INTERNATIONAL MICROCOMPUTER SOFTWARE INC /CA/
Form 8-K
February 16, 2005

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

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported) February 14, 2005
Commission File Number **0-15949**

INTERNATIONAL MICROCOMPUTER SOFTWARE, INC.
(Exact name of registrant as specified in its charter)

California	**94-2862863**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer identification No.)**

100 Rowland Way, Suite 300, Novato, CA	**94945**
(Address of principal executive offices)	**(Zip code)**

(415) 878-4000
(Registrant's telephone number including area code)

ITEM 7.01 REGULATION FD DISCLOSURE (INFORMATION FURNISHED PURSUANT TO ITEM 12, "DISCLOSURE OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION").

On February 14, 2005, International Microcomputer Software, Inc. (the "Company") announced its financial results for the three and six months ended December 31, 2004. The full text of the press release issued in connection with the announcement is attached as Exhibit 99.1 to this Current Report on Form 8-K.

In accordance with the procedural guidance in SEC Release Nos. 33-8216 and 34-47583, the information in this Form 8-K and the Exhibit attached hereto is being furnished under "Item 9. Regulation FD Disclosure" rather than under "Item 12. Disclosure of Results of Operations and Financial Condition." The information shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act, except as expressly set forth by specific reference in such a filing.

ITEM 9.01 FINANCIAL STATEMENTS, PRO FORMA FINANCIAL INFORMATION AND EXHIBITS.

(a) Not applicable.

(b) Not applicable.

(c) Exhibits.

Exhibit No.	Description of Exhibit
99.1	Press release dated February 14, 2005.

SIGNATURE

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 hereunto duly authorized.

INTERNATIONAL MICROCOMPUTER SOFTWARE, INC.

Dated: February 14, 2005

By: /s/ MARTIN WADE, III

Name: Martin Wade, III
Title: Chief Executive Officer

EXHIBIT INDEX

Exhibit No.	Description of Exhibit
99.1	Press release dated February 14, 2005.

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Income from continuing operations before income taxes

17,594

1,724

19,318

Provision for income taxes

(1,188

)

(1,188

)

Income from continuing operations

17,594

536

18,130

Loss from discontinued operations

(6,033

)

(6,033

)

Net income

11,561

536

12,097

Preferred stock dividends

(6,423

)

(6,423

)

Preferred stock conversion and redemption charges

(2,013

)

(2,013

)

Net income available to common

$

3,125

$

536

$

3,661

Income per common share:

Basic:

Income from continuing operations

$

0.18

$

0.01

$

0.19

Net income

$

0.06

$

0.01

$

0.07

Diluted:

Income from continuing operations

$

0.18

$

0.01

$

0.19

Net income

$

0.06

$

0.01

$

0.07

Dividends declared and paid per common share

$

0.41

$

$

0.41

Weighted-average shares outstanding, basic

50,980

50,980

Weighted-average shares outstanding, diluted

51,339

51,339

Components of other comprehensive income:

Net income

$

11,561

$

536

$

12,097

Unrealized gain (loss) on common stock investment

Unrealized gain (loss) on preferred stock investment

(627

)

(627

)

Total comprehensive income

$

11,561

$

(91

)

$

11,470

17

NOTE 3 PROPERTIES

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

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

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

	Leased Property	Mortgage Notes Receivable	Facilities Held for Sale	Total Healthcare Facilities
Facility Count				
Balance at December 31, 2005	192	32	3	227
Properties sold/mortgages paid		(15)	(3)	(18)
Properties transferred to assets held for sale	(1)		1	
Properties transferred to purchase/leaseback	7	(7)		
Balance at June 30, 2006	198	10	1	209
Investment ($000 s)				
Balance at December 31, 2005	$ 996,127	$ 104,522	$ 1,243	$ 1,101,892
Properties sold/mortgages paid		(48,990)	(1,860)	(50,850)
Properties transferred to assets held for sale	(865)		865	
Properties transferred to purchase/leaseback	61,750	(22,750)		39,000
Impairment on properties	(121)			(121)
Capital expenditures and other	3,335	(401)		2,934
Balance at June 30, 2006	$ 1,060,226	$ 32,381	$ 248	$ 1,092,855

Leased Property

Our leased real estate properties, represented by 196 long-term care facilities and two rehabilitation hospitals at June 30, 2006, are leased under provisions of single leases and master leases with initial terms typically ranging from 5 to 15 years, plus renewal options. Substantially all of the leases and master leases provide for minimum annual rentals that are subject to annual increases based upon increases in the Consumer Price Index (CPI). Under the terms of the leases, the lessee is responsible for all maintenance, repairs, taxes and insurance on the leased properties.

