labor markets in most of the areas in which we operate, regular merit and inflationary raises for personnel (increase of approximately 4.6% for the period).

Workers' compensation insurance expense was approximately $0.2 million higher in 2008 compared to 2007. We have had increases in claims costs related to certain prior year claims during 2008, resulting in higher expense.

Operating costs were impacted by higher food and utility expenses. Food costs were approximately $0.2 million higher on a same center basis, an increase in expense per patient day of 17.9%. Utility costs were approximately $0.1 million higher, or approximately 8.6%.

Our three Houston area nursing centers incurred additional costs in 2008 as a result of Hurricane Ike. We incurred approximately $0.2 million in incremental operating costs.

The remaining increases in same center operating expense are primarily due to the effects of increases in patient acuity levels as indicated by RUG level scores, which were higher in 2008, resulting in greater costs to care for these patients.

*Lease expense* . Lease expense increased to $5.8 million in 2008 from $5.2 million in 2007. Lease expense related to the New Texas Facilities was $1.0 million for 2008 and $0.5 million in 2007. Same center lease expense increased to $4.7 million in 2008 from $4.6 million in 2007, primarily due to increases for lessor funded property renovations.

*Professional liability.* Professional liability in 2008 was an expense of $0.3 million, compared to a benefit of $6,000 in 2007, an increase in expense of $0.3 million. Professional liability expense related to the New Texas Facilities was $0.1 million in 2008 and $0.1 million in 2007. Our cash expenditures for professional liability costs were $1.7 million and $0.7 million for 2008 and 2007, respectively. These cash expenditures can fluctuate from year to year. Our total recorded liabilities for self-insured professional liability declined to $17.0 million at September 30, 2008, down from $18.6 million at June 30, 2008.

*General and administrative expense* . General and administrative expense was approximately $4.6 million in 2008 and 2007. As a percentage of revenue, general and administrative expense decreased to 6.4% in 2008 from 7.2% in 2007. General and administrative expense related to the New Texas Facilities was $0.2 million in 2008 and $0.4 million in 2007, including $0.3 million for post acquisition integration costs in 2007. Same center general and administrative expense increased to $4.4 million in 2008 from $4.2 million in 2007, an increase of $0.2 million, or 5.7%. Compensation costs increased by approximately $0.2 million, including normal merit and inflationary increases and new positions added to improve operating and financial controls. Travel costs increased by approximately $0.1 million. These increases were offset by a decrease in incentive compensation expense of $0.3 million.

*Depreciation and amortization* . Depreciation and amortization expense was approximately $1.4 million in 2008 and $1.0 million in 2007. The increase in 2008 is primarily due to depreciation and amortization expenses related to the New Texas Facilities.

*Foreign currency transaction gain (loss)* . A foreign currency transaction loss of $0.1 million was recorded in 2008, compared to a gain of $0.3 million in 2007. Such gains and losses result primarily from foreign currency translation of a note receivable from the sale of our Canadian operations in 2004.

*Interest expense* . Interest expense decreased to $0.7 million in 2008 compared to $1.0 million in 2007. The effects of additional borrowings to complete the SMSA Acquisition were offset by principal payments made during 2007 and 2008, the effects of lower interest rates following our refinancing transaction in 2007, and reductions in variable interest rates during the periods.

*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 $1.2 million in 2008 compared to $3.4 million in 2007. The provision for income taxes was $0.5 million in 2008, an effective rate of 41.6%, compared to $1.4 million in 2007, an effective rate of 40.3%. The basic and diluted income per common share from continuing operations were $0.10 each in 2008, as compared to a basic and diluted income per common share from continuing operations of $0.33 and $0.32, respectively, in 2007.

*Income from discontinued operations* . As discussed in the overview at the start of Management's Discussion and Analysis of Financial Condition and Results of Operations, we have completed certain divestitures and have reclassified our consolidated financial statements to present these divestitures as discontinued operations for all periods presented. Operating loss of discontinued operations, net of taxes, was approximately $4,000 in 2008 and $100,000 in 2007. The disposition of discontinued operations and completions of lease terminations resulted in no gain or loss in 2008 and a gain of $28,000, net of taxes, in 2007.

**Nine Months Ended September 30, 2008 Compared With Nine Months Ended September 30, 2007**

As noted in the overview, during 2007 we completed the SMSA Acquisition and entered into a lease for an additional facility in Texas (together, the "New Texas Facilities"). All results for the New Texas Facilities are included from the effective date of acquisition or inception of lease. Accordingly, the data referenced in comparisons below for the New Texas Facilities is comparing the full nine months of 2008 to a partial period in 2007.

In addition, we have entered into certain divestiture transactions in recent periods, and our consolidated financial statements have been reclassified to present such transactions as discontinued operations. Accordingly, the related revenue, expenses, assets, liabilities and cash flows have been reported separately, and the discussion below addresses principally the results of our continuing operations.

*Patient Revenues* . Patient revenues increased to $214.5 million in 2008 from $173.9 million in 2007, an increase of $40.7 million, or 23.4%. Revenues related to the New Texas Facilities were $38.8 million in 2008 and $6.6 million in 2007. Same center patient revenues increased to $175.7 million in 2008 from $167.3 million in 2007, an increase of $8.4 million, or 5.1%. This increase is primarily due to Medicare rate increases, increased Medicaid rates in certain states and increased private pay and managed care rates and census, partially offset by the effects of lower Medicare and Medicaid census.

The following table summarizes key revenue and census statistics for continuing operations for each period and segregates effects of the New Texas Facilities:

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| Skilled nursing occupancy: | | |
| Same center | 77.9% | 78.7% |
| New Texas Facilities | 65.9% | 68.4% |
| Total continuing operations | 75.0% | 78.2% |
| Medicare census as percent of total: | | |
| Same center | 13.9% | 14.2% |
| New Texas Facilities | 11.9% | 12.0% |
| Total continuing operations | 13.4% | 14.1% |
| Medicare revenues as percent of total: | | |
| Same center | 31.5% | 31.1% |
| New Texas Facilities | 32.7% | 33.1% |
| Total continuing operations | 31.7% | 31.2% |
| Medicaid revenues as percent of total: | | |
| Same center | 54.9% | 56.6% |
| New Texas Facilities | 46.1% | 46.0% |
| Total continuing operations | 53.3% | 56.2% |
| Medicare average rate per day: | | |
| Same center | $379.53 | $344.88 |
| New Texas Facilities | $396.52 | $375.13 |
| Total continuing operations | $382.66 | $346.04 |
| Medicaid average rate per day: | | |
| Same center | $144.76 | $139.05 |
| New Texas Facilities | $113.36 | $109.62 |
| Total continuing operations | $138.76 | $137.89 |

On a same center basis, the Company's average rate per day for Medicare Part A patients increased 10.0% in 2008 compared to 2007 as a result of annual inflation adjustments and increased acuity levels of Medicare patients in our nursing centers, as indicated by RUG level scores, which were higher in 2008 than in 2007. Our average rate per day for Medicaid patients increased 4.1% in 2008 compared to 2007 as a result of increasing patient acuity levels and other rate increases in certain states.

