

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: March 31, 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 No.: 1-12996

Advocat Inc.

(exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

62-1559667

(IRS Employer Identification No.)

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

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

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting Company

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

5,668,987
(Outstanding shares of the issuer's common stock as of May 1, 2008)

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Part I. FINANCIAL INFORMATION

ITEM 1 — FINANCIAL STATEMENTS

ADVOCAT INC.

INTERIM CONSOLIDATED BALANCE SHEETS
(in thousands)

	March 31, 2008 (Unaudited)	December 31, 2007
CURRENT ASSETS:		
Cash and cash equivalents	\$ 10,289	\$ 11,658
Receivables, less allowance for doubtful accounts of \$2,539 and \$2,158, respectively	26,139	26,444
Current portion of note receivable	608	629
Prepaid expenses and other current assets	3,037	2,130
Insurance refunds receivable	—	1,234
Deferred income taxes	2,746	2,110
Total current assets	<u>42,819</u>	<u>44,205</u>
PROPERTY AND EQUIPMENT, at cost		
Less accumulated depreciation	(35,094)	(34,091)
Discontinued operations, net	1,455	1,455
Property and equipment, net	<u>32,561</u>	<u>31,658</u>
OTHER ASSETS:		
Deferred income taxes	16,130	16,568
Note receivable, net of current portion	4,880	4,983
Deferred financing and other costs, net	1,185	1,239
Other assets	2,072	1,945
Acquired leasehold interest, net	9,414	9,492
Total other assets	<u>33,681</u>	<u>34,227</u>
	<u>\$ 109,061</u>	<u>\$ 110,090</u>

(Continued)

ADVOCAT INC.

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

	March 31, 2008 <u>(Unaudited)</u>	December 31, 2007
CURRENT LIABILITIES:		
Current portion of long-term debt	\$ 2,094	\$ 1,942
Trade accounts payable	5,239	6,636
Accrued expenses:		
Payroll and employee benefits	10,642	11,360
Current portion of self-insurance reserves	7,161	4,597
Income taxes payable	1,608	393
Other current liabilities	2,837	3,600
Total current liabilities	<u>29,581</u>	<u>28,528</u>
NONCURRENT LIABILITIES:		
Long-term debt, less current portion	31,868	32,513
Self-insurance reserves, less current portion	13,499	17,578
Other noncurrent liabilities	9,905	9,137
Total noncurrent liabilities	<u>55,272</u>	<u>59,228</u>
COMMITMENTS AND CONTINGENCIES		
SERIES C REDEEMABLE PREFERRED STOCK		
\$.10 par value, 5,000 shares authorized, issued and outstanding, including premium of \$4,247 and \$4,672 at March 31, 2008 and December 31, 2007, respectively.	<u>9,165</u>	<u>9,590</u>
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, 5,901,000 and 5,878,000 shares issued, and 5,723,000 and 5,804,000 shares outstanding, respectively	59	59
Treasury stock at cost, 178,000 and 74,000 shares of Common stock, respectively	(1,923)	(817)
Paid-in capital	16,206	15,804
Retained earnings (accumulated deficit)	701	(2,302)
Total shareholders' equity	<u>15,043</u>	<u>12,744</u>
	<u>\$ 109,061</u>	<u>\$ 110,090</u>

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 March 31,	
	2008	2007
PATIENT REVENUES, net	\$ 71,466	\$ 54,592
EXPENSES:		
Operating	55,536	41,743
Lease	5,704	4,596
Professional liability	(1,043)	423
General and administrative	4,559	4,144
Depreciation and amortization	1,242	909
Total expenses	65,998	51,815
OPERATING INCOME	5,468	2,777
OTHER INCOME (EXPENSE):		
Foreign currency transaction gain (loss)	(229)	47
Interest income	160	251
Interest expense	(831)	(816)
	(900)	(518)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	4,568	2,259
PROVISION FOR INCOME TAXES	(1,467)	(879)
NET INCOME FROM CONTINUING OPERATIONS	3,101	1,380
NET INCOME (LOSS) FROM DISCONTINUED OPERATIONS:		
Operating income (loss), net of taxes of \$(7) and \$11, respectively	(12)	16
Loss on sale, net of taxes of \$0 and \$(23), respectively	—	(35)
DISCONTINUED OPERATIONS	(12)	(19)
NET INCOME	3,089	1,361
PREFERRED STOCK DIVIDENDS	(86)	(86)
NET INCOME FOR COMMON STOCK	\$ 3,003	\$ 1,275
NET INCOME PER COMMON SHARE:		
Per common share — basic		
Continuing operations	\$ 0.52	\$ 0.22
Discontinued operations	—	—
	\$ 0.52	\$ 0.22
Per common share — diluted		
Continuing operations	\$ 0.50	\$ 0.21
Discontinued operations	—	—
	\$ 0.50	\$ 0.21
WEIGHTED AVERAGE COMMON SHARES:		
Basic	5,754	5,870
Diluted	6,017	6,126

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)

	Three Months Ended March 31,	
	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 3,089	\$ 1,361
Discontinued operations	(12)	(19)
Net income from continuing operations	3,101	1,380
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:		
Depreciation and amortization	1,242	909
Provision for doubtful accounts	556	110
Deferred income tax provision (benefit)	(198)	350
Provision for (benefit from) self-insured professional liability, net of cash payments	(1,413)	(472)
Stock based compensation	178	69
Amortization of deferred balances	129	69
Provision for leases in excess of cash payments	466	583
Foreign currency transaction (gain) loss	229	(47)
Non-cash interest income	(33)	(30)
Changes in other assets and liabilities affecting operating Activities:		
Receivables, net	(323)	755
Prepaid expenses and other assets	328	850
Trade accounts payable and accrued expenses	(1,765)	(1,532)
Net cash provided by continuing operations	2,497	2,994
Discontinued operations	(12)	40
Net cash provided by operating activities	2,485	3,034
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,067)	(1,737)
Decrease in cash restricted for capital expenditures	—	662
Deposits and other deferred balances	(150)	(113)
Net cash used by continuing operations	(2,217)	(1,188)
Discontinued operations	(49)	—
Net cash used by investing activities	(2,266)	(1,188)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of debt obligations	(493)	(1,617)
Financing costs	(4)	—
Repurchase of common stock	(1,106)	—
Proceeds from exercise of stock options	224	27
Payment of preferred stock dividends	(86)	(86)
Payment for preferred stock restructuring	(123)	(86)
Net cash used by financing activities	(1,588)	(1,762)

(Continued)

ADVOCAT INC.

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

	Three Months Ended March 31,	
	2008	2007
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ (1,369)	\$ 84
CASH AND CASH EQUIVALENTS, beginning of period	11,658	12,344
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 10,289</u>	<u>\$ 12,428</u>
SUPPLEMENTAL INFORMATION:		
Cash payments of interest	<u>\$ 733</u>	<u>\$ 707</u>
Cash payments of income taxes	<u>\$ 435</u>	<u>\$ 176</u>

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

ADVOCAT INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 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 March 31, 2008, the Company's continuing operations consist of 50 nursing centers with 5,773 licensed nursing beds and 66 assisted living units. The Company's continuing operations include nine owned nursing centers and 41 leased nursing centers. The Company's continuing operations include centers 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 month periods ended March 31, 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 generally accepted accounting principles 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 March 31, 2008 and the results of operations and cash flows for the three month periods ended March 31, 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 month periods ended March 31, 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 a 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.

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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 is subject to change during the twelve month period subsequent to the acquisition date for items including actual settlement of the assumed liabilities. The operating results have been included in the Company's consolidated financial statements since the date of the acquisition.

The following table summarizes the preliminary purchase price allocation of the net assets acquired at the date of acquisition:

Current assets	\$ 70,000
Property and equipment	132,000
Deferred tax asset	116,000
Acquired leasehold interest intangible	<u>9,639,000</u>
Total assets acquired	9,957,000
Current liabilities	<u>862,000</u>
Total net assets acquired	<u>\$9,095,000</u>

The purchase price allocation resulted in an acquired leasehold interest intangible asset of approximately \$9,639,000. 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 \$88,000 related to this intangible asset was recorded during the three months ended March 31, 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 the new 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 is expected to begin during the second quarter of 2008, with completion expected in mid-2009. Rent will commence upon completion of

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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 is expected to be approximately \$6.8 million. Costs incurred in excess of \$7 million, if any, will 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 the completion of the construction of the replacement facility, the Company may terminate the lease, at its sole option. If the Company elects to continue the lease, annual rentals for this facility will be increased by an amount equal to one half of the amount of the cash flow of the facility, as defined, 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.

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.

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 \$19,262,000 as of March 31, 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.

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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:

	March 31, 2008	December 31, 2007
Policy Year End March 9,		
2009	\$ 390,000	\$ —
2008	5,085,000	5,134,000
2007	7,069,000	7,625,000
2006	4,032,000	4,757,000
2005	1,866,000	2,339,000
2004 and earlier	820,000	820,000
	<u>\$19,262,000</u>	<u>\$20,675,000</u>

The Company's cash expenditures for self-insured professional liability costs were \$216,000 and \$743,000 for the three months ended March 31, 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. The settlement amounts for these claims were fully accrued as of March 31, 2008, 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 \$363,000 as of March 31, 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 three months ended March 31, 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. Effective July 1, 2007, the

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Company obtained a guaranteed cost policy for workers compensation insurance, under which expense will be equal to the premiums paid. As a result, there will be no premium refunds associated with this new policy.

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 \$1,036,000 at March 31, 2008. The differences between actual settlements and reserves are included in expense in the period finalized.

6. STOCK-BASED COMPENSATION

In March 2008 the Compensation Committee of the Board of Directors approved the grant of 107,700 Stock only Stock Appreciation Rights ("SOSARs") at an exercise price of \$10.88, the market price of the Company's common stock on the date the SOSARs were granted. 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 \$27,000 in stock-based compensation expense for the three months ended March 31, 2008. As of March 31, 2008, there was approximately \$943,000 of remaining compensation costs related to these 2008 SOSARs granted 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 \$178,000 and \$69,000 in the three month periods ended March 31, 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 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

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reduced. This facility accounted for revenues of approximately \$586,000 in the three month period ended March 31, 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 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 March 31,	
	2008	2007
Net income per common share:		
Per common share — basic		
Income from continuing operations	\$ 0.52	\$ 0.22
Income (loss) from discontinued operations		
Operating income, net of taxes	—	0.01
Loss on sale, net of taxes	—	(0.01)
Discontinued operations, net of taxes	—	—
Net income	<u>\$ 0.52</u>	<u>\$ 0.22</u>
Per common share — diluted		
Income from continuing operations	\$ 0.50	\$ 0.21
Income (loss) from discontinued operations		
Operating income, net of taxes	—	0.01
Loss on sale, net of taxes	—	(0.01)
Discontinued operations, net of taxes	—	—
Net income	<u>\$ 0.50</u>	<u>\$ 0.21</u>

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 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 March 31, 2008, the letter of credit and the current maximum loan amount of \$15,000,000, the balance available for revolving credit loans as of March 31, 2008 was \$6,883,000. As of March 31, 2008, the Company had no borrowings outstanding under the revolving credit facility.

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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. During the three months ended March 31, 2008 the Company would have been required to pay \$2,255,000 in additional payments from excess cash flow and amounts realized related to collateral had the Company not made the voluntary prepayments. Based on the Company's operating results for the three months ended March 31, 2008, the Company will be required to make a mandatory prepayment based on excess cash flows of approximately \$346,000 in March 2009.

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 such covenants at March 31, 2008.

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 three months ending March 31, 2008.

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 March 31, 2008, our continuing operations consist of 50 nursing centers with 5,773 licensed nursing beds and 66 assisted living units. As of March 31, 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 \$10.0 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. We have undertaken certain divestitures through sale of assets and lease terminations. The divested operations have generally been poor performing properties. Effective March 31, 2007, we terminated operations at a leased facility in Arkansas. The owner of the facility sold the property and we cooperated in an orderly transition to the new owner. In accordance with Statement of Financial Accounting Standards ("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 85.1% and 87.9% for the three month periods ended March 31, 2008 and 2007,

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respectively). Medicare intermediaries make retroactive adjustments based on changes in allowed claims. In addition, certain of the states in which we operate require complicated 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 0.2% for the three month periods ended March 31, 2008 and 2007, 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 \$19.3 million as of March 31, 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 the Actuarial Division of Willis of Tennessee, Inc. ("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:

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	March 31, 2008	December 31, 2007
Policy Year End March 9,		
2009	\$ 390,000	\$ —
2008	5,085,000	5,134,000
2007	7,069,000	7,625,000
2006	4,032,000	4,757,000
2005	1,866,000	2,339,000
2004 and earlier	820,000	820,000
	<u>\$19,262,000</u>	<u>\$20,675,000</u>

The Company's cash expenditures for self-insured professional liability costs were \$216,000 and \$743,000 for the three months ended March 31, 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. The settlement amounts for these claims were fully accrued as of March 31, 2008, and were 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 negative \$1.0 million for the three month period ended March 31, 2008, compared to an expense of \$423,000 for the three months ended March 31, 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 \$3.1 million and \$1.4 million, respectively. The total liability recorded at March 31, 2008, was \$19.3 million, compared to current assets of \$42.8 million and total assets of \$109.1 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 Claims-

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 three months ended March 31, 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. Effective July 1, 2007, we entered into a guaranteed cost policy for workers' compensation insurance, under which expense will be equal to the premiums paid. As a result, there will be no premium refunds associated with this new policy.

