FIVE STAR QUALITY CARE INC
Form S-1/A
March 20, 2002

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**As filed with the Securities and Exchange Commission on March 20, 2002**

**Registration No. 333-83648**

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# PRE-EFFECTIVE AMENDMENT NO. 1

**TO**

# FORM S-1

**REGISTRATION STATEMENT**
**UNDER**
**THE SECURITIES ACT OF 1933**

# FIVE STAR QUALITY CARE, INC.

(Exact name of registrant as specified in its charter)

| | | |
|---|---|---|
| **Maryland** | **8051** | **04-3516029** |
| (State or other jurisdiction of incorporation or organization) | (Primary Standard Industrial Classification Code Number) | (I.R.S. Employer Identification Number) |

**400 Centre Street**
**Newton, Massachusetts 02458**
**(617) 796-8387**

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

**Evrett W. Benton, President**
**Five Star Quality Care, Inc.**
**400 Centre Street**
**Newton, Massachusetts 02458**
**(617) 796-8387**

(Name, address, including zip code, telephone number, including area code, of agent for service)

**Copy to:**

| | |
|---|---|
| **William J. Curry, Esq.**<br>**Sullivan & Worcester LLP**<br>**One Post Office Square**<br>**Boston, Massachusetts 02109**<br>**(617) 338-2800** | **Frederick W. Kanner, Esq.**<br>**Glenn R. Pollner, Esq.**<br>**Dewey Ballantine LLP**<br>**1301 Avenue of the Americas**<br>**New York, New York 10019**<br>**(212) 259-8000** |

**Approximate date of commencement of proposed sale to the public: As soon as practicable after this Registration Statement becomes effective.**

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. / /

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. / /

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. / /

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. / /

**The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until this Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.**

PRELIMINARY PROSPECTUS Subject to completion March 20, 2002

**Information contained herein is subject to completion or amendment. A registration statement relating to these securities has been filed with the Securities and Exchange Commission. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This prospectus shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of such state.**

# 3,000,000 Shares

# Common Stock

We are selling all of the 3,000,000 shares of common stock offered in this prospectus.

Our common shares are traded on the American Stock Exchange, under the symbol "FVE". On March 19, 2002, the last reported sale price of our common shares on the American Stock Exchange was $7.51 per share.

**Investment in our shares involves a high degree of risk. You should read carefully this entire prospectus, including the section entitled "Risk factors" that begins on page 5 of this prospectus, which describes the material risks.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful and complete. Any representation to the contrary is a criminal offense.**

| | Per share | Total |
|---|---|---|
| Public offering price | $ | $ |
| Underwriting discounts and commissions | $ | $ |
| Proceeds, before expenses, to us | $ | $ |

| | Per share | Total |
|---|---|---|

The underwriters may also purchase from us up to an additional 450,000 shares, at the public offering price less the underwriting discount, to cover over-allotments, if any, within 30 days from the date of this prospectus.

The underwriters are offering our shares as described in "Underwriting". Delivery of the shares will be made on or about March , 2002.

**UBS Warburg**

**Jefferies & Company, Inc.**

**Wachovia Securities**

You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized anyone to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information contained in this prospectus is accurate as of the date on the cover. Changes may occur after that date and we may not update this information except as required by applicable law.

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References in this prospectus to "we", "us", "our", the "Company" or "Five Star" mean Five Star Quality Care, Inc. and its subsidiaries. In presenting "as adjusted" information in this prospectus, we have assumed that this offering has been completed and that we have applied the net proceeds as described in this prospectus. References in this prospectus to "Marriott" mean Marriott Senior Living Services, Inc., a subsidiary of Marriott International, Inc.

# Prospectus summary

*The following summary highlights information contained in other parts of this prospectus. Because it is a summary, it does not contain all of the information you should consider before investing in our common shares. You should read the entire prospectus carefully including "Risk factors" and the financial statements and related notes before making an investment decision.*

**OUR COMPANY**

We operate independent living and congregate care communities, assisted living facilities and nursing homes. We were formed in 2000 as a subsidiary of Senior Housing Properties Trust, a publicly traded real estate investment trust, or REIT, with $1.2 billion of assets. On December 31, 2001, Senior Housing distributed substantially all of our common shares to its shareholders in a spin off transaction and we became a separate publicly traded company. We currently operate 87 senior living facilities, all of which we lease from Senior Housing. Marriott manages 31 of these facilities for us. We recently agreed to acquire five additional senior living communities for $45.5 million. We intend to use substantially all of the proceeds from this offering to partially fund this acquisition. The following chart summarizes our operations for 2001, on a pro forma basis as if we had conducted our current operations and had completed our pending acquisition, as of the beginning of that year:

| Facilities | | Living Units | | Other Data | |
|---|---|---|---|---|---|
| Indep. liv. apts. and mixed communities | 30 | Indep. liv. apts. | 4,591 | Revenues: | $521 million |
| Asst. liv. facilities | 8 | Asst. living suites | 1,939 | -from residents' private resources | 60% |
| Nursing homes | 54 | Spec. care beds | 294 | -from Medicare / Medicaid | 40% |
| Total: | 92 | Nursing beds | 6,578 | Occupancy at 12/31/01 | 90% |
| | | Total: | 13,402 | Locations | 22 states |

**THE MARKET OPPORTUNITY**

We believe significant opportunities exist for us to expand because of current conditions in the senior living industry, including:

**A large number of senior living facilities are for sale.** As a result of excessive development of senior living facilities in the 1990s, many operators experienced lower than expected occupancy. Newly developed facilities attracted residents from established facilities. These factors resulted in increased financial pressure on operators who had incurred significant debts to finance their growth. Further, significant Medicare rate reductions forced many nursing homes into bankruptcy. These factors have caused many operators to offer facilities for sale or to seek to exit the industry.

**The senior living business is improving.** New development of senior living facilities has been curtailed and many outdated facilities have closed. At the same time, the U.S. population continues to age. These factors have created increased occupancy at many existing senior living facilities. Labor is a major cost at senior living facilities and the current economic slow-down has lessened wage pressures. Also, nursing homes are adjusting their operations to new payment levels.

**Many of our competitors are financially weak.** As a result of financial difficulties resulting from the factors described above, many of our competitors have recently been focused more upon reorganizing their debt than upon growth. Many senior living companies started in the 1990s have experienced failed business plans and have had difficulty attracting new capital. Some of our competitors cannot access growth capital because they are in or have recently emerged from bankruptcy and are now controlled by their former creditors.



**OUR GROWTH STRATEGY**

Our growth strategy is to acquire facilities that provide high quality services to residents who pay with private resources. In January 2002, we leased 31 senior living communities from Senior Housing. Approximately 88% of the revenues from these communities is paid by residents from their private resources. At the five communities we have agreed to acquire, all of the revenues are paid by residents from private resources. Our nursing homes derive a majority of their revenue from Medicare and Medicaid. In the future we may decide to expand our nursing home operations; however, if we do so, we expect to price such acquisitions at levels which take account of the increased risks associated with Medicare and Medicaid revenues.

Our senior management team has significant experience in the senior living industry. Although we have substantial lease obligations, we currently have zero debt. We believe our relationship with our former parent company, Senior Housing, may provide us with capital to finance some acquisitions. We believe that this combination of our experienced management, our financial position and our relationship with Senior Housing will enable us to expand our operations and compete successfully in the senior living industry.

**OUR HISTORY**

We were formed in 2000 as a subsidiary of Senior Housing. In July 2000, Senior Housing repossessed senior living properties from former tenants and we began to operate those facilities. Between July 2000 and December 2001, we closed unprofitable facilities and stabilized operations of other facilities. At year end 2001, substantially all of our shares were distributed to Senior Housing shareholders and we became a separate company listed on the American Stock Exchange.

At the time of our spin-off we leased 56 senior living facilities which we formerly operated for Senior Housing, consisting of 54 nursing homes and two assisted living communities with 5,211 living units. Our 2001 pro forma revenues from these facilities are $227 million, and our rent is $7 million annually.

In January 2002, we leased 31 up-market retirement communities with 7,487 living units, a majority of which are independent living apartments. These communities are managed by Marriott. Our pro forma 2001 revenues from these facilities are $277 million, and our rent is $63 million annually plus a percentage of gross revenues which is escrowed as a capital expenditure reserve.

In January 2002, we agreed to acquire five senior living communities for $45.5 million. These five communities are located in five states and contain 704 living units, including 531 independent living apartments and 173 assisted living suites. These communities are 88% occupied and 100% of their revenues are paid from residents' private resources. We expect to finance this acquisition with the proceeds of this offering and our cash on hand. Before or after this acquisition is closed, we may enter a financing transaction for some or all of these properties. We expect this acquisition will be completed in April 2002, but there is no assurance that it will close. The closing of this acquisition is subject to completion of various state licensing matters and other customary closing conditions. This offering is not contingent upon our closing this acquisition.



# The offering

| | |
|---|---|
| Common stock being offered | 3,000,000 shares |
| Common stock to be outstanding after the offering | 7,624,334 shares |
| Use of proceeds | The estimated net proceeds to us from this offering will be $23.4 million. We intend to use these net proceeds for our pending acquisition. If this acquisition does not occur, we will use these proceeds for general business purposes, possibly including other acquisitions which have not yet been identified. |
| American Stock Exchange symbol | FVE |
| Risk factors | An investment in our common shares involves significant risks. Before making an investment in our common shares, you should carefully review the information under the caption "Risk factors". |

The number of shares to be outstanding after the offering is based on 4,624,334 shares outstanding on March 20, 2002. If the underwriters exercise their over-allotment option in full, we will issue an additional 450,000 shares.