*Operating expense* . Operating expense increased to $169.8 million in 2008 from $132.9 million in 2007, an increase of $36.9 million, or 27.8%. Operating expense related to the New Texas Facilities was $35.1 million in 2008 and $5.9 million in 2007. Same center operating expense increased to $134.8 million in 2008 from $127.0 million in 2007, an increase of $7.8 million, or 6.1%. This increase is primarily attributable to cost increases related to wages and other cost increases discussed below. On a same center basis, operating expense increased to 76.7% of revenue in 2008, compared to 75.9% of revenue in 2007.

The largest component of operating expenses is wages, which increased to $100.9 million in 2008 from $79.3 million in 2007, an increase of $21.6 million, or 27.2%. Wages related to the New Texas Facilities were approximately $21.4 million in 2008 and $3.4 million in 2007. Same center wages increased approximately $3.6 million, or 4.7%, primarily due to increases in wages as a result of competitive labor markets in most of the areas in which we operate, regular merit and inflationary raises for personnel (increase of approximately 4.3% for the period), and labor costs associated with increases in patient acuity levels.

Bad debt expense was $0.4 million higher in 2008 compared to 2007 on a same center basis. During 2007, bad debt expense was lower due to better than expected collections experience.

Workers' compensation insurance expense was approximately $0.5 million higher in 2008 compared to 2007. We have had increases in claims costs related to certain prior year claims during 2008, resulting in higher expense.

Employee health insurance costs were approximately $0.4 million higher in 2008 compared to 2007 on a same center basis. The Company is self insured for the first $150,000 in claims per employee each year. Employee health insurance costs can vary significantly from year to year.

Operating costs were impacted by higher food and utility expenses. Food costs were approximately $0.4 million higher on a same center basis, an increase in expense per patient day of 11.3%. Utility costs were approximately $0.3 million higher, or approximately 7.8%.

Our three Houston area nursing centers incurred additional costs in 2008 as a result of Hurricane Ike. We incurred approximately $0.2 million in incremental operating costs.

The remaining increases in same center operating expense are primarily due to the effects of increases in patient acuity levels as indicated by RUG level scores, which were higher in 2008, resulting in greater costs to care for these patients.

*Lease expense* . Lease expense increased to $17.2 million in 2008 from $14.4 million in 2007. Lease expense related to the New Texas Facilities was $3.0 million for 2008 and $0.5 million in 2007. Same center lease expense increased to $14.2 million in 2008 from $13.8 million in 2007, primarily due to increases for lessor funded property renovations.

*Professional liability.* Professional liability in 2008 was an expense of $0.6 million, compared to a benefit of $3.0 million in 2007, an increase in expense of $3.6 million. Professional liability expense related to the New Texas Facilities was $0.1 million in 2008 and $0.1 million in 2007. Our cash expenditures for professional liability costs were $3.8 million and $2.6 million for 2008 and 2007, respectively. These cash expenditures can fluctuate from year to year. During 2008, our total recorded liabilities for self-insured professional liability declined to $17.0 million at September 30, 2008, a decrease from $20.7 million at December 31, 2007.

*General and administrative expense* . General and administrative expense increased to $13.8 million in 2008 from $12.9 million in 2007, an increase of $0.9 million or 7.2%. As a percentage of revenue, general and administrative expense decreased to 6.5% in 2008 from 7.4% in 2007. General and administrative expense related to the New Texas Facilities was $0.7 million in 2008 and $0.4 million in 2007, including $0.3 million for post acquisition integration costs in 2007. Same center general and administrative expense increased to $13.2 million in 2008 from $12.5 million in 2007, an increase of $0.7 million, or 5.3%. Compensation costs increased by approximately $0.7 million, including normal merit and inflationary increases and new positions added to improve operating and financial controls. Travel costs increased by approximately $0.3 million. Stock- based compensation costs increased by approximately $0.1 million. These increases were partially offset by a decrease in incentive compensation expense of $0.9 million.

*Depreciation and amortization* . Depreciation and amortization expense was approximately $3.9 million in 2008 and $2.9 million in 2007. The increase in 2008 is primarily due to depreciation and amortization expenses related to the New Texas Facilities.

*Foreign currency transaction gain (loss)* . A foreign currency transaction loss of $0.3 million was recorded in 2008, compared to a gain of $0.7 million in 2007. Such gains and losses result primarily from foreign currency translation of a note receivable from the sale of our Canadian operations in 2004.

*Interest expense* . Interest expense decreased to $2.2 million in 2008 from $2.5 million in 2007. The effects of additional borrowings to complete the SMSA Acquisition were offset by principal payments made during 2007 and 2008, the effects of lower interest rates following our refinancing transaction in 2007, and reductions in variable interest rates during the periods.

*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 $6.9 million in 2008 compared to $12.6 million in 2007. The provision for income taxes was $2.5 million in 2008, an effective rate of 35.4%, compared to $4.9 million in 2007, an effective rate of 39.2%. In periods prior to 2001, we generated tax credits under the Work Opportunity Tax Credit program totaling approximately $0.3 million. As we were incurring taxable losses in those years we did not record tax assets related to these credits. During the three months ending March 31, 2008, we recorded these carryforward credits as deferred tax assets as we anticipate using them to reduce our taxes payable in 2008. The impact of recording these assets reduced the effective tax rate for the nine months ending September 30, 2008. The basic and diluted income per common share from continuing operations were $0.74 and $0.71, respectively, in 2008, as compared to a basic and diluted income per common share from continuing operations of $1.26 and $1.21, respectively, in 2007.

*Income from discontinued operations* . As discussed in the overview at the start of Management's Discussion and Analysis of Financial Condition and Results of Operations, we have completed certain divestitures and have reclassified our consolidated financial statements to present these divestitures as discontinued operations for all periods presented. Operating loss of discontinued operations, net of taxes, was approximately $35,000 in 2008, compared to $101,000 in 2007. The disposition of discontinued operations and completions of lease terminations resulted in no gain or loss in 2008 and a loss of $7,000, net of taxes, in 2007.