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

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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 March 31, 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 three month periods ended March 31, 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 Black-Scholes-Merton 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 three month periods ended March 31, 2008 and 2007, we recorded charges of approximately \$0.2 million and \$0.1 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 statutes and regulations as well as laws and regulations governing quality of care issues in the skilled nursing profession in general. Violations of these laws and regulations could result in exclusion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with such laws and regulations is subject to ongoing government review and interpretation, as well as regulatory actions in which government agencies seek to impose fines and penalties. 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. The Centers for Medicare and Medicaid 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 December 2007, Congress passed the Medicare, Medicaid and SCHIP Extension Act of 2007, which includes an extension of the existing exceptions process through June 30, 2008. If the exception process is discontinued after June 2008, 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 will become effective for fiscal years beginning after January 1, 2008. This change is not expected to have a material impact on our results of operations.

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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 is not expected to have 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. On May 1, 2008, CMS issued a draft regulation that would reduce Medicare payments to skilled nursing facilities by approximately 0.3%, effective October 1, 2008. The decrease is 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." The proposed rule is expected to be finalized in late July 2008 and remains subject to further change.

Effective January 1, 2008, the state of Florida enacted Medicaid reductions that reduced our Medicaid revenues by approximately \$0.1 million per quarter. The state recently passed a budget that is expected to result in a further reduction in our Medicaid rates effective July 1, 2008. We believe the combined effect of these reductions will be approximately \$0.2 million per quarter beginning July 1, 2008.

We are unable to predict whether the proposed CMS rule will be adopted, 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 three months ended March 31, 2008, we derived 32.5% and 52.6% 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

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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 March 31, 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)	\$ 40,311	\$ 4,151	\$ 10,308	\$ 25,852	\$ —
Settlement Obligations (2)	\$ 4,905	\$ 4,905	\$ —	\$ —	\$ —
Series C Preferred Stock (3)	\$ 5,778	\$ 344	\$ 5,434	\$ —	\$ —
Elimination of Preferred Stock Conversion feature (4)	\$ 7,211	\$ 687	\$ 1,374	\$ 1,374	\$ 3,776
Operating leases	\$618,813	\$ 21,390	\$ 43,714	\$ 44,448	\$509,261
Required capital expenditures under mortgage loans (5)	\$ 816	\$ 245	\$ 490	\$ 81	\$ —
Required capital expenditures under operating leases (6)	\$ 30,528	\$ 955	\$ 1,876	\$ 1,849	\$ 25,848
Total	\$708,362	\$ 32,677	\$ 63,196	\$ 73,604	\$538,885

- (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), or upon a change of control of the Company (as defined). The maximum contingent liability under these agreements is approximately \$2.0 million as of March 31, 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 March 31, 2008, the maximum contingent liability for the repurchase of the equity grants is approximately \$1.6 million. No amounts have been accrued for this contingent liability.

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Results of Operations

The following tables present the unaudited interim statements of income and related data for the three month periods ended March 31, 2008 and 2007:

(in thousands)	Three Months Ended March 31,			%
	2008	2007	Change	
PATIENT REVENUES, net	\$ 71,466	\$ 54,592	\$ 16,874	30.9
EXPENSES:				
Operating	55,536	41,743	13,793	33.0
Lease	5,704	4,596	1,108	24.1
Professional liability	(1,043)	423	(1,466)	(346.6)
General and administrative	4,559	4,144	415	10.0
Depreciation and amortization	1,242	909	333	36.6
Total expenses	65,998	51,815	14,183	27.4
OPERATING INCOME	5,468	2,777	2,691	96.9
OTHER INCOME (EXPENSE):				
Foreign currency transaction gain (loss)	(229)	47	(276)	(587.2)
Interest income	160	251	(91)	(36.3)
Interest expense	(831)	(816)	(15)	(1.8)
	(900)	(518)	(382)	(73.7)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	4,568	2,259	2,309	102.2
PROVISION FOR INCOME TAXES	(1,467)	(879)	(588)	(66.9)
NET INCOME FROM CONTINUING OPERATIONS	\$ 3,101	\$ 1,380	1,721	124.7

Percentage of Net Revenues

	Three Months Ended March 31,	
	2008	2007
PATIENT REVENUES, net	100.0%	100.0%
EXPENSES:		
Operating	77.7	76.5
Lease	8.0	8.4
Professional liability	(1.5)	0.8
General and administrative	6.4	7.6
Depreciation and amortization	1.7	1.6
Total expenses	92.3	94.9
OPERATING INCOME	7.7	5.1
OTHER INCOME (EXPENSE):		
Foreign currency transaction gain (loss)	(0.3)	0.1
Interest income	0.2	0.4
Interest expense	(1.2)	(1.5)
	(1.3)	(1.0)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	6.4	4.1
PROVISION FOR INCOME TAXES	(2.1)	(1.6)
NET INCOME FROM CONTINUING OPERATIONS	4.3%	2.5%

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As a supplement to the tables above, the following table presents the unaudited statements of income from continuing operations before income taxes and related data for the three month periods ended March 31, 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 March 31,			%
	2008	2007	Change	
PATIENT REVENUES, net	\$ 58,543	\$ 54,592	3,951	7.2
EXPENSES:				
Operating	44,212	41,743	2,469	5.9
Lease	4,702	4,596	106	2.3
Professional liability	(969)	423	(1,392)	(329.1)
General and administrative	4,321	4,144	177	4.3
Depreciation and amortization	981	909	72	7.9
Total expenses	53,247	51,815	1,432	2.8
OPERATING INCOME	5,296	2,777	2,519	90.7
OTHER INCOME (EXPENSE):				
Foreign currency transaction gain	(229)	47	(276)	(587.2)
Interest income	160	251	(91)	(36.3)
Interest expense	(657)	(816)	159	19.5
	(726)	(518)	(208)	(40.2)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	4,570	2,259	2,311	102.3

Three Months Ended March 31, 2008 Compared With Three Months Ended March 31, 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.

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 \$71.5 million in 2008 from \$54.6 million in 2007, an increase of \$16.9 million, or 30.9%. Revenues related to the New Texas Facilities were \$12.9 million in 2008. Same center patient revenues increased to \$58.5 million in 2008 from \$54.6 million in 2007, an increase of \$3.9 million, or 7.2%. 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 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	
	March 31,	
	2008	2007
Skilled nursing occupancy:		
Same center	78.3%	78.3%
New Texas Facilities	64.9%	N/A
Total continuing operations	75.1%	78.3%
Medicare census as percent of total:		
Same center	13.9%	14.8%
New Texas Facilities	13.3%	N/A
Total continuing operations	13.7%	14.8%
Medicare revenues as percent of total:		
Same center	31.9%	32.3%
New Texas Facilities	35.6%	N/A
Total continuing operations	32.5%	32.3%
Medicaid revenues as percent of total:		
Same center	54.4%	55.6%
New Texas Facilities	44.2%	N/A
Total continuing operations	52.6%	55.6%
Medicare average rate per day:		
Same center	\$379.48	\$ 339.21
New Texas Facilities	\$394.01	N/A
Total continuing operations	\$382.35	\$ 339.21
Medicaid average rate per day:		
Same center	\$143.75	\$ 137.21
New Texas Facilities	\$112.74	N/A
Total continuing operations	\$138.02	\$ 137.21

On a same center basis, the Company's average rate per day for Medicare Part A patients increased 11.9% in 2008 compared to 2007 as a result of annual inflation adjustments and the 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 4.8% in 2008 compared to 2007 as a result of increasing patient acuity levels, certain state increases to offset minimum wage adjustments and other rate increases in certain states.

Operating expense. Operating expense increased to \$55.5 million in 2008 from \$41.7 million in 2007, an increase of \$13.8 million, or 33.0%. Operating expense related to the New Texas Facilities was \$11.3 million in 2008. Same center operating expense increased to \$44.2 million in 2008 from \$41.7 million in 2007, an increase of \$2.5 million, or 5.9%. This increase is primarily attributable to cost increases related to wages and benefits and an increase in bad debt expense. On a same center basis, operating expense decreased to 75.5% of revenue in 2008, compared to 76.5% of revenue in 2007. The decrease in same center operating expense as a percentage of revenue was due to the effects of increases in Medicare and Medicaid rates.

The largest component of operating expenses is wages, which increased to \$32.9 million in 2008 from \$24.8 million in 2007, an increase of \$8.1 million, or 33.0%. Wages related to the New Texas Facilities were approximately \$6.8 million. Same center wages increased approximately \$1.4 million, or 5.5%, 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 3.7% for the period), and labor costs associated with increases in patient acuity levels. Although overall Medicare census declined, the acuity levels of the Company's patients, as

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indicated by RUG level scores, were higher than in 2007, resulting in greater costs to care for these patients.

In addition to increased wages, bad debt expense and employee health insurance costs were higher. Bad debt expense was \$0.3 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. Employee health insurance costs were approximately \$0.3 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.

Lease expense. Lease expense increased to \$5.7 million in 2008 from \$4.6 million in 2007. Lease expense related to the New Texas Facilities was \$1.0 million for 2008. Same center lease expense increased to \$4.7 million in 2008 from \$4.6 million in 2007. There was an increase in lease expense of \$0.1 million resulting from rent increases for lessor funded property renovations.

Professional liability. Professional liability in 2008 was a benefit of \$1.0 million, compared to an expense of \$0.4 million in 2007, a decrease in expense of \$1.4 million. Professional liability expense related to the New Texas Facilities was a benefit of \$0.1 million. Our cash expenditures for professional liability costs were \$0.2 million and \$0.7 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 \$19.3 million at March 31, 2008, down from \$20.7 million at December 31, 2007.

General and administrative expense. General and administrative expense increased to \$4.6 million in 2008 from \$4.1 million in 2007, an increase of \$0.5 million or 10.0%. As a percentage of revenue, general and administrative expense decreased to 6.4% in 2008 from 7.6% in 2007. General and administrative expense related to the New Texas Facilities was \$0.2 million in 2008. Same center general and administrative expense increased to \$4.3 million in 2008 from \$4.1 million in 2007, an increase of \$0.2 million, or 4.3%. Compensation costs increased by approximately \$0.2 million, including normal merit and inflationary increases and new positions added to improve marketing, operating and financial controls. Non-cash stock based compensation expense was approximately \$0.1 million higher in 2008. These increases were offset by a decrease in incentive compensation expense of \$0.3 million. The remaining increase is due to higher travel costs and professional fees.

Depreciation and amortization. Depreciation and amortization expense was approximately \$1.2 million in 2008 and \$0.9 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 \$229,000 was recorded in 2008, compared to a gain of \$47,000 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 remained constant at \$0.8 million in 2008 and 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 interest resulting from a decrease 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 \$4.6 million in 2008 compared to \$2.3 million in 2007. The provision for income taxes was \$1.5 million in 2008, an effective rate of 32.1%, compared to \$0.9 million in 2007, an effective rate

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of 38.9%. 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 three months ending March 31, 2008. The basic and diluted income per common share from continuing operations were \$0.52 and \$0.50, respectively, in 2008, as compared to a basic and diluted income per common share from continuing operations of \$0.22 and \$0.21, 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 \$12,000 in 2008, compared to a gain of \$16,000 in 2007. The disposition of discontinued operations and completions of lease terminations resulted in no gain or loss in 2008 and a loss of \$35,000, net of taxes, in 2007.

Liquidity and Capital Resources

Capital Resources

As of March 31, 2008, we had \$34.0 million of outstanding borrowings, including \$2.1 million in payments scheduled to be made in the next twelve months. Based on our 2008 year to date results, we will be required to make a mandatory prepayment based on excess cash flows of approximately \$0.3 million in March 2009.

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%, a maturity of five years, 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. 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 \$11.9 million as of March 31, 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 provided 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 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 March 31, 2008, the letter of credit and the current maximum loan of \$15 million, the balance available for future revolving credit loans would be \$6.9 million. Such amounts are available to fund the working capital needs of this transaction and future expansion opportunities. As of March 31, 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 March 31, 2008.