Unless otherwise stated, all information contained in this prospectus assumes no exercise of the over-allotment option we granted to the underwriters.

All information in this prospectus pertaining to estimated offering price and net proceeds is based on an assumed price of $8.29 per share, which was the last reported sale price of our common shares on the American Stock Exchange on February 28, 2002, the day immediately preceding the date of our preliminary prospectus. The last reported sale price of our common shares on the American Stock Exchange on March 19, 2002 was $7.51.

We are a Maryland corporation. Our principal place of business is 400 Centre Street, Newton, Massachusetts 02458, and our telephone number is (617) 796-8387.



# Summary historical and pro forma financial data

The following summary financial data has been derived from the financial statements included elsewhere in this prospectus, and shows, for the period or date presented, our summary historical and pro forma income statement and balance sheet data, giving effect to this offering and the transactions which have occurred and transactions that we expect to occur as described in detail in the footnotes to our pro forma financial statements included elsewhere in this prospectus. As discussed under "Risk factors" and "Management's discussion and analysis of financial condition and results of operations", we are a relatively new company and our historical financial information is not reflective of our current operations. Accordingly, you should not place undue reliance on our historical financial information. In addition, pro forma financial information may not be reflective of what our financial results or financial position would have been had these transactions been consummated as of the dates indicated in our pro forma financial statements.

| | **Year Ended December 31, 2001** | | | |
|---|---|---|---|---|
| **Statement of operations data** | **Historical** | **After giving pro forma effect to the spin off, the FSQ merger and the lease of 31 Marriott communities** | **As adjusted for this offering and after giving pro forma effect to the spin off, the FSQ merger and the lease of 31 Marriott communities** | **As adjusted for this offering and after giving pro forma effect to the spin off, the FSQ merger, the lease of 31 Marriott communities and the pending acquisition** |
| | ($ in thousands, except share data) | | | |
| Revenues | $229,235 | $506,734 | $506,734 | $520,951 |
| Expenses: | | | | |
| Property operating expenses | 211,850 | 396,892 | 396,892 | 405,397 |
| Rent | | 77,354 | 77,354 | 77,354 |
| Depreciation and amortization | 1,274 | 406 | 406 | 1,441 |
| Interest, net | (43) | | | |
| General and administrative | 15,627 | 32,137 | 32,137 | 32,222 |
| Total expenses | 228,708 | 506,789 | 506,789 | 516,414 |

| | Year Ended December 31, 2001 | | | |
|---|---|---|---|---|
| Income before income taxes | 527 | (55) | (55) | 4,537 |
| Provision for income taxes | | (20) | (20) | 1,587 |
| Net income | $527 | $(35) | $(35) | $2,950 |
| Net income per share | $0.12 | $(0.01) | $0.00 | $0.39 |
| Weighted average shares | 4,374 | 4,624 | 7,624 | 7,624 |
| **Other data:** | | | | |
| Occupancy | 88% | 90% | 90% | 90% |
| Total units | 5,211 | 12,698 | 12,698 | 13,402 |
| Private pay % of revenues | 24% | 59% | 59% | 60% |
| EBITDA (1) | 1,758 | 351 | 351 | 5,978 |

**Balance sheet data**

| | At December 31, 2001 | | | |
|---|---|---|---|---|
| | ($ in thousands) | | | |
| Cash and cash equivalents | $24,943 | $30,608 | $53,986 | $7,986 |
| Total assets | 68,043 | 81,297 | 104,675 | 104,675 |
| Total debt | | | | |
| Total liabilities | 17,810 | 32,018 | 32,018 | 32,018 |
| Shareholders' equity | $50,233 | $49,279 | $72,657 | $72,657 |

(1) EBITDA consists of earnings before interest, taxes, depreciation and amortization. We consider EBITDA to be an indicative measure of our operating performance. EBITDA is also useful in measuring our ability to service debt, fund capital expenditures and expand our business. Furthermore, we believe that EBITDA is a meaningful disclosure that will help shareholders and the investment community to understand better our financial performance, including comparing our performance to other companies. However, EBITDA as presented may not be comparable to amounts calculated by other companies. This information should not be considered as an alternative to net income, operating profit, cash from operations, or any other operating or liquidity performance measure prescribed by accounting principles generally accepted in the United States. Cash expenditures for various long term assets, interest expense and income taxes have been or will be incurred which are not reflected in EBITDA.



# Risk factors

Investing in our common shares entails significant risk. You should carefully consider the risks and uncertainties described below and elsewhere in this prospectus before making an investment decision. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations. If any of the following risks or uncertainties actually occur, our business could be adversely affected. In this event, the trading price of our common shares could decline and you could lose part or all of your investment.

**We have a short operating history.**

We are a recently formed company, have a limited operating history, limited historical financial data, and we have operated as an independent public company only since December 31, 2001. Accordingly, we may be unable to execute our business plans effectively. Also, you should not place undue reliance on our historical financial information.

**We cannot predict the trading market of our common shares.**

Although a trading market exists for our common shares on the American Stock Exchange, our shares recently began trading. We are selling 3,000,000 common shares, assuming the underwriters do not exercise their over-allotment option, which equals 65% of our outstanding common shares before the offering. We can make no prediction as to the effect, if any, that market sales of our common shares or the availability of common shares for sale will have on liquidity, or your ability to readily buy or sell our common shares without adversely affecting the market price, or on the market prices prevailing from time to time. Sales of substantial amounts of our common shares in the public market, or the perception that such sales could occur, could adversely affect the liquidity of the market for our common shares and their price. The liquidity of the market and price of our common shares may be also adversely affected by changes in our financial performance or prospects, or in the prospects for companies in our industry generally.

**Our operating margins are narrow and a small percentage decline in our revenues or increase in our expenses can have a large percentage impact upon our profits.**

Our pro forma operating revenues for 2001 are $507 million, and our pro forma loss before income taxes for 2001 is $55,000, in each case before giving effect to our pending acquisition. Assuming the pending acquisition is completed, our pro forma operating revenues for 2001 are $521 million, and our pro forma income before income taxes is $4.5 million. A small percentage decline in our revenues or increase in our expenses might have a dramatic negative impact upon our income, may produce losses or may produce a need for additional capital which may not be available on acceptable terms or at all.

**Our pending purchase of five senior living communities may not be completed.**

We have agreed to purchase five senior living communities with 704 living units for $45.5 million. We intend to use the proceeds of this offering to partially fund this purchase. This purchase is subject to licensing and other customary conditions. Although we expect to complete this purchase during April 2002, it may not occur by then if at all. If this purchase does not occur, we intend to use the proceeds of this offering for our general business purposes including possibly other acquisitions which



have not been identified. Any alternative use of the proceeds of this offering may be less profitable to us than the pending acquisition.

**Our growth strategy may not succeed.**

Our business plan includes acquiring additional senior living facilities, some of which will be owned and some of which will be leased. An acquisition strategy involves risks. For example:

- we may be unable to locate facilities available for purchase at acceptable prices;
- we may be unable to obtain waivers of Senior Housing's rights of first refusal if the acquisition involves real estate;
- we may be unable to access the capital to acquire or operate additional facilities because we have limited financeable assets, because our charter prohibits ownership of greater than 9.8% of our shares by any party or for other reasons;
- acquired operations may bring with them contingent liabilities which mature; and
- combining our present operations with newly acquired operations may be disruptive.

For these reasons and others, our business plan to grow may not succeed, the benefits which we hope to achieve by growing may not be achieved and our existing operations could suffer from a lack of management attention or financial resources if such attention and resources are devoted to a failed growth strategy.

**Medicare or Medicaid rate reductions or a failure of those rates to match increasing costs could cause us to earn less or become unprofitable.**

At some of our facilities, operating revenues are received from the Medicare and Medicaid programs. On a pro forma basis, giving effect to all of the transactions described in the notes to our pro forma financial statements, 40% of our total revenues in 2001, 41% if our pending acquisition does not close, was derived from these programs. Since 1998, a Medicare prospective payment system has generally lowered Medicare rates paid for services at facilities such as those that we operate. Many states have adopted formulas to limit Medicaid rates. As a result, in some instances Medicare and Medicaid rates no longer cover costs incurred by operators, including us. Eleven of our nursing homes generated operating expenses in excess of operating revenues for 2001. These eleven facilities derived an average of 81% of their revenues from Medicare or Medicaid programs during 2001. At present there is an active debate within the federal government and within many state governments regarding whether current Medicare and Medicaid rates should remain at their current levels. Medicare or Medicaid rate reductions or a failure of those rates to match our increasing costs could cause us to earn less or become unprofitable.