## Liquidity and Capital Resources

*Capital Resources*

As of September 30, 2008, we had $32.9 million of outstanding borrowings, including $4.1 million in payments scheduled to be made in the next twelve months. The $4.1 million in payments to be made during the next twelve months includes approximately $2.0 million to be paid on our term loan upon collection of a note receivable.

In August 2007, we entered into an agreement with a bank for a $16.5 million term loan to finance the SMSA acquisition and repay certain existing indebtedness. The term loan has an interest rate of LIBOR plus 2.5%, and principal payments based on a ten year amortization, with additional payments based on cash flow from operations and amounts realized related to certain collateral and matures in August 2012. The term loan is secured by receivables and all other unencumbered assets of the company, including land held for sale, insurance refunds receivable and notes receivable. This term loan has an outstanding balance of $11.1 million as of September 30, 2008.

The bank loan agreement also includes a $15 million revolving credit facility that provides for revolving credit loans as well as the issuance of letters of credit. The revolver is secured by accounts receivable and provides for a maximum draw of up to $15 million. There are limits on the maximum amount of loans that may be outstanding under the revolver based on borrowing base restrictions. The revolver has a term of three years, expiring in August 2010, and bears interest at our option of LIBOR plus 2.25% or the bank's prime lending rate. Annual fees for letters of credit issued under this revolver are 2.25% of the amount outstanding. We have issued a letter of credit of approximately $8.1 million to serve as a security deposit for our leases with Omega. Considering the balance of eligible accounts receivable at September 30, 2008, the letter of credit and the current maximum loan of $15 million, the balance available for future revolving credit loans would

be $6.5 million. As of September 30, 2008, we had no borrowings outstanding under our revolving credit facility.

Our debt agreements contain various financial covenants the most restrictive of which relate to cash flow, debt service coverage ratios, liquidity and limits on the payment of dividends to shareholders. We are in compliance with such covenants at September 30, 2008, with the exception of the Minimum Fixed Charge Coverage Covenant related to our term loan. The Minimum Fixed Charge Coverage Covenant was impacted by a combination of the decline in our operating performance and increased capital expenditures. On November 3, 2008 we received a covenant waiver from the bank effective for the period ending September 30, 2008 through the earlier of October 1, 2009 or the date we amend the Minimum Fixed Charge Coverage Covenant. We are currently in discussions with the bank to amend the provisions of the Minimum Fixed Charge Coverage Covenant, and the terms of the waiver require that this amendment be completed by December 31, 2008. It is anticipated that the amendment will be completed in the fourth quarter of 2008 and that we will be in compliance with the proposed covenant for at least the next twelve months.

We are subject to a covenant under our mortgage loan that requires us to maintain a combined occupancy for seven owned homes that serve as collateral for the mortgage loan. We are in compliance with the covenant at September 30, 2008, however, the covenant becomes more restrictive as of December 31, 2008 and based on our occupancy at September 30, 2008, we would not be in compliance with the more restrictive covenant. We are currently in discussions with the mortgage lender to amend these covenants, and based on our discussions with the lender and forecasted occupancy at these facilities, we anticipate we will remain in compliance with the revised covenant for at least the next twelve months.

There can be no assurances that we will be able to successfully negotiate these proposed amendments to our debt agreements, or meet all of the covenants set forth in our amended debt agreements. A failure to meet any such covenant could have a material adverse effect on us.

*New Facility Construction*

In November 2007, we entered into a short-term, single facility lease with Omega for an existing 102 bed skilled nursing center in Paris, Texas, and undertook an evaluation of the feasibility of entering into an agreement with Omega for the construction of a replacement facility. On March 14, 2008, we entered into an amendment to our master lease with Omega to provide for the construction and lease of a replacement facility. Upon the completion of the construction of the replacement facility, the existing building will be closed and the single facility lease terminated.

Under the terms of the lease amendment, Omega will provide funding and we will supervise the construction of the facility. Construction began during the second quarter of 2008, with completion expected in mid-2009. Rent will commence upon completion of the project, but no later than August 2009. Once construction is completed, annual rent will be equal to 10.25% of the total cost of the replacement facility, including direct costs of construction, carrying costs during the construction period, furnishings and equipment, land cost and the value of the related skilled nursing facility license. The total cost of the replacement facility was originally expected to be approximately $7.0 million and is currently expected to be approximately $7.9 million. Under the terms of the March 14, 2008 lease amendment and an October 24, 2008 lease amendment, costs incurred in excess of the current estimated cost of $7.9 million would be borne by us. The lease amendment provides for renewal options with respect to the new facility through 2035.

The replacement facility will be subject to the requirements of our current master lease, with certain exceptions for capital spending requirements. At the fifth anniversary of rent commencement for the replacement facility, we may terminate the lease with respect to this facility. Beginning 18 months after the facility commences operations and continuing until the fifth anniversary of rent commencement, Omega may terminate the lease for this facility if the cash flow of the facility (as

defined in the lease amendment) is less than 1.2 times the then existing rent. If we elect to continue the lease, annual rentals for this facility may be increased by an amount equal to one half of the amount of the cash flow of the facility (as defined in the lease amendment) in excess of 1.2 times the then existing rent, effective as of the start of the sixth year after the completion of the building. If at any time beginning 18 months after the completion of the building the average annual cash flow of the facility exceeds 1.3 times the then existing rent, the termination options of both Omega and the Company are eliminated, and the rent reset provisions described above are eliminated.

As previously disclosed, we have entered into an option agreement to purchase certain assets of a skilled nursing facility in West Virginia. We made an application to state regulatory authorities to allow us to operate the facility, and this application was approved in February 2008, subject to rights of appeal by contesting parties. The period for appeal terminated during 2008. As of September 30, 2008, we have advanced a total of $0.9 million toward the purchase of these assets. We plan to arrange financing and construct a new 90 bed replacement facility. However, no assurances can be given we will be able to arrange construction financing on suitable terms for this project.

*Share Repurchase*

In November 2007, the Company's Board of Directors authorized the repurchase of up to $2.5 million of our common stock pursuant to a plan under Rule 10b5-1 and in compliance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended. As of November 1, 2007, there were approximately 5.9 million shares of common stock outstanding.