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

Haven Eldercare, LLC

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

- In conjunction with the above transactions and the application of FIN 46R, we consolidated the financial statements and related real estate of this Haven entity into our financial statements. The

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consolidation resulted in the following changes to our consolidated balance sheet as of June 30, 2006: (1) an increase in total gross investments of $39.0 million; (2) an increase in accumulated depreciation of $0.8 million; (3) an increase in other long-term borrowings of $39.0 million; and (4) a reduction of $0.8 million in cumulative net earnings for the six months ended June 30, 2006 due to the increased depreciation expense. General Electric Capital Corporation and Haven s other creditors do not have recourse to our assets. We have an option to purchase the mortgaged facilities for a fixed price in 2012. Our results of operations reflect the effects of the consolidation of this entity, which is being accounted for similarly to our other purchase-leaseback transactions.

Acquisitions

- There were no acquisitions made during the three and six months ended June 30, 2006.

Assets Sold or Held for Sale

Assets Sold

- On June 30, 2006, we sold two SNFs in California resulting in an accounting loss of approximately $0.1 million.

- On March 31, 2006, we sold a SNF in Illinois resulting in an accounting loss of approximately $0.2 million.

Held for Sale

- At June 30, 2006, we had one asset held for sale with a net book value of approximately $0.2 million.

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

Mortgage Notes Receivable

Mortgage notes receivable relate to 10 long-term care facilities. The mortgage notes are secured by first mortgage liens on the borrowers underlying real estate and personal property. The mortgage notes receivable relate to facilities located in five states, operated by seven independent healthcare operating companies. We monitor compliance with mortgages and when necessary have initiated collection, foreclosure and other proceedings with respect to certain outstanding loans. As of June 30, 2006, we had no foreclosed property, and none of our mortgages were in foreclosure proceedings.

Mortgage interest income is recognized as earned over the terms of the related mortgage notes. Reserves are taken against earned revenues from mortgage interest when collection of amounts due becomes questionable or when negotiations for restructurings of troubled operators lead to lower expectations regarding ultimate collection. When collection is uncertain, mortgage interest income on impaired mortgage loans is recognized as received after taking into account application of security deposits.

Hickory Creek Healthcare Foundation, Inc.

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

Haven Eldercare, LLC.

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

NOTE 4 CONCENTRATION OF RISK

As of June 30, 2006, our portfolio of domestic investments consisted of 209 healthcare facilities, located in 27 states and operated by 34 third-party operators. Our gross investment in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately $1.1 billion at June 30, 2006, with approximately 98% of our real estate investments related to long-term care facilities. This portfolio is made up of 196 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on 10 long-term healthcare facilities and one facility held for sale. At June 30, 2006, we also held miscellaneous investments of approximately $43 million, consisting primarily of secured loans to third-party operators of our facilities.

At June 30, 2006, approximately 25% of our real estate investments were operated by two public companies: Sun Healthcare Group, Inc. (Sun) (15%) and Advocat (10%). Our largest private company operators (by investment) were CommuniCare Health Services, Inc. (CommuniCare) (18%), Haven (11%), Guardian LTC Management, Inc. (7%) and Essex Healthcare Corporation (7%). No other operator represents more than 5% of our investments. The three states in which we had our highest concentration of investments were Ohio (25%), Florida (10%) and Pennsylvania (9%) at June 30, 2006.

For the three-month period ended June 30, 2006, our revenues from operations totaled $32.4 million, of which approximately $5.8 million were from Sun (18%), $5.1 million from CommuniCare (16%) and $3.6 million from Advocat (11%). For the six-month period ended June 30, 2006, our revenues from operations totaled $64.6 million, of which approximately $11.6 million were from Sun (18%), $10.1 million from CommuniCare (16%) and $7.2 million from Advocat (11%). No other operator generated more than 10% of our revenues from operations for the three- and six-month periods ended June 30, 2006.