**Nursing home and senior living operators like us are being subjected to increased litigation and insurance costs.**

There are various federal and state laws prohibiting fraud by healthcare providers, including criminal provisions that prohibit filing false claims for Medicare and Medicaid payments and laws that govern patient referrals. The state and federal governments seem to be devoting increasing resources to anti-fraud initiatives against healthcare providers. In some states, advocacy groups have been created to monitor the quality of care at senior living facilities, and these groups have brought litigation against operators. Also, in several instances private litigation by nursing home patients has succeeded



in winning very large damage awards for alleged abuses. The effect of this litigation and potential litigation has been to increase materially the costs of monitoring and reporting quality of care compliance. In addition, the cost of medical malpractice insurance has increased and may continue to increase so long as the present litigation environment affecting the operations of nursing homes and other senior living facilities continues. We may be unable to increase the rates which we are paid to cover these increased costs and we may become unprofitable.

**If we fail to comply with complex regulations which govern our operations we may be unable to operate profitably.**

Physical characteristics of senior living facilities are mandated by various governmental authorities. Changes in these regulations may require significant expenditures. Our leases with Senior Housing require us to maintain our facilities in compliance with applicable laws. In the future, our facilities may require significant expenditures to address ongoing required maintenance and make them attractive to residents. Our available financial resources may be insufficient to fund these expenditures.

State licensing and Medicare and Medicaid laws also require operators of nursing homes and assisted living facilities to comply with extensive standards governing operations. Federal and state agencies administering these laws regularly inspect such facilities and investigate complaints. During the past three years, the Federal Centers for Medicare and Medicaid Services, or the Federal Centers, have increased their efforts to enforce Medicare and Medicaid standards and their oversight of state survey agencies which inspect senior living facilities and investigate complaints. When deficiencies are identified, sanctions and remedies such as denials of payment for new Medicare and Medicaid admissions, civil money penalties, state oversight and loss of Medicare and Medicaid participation may be imposed. The Federal Centers and the states are increasingly using such sanctions and remedies when deficiencies, especially those involving findings of substandard care or repeat violations, are identified. We and Marriott receive notices of potential sanctions and remedies from time to time, and such sanctions have been imposed on some of our nursing homes and assisted living facilities from time to time. Sanctions imposed on us or Marriott for deficiencies which are identified in the future, may have adverse financial consequences to us.

**We are subject to possible conflicts of interest.**

Our creation was, and our continuing business is, subject to possible conflicts of interest, as follows:

- All of our directors were members of the Board of Trustees of Senior Housing at the time we were created.
- Four of our five current directors are members of the Board of Trustees of Senior Housing.
- Our Chief Executive Officer and our Chief Financial Officer are also part time employees of Reit Management & Research LLC. Reit Management is the investment manager for Senior Housing, HRPT Properties Trust and Hospitality Properties Trust and we purchase various services from Reit Management pursuant to a shared services agreement.

> Our Managing Directors, Barry M. Portnoy and Gerard M. Martin, are also Managing Trustees of Senior Housing and of other REITs managed by Reit Management. Messrs. Portnoy and Martin also own Reit Management and another entity that leases office space to us, and they owned FSQ, Inc. at the time of our merger with FSQ, Inc.



These conflicts may have caused, and in the future may cause, our business to be adversely affected, including as follows:

> The leases we entered with Senior Housing may be on terms less favorable to us than leases which would have been entered as a result of arm's length negotiations.

> The terms of our merger with FSQ, Inc., our shared services agreement with Reit Management or our office lease with another entity owned by Messrs. Portnoy and Martin may be less favorable to us than we could have achieved on an arm's length basis; specifically, the consideration we paid in the merger of 250,000 of our shares, our payments to Reit Management of 0.6% of our total revenues for shared services, equal to $3.1 million on a pro forma basis for 2001 after giving effect to the transactions described in the footnotes to our pro forma financial statements, or office rent of $531,069 per year may be greater than they would have been had these matters been negotiated with third parties.

> Future business dealings between us and Senior Housing, Reit Management, Messrs. Portnoy and Martin and their affiliates may be on terms less favorable to us than we could achieve on an arm's length basis.

> We have to compete with Senior Housing and Reit Management for the time and attention of our directors and officers, including Messrs. Portnoy and Martin.

For more information regarding transactions involving us and related parties, you should read the information under the caption "Certain relationships".

**Anti-takeover provisions in our governing documents and material agreements may prevent you from receiving a takeover premium for your shares.**

Our charter prohibits any party from owning more than 9.8% of our outstanding common shares. Our leases with Senior Housing, our shared services agreement with Reit Management and the transaction agreement we entered in connection with our spin-off from Senior Housing also restrict our share ownership and prohibit any change of control of us. Our charter and bylaws contain other provisions that may increase the difficulty of acquiring control of us by means of a tender offer, open market purchases, a proxy fight or otherwise, if the acquisition is not approved by our Board of Directors. These other anti-takeover provisions include the following:

> a staggered Board of Directors with separate terms for each class of directors;

> the availability, without a shareholders' vote, of additional shares and classes of shares that our Board of Directors may authorize and issue on terms that it determines;

> a 75% shareholder vote required for removal of directors for cause; and

> advance notice procedures with respect to nominations of directors and shareholder proposals.

For all of these reasons, you may be unable to realize a change of control premium for the common shares that you purchase in this offering.

**Our business is highly competitive.**

We compete with numerous other companies which provide senior living alternatives, including home healthcare companies and other real estate based service providers. Historically, nursing homes have been somewhat protected from competition by state laws requiring certificates of need to develop new facilities; however, these barriers are being eliminated in many states. Also, there are few barriers to



competition for home healthcare or for independent and assisted living services. Growth in availability of nursing home alternatives, including assisted living facilities, has and may in the future have the effect of reducing the occupancy or operating profitability at nursing homes including those we operate. Many of our existing competitors are larger and have greater financial resources than we do. Accordingly, we cannot provide any assurances that we will be able to attract a sufficient number of residents to our facilities or that we will be able to attract employees and keep wages and other employee costs at levels which will allow us to operate profitably, and we do not know whether we will be able to grow our business by acquiring additional operations.

**Default provisions in our leases may magnify the impact of a default in other agreements.**

We lease a substantial number of facilities from Senior Housing under two leases. In addition to being cross-defaulted with one another, events of default under each of these leases include, among other things, our failure to pay obligations under agreements other than the leases. In the future, if Senior Housing finances other facilities for us, we may agree to add facilities to existing leases or we may agree to further cross-default provisions. The existence of these cross-default provisions may create situations that we are unable to evaluate individually or that cause simultaneous defaults of several agreements, either of which could have a material impact upon our business.

**Our existing contracts with Senior Housing and others may inhibit our ability to grow.**

In connection with our recent spin-off from Senior Housing, we entered agreements which prohibit us from acquiring or financing real estate in competition with Senior Housing, HRPT Properties, Hospitality Properties or other real estate entities managed by Reit Management, unless those investment opportunities are first offered to Senior Housing, HRPT Properties, Hospitality Properties or those real estate entities. Although we have obtained the necessary waivers to allow us to complete the pending acquisition of the five communities described in this prospectus, these agreements may make it difficult, more expensive or impossible for us to acquire additional facilities in the future. In addition, certain provisions of our leases with Senior Housing, such as the provisions limiting our ability to discontinue operations in any of the facilities or assign the leases, limit our operating flexibility. Also, because of our various relationships with Senior Housing and Reit Management, competitors of those companies may be unwilling to lease senior living facilities to us or conduct business with us. These circumstances may prevent us from realizing some growth opportunities.

**Senior Housing creditors may have the right to cancel our leases.**

Our leases with Senior Housing are subordinated to mortgages and other indebtedness of Senior Housing totaling $33.1 million at January 31, 2002, and may be subordinated to additional indebtedness that Senior Housing incurs. In the event Senior Housing defaults upon debts to which our leases are subordinated, we may lose our rights to operate the leased properties.

**Our management team has limited experience working together and have other business interests that may prevent them from working full time on our business.**

Our management team has been assembled for less than two years. We do not have employment agreements with any of our executive officers. Two of our executive officers have other business interests which may prevent them from working full time on our business. All of our directors have



other business interests which will prevent them from working full time on our business. These conditions may make it difficult for us to carry out our business plans.

**Our owned and leased properties are subject to real estate risks.**

Our leases require that we pay for and indemnify Senior Housing from all liabilities associated with the ownership or operation of the facilities we lease from Senior Housing which arise prior to or during the terms of our leases. Also, we may own real estate in the future, including as a result of our pending acquisition. Accordingly, our business is subject to risks associated with real estate, including:

- costs associated with uninsured damages, including damages for which insurance may be unavailable or unavailable on commercially reasonable terms;
- costs and damages caused by eminent domain takings;
- costs that may be required for maintenance and repair; and
- the need to make expenditures due to changes in laws and other regulations, including the Americans with Disabilities Act.

**Our business exposes us to environmental risks.**

Under various laws in the United States, operators of real estate may be required to investigate and clean up hazardous substances present at their leased properties, including but not limited to medical waste, mishandled petroleum products and asbestos containing materials, and may be held liable for property damage or personal injuries that result from such contamination. These laws also expose us to the possibility that we become liable to reimburse the government for damages and costs it incurs in connection with the contamination. As the owner of real estate leased to us, Senior Housing may be also subject to similar liabilities, and we have agreed to indemnify Senior Housing from costs it incurs at our leased properties related to environmental hazards which arise prior to or during the terms of our leases. We can give you no assurance that environmental liabilities are not present in our operated facilities or that costs we incur to remediate contamination or the presence of asbestos will not have a material adverse effect on our business and financial condition.