From the inception of the plan in November 2007 through April 2008, we purchased a total of 231,800 shares for $2.5 million, the maximum amount authorized by our plan. Repurchases were made through open market or privately negotiated transactions in accordance with all applicable securities laws, rules, and regulations and were funded from available working capital.

*Professional Liability*

We have numerous pending liability claims, disputes and legal actions for professional liability and other related issues. For several years, due to our past claim experience and increasing cost of claims throughout the long-term care industry, the premiums paid by us for professional liability and other liability insurance exceeded the coverage purchased so that it cost more than $1 to purchase $1 of insurance coverage. For this reason, effective March 9, 2001, we purchased professional liability insurance coverage for our facilities that, based on historical claims experience, was substantially less than the amount required to satisfy claims that were incurred. As a result, we have been effectively self-insured. We have essentially exhausted all general and professional liability insurance available for claims first asserted prior to March 10, 2007. For claims made during the period from March 10, 2007 through March 9, 2009, we maintain insurance coverage limits of $100,000 per medical incident and total annual aggregate policy coverage limits of $500,000. As of September 30, 2008, payments already made by the insurance provider for the period from March 10, 2007 through March 9, 2009 have reduced the remaining aggregate coverage amount in the policy period, but coverage has not been exhausted.

As of September 30, 2008, we have recorded total liabilities for reported and settled professional liability claims and estimates for incurred but unreported claims of $17.0 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. In April 2008, we entered into individual agreements to settle eight professional liability cases for a total of $5.0 million, including $200,000 paid from insurance proceeds. These settlements will be paid in installments from April 2008 through January 2009. As of September 30, 2008, we are obligated to pay installments that total $2.1 million related to these settlements. The remaining obligation for these claims is fully accrued

and included in the accrual for professional liability claims. The defense of and settlements related to other pending claims will require additional cash expenditures.

*Liquidity*

Net cash provided by operating activities of continuing operations totaled $8.9 million and $7.1 million in 2008 and 2007, respectively. Discontinued operations used cash of $35,000 and $21,000 in 2008 and 2007, respectively.

Investing activities of continuing operations used cash of $6.9 million and $11.2 million in 2008 and 2007, respectively. These amounts primarily represent cash used for purchases of property and equipment and the SMSA Acquisition in 2007. We have used between $3.4 million and $6.8 million for capital expenditures of continuing operations in each of the three calendar years ended December 31, 2007. The capital expenditures we made during 2007 were driven by three nursing center renovation projects or initiatives that totaled $3.6 million of the $6.8 million spent in total. We spent $0.6 million and $0.8 million at owned facilities in Arkansas and Texas, respectively, as well as $2.2 million at our New Texas facilities. Such expenditures were primarily for facility improvements and equipment, which were financed principally through working capital. For the year ending December 31, 2008, we anticipate that capital expenditures for improvements and equipment for our existing facility operations will be higher as we complete facility renovations and significant projects at certain owned and leased facilities. We expect to use approximately $3.3 million of working capital for facility renovation projects in 2008. Cash used in investing activities of continuing operations were offset by collections of a note receivable of $0.8 million and $0.7 million in 2008 and 2007, respectively. Discontinued operations used cash of $49,000 in 2008 and there were no cash flows from investing activities of discontinued operations in 2007.

Financing activities of continuing operations used cash of $3.6 million in 2008 and provided cash of $5.8 million in 2007. The cash used in 2008 resulted primarily from the repayment of debt obligations as well as the repurchase of $1.7 million of our common stock in 2008. The cash provided in 2007 resulted from the issuance of debt offset by payments to retire existing debt. There were no cash flows from financing activities of discontinued operations in 2008 or 2007. No interest costs or debt were allocated to discontinued operations.

**Amendment to Shareholders' Rights Plan**

On August 1, 2008, the Company's Board of Directors approved amending our current Amended and Restated Rights Agreement (the "Rights Agreement"). The amendment provides for an increase of the exercise price of the rights under the Rights Agreement (the "Rights") to $50 from $15 and for the extension of the Expiration Date of the Rights to August 2, 2018. In addition, the amendment includes a share exchange feature that provides the Company's Board of Directors the option of exchanging, in whole or in part, each Right, other than those of the hostile acquiring holder, for one share of our common stock. This provision is intended to avoid requiring Rights holders to pay cash to exercise their Rights and to alleviate the uncertainty as to whether holders will exercise their Rights.

**Facility 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, 2008, we have completed renovation projects at eight facilities and have three additional renovation projects in progress, with one completed in October 2008 and expected completion of another in November 2008. The third facility renovation is expected to be completed in 2009.

A total of $13.8 million has been spent on these renovation programs to date, with $10.0 million financed through Omega and $3.8 million financed with internally generated cash. The amounts financed by Omega have resulted in increased rent and are not reflected as capital expenditures. The total renovation funding commitment from Omega was $10.0 million, which we exhausted during the third quarter of 2008 with the two projects completed in the fourth quarter of 2008. We expect to fund the costs of current renovations with working capital.

For the eight facilities with renovations completed before the beginning of the third quarter 2008 compared to the last twelve months prior to the commencement of renovation, average occupancy increased from 63.2% to 70.7% and Medicare average daily census increased from a total of 81 to 88 in the third quarter of 2008. No assurance can be given that these facilities will continue to show such occupancy or Medicare average daily census improvement or that the other renovated facilities will experience similar improvements.

**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 $26.6 million at September 30, 2008, compared to $27.9 million at December 31, 2007, representing approximately 34 and 37 days revenue in accounts receivable at each period end, respectively. As part of the procedural Medicare and Medicaid change of ownership process, payments from Medicaid and Medicare for the New Texas facilities were temporarily delayed, and $4.7 million of the balance in receivables at December 31, 2007 was due to these delays. These amounts were substantially collected prior to September 30, 2008. As of September 30, 2008, Alabama Medicaid payments due in September 2008 were temporarily delayed for Alabama nursing facilities until the first week of October, 2008, resulting in an increase to our accounts receivable of approximately $1.8 million at September 30, 2008. Excluding these payor delays, our days revenue in accounts receivable are 32 and 31 days as of September 30, 2008 and December 31, 2007, respectively.

The allowance for bad debt was $3.2 million at September 30, 2008, compared to $2.2 million at December 31, 2007. 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**

We do not believe that our operations have been materially affected by inflation for the three most recent years; however, in the third quarter of 2008, the cost of food and utilities at our nursing facilities increased at a higher than expected rate. We are unsure whether this rate of increase will continue in future periods. We expect salary and wage increases for our skilled staff to continue to be higher than average salary and wage increases, as is common in the health care industry.

