

ASSISTED LIVING CONCEPTS INC  
Form 10-Q  
August 09, 2001  
Table of Contents

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20459

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**FORM 10-Q**

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

For the quarterly period ended June 30, 2001

OR

- TRANSITION REPORT PURSUANT TO SECTION 12 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition period from \_\_\_\_\_ to \_\_\_\_\_ .

Commission file number 1-83938

**ASSISTED LIVING CONCEPTS, INC.**

(Exact name of registrant as specified in its charter)

Nevada  
(State or other jurisdiction of  
incorporation or organization)

93-1148702  
(IRS Employer  
Identification No.)

11835 NE Glenn Widing Drive, Building E

Portland, Oregon 97220  
(Address of principle executive offices)

(503) 252-6233

(Registrant's telephone number, including area code)

Indicate by check mark whether Registrant (1) has filed all reports 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 Registrants was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

The Registrant had 17,120,745 shares of common stock, \$.01 par value, outstanding at August 6, 2001.

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**TABLE OF CONTENTS**

**PART I -- FINANCIAL INFORMATION**

Item 1. Financial Statements

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

Item 3. Quantitative and Qualitative Disclosure Regarding Market Risk and Risk Sensitive Instruments

**PART II -- OTHER INFORMATION**

Item 1. Legal Proceedings

Item 6. Exhibits and Reports on Form 8-K

**SIGNATURES**

EXHIBIT 4.1

EXHIBIT 10.1

Exhibit 12

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**Table of Contents**

ASSISTED LIVING CONCEPTS, INC.

FORM 10-Q

June 30, 2001

INDEX

**Page**

**PART I  
FINANCIAL  
INFORMATION**

Item 1.

Financial  
Statements

Consolidated  
Balance Sheets,  
December 31,  
2000 and June 30,  
2001 1

Consolidated  
Statements of  
Operations, Three  
and Six Months  
Ended June 30,  
2000 and 2001 2

Consolidated  
Statements of Cash  
Flows, Six Months  
Ended June 30,  
2000 and 2001 3

Notes to  
Consolidated  
Financial  
Statements 4  
Item 2.

Management's  
Discussion and  
Analysis of  
Financial  
Condition and  
Results of  
Operations 10  
Risk Factors 18  
Item 3.  
Quantitative and  
Qualitative  
Disclosures About  
Market Risk and  
Risk Sensitive  
Instruments 25  
**PART II**  
**OTHER**  
**INFORMATION**  
Item 1.  
Legal  
Proceedings 26  
Item 6.  
Exhibits and  
Reports on Form  
8-K 26  
Signatures 27  
Exhibit Index 28

---

**Table of Contents**

**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**ASSISTED LIVING CONCEPTS, INC.**

**CONSOLIDATED BALANCE SHEETS**

**(In thousands, except share amounts)**

**ASSETS**

	<b>December 31, 2000</b>	<b>June 30, 2001</b>
	<hr/>	<hr/>
		<b>(unaudited)</b>
Current assets:		
Cash, cash equivalents and cash held for tenant security deposits		
\$9,889 \$5,679		

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Accounts receivable, net of  
allowance for doubtful accounts of  
\$1,399 and \$353, respectively  
2,448 2,207  
Prepaid insurance  
1,765 1,094  
Prepaid expenses  
1,042 485  
Other current assets  
2,729 3,121

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Total current assets  
17,873 12,586

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Restricted cash  
6,466 8,474  
Property and equipment, net  
298,744 294,669  
Goodwill, net  
4,785 4,639  
Other assets, net  
8,590 11,030

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Total assets  
\$336,458 \$331,398

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LIABILITIES AND  
SHAREHOLDERS' EQUITY

Current liabilities:

Accounts payable  
\$2,708 \$1,525  
Accrued real estate taxes  
4,835 3,969  
Accrued interest expense  
1,937 2,013  
Accrued payroll expense  
4,017 4,379  
Other accrued expenses  
4,855 3,775  
Bridge loan payable  
4,000  
Litigation settlement payable  
7,765 3,256  
Tenant security deposits  
2,484 2,453  
Insurance premium obligation  
1,228

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Other current liabilities

565 421

Current portion of long-term debt  
and capital lease obligation

1,690 11,827

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Total current liabilities

34,856 34,846

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Other liabilities

6,059 5,751

Long-term debt and capital lease  
obligation, net of current portion

70,407 74,474

Convertible subordinated  
debentures

161,250 161,250

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Total liabilities

272,572 276,321

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Commitments and contingencies

Shareholders' equity:

Preferred Stock, \$.01 par value;  
1,000,000 shares authorized; none  
issued or outstanding

Common Stock, \$.01 par value;  
80,000,000 shares authorized;  
issued and outstanding 17,120,745  
shares in 2000 and 2001

171 171

Additional paid-in capital

144,212 144,212

Accumulated deficit

(80,497) (89,306)

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Total shareholders' equity

63,886 55,077

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Total liabilities and shareholders  
equity  
\$336,458 \$331,398

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

1

**Table of Contents**

**ASSISTED LIVING CONCEPTS, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**(In thousands, except per share amounts)  
(Unaudited)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2000</b>	<b>2001</b>	<b>2000</b>	<b>2001</b>
Revenue	\$34,146	\$37,371	\$67,278	\$74,248
Operating expenses:				
Residence operating expenses				
22,305 24,891 44,987 50,449				
Corporate general and administrative				
5,066 4,440 9,114 8,708				
Building rentals				
3,685 4,151 7,330 8,322				
Building rentals to related party				
317 634				
Depreciation and amortization				
2,339 2,571 4,751 5,123				
Debt and lease restructure costs				
1,063 1,366				
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Total operating expenses				
33,712 37,116 66,816 73,968				
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Operating income  
434 255 462 280

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Other income (expense):

Interest expense  
(4,090) (4,905) (8,118) (9,307)

Interest income  
180 139 389 287

Gain (loss) on sale and disposal of assets  
13 (52) 13 (88)

Loss on sale of marketable securities  
(368) (368)

Other income (expense), net  
10 (48) 10 19

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Total other expense  
(4,255) (4,866) (8,074) (9,089)

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Net loss  
\$(3,821) \$(4,611) \$(7,612) \$(8,809)

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Basic and diluted net loss per common share  
\$(0.22) \$(0.27) \$(0.44) \$(0.51)

Basic and diluted weighted average common shares outstanding
17,121 17,121 17,121 17,121

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

**Table of Contents**

**ASSISTED LIVING CONCEPTS, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In thousands)  
(Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2000</b>	<b>2001</b>
<b>Operating Activities:</b>		
Net loss		
	\$(7,612)	\$(8,809)
Adjustment to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	4,751	5,123
Provision for doubtful accounts	291	(21)
Loss on sale of marketable securities	368	
Compensation expense on issuance of consultant options		



8

Loss on disposal of assets

(13) 88

Changes in assets and liabilities:

Accounts receivable

(267) 262

Prepaid expenses

(95) 1,228

Other current assets

387 (444)

Other assets

889 694

Accounts payable

(462) (1,183)

Accrued expenses

(915) (1,211)

Insurance premium obligation

1,228

Other current liabilities

240 (4,981)

Other liabilities

18 (308)

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Net cash used in operating activities

(2,412) (8,334)

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**Investing Activities:**

Restricted cash

(941) (2,008)

Sale of investment securities

1,632

Purchases of property and equipment

(1,679) (938)

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Net cash used in investing activities

(988) (2,946)

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**Financing Activities:**

Proceeds from long-term debt

14,777

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Payments on long-term debt  
and capital lease obligation  
(328) (573)  
Payments on bridge loan  
payable  
(4,000)  
Debt issuance costs  
(3,134)

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Net cash (used in) provided by  
financing activities  
(328) 7,070

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Net decrease in cash, cash  
equivalents and cash held for  
tenant security deposits  
(3,728) (4,210)  
Cash, cash equivalents and  
cash held for tenant security  
deposits, beginning of period  
7,606 9,889

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Cash, cash equivalents and  
cash held for tenant security  
deposits, end of period  
\$3,878 \$5,679

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**Supplemental disclosure of  
cash flow information:**

Cash payments for interest  
\$7,500 \$7,819  
Decrease in construction  
payable and property and  
equipment  
\$(794) \$  
Reclassification of other  
current and other liabilities to  
current and non-current  
long-term debt and capital lease  
obligation  
\$ \$550

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

**Table of Contents**

**ASSISTED LIVING CONCEPTS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. The Company**

Assisted Living Concepts, Inc., a Nevada Corporation, (the Company) owns, leases and operates assisted living residences which provide housing to older persons who need help with the activities of daily living, such as bathing and dressing. The Company provides personal care and support services and makes available routine health care services, as permitted by applicable law, designed to meet the needs of its residents.

*Basis of Presentation and Principles of Consolidation*

These consolidated financial statements have been prepared without being audited, as allowed by the rules and regulations of the Securities and Exchange Commission. The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries that own, lease and operate assisted living residences. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures that are normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted as allowed by rules and regulations of the Securities and Exchange Commission. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

The financial information included in these financial statements contain all adjustments (which consist of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of results for the quarterly periods. The results of operations for the three and six month periods ended June 30, 2001 do not necessarily indicate the results that are expected for the full year.