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

NOTE 5 - DIVIDENDS

In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our REIT taxable income (computed without regard to the dividends paid deduction and our net capital gain), and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of non-cash income. In addition, if we dispose of any built-in gain asset during a recognition period, we will be required to distribute at least 90% of the built-in gain (after tax), if any, recognized on the disposition of such asset. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to

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one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our REIT taxable income, as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates. In addition, our $200 million revolving senior secured credit facility (Credit Facility) has certain financial covenants that limit the distribution of dividends paid during a fiscal quarter to no more than 95% of our aggregate cumulative funds from operations (FFO) as defined in the loan agreement governing the Credit Facility (the Loan Agreement), unless a greater distribution is required to maintain REIT status. The Loan Agreement defines FFO as net income (or loss) plus depreciation and amortization and shall be adjusted for charges related to: (i) restructuring our debt; (ii) redemption of preferred stock; (iii) litigation charges up to $5.0 million; (iv) non-cash charges for accounts and notes receivable up to $5.0 million; (v) non-cash compensation related expenses; and (vi) non-cash impairment charges.

Common Dividends

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

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

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

Series D Preferred Dividends

On July 17, 2006, the Board of Directors declared the regular quarterly dividends for the 8.375% Series D Cumulative Redeemable Preferred Stock (Series D Preferred Stock) to stockholders of record on July 31, 2006. The stockholders of record of the Series D Preferred Stock on July 31, 2006 will be paid dividends in the amount of $0.52344 per preferred share on August 15, 2006. The liquidation preference for our Series D Preferred Stock is $25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period May 1, 2006 through July 31, 2006.

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

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

NOTE 6 TAXES

So long as we qualify as a REIT and, among other things, we distribute 90% of our taxable income, we will not be subject to Federal income taxes on our income, except as described below. We are permitted to own up to 100% of a taxable REIT subsidiary (TRS). Currently, we have two TRSs that are taxable as corporations and that pay federal, state and local income tax on their net income at the applicable corporate rates. These TRSs had net operating loss carry-forwards as of June 30, 2006 of $10.1 million. These loss carry-forwards were fully reserved with a valuation allowance due to uncertainties regarding realization.

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

As a result of the potential related party tenant issue described above and further discussed in Note 2 Restatement of Previously Issued Financial Statements, we have recorded a $0.6 million and $1.1 million provision for income taxes, including related interest expense, for the three and six months ended June 30, 2006, respectively, and $0.6 million and $1.2 million for the three and six months ended June 30, 2005, respectively. The amount accrued represents the estimated liability, which remains subject to final resolution and therefore is subject to change. In addition, in October 2006, we restructured our Advocat relationship and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007. We will continue to accrue an income tax liability related to this matter during 2006.

NOTE 7 STOCK-BASED COMPENSATION

Stock Options

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

Under the terms of our 2000 Stock Incentive Plan (the 2000 Plan), we reserved 3,500,000 shares of common stock. The exercise price per share of an option under the 2000 Plan cannot be reduced after the date of grant, nor can an option be cancelled in exchange for an option with a lower exercise price per share. The 2000 Plan provides for non-employee directors to receive options that vest over three years while other grants vest over the period required in the agreement applicable to the individual recipient. Directors, officers, employees and consultants are eligible to participate in the 2000 Plan. At June 30, 2006, there were

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outstanding options for 52,581 shares of common stock granted to eight eligible participants under the 2000 Plan. Additionally, 355,655 shares of restricted stock have been granted under the provisions of the 2000 Plan, and as of June 30, 2006, there were no shares of unvested restricted stock outstanding under the 2000 Plan.

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

Option Price Range	**Number**	**Weighted Average Exercise Price**	**Weighted Average Remaining Life (Years)**	**Number Exercisable**	**Weighted Average Price on Options Exercisable**
$2.96 -$3.81	11,918	$ 3.41	5.51	11,918	$ 3.41
$6.02 -$9.33	22,330	$ 6.67	6.06	20,661	$ 6.46
$20.25 -$37.20	18,333	$ 28.23	2.02	18,333	$ 28.23

On April 20, 2004, our Board of Directors approved the 2004 Stock Incentive Plan (the 2004 Plan), which was subsequently approved by our stockholders at our annual meeting held on June 3, 2004. Under the terms of the 2004 Plan, we reserved 3,000,000 shares of common stock. The exercise price per share of an option under the 2004 Plan cannot be less than fair market value (as defined in the 2004 Plan) on the date of grant. The exercise price per share of an option under the 2004 Plan cannot be reduced after the date of grant, nor can an option be cancelled in exchange for an option with a lower exercise price per share. Directors, officers, employees and consultants are eligible to participate in the 2004 Plan. As of June 30, 2006, a total of 348,695 shares of restricted stock and 317,500 restricted stock units have been granted under the 2004 Plan, and as of June 30, 2006, there were no outstanding options to purchase shares of common stock under the 2004 Plan.