### Off-Balance Sheet Arrangements

We had letters of credit outstanding of approximately $8.1 million as of September 30, 2008, which serves as a security deposit for our facility leases with Omega. The letters of credit were in connection with our revolving credit facility. Our accounts receivable serve as the collateral for this revolving credit facility.

### Recent Accounting Pronouncements

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles (“GAAP”)” (“SFAS No. 162”). The purpose of the new standard is to provide a consistent framework for determining what accounting principles should be used when preparing U.S. GAAP financial statements. Previous guidance did not properly rank the accounting literature. The new standard is effective 60 days following the Securities and Exchange Commission’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.* The adoption of SFAS No. 162 is not expected to have a material effect on our financial statements.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS No. 157”). This new standard provides guidance for using fair value to measure assets and liabilities and establishes a fair value hierarchy that prioritizes the information used to develop the measurements. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. The provisions of SFAS No. 157 were effective for us beginning January 1, 2008. The adoption of SFAS No. 157 did not have an impact on our financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities — including an Amendment of FASB Statement No. 115” (“SFAS No. 159”). The new standard permits entities to choose to measure many financial instruments and certain other items at fair value. Most provisions of SFAS No. 159 will only impact those entities that elect the fair value option or have investments accounted for under FASB Statement No. 115. The provisions of SFAS No. 159 were effective for us beginning January 1, 2008. The adoption of this new standard did not have an impact on our financial position.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), “Business Combinations” (“SFAS No. 141R”). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree as well as the goodwill acquired or gain recognized in a bargain purchase. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. The provisions of SFAS No. 141R will be effective for us beginning January 1, 2009. We are currently assessing the impact, if any, the new standard will have on our financial position, results of operations and cash flows.

### 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 Annual Report on Form 10-K for the year ended December 31, 2007. 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 integrate the acquired skilled nursing facilities into our business and achieve the anticipated cost savings, our ability to successfully construct and operate the Paris replacement facility, our ability to increase census at our renovated facilities, changes in governmental reimbursement, government regulation and health care reforms, the increased cost of borrowing under our credit agreements, a failure to comply with covenants contained in those credit agreements, 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 regulatory proceedings alleging violations of laws and regulations governing quality of care or violations of other laws and regulations applicable to our business, our ability to control costs, changes to our valuation of deferred tax assets, changes in occupancy rates in our facilities, changing economic conditions 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 Part II. “Item 1A. Risk Factors” below 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, 2008, we had outstanding borrowings of approximately $32.9 million, all of which are at variable rates of interest. In the event that interest rates were to change 1%, the impact on future cash flows would be approximately $0.3 million annually, representing the impact of increased or decreased interest expense on variable rate debt.

We have a note receivable denominated in Canadian dollars related to the sale of our Canadian operations. This note is currently recorded on our balance sheet at $4.7 million US based on the outstanding balance of the note and the exchange rate as of September 30, 2008. The carrying value of the note in our financial statements will be increased or decreased each period based on fluctuations in the exchange rate between US and Canadian currencies, and the effect of such changes will be included as income or loss in our income statements in the period of change. In the nine month periods ended September 30, 2008 and 2007, we reported transaction gains (losses) of $(293,000) and $743,000, respectively, as a result of the effect of changes in the currency exchange rates on this note. A further change of 1% in the exchange rate between US and Canadian currencies would result in a corresponding increase or decrease to earnings of approximately $47,000.

## 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, 2008. 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, 2008 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.

As of September 30, 2008, we were engaged in 29 professional liability lawsuits, as compared to 24 professional liability lawsuits as of December 31, 2007. Two lawsuits are currently scheduled for trial within the next year and we expect that additional cases will be set for trial during this period. In April 2008, we entered into individual agreements to settle eight professional liability cases for $5.0 million, including $200,000 paid from insurance proceeds. These settlements will be paid in installments from April 2008 through January 2009. As of September 30, 2008, we are obligated to pay installments that total $2.1 million related to these settlements. The remaining obligation for these claims is fully accrued and is included in the accrual for professional liability claims. 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.

The Company has initiated litigation filed in the United States Bankruptcy Court for the Northern District of Texas against SMSA, Lyric Health Care Holdings, Inc., IHS Acquisition No. 128, Inc. and Lyric Health Care LLC adversary proceeding number 08-03393. The Company is seeking a declaratory judgment that the defendants are responsible for the overpayments claimed by CMS as described in Note 3 to the Notes to the Financial Statements. The claimed overpayments at issue occurred several years prior to our purchase of the facility, and the defendants are prior owners of the facility. This litigation has only recently begun, and the Company does not anticipate that it will be resolved in the near future.

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 have a material adverse impact on our financial condition, cash flows or results of operations and could also subject us to fines, penalties and damages. Moreover, we could be excluded from the Medicare, Medicaid or other state or federally-funded health care programs, which would also have a material adverse impact on our financial condition, cash flows or results of operations.

## ITEM 1A. RISK FACTORS

Information regarding risk factors appears in “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Forward-Looking Statements,” in Part I — Item 2 of this Form 10-Q and in “Risk Factors” in Part I — Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007. In addition to the risk factors previously disclosed in our Annual Report on Form 10-K, the following factor could cause our results to differ from our expectations.

**If we are unable to improve occupancy and increase profitability of the operations of the facilities acquired in August 2007 from Senior Management Services, our profits will continue to be lower than the profits generated prior to completion of that acquisition.**

During the second and third quarters of 2008, the facilities we acquired in August 2007 from Senior Management Services incurred losses from continuing operations before taxes. If we do not improve the occupancy, occupancy mix and profitability of these acquired facilities, their financial performance will continue to negatively affect our overall performance and will continue to reduce our profits as compared to the profits generated prior to the completion of that acquisition.

**If we are unable to complete construction of the Paris, Texas replacement facility in a timely manner and at our budgeted costs, and if we are unable to develop the necessary census and payor mix as projected, we will not realize the anticipated potential benefits from the project and our business and results of operations could be adversely affected.**

The completion of the construction of the Paris, Texas replacement facility will require that we complete construction in a timely manner and at budgeted costs. The total cost of the replacement facility is expected to be approximately $7.9 million. Construction costs in excess of $7.9 million will be borne by us and if the building is not ready to be operated at July 31, 2009, we will be required to pay rent on a building not in use. Successful construction will depend on our ability to supervise construction such that the building is ready for use substantially on time and that construction costs are substantially within the amounts budgeted. Our ability to develop the necessary census and payor mix to justify the increased rent associated with the new building will require that we maintain our existing census as well as increase our current market share among new residents, especially the more desirable payor types. Difficulties could include delayed or more costly construction than was anticipated, increased demands on our management, financial, technical and other resources, a decline in census or a less than desired increase in census, unsatisfactory mix of resident payor sources and unanticipated cost increases. Some of these factors are beyond our control. If we are unable to successfully complete the project, we will not realize the anticipated potential benefits from the project and our business and results of operations would be adversely affected.