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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 the new 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 is expected to begin 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 is expected to be approximately \$6.8 million. We will bear all costs, if any, in excess of \$7 million. 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 the completion of the construction of the replacement facility, we may terminate the lease at our sole option. If we elect to continue the lease, annual rentals for this facility will be increased by an amount equal to one half of the amount of the cash flow of the facility, as defined, 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.

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.

Share repurchases under this program are authorized through the earlier of one year from November 6, 2007 or the repurchase of the full amount authorized to be repurchased under the plan, subject to conditions specified in the plan. Repurchases may be made through open market or privately negotiated transactions in accordance with all applicable securities laws, rules, and regulations and are funded from available working capital. The share repurchase program may be terminated at any time without prior notice. During the three months ending March 31, 2008, we spent \$1.1 million to repurchase 103,600 shares of our common stock, and during April, we completed purchases under our plan. Since the inception of the plan in November 2007 we have purchased a total of 231,800 shares for \$2.5 million. See "Item 2. Unregistered Sales of Equity Securities and Use of Proceeds."

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

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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 March 31, 2008, we have recorded total liabilities for reported and settled professional liability claims and estimates for incurred but unreported claims of \$19.3 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. The settlement amounts for these claims were fully accrued as of March 31, 2008. 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 \$2.5 million and \$3.0 million in 2008 and 2007, respectively. Discontinued operations used cash of \$12,000 in 2008 and provided cash of \$40,000 in 2007.

Investing activities of continuing operations used cash of \$2.2 million and \$1.2 million in 2008 and 2007, respectively. These amounts primarily represent cash used for purchases of property, plant and equipment. 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 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 \$4.0 million of working capital for facility renovation projects in 2008. 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 \$1.6 million and \$1.8 million in 2008 and 2007, respectively. The cash used resulted from the repayment of debt obligations in both years as well as the repurchase of \$1.1 million of our common stock in 2008. 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.

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 March 31, 2008, we have completed renovation projects at eight facilities and have two additional renovation projects in progress, with expected completion by the third quarter of 2008.

A total of \$11.3 million has been spent on these renovation programs to date, with \$9.1 million spent on facilities leased from Omega and \$2.2 million spent on owned facilities. The amounts spent on the facilities leased from Omega have been financed through increased rent and are not reflected as capital expenditures. We expect the two projects currently in progress will use financing provided by Omega, and we intend to finance future renovation projects with working capital.

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For the seven facilities with renovations completed before the beginning of the first quarter 2008 compared to the last twelve months prior to the commencement of renovation, average occupancy increased from 64.6% to 71.9% in the first quarter of 2008, and Medicare census increased from 12.8% to 14.1% in the first quarter of 2008. No assurance can be given that these facilities will continue to show such occupancy or revenue mix 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 \$28.3 million at March 31, 2008, compared to \$27.9 million at December 31, 2007, representing approximately 36 and 37 days revenue in accounts receivable at each period end, respectively. The New Texas Facilities resulted in an increase in accounts receivable of approximately \$8.2 million and \$8.8 million at March 31, 2008 and December 31, 2007, respectively. As part of the procedural Medicare and Medicaid change of ownership process, payments from Medicaid and Medicare for these facilities were temporarily delayed, and \$3.8 million and \$4.7 million of the increase in receivables at March 31, 2008 and December 31, 2007, respectively, were due to these delays. The majority of the remaining payments from Medicare and Medicaid are expected to be collected during the second quarter of 2008. Excluding these payor delays, our days revenue in accounts receivable are 32 days and 31 days as of March 31, 2008 and December 31, 2007, respectively.

The allowance for bad debt was \$2.5 million at March 31, 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. 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 March 31, 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 September 2006, the Financial Accounting Standards Board (“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. 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, changes in governmental reimbursement, government regulation and health care reforms, the increased cost of borrowing under our 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

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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 March 31, 2008, we had outstanding borrowings of approximately \$34.0 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 \$5.5 million US based on the outstanding balance of the note and the exchange rate as of March 31, 2008. We also have recorded certain liabilities of \$0.3 million US that are denominated in Canadian dollars. The carrying value of the note and the liabilities 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 three month periods ended March 31, 2008 and 2007, we reported transaction gains (losses) of \$(229,000) and \$47,000, respectively, as a result of the effect of changes in the currency exchange rates on this note and liabilities. 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 \$52,000.

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 March 31, 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 March 31, 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 March 31, 2008, we were engaged in 26 professional liability lawsuits. Four 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 of these 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. 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.

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 Report on Form 10-K for the fiscal year ended December 31, 2007. In addition to the risk factors previously disclosed in our Report on Form 10-K, the following factor could cause our results to differ from our expectations.

If we are unable to complete construction of the Paris 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 replacement facility will require that we complete construction in a timely manner and at budgeted costs. Construction costs in excess of \$7.0 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

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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 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Repurchase of Common Stock. The following table presents information on our purchases of our common stock during the quarter ended March 31, 2008.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (1)
January 1 through 31	52,800	\$ 10.77	127,300	\$ 1,114,000
February 1 through 29	200	\$ 11.48	127,500	\$ 1,112,000
March 1 through 31	50,600	\$ 10.57	178,100	\$ 577,000
Total	103,600			

(1) All share repurchases between January 1, 2008 and March 31, 2008 were made pursuant to a share repurchase program authorized by the Company's Board of Directors and publicly announced on November 6, 2007, which allows for the repurchase of up to \$2.5 million of our common stock from time to time pursuant to a plan under 10b5-1 and in compliance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended, through November 6, 2008. The total number of shares purchased includes shares purchased in 2007 following the announcement of the plan.

During April 2008, we completed purchases under the plan. Since the inception of the plan in November 2007, we have purchased a total of 231,800 shares for a total of \$2.5 million.

ITEM 6. EXHIBITS

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

SIGNATURES

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

ADVOCAT INC.

May 7, 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

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<u>Exhibit Number</u>	<u>Description of Exhibits</u>
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).
10.1	Sixth Amendment to Consolidated Amended and Restated Master Lease dated March 14, 2008, by and between Sterling Acquisition Corp., a Kentucky corporation, and Diversicare Leasing Corp., a Tennessee corporation
10.2	Second Amendment to Loan Agreement and Joinder dated as of March 14, 2008, is by and among Diversicare Paris, LLC, a Delaware limited liability company, those certain entities set forth on Schedule 1 thereto, which are signatories thereto, and LaSalle Bank National Association, a national banking association.
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).

SIXTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

This Sixth Amendment to Consolidated Amended and Restated Master Lease (this "Amendment") is executed and delivered as of March 14, 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, as amended by a First Amendment to Consolidated Amended and Restated Master Lease dated as of September 30, 2001, 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, and a Fifth Amendment to Consolidated Amended and Restated Master Lease dated as of August 10, 2007 (the "Existing Master Lease") pursuant to which Lessee leased from Lessor certain healthcare facilities.

B. Pursuant to that certain Unimproved Property Contract (the "Paris Purchase Agreement") dated as of September 4, 2007 between Haynes, Haynes and Jones, a general partnership, and Omega Healthcare Investors, Inc., a Maryland corporation ("Omega"), Omega has the right to acquire that certain parcel of unimproved land described on attached Exhibit A and located in Paris, Texas (the "Paris Land").

C. Omega is the parent corporation of Lessor and intends to assign its right to purchase the Paris Land to Lessor.

D. Lessor and Lessee desire to have a skilled nursing facility constructed on the Paris Land (the "Paris Facility") and for Lessee to lease the Paris Facility from Lessor pursuant to the Existing Master Lease.

E. Lessee and Lessor desire to amend the Existing Master Lease to add the Paris Facility to the Existing Master Lease on the terms and conditions of this Amendment.

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 Leases or the other Transaction Documents to the "Lease" or "Master Lease" means, as applicable, the Existing Master Lease or Existing Master Leases as modified by this Amendment.

(b) In addition to the other definitions contained herein, when used in this Amendment the following terms shall have the following meanings:

“Acquisition Date” means the date that the Land described in Exhibit A to this Amendment is acquired by Lessor or its Affiliates.

“Actual Funded Amount” means (i) the amount actually expended for the acquisition of the Paris Land by Lessor and the amount actually advanced and disbursed by Lessor for completion of the Paris Facility in accordance with this Amendment, as of a given date, plus (ii) the allocated bed costs set forth in the Construction Budget.

“Closing Date” means the date that Lessor acquires the Paris Facility.

“Construction Budgets” means the detailed budget for the construction of the Paris Facility attached as Schedule 1, which sets forth Lessee’s good faith estimate of the Project Costs on an itemized basis and designates each item by amount, whether such item constitutes an item of Hard Costs or Soft Costs and the amount of proceeds, if any, of the Maximum Funded Amount allocable to each item of Hard Costs and Soft Costs.

“Developer’s Fees” means the fees and commissions, including Developer’s Overhead, payable to Lessee or any Affiliate of Lessee for services rendered in connection with the development, construction management or leasing of the Paris Facility, as set forth on the Construction Budget.

“Developer’s Overhead” means costs incurred by Lessee and set forth on the Construction Budget for developer’s overhead and profit.

“Event of Force Majeure” is any event or condition of Force Majeure, not existing as of the Closing Date, not reasonably foreseeable as of such date and not reasonably within the control of Lessee, that prevents in whole or in material part the performance by Lessee of its obligations under this Amendment or that renders the performance of such obligations so difficult as to make such performance commercially unreasonable.

“Funded Amount” means (i) the amount actually expended for the acquisition of the Paris Land and completion of the Paris Facility as of a given date, plus (ii) the allocated bed costs set forth in the Construction Budget.

“Hard Costs” means costs paid to renovate and complete the Paris Facility, including without limitation, demolition costs, site preparation costs, contractor’s fees, and costs of labor and material paid or necessarily incurred by Lessee in connection with the construction of the Paris Facility, but excluding Developer’s Fees, Developer’s Overhead and Contractor’s Overhead, and the contingency reserve, if any, set forth on the Construction Budget.

“Initial Paris Base Rent” means an annual amount equal to (i) the Actual Funded Amount as of the first day of the applicable month during the applicable Lease Year *multiplied by* (ii) ten and one quarter percent (10.25%).

“In Service Date” shall be the date of completion of construction and licensing of the Paris Facility for its intended use as a skilled nursing facility.

“Joinder Agreement” means the Joinder Agreement and Amendment to Texas Collateral Documents from the Paris Sublessee, the Texas Sublessees, and Lessor dated as of the date of this Amendment.

“Maximum Funded Amount” means Seven Million Dollars (\$7,000,000).

“Plans and Specifications” means the written plans and specification for the construction of the Paris Facility submitted by Lessee and approved by Lessor, as such plans and specifications may be amended as set forth in this Amendment.

“Paris Base Rent Commencement Date” shall be the earlier of (i) the 15th day of the calendar month following the In Service Date or (ii) August 15, 2009.

“Paris Base Rent” shall be:

(a) During the first Renewal Term, the Paris Base Rent shall be:

(1) Prior to the Paris Base Rent Commencement Date, no Paris Base Rent shall be due and owing;

(2) During the twelve month period commencing on the Paris Base Rent Commencement Date, the Initial Paris Base Rent;

(3) Subject to sub-sections (a)(4) of this defined term, during each subsequent twelve month period commencing on the anniversary of the Paris Base Rent Commencement Date (the “Adjustment Date”), until the end of the Term (including any Renewal Terms), the Paris Base Rent for the previous Lease Year, increased by the product of (i) the Paris Base Rent during the immediately preceding Lease Year and (ii) the *lesser* of one (1) times the increase, if any, in the CPI (expressed as a percentage) from the Paris Base Rent Commencement Date to the applicable Adjustment Date and two and one-half percent (2.5%).

Under no circumstances will the Paris Base Rent in any twelve month period be less than the Paris Base Rent during the preceding twelve month.

(4) If, after the Paris Rent Reset Date, the Paris Formula Rent is greater than the Paris Scheduled Rent, then

(A) for the twelve month period after the Paris Rent Reset Date, the Paris Base Rent shall be equal to the Paris Formula Rent; and

(B) during each subsequent twelve month period commencing on the anniversary of the Paris Rent Reset Date (the “Adjustment Date”), until the end of the Term (including any Renewal Terms), Paris Base Rent for the previous Lease Year, increased by the product of (i) the Paris Base Rent during the immediately preceding Lease Year and (ii) the lesser of

one (1) times the increase, if any, in the CPI (expressed as a percentage) from the Paris Rent Reset Date to the applicable Adjustment Date and two and one-half percent (2.5%).

Under no circumstances will the Paris Base Rent in any Lease Year be less than the Paris Base Rent during the preceding Lease Year.