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

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

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

Cash received from exercise under all stock-based payment arrangements for the six months ended June 30, 2006 and 2005 was $0.9 million and $0.1 million, respectively. Cash used to settle equity instruments granted under stock-based payment arrangements for the six months ended June 30, 2006 and 2005 was $0.7 million and $0.9 million, respectively.

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

The reported and pro forma net income and earnings per share figures for 2006 in the table are the same because share-based compensation expense is calculated under the provisions of FAS No. 123R. The 2006 amounts are included in the table below to provide detail for comparative purposes to the 2005 amounts.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006 Restated	**2005 Restated**	**2006 Restated**	**2005 Restated**
	(in thousands, except per share amounts)			
Net income (loss) to common stockholders	$ 15,009	$ (2,430)	$ 22,703	$ 3,661
Add: Stock-based compensation expense included in net income (loss) to common stockholders	292	285	585	571
	15,301	(2,145)	23,288	4,232
Less: Stock-based compensation expense determined under the fair value based method for all awards	292	342	585	690
Pro forma net income (loss) to common stockholders	$ 15,009	$ (2,487)	$ 22,703	$ 3,542
Earnings (loss) per share:				
Basic, as reported	$ 0.26	$ (0.05)	$ 0.39	$ 0.07
Basic, pro forma	$ 0.26	$ (0.05)	$ 0.39	$ 0.07
Diluted, as reported	$ 0.26	$ (0.05)	$ 0.39	$ 0.07
Diluted, pro forma	$ 0.26	$ (0.05)	$ 0.39	$ 0.07

Restricted Stock

On September 10, 2004, we entered into restricted stock agreements with four executive officers under the 2004 Plan. A total of 317,500 shares of restricted stock were granted, which equated to

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approximately $3.3 million of deferred compensation. The shares vest thirty-three and one-third percent (33 1/3%) on each of January 1, 2005, January 1, 2006 and January 1, 2007 so long as the executive officer remains employed on the vesting date, with vesting accelerating upon a qualifying termination of employment or upon the occurrence of a change of control (as defined in the applicable restricted stock agreements). As a result of the grant, we recorded $0.3 million and $0.6 million of non-cash compensation expense for the three and six-month periods ended June 30, 2006 and 2005, respectively.

For the six-month period ended June 30, 2006, we issued 1,822 shares of restricted common stock to each non-employee director and an additional 2,000 shares of restricted common stock to the Chairman of the Board under the 2004 Plan for a total of 11,110 shares. These shares represent a payment of the portion of the directors annual retainer that is payable in shares of our common stock.

As of June 30, 2006, there was $670 thousand of total unrecognized compensation cost related to these restricted stock awards.

Performance Restricted Stock Units

On September 10, 2004, we entered into performance restricted stock unit agreements with our four executive officers under the 2004 Plan. A total of 317,500 restricted stock units were issued under the 2004 Plan and will fully vest into shares of common stock when our company attains $0.30 per share of adjusted funds from operations (as defined in the applicable restricted stock unit agreements) for two (2) consecutive quarters, with vesting accelerating upon a qualifying termination of employment or upon the occurrence of a change of control (as defined in the applicable restricted stock unit agreements). The performance restricted stock units expire on December 31, 2007 if the performance criteria has not been met. As of June 30, 2006, we achieved the initial $0.30 per share adjusted funds from operations criteria as defined in the applicable restricted stock unit agreements. However, we have determined that it is not probable at this time that we will achieve the second consecutive quarter of $0.30 per share adjusted funds from operations, and therefore, it is not probable at this time that the restricted stock units will vest. In accordance with FAS No. 123R (i.e., compensation expense for a performance-based stock award shall be recognized when the satisfaction of the performance conditions that cause the award to vest are probable to occur), we have not recorded any compensation expense associated with the performance restricted stock units.

In accordance with FASB Statement No. 128, *Earnings per Share*, (FAS No. 128), the restricted stock unit shares are not included in the computation of basic EPS until all necessary conditions for the vesting of the restricted units have been satisfied. However, in accordance with FAS No. 128, the units are included in the quarterly and year-to-date diluted EPS as of June 30, 2006, using the treasury stock method as we have achieved the initial $0.30 per share adjusted funds from operations during the quarter ended June 30, 2006. See Note 12 Earnings per Share.