## ITEM 6. EXHIBITS

The exhibits filed as part of this quarterly 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 6, 2008

By: /s/ William R. Council, III
William R. Council, III
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 | 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). |
| 3.5 | 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 | Rights Agreement dated March 13, 1995, between the Company and Third National Bank in Nashville (incorporated by reference to Exhibit 1 to the Company's Current Report on Form 8-K dated March 13, 1995). |
| 4.3 | Summary of Shareholder Rights Plan adopted March 13, 1995 (incorporated by reference to Exhibit B of Exhibit 1 to Form 8-A filed March 30, 1995). |
| 4.4 | Rights Agreement of Advocat Inc. dated March 23, 1995 (incorporated by reference to Exhibit 1 to Form 8-A filed March 30, 1995). |
| 4.5 | 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). |
| 4.6 | Second Amendment to Amended and Restated Rights Agreement, dated as of August 15, 2008, between Advocat, Inc. and Computershare Trust Company, N.A., a federally chartered trust company, as successor to SunTrust Bank, (incorporated by reference to the Company's Registration Statement on Form 8-A/A filed on August 19, 2008). |
| 10.1 | Seventh Amendment to Consolidated Amended and Restated Master Lease executed and delivered as of October 24, 2008 by and between Sterling Acquisition Corp., a Kentucky corporation and Diversicare Leasing Corp **.** |
| 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). |

**Exhibit 10.1**

SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

This Seventh Amendment to Consolidated Amended and Restated Master Lease (this " Amendment ") is executed and delivered as of October 24, 2008 by and between STERLING ACQUISITION CORP., a Kentucky corporation (" Lessor "), the address of which is 9690 Deereco Road, Suite 100, Timonium, MD 21093, and DIVERSICARE LEASING CORP., a Tennessee corporation, the address of which is 1621 Galleria Boulevard, Brentwood, TN 37027.

RECITALS:

A. Lessee has executed and delivered to Lessor a Consolidated Amended and Restated Master Lease dated as of November 8, 2000, but effective as of October 1, 2000 (the " Master Lease "), as amended by a First Amendment to Consolidated Amended and Restated Master Lease dated as of September 30, 2001 (the " First Amendment "), a Second Amendment to Consolidated Amended and Restated Master Lease dated as of June 15, 2005 (the " Second Amendment "), a Third Amendment to Consolidated Amended and Restated Master Lease dated as of October 20, 2006 (the " Third Amendment "), a Fourth Amendment to Consolidated Amended and Restated Master Lease dated as of April 1, 2007 (the " Fourth Amendment "), a Fifth Amendment to Consolidated Amended and Restated Master Lease dated as of August 10, 2007 (the " Fifth Amendment "), and a Sixth Amendment to Consolidated Amended and Restated Master Lease dated as of March 14, 2008 (the " Sixth Amendment ") (collectively, the " Existing Master Lease ") pursuant to which Lessee leases from Lessor certain healthcare facilities.

B. Lessee and Lessor desire to amend certain terms used and set forth in the Sixth Amendment and to provide Lessor and Lessee with certain additional rights and options under the Sixth Amendment with respect to the Paris Facility described therein.

NOW THEREFORE, the parties agree as follows:

1. Definitions.

(a) Any capitalized term used but not defined in this Amendment will have the meaning assigned to such term in the Master Lease. From and after the date of this Amendment, each reference in the Existing Master Lease or the other Transaction Documents to the "Lease" or "Master Lease" means, as applicable, the Existing Master Lease as modified by this Amendment.

(b) The following definitions defined in Section 1(b) of the Sixth Amendment are hereby amended in their entirety and restated as follows:

" Maximum Funded Amount " means Seven Million Nine Hundred Thirty-Four Thousand Five Hundred Fifty-Five and No/100 Dollars ($7,934,555.00).

" Paris Cash Flow ": For any period, the sum of (a) Net Income of Lessee arising solely from the operation of the Paris Facility for the applicable period, and (b) the amounts deducted in computing Lessee's Net Income for the period for (i) the provision for self-insured, professional and general liability, (ii) depreciation, (iii) amortization, (iv)

Paris Base Rent, (v) interest (including payments in the nature of interest under Capitalized Leases and interest on any Purchase Money Financing for personal property used in connection with the Paris Facility), (vi) income taxes (or, if greater, income tax actually paid during the period attributable to the Paris Facility), and (vii) management fees payable in connection with the Paris Facility, and less (c) an imputed management fee equal to five percent (5%) of Gross Revenues for the Paris Facility, and less (d) the Cash Cost of Self-Insured Professional and General Liability attributable to the Paris Facility. The Cash Cost of Self-Insured Professional and General Liability shall mean: For any period, the average total per bed cash expenditure associated with professional and general liability related settlements, judgments, legal fees or administration for skilled nursing facilities in the State of Texas as from time to time estimated and published by Aon Risk Consultants, or its successors, for the American Health Care Association, multiplied by the average number of occupied beds in the Paris Facility.

(c) The following new definitions are hereby added to Section 1(b) of the Sixth Amendment:

" Initial Rent Coverage Determination Date " shall mean the date that is the first day of the first calendar month immediately following the expiration of the first eighteen (18) months after the In Service Date.

" Rent Coverage Determination Date " shall mean and include the Initial Rent Coverage Determination Date and the first day of each successive calendar month thereafter.

2. Amendments to Certain Schedules Attached to the Sixth Amendment . Schedule 1, Construction Budget, attached to the Sixth Amendment is amended in its entirety and replaced with Schedule 1, Construction Budget, attached to this Amendment.

3. Amendments to Certain provisions of Existing Master Lease . Section 2 of the Sixth Amendment is hereby amended in its entirety and restated as follows:

"2. Paris Base Rent; Rent Reset; Termination Options; a "Texas Facility"; Delay.