*Reclassifications*

Certain reclassifications have been made in the prior period's financial statements to conform to the current period's presentation. Such reclassifications had no effect on previously reported net loss or total shareholders' equity.

**2. Debt and Lease Restructure Costs**

Debt and lease restructure costs include legal, financial advisory and other professional fees related to the potential restructuring of the Company's under-performing loans and leases, and convertible debentures maturing in 2002 and 2003. Since the Company does not expect to raise any new capital as a result of such restructuring, these amounts are expensed as incurred in the accompanying financial statements. Costs were \$1.1 million and \$1.4 million for the three and six months ended June 30, 2001, respectively.

**Table of Contents**

**ASSISTED LIVING CONCEPTS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**3. Cash, Cash Equivalents and Cash Held for Tenant Security Deposits**

The Company's cash, cash equivalents and cash held for tenant security deposits consist of the following (in thousands):

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	<u>December 31, 2000</u>	<u>June 30, 2001</u>
Cash	\$2,863	\$2,097
Cash equivalents 4,581 1,169		
Cash held for tenant security deposits 2,445 2,413		
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Total cash, cash equivalents and cash held for tenant security deposits \$9,889 \$5,679		
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Cash held for tenant security deposits is a general unrestricted asset of the Company.

**4. Restricted Cash**

Restricted cash consists of the following (in thousands):

	<u>December 31, 2000</u>	<u>June 30, 2001</u>
Cash held for loan agreements with U.S. Bank National Association ( U.S. Bank )	\$4,354	\$4,418
Cash held in accordance with lease agreements 1,001 1,022		
Workers' compensation deposits 1,072 2,994		
State regulated restricted tenant security deposits 39 40		
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Total restricted cash \$6,466 \$8,474		
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**5. Property and Equipment**

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The Company's property and equipment, stated at cost, consists of the following (in thousands):

	December 31, 2000	June 30, 2001
Land and improvements	\$21,378	\$21,383
Buildings and improvements		
287,178	287,251	
Equipment		
7,149	7,385	
Furniture		
8,638	8,679	
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Total property and equipment		
324,343	324,698	
Less accumulated depreciation		
25,599	30,029	
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Property and equipment, net		
\$298,744	\$294,669	
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**6. Insurance Premium Obligation**

During the six months ended June 30, 2001, the Company entered into several short-term agreements to finance its annual insurance premiums. These are nine month agreements and bear interest at annual fixed rates of approximately 8% to 9%.

**Table of Contents**

**ASSISTED LIVING CONCEPTS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**7. Long-Term Debt**

*Equipment Financing*

Effective February 22, 2001, the Company entered into a loan agreement to finance technology equipment in the amount of \$550,000. The agreement required an initial payment of \$150,000 (which has been paid) and monthly payments of \$25,000 (principal and interest) until maturity on August 31, 2002. This loan bears an interest rate of 12.5% and is secured by the related technology equipment which the Company purchased during the year ended December 31, 2000.

*Heller Financing*

On March 2, 2001, the Company entered into an agreement with Heller Healthcare Finance, Inc. ( Heller ) for a line of credit facility up to \$45.0 million. This line was scheduled to mature on August 31, 2002 and would have been secured by up to 32 properties.

As of June 27, 2001, the Company amended its line of credit facility with Heller, reducing the aggregate line of credit available from \$45.0 million to \$20.0 million. This amended line bears an interest rate of 3.85% over the three-month LIBOR rate floating monthly and requires monthly interest-only payments until maturity. The amended line is secured by 26 properties. The maturity date for the amended line is September 28, 2001; accordingly, the outstanding balance is included in current portion of long-term debt in the accompanying financial statements. If the Company or any of the borrower subsidiaries is not subject to Chapter 11 of the U.S. Bankruptcy Code before such date, the borrower subsidiaries may extend the maturity date to the earlier of May 31, 2002, or the earliest date on which the Company or any of the borrower subsidiaries is subject to such a petition. Fees incurred to date, including commitment fees, funding fees, closing fees and professional fees associated with the establishment of this line of credit and amendment were \$2.9 million. The balance outstanding on this line is \$10.1 million at June 30, 2001 (\$12.2 million at August 6, 2001).

As amended, the facility may be used to pay trade payables, certain professional fees relating to its debt and lease restructuring, closing costs and other anticipated costs, and to fund an interest reserve and tenant deposit account. As amended, the line of credit facility may no longer be used to fund interest payments on the Company's convertible debentures, to repurchase leased facilities or debentures, or to fund future payments in connection with the Company's class action litigation settlement. While the line remains outstanding, the Company has agreed that it will not sell or grant mortgages on all but one of its remaining unencumbered properties, unless the net proceeds are used to repurchase the Company's convertible debentures or otherwise reduce its indebtedness (if approved by Heller).

The line of credit is guaranteed by the Company; however, as amended, the filing of a petition under Chapter 11 of the U.S. Bankruptcy Code by the Company no longer triggers an event of default under the loan agreement.

*Housing and Urban Development ( HUD ) Insured Financing*

On June 14, 2001, the Company entered into two loan agreements for \$1.8 million and \$2.7 million with Red Mortgage Capital, Inc. ( Red Mortgage ) for long-term HUD insured financing. Each loan is secured by a property in Texas, each loan matures on July 1, 2036 and together require monthly principal and interest payments of \$31,000. Each of these loans bears a fixed annual interest rate of 7.40%. Of the \$4.5 million in proceeds, \$4.0 million was used to pay off bridge financing provided by Red Mortgage, \$200,000 was used for loan closing costs, \$190,000 was used to pay down the Heller line of credit and the remaining proceeds were used to fund escrow accounts.

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**Table of Contents**

**ASSISTED LIVING CONCEPTS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

On July 19, 2001, the Company entered into a \$3.0 million loan agreement with Red Mortgage for long-term HUD insured financing. This loan is secured by one property in Texas, matures on July 1, 2036 and requires monthly principal and interest payments of \$20,000. This loan bears a fixed annual interest rate of 7.55%. \$2.8 million of the proceeds were used to pay down the Heller line of credit and the remaining proceeds were used for loan closing fees and to fund escrow accounts.

*U.S. Bank Loan Amendment*

On March 12, 2001, in exchange for a waiver of U.S. Bank's right to declare an event of default for the Company's failure to comply with certain financial covenants as of December 31, 2000 and March 31, 2001, and for the modification of certain financial covenants, the Company agreed to maintain minimum cash balances of \$11.0 million at the end of each fiscal quarter, except for the fiscal quarter ending June 30, 2001 which has a required minimum balance of \$8.0 million. The amendment also requires the Company to deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing its obligations to U.S. Bank. U.S. Bank is required to release such deposits upon satisfactory resolution of the regulatory action. As of the date of this filing, no such additional deposits

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have been required. Failure to comply with any covenant constitutes an event of default, which will allow U.S. Bank (at its discretion) to declare any amounts outstanding under the loan documents to be due and payable.

In May, 2001, the Company received a waiver of U.S. Bank's right to declare an event of default for the Company's failure to meet the March 31, 2001 cash balance requirements set forth in the March 12, 2001 U.S. Bank loan amendment.

Additionally, in August, 2001, the Company received a waiver of U.S. Bank's right to declare an event of default for the Company's failure to meet the June 30, 2001 cash balance requirements and other financial ratios set forth in the amended U.S. Bank loan agreement. There can be no assurance that the Company will be able to meet these requirements as of the end of future quarters or that U.S. Bank will grant waivers of any such future failure to meet these requirements.

Many of the Company's debt instruments and leases contain cross-default provisions pursuant to which a default under one obligation can cause a default under one or more other obligations. Accordingly, if enforced, the Company could experience a material adverse effect on its financial condition.

### **8. Litigation**

#### *Arbitration of Insurance Coverage Dispute*

In September, 2000, the Company reached an agreement to settle the class action litigation relating to the restatement of its consolidated financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and the Company was dismissed from the litigation with prejudice. Although the Company has been dismissed from the litigation with prejudice, an outstanding dispute regarding coverage exists with the Company's corporate liability insurance carriers. The Company and the insurance carriers agreed to resolve this dispute through binding arbitration. To the extent that the carriers are successful, they have agreed that their recovery is not to exceed \$4.0 million. The carriers further agreed that payment of any such amount awarded or agreed to will not be due in any event until 90 days after the Company has satisfied its obligations to the plaintiffs in the class action, with any such amount to be subordinated to new or refinancing of existing obligations. The Company believes it has strong defenses regarding this dispute and consequently has not recorded a liability in relation to this matter.

Although the Company believes it has strong defenses regarding its dispute with the insurance carriers, the Company cannot predict the outcome of this arbitration and currently is unable to evaluate the likelihood

### **Table of Contents**

#### **ASSISTED LIVING CONCEPTS, INC.**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

#### **(Unaudited)**

of success or the range of possible loss. However, if such arbitration were determined adversely to the Company, such a determination could have a material adverse effect on its financial condition, results of operations, cash flow and liquidity.

#### *Other Litigation*

In addition to the matter referred to above, the Company is involved in various lawsuits and claims arising in the normal course of business. In the aggregate, settlement of such suits and claims should not have a material adverse effect on the Company's financial condition, results of operations, cash flow and liquidity.