Under no circumstances will the Paris Base Rent in any Lease Year during the Renewal Term be less than the Paris Base Rent during the preceding Lease Year.

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 six percent (6%) 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.

"Paris Formula Rent" means the sum of:

(a) the Paris Scheduled Rent; plus

(b) one half of (i) the average annual Paris Cash Flow for the twenty four month period ending prior to the Paris Rent Reset Date, less (ii) the Paris Scheduled Rent *multiplied by 1.2*.

"Paris Rent Reset Date" means the first day of the sixth full Lease Year after the Paris Base Rent Commencement Date.

"Paris Scheduled Rent" means the Paris Base Rent as of the Paris Rent Reset Date as calculated pursuant to subsection (a)(3) of the definition of Paris Base Rent.

"Paris Sublessee" means Diversicare Paris, LLC, a Delaware limited liability company.

"Project Costs" means all Hard Costs, Soft Costs, Developer's Fees, Contractor's Overhead and other costs and fees associated with the construction of the Construction Facilities.

“Soft Costs” means premiums for title, casualty and other insurance required by Lessor under the Paris Purchase Agreement or this Lease; the cost of recording and filing the closing documents under the Paris Purchase Agreement and any tax levied upon such filing; real estate taxes and other assessments that Lessee is obligated to pay; fees and disbursements of the Lessor’s attorneys, architects and engineers, appraisers, environmental engineers and surveyors; architectural design and monitoring fees; permit fees; all fees and expenses payable under that certain Development Agreement dated as of October 31, 2007 between OHI Asset (TX) Paris, LLC, a Delaware limited liability company, and LMG Development, LLC, a Texas limited liability company; allocated best costs as set forth in the Construction Budget; and interest (including any reserve for interest set forth on the Construction Budgets), fees and miscellaneous transaction closing costs and charges payable by Lessee to Lessor as they become due and payable.

“Survey Requirements” means the survey requirements set forth in Exhibit B to this Amendment.

“Target Completion Date” means July 1, 2009.

“Title Company” means a title company selected by Lessor and reasonably acceptable to Lessee.

(c) The following definitions defined in §2.1 of the Existing Master Lease and §1 of the Fifth Amendment are hereby amended in their entirety as follows:

(1) §2.1 of the Existing Master Lease:

Base Rent: means the sum of (i) the Non-Texas Base Rent, (ii) the Texas Base Rent, and (iii) subject to Section 1(c) of this Amendment, the Paris Base Rent.

Commencement Date: October 1, 2000 for the Non-Texas Facilities (other than the Paris Facility), August 11, 2007 for the Texas Facilities, and the Closing Date for the Paris Facility.

Expiration Date: means the First Renewal Term Expiration Date, the Second Renewal Term Expiration Date, the First Texas Renewal Term Expiration Date, or the Second Texas Renewal Term Expiration Date, as applicable.

Facilit(y)(ies): Each health care facility on the Land, including the Leased Property associated with such Facility, and together, all such facilities on the Leased Properties; all of which Facilities are collectively listed on Exhibit C to this Amendment.

Land: The real property described in listed on attached Exhibit A to the Existing Master Lease, Exhibit A to the Fifth Amendment and Exhibit A to this Amendment.

Lease Year: October 1, 2000 through September 30, 2001, and each twelve month period thereafter, except that for purposes of determining the Texas Base Rent and the Paris Base Rent, “Lease Year” shall mean (i) with respect to the Texas Base Rent, the twelve month period commencing on February 1 and ending January 31, and each twelve month period thereafter, and (ii) with respect to the Paris Base Rent, the twelve month

period commencing on the Paris Base Rent Commencement Date, and each twelve month period thereafter commencing on the anniversary of the Paris Base Rent Commencement Date.

Leased Property: The portion of the Land on which a Facility is located, the legal description of which is set forth beneath the Facility's name on Exhibits A-1 through A-28 to the Existing Master Lease, Exhibit A-1 through A-7 to the Fifth Amendment, and Exhibit A to this Amendment, the Leased Improvements on such portion of the Land, the Related Rights with respect to such portion of the land, and Lessor's Personal Property with respect to such Facility.

Permitted Encumbrances: Encumbrances listed on attached Exhibit B to the Existing Master Lease, Exhibit C to the Fifth Amendment, and Exhibit D to this Amendment.

(2) §1 of the Fifth Amendment:

Pre-Existing Hazardous Substances: means Hazardous Substances located on, under, about or with respect to the Treemont Facility prior to February 1, 2003, or the Katy Facility prior to July 1, 2003, or the Humble Facility prior to July 1, 2003, or the Paris Facility prior to the Acquisition Date for the Paris Facility.

Pre-Existing Environmental Conditions: means any Contamination or other environmental condition on, under, about or with respect to the Treemont Facility prior to February 1, 2003, or the Katy Facility prior to July 1, 2003, or the Humble Facility prior to July 1, 2003, or the Paris Facility prior to the Acquisition Date for the Paris Facility.

Texas Facilities: means, except as otherwise expressly provided herein with respect to the Paris Facility, the Facilities located on the real property described in Exhibits A-1 through A-7 to the Fifth Amendment and Exhibit A to this Amendment.

Texas Pledge Agreements: means the Pledge Agreements dated as of the same date as the Fifth Amendment, as amended by the Joinder Agreement, from the equity owners of the Texas Sublessees in favor of Lessor.

Texas Sublessees: means (i) the Master Texas Sublessee, (ii) 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, and (iii) the Paris Sublessee.

Texas Sublessees Guaranty: means the Guaranty dated as of the same date as the Fifth Amendment, as joined in by Paris Sublessee pursuant to the Joinder Agreement, in favor of Lessor.

Texas Sublessee Security Agreement: means the Security Agreement dated as of the same date as the Fifth Amendment, as joined in by Paris Sublessee pursuant to the Joinder Agreement, in favor of Lessor.

(d) For purposes of the adjustments to Texas Base Rent provided for in subparagraphs (3) and (4) of the definition of Texas Base Rent set forth in Section 1 of the Fifth Amendment, the “change” or “increase” in CPI referred to therein shall be deemed to mean the “change” or increase” in CPI from the Commencement Date to the commencement of the twelve month period (being February 1 through January 31) for which the adjustment in Texas Base Rent, if any, is to be made.

2. Paris Base Rent; Rent Reset; Termination Option; 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 anything in this Amendment to the contrary, Lessor shall have no obligation to make further advances of the Funded Amount on or after the Paris Base Rent Commencement Date.

(b) Paris Base Rent Reset. 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) Paris Termination Option. Pursuant to written notice delivered to Lessor not more than thirty (30) days prior to, nor later than, the fifth anniversary of the Paris Base Rent Commencement Date (“Paris Termination Notice”), 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 “Paris Termination Date”). If the Paris Termination Notice is delivered, then Lessee shall have no further obligation to pay Paris Base Rent for periods from and after the Paris Termination Date.

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

(e) 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.

3. Accrual of Financing Costs. During the period from the Closing Date until the Base Rent Commencement Date, financing costs on the Actual Funded Amount shall accrue monthly at the rate of ten and one-quarter percent (10.25%) per annum. In the month such financing costs accrues, such financing costs shall be deemed to have been advanced as part of the Actual Funded Amount for all purposes under this Amendment.

4. Sublease; Management. Lessee may sublease the Paris Facility to the Master Texas Sublessee and the Master Texas Sublessee may sublease the Facility to the Paris Sublessee. The Paris Sublessee shall guaranty this Lease and provide the same collateral to secure this Lease as are provided by all other Sublessees under this Lease. The form of sublease between Lessee and the Paris Sublessee (the "Paris Sublease") shall be subject to Lessor's reasonable approval. All equity owners of the Paris Sublessee shall (i) pledge their interests in the Sublessee to secure the Lease and the other Transaction Documents, and (ii) subordinate any management, consulting or other agreements between the Paris Sublessee and such equity owners (or any of their affiliates) to the Paris Sublease, this Lease and the other Transaction Documents. Pursuant to Section 8.4 of the Existing Master Lease, Lessor hereby consents to the management of the Paris Facility by Diversicare Management Services Co., an Affiliate of Lessee, under its current form of Management Agreement with the Lessee or Sublessee, as the case may be, of the other Facilities covered by the Existing Master Lease.

5. Regulatory Approvals. Lessee will be required to, or to cause Paris Sublessee to, apply for, and to diligently pursue at its own expense, all licenses and regulatory approvals to operate the Paris Facility as a skilled nursing facility (the "Licenses"). Lessee represents and warrants that it knows of no facts or circumstances that would make it unlikely that the Licenses will be issued. Lessor covenants and agrees that it will cooperate in good faith with Lessee and use commercially reasonable efforts, where necessary or required from Lessor as owner of the Paris Land, to enable and assist Lessee to obtain the Licenses.

6. Construction of the Paris Facility.

(a) Commencement and Completion of Construction. Lessee shall commence substantial on-site construction of the Paris Facility within sixty (60) days of the Closing Date and, subject to a temporary suspension of performance pursuant to Section 16 below, or Lessor Delay, will continue diligently to complete the Paris Facility on or before the Target Completion Date (or as soon thereafter as reasonably possible) and will supply such moneys and perform such duties as may be necessary in connection therewith. The Paris Facility will be complete for purposes of this Section only at such time as (i) all improvements to the Paris Facility called for in the Plans and Specifications have been installed or completed in a manner satisfactory to Lessor and (ii) the local public authority has issued a final certificate of occupancy for the Paris Facility subject only to such conditions as may be acceptable to Lessor.

(b) Lessor's Architect; Approval of Plans. Lessor may retain the services of architects and engineers, including architects and engineers employed by Lessor (the "Lessor's Architect"), to act as Lessor's agent in reviewing the Plans and Specifications and the progress of construction and in making such certifications and performing such other tasks and duties as Lessor deems appropriate. Lessee will pay all reasonable fees, costs and expenses of the Lessor's Architect within ten (10) days after demand by Lessor, accompanied by a reasonably detailed invoice or statement of the amount due from Lessor's Architect. Lessee, at Lessee's option, may utilize and retain the services of Lessor's Architect or may retain the services of its own architects and engineers (the "Lessee's Architect") to develop and prepare the Plans and Specifications for construction of the Paris Facility. Whether Lessee utilizes Lessor's Architect or Lessee's Architect as the "Project Architect" to develop and prepare the Plans and Specifications, Lessee shall be responsible for payment of the fees, costs and expenses of the Project Architect in developing and preparing the Plans and Specifications. Lessor and Lessee shall cooperate with each other in developing the Plans and Specifications. Lessee shall cause the Project Architect to deliver to Lessor the Plans and Specifications for review and approval by Lessor. The Plans and Specifications shall be subject to Lessor's approval within ten (10) Business Days of receipt by Lessor of a complete set of the Plans and Specifications. Lessor's approval shall not be unreasonably withheld, delayed or conditioned. If Lessor does not approve the same, Lessor shall advise Lessee in writing specifically of the changes required in the Plans and Specifications so that they will meet with Lessor's approval. If Lessor provides Lessee comments as to the Plans and Specifications, Lessee shall provide revised Plans and Specifications to Lessor within ten (10) Business Days and Lessor shall review such revised Plans and Specifications and within ten (10) Business Days of receipt give its approval or provide the changes required for approval to be given. This process shall continue in accordance with these time frames until such time as Lessor and Lessee have finally approved the Plans and Specifications. The review by Lessor of the Plans and Specifications is for Lessor's benefit only, and Lessor's approval of any such Plans and Specifications shall impose no liability on Lessor, express or implied, including without limitation any representation or warranty that such Plans and Specifications are complete or accurate, or that such Plans and Specifications comply with zoning or other land use laws, local building department requirements, or any applicable public or private covenants, conditions or restrictions, and shall not in any way relieve Lessee of its obligation to perform its work in accordance with this Amendment and all applicable laws and requirements.