# Forward-looking statements

We have made statements that are not historical facts in this prospectus that constitute "forward-looking statements" as that term is defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements concern:

- our ability to successfully close the pending acquisition on negotiated terms or at all;
- our ability to manage effectively the 56 facilities we lease from Senior Housing and the communities we intend to acquire;
- Marriott's ability to manage effectively the 31 retirement communities we lease from Senior Housing;
- our ability to generate revenues in excess of our operating expenses and the sufficiency of these and other resources to provide capital for our growth or to pay our liabilities, including rent, as they come due;
- our ability to close our pending $20 million line of credit;
- our ability to access additional capital to fund our operations and growth;
- our ability to acquire and operate successfully additional senior living businesses; and
-

our ability to operate successfully as a separate public company.

Also, whenever we use words such as "believe", "expect", "anticipate", "estimate" or similar expressions, we are making forward-looking statements. Forward-looking statements are not guaranteed to occur and involve risks and uncertainties. Our expected results may not be achieved, and actual results may differ materially from our expectations. This may be a result of various factors, including risks outlined under "Risk factors".

Investors should not rely upon forward-looking statements except as statements of our present intentions and of our present expectations which may or may not occur.



# Use of proceeds

The net proceeds to us from this offering, after deduction of the underwriting discount and estimated offering expenses payable by us, are estimated to be $23.4 million ($26.9 million if the underwriters' over-allotment option is exercised in full). We intend to use these net proceeds to fund a portion of our pending acquisition of five communities for $45.5 million. Until we complete our pending acquisition, we may deposit all or a portion of the net proceeds in interest bearing accounts or invest them in short term securities, including securities that may not be investment grade rated. In the event this acquisition is not completed we intend to use the net proceeds for general business purposes, including possibly other acquisitions which have not been identified.

# Market price of common shares

Our common shares are traded on the American Stock Exchange under the symbol "FVE." The following table presents the high and low closing price for our common shares as reported on the American Stock Exchange for each calendar quarter since they began to trade:

| **Period** | **Low** | **High** |
|---|---|---|
| December 13 to 31, 2001 | $6.12 | $7.50 |
| January 1 to March 19, 2002 | 6.97 | 8.75 |

On March 19, 2002 the last reported sale price of our common shares on the American Stock Exchange was $7.51 per share. As of March 19, 2002, there were approximately 5,000 shareholders of record of our common shares.

# Dividend policy

We do not expect to pay dividends in the foreseeable future.



# Capitalization

The following table describes our capitalization as of December 31, 2001, on a historical basis, and on a pro forma basis after giving effect to the transactions described in the footnotes to our pro forma financial statements appearing elsewhere in this prospectus:

| | **At December 31, 2001** | | | |
|---|---|---|---|---|
| | **Historical** | **After giving pro forma effect to the** | **As adjusted for this Offering and** | **As adjusted for this Offering and** |

**At December 31, 2001**

| | | FSQ merger and the lease of 31 Marriott communities | after giving pro forma effect to the FSQ merger and the lease of 31 Marriott communities | after giving pro forma effect to the FSQ merger, the lease of 31 Marriott communities and the pending acquisition |
|---|---|---|---|---|
| | ($ in thousands) | | | |
| Cash and cash equivalents | $24,943 | $30,608 | $53,986 | $7,986 |
| Debt | | | | |
| Shareholders' equity: | | | | |
| Common Stock, par value $0.01, shares outstanding: 4,374,334 historical; 4,624,334 pro forma; and 7,624,334 pro forma as adjusted | | | | |
| Total shareholders' equity: | 50,233 | 49,279 | 72,657 | 72,657 |
| Total capitalization | $50,233 | $49,279 | $72,657 | $72,657 |

## Dilution

The recent trading price of our common shares is less than their net tangible book value per share determined according to generally accepted accounting principles, or GAAP. Accordingly, assuming that you purchase our shares at the price set forth on the cover of this prospectus, you will not suffer dilution in net tangible book value. Net tangible book value per share at December 31, 2001, was $11.48; as adjusted for this offering, after giving pro forma effect to our spin-off, the FSQ, Inc. merger, the lease of the 31 Marriott communities and the pending acquisition, net tangible book value per share will be $9.58.



## Selected financial data

The following table presents selected financial data which has been derived from our historical financial statements for the period from April 27, 2000 (the date we commenced operations) through December 31, 2001. The following data should be read in conjunction with our financial statements and the notes thereto included elsewhere in this prospectus, and "Management's discussion and analysis of financial condition and results of operations". As discussed under "Risk factors" and "Management's discussion and analysis of financial condition and results of operations", we are a relatively new company and our historical financial information is not reflective of our current operations. Accordingly, you should not place undue reliance on our historical financial information.

| | Year ended December 31, 2001 | Period from April 27, 2000 through December 31, 2000 |
|---|---|---|

| | | Year ended December 31, 2001 | | Period from April 27, 2000 through December 31, 2000 |
|---|---|---|---|---|
| | ($ in thousands, except per share amounts) | | | |
| **Five Star Quality Care, Inc.** | | | | |
| Operating data | | | | |
| Total revenues | | $229,235 | | $2,520 |
| Net income (loss) | $ | 527 | $ | (1,316) |
| Earnings (loss) per share | $ | 0.12 | $ | (0.30) |
| Balance sheet data | | | | |
| Total assets | | $68,043 | | $54,788 |

The following table presents selected financial data of our two predecessors and has been derived from historical financial statements of those predecessors included elsewhere in this prospectus. The following data should be read in conjunction with the financial statements and notes thereto entitled Combined Financial Statements of the Forty-two Facilities Acquired by Senior Housing Properties Trust from Integrated Health Services, Inc. and Combined Financial Statements of Certain Mariner Post-Acute Network Facilities (Operated by subsidiaries of Mariner Post-Acute Network) included elsewhere in this prospectus, and "Management's discussion and analysis of financial condition and results of operations Historical Results of Operations Mariner Predecessor" and "Historical Results of Operations Integrated Predecessor".

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | 2000 | 1999 | 1998 | 1997 |
| | ($ in thousands) | | | |
| **Integrated Predecessor** | | | | |
| Operating data | | | | |
| Operating revenues | $135,378 | $130,333 | $140,116 | $104,727 |
| Net loss | (25,252) | (126,939) | (17,183) | (10,432) |
| Balance sheet data | | | | |
| Total assets | $34,942 | $61,274 | $190,553 | $174,954 |
| Long term liabilities | | 17,500 | 17,751 | 18,006 |
| **Mariner Predecessor** | | | | |
| Operating data | | | | |
| Operating revenues | $85,325 | $86,945 | $105,486 | $107,829 |
| Net loss | (7,421) | (43,804) | (7,710) | (9,435) |
| Balance sheet data | | | | |
| Total assets | $23,052 | $17,433 | $62,502 | $84,119 |
| Long term liabilities | 32,091 | 28,603 | 33,195 | 15,498 |



# Management's discussion and analysis of financial condition and results of operations

You should read the following discussion in conjunction with our historical and pro forma financial statements and the financial statements of our predecessors and others included elsewhere in this prospectus.

**OVERVIEW**

We were incorporated in April 2000 as a Delaware corporation and reincorporated in Maryland in September 2001. We were formed as a 100% owned subsidiary of Senior Housing. Effective July 1, 2000, we assumed the operations of healthcare facilities from two bankrupt former tenants of Senior Housing. At the time we assumed operations of these facilities, we had not received substantially all of the required licenses for these facilities. As a result, for the period from July 1, 2000, through December 31, 2000, we accounted for the operations of these facilities using the equity method of accounting and we only recorded the net income from these operations. Since that time, we have obtained all necessary licenses to operate these facilities, and on January 1, 2001, we began to consolidate the results of operations of these facilities. On December 31, 2001, Senior Housing distributed substantially all of our shares to its shareholders in a spin-off transaction and we became an independent public company.

Since we succeeded to substantially all of the business formerly conducted by subsidiaries or units of two former tenants of Senior Housing, these subsidiaries and units are considered to be our predecessors. We have included the financial statements of these predecessors in this prospectus and discuss their results of operations. Our predecessors' financial statements are entitled: Certain Mariner Post-Acute Network Facilities (Operated by subsidiaries of Mariner Post-Acute Network) (referred to herein as Mariner Predecessor); and Forty-Two Facilities Acquired by Senior Housing Properties Trust from Integrated Health Services, Inc. (referred to herein as Integrated Predecessor).

Our revenues consist primarily of payments for services provided to residents at our facilities. The payments are either paid for by the residents, their families or insurers, or by the Medicare and Medicaid programs. The substantial majority of our historical revenues have been paid by the Medicare and Medicaid programs. The substantial majority of the revenues associated with the 31 Marriott facilities are paid by the patients, or private pay. On a pro forma basis, after giving effect to the new lease which we entered for the 31 Marriott facilities in January 2002 and the pending acquisition of five facilities, for the year ended December 31, 2001, private pay revenues would have represented 60% of our total revenues, or 59% if our pending acquisition does not close. Our expenses consist primarily of wages and benefits of personnel, food, supplies and other resident costs, as well as taxes, insurance and other property related costs.