### **9. Liquidity**

The Company will have to pay all outstanding balances under the Heller line of credit maturing on September 28, 2001 (which the borrower subsidiaries may extend, if the Company or any borrower subsidiaries is not subject to Chapter 11 of the U.S. Bankruptcy Code before such

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date, to the earlier of May 31, 2002 or the date on which the Company or any of the borrower subsidiaries is subject to Chapter 11) and \$161.3 million in principal amount of convertible debentures maturing in November 2002 and May 2003. The Company does not have sufficient liquidity to pay these amounts as they mature and is currently exploring various refinancing and restructuring alternatives. The Company has 38 unencumbered residences, 37 of which are subject to negative covenants not to encumber them unless the net proceeds are used to repurchase the Company's convertible debentures or otherwise reduce its indebtedness (if approved by Heller). If the Company makes its final payment on the litigation payable on October 23, 2001, the Company will have 8 additional unencumbered residences, none of which will be subject to negative covenants.

The Company has retained a financial advisor to explore possible restructuring options with respect to its convertible debentures. The Company's financial advisors and the financial advisors of an unofficial committee (the Committee) of the holders of 64% in principal amount of the Company's two series of convertible debentures (collectively, the Debentures) worked together from March, 2001 to July, 2001, negotiating restructuring options with respect to the Debentures. On July 2, 2001, the Company announced that the Committee had not accepted a proposal concerning a restructuring of the Debentures that the Company made to the Committee's advisors on April 12, 2001, nor had the Committee reached a consensus on any counteroffer. A confidentiality agreement and agreement to restrict trading of securities, dated May 24, 2001 (the Confidentiality Agreement), between the Company and the individual Committee members, expired June 30, 2001. The Company had entered into the Confidentiality Agreement to facilitate negotiations with the Debenture holders concerning a restructure.

The Company has continued its negotiations with certain members of the original Committee. The Company believes that such negotiations will lead to a consensual restructuring of the Debentures which will result in a significant reduction in principal amount of the Debentures and a substantial dilution, or elimination of, the Company's existing common stock ownership. The Company is also in negotiations with lenders and lessors of certain of the Company's loans and leases associated with under-performing properties. If the Company reaches an agreement with the Debenture holders, it is anticipated that the restructuring will be implemented through a prenegotiated plan of reorganization under Chapter 11 of the United States Bankruptcy Code through which certain under-performing leases may be rejected and certain under-performing properties subject to mortgages may be conveyed in full satisfaction of the indebtedness due. However, no agreement is currently in place and there can be no assurance that the Company will reach an agreement with the Debenture holders, lenders and lessors on a consensual restructuring of these obligations.

If the Company is unable to implement a prenegotiated plan, it will likely seek protection under Chapter 11 of the United States Bankruptcy Code. If it does so, no event of default will be triggered under the Heller line of credit, as amended.

### **Table of Contents**

#### **ASSISTED LIVING CONCEPTS, INC.**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

#### **(Unaudited)**

In either event, the Company expects to incur substantial costs for financial advisory, legal, accounting and lender fees that are currently estimated to exceed \$6.0 million.

#### **10. Subsequent Events**

##### *HUD Insured Financing*

On July 19, 2001, the Company borrowed \$3.0 million under a loan agreement with Red Mortgage for long-term HUD insured financing (Note 7).

##### *Amendment of Shareholder Rights Agreement*

On July 26, 2001, the Company modified and amended its Rights Agreement by and between it and American Stock Transfer and Trust Company, dated June 12, 1997, as previously modified and amended on November 8, 2000 (the Rights Agreement), by changing the expiration date from June 12, 2007 to July 26, 2001. As a result of this action, the preferred share purchase rights granted under the Rights Agreement also expired on July 26, 2001.



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

References in this section to ALC, the Company, us or we refer to Assisted Living Concepts, Inc. and its wholly-owned subsidiaries.

**Overview**

We operate, own and lease free-standing assisted living residences. These residences are primarily located in small middle-market rural and suburban communities with a population typically ranging from 10,000 to 40,000. We provide personal care and support services, and make available routine nursing services (as permitted by applicable law) designed to meet the personal and health care needs of our residents. As of June 30, 2001, we had operations in 16 states.

We experienced significant and rapid growth between 1994 and 1998, primarily through the development of assisted living residences and, to a lesser extent, through the acquisition of assisted living residences, opening our last twenty residences in 1999. At the closing of our initial public offering in November 1994, we had an operating base of five leased residences (137 units) located in Oregon. As of June 30, 2001, we operated 185 residences (7,149 units), of which we owned 115 residences (4,515 units) and leased 70 residences (2,634 units).

We derive our revenues primarily from resident fees for room, board and care. Resident fees typically are paid monthly by residents, their families, state Medicaid agencies or other third parties. Resident fees include revenue derived from a multi-tiered rate structure, which varies based on the level of care provided. Resident fees are recognized as revenues when services are provided. Our operating expenses include:

residence operating expenses, such as staff payroll, food, property taxes, utilities, insurance and other direct residence operating expenses;

general and administrative expenses consisting of regional management and corporate support functions such as legal, accounting and other administrative expenses;

building rentals;

depreciation and amortization; and

debt and lease restructure costs.

We anticipate that the majority of our revenues will continue to come from private pay sources. However, we believe that by having located residences in states with favorable regulatory and reimbursement climates, we should have a stable source of residents eligible for Medicaid reimbursement to the extent that private pay residents are not available and, in addition, provide our private pay residents with alternative sources of income when their private funds are depleted and they become Medicaid eligible.

Although we manage the mix of private paying tenants and Medicaid paying tenants residing in our facilities, any significant increase in our Medicaid population could have an adverse effect on our financial position, results of operations or cash flows, particularly if states operating these programs continue to limit, or more aggressively seek limits on, reimbursement rates. See Risk Factors We Depend on Reimbursement by Third-Party Payors.

**Table of Contents****Results of Operations**

The following table sets forth, for the periods presented, results of operations (in millions), operating expenses as a percentage of revenue, the number of total residences and units operated, average occupancy and rental rates and the sources of our revenue. The portion of revenues

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received from state Medicaid agencies are labeled as Medicaid state paid portion while the portion of our revenues that a Medicaid-eligible resident must pay out of his or her own resources is labeled Medicaid resident paid portion.

	Three Months Ended June 30,				Three Months Ended June 30,	
	2000	2001	Percentage Increase/Decrease	Percentage Increase/Decrease	2000	2001
	(in millions, except percentages)				(as percentage of revenue)	
Revenue	\$34.1	\$37.4	\$3.3	9.7%	100.0%	100.0%
Operating expenses:						
Residence operating expenses	22.3	24.9	2.6	11.7	65.4	66.6
Corporate general and administrative	5.1	4.4	(0.7)	(13.7)	15.0	11.8
Building rentals	4.0	4.1	0.1	3.0	11.7	11.2
Depreciation and amortization	2.3	2.6	0.3	13.0	6.7	7.0
Debt and lease restructure costs	1.1	1.1	100.0		2.9	
Total operating expenses	33.7	37.1	3.4	10.1	98.8	99.5
Operating income	0.4	0.3	(0.1)	0.3	1.2	0.5

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Other income (expense):

Interest expense

(4.1) (4.9) (0.8) (19.5) (12.0) (13.1)

Interest income

0.2 0.1 (0.1) 0.4 0.6 0.3

Gain (loss) on sale and disposal of assets

(0.1) (0.1) (100.0) (0.3)

Loss on sale of marketable securities

(0.4) 0.4 100.0 (1.2)

Other income (expense), net

.1 (0.1) (100.0) (1.2)

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Total other expense

(4.3) (4.9) 0.6 14.0 (12.6) (13.1)

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Net loss

\$(3.8) \$(4.6) \$(0.8) (20.5)% (11.4)% (12.6)%

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Other Data:

Residences operated (end of period)

185 185

Units operated (end of period)

7,148 7,149

Average occupancy rate (based on occupied units)

79.8% 83.9%

End of period occupancy rate (based on occupied units)

82.2% 84.2%

Average monthly rental rate

\$1,965 \$2,056

Sources of revenue:

Medicaid state paid portion

10.6% 12.7%

Medicaid resident paid portion

5.9 6.6

Private resident paid portion

83.5 80.7

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Total

100.0% 100.0%

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***Three months ended June 30, 2001 compared to three months ended June 30, 2000:***

We incurred a net loss of \$4.6 million, or \$0.27 per basic and diluted common share, on revenue of \$37.4 million for the three months ended June 30, 2001 (the June 2001 Quarter ) as compared to a net loss of \$3.8 million or \$0.22 per basic and diluted common share, on revenues of \$34.1 million for the three months ended June 30, 2000 (the June 2000 Quarter ).

*Revenues.* Revenues were \$37.4 million for the June 2001 Quarter as compared to \$34.1 million for the June 2000 Quarter, a net increase of \$3.3 million. The increase in revenue was attributable to a combination of an increase in average occupancy to 83.9% and average monthly rental rate to \$2,056 for the June 2001 Quarter as compared to average occupancy of 79.8% and average monthly rental rate of \$1,965 for June 2000 Quarter.

*Residence Operating Expenses.* Residence operating expenses were \$24.9 million for the June 2001 Quarter as compared to \$22.3 million for the June 2000 Quarter, a net increase of \$2.6 million.