(c) Plans and Specifications. Lessee will deliver to Lessor accurate and complete copies of the approved Plans and Specifications and all other contract documents requested by Lessor, including all modifications thereof. Lessee represents and warrants that the Plans and Specifications and construction of the Paris Facility pursuant to thereto comply and will comply with all applicable governmental laws and regulations and requirements, zoning and subdivision ordinances, and standards and regulations of all governmental bodies exercising jurisdiction over the Paris Facility, including health care licensing. Lessee agrees to provide to Lessor a certification of the Project Architect to such effect as well as the approvals of any governmental body or agency exercising jurisdiction of the Paris Facility. Except as provided below, Lessee will not make, or cause or permit to be made, any change to the Plans and Specifications unless a request for the change has been submitted in writing to Lessor and approved in writing by the construction manager or general contractor, as the case may be, any tenants whose approval is required, Lessor and such other parties as Lessor may require. Lessor's approval may be subject to such terms and conditions as Lessor reasonably may

prescribe. Under no circumstances will any failure by Lessor to respond to a request for approval of a change in the Plans and Specifications be deemed to constitute approval of the request. Lessee will deliver promptly to Lessor copies of all bulletins, addenda, change orders and modifications to the Plans and Specifications. Lessor has the right at all times to require strict compliance with the original Plans and Specifications, but Lessee may effect changes in the Plans and Specifications from time to time, without first obtaining Lessor's approval, if (i) the changes do not impair the structural integrity, design concept or architectural appearance of the Paris Facility or change the useable area of the Paris Facility in any way, (ii) the changes will not result in a default in any other obligation to any other party or authority and (iii) the changes will not result in a net increase or decrease in the total Project Costs of TWO HUNDRED FIFTY THOUSAND DOLLARS (\$250,000.00) or more in the aggregate for all changes. Notwithstanding the foregoing, to the extent that the cost to complete the Paris Facility exceeds the Maximum Funded Amount (whether or not as a result of any such changes in the Plans and Specifications), Lessee will be responsible for payment of the excess.

(d) Character of Construction. All construction will be in accordance with the Plans and Specifications, of sound materials, in good and workmanlike manner, free and clear of all liens, claims and encumbrances (other than the liens and security interests securing the obligations of the Lessee under this Lease), and in compliance with all laws, ordinances, regulations and restrictions affecting the Paris Facility and all requirements of all governmental authorities having jurisdiction over the Paris Facility and of the appropriate board of fire underwriters or other similar body, if any, and any applicable health care authority related to the Licenses. Lessee will furnish Lessor with evidence of such compliance as Lessor requires from time to time.

(e) Construction Contract and Architectural/Engineering Agreement.

(i) The identity of the construction manager(s) or general contractor(s), as the case may be, and the Project Architect, and the contracts under which each is retained in connection with the Paris Facility must be approved by Lessor in writing prior to the commencement of construction, which approval shall not be unreasonably withheld. Any change to the construction manager(s) or general contractor(s), as the case may be, and the Project Architect in connection with the Paris Facility must be approved by Lessor in writing. Lessee will execute the construction management agreement or general contract(s) between Lessee and the construction manager or general contractor(s) covering all work to be done in connection with the Paris Facility. Upon request of Lessor, Lessee will promptly furnish to Lessor executed copies of the construction management, general contracts, and all subcontracts between the construction manager or general contractor(s) and all of their subcontractors and suppliers. Upon request of Lessor, Lessee will promptly furnish to Lessor any amendments or modifications (including change orders) to any of the foregoing. Lessee will not modify or amend or permit to be modified or amended (including by way of change order) any construction management agreement, construction contract or construction subcontract without Lessor's prior written approval; provided, however, that Lessor's prior approval need not be obtained with respect to any change order that results from a change in the Plans and Specifications with respect to which Lessor's consent is not required pursuant to Section 1(g) above. Upon request of Lessor, Lessee will also furnish to Lessor an executed copy of the architectural and/or engineering agreement between Lessee and the Project Architect with respect to the Paris Facility.

(ii) Lessee will perform its obligations under the contracts described in subparagraph (i) above, and will use reasonable best efforts to cause each other party to such contracts to perform its obligations under such contracts.

(iii) Lessee will enforce or cause to be enforced the prompt performance of the contracts described in subparagraph (i) above and will allow Lessor to take advantage of all rights and benefits of such contracts. In addition, effective upon the expiration or termination of this Lease as to the Paris Facility, Lessee hereby assigns to Lessor all warranties given to Lessee under the contracts described in subparagraph (i) above. Lessee shall deliver such further documents and agreements as may be reasonably requested by Lessor in connection with the assignment of warranties provided for in this Section.

(f) Records and Reports. Lessee will keep accurate and complete books and records relating to the construction of the Paris Facility, and Lessor will have access thereto during usual business hours upon 24 hours advance notice. Lessee will furnish or cause to be furnished to Lessor from time to time, promptly upon request, (i) copies and lists of all paid and unpaid bills for labor and materials with respect to the Paris Facility, (ii) Construction Budgets and revisions thereof showing the estimated cost of the Paris Facility and the source of the funds required at any given time to complete and pay for the same, (iii) receipted bills or other evidence of payment with respect to the cost of the Paris Facility, and (iv) such reports as to other matters relating to the Paris Facility as Lessor may request. This paragraph will supplement any similar provision in this Lease.

(g) Access. Notwithstanding anything to the contrary contained in this Lease, Lessee will, and will cause the Paris Sublessee to, permit Lessor's representatives to have access to the Paris Facility at all reasonable times and to conduct such investigations and inspections thereof as Lessor shall determine necessary, including without limitation in connection with inspecting the Paris Facility and all work done, labor performed and materials furnished in connection with the construction thereof. Lessee will, and will cause the Paris Sublessee to, cooperate and cause the construction manager or general contractor, as the case may be, to cooperate with Lessor and its representatives and agents during such inspections. Notwithstanding the foregoing, Lessee will, and will cause the Paris Sublessee to, be responsible for making inspections as to the Paris Facility during the course of construction and will determine to their own satisfaction that the work done or materials supplied by the contractors and subcontractors has been properly supplied or done in accordance with applicable contracts. All inspections that may be performed by Lessor and its agents will be exclusively for the benefit of Lessor and will impose no obligation whatever upon Lessor for the benefit of any person. Lessee will, and will cause the Paris Sublessee to, hold Lessor harmless from, and Lessor will have no liability or obligation of any kind to Lessee, the Paris Sublessee or creditors of any of them in connection with, any defective, improper or inadequate workmanship or materials brought in or related to the Paris Facility, or any construction lien arising as a result of such workmanship or materials. No inspection by Lessor will create any obligation on Lessor or relieve Lessee or the Paris Sublessee of any obligation.

(h) Damage by Fire or Other Casualty. If the Paris Facility is partially or totally damaged or destroyed by fire or other casualty or taken under the power of eminent domain, proceeds of such event will be applied as provided in this Lease.

(i) Payment of Costs. Lessee will pay when due all obligations incurred by Lessee, or the Paris Sublessee for the Paris Facility, including any cost for restoration.

7. Disbursements of Funded Amount. Upon satisfaction of the conditions set forth in subparagraphs (a) and (b) below, Lessor will disburse from time to time (but no more frequently than once per month) to Lessee advances of the Funded Amount, subject to the limitations set forth in Section 7 below.

(a) Lessor has received:

(i) a request for disbursement, in the form of AIA 706 (the "Request"), executed by an executive officer of Lessee and setting forth, among other things, the portion of the Funded Amount that Lessee then is requesting be disbursed, the amount that Lessee in good faith believes to be the cost to complete construction (after disbursement of the portion of the Funded Amount then being requested), a detailed breakdown of the costs and expenses incurred in the construction of the Paris Facility to the date of Request, a detailed cost breakdown of the percentage of completion of the construction of the Paris Facility (including both Hard Costs and Soft Costs) to the date of the Request, the amounts then due and unpaid with respect to such construction, such other information or documentation as may be required by the Title Company and the date upon which the disbursement is desired, provided that the date of the payment must not be less than seven (7) Business Days after the date upon which the Lessor receives the Request and the other items set forth in clauses (ii) through (vi) below;

(ii) A certification from Lessee that, as of the date of the Request, no Event of Default exists under this Amendment or any of the Transaction Documents, all representations and warranties set forth in this Amendment and all of the other Transaction Documents are accurate and complete, and there are no actions, suits or proceedings pending, or to the knowledge of the person making the certification, threatened or involving (or that could involve) Lessee, the Paris Sublessee or all or any part of the Facilities and that could impair the Facilities or the ability of Lessee and the Paris Sublessee to perform under this Amendment or any of the other Transaction Documents;

(iii) Certificates of the Project Architect, Lessor's Architect (if not the Project Architect) and Lessee, certified to Lessor and Lessee and certifying that (a) the Request is correct and, to the best of its knowledge, all work on the Paris Facility up to the date thereof has been done in substantial compliance with the Plans and Specifications therefor; (b) to the date thereof, there has been no material deviation from the budgeted cost of the Paris Facility or construction progress schedule, except as authorized by Lessee and approved by Lessor; and (c) the undisbursed portion of the Funded Amount will be sufficient to meet all known costs to complete the work covered by the Plans and Specifications, after giving effect to all amounts previously disbursed, plus the amount then requested; and

(iv) Evidence that Lessee have delivered the items described in (i) – (iii) above to Lessor.

(b) Upon the request of Lessor, the Title Company is prepared, without condition, to issue to Lessor a date-down endorsement, dated as of the date of the disbursement, insuring Lessor's title to the Paris Facility subject to no other exceptions than are set forth on the Title Policies delivered to Lessor at closing.

8. Limitation on Disbursements. In no event will Lessor pay amounts in excess of the *lesser* of: (i) the amounts actually paid in acquiring the Paris Land and for labor, services or materials incorporated into the Paris Facility; and (ii) the Maximum Funded Amount.

9. Sufficiency of Funded Amount. Lessor shall be entitled to not make a disbursement, or to make a disbursement in an amount less than the amount requested, if Lessor is not satisfied in its sole discretion that following the requested disbursement the undisbursed proceeds of the Funded Amount budgeted for the construction of the Paris Facility will be at least equal to the sum of 100% of the estimated Project Costs to complete the Paris Facility in accordance with the Plans and Specifications (including all costs incurred in connection with changes in the Plans and Specifications). If at any time it appears to Lessor that the undisbursed balance of the Funded Amount is less than the amount required by this Section, Lessor may give written notice to Lessee specifying the amount of the deficiency and Lessee immediately will deposit with Lessor the amount of the deficiency, which will be expended first in the same manner as the Funded Amount before any further payment of the Funded Amount will be made by Lessor. Lessor may reasonably determine the cost of construction of the Paris Facility and Lessee will be obligated to pay any sums so determined in excess of the Funded Amount prior to any payment under this Amendment.

10. Payments to Contractor, Subcontractors and Suppliers. In order to induce the Title Company to insure Lessor's title to the Paris Facility without exception for the construction or mechanics' liens, Lessor may make payments either through the Title Company or directly to any contractor, subcontractor or supplier furnishing labor or materials to the Paris Facility.

11. Lessor's Right to Cure. If Lessee fails to perform any of Lessee's undertakings set forth in this Amendment or in any other Transaction Document and fails to cure the same within any grace or cure period applicable thereto, upon such Notice as may be expressly required herein or therein (or, if Lessor reasonably determines that the giving of such Notice would risk loss to the Paris Facility or cause damage to Lessor, upon such Notice as is practical under the circumstances), and without waiving or releasing any obligation of Lessee, Lessor may, but will not be required to, perform the same, and Lessee will reimburse Lessor any amounts expended by Lessor in so doing.

12. Application of Advances. Lessee will apply each payment of Funded Amount against amounts due and payable for construction of the Paris Facility or obligations in connection therewith as set forth in each Request. Nothing contained in this Amendment will impose upon Lessor any obligation to see to the proper application of the advances by Lessee or any other party.

13. Construction or Other Liens. In the event any construction or other lien or encumbrance is filed or attached against the Paris Facility or any part thereof without the prior written consent of Lessor, and the same is not being contested by Lessee in accordance with Article XII of the Existing Master Lease, Lessor may, at its option and without regard to the priority of such construction or other lien or encumbrance, and without regard to any defenses that Lessee may have with respect to the lien or encumbrance, pay the same, and Lessee will reimburse all amounts expended by Lessor for such purpose within ten (10) days of written notice thereof.

14. Conditions to Final Payment. Lessor shall be entitled to withhold the final payment of the Funded Amount unless and until all of the following conditions have been fulfilled to Lessor's satisfaction:

(a) All conditions for all previous disbursements have been, and, as of the date of the final disbursement continue to be, fulfilled.

(b) Lessor have received, at least seven (7) Business Days prior to the final payment, the following items, all of which Lessee agree to obtain and submit to Lessor at Lessee' sole expense:

(i) A final "as built" survey prepared and certified in accordance with the Survey Requirements;

(ii) Certificates of the Project Architect, Lessor's Architect (if not the Project Architect), and Lessee certified to both Lessor and Lessee and certifying that (a) to the best of its knowledge, the Paris Facility are complete in accordance with the Plans and Specifications therefor; (b) to the date thereof, there has been no material deviation from the budgeted cost of the Paris Facility or construction progress schedule, except as authorized by Lessee and approved by Lessor; and (c) the amount of the final payment will be sufficient to meet all known costs to complete the work covered by the Plans and Specifications; and

(iii) A final, unconditional certificate of occupancy for the Paris Facility.