We were a subsidiary of Senior Housing until December 31, 2001. The 2001 results presented in this prospectus are for a period during which we were a subsidiary of Senior Housing and they are not necessarily indicative of what our results would have been as a separate public company. Similarly these results are not indicative of future financial performance. Our future results of operations are expected to differ materially from the historical results presented in this prospectus. Material differences are expected because our future operations will include, among other factors, rent expense on leases to Senior Housing, general and administrative costs incurred by us as a separate company, revenues and expenses related to our lease entered in January 2002 for 31 retirement communities operated by Marriott and from the pending acquisition, if it closes.



We accounted for our merger with FSQ as the termination of a management contract rather than as a business combination. As a result, at the closing of the merger, because the FSQ liabilities assumed plus the value of our common shares issued in connection with the FSQ acquisition exceeded the fair value of FSQ's assets acquired, we recognized an expense of $2.8 million. For this purpose, the fair value of our common shares was based on the average of the high and low price of our shares on the day of the merger, or $7.50 per share.

**OUR HISTORICAL RESULTS OF OPERATIONS**

As described above, we operated, until completion of the spin-off, as a subsidiary of Senior Housing. Our past operations as Senior Housing's subsidiary differ from our current operations as an independent public company as follows:

> our historical operating business included certain facilities, assets and activities which we do not own or conduct and did not include such other factors discussed above; and

> the principal source of financing for these operating businesses was intercompany advances from Senior Housing, an entity with financial resources substantially in excess of ours.

We believe that because of these differences, the historical results of operations described below are not comparable to our current operations or our expected future operations. Specifically, in the historical periods discussed we operated only 56 properties for Senior Housing, which owned the real estate as well as the operations. Effective December 31, 2001, we leased these 56 facilities from Senior Housing which continued to own the real estate. On January 11, 2002, we began to lease an additional 31 facilities from Senior Housing. Moreover, we now conduct our own affairs and incur costs as a separate public company some of which are more and some of which are less than the costs incurred by Senior Housing and allocated to us in the historical periods.

**Years ended December 31, 2001 and 2000**

We did not begin to operate the senior living facilities of our predecessors or generate revenue until July 1, 2000. Therefore, our results for the year ended December 31, 2001, are not comparable to the year ended December 31, 2000.

Revenues for the year ended December 31, 2001, were $229.2 million. On a combined basis, the two predecessor entities had revenues of $220.7 million for the year ended December 31, 2000. This increase was due mainly to an increase in the average daily rate received during these periods.

Expenses for the year ended December 31, 2001, were $228.8 million. On a combined basis, the predecessor entities had expenses of $253.4 million for the year ended December 31, 2000. The decrease is due primarily to rent and interest expenses which were included in the 2000 expenses of our predecessors but were zero in 2001 because, after Senior Housing's repossessions and foreclosures, rent and interest payments on the leases and mortgages ceased.

**Period from April 27, 2000 (date operations commenced) through December 31, 2000**

This period was our first period of operations and, therefore, there is no comparable period.

During 2000 we accounted for our investment in these operating businesses using the equity method of accounting. As a result, the reported revenues included our equity in earnings of these investees. Revenues for 2000 were $2.5 million and represent the net amount of net patient revenues in excess of expenses of these operations for the 2000 period. Net patient revenues at the operating businesses for the six months ended December 31, 2000, were $114.5 million and expenses incurred for the period were $112.0 million.



**LIQUIDITY AND CAPITAL RESOURCES**

On a historical basis our expenditures, including capital expenditures and for working capital, were provided by Senior Housing. We maintained no financing sources apart from Senior Housing.

At the time of our spin off from Senior Housing on December 31, 2001, we had cash of $24.9 million, operating accounts receivable of $36.4 million and accrued operating expenses and other liabilities totaling $17.8 million.

We lease all of our current facilities from Senior Housing. Our leases with Senior Housing require us to pay a total of $70 million of base rent annually. Percentage rent on our current leases does not begin until 2003 and 2004. We expect these increases to be modest relative to our overall liquidity. Payments required of us under our lease for 31 Marriott facilities also include a percentage of revenues for a capital expenditure reserve. If events of default under the leases occur, Senior Housing has the ability to accelerate our rent payments. Our leases with Senior Housing are cross-defaulted with one another, and events of default include: our failure to pay rent when due; our default under any indebtedness which gives the holder the right to accelerate; our default under the Marriott management agreements; and our being declared ineligible to receive reimbursement under Medicare and Medicaid programs for any of the leased facilities.

On January 10, 2002, we accepted a non-binding letter of intent from a lender for a new, three year $20 million line of credit to be secured by our accounts receivable. This financing is subject to lender diligence, final documentation and other customary conditions. We expect this financing to close on or before April 30, 2002, but it may not close before that date or at all.

On January 23, 2002, we agreed to acquire five communities for $45.5 million. We expect to fund this acquisition with our cash, the proceeds of this offering and possibly also with proceeds of our proposed secured line of credit. We have also had preliminary discussions with Senior Housing concerning its providing interim or long term financing for this acquisition in the event that the funds available to us are not sufficient to close this acquisition; however, we have not reached any agreement with Senior Housing concerning such interim or long term financing.

Other than our leases with Senior Housing and our agreement to acquire five communities, we have no individually material contractual or commercial obligations or commitments.

Our primary source of cash to fund operating expenses, including rent and routine capital expenditures, is the resident revenues we generate at our facilities. Changes in laws and regulations which impact Medicare or Medicaid rates, on which many of our properties rely for substantial amounts of revenues, or changes in insurance costs caused by recent, material litigation awards in some states may materially affect our future results. We believe that our revenues will be sufficient to allow us to meet our ongoing operating expenses, working capital needs and rent payments to Senior Housing in the short term, or next 12 months, and long term, whether or not we arrange for a line of credit secured by our receivables, as described above. Despite this belief, our operating cash flow as a percentage of our revenues is small; a small percentage decline in revenue or increase in our operating expenses could eliminate or reduce our operating cash flow. If our other resources, such as our cash on hand, or our pending $20 million line of credit, are not available or insufficient, the decline in operating cash flow may cause lease defaults or other material consequences.

Our shared services agreement with Reit Management allows us to defer payments to Reit Management under the shared services agreement if necessary to make rent payments to Senior Housing. On a pro forma basis, assuming completion of our January 2002 lease for 31 Marriott facilities and our pending acquisition, payments to Reit Management for shared services would have totaled $3.1 million during the year ended December 31, 2001.



**SEASONALITY**

Our business is subject to modest effects of seasonality. During the calendar fourth quarter holiday periods nursing home and assisted living residents are sometimes discharged to join family celebrations and admission decisions are often deferred. The first quarter of each calendar year usually coincides with increased illness among nursing home and assisted living residents which can result in increased costs or discharges to hospitals. As a result of these factors, nursing home and assisted living operations sometimes produce greater earnings in the second and third quarters of a calendar year and lesser earnings in the first and fourth quarters. We do not believe that this seasonality will cause fluctuations in our revenues or operating cash flow to such an extent that we will have difficulty paying our expenses, including rent, which do not fluctuate seasonally.

**INFLATION AND DEFLATION**

Inflation in the past several years in the United States has been modest. Future inflation might have both positive or negative impacts on our business. Rising price levels may allow us to increase occupancy charges to residents, but may also cause our operating costs, including our percentage rent, to increase.

Deflation would likely have a negative impact upon us. A large component of our expenses consist of minimum rental obligations to Senior Housing. Accordingly we believe that a general decline in price levels which could cause our charges to residents to decline would likely not be fully offset by a decline in our expenses.

**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We have no obligations for funded debt and as such are not directly affected by changes in market interest rates. However, as discussed above, we expect to enter a $20 million revolving credit facility secured by our accounts receivable. We expect that this loan facility will require interest on drawn amounts at floating rates based upon a spread above LIBOR. Accordingly, whenever borrowings are outstanding under such a credit facility we may be exposed to market changes in interest rates, especially market changes in short term LIBOR rates. For example, if the full amount of a $20 million line of credit were drawn and interest rates rose by 1% per annum, our interest expense would increase by $200,000 per year, or $0.04 per share.

We may from time to time consider our exposure to interest rate risks if we have or expect to have material amounts of floating rate obligations. As a result of these considerations we may decide to purchase interest rate caps or other hedging instruments.

**CRITICAL ACCOUNTING POLICIES**

Our most critical accounting policies regard revenue recognition and our assessment of the net realizable value of our accounts receivable. These policies involve significant judgments based upon our experience, including judgments about changes in payment methodology, contract modifications and economic conditions that may affect the collectibility of our accounts receivable. In the future we may need to revise our assessment to incorporate information which is not yet known and such revisions could increase or decrease our net revenues or cause us to adjust the net carrying value of our accounts receivable.

**HISTORICAL RESULTS OF OPERATIONS MARINER PREDECESSOR**

The Mariner Predecessor conducted operations of 17 facilities leased from Senior Housing. The operations of the Mariner Predecessor during the period prior to its acquisition by Senior Housing differ from our operations as follows:

> The business of the Mariner Predecessor was conducted by its then parent, Mariner Post-Acute Network, an entity with a capital structure, corporate overhead costs, and operating systems substantially different than ours.

> During the period of Mariner's operation of this business, significant write-offs of goodwill and other long lived assets of the Mariner Predecessor occurred and Mariner filed for bankruptcy.