**Table of Contents**

The principal elements of the increase in operating expenses include:

\$2.2 million related to an increase in payroll costs as a result of increases in occupancy, wages and benefits;

\$300,000 related to a 13% increase in utility costs;

\$400,000 related to an increase in kitchen expense as a result of increases in occupancy, and

\$500,000 related to increases in professional and property liability insurance premiums and deductibles or retentions.

These increases were offset by the following decreases:

a decrease of \$600,000 in property tax expense as a result of changes in assessments and related estimates; and

a decrease of \$300,000 in bad debt expense due to more timely collection of aged accounts receivables.

*Corporate, General and Administrative.* Corporate, general and administrative expenses were \$4.4 million for the June 2001 Quarter compared to \$5.1 million for the June 2000 Quarter, decrease of approximately \$700,000.

The principal elements of the decrease include:

\$500,000 related to legal fees associated with the class action litigation incurred during the June 2000 Quarter;

\$50,000 decrease in travel and entertainment expenses; and

\$150,000 decrease in payroll and related expenses.

*Building Rentals.* Building rentals were \$4.2 million for the June 2001 Quarter as compared to \$4.0 million for the June 2000 Quarter, an increase of \$200,000. The increase was due to annual rent escalators.

*Depreciation and Amortization.* Depreciation and amortization expense was \$2.6 million in the June 2001 Quarter as compared to \$2.3 million in the June 2000 Quarter. The increase is due to depreciation expense related to the equipment acquired to support our communications infrastructure.

*Debt and Lease Restructure Costs.* Debt and lease restructure costs were \$1.1 million for the June 2001 Quarter. These are professional fees, including legal and financial advisory fees, related to the potential restructuring of our under-performing loans and leases, and our convertible debentures maturing in 2002 and 2003. Since we do not expect to raise any new capital as a result of such restructuring, these amounts are expensed as incurred in the accompanying financial statements.

*Interest Expense.* Interest expense was \$4.9 million for the June 2001 Quarter compared to \$4.1 million for the June 2000 Quarter, an increase of \$800,000. The increase was related to interest incurred on our \$4.0 million bridge loan entered into in November 2000, interest costs associated with our draws of \$10.3 million on the Heller line of credit and the related amortization of financing fees associated with this line which was entered into in March 2001.

*Interest Income.* Interest income was \$139,000 for the June 2001 Quarter compared to \$180,000 for the June 2000 Quarter, a decrease of \$41,000. This decrease is the result of decreased balances in cash and cash equivalents.

*Net Loss.* As a result of the above, we incurred a net loss of \$4.6 million or \$0.27 per basic and diluted common share for the June 2001 Quarter, compared to a net loss of \$3.8 million, or \$0.22 per basic and diluted common share, for the June 2000 Quarter.

**Table of Contents**

*Six months ended June 30, 2001 compared to six months ended June 30, 2000:*

The following table sets forth, for the periods presented, results of operations (in millions), operating expenses as a percentage of revenue, the number of total residences and units operated, average occupancy and rental rates and the sources of our revenue. The portion of revenues received from state Medicaid agencies are labeled as Medicaid state paid portion while the portion of our revenues that a Medicaid-eligible resident must pay out of his or her own resources is labeled Medicaid resident paid portion.

	Six Months Ended June 30,			Six Months Ended June 30,	
	2000	2001	Percentage Increase/ (Decrease)	2000	2001
	(in millions, except percentages)			(as percentage of revenue)	
Revenue	\$67.3	\$74.2	\$6.9 10.3%	100.0%	100.0%
Operating expenses:					
Residence operating expenses	45.0	50.4	5.4 12.0	66.9	67.9
Corporate general and administrative	9.1	8.7	(0.4) (4.4)	13.5	11.7
Building rentals	8.0	8.3	0.3 3.8	11.9	11.2
Depreciation and amortization	4.8	5.1	0.3 6.3	7.1	6.9
Debt and lease restructure costs	1.4	1.4	100.0	1.9	
<b>Total operating expenses</b>	<b>66.9</b>	<b>73.9</b>	<b>7.0 10.5</b>	<b>99.4</b>	<b>99.6</b>

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Operating income  
 0.4 0.3 (0.1) (25.0) 0.6 0.4

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Other income (expense):

Interest expense  
 (8.1) (9.3) (1.2) (14.8) (12.0) (12.5)

Interest income  
 0.4 0.3 (0.1) (25.0) 0.6 0.4

Gain (loss) on sale and disposal of assets  
 (0.1) (0.1) (100.0) (0.1)

Loss on sale of marketable securities  
 (0.4) 0.4 100.0 (0.6)

Other income (expense), net  
 0.1 (0.1) (100.0) (0.6)

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Total other expense  
 (8.0) (9.1) 1.1 (12.3) (12.0) (12.3)

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Net loss  
 \$(7.6) \$(8.8) \$(1.1) (14.3)% (11.4)% (11.9)%


Other Data:

Residences operated (end of period)

185 185

Units operated (end of period)

7,148 7,149

Average occupancy rate (based on occupied units)

79.2% 83.6%

End of period occupancy rate (based on occupied units)

82.2% 84.2%

Average monthly rental rate

\$1,959 \$2,048

Sources of revenue:

Medicaid state paid portion

10.8% 12.3%

Medicaid resident paid portion

6.1 6.8

Private resident paid portion

83.1 80.7

Total

100.0% 100.0%

We incurred a net loss of \$8.8 million, or \$0.51 per basic and diluted common share, on revenue of \$74.2 million for the six months ended June 30, 2001 (the June 2001 YTD Period ) as compared to a net loss of \$7.6 million or \$0.44 per basic and diluted common share, on revenues of \$67.3 million for the six months ended June 30, 2000 (the June 2000 YTD Period ).

*Revenues.* Revenues were \$74.2 million for the June 2001 YTD Period as compared to \$67.3 million for the June 2000 YTD Period, a net increase of \$6.9 million. The increase in revenue was attributable to a combination of an increase in average occupancy to 83.6% and average monthly rental rate to \$2,048 for the June 2001 YTD Period as compared to average occupancy of 79.2% and average monthly rental rate of \$1,959 for June 2000 YTD Period.

*Residence Operating Expenses.* Residence operating expenses were \$50.4 million for the June 2001 YTD Period as compared to \$45.0 million for the June 2000 YTD Period, a net increase of \$5.4 million.



**Table of Contents**

The principal elements of the increase in operating expenses include:

\$4.1 million related to an increase in payroll costs as a result of increases in occupancy, wages and benefits;

\$700,000 related to a 17% increase in utility costs;

\$150,000 related to increased hiring expenses;

\$500,000 related to an increase in kitchen expense as a result of increases in occupancy; and

\$950,000 related to increases in professional and property liability insurance premiums and deductibles or retentions.

These increases were offset by the following decreases:

decrease of \$700,000 in property tax expense as a result of changes in assessments and related estimates; and

decrease in bad debt of \$300,000 due to more timely collection of aged receivables.

*Corporate, General and Administrative.* Corporate, general and administrative expenses were \$8.7 million for the June 2001 YTD Period compared to \$9.1 million for the June 2000 YTD Period, decrease of approximately \$400,000.

The principal elements of the decrease include:

\$350,000 of legal and accounting fees associated with the class action litigation incurred during the June 2000 YTD Period;

\$200,000 related to decrease in director and officer insurance premium for the 2001 renewal period; and

\$150,000 related to decreased payroll expenses.

The decrease was offset by increases in corporate, general and administrative expense of:

\$130,000 as a result of implementation of communication infrastructure and decrease in dial-up related charges; and

\$160,000 related to hiring and retention consulting.

*Building Rentals.* Building rentals were \$8.3 million for the June 2001 YTD Period as compared to \$8.0 million for the June 2000 YTD period, an increase of \$300,000. The increase was due to annual rent escalators and to a retroactive rent increase of \$145,000 paid to one lessor during the March 2001 Quarter.

*Depreciation and Amortization.* Depreciation and amortization expense was \$5.1 million in the June 2001 YTD Period as compared to \$4.8 million in the June 2000 YTD Period, an increase of \$300,000. The increase is due to depreciation expense related to the equipment acquired to support our communications infrastructure.

*Debt and Lease Restructure Costs.* Debt and lease restructure costs were \$1.4 million for the June 2001 YTD Period. These are professional fees, including legal and financial advisory fees, related to the potential restructuring of our under-performing loans and leases, and our convertible debentures maturing in 2002 and 2003. Since we do not expect to raise any new capital as a result of such restructuring, these amounts are expensed as incurred in the accompanying financial statements.

*Interest Expense.* Interest expense was \$9.3 million for the June 2001 YTD Period compared to \$8.1 million for the June 2000 YTD Period, an increase of \$1.2 million. The increase was related to interest incurred on our \$4.0 million bridge loan entered into in November 2000, interest costs associated with our draws of \$10.3 million on the Heller line of credit and the related amortization of financing fees associated with this line which was entered into in March 2001.

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*Interest Income.* Interest income was \$287,000 for the June 2001 YTD Period compared to \$389,000 for the June 2000 YTD Period, a decrease of \$102,000. This decrease is the result of decreased balances in cash and cash equivalents.

14

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### **Table of Contents**

*Net Loss.* As a result of the above, we incurred a net loss of \$8.8 million or \$0.51 per basic and diluted common share for the June 2001 YTD Period, compared to a net loss of \$7.6 million, or \$0.44 per basic and diluted common share, for the June 2000 YTD Period.