15. Guaranty of Completion. Subject to a temporary suspension of performance pursuant to Section 16 or Lessor Delay, but regardless of whether the cost thereof exceeds the amount of the Maximum Funded Amount, Lessee will diligently and continuously carry out or cause to be carried out the construction of the Paris Facility so as to insure the completion of construction of the Paris Facility, the opening of the Paris Facility and the acquisition of all Licenses for the Paris Facility, all by the applicable Target Completion Date. Regardless of whether the cost thereof exceeds the amount of the Funded Amount, Lessee will be responsible for payment of all costs of completing, opening and licensing the Paris Facility, including the payment of all costs in excess of the Construction Budgets. Promptly following receipt of written notice from Lessor specifying the defect or departure, Lessee will correct any structural defects in the Paris Facility or any departure from the Plans and Specifications not previously approved by Lessor. The approval or absence of disapproval by Lessor of any payment of Funded Amount shall not constitute a waiver of Lessor's right to require compliance with this Section.

16. Force Majeure. Upon the occurrence and during the continuance of an Event of Force Majeure and the giving of written notice thereof to Lessor, Lessee shall be temporarily released without any liability on its part from the performance of its obligations to construct the Paris Facility under this Amendment, except for the obligation to pay any amounts due and owing thereunder, but only to the extent and only for the period that its performance of each such obligation is prevented by the Event of Force Majeure. Such notice shall include a description of the nature of the Event of Force Majeure, and its cause and possible consequences. Lessee shall promptly notify Lessor of the termination of such event. Upon the request of Lessor, Lessee shall provide confirmation of the existence of the circumstances constituting an Event of Force

Majeure. Such evidence may consist of a statement of an appropriate governmental department or agency where available, or a statement describing in detail the facts claimed to constitute an Event of Force Majeure. During the period that the performance by Lessee has been suspended by reason of an Event of Force Majeure, Lessor may likewise suspend the performance of all or part of its obligations under this Amendment to the extent that such suspension is commercially reasonable and, notwithstanding anything in this Amendment to the contrary, Lessor shall have no obligation to make disbursements of the Funded Amount.

17. Expenses of Lessor. All costs incurred by Lessor in connection with the acquisition and construction of the Paris Facility and this Amendment, including, but not limited to, Lessor's legal counsel and due diligence costs, title insurance, survey, appraisal, UCC searches and filing fees, environmental and building assessments, consulting fees and brokers' fees, if any, shall be added to the Funded Amount; provided, however, to the extent the Maximum Funded Amount has been funded by Lessor, such costs shall be paid (or reimbursed) to Lessor by Lessee.

18. Amendments to Certain Provisions of Existing Master Lease. Section 8.3 of the Existing Master Lease is hereby amended to add the following new Section 8.3.3 as follows:

8.3.3 Paris Facility Capital Expenditures. Notwithstanding the provisions of Section 8.3.2 and as an exception thereto, Lessee shall not be required to expend any Minimum Qualified Capital Expenditures during the first three (3) Lease Years, following the Paris Base Rent Commencement Date. During such period, the number of licensed beds in the Paris Facility shall be excluded from and not used in the calculations for determining the Minimum Qualified Capital Expenditures under Section 8.3.2. During the fourth Lease Year following the Paris Base Rent Commencement Date, Lessee shall expend with respect to the Paris Facility at least One Hundred Fifty Dollars (\$150.00) per-licensed-bed as Minimum Qualified Capital Expenditures to improve the Paris Facility. During the fifth Lease Year following the Paris Base Rent Commencement Date, Lessee shall expend with respect to the Paris Facility at least Two Hundred Dollars (\$200.00) per-licensed bed as Minimum Qualified Capital Expenditure to improve the Paris Facility. Beginning with the sixth Lease Year following the Paris Base Rent Commencement Date and continuing for the remainder of the Term, Lessee shall expend with respect to the Paris Facility at least the amount of Minimum Qualified Capital Expenditures per-licensed-bed to improve the Paris Facility as may be required from time to time under Section 8.3.2, above.

19. Single, indivisible Lease. The Master Lease constitutes one indivisible lease of the Leased Properties, and not separate leases governed by similar terms. The Leased Properties constitute one economic unit, and the Base Rent and all other provisions have been negotiated and agreed to based on a demise of all of the Leased Properties as a single, composite, inseparable transaction and would have been substantially different had separate leases or a divisible lease been intended. Except as expressly provided herein for specific, isolated purposes (and then only to the extent expressly otherwise stated), all provisions of this Lease apply equally and uniformly to all the Leased Properties as one unit. An Event of Default with respect to any Leased Property is an Event of Default as to all of the Leased Properties. The parties intend that the provisions of this Lease shall at all times be construed, interpreted and applied so as to carry out their mutual objective to create an indivisible lease of all the Leased Properties and, in

particular but without limitation, that for purposes of any assumption, rejection or assignment of this Lease under 11 U.S.C. 365, this is one indivisible and non-severable lease and executory contract dealing with one legal and economic unit which must be assumed, rejected or assigned as a whole with respect to all (and only all) the Leased Properties covered hereby.

20. Conditions to Commencement of Construction and Obligations of Lessor and Lessee under this Amendment. Lessee shall not commence construction unless and until the the Acquisition Date has occurred (the "Commencement Conditions"). If the Commencement Conditions have not occurred on or before June 30, 2008, as such date may be extended by mutual agreement of Lessor and Lessee, then either Lessor or Lessee may terminate their obligations under this Amendment by written notice to other and this Amendment shall be of no further force or effect. If the Commencement Conditions have not been satisfied on or before April 15, 2008, then the Target Completion Date and the Rent Commencement Date shall each be extended one day for each day after April 15, 2008 that the Commencement Conditions have not been satisfied.

21. 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.

22. 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.

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

24. 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
SIXTH 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 14th day of March, 2008, by Glynn Riddle, the EVP & CFO of DIVERSICARE LEASING CORP., a Tennessee corporation, on behalf of said company

/s/ Jacqueline S. Reed

Notary Public, Tenn. County, Williamson

My commission expires: 1/24/2010

Signature Page 2 of 2

Acknowledgment to
SIXTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

The undersigned hereby consent to the transactions contemplated by this Sixth Amendment to Consolidated Amended and Restated Master Lease (the "Sixth 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 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 14th day of March, 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.

/s/ Jacqueline S. Reed
Notary Public, Tenn. County, Williamson
My Commission Expires: 1/24/2010

Acknowledgment to
SIXTH 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 14th day of March, 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.

/s/ Jacqueline S. Reed

Notary Public, Tenn. County, Williamson

My Commission Expires: 1/24/2010

Acknowledgment to
SIXTH 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 14th day of March, 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.

/s/ Jacqueline S. Reed

Notary Public, Tenn. County, Williamson

My Commission Expires: 1/24/2010

Acknowledgment to
SIXTH 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 14th day of March, 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.

/s/ Jacqueline S. Reed
Notary Public, Tenn. County, Williamson
My Commission Expires: 1/24/2010

Acknowledgment to
SIXTH 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 14th day of March, 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.

/s/ Jacqueline S. Reed
Notary Public, Tenn. County, Williamson
My Commission Expires: 1/24/2010

List of Exhibits and Schedules to
SIXTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

Exhibit A	Legal Description of Paris Facility
Exhibit B	Survey Requirements
Exhibit C	List of Facilities and Facility Trade Names
Exhibit D	Permitted Encumbrances for Paris Facility
Schedule 1	Construction Budget

Exhibit and Schedules to
SIXTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

EXHIBIT A

Situated within the Limits of the City of Paris, County of Lamar, and State of Texas, part of the Reddin Russell Survey #786, and being part of a called and being a part of a called 172.5 acre tract of land conveyed to May Belle Dunagan by deed recorded in Vol. 208, Page 316, of the Deed Records of said County and State.

Beginning at a 1/2" iron pin (f) for corner at the Easterly Northeast corner of a called 31.61 acre tract of land conveyed to North Lamar Independent School District by deed recording in Vol. 714, Page 748, of said Deed Records, said North Lamar ISD 31.61 acre tract originally being a part of said Dunagan 172.5 acre tract.

Thence North 26°57'07" West a distance of 798.43 feet to a 1/2" capped (NELSON SURVEYING) iron pin (f) for corner at the Northerly Northeast corner of said North Lamar ISD 31.61 acre tract;

Thence South 86°45'33" East a distance of 505.04 feet to a 1/2" capped (NELSON SURVEYING) iron pin (s) for corner;

Thence South 35°43'12" East a distance of 448.76 feet to a 1/2" capped (NELSON SURVEYING) iron pin (s) for corner;

Thence along the Northwesterly Boundary Line of said Stillhouse Road / Lamar County Road 41100 as follows: South 54°43'04" West a distance of 43.45 feet to a 1/2" capped (NELSON SURVEYING) iron pin (f); South 55°2'33" West a distance of 162.05 feet to a 1/2" capped (NELSON SURVEYING) iron pin (f); South 51°44'20" West a distance of 98.92 feet to a 1/2" capped (NELSON SURVEYING) iron pin (f); South 48°17'45" West a distance of 105.04 feet to a 1/2" capped (NELSON SURVEYING) iron pin (f); South 48°54'59" West a distance of 106.10 feet to the place of beginning and containing 286,255.28 square feet, or 6.5708 acres of land.

Note: Legal description will be revised as appropriate to match legal description of deed delivered to Lessor on the Acquisition Date.

Exhibit and Schedules to
SIXTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

Exhibit B

SURVEY REQUIREMENTS

A staked, boundary survey of the property (including a legally adequate property description and a statement of acreage). The survey shall be prepared by a surveyor or engineer duly licensed to practice as such in the State of _____, acceptable to the Lessor and the title company, shall be certified to the lender and the title company, and shall be a [specify either "Urban", "Suburban", "Rural" or "Mountain"] "ALTA/ACSM LAND TITLE SURVEY" meeting the currently effective Accuracy Standards adopted by ALTA and ACSM. The survey shall also incorporate items 1, 2, 3, 4, 6, 7, 8, 9, 10, 11, 13, 14, 16, 17 and 18 listed in Table A of the Minimum Standard Detail Requirements for ALTA/ACSM Land Title Surveys, jointly established and adopted by ALTA and ACSM in 2005.

SURVEY CERTIFICATION

_____ certify to (name of lessor) and (name of title company) that this map or plat and the survey on which it is based were made (i) in accordance with the "Minimum Standard Detail Requirements for ALTA/ACSM Land Title Surveys" jointly established and adopted by ALTA and ACSM in 2005, and incorporates items 1, 2, 3, 4, 6, 7, 8, 9, 10, 11, 13, 14, 16, 17 and 18 listed in Table A thereof, (ii) pursuant to the Accuracy Standards adopted by ALTA and ACSM and in effect on the date of this certification for a(n) [insert either "Urban", "Suburban", "Rural", or "Mountain"] Survey, and (iii) after a review of (name of title company) Commitment No. _____, effective date _____, 200____ and the instruments referred to therein as exceptions to title.