We believe that because of these differences, the historical results of operations described below are not comparable to our operations. Specifically, the historical operations described below include: revenues and operating expenses for only 17 facilities, one of which has since been closed, while currently we generate revenues and incur operating expenses at 87 facilities; revenues prior to 1999 which were based in part upon Medicare rates established prior to the completion of the phase-in of the new Medicare prospective payment system; depreciation expenses which relate to real estate and amortization expenses which relate to goodwill, while we do not have substantial depreciable assets; expenses related to allocation of corporate overhead by the parent of these operations, while we incur different corporate expenses; rent expense under a lease which has been cancelled; charges for impairments of long lived assets of substantial amounts, while we do not have substantial long lived assets and have not incurred similar changes; and interest expense incurred on debt, while we have no debt as of the date of this prospectus.

**Years ended December 31, 2000 and 1999 Mariner Predecessor**

Revenues for the year ended December 31, 2000, were $85.3 million. These revenues represent a decrease of $1.6 million from the revenues in the 1999 period. This decrease is attributable primarily to a slight decrease in occupancy at the facilities in operation during both periods and to the closing of one facility.

Expenses for the year ended December 31, 2000, were $92.6 million, a decrease of $1.6 million over the 1999 period, excluding non-recurring or unusual charges and write-offs incurred in 1999. This decrease is attributable primarily to decreases in general and administrative costs and provision for bad debts and rent, offset by an increase in salary, wages and benefits.

Net loss for the year ended December 31, 2000, was $7.4 million, a decrease in loss of $36.4 million over the 1999 period. This decrease in loss is principally attributable to the impact of unusual charges related to the impairment of long lived assets in 1999.

**HISTORICAL RESULTS OF OPERATIONS INTEGRATED PREDECESSOR**

The Integrated Predecessor conducted operations of 42 facilities leased from or mortgaged to Senior Housing. The operations of the Integrated Predecessor during the period prior to its acquisition by Senior Housing differ from our operations as follows:

> The business of the Integrated Predecessor was conducted by its then parent, Integrated Health Services, Inc., an entity with a capital structure, corporate overhead costs, and operating systems substantially different than ours.



> During the period of Integrated Health Services' operation of this business, significant write-offs of goodwill and other long lived assets of the Integrated Predecessor occurred and Integrated Health Services filed for bankruptcy.

We believe that because of these differences, the historical results of operations described below are not comparable to our operations. Specifically, the historical operations described below include: revenues and operating expenses for only 42 facilities, one of which has since been closed, while we currently generate revenues and incur operating expenses at 87 facilities; revenues prior to 1999 which were based in part upon Medicare rates established prior to the completion of the phase in of the new Medicare prospective payment system; depreciation expenses which relate to real estate and amortization expenses which relate to intangible assets, while we do not have substantial depreciable assets; expenses related to corporate overhead and management fees charged by the parent of the Integrated Predecessor, while we incur different corporate expenses; rent expense under a lease which has been cancelled; charges for impairments of long lived assets of substantial amounts, while we do not have substantial long lived assets and have not incurred similar charges; and interest expense incurred on debt, while we have no debt as of the date of this prospectus.

**Years ended December 31, 2000 and 1999 Integrated Predecessor**

Revenues for the year ended December 31, 2000, were $135.4 million. These revenues represent an increase of $5.0 million over the revenues in the 1999 period. This increase resulted primarily from an increase in Medicaid rates and an increase in occupancy at the Integrated Predecessor facilities.

Expenses for the year ended December 31, 2000, excluding non-recurring or unusual charges and write offs of $16.7 million as discussed in the next paragraph, were $144.0 million, a decrease of $2.1 million from the 1999 period. This decrease is attributable primarily to a decrease in rent, depreciation and amortization at the Integrated Predecessor facilities offset by increased operating expenses.

During the 2000 period, the Integrated Predecessor incurred unusual charges related to a loss on settlement of lease and mortgage obligations of $16.7 million. These charges were a result of the bankruptcy settlement between Integrated and Senior Housing and represent the carrying value of the tangible and intangible assets of the facilities conveyed to Senior Housing, less the debts due Senior Housing which were not paid. During the 1999 period, the Integrated Predecessor incurred write-offs and unusual charges related to a loss on impairment of long lived assets of $120.0 million.

Net loss for the year ended December 31, 2000, was $25.3 million, a decrease of $101.7 million from the net loss of $126.9 million in 1999. This decrease in loss is attributable to the decreases in rent, depreciation and amortization and the impact of unusual charges discussed above.



# Business

**GENERAL**

We are in the business of operating senior living facilities, including independent living and congregate care communities, assisted living facilities and nursing homes. We lease and operate 56 senior living facilities. We lease 31 communities that Marriott manages. Combined, these 87 facilities, which we lease from Senior Housing, include 4,060 independent living apartments, 1,766 assisted living suites, 294 special care beds and 6,578 nursing beds; 59% of their revenues in 2001 was paid from residents' private resources and 41% was paid by Medicare and Medicaid.

We have recently agreed to purchase five senior living communities which we will own and operate. In combination with our existing facilities, these 92 facilities include 4,591 independent living apartments, 1,939 assisted living suites, 294 special care beds and 6,578 nursing beds. Sixty percent of our pro forma revenues from these 92 facilities in 2001 was paid from residents' private resources and 40% was paid by Medicare and Medicaid:

| FIVE STAR UNITS AFTER COMPLETION OF PENDING ACQUISITION | FIVE STAR REVENUES AFTER COMPLETION OF PENDING ACQUISITION |
| --- | --- |

| FIVE STAR UNITS AFTER COMPLETION OF PENDING ACQUISITION | FIVE STAR REVENUES AFTER COMPLETION OF PENDING ACQUISITION |
|---|---|



**OUR BUSINESS AND GROWTH STRATEGY**

Our growth strategy is to acquire facilities that provide high quality services to residents who pay with private resources. In January 2002, we leased 31 senior living communities from Senior Housing. Approximately 88% of the revenues from these communities is paid by residents from their private resources. At the five communities we have agreed to acquire, all of the revenues are paid by residents from private resources. Our nursing homes derive a majority of their revenues from Medicare and Medicaid. In the future we may decide to expand our nursing home operations; however, if we do so, we expect to price such acquisitions at levels which take account of the increased risks associated with Medicare and Medicaid revenues.

Our senior management team has significant experience in the senior living industry. Although we have substantial lease obligations, we currently have zero debt. We believe our relationship with our former parent company, Senior Housing, may provide us with capital to finance some acquisitions. We believe that this combination of our experienced management, our financial position and our relationship with Senior Housing will enable us to expand our operations and compete successfully in the senior living industry.

**OUR HISTORY**

In July 2000, Senior Housing repossessed or acquired senior living facilities from two former tenants. We were created by Senior Housing in 2000 as a 100% subsidiary to conduct the businesses of operating these facilities. Under the amended Internal Revenue Code, or IRC, Senior Housing was required to engage an independent operating company to manage the healthcare businesses which we owned. Messrs. Portnoy and Martin formed FSQ, Inc. to manage these facilities. During the past year, we believe the combined operations at these 56 facilities have stabilized and improved.

In August 2001, Senior Housing agreed to acquire 31 Marriott senior living facilities. The operations at these 31 communities are managed by Marriott under long term management contracts. The operating income generated by these facilities is not REIT qualified income under applicable IRC rules. To complete this acquisition and remain a REIT, Senior Housing was required to identify a taxable entity to lease these facilities.

On December 31, 2001, Senior Housing distributed substantially all of our outstanding shares to its shareholders and we became a separate publicly owned company listed on the American Stock Exchange. Pursuant to the transaction agreement governing this spin-off:

- Senior Housing capitalized us with $50 million of equity, consisting of cash and working capital, primarily operating receivables net of operating payables;

> we leased 56 facilities from Senior Housing;

> we agreed to merge with FSQ, Inc. in order to acquire the personnel, systems and assets necessary to operate these 56 facilities; and

> we agreed to lease the 31 Marriott communities from Senior Housing when they were acquired by Senior Housing.

Effective January 2, 2002, we completed our merger with FSQ, Inc. As consideration for this merger Messrs. Portnoy and Martin each received 125,000 of our common shares.

On January 10, 2002, we entered a non-binding letter of intent for a new, three year, $20 million credit line which will be secured by our accounts receivable. Although the closing of this transaction is subject to customary conditions, we expect it to occur on or before March 31, 2002.



On January 11, 2002, Senior Housing completed its acquisition of the 31 Marriott communities, and we leased these facilities from Senior Housing.

On January 23, 2002, we agreed to acquire five senior living communities for $45.5 million. The closing of this acquisition is subject to completion of various state licensing matters and other customary closing conditions, and although we expect it to be completed during April 2002, we can give no assurances that it will close. We intend to use the proceeds of this offering to partially fund this acquisition.

**TYPES OF FACILITIES**

Our present business plan contemplates the leasing and management of senior apartments, independent living apartments or congregate care communities, assisted living facilities and nursing homes. Some facilities combine more than one type of service in a single building or campus.

**Senior apartments**

Senior apartments are marketed to residents who are generally capable of caring for themselves. Residence is usually restricted on the basis of age. Purpose built facilities may have special function rooms, concierge services, high levels of security and assistance call systems for emergency use. Tenants at these facilities who need healthcare or assistance with the activities of daily living are expected to contract independently for these services with home healthcare companies.