### **Liquidity and Capital Resources**

At June 30, 2001, we had a working capital deficit of \$22.3 million (including current portion of litigation settlement payable of \$3.3 million and Heller line of credit of \$10.1 million) and unrestricted cash, cash equivalents and cash held for tenant security deposits of \$5.7 million.

Net cash used in operating activities was \$8.3 million during the six months ended June 30, 2001. The primary uses were reductions of \$1.2 million in accrued liabilities, \$1.2 million in accounts payable and \$5.0 million in other current liabilities consisting primarily of payments of \$4.5 million on our class action litigation settlement payable. These uses were offset by an increase of \$1.2 million in prepaid expenses.

Net cash used in investing activities was \$2.9 million during the six months ended June 30, 2001. The primary use was an increase of \$2.0 million in restricted cash related to workers' compensation deposits required by our insurance carrier. Funds will be withdrawn from this account as 2001 workers' compensation claims are incurred and paid.

Net cash provided by financing activities was \$7.1 million during the six months ended June 30, 2001. We received proceeds of \$4.5 million in connection with long-term HUD insured financing secured by two Texas properties and \$10.3 million in draws on our Heller line of credit during the six months ended June 30, 2001. Costs associated with the closing of the HUD insured financings and the establishment of the Heller line of credit were \$200,000 and \$2.9 million, respectively. Of the \$4.5 million in proceeds we received from the HUD insured financing, \$4.0 million was used to pay off our \$4.0 million bridge loan payable, \$200,000 was used for HUD insured loan closing costs, \$190,000 was used to pay down the Heller line of credit and the remaining proceeds were used to fund escrow accounts. Principal payments on long term debt and capital lease obligations were \$573,000 for the six months ended June 30, 2001.

On March 12, 2001, in exchange for a waiver of U.S. Bank's right to declare an event of default for our failure to comply with certain financial covenants as of December 31, 2000 and March 31, 2001, and for the modification of certain financial covenants, we agreed to maintain minimum cash balances of \$11.0 million at the end of each fiscal quarter, except for the fiscal quarter ending June 30, 2001, which had a required minimum balance of \$8.0 million. The amendment also requires us to deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing our obligations to U.S. Bank. U.S. Bank is required to release such deposits upon satisfactory resolution of the regulatory action.

In May, 2001, we received a waiver of U.S. Bank's right to declare an event of default for our failure to meet the March 31, 2001 cash balance requirements set forth in the March 12, 2001 U.S. Bank loan amendment.

Additionally, in August, 2001, we received a waiver of U.S. Bank's right to declare an event of default for our failure to meet the June 30, 2001 cash balance requirements and other financial ratios set forth in the amended U.S. Bank loan agreement. There can be no assurance that we will be able to meet these requirements as of the end of future quarters or that U.S. Bank will grant waivers of any such future failure to meet these requirements.

Failure to comply with any covenant constitutes an event of default, which will allow U.S. Bank (at its discretion) to declare any amounts outstanding under the loan documents to be due and payable. Certain of our leases and loan agreements contain covenants and cross-default provisions such that a default on one of those agreements could cause us to be in default on one or more other agreements.

On March 2, 2001, we entered into an agreement with Heller Healthcare Finance, Inc. (Heller) for a line of credit facility up to \$45.0 million. This line was scheduled to mature on August 31, 2002 and would have been secured by up to 32 properties.

15

## **Table of Contents**

As of June 27, 2001, we amended the line of credit facility with Heller, reducing the aggregate line of credit available from \$45.0 million to \$20.0 million. This amended line bears an interest rate of 3.85% over the three-month LIBOR rate floating monthly and requires monthly interest-only payments until maturity. The amended line is secured by 26 properties. The maturity date for the amended line is September 28, 2001; accordingly, the outstanding balance is included in current portion of long-term debt in the accompanying financial statements. If the Company or any of our borrower subsidiaries is not subject to Chapter 11 of the U.S. Bankruptcy Code before such date, the borrower subsidiaries may extend the maturity date to the earlier of May 31, 2002, or the earliest date on which the Company or any of our borrower subsidiaries files such a petition. Fees incurred to date, including commitment fees, funding fees, closing fees and professional fees associated with the establishment of this line of credit and amendment were \$2.9 million. The balance outstanding on this line is \$10.1 million at June 30, 2001 (\$12.2 million at August 6, 2001).

On June 14, 2001, we entered into two loan agreements for \$1.8 million and \$2.7 million with Red Mortgage Capital, Inc. ( Red Mortgage ) for long-term HUD insured financing. Each loan is secured by a property in Texas, each loan matures on July 1, 2036 and together require monthly principal and interest payments of \$31,000. Each loan bears a fixed annual interest rate of 7.40%.

We made four payments of \$2.3 million each towards our class action litigation settlement on October 23, 2000, January 23, 2001, April 23, 2001 and July 23, 2001, and on May 31, 2001 we made our \$4.7 million semi-annual interest payment on our convertible subordinated debentures. We are obligated to pay the remaining \$1.0 million related to the litigation settlement on October 23, 2001. Eight properties currently secure our class action litigation settlement payable which will become unencumbered upon final payment on October 23, 2001. Additionally, our next \$4.7 million semi-annual interest payment on our convertible subordinated debentures is due on November 1, 2001. If our corporate liability insurance carriers were to prevail in the pending coverage dispute, now subject to binding arbitration, we could also be required to pay our insurance carriers up to \$4.0 million in damages (see Part II, Item 1 of this report).

Approximately \$27.2 million of our indebtedness was secured by letters of credit as of June 30, 2001 which in some cases have termination dates prior to the maturity of the underlying debt. As such letters of credit expire, beginning in 2003, we will need to obtain replacement letters of credit, post cash collateral or refinance the underlying debt. There can be no assurance that we will be able to procure replacement letters of credit from the same or other lending institutions on terms that are acceptable to us. In the event that we are unable to obtain a replacement letter of credit or provide alternate collateral prior to the expiration of any of these letters of credit, we would be in default on the underlying debt.

We will have to pay all outstanding balances under the Heller line of credit maturing on September 28, 2001 (which the borrower subsidiaries may extend if we or any borrower subsidiary is not subject to Chapter 11 of the U.S. Bankruptcy Code before such date to the earlier of May 31, 2002 or the date on which we or any borrower subsidiary is subject to Chapter 11) and \$161.3 million in principal amount of convertible debentures maturing in November 2002 and May 2003. We do not have sufficient liquidity to pay these amounts as they mature and are currently exploring various refinancing and restructuring alternatives. We have 38 unencumbered residences, 37 of which are subject to negative covenants not to encumber them unless the net proceeds are used to repurchase our convertible debentures or otherwise reduce our indebtedness (if approved by Heller). If we make our final payment on the litigation payable on October 23, 2001, we will have 8 additional unencumbered residences, none of which will be subject to negative covenants.

We have retained a financial advisor to explore possible restructuring options with respect to our convertible debentures. Our financial advisors and the financial advisors of an unofficial committee (the Committee ) of the holders of 64% in principal amount of the Company's two series of convertible debentures (collectively, the Debentures ) have worked together from March, 2001 to July, 2001, negotiating restructuring options with respect to our Debentures. On July 2, 2001, we announced that the Committee had not accepted a proposal concerning a restructuring of the Debentures that we had made to the Committee's advisors on April 12, 2001, nor had the Committee reached a consensus on any counteroffer. A confidentiality agreement and agreement to restrict trading of securities, dated May 24, 2001 (the Confidentiality Agreement ), between us and the individual Committee members, expired June 30, 2001. We had

## **Table of Contents**

entered into the Confidentiality Agreement to facilitate negotiations with the Debenture holders concerning a restructure.

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We have continued our negotiations with certain members of the original Committee. We believe that such negotiations will lead to a consensual restructuring of the Debentures which will result in a significant reduction in principal amount of our Debentures and a substantial dilution, or elimination of, our existing common stock ownership. We are also in negotiations with lenders and lessors of certain of our loans and leases associated with under-performing properties. If we reach an agreement with the Debenture holders, it is anticipated that the restructuring would be implemented through a prenegotiated plan of reorganization under Chapter 11 of the United States Bankruptcy Code through which certain under-performing leases may be rejected and certain properties subject to under-performing mortgages may be conveyed in full satisfaction of the indebtedness due. However, no agreement is currently in place and there can be no assurance that we will reach an agreement with the Debenture holders, lenders and lessors on a consensual restructuring of these obligations.

If we are unable to implement a prenegotiated plan, we will likely seek protection under Chapter 11 of the United States Bankruptcy Code. If we do so, no event of default will be triggered under the Heller line of credit, as amended.

In either event, we expect to incur substantial costs for financial advisory, legal, accounting and lender fees that are currently estimated to exceed \$6.0 million.

### **Recent Accounting Pronouncements**

In July 2001, the Financial Accounting Standards Board (FASB) issued FASB Statements Nos. 141 and 142 (FAS 141 and FAS 142), Business Combinations and Goodwill and Other Intangible Assets. FAS 141 replaces APB 16 and eliminates pooling-of-interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. FAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill will be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. FAS 141 and FAS 142 are effective for all business combinations initiated after June 30, 2001.