(a) Paris Base Rent Commencement Date . Commencing as of the Paris Base Rent Commencement Date, Lessee shall pay the Paris Base Rent pursuant to the terms and conditions of Article III of the Master Lease. Notwithstanding the commencement of payment of the Paris Base Rent by Lessee, in the event that the construction of the Paris Facility has not been completed and the Maximum Funded amount has not been advanced by the Paris Rent Commencement Date, Lessor shall continue to make further advances of the Funded Amount, up to but not exceeding the Maximum Funded Amount, on or after the Paris Base Rent Commencement Date in accordance with the terms of this Amendment.

(b) Paris Base Rent Reset . If Lessee has not elected to terminate the Master Lease as to the Paris Facility pursuant to sub-section (c) below, and subject to sub-section (e), below, as soon as reasonably possible after the fifth anniversary of the Paris Base Rent Commencement Date, Lessor and Lessee shall calculate the Paris Formula Rent. If the Paris

Formula Rent is greater than the Paris Scheduled Rent, then the Paris Base Rent shall be reset to the Paris Formula Rent effective as of the Paris Rent Reset Date.

(c) Lessee's Paris Termination Option . Subject to sub-section (e), below, pursuant to written notice (" Lessee's Paris Termination Notice ") delivered by Lessee to Lessor not more than thirty (30) days prior to, nor later than, the fifth anniversary of the Paris Base Rent Commencement Date (" Lessee's Paris Termination Period "), Lessee may elect to terminate the Master Lease as to the Paris Facility only. After delivery of the Paris Termination Notice, this Lease shall be terminated as to the Paris Facility only, effective on the earlier of (i) a date set by written notice given by Lessor at least thirty (30) days prior to the effective date, and (ii) the first day of the sixth month after fifth anniversary of the Paris Base Rent Commencement Date (the " Lessee Paris Termination Date "). If Lessee's Paris Termination Notice is delivered, then Lessee shall have no further obligation to pay Paris Base Rent for periods from and after the Lessee Paris Termination Date.

(d) Lessor's Paris Termination Option . As soon as reasonably possible after the Initial Rent Coverage Determination Date and, subject to sub-section (e), below, each subsequent Rent Coverage Determination Date thereafter occurring up to but not later than the date that is thirty (30) days prior to the commencement of Lessee's Paris Termination Period, Lessor and Lessee shall calculate the Paris Cash Flow for the six (6) month period ending immediately prior to such Rent Coverage Determination Date. In the event that the average annual Paris Cash Flow as determined, on a rolling basis, for the six (6) month period ending immediately prior to any such Rent Coverage Determination Date is less than the Paris Base Rent multiplied by 1.2 (the " Minimum Rent Coverage "), then Lessor may elect to terminate the Master Lease as to the Paris Facility only. Such election shall be made by delivery of written notice (" Lessor's Paris Termination Notice ") to Lessee not more than thirty (30) days after the determination by Lessor and Lessee of the Paris Cash Flow for the Rent Coverage Determination Date in question (but, as to the final such Rent Coverage Determination Date, prior to the commencement of Lessee's Paris Termination Period). Upon delivery of Lessor's Paris Termination Notice, the Master Lease shall be terminated as to the Paris Facility only, effective on the earlier of (i) a date set by written notice given by Lessor at least thirty (30) days prior to the effective date and (ii) the first day of the sixth calendar month after the date of Lessor's Paris Termination Notice (" Lessor's Paris Termination Date "). If Lessor's Paris Termination Notice is delivered, then Lessee shall have no further obligation to pay Paris Base Rent for periods from and after Lessor's Paris Termination Date.

(e) Elimination of Termination by Lessee or Lessor and Rent Reset . If for any Rent Coverage Determination Date occurring up to but not later than thirty (30) days prior to the commencement of Lessee's Paris Termination Period, the average annual Paris Cash Flow as determined, on a rolling basis, for the six (6) month period ending immediately prior to such Rent Coverage Determination Date is more than the Paris Base Rent multiplied by 1.3 (the " Maximum Rent Coverage ") then: (i) the right of the Lessee to terminate the Master Lease as to the Paris Facility provided for in sub-section (c), above, shall automatically terminate and be of no further force and effect, (ii) the right of the Lessor to terminate the Master Lease provided for in sub-section (d), above, shall automatically terminate and be of no further force and effect, and (iii) the Paris Base Rent reset provisions set forth in sub-section (b), above, shall automatically terminate and be of no further force and effect. In such event, Lessee shall not have the right to

elect to terminate the Master Lease on the fifth anniversary of the Paris Base Rent Commencement Date as provided in sub-section (e), above, Lessor shall no longer have the right to elect to terminate the Master Lease due to the failure of Lessee to achieve the Minimum Rent Coverage as provided in sub-section (d), above, and there shall be no resetting of the Paris Base Rent to the Paris Formula Rent after the fifth anniversary of the Paris Base Rent Commencement Date as provided in sub-section (b), above. Thereafter, the defined terms "Paris Formula Rent" and "Paris Rent Reset Date" and the provisions of sub-section (a)(4) of the defined term "Paris Base Rent" regarding adjustment of the Paris Base Rent to the Paris Formula Rent shall have no further force and effect and shall be deleted from Section 1 of the Sixth Amendment.

(f) Texas Facility . For all purposes under this Lease other than the calculation of Base Rent, the Paris Facility shall constitute a Texas Facility.

(g) Delay . In the event that Lessee is unable to obtain completion of the Paris Facility as described in Section 6(a) below by the Target Completion Date due to an Event of Force Majeure or Lessor Delay, then the Target Completion Date and the Paris Base Rent Commencement Date shall each be extended by one (1) day for each one (1) day of delay in the completion of the Paris Facility caused by such Event of Force Majeure or Lessor Delay. For purposes of this Amendment, the term "Lessor Delay" shall mean any delay in achieving completion of the Paris Facility as described in Section 6(a) below arising solely and directly as a result of:

(i) Lessor's failure to furnish any information or documents in accordance with this Amendment and the continuation of such failure after the receipt of written notice from Lessee to Lessor, to the extent such failure causes a delay in completion;

(ii) Lessor's failure or delay in giving approval or consent (or comments or corrections) where Lessor's approval or consent (or comments or corrections), as applicable, is required herein and has been requested in writing by Lessee, to the extent such failure or delay causes a delay in completion; and

(iii) Lessor's failure to perform or comply with its obligations under this Amendment and the continuation of such failure after the receipt of written notice from Lessee to Lessor, to the extent such failure causes a delay."