Date: _____

(signature of surveyor)

Exhibit and Schedules to
SIXTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

EXHIBIT C

	<u>Name</u>	<u>Street Address</u>	<u>City</u>	<u>County</u>	<u>State</u>	<u>Zip</u>
1.	Arbor Oaks Health & Rehab Center (Stillmeadow)	105 Russellville Road, Route 2, Highway 67 South	Malvern	Hot Spring	AR	72104
2.	Ash Flat Nursing & Rehab Center	66 Ozbirn Lane	Ash Flat	Sharp	AR	72513
3.	Best Care, Inc.	2159 Dogwood Ridge	Whealersburg	Scioto	OH	45694
4.	Boone Health Care Center, Inc.	Lick Creek Road, P.O. Box 605	Danville	Boone	WV	25053
5.	Boyd Nursing and Rehab Center	12800 Princland Drive	Ashland	Boyd	KY	41102
6.	Canterbury Health Center	1720 Knowles Road	Phenix City	Russell	AL	36867
7.	Carter Nursing & Rehab Center	250 McDavid Boulevard, P.O. Box 904	Grayson	Carter	KY	41143
8.	Conway Health & Rehab Center (Faulkner)	2603 Dave Ward Drive	Conway	Faulkner	AR	72032
9.	Des Arc Nursing & Rehab Center	2216 West Main, P.O. box 143B	Des Arc	Prairie	AR	72040
10.	Elliott Nursing & Rehab Center	Howard Creek Road, P.O. Box 694, Route 32 East	Sandy Hook	Elliott	KY	41171
11.	Garland Nursing & Rehab Center and Apts.	610 Carpenter Dam Road	Hot Springs	Garland	AR	71901
12.	Hardee Manor Care Center	401 Orange Place	Wauchula	Hardee	FL	33873
13.	Laurel Manor Health Center	902 Buchanan Road, P.O. Box 505	New Tazewell	Claiborne	TN	37825
14.	Laurel Nursing & Rehab Center	HC 75, Box 153, Clinic Road	Ivydale	Clay	WV	25113
15.	Lynwood Nursing Home	4164 Halls Mill Road	Mobile	Mobile	AL	36693
16.	Manor House of Dover	537 Spring Street, P.O. Box 399	Dover	Stewart	TN	37058
17.	Mayfield Rehab and Special Care Center	200 Mayfield Drive	Smyrna	Rutherford	TN	37167
18.	Northside Health Care	700 Hutchins Ave	Gadsden	Etowah	AL	35901
19.	Ouachita Nursing /Pine Manor Apts.	1411 Country Club Road	Camden	Ouachita	AR	71701
20.	Pocahontas Nursing & Rehab Center	105 Country Club Road	Pocahontas	Randolph	AR	72455
21.	Rich Mountain Nursing & Rehab Center	306 Hornbeck	Mena	Polk	AR	71953
22.	Sheridan Nursing & Rehab Center	113 South Briarwood Drive	Sheridan	Grant	AR	72150
23.	South Shore Nursing & Rehab Center	James Hannah Drive, P.O. box 489	South Shore	Greenup	KY	41175
24.	The Pines Nursing & Rehab Center	524 Carpenter Dam Road	Hot Springs	Garland	AR	71901
25.	Walnut Ridge Nursing & Rehab Center	1500 West Main	Walnut Ridge	Lawrence	AR	72476
26.	West Liberty Nursing & Rehab Center	774 Liberty Road, P.O. Box 219, Route 5 Wells Hill	West Liberty	Morgan	KY	41472

27. Westside Health Care Center

4320 Judith Lane

Huntsville

Madison

AL

35805

Exhibit C – Page 1 of 2

	<u>Name</u>	<u>Street Address</u>	<u>City</u>	<u>County</u>	<u>State</u>	<u>Zip</u>
28.	Wurtland Nursing & Rehab Center	100 Wurtland Avenue, P.O. Box 677	Wurtland	Greenup	KY	41144
29.	Doctors Healthcare	9009 White Rock Trail	Dallas	Dallas	TX	75238
30.	Estates at Ft. Worth	201 Sycamore School Road	Fort Worth	Tarrant	TX	76134
31.	Heritage Oaks Estates	2001 N. 6th Street	Ballinger	Runnels	TX	76821
32.	Humble	8450 Will Clayton Parkway	Humble	Harris	TX	77338
33.	IHS of Dallas at Treemont	5550 Harvest Hill Road	Dallas	Dallas	TX	75230
34.	Katy	1525 Tull Drive	Katy	Harris	TX	77499
35.	Normandy Terrace	841 Rice Road	San Antonio	Bexar	TX	78220
36.	Paris Facility	### Stillhouse Road	Paris	Lamar	TX	

Exhibit and Schedules to
SIXTH AMENDMENT TO CONSOLIDATED
AMENDED AND RESTATED MASTER LEASE

EXHIBIT D

Permitted Exceptions

1. Easement to Texas Power & Light Co. dated *07/08/52* and recorded in Book 327, Page 397, Lamar County Deed Records.
2. Easement to Texas Power & Light Co., dated *05/09/56* and recorded in Book 349, Page 456, Lamar County Deed Records.
3. Easement to Texas Power & Light Co., dated *05/12/66* and recorded in Book 443, Page 175, Lamar County Deed Records.
4. Easement to Texas Power & Light Co, dated *03/21/68* and recorded in Book 469, Page 237, Lamar County Deed Records.
5. Right of Way Easement to Lamar County Water Supply dated *02/09/83*, and recorded in Book 655, Page 112, Lamar County Deed Records.
6. Easement and Right of Way to Texas Power & Light Co., dated *05/17/49*, and recorded in Book 308, Page 600, Lamar County Deed Records.

Exhibit and Schedules to
**SIXTH AMENDMENT TO CONSOLIDATED
 AMENDED AND RESTATED MASTER LEASE**

SCHEDULE 1
 Construction Budget

FACILITY DESCRIPTION	Omega/Paris Estimated Project Cost
Size in Square Feet	45,000
Stories	1
Units	70
Beds	120
Medicaid Beds	
Double Occupancy (Units)	50
Approximate Land Size (Acres)	6.489
Approximate Land Size (SF)	282,661
Units per Acre	11
Beds per Acre	18
DEVELOPMENT COST ANALYSIS	
Total Development Cost	6,841,902
Total Development Cost per Sq. Ft.	152.04
Total Development Cost per Unit	97,741
Total Development Cost per Bed	57,016
Land Cost [1]	
Land Cost [1]	175,203
Land Cost per Sq. Ft.	0.62
Land Cost per Acre	27,000
Land Cost per Unit	2,503
Land Cost per Bed	1,460
Building Cost	
Building Cost	4,000,635
Building Cost per Sq. Ft.	88.90
Building Cost per Unit	57,152
Building Cost per Bed	33,339
FF& E	
FF& E	552,500
FF& E per Sq. Ft.	12.28
FF& E per Unit	7,893
FF& E per Bed	4,604
Ach. & Eng. Fees	
Ach. & Eng. Fees	184,500
Site Work	602,000
Interest Expense [2]	315,000
Contingency [3]	400,064
	2.90% 10.0%

Exhibit and Schedules to
 SIXTH AMENDMENT TO CONSOLIDATED
 AMENDED AND RESTATED MASTER LEASE

			Omega/Paris Estimated Project Cost
Medicaid Bed Contract [4]	\$4,167	\$4,000	408,000
Title			35,000
Misc. Administrative Project Exp.			7,500
Closing Fee			5,000
Property Tax			25,000
Developer's Fee			80,000
Points [5]	1.15%	0.00%	0
Appraisal			4,500
Insurance Premium			12,000
Legal (Transaction Specific)			35,000
TOTAL CONSTRUCTION COSTS			6,841,902
Cost per Bed	140		48,871
Cost per Bed	120		57,016
Resulting Annual Rent at 10.25%			701,294.90

SECOND AMENDMENT TO LOAN AGREEMENT AND JOINDER

This Second Amendment to Loan Agreement and Joinder (this "Amendment"), dated as of March 14, 2008, is by and among **DIVERSICARE PARIS, LLC**, a Delaware limited liability company (the "New Borrower"), those certain entities set forth on Schedule 1 hereto, which are signatories hereto (such entities, collectively, the "Original Borrower" and together with the New Borrower, individually and collectively, the "Borrower"), and **LASALLE BANK NATIONAL ASSOCIATION**, a national banking association (together with its successors and assigns, the "Lender").

RECITALS

A. Original Borrower and Lender are parties to that certain Loan Agreement dated as of August 10, 2007 as amended by First Amendment to Loan Agreement (the "First Amendment") dated as of December 18, 2007 (as amended, restated, supplemented and otherwise modified, the "Loan Agreement").

B. The Original Borrower and Lender desire to amend certain terms and provisions of the Loan Agreement on the terms and conditions set forth herein.

C. The Lender desires that the New Borrower execute this Amendment for the purpose of acknowledging that it is a Borrower under the Loan Agreement.

NOW, THEREFORE, in consideration of the premises herein contained, and for other good and valuable consideration (the receipt, sufficiency and adequacy of which are hereby acknowledged), the parties hereto (intending to be legally bound) hereby agree as follows:

1. Definitions. Terms capitalized herein and not otherwise defined herein shall have the meanings ascribed to such terms in the Loan Agreement, as amended hereby.

2. Joinder and Assumption. From and after the date hereof, New Borrower hereby absolutely and unconditionally (i) joins as and becomes a party to the Loan Agreement as a Borrower thereunder, (ii) assumes, as a joint and several obligor thereunder, all of the obligations, liabilities and indemnities of a Borrower under the Loan Agreement and all other Financing Agreements (including, without limitation, the Liabilities), and (iii) covenants and agrees to be bound by and adhere to all of the terms, covenants, waivers, releases, agreements and conditions of or respecting the Borrower with respect to the Loan Agreement and each other Financing Agreements and all of the representations and warranties contained in the Loan Agreement and the other Financing Agreements. From and after the date hereof, any reference to the term "Borrower" in the Loan Agreement and each other Financing Agreement shall also include the New Borrower.

3. Amendments to Loan Agreement. Subject to the terms and conditions contained herein, the Borrower and the Lender hereby amend the Loan Agreement as follows:

(a) The definition of "Omega Master Lease Agreement" set forth in Section 1.1 of the Loan Agreement is hereby amended to (i) delete the word "and" immediately preceding clause (e) thereof and (ii) add the following new clauses (f) immediately following such clause (e): "and (f) that certain Sixth Amendment to Consolidated, Amended and Restated Master Lease dated as of March 14, 2008, by and between DLC and Omega."

(b) The definition of "Adjusted Leased Asset EBITDA" set forth in Section 1.1 of the Loan Agreement, as amended and restated in the First Amendment, is hereby further amended to add the following sentence to that definition:

"For purposes of determining Adjusted Leased Asset EBITDA, overhead costs of Diversicare Management Services, Co. and Parent shall be allocated on the basis of revenues of the Leased Assets in proportion to total consolidated revenues."

(c) The definition of "Leased Asset Adjusted EBITDA" currently set forth in Section 1.1 of the Loan Agreement is hereby deleted.

(d) Section 12.12 of the Loan Agreement is hereby amended to delete the contact information for Lender and substitute in lieu thereof the following new contact information:

Bank of America, N.A.
414 Union Street
Nashville, Tennessee
Attention: Gail Banasiak
Telephone No.: (615) 749-4607
Facsimile No.: (615) 749-4951

(e) Schedule 1 of the Loan Agreement is hereby amended to include the following new final row in the table set forth therein:

Diversicare Paris, LLC	Delaware limited liability company	1621 Galleria Boulevard Brentwood, TN 37027
------------------------	------------------------------------	--

(f) Schedule 1.1(a) of the Loan Agreement is hereby amended to include a reference to (i) "Parkview Care Center" and (ii) "Paris Healthcare and Rehabilitation Center or such other name(s) as communicated in writing by the Borrower to the Lender" under the "Texas" heading.

(g) The first paragraph of Schedule 1.1(e) of the Loan Agreement is hereby amended to delete the reference to "and as further amended by that certain Fifth Amendment to Consolidated Amendment, Amended and Restated Master Lease dated as of August 10, 2007" and substitute in lieu thereof a reference to "as further amended by that certain Fifth Amendment to Consolidated Amendment, Amended and Restated Master Lease dated as of August 10, 2007 and as further amended by that certain Sixth Amendment to Consolidated Amendment, Amended and Restated Master Lease dated as of March 14, 2008 (the 'Sixth Amendment')."

(h) Section (b) of Schedule 1.1(e) of the Loan Agreement is hereby amended to delete the reference to “August 3, 2007” and substitute in lieu thereof a reference to “August 3, 2007, as amended by that certain First Amendment to Master Sublease dated ____, 2009 (adding Paris Healthcare and Rehabilitation Center, or such other name(s) as communicated to the Lender by Borrower in writing).”

(i) Section (b) of Schedule 1.1(e) of the Loan Agreement is hereby further amended to include the following new clause (viii):

“(viii) Sublease dated ____, 2009, by Diversicare Texas I, LLC, as Master Sublessor, and Diversicare Paris, LLC, as Sublessee, with respect to the Paris Healthcare and Rehabilitation Center (or such other name(s) as communicated in writing by the Borrower to the Lender).”

(j) Schedule 1.1(e) of the Loan Agreement is hereby further amended to include the following new paragraphs 3 and 4:

“3. Single Facility Lease (Paris, Texas) dated October 31, 2007 by and between Long Term Care Associates–Texas, Inc., a Texas corporation, as Lessor, and New Borrower, as Lessee, as amended by First Amendment to Single Facility Lease (Paris, Texas) dated March 14, 2008.

4. Lease Agreement dated as of March 18, 2005 by and between Health Care Ventures, Inc., as Lessor, and Diversicare Leasing Corp., as Lessee, for Martin Health Care in Martin, Tennessee.”

(k) Schedule 7.8 of the Loan Agreement is hereby amended to include the following references in appropriate alphabetical order:

“Diversicare Paris, LLC (i) is qualified to do business, and does business, as a foreign limited liability company in the State of Texas under the name ‘Parkview Care Center’ and, (ii) if Borrower delivers written notice to the Lender that it intends for Diversicare Paris, LLC to do business under another name (or other names) upon execution of the Sixth Amendment by the parties thereto or thereafter, will be qualified to do business under such other name(s).”

4. Conditions Precedent. The amendments contained in Section 3 hereof are subject to, and contingent upon, the prior or contemporaneous satisfaction of the following conditions precedent:

(a) The Borrower and Lender shall have executed and delivered to each other this Amendment,

(b) The Borrower and Lender shall have executed and delivered to each other that certain Joinder No. 1 to Revolving Loan Note of even date herewith.