Upon adoption of FAS 142, amortization of goodwill recorded for business combinations consummated prior to July 1, 2001 will cease, and intangible assets acquired prior to July 1, 2001 that do not meet the criteria for recognition under FAS 141 will be reclassified to goodwill. Companies are required to adopt FAS 142 for fiscal years beginning after December 15, 2001. The Company will adopt FAS 142 on January 1, 2002. In connection with the adoption of FAS 142, the Company will be required to perform a transitional goodwill impairment assessment. The Company has not yet determined the impact these standards will have on its results of operations and financial position.

17

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### **Table of Contents**

#### **RISK FACTORS**

Set forth below are the risks that we believe are material. This report on Form 10-Q, including the risks discussed below, contains forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may be affected by risks and uncertainties, including without limitation (i) our ability to control costs and improve operating margins, (ii) the degree to which our future operating results and financial condition will be affected by litigation described in this report, (iii) the possibility that we will experience a decrease in occupancy in our residences, which would adversely affect residence revenues and operating margins, (iv) our ability to operate our residences in compliance with evolving regulatory requirements (v) the degree to which our future operating results and financial condition may be affected by a reduction in Medicaid reimbursement rates, and (vi) the possibility that we will not be able to restructure our \$161.3 million of convertible debentures due in November 2002 and May 2003, in which event we are likely to seek protection under Chapter 11 of the United States Bankruptcy Code. In light of such risks and uncertainties, our actual results could differ materially from such forward-looking statements. Except as may be required by law, we do not undertake any obligation to publicly release any revisions to any forward-looking statements contained herein to reflect events and circumstances occurring after the date hereof or to reflect the occurrence of unanticipated events.

#### **We Will Need to Restructure Our Obligations and are Considering a Prenegotiated Plan of Reorganization under Chapter 11 of the United States Bankruptcy Code.**

We will have to pay all outstanding balances under the Heller line of credit maturing on September 28, 2001 (which the borrower subsidiaries may extend, if we or any of the borrower subsidiaries is not subject to Chapter 11 of the U.S. Bankruptcy Code before such date, to the earlier of May 31, 2002 or the date on which we or any borrower subsidiary is subject to Chapter 11) and \$161.3 million in principal amount of convertible debentures maturing in November 2002 and May 2003. We do not have sufficient liquidity to pay these amounts as they mature and are currently exploring various refinancing and restructuring alternatives. We have 38 unencumbered residences, 37 of which are subject to

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negative covenants not to encumber them unless the net proceeds are used to repurchase our convertible debentures or otherwise reduce our indebtedness (if approved by Heller). If we make our final payment on the litigation payable on October 23, 2001, we will have 8 additional unencumbered residences, none of which will be subject to negative covenants.

We have retained a financial advisor to explore possible restructuring options with respect to our convertible debentures. Our financial advisors and the financial advisors of an unofficial committee (the Committee) of the holders of 64% in principal amount of our two series of convertible debentures (collectively, the Debentures) worked together from March, 2001 to July, 2001, negotiating restructuring options with respect to our Debentures. On July 2, 2001, we announced that the Committee had not accepted the proposal concerning a restructuring of the Debentures that we had made to the Committee's advisors on April 12, 2001, nor had the Committee reached a consensus on any counteroffer. A confidentiality agreement and agreement to restrict trading of securities, dated May 24, 2001 (the Confidentiality Agreement), between us and the individual Committee members, expired June 30, 2001. We had entered into the Confidentiality Agreement to facilitate negotiations with the Debenture holders concerning a restructure.

We have continued our negotiations with certain members of the original Committee. We believe that such negotiations will lead to a consensual restructuring of the Debentures which will result in a significant reduction in principal amount of our Debentures and a substantial dilution, or elimination of, our existing common stock ownership. We are also in negotiations with lenders and lessors of certain of our loans and leases associated with under-performing properties. If we reach an agreement with the Debenture holders, it is anticipated that the restructuring will be implemented through a prenegotiated plan of reorganization under Chapter 11 of the United States Bankruptcy Code through which certain under-performing leases may be rejected and certain properties subject to under-performing mortgages may be conveyed in full satisfaction of the indebtedness due. However, no agreement is currently in place and there can be no assurance that we will reach an agreement with the convertible debenture holders, lenders and lessors on a consensual restructuring of these obligations.

18

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### **Table of Contents**

If we are unable to implement a prenegotiated plan, we will likely seek protection under Chapter 11 of the United States Bankruptcy Code.

In either event, we expect to incur substantial costs for financial advisory, legal, accounting and lender fees that are currently estimated to exceed \$6.0 million.

### **We Are Highly Leveraged; Our Loan and Lease Agreements Contain Financial Covenants.**

We are highly leveraged. We had total indebtedness, including short term portion, of \$250.8 million as of June 30, 2001. In addition, we had shareholders' equity of \$55.1 million as of June 30, 2001. The degree to which we are leveraged could have important consequences, including:

making it more difficult to satisfy our debt or lease obligations;

increasing our vulnerability to general adverse economic and industry conditions;

limiting our ability to obtain additional financing;

requiring dedication of a substantial portion of our cash flow from operations to the payment of principal and interest on our debt and leases, thereby reducing the availability of such cash flow to fund working capital, capital expenditures or other general corporate purposes;

limiting our flexibility in planning for, or reacting to, changes in our business or industry; and

placing us at a competitive disadvantage to less leveraged competitors.

Several of our debt instruments and leases contain financial covenants, including debt-to-cash flow and net worth tests. On March 12, 2001, in exchange for a waiver of U.S. Bank's right to declare an event of default for our failure to comply with certain financial covenants as of December 31, 2000 and March 31, 2001, and for the modification of certain financial covenants, we agreed to maintain minimum cash balances of \$11.0 million at the end of each fiscal quarter, except for the fiscal quarter ending June 30, 2001 which has a required minimum balance of \$8.0 million. The amendment also requires us to deposit \$500,000 in cash collateral with U.S. Bank in the event certain regulatory actions are commenced with respect to the properties securing our obligations to U.S. Bank. U.S. Bank is required to release such deposits upon satisfactory

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resolution of the regulatory action. As of the date of this filing, no such additional deposits have been required.

In May, 2001, we received a waiver of U.S. Bank's right to declare an event of default for our failure to meet the quarterly cash balance requirements set forth in the March 12, 2001 U.S. Bank loan amendment.

Additionally, in August, 2001, we received a waiver of U.S. Bank's right to declare an event of default for our failure to meet the quarterly cash balance requirements and other financial covenants set forth in the amended U.S. Bank loan agreements.

Failure to comply with any covenant constitutes an event of default, which will allow U.S. Bank (at its discretion) to declare any amounts outstanding under the loan documents to be due and payable. We cannot provide assurance that we will comply in the future with the modified financial covenants included in the agreement, or with the financial covenants set forth in our other debt agreements and leases. If we fail to comply with one or more of the U.S. Bank covenants or any other debt or lease covenants (after giving effect to any applicable cure period), the lender or lessor may declare us in default of the underlying obligation and exercise any available remedies, which may include:

in the case of debt, declaring the entire amount of the debt immediately due and payable;

foreclosing on any residences or other collateral securing the obligation; and

in the case of a lease, terminating the lease and suing for damages.

Many of our debt instruments and leases contain cross-default provisions pursuant to which a default under one obligation can cause a default under one or more other obligations. Accordingly, if enforced, we could experience a material adverse effect on our financial condition.

19

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### **Table of Contents**

#### **We Have Incurred Significant Increases in Utility Costs Related to Increases in Utility Rates During the Three and Six Months Ended June 30, 2001 and Are Advised That We Should Anticipate Substantial Future Increases.**

During the three and six months ended June 30, 2001 we experienced significant increases in utility rates, and have been advised that we should anticipate substantial increases in the future which could have a material adverse effect on our financial condition, results of operations or cash flows. We may attempt to add utility surcharges to our rental rates; however, there can be no assurance that we will be successful in doing so or that such surcharges will be high enough to cover rate increases we may incur. See Part I, Item 2 of this report.

#### **Possible American Stock Exchange Delisting.**

Our common stock currently is listed on the AMEX under the symbol ALF, our 5.625% Debentures currently are listed on AMEX under the symbol ALS5E03 and our 6.0% Debentures currently are listed on AMEX under the symbol ALS6K02. AMEX has notified us that we have fallen below certain of AMEX's continued listing guidelines and that it is reviewing our listing eligibility. In particular, we have incurred losses from continued operations for each of our past six fiscal years ending December 31, 2000, and last two fiscal quarters ending June 30, 2001, and the price per share of our common stock as quoted on AMEX recently has been below the minimum bid price of \$1.00 per share. We have provided AMEX with additional information and have been involved in ongoing discussions with AMEX in connection with its review of our listing eligibility. While AMEX has decided not to delist us at this time, they will continue to review our listing status.

If AMEX were to delist our securities, it is possible that the securities would continue to trade on the over-the-counter market. However, the extent of the public market for the securities and the availability of quotations would depend upon such factors as the aggregate market value of each class of securities, the interest in maintaining a market in such securities on the part of securities firms and other factors. There can be no assurance that any public market for our securities will exist in the event that our securities are delisted.