NOTE 8 INVESTMENTS IN DEBT AND EQUITY SECURITIES

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

At June 30, 2006, we had the following two marketable securities:

Sun Healthcare Common Stock Investment

- Under our 2004 restructuring agreement with Sun, we received the right to convert deferred base rent owed to us, totaling approximately $7.8 million, into 800,000 shares of Sun s common stock, subject to certain non-dilution provisions and the right of Sun to pay cash in an amount equal to the value of that stock in lieu of issuing stock to us.

- On March 30, 2004, we notified Sun of our intention to exercise our right to convert the deferred base rent into fully paid and non-assessable shares of Sun s common stock. On April 16, 2004, we received a stock certificate for 760,000 restricted shares of Sun s common stock and cash in the amount of approximately $0.5 million in exchange for the remaining 40,000 shares of Sun s common stock. On July 23, 2004, Sun registered these shares with the SEC. We are accounting for the 760,000 shares received as available for sale marketable securities with changes in market value recorded in other comprehensive income.

- In accordance with FASB No. 115, for the three- and six-month periods ended June 30, 2006, we recorded a $0.9 million and $1.6 million adjustment to other comprehensive income, respectively, to adjust our holdings in Sun common stock to their then current fair market value.

Advocat Subordinated Debt and Convertible Preferred Stock Investments

- Under our 2000 restructuring agreement with Advocat, we received the following: (i) 393,658 shares of Advocat s Series B non-voting, redeemable (on or after September 30, 2007), convertible preferred stock, which was convertible into up to 706,576 shares of Advocat s common stock (representing 9.9% of the outstanding shares of Advocat s common stock on a fully diluted, as-converted basis and accruing dividends at 7% per annum); and (ii) a secured convertible subordinated note in the amount of $1.7 million bearing interest at 7% per annum with a September 30, 2007 maturity (see Note 2 Restatement of Previously Issued Financial Statements).

- In accordance with FAS No. 115, the Advocat Series B security is a compound financial instrument. The embedded derivative value of the conversion feature is recorded separately at fair market value in accordance with FAS No. 133. The non-derivative portion of the security is classified as an available-for-sale investment and is stated at its fair value with unrealized gains or losses recorded in accumulated other comprehensive income. For the three- and six-month periods ended June 30, 2006, we recorded an adjustment of $0.3 million and $0.6 million to other comprehensive income, respectively, and for the three- and six-month periods ended June 30, 2005, we recorded an adjustment of $0.3 million and $0.6 million to other comprehensive income, respectively, to adjust the non-derivative portion of the Advocat security to its then current fair market value.

- In accordance with FASB No. 114 and FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan Income Recognition and Disclosures*, the Advocat secured convertible subordinated note is fully reserved and accounted for using the cost-recovery method applying cash received against the outstanding principal balance prior to recording interest income.

NOTE 9 FINANCING ACTIVITIES AND BORROWING ARRANGEMENTS

Bank Credit Agreements

At June 30, 2006, we had no outstanding borrowings under our $200 million revolving senior secured credit facility (the New Credit Facility); however, $2.9 million was utilized for the issuance of letters of credit, leaving availability of $197.1 million. The New Credit Facility, entered into on March

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31, 2006, is being provided by Bank of America, N.A., as Administrative Agent, Deutsche Bank Trust Company Americas, UBS Securities LLC, General Electric Capital Corporation, LaSalle Bank N.A., and Citicorp North America, Inc. and will be used for acquisitions and general corporate purposes.

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

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

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

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

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

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

Other Long-Term Borrowings

During the three months ended March 31, 2006, Haven used the $39 million of proceeds from the GE Loan to partially repay a portion of a $62 million mortgage it has with us. Simultaneously, we subordinated the payment of its remaining $23 million on the mortgage note to that of the GE Loan. In conjunction with the above transactions and the application of FIN 46R, we consolidated the financial statements of this Haven entity into our financial statements, which contained the long-term borrowings with General Electric Capital Corporation of $39.0 million. The loan has an interest rate of

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approximately seven percent and is due in 2012. The lender of the $39.0 million does not have recourse to our assets (see Note 3 Properties; Leased Property).

NOTE 10 LITIGATION

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

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

NOTE 11 DISCONTINUED OPERATIONS

Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* requires the presentation of the net operating results of facilities sold during 2006 or currently classified as held-for-sale as income from discontinued operations for all periods presented. We incurred a net loss from discontinued operations of approximately $0.1 million and $0.5 million for the three- and six-month periods ended June 30, 2006, respectively, in the accompanying consolidated statements of operations.

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