(c) The Borrower, Lender and Sterling Acquisition Corp., a Kentucky corporation, shall have amended the Omega-Sterling Intercreditor Agreement in form and substance reasonably satisfactory to the Lender, and

(d) The Borrower shall have delivered to the Lender correct and complete copies of the resolutions of the Borrower Agent authorizing or ratifying the execution, delivery and performance by the Borrower of this Amendment.

5. Acknowledgment: Post-Amendment Deliveries.

(a) Promptly upon execution thereof, but in any event, on or before April 30, 2008, the Borrower shall have delivered to the Lender correct and complete copies of the Sixth Amendment to Consolidated Amendment, Amended and Restated Master Lease by and between DLC and Omega.

(b) Promptly upon execution thereof, the Borrower shall deliver to the Lender correct and complete copies of the Sublease by Diversicare Texas I, LLC, as Master Sublessor, and Diversicare Paris, LLC, as Sublessee, with respect to the Paris Healthcare and Rehabilitation Center or such other facility name(s) as communicated in writing by the Borrower to the Lender (as amended, restated, supplemented or otherwise modified from time to time, the "Paris Sublease" and the facility subleases thereunder, the "New Paris Facility").

(c) Borrower and Lender acknowledge and agree (i) that upon execution thereof by the parties thereto, the Paris Sublease will be a Commercial Lease and Restricted Agreement; (ii) that certain Single Facility Lease dated October 31, 2007 (as amended, restated, supplemented or otherwise modified from time to time, the "Single Facility Lease") by and between Long Term Care Associates – Texas, Inc., a Texas corporation, and New Borrower is a Commercial Lease and a Restricted Agreement and (iii) that ninety (90) days following the completion of construction and licensing of the New Paris Facility for its intended use as a skilled nursing facility, the Single Facility Lease shall be terminated and of no further force or effect, if not sooner terminated by the parties thereto.

6. Reference to and Effect on the Loan Agreement.

(a) Except as expressly provided herein, the Loan Agreement and all of the other Financing Agreements shall remain unmodified and continue in full force and effect and are hereby ratified and confirmed.

(b) Except as expressly provided herein, the execution, delivery and effectiveness of this Amendment shall not operate as a waiver of: (i) any right, power or remedy of the Lender under the Loan Agreement or any of the other Financing Agreements, or (ii) any Default or Event of Default under the Loan Agreement.

7. Costs, Expenses and Taxes. Without limiting the obligation of the Borrower to reimburse the Lender for costs, fees, disbursements and expenses incurred by the Lender as specified in the Loan Agreement, the Borrower agrees to pay on demand all reasonable costs, fees, disbursements and expenses of the Lender in connection with the preparation, execution and delivery of this Amendment and the other agreements, instruments and documents

contemplated hereby, including, without limitation, reasonable attorneys' fees and out-of-pocket expenses.

8. Representations and Warranties of the Borrower. The Borrower hereby represents and warrants to the Lender, which representations and warranties shall survive the execution and delivery hereof, that on and as of the date hereof and after giving effect to this Amendment:

(a) The Borrower has the requisite power and authority to execute, deliver and perform its obligations under this Amendment. This Amendment has been duly authorized by all necessary action of the Borrower. This Amendment constitutes the legal, valid and binding obligation of the Borrower, enforceable against the Borrower in accordance with its terms, subject to the effect of any applicable bankruptcy, insolvency, reorganization or similar law affecting creditors' rights generally and general principles of equity;

(b) The Borrower's representations contained in Section 7 of the Loan Agreement are true and correct in all material respects (without duplication of materiality) on and as of the date hereof (unless expressly related to an earlier date, in which case such representations shall be true and correct as of such earlier date); and

(c) No Default or Event of Default has occurred and is continuing.

9. Reference to Loan Agreement; No Waiver.

(a) Upon the effectiveness of this Amendment, each reference in the Loan Agreement to "this Loan Agreement," "this Agreement," "hereunder," "hereof," "herein" or words of like import shall mean and be a reference to the Loan Agreement as amended hereby. The term "Financing Agreements" as defined in Section 1.1 of the Loan Agreement shall include (in addition to the Financing Agreements described in the Loan Agreement) this Amendment and any other agreements, instruments or other documents executed in connection herewith.

(b) The Lender's failure, at any time or times hereafter, to require strict performance by the Borrower of any provision or term of the Loan Agreement, this Amendment or the other Financing Agreements shall not waive, affect or diminish any right of the Lender hereafter to demand strict compliance and performance herewith or therewith. Any suspension or waiver by the Lender of a breach of this Amendment or any Event of Default under the Loan Agreement shall not, except as expressly set forth herein, suspend, waive or affect any other breach of this Amendment or any Event of Default under the Loan Agreement, whether the same is prior or subsequent thereto and whether of the same or of a different kind or character. None of the undertakings, agreements, warranties, covenants and representations of the Borrower contained in this Amendment, shall be deemed to have been suspended or waived by the Lender unless such suspension or waiver is: (i) in writing and signed by the Lender, and (ii) delivered to the Borrower. In no event shall the Lender's execution and delivery of this Amendment establish a course of dealing among the Lender, the Borrower or any other obligor or in any other way obligate the Lender to hereafter provide any amendments or waivers with respect to the Loan Agreement. The terms and provisions of this Amendment shall be limited precisely as written and shall not be deemed: (A) to be a consent to a modification (except as expressly

provided herein) or waiver of any other term or condition of the Loan Agreement or of any other Financing Agreement, or (B) to prejudice any right or remedy that the Lender may now have under or in connection with the Loan Agreement or any of the other Financing Agreements.

10. Successors and Assigns. This Amendment shall be binding upon and inure to the benefit of the Lender and each of the other parties hereto and their respective successors and assigns; provided, however, the Borrower may not assign this Amendment or any of the Borrower's rights hereunder without the Lender's prior written consent. Any prohibited assignment of this Amendment shall be absolutely null and void. This Amendment may only be amended or modified by a writing signed by the Lender and the Borrower.

11. Severability. Wherever possible, each provision of this Amendment shall be interpreted in such a manner so as to be effective and valid under applicable law, but if any provision of this Amendment is held to be prohibited by or invalid under applicable law, such provision or provisions shall be ineffective only to the extent of such provision and invalidity, without invalidating the remainder of this Amendment.

12. Governing Law. This Amendment shall be deemed to be a contract made under the laws of the State of Illinois, and the rights and obligations of the parties hereunder shall be construed in accordance with and be enforced and governed by the internal laws of the State of Illinois, without regard to conflict of law or choice of law principles.

13. Counterparts: Facsimile or Other Electronic Transmission. This Amendment may be executed in one or more counterparts, each of which taken together shall constitute one and the same instrument. Delivery of an executed counterpart of this Amendment by telefacsimile or other electronic transmission shall be equally as effective as delivery of a manually executed counterpart of this Amendment. Any party delivering an executed counterpart of this Amendment by telefacsimile or other electronic transmission shall also deliver a manually executed counterpart of this Amendment, but the failure to deliver a manually executed counterpart shall not affect the validity, enforceability or binding effect of this Amendment.

Signature Page Follows

IN WITNESS WHEREOF, the undersigned have caused this Second Amendment to Loan Agreement and Joinder to be duly executed and delivered as of the date first above written.

BORROWER:

DIVERSICARE MANAGEMENT SERVICES CO., a Tennessee corporation, as
Borrower Agent

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

ADVOCAT ANCILLARY SERVICES, INC., a Tennessee corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

ADVOCAT FINANCE, INC., a Delaware corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

DIVERSICARE MANAGEMENT SERVICES CO., a Tennessee corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

ADVOCAT DISTRIBUTION SERVICES, INC., a Tennessee corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

DIVERSICARE ASSISTED LIVING SERVICES, INC., a Tennessee corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

DIVERSICARE ASSISTED LIVING SERVICES NC, LLC, a Tennessee limited liability company

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

DIVERSICARE LEASING CORP., a Tennessee corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

STERLING HEALTH CARE MANAGEMENT, INC., a Kentucky corporation

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

SENIOR CARE CEDAR HILLS, LLC, a
Delaware limited liability company

BY: SENIOR CARE FLORIDA LEASING, LLC, its sole member

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial Officer

SENIOR CARE GOLFCREST, LLC, a
Delaware limited liability company

BY: SENIOR CARE FLORIDA LEASING, LLC, its sole member

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial Officer

SENIOR CARE GOLFPVIEW, LLC, a
Delaware limited liability company

BY: SENIOR CARE FLORIDA LEASING, LLC, its sole member

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial Officer

**SENIOR CARE FLORIDA LEASING,
LLC**, a Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

**SENIOR CARE SOUTHERN PINES,
LLC**, a Delaware limited liability company

**BY: SENIOR CARE FLORIDA LEASING,
LLC**, its sole member

BY: DIVERSICARE LEASING CORP., its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE AFTON OAKS, LLC, a
Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE ASSISTED LIVING SERVICES NC I, LLC, a Delaware limited liability company

BY: DIVERSICARE ASSISTED LIVING SERVICES NC, LLC, its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial Officer

DIVERSICARE ASSISTED LIVING SERVICES NC II, LLC, a Delaware limited liability company

BY: DIVERSICARE ASSISTED LIVING SERVICES NC, LLC, its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial Officer

DIVERSICARE BRIARCLIFF, LLC, a Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial Officer

DIVERSICARE CHISOLM, LLC, a
Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE HARTFORD, LLC, a
Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE HILLCREST, LLC, a
Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE LAMPASAS, LLC, a
Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE PINEDALE, LLC, a
Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE WINDSOR HOUSE,
LLC, a Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE YORKTOWN, LLC, a
Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE BALLINGER, LLC, a
Delaware limited liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE DOCTORS, LLC, a
Delaware limited liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE ESTATES, LLC, a
Delaware limited liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE HUMBLE, LLC, a
Delaware limited liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
Financial Officer

DIVERSICARE KATY, LLC, a Delaware
limited liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

**DIVERSICARE NORMANDY
TERRACE, LLC**, a Delaware limited
liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

DIVERSICARE TEXAS I, LLC, a
Delaware limited liability company

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

DIVERSICARE TREEMONT, LLC, a
Delaware limited liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief Financial
Officer

DIVERSICARE ROSE TERRACE, LLC,
a Delaware limited liability company

BY: DIVERSICARE LEASING CORP., its sole member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
 Financial Officer

DIVERSICARE PARIS, LLC, a
Delaware limited liability company

BY: DIVERSICARE TEXAS I, LLC, its sole
member

By: /s/ Glynn Riddle
Name: Glynn Riddle
Its: Executive Vice President & Chief
 Financial Officer

LENDER:

LASALLE BANK NATIONAL ASSOCIATION

By: Bank of America, N.A.
Its: _____

By: /s/ Khuzaim Shakir
 Khuzaim Shakir
 Senior Vice President

SCHEDULE 1

2. BORROWERS

Advocat Ancillary Services, Inc.
Advocat Finance, Inc.
Diversicare Management Services Co.
Advocat Distribution Services, Inc.
Diversicare Assisted Living Services, Inc.
Diversicare Assisted Living Services NC, LLC
Diversicare Leasing Corp.
Sterling Health Care Management, Inc.
Senior Care Cedar Hills, LLC
Senior Care Golfcrest, LLC
Senior Care Golfview, LLC
Senior Care Florida Leasing, LLC
Senior Care Southem Pines, LLC
Diversicare Afton Oaks, LLC
Diversicare Assisted Living Services NC I, LLC
Diversicare Assisted Living Services NC II, LLC
Diversicare Briarcliff, LLC
Diversicare Chisolm, LLC
Diversicare Hartford, LLC
Diversicare Hillcrest, LLC,
Diversicare Lampasas, LLC
Diversicare Pinedale, LLC
Diversicare Windsor House, LLC
Diversicare Yorktown, LLC
Diversicare Ballinger, LLC
Diversicare Doctors, LLC
Diversicare Estates, LLC
Diversicare Humble, LLC
Diversicare Katy, LLC
Diversicare Normandy Terrace, LLC
Diversicare Texas I, LLC
Diversicare Treemont, LLC
Diversicare Rose Terrace, LLC

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-15e and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 7, 2008

/s/ William R. Council, III
William R. Council, III
Chief Executive Officer

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

(ii) CERTIFICATION

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

1. I have reviewed this quarterly report on Form 10-Q of Advocat Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15e and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 7, 2008

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

**CERTIFICATION OF QUARTERLY REPORT ON FORM 10-Q
OF ADVOCAT INC.
FOR THE QUARTER ENDED MARCH 31, 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 March 31, 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 May 7, 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.