**Independent living apartments**

Independent living apartments, or congregate care communities as they are sometimes called, also provide high levels of privacy to residents and require residents to be capable of relatively high degrees of independence. Unlike a senior apartment facility, an independent living apartment usually bundles several services as part of a regular monthly charge for example, one or two meals per day in a central dining room, weekly maid service and a social director. Additional services are generally available from staff employees on a fee-for-service basis. In some congregate care communities, separate parts of the facility are dedicated to assisted living or nursing services.

**Assisted living facilities**

Assisted living facilities are typically comprised of one bedroom suites which include private bathrooms and efficiency kitchens. Services bundled within one charge usually include three meals per day in a central dining room, daily housekeeping, laundry, medical reminders and 24 hour availability of assistance with the activities of daily living such as dressing and bathing. Professional nursing and healthcare services are usually available at the facility on call or at regularly scheduled times.

**Nursing homes**

Nursing homes generally provide extensive nursing and healthcare services similar to those available in hospitals, without the high costs associated with operating theaters, emergency rooms or intensive care units. A typical purpose built nursing home includes mostly two-bed units with a separate bathroom in each unit and shared dining and bathing facilities. Some private rooms are often available for those residents who can afford to pay higher rates or for patients whose medical conditions require segregation. Nursing homes are generally staffed by licensed nursing professionals 24 hours per day.

During the past few years, nursing home operators have faced two significant business challenges. First, the rapid expansion of the assisted living industry which started in the early 1990s has attracted a number of residents away from nursing homes. This was especially significant because the residents who chose assisted living facilities often previously had been the most profitable residents in the



nursing homes. These residents required a lesser amount of care and were able to pay higher private rates rather than government rates.

The second major challenge arose as a result of Medicare and Medicaid cost containment laws, particularly 1997 federal legislation that required the Medicare program to implement a prospective payment program for various subacute services provided in nursing homes. Implementation of this Medicare prospective payment program began on July 1, 1998. Prior to the prospective payment program, Medicare generally paid nursing home operators based upon audited costs for services provided. The new prospective payment system sets Medicare rates based upon government estimated costs of treating specified medical conditions. Although it is possible that a nursing home may increase its profit if it is able to provide services at below average costs, we believe that the effect of the Medicare prospective payment system has been and will be to reduce the profitability of Medicare services in nursing homes. This belief is based upon our observation of the impact of similar Medicare changes that were implemented for hospitals during the 1980s and the large number of bankruptcies which have occurred in the nursing home industry since the implementation of the Medicare prospective payment system began.

**OUR SENIOR LIVING FACILITIES**

Assuming we close our pending acquisition of five communities, we will lease or operate 92 senior living facilities: five facilities which we expect to own and operate directly; 56 facilities included in one lease which we operate directly; and 31 communities included in a second lease which are managed by Marriott:

| | No. of Units | | | | | Year ended December 31, 2001 | |
|---|---|---|---|---|---|---|---|
| **Ownership** | **Independent Living Apartments** | **Assisted Living Suites** | **Specialty Care Beds** | **Nursing Beds** | **Total** | **Rent** | **Revenues** |
| | | | | | | **($ in thousands)** | |
| Pending acquisition (5 facilities owned and operated by us) | 531 | 173 | | | 704 | N/A | $14,194(2) |
| Senior Housing Lease No. 1 (56 facilities operated by us) | 79 | 153 | | 4,979 | 5,211 | $7,000 | 227,044 |
| Senior Housing Lease No. 2 (31 facilities managed by Marriott) | 3,981 | 1,613 | 294 | 1,599 | 7,487 | 63,000(1) | 277,461 |
| Total units: | 4,591 | 1,939 | 294 | 6,578 | 13,402 | | |

(1) *In addition to the $63 million of rent, we are required to pay a percentage of our gross revenue as an escrowed reserve for recurring capital expenditures. In 2001 this pro forma amount was $7.4 million.*

(2) *For the twelve months ended November 30, 2001.*

**PENDING ACQUISITION**

In January 2002, we agreed to purchase five senior living communities. Our acquisition of these five communities is subject to completion of various state licensing matters and other customary closing conditions. At this time we expect to own and operate these communities directly. In the future we may decide to finance these properties with Senior Housing or another third party. These five communities contain 704 living units and are located in five states. The following table provides additional information about these five communities and their current operations:

| Location | No. of units | Type of units | Occupancy(1) | Revenues(2) | Percent of revenues from private pay sources |
|---|---|---|---|---|---|
| | | | | ($ in thousands) | |
| 1. Stockton, CA | 84 | ind. liv. apts. | | | |
| | 80 | asst. liv. suites | | | |
| | 164 | total units | 94% | $ 3,406 | 100% |
| 2. Ft. Myers, FL | 186 | ind. liv. apts. | | | |
| | 20 | asst. liv. suites | | | |
| | 206 | total units | 90% | 4,107 | 100% |
| 3. Overland Park, KS | 141 | ind. liv. apts. | 91% | 2,887 | 100% |
| 4. Florissant, MO | 120 | ind. liv. apts. | 81% | 1,974 | 100% |
| 5. Omaha, NE | 73 | asst. liv. suites | 82% | 1,820 | 100% |
| Totals: 5 communities in 5 states | 531 | ind. liv. apts. | | | |
| | 173 | asst. liv. suites | | | |
| | 704 | units | 88% | $14,194 | 100% |

*(1)* *As of November 30, 2001.*

*(2)* *For the twelve months ended November 30, 2001.*



**SENIOR HOUSING LEASE NO. 1 FACILITIES**

We lease and operate 56 senior living facilities which are owned by Senior Housing. These 56 facilities include 54 nursing homes and two assisted living facilities; four of the nursing homes also contain some assisted living units or independent living apartments. These 56 facilities have 5,211 beds or living units and they are located in 12 states. The following table provides additional information about these facilities and their current operations as of and for the year ended December 31, 2001:

| Location/Units | Occpy. | Revenues ($ in 000s) | Percent of revenues from Medicare/ Medicaid |
|---|---|---|---|
| 1. Phoenix, AZ<br>119 nursing beds | 80% | $4,367 | 80% |
| 2. Yuma, AZ<br>125 nursing beds | 92% | 6,080 | 80% |
| 3. Yuma, AZ<br>52 asst. liv. suites | 84% | 576 | 0% |
| 4. Arleta, CA<br>85 asst. liv. suites | 87% | 1,473 | 0% |
| 5. Lancaster, CA<br>99 nursing beds | 94% | 4,860 | 67% |
| 6. Stockton, CA<br>116 nursing beds | 97% | 6,620 | 72% |
| 7. Thousand Oaks, CA<br>124 nursing beds | 94% | 7,142 | 72% |
| 8. Van Nuys, CA<br>58 nursing beds | 97% | 2,835 | 83% |
| 9. Canon City, CO<br>85 nursing beds<br>48 ind. liv. apts. | 91% | 3,576 | 62% |
| 10. Cherrelyn, CO<br>198 nursing beds | 90% | 9,272 | 83% |
| 11. Colorado Springs, CO<br>75 nursing beds | 100% | 3,833 | 75% |
| 12. Delta, CO<br>76 nursing beds<br>16 asst. liv. suites | 78% | 3,572 | 83% |
| 13. Grand Junction, CO<br>95 nursing beds | 87% | 4,152 | 62% |
| 14. Grand Junction, CO<br>82 nursing beds | 93% | 4,221 | 71% |
| 15. Lakewood, CO<br>125 nursing beds | 86% | 5,677 | 82% |
| 16. New Haven, CT<br>150 nursing beds | 98% | 10,101 | 95% |
| 17. Waterbury, CT<br>150 nursing beds | 95% | 10,109 | 93% |
| 18. College Park, GA<br>99 nursing beds | 91% | 3,163 | 98% |
| 19. Dublin, GA<br>130 nursing beds | 85% | 3,798 | 97% |
| 20. Glenwood, GA<br>61 nursing beds | 81% | 1,694 | 95% |
| 21. Marietta, GA<br>109 nursing beds | 87% | 3,745 | 88% |
| 22. Clarinda, IA<br>96 nursing beds | 60% | 2,366 | 70% |
| 23. Council Bluffs, IA<br>62 nursing beds | 95% | 2,428 | 87% |
| 24. Des Moines, IA<br>85 nursing beds | 88% | 3,862 | 80% |
| 25. Glenwood, IA<br>116 nursing beds | 100% | 6,754 | 99% |

| Location/Units | Occpy. | Revenues ($ in 000s) | Percent of revenues from Medicare/ Medicaid |
|---|---|---|---|
| 26. Mediapolis, IA<br>62 nursing beds | 89% | 2,299 | 66% |
| 27. Pacific Junction, IA<br>12 nursing beds | 100% | 733 | 96% |
| 28. Winterset, IA<br>98 nursing beds<br>19 ind. liv. apts. | 70% | 2,637 | 50% |
| 29. Ellinwood, KS<br>55 nursing beds<br>4 ind. liv. apts. | 93% | 1,821 | 56% |
| 30. Farmington, MI<br>149 nursing beds | 76% | 9,985 | 78% |
| 31. Howell, MI<br>149 nursing beds | 88% | 9,999 | 86% |
| 32. Tarkio, MO<br>75 nursing beds | 69% | 1,936 | 70% |
| 33. Ainsworth, NE<br>48 nursing beds | 87% | 1,652 | 71% |
| 34. Ashland, NE<br>101 nursing beds | 94% | 4,423 | 69% |
| 35. Blue Hill, NE<br>63 nursing beds | 85% | 2,136 | 69% |
| 36. Campbell, NE<br>45 nursing beds | 85% | 1,538 | 76% |
| 37. Central City, NE<br>65 nursing beds | 95% | 2,310 | 73% |
| 38. Columbus, NE<br>48 nursing beds | 98% | 2,087 | 63% |