4. Representations and Warranties of Lessee . Lessee hereby represents and warrants to Lessor that (i) it has the right and power and is duly authorized to enter into this Amendment; and (ii) the execution of this Amendment does not and will not constitute a breach of any provision contained in any agreement or instrument to which Lessee is or may become a party or by which Lessee is or may be bound or affected.

5. Execution and Counterparts . This Amendment may be executed in any number of counterparts, each of which, when so executed and delivered, shall be deemed to be an original, but when taken together shall constitute one and the same Amendment.

6. Headings . Section headings used in this Amendment are for reference only and shall not affect the construction of the Amendment.

7. Enforceability . Except as expressly and specifically set forth herein, the Existing Master Lease remains unmodified and in full force and effect. In the event of any discrepancy between the Existing Master Lease and this Amendment, the terms and conditions of this Amendment will control and the Existing Master Lease is deemed amended to conform hereto.

[SIGNATURE PAGES AND ACKNOWLEDGEMENTS FOLLOW]

*Signature Page to*
SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

LESSOR:

STERLING ACQUISITION CORP.,
a Kentucky corporation

By: /s/ Taylor Pickett
Name: Taylor Pickett
Title: Chief Executive Officer

STATE OF MARYLAND )

COUNTY OF BALTIMORE )

This instrument was acknowledged before me on the ___ day of October, 2008, by Taylor Pickett, the CEO of STERLING ACQUISITION CORP., a Kentucky corporation, on behalf of said company.

_____
Notary Public, Baltimore County, MD
My commission expires: _____

*Signature Page to*
SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

LESSEE:

DIVERSICARE LEASING CORP.,
a Tennessee corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Title: EVP and CFO

STATE OF TENNESSEE )

COUNTY OF WILLIAMSON )

This instrument was acknowledged before me on the ___ day of October, 2008, by Glynn Riddle, the EVP & CFO of DIVERSICARE LEASING CORP., a Tennessee corporation, on behalf of said company

_____
Notary Public, Tenn. County, Williamson
My commission expires: _____

*Acknowledgment to*
SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

The undersigned hereby consent to the transactions contemplated by this Seventh Amendment to Consolidated Amended and Restated Master Lease (the " Seventh Amendment "), ratify and affirm their respective Guaranties, Pledge Agreements, Security Agreements, Subordination Agreements and other Transaction Documents, and acknowledge and agree that the performance of the Master Lease and obligations described therein are secured by their Guaranties, Pledge Agreements, Security Agreement, Subordination Agreement and other Transaction Documents on the same terms and conditions in effect prior to this Seventh Amendment.

ADVOCAT, INC. a Delaware corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Title: EVP & CFO

STATE OF TENNESSEE )

COUNTY OF WILLIAMSON )

The foregoing instrument was acknowledged before me this ___ day of October, 2008, by Glynn Riddle, who is EVP & CFO of ADVOCAT, INC. a Delaware corporation, on behalf of the corporation, who acknowledged the same to be his or her free act and deed and the free act and deed of the corporation.

Notary Public, Tenn. County, Williamson
My Commission Expires: _____

*Acknowledgment to*
SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

DIVERSICARE MANAGEMENT SERVICES CO.,
a Tennessee corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Title: EVP & CFO

STATE OF TENNESSEE )

COUNTY OF WILLIAMSON )

The foregoing instrument was acknowledged before me this ___ day of October, 2008, by Glynn Riddle, who is EVP & CFO of DIVERSICARE MANAGEMENT SERVICES CO., a Tennessee corporation, on behalf of the corporation, who acknowledged the same to be his or her free act and deed and the free act and deed of the corporation.

_____
Notary Public, Tenn. County, Williamson
My Commission Expires: _____

*Acknowledgment to*
SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

ADVOCAT FINANCE INC.,
a Delaware corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Title: EVP & CFO

STATE OF TENNESSEE )

COUNTY OF WILLIAMSON )

The foregoing instrument was acknowledged before me this ___ day of October, 2008, by Glynn Riddle, who is EVP & CFO of ADVOCAT FINANCE INC., a Delaware corporation, on behalf of the corporation, who acknowledged the same to be his or her free act and deed and the free act and deed of the corporation.

_____
Notary Public, Tenn. County, Williamson
My Commission Expires: _____

*Acknowledgment to*
SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

STERLING HEALTH CARE
MANAGEMENT, INC., a Kentucky corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Title: EVP & CFO

STATE OF TENNESSEE )

COUNTY OF WILLIAMSON )

The foregoing instrument was acknowledged before me this ___ day of October, 2008, by Glynn Riddle, who is EVP & CFO of STERLING HEALTH CARE MANAGEMENT, INC., a Kentucky corporation, on behalf of the corporation, who acknowledged the same to be his or her free act and deed and the free act and deed of the corporation.

_____
Notary Public, Tenn. County, Williamson
My Commission Expires: _____

*Acknowledgment to*
SEVENTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

DIVERSICARE TEXAS I, LLC

By: /s/ Glynn Riddle
Name: Glynn Riddle
Title: EVP & CFO

DIVERSICARE BALLINGER, LLC
DIVERSICARE DOCTORS, LLC
DIVERSICARE ESTATES, LLC
DIVERSICARE HUMBLE, LLC
DIVERSICARE KATY, LLC
DIVERSICARE NORMANDY TERRACE, LLC
DIVERSICARE TREEMONT, LLC

BY: DIVERSICARE TEXAS I, LLC,
its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Title: EVP & CFO

STATE OF TENNESSEE )

COUNTY OF WILLIAMSON )

The foregoing instrument was acknowledged before me this ___ day of October, 2008, by Glynn Riddle, who is EVP & CFO of DIVERSICARE TEXAS I, LLC, on behalf of itself and as the sole member of each of DIVERSICARE BALLINGER, LLC, DIVERSICARE DOCTORS, LLC, DIVERSICARE ESTATES, LLC, DIVERSICARE HUMBLE, LLC, DIVERSICARE KATY, LLC, DIVERSICARE NORMANDY TERRACE, LLC, and DIVERSICARE TREEMONT, LLC, each a Delaware limited liability company, on behalf of the limited liability companies, who acknowledged the same to be his or her free act and deed and the free act and deed of the limited liability companies.

_____
Notary Public, Tenn. County, Williamson
My Commission Expires: _____

***Exhibit 31.1***

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

**(i) CERTIFICATION**

I, William R. Council, III, 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-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and 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 fiscal 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 6, 2008

/s/ William R. Council, III

William R. Council, III
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-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and 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 fiscal 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 6, 2008

/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, 2008**

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, 2008 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 6, 2008.

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