#### **We May Incur Significant Costs and Liability as a Result of Litigation.**

##### *Arbitration of Insurance Coverage Dispute*

In September 2000, we reached an agreement to settle the class action litigation relating to the restatement of our financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on

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November 30, 2000, and we were dismissed from the litigation with prejudice. Although we have been dismissed from the litigation with prejudice, an outstanding dispute regarding coverage exists with our corporate liability insurance carriers and us. We have agreed with our insurance carriers to resolve this dispute through binding arbitration. To the extent that the carriers are successful, they have agreed that their recovery will not exceed \$4.0 million. The carriers further agreed that payment of any such amount awarded will not be due in any event until 90 days after we have satisfied our obligations to the plaintiffs in the class action, with any such amount to be subordinated to new or refinancing of existing obligations. We believe that we have strong defenses regarding this dispute and consequently have not recorded a liability in relation to this matter.

Although we believe we have strong defenses regarding our dispute with our insurance carriers, we cannot predict the outcome of this arbitration and currently are unable to evaluate the likelihood of success or the range of possible loss. However, if such arbitration were determined adversely to us, such a determination could have a material adverse effect on our financial condition, results of operations, cash flow and liquidity.

### *Other Litigation*

In addition to the matter referred above, we are involved in various lawsuits and claims arising in the normal course of business. In the aggregate, settlement of such suits and claims should not have a material adverse effect on our financial condition, results of operations, cash flow and liquidity. However, if these

### **Table of Contents**

matters were determined adversely to us, such a determination could have a material adverse effect on our financial condition, results of operations, cash flow and liquidity.

### **We Are Subject to Significant Government Regulation.**

The operation of assisted living facilities and the provision of health care services are subject to federal laws, and state and local licensure, certification and inspection laws that regulate, among other matters:

- the number of licensed residences and units per residence;
- the provision of services;
- equipment;
- staffing, including professional licensing and criminal background checks;
- operating policies and procedures;
- fire prevention measures;
- environmental matters;
- resident characteristics;
- physical design and compliance with building and safety codes;
- confidentiality of medical information;
- safe working conditions;

family leave; and

disposal of medical waste.

Our cost to comply with these regulations is significant. In addition, it could adversely affect our financial condition or results of operations if a court or regulatory tribunal were to determine that we had failed to comply with any of these laws or regulations. Because these laws and regulations are amended from time to time we cannot predict when and to what extent liability may arise. See Confidentiality of Medical Information, Restrictions Imposed by Laws Benefiting Disabled Persons and Medical Waste.

In the ordinary course of our business, we receive and have received notices of deficiencies for failure to comply with various regulatory requirements. We review such notices and, in most cases, we will agree with the regulator upon the steps to be taken to bring the facility into compliance with regulatory requirements. From time to time, we may dispute the matter and sometimes will seek a hearing if we do not agree with the regulator. In some cases or upon repeat violations, the regulator may take one or more adverse actions against a facility. These adverse actions can include:

the imposition of fines we paid \$16,000 and \$8,800, respectively, in the aggregate for the year ended December 31, 2000 and the six months ended June 30, 2001;

temporary stop placement of admission of new residents, or imposition of other conditions to admission of new residents to the facility four residences (two in Washington and two in Idaho) in 2000, two continued into 2001, one of which is still in stop placement as of this date;

termination of a facility's Medicaid contract;

conversion of license to provisional status; and

suspension or revocation of a facility's license, which in both 2000 and 2001 included one residence in Washington against which the state has commenced license revocation procedures. This matter is still pending at the time of this filing.

To date, these adverse actions have resulted in minimal fines and temporary suspension of admissions at certain residences. Because regulations vary from one jurisdiction to another and because determinations

## **Table of Contents**

regarding whether to make a license provisional, to suspend or revoke a license, or to impose a fine, are subject to administrative discretion, it is difficult for us to predict whether a particular remedy will be sought or obtained in any given case. These types of regulatory enforcement actions may adversely affect residence occupancy levels, revenues and costs of operation. We cannot guarantee that federal, state, or local governments will not impose additional restrictions on our activities that could materially adversely affect us.

The operation of our residences is subject to federal and state laws prohibiting fraud by health care providers, including criminal provisions, which prohibit filing false claims or making false statements to receive payment or certification under Medicaid, or failing to refund overpayments or improper payments. Violation of these provisions is a felony punishable by up to five years imprisonment and/or \$25,000 fines. Civil provisions prohibit the knowing filing of a false claim or the knowing use of false statements to obtain payment. The penalties for such a violation are fines of not less than \$5,000 or more than \$10,000, plus treble damages, for each claim filed.

State and federal governments are devoting increasing attention and resources to anti-fraud initiatives against health care providers. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) (see Confidentiality of Medical Information) and the Balanced Budget Act of 1997 expanded the penalties for health care fraud, including broader provisions for the exclusion of providers from the Medicaid program. We have established policies and procedures that we believe are sufficient to ensure that our facilities will operate in substantial compliance with these anti-fraud and abuse requirements. While we believe that our business practices are consistent with Medicaid criteria, those criteria are often vague and subject to change and interpretation. Aggressive anti-fraud actions, however, could have an adverse effect on our financial position, results of operations or cash flows.

### **Overbuilding in the Assisted Living Industry.**



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We believe that many assisted living markets have been overbuilt. Regulation and other barriers to entry into the assisted living industry are not substantial. The effects of such overbuilding include (a) significantly longer fill-up periods, (b) pressure to lower or refrain from increasing rates, (c) competition for workers in already tight labor markets and (d) lower margins until excess units are absorbed. We believe that each local market is different, and we are and will continue to react in a variety of ways to the specific competitive environment that exists in each market. There can be no assurance that we will be able to compete effectively in those markets where overbuilding exists, or that future overbuilding in other markets where we operate residences will not adversely affect our operations.

### **We May Not Be Able to Attract and Retain Qualified Employees and Control Labor Costs.**

We compete with other providers of long-term care with respect to attracting and retaining qualified personnel. We also depend upon the available labor pool of low-wage employees. A shortage of qualified personnel may require us to enhance our wage and benefits packages in order to compete. Some of the states in which we operate impose licensing requirements on individuals serving as program directors at assisted living residences and others may adopt similar requirements. We cannot guarantee that our labor costs will not increase, or that, if they do increase, they can be matched by corresponding increases in revenues.

### **Our Properties Are Geographically Concentrated and We Depend on the Economies of the Specific Areas in Which We Operate Our Properties.**

We depend significantly on the economies of Texas, Indiana, Oregon, Ohio and Washington. As of June 30, 2001, 21.6% of our properties were in Texas, 11.4% in Indiana, 10.3% in Oregon, 9.7% in Ohio and 8.6% in Washington. Adverse changes in general economic factors affecting the respective health care industries or laws and regulatory environment in any of these states could have a material adverse effect on our financial condition and results of operations.

22

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## **Table of Contents**

### **We Depend on Reimbursement by Third-Party Payors.**

Although revenues at a majority of our residences come primarily from private payors, a portion of our revenues depend upon reimbursements from third-party government payors, including state Medicaid waiver programs. For the years ended December 31, 1998, 1999 and 2000 and the six months ended June 30, 2000 and June 30, 2001, direct payments received from Medicaid funded programs accounted for approximately 10.7%, 10.4%, 11.1%, 10.7% and 12.3% respectively, of our revenue. Also, our tenant-paid portion of Medicaid revenue accounted for approximately 5.8%, 5.9%, 6.2%, 6.0% and 6.8% respectively, of our revenue during the years ended December 31, 1998, 1999 and 2000 and the six months ended June 30, 2000 and June 30, 2001. We expect that state Medicaid waiver programs will continue to constitute a significant source of our revenue in the future. Furthermore, we cannot guarantee that our proportionate percentage of revenue received from Medicaid waiver programs will not increase. There are continuing efforts by governmental and private third-party payors to contain or reduce the costs of health care by lowering reimbursement rates, increasing case management review of services and negotiating reduced contract pricing. Also, there has been, and our management expects that there will continue to be, additional proposals attempting to reduce the federal and some state budget deficits by limiting Medicaid reimbursement in general. Adoption of any of these proposals could have a material adverse effect on our business, financial condition, results of operations and prospects. The State of Oregon recently proposed a substantial reduction in Medicaid funding which was ultimately not adopted.

We anticipate that revenues at a majority of our residences will continue to come from private pay sources. However, we believe that by having located residences in states with favorable regulatory and reimbursement climates, we should have a stable source of residents eligible for Medicaid reimbursement to the extent that private pay residents are not available and, in addition, provide our private pay residents with alternative sources of income if their private funds are depleted and they become Medicaid eligible.

The following table sets forth the sources of our revenue for states where we participate in Medicaid programs. The portion of revenues received from state Medicaid agencies are labeled as Medicaid State Paid Portion while the portion of our revenues that a Medicaid-eligible resident must pay out of his or her own resources is labeled Medicaid Tenant Paid Portion.

<b>Six Months Ended June 30, 2000</b>		<b>Six Months Ended June 30, 2001</b>	
<b>Medicaid</b>	<b>Private</b>	<b>Medicaid</b>	<b>Private</b>

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	State Paid Portion	Tenant Paid Portion	Tenant Paid Portion	State Paid Portion	Tenant Paid Portion	Tenant Paid Portion
Oregon	27.8%	15.4%	56.8%	28.7%	16.6%	54.7%
Washington	26.6%	13.9%	59.5%	30.0%	17.1%	52.9%
Idaho	5.0%	1.5%	93.5%	15.8%	10.7%	73.5%
Arizona	9.6%	6.7%	83.7%	14.6%	12.5%	72.9%
New Jersey	15.1%	7.6%	77.3%	19.5%	6.3%	74.2%
Texas	12.9%	8.2%	78.9%	15.3%	7.9%	76.8%
Nebraska	8.0%	4.1%	87.9%	9.1%	5.5%	85.4%

Although we manage the mix of private paying tenants and Medicaid paying tenants residing in our facilities, any significant increase in our Medicaid population could have an adverse effect on our financial position, results of operations or cash flows, particularly if the states operating these programs continue to limit, or more aggressively seek limits on, reimbursement rates.

### **Confidentiality of Medical Information.**

In 1996, the HIPAA law created comprehensive new requirements regarding the confidentiality of medical information that is or has been electronically transmitted or maintained. Under the 1996 law, Congress required the Department of Health and Human Services to promulgate regulations. The requirements set forth in the regulations are extensive and may require us to significantly change the way we maintain and transmit healthcare information for our residents.

### **Table of Contents**

Healthcare providers must take reasonable steps to ensure that the provider, as well as the provider's business partners, comply with the law's requirements. Therefore, we may be required to ensure that the other entities with which we do business are also in compliance with these laws. HIPAA also created certain consumer rights with which we may be required to comply, including a right of notice regarding our information practices, a right of access to inspect and copy such individual's protected medical information, and a right to receive an accounting of all disclosures made by us, with certain exceptions. Significant changes in these regulations have recently occurred but enforcement is not expected until April, 2003. The costs to comply with these final regulations could have an adverse effect on our financial position, results of operations, cash flows and prospects.

### **Restrictions Imposed by Laws Benefiting Disabled Persons.**

Under the Americans with Disabilities Act of 1990, all places of public accommodation are required to meet certain federal requirements related to access and use by disabled persons. A number of additional federal, state and local laws exist that also may require us to modify existing residences to allow disabled persons to access the residences. We believe that our residences are either substantially in compliance with present requirements or are exempt from them. However, if required changes cost more than anticipated, or must be made sooner than anticipated, we would incur additional costs. Further legislation may impose additional burdens or restrictions related to access by disabled persons, and the costs of compliance could be substantial.

### **Medical Waste.**

Our facilities generate potentially infectious waste due to the illness or physical condition of the residents, including, for example, blood-soaked bandages, swabs and other medical waste products and incontinence products of those residents diagnosed with infectious diseases. The management of potentially infectious medical waste, including handling, storage, transportation, treatment and disposal, is subject to regulation under various laws, both federal and state. These laws and regulations set forth the management requirements, as well as permit, record keeping, notice and reporting obligations. Any finding that we are not in compliance with these laws and regulations could adversely

affect our business operations and financial condition. Because these laws and regulations are amended from time to time, we cannot predict when and to what extent liability may arise. In addition, because these environmental laws vary from state to state, expansion of our operations to states where we do not currently operate may subject us to additional restrictions on the manner in which we operate our facilities.

**We May Be Liable for Losses Not Covered by or in Excess of Our Insurance.**

Providing services in the senior living industry involves an inherent risk of liability. Participants in the senior living and long-term care industry are subject to lawsuits alleging negligence or related legal theories, many of which may involve large claims and result in the incurrence of significant legal defense costs. We currently maintain insurance policies to cover such risks in amounts which we believe are in keeping with industry practice. There can be no assurance that a claim in excess of our insurance will not be asserted. A claim against us not covered by, or in excess of, our insurance, could have a material adverse affect on us.

Based on poor loss experience, insurers for the long term care industry have become increasingly wary of liability exposures. A number of insurance carriers have stopped writing coverage to this market, and those remaining have increased premiums and deductibles substantially. While nursing homes have been the primary targets of these insurers, assisted living companies, including us, have experienced premium and deductible increases. During our claim year ended December 31, 2000, our professional liability insurance coverage included deductible levels of \$100,000 per incident; for the claim year ending December 31, 2001 this deductible has been replaced with a retention level of \$250,000, except in Florida and Texas in which the retention level is \$500,000. In certain states, particularly Florida and Texas, many long-term care providers are facing very difficult renewals. There can be no assurance that we will be able to obtain liability insurance in the future or that, if such insurance is available, it will be available on terms acceptable to us.

**Table of Contents**

**We Could Incur Significant Costs Related to Environmental Remediation or Compliance.**

We are subject to various federal, state and local environmental laws, ordinances and regulations. Some of these laws, ordinances and regulations hold a current or previous owner, lessee or operator of real property liable for the cost of removal or remediation of some hazardous or toxic substances that could be located on, in or under such property. These laws and regulations often impose liability whether or not we knew of, or were responsible for, the presence of the hazardous or toxic substances. The costs of any required remediation or removal of these substances could be substantial. Furthermore, there is no limit to our liability under such laws and regulations. As a result, our liability could exceed our property's value and aggregate assets. The presence of these substances or failure to remediate these substances properly may also adversely affect our ability to sell or lease the property, or to borrow using our property as collateral.

We may be liable under some laws and regulations as an owner, operator or an entity that arranges for the disposal of hazardous or toxic substances at a disposal site. In that event, we may be liable for the costs of any required remediation or removal of the hazardous or toxic substances at the disposal site. In connection with the ownership or operation of our properties, we could be liable for these costs, as well as some other costs, including governmental fines and injuries to persons or properties. As a result, any hazardous or toxic substances which are present, with or without our knowledge, at any property we hold or operate could have an adverse effect on our business, financial condition or results of operations.

**Item 3. *Quantitative and Qualitative Disclosure Regarding Market Risk and Risk Sensitive Instruments***

Market risk represents the risk of changes in value of a financial instrument, derivative or non-derivative, caused by fluctuations in interest rates, foreign exchange rates and equity prices. Changes in these factors could cause fluctuations in our earnings and cash flows.

For fixed rate debt, changes in interest rates generally affect the fair market value of the debt instrument, but not our earnings or cash flows. We do not have an obligation to prepay any of our fixed rate debt prior to maturity, and therefore, interest rate risk and changes in the fair market value of our fixed rate debt will not have an impact on our earnings or cash flows until we decide, or are required, to refinance such debt.

For variable rate debt, changes in interest rates generally do not impact the fair market value of the debt instrument, but do affect our future earnings and cash flows. We had variable rate debt of \$37.3 million outstanding at June 30, 2001 with a weighted average interest rate of 4.9%. Assuming that our balance of variable rate debt remains constant at \$37.3 million, each one-percent increase in interest rates would result in an annual increase in interest expense, and a corresponding decrease in cash flows, of \$373,000. Conversely, each one-percent decrease in interest

rates would result in an annual decrease in interest expense, and a corresponding increase in cash flows, of \$373,000.

We are also exposed to market risks from fluctuations in interest rates and the effects of those fluctuations on market values of our cash equivalents and short-term investments. These investments generally consist of overnight investments that are not significantly exposed to interest rate risk, except to the extent that changes in interest rates will ultimately affect the amount of interest income earned and cash flow from these investments.

We do not have any derivative financial instruments in place to manage interest costs, but that does not mean we will not use them as a means to manage interest rate risk in the future.

We do not use foreign currency exchange forward contracts or commodity contracts and do not have foreign currency exposure.

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**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

*Arbitration of Insurance Coverage Dispute*

In September 2000, we reached an agreement to settle the class action litigation relating to the restatement of our financial statements for the years ended December 31, 1996 and 1997 and the first three fiscal quarters of 1998. This agreement received final court approval on November 30, 2000 and we were dismissed from the litigation with prejudice. Although we have been dismissed from the litigation with prejudice, an outstanding dispute regarding coverage exists with our corporate liability insurance carriers and us. We have agreed with our insurance carriers to resolve this dispute through binding arbitration. To the extent that the carriers are successful, they have agreed that their recovery will not exceed \$4.0 million. The carriers further agreed that payment of any such amount awarded will not be due in any event until 90 days after we have satisfied our obligations to the plaintiffs in the class action, with any such amount to be subordinated to new or refinancing of existing obligations. We believe that we have strong defenses regarding this dispute and consequently have not recorded a liability in relation to this matter.

Although we believe we have strong defenses regarding our dispute with the insurance carriers, we cannot predict the outcome of this arbitration and currently are unable to evaluate the likelihood of success or the range of possible loss. However, if such arbitration were determined adversely to us, such a determination could have a material adverse effect on our financial condition, results of operations, cash flow and liquidity.

*Other Litigation*

In addition to the matter referred to above, we are involved in various lawsuits and claims arising in the normal course of business. In the aggregate, settlement of such suits and claims should not have a material adverse effect on our financial condition, results of operations, cash flow and liquidity. However, if these matters were determined adversely to us, such a determination could have a material adverse effect on our financial condition, results of operations, cash flow and liquidity.

**Item 6. Exhibits and Reports on Form 8-K**

(a) The following documents are filed as part of this report:

**Exhibit  
Number**

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**Number**

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4.1	Amendment to Rights Agreement
10.1	First Amendment to Loan Documents, as of June 27, 2001, between ALC Ohio, Inc., ALC Pennsylvania, Inc., ALC Iowa, Inc., ALC Nebraska, Inc., ALC New Jersey, Inc., ALC Indiana, Inc., Assisted Living Concepts, Inc. and Heller Healthcare Finance, Inc.
12	Ratio of Earnings to Fixed Charges