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| | | | |
|---|---|---|---|
| 39. Edgar, NE<br>52 nursing beds | 86% | 1,680 | 66% |
| 40. Exeter, NE<br>48 nursing beds | 87% | 1,489 | 58% |
| 41. Grand Island, NE<br>74 nursing beds | 98% | 3,091 | 66% |
| 42. Gretna, NE<br>63 nursing beds | 93% | 2,459 | 67% |
| 43. Lyons, NE<br>63 nursing beds | 81% | 1,822 | 57% |
| 44. Milford, NE<br>54 nursing beds | 90% | 1,950 | 69% |
| 45. Sutherland, NE<br>62 nursing beds | 92% | 2,354 | 80% |
| 46. Utica, NE<br>40 nursing beds | 96% | 1,715 | 75% |
| 47. Waverly, NE<br>50 nursing beds | 86% | 2,003 | 49% |
| 48. Brookfield, WI<br>226 nursing beds | 95% | 11,612 | 73% |
| 49. Clintonville, WI<br>101 nursing beds | 87% | 3,634 | 74% |
| 50. Clintonville, WI<br>61 nursing beds | 94% | 3,264 | 67% |

| | | | |
|---|---|---|---|
| 51. Madison, WI<br>63 nursing beds | 74% | 2,891 | 59% |
| 52. Milwaukee, WI<br>154 nursing beds | 80% | 6,816 | 76% |
| 53. Pewaukee, WI<br>175 nursing beds | 84% | 7,275 | 71% |
| 54. Waukesha, WI<br>105 nursing beds | 96% | 5,327 | 56% |
| 55. Laramie, WY<br>98 nursing beds | 92% | 4,416 | 70% |
| 56. Worland, WY<br>85 nursing beds<br>8 ind. liv. apts. | 84% | 3,414 | 71% |
| Totals: 56 facilities in 12 states, 5,211 units | 88% | $227,044 | 76% |

After it repossessed or acquired the foregoing facilities from former tenants, Senior Housing undertook to correct deferred maintenance which had been allowed to occur by former operators. Between July 2000 and December 2001, $8.3 million was spent by Senior Housing under this program. At the time of our spin off from Senior Housing, Senior Housing provided us cash of $1.6 million to fund the estimated costs of these projects which remained unfinished. During the course of these projects, parts of these facilities are sometimes closed and these closings can adversely impact occupancy; however, we believe these projects are necessary for continuing operations at these facilities and may make the facilities more attractive to residents. We expect this correction of deferred maintenance projects to be completed in 2002.

**OUR LEASE FOR THE 56 FACILITIES**

One of our subsidiaries leases the 56 facilities described above; and we have guaranteed our subsidiary's obligations under the lease. The lease has been filed as an exhibit to the registration statement of which this prospectus is a part. If you want more information about the lease terms, you should read the entire lease. The following is a summary of material terms of this lease:

**Operating costs**

The lease is a so-called "triple-net" lease which requires us to pay all costs incurred in the operation of the facilities, including the costs of personnel, service to residents, insurance and real estate and personal property taxes.

**Minimum rent**

Our minimum rent is $7 million per year.



**Percentage rent**

Starting in 2004, we are required to pay additional rent with respect to each lease year in an amount equal to three percent (3%) of net patient revenues at each leased facility in excess of net patient revenues at the facility during 2003.

**Term**

The initial term expires on December 31, 2018.

**Renewal option**

We have the option to renew the lease for all but not less than all the 56 facilities for one renewal term ending on December 31, 2033, by notice on or before December 31, 2015. We may not exercise this renewal option unless we also exercise our renewal option under our lease for the Marriott facilities.

**Rent during renewal term**

Rent during the renewal term is a continuation of minimum rent and percentage rent payable during the initial term.

**Maintenance and alterations**

We are required to operate continuously and maintain, at our expense, the leased facilities in good order and repair, including structural and nonstructural components. We may request Senior Housing to fund amounts needed for repairs and renovations in return for rent adjustments to provide Senior Housing a return on its investment according to a formula set forth in the lease. At the end of the lease term, we are required to surrender the leased facilities in substantially the same condition as existed on the commencement date of the lease, subject to any permitted alterations and subject to ordinary wear and tear.

**Assignment and subletting**

Senior Housing's consent is generally required for any direct or indirect assignment or sublease of any of the facilities. In the event of any assignment or subletting, we will remain liable under the lease.

**Environmental matters**

We are required, at our expense, to remove and dispose of any hazardous substance at the leased facilities in compliance with all applicable environmental laws and regulations. We have indemnified Senior Housing for any liability which may arise as a result of the presence of hazardous substances at any leased facilities and from any violation or alleged violation of any applicable environmental law or regulation.

**Indemnification and insurance**

With limited exceptions, we are required to indemnify Senior Housing from all liabilities which may arise from the ownership or operation of the facilities. We generally are required to maintain commercially reasonable insurance, including:

> "all-risk" property insurance, in an amount equal to 100% of the full replacement cost of the facilities;

> business interruption insurance;

> comprehensive general liability insurance, including bodily injury and property damage, in amounts as are generally maintained by companies providing senior living services;



> flood insurance if any facility is located in whole or in part in a flood plain;

> worker's compensation insurance if required by law; and

> such additional insurance as may be generally maintained by companies providing senior living services.

The lease requires that Senior Housing be named as an additional insured under these policies.

**Damage, destruction or condemnation**

If any of the leased facilities is damaged by fire or other casualty or taken for a public use, we are generally obligated to rebuild unless the facility cannot be restored. If the facility cannot be restored, Senior Housing will generally receive all insurance or taking proceeds and we are liable to Senior Housing for the amount of any deductible or deficiency between the replacement cost and the insurance proceeds.

**Events of default**

Events of default under the lease include the following:

> our failure to pay rent or any other sum when due;

> our failure to maintain the insurance required under the lease;

> the occurrence of certain events with respect to our insolvency;

> the institution of a proceeding for our dissolution;

> any person or group of affiliated persons acquiring ownership of more than 9.8% of us without Senior Housing's consent;

> any change in our control or sale of a material portion of our assets without Senior Housing's consent;

> our default under the lease for the Marriott facilities;

> our default under any indebtedness which gives the holder the right to accelerate;

> our being declared ineligible to receive reimbursement under Medicare or Medicaid programs for any of the leased facilities; and

> our failure to perform any terms, covenants or agreements of the lease and the continuance thereof for a specified period of time after written notice.

**Remedies**

Upon the occurrence of any event of default, the lease provides that, among other things, Senior Housing may, to the extent legally permitted:

> accelerate the rent;

> terminate the lease;

> terminate the other lease which we have with Senior Housing;

> enter the property and take possession of any and all our personal property and retain or sell the same at a public or private sale; and

> make any payment or perform any act required to be performed by us under the lease.



We are obligated to reimburse Senior Housing for all costs and expenses incurred in connection with any exercise of the foregoing remedies.

**Management**

We may not enter into, amend or modify any management agreement affecting any leased property without the prior written consent of Senior Housing.

**Lease subordination**

Our lease may be subordinated to any mortgages of the leased properties by Senior Housing.

**Financing limitations; security**

We may not incur debt secured by our investments in our tenant subsidiary. Further, our tenant subsidiary is prohibited from incurring liabilities other than operating liabilities incurred in the ordinary course of business, those liabilities secured by accounts receivables or purchase money debt. We are required to pledge 100% of the equity interests of our tenant subsidiary to Senior Housing or its lenders.

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## SENIOR HOUSING LEASE NO. 2 FACILITIES

We lease 31 senior living facilities from Senior Housing which are managed by Marriott. These facilities contain 7,487 living units and are located in 13 states. The following table provides additional information about these facilities and their current operations as of and for Marriott's fiscal year ended December 28, 2001:

| | | | | | | | Year ended December 28, 2001 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Location | Ind. liv. apts. | Asst. liv. suites | Spec. care beds | Nursing beds | Totals | Occupancy | Revenues ($ in 000s) | Percent of revenues from private pay resources |
| 1. | Peoria, AZ | 155 | 79 | | 57 | 291 | 90% | $9,119 | 93% |
| 2. | Scottsdale, AZ | 167 | 33 | | 96 | 296 | 91% | 10,675 | 90% |
| 3. | Tucson, AZ | 202 | 30 | 27 | 67 | 326 | 96% | 11,835 | 92% |
| 4.,5. | San Diego, CA | 246 | 100 | | 59 | 405 | 93% | 18,380 | 98% |
| 6. | Newark, DE | 62 | 26 | | 110 | 198 | 97% | 9,865 | 66% |
| 7. | Wilmington, DE | 140 | 37 | | 66 | 243 | 97% | 11,495 | 82% |
| 8. | Wilmington, DE | 71 | 44 | | 46 | 161 | 94% | 6,070 | 93% |
| 9. | Wilmington, DE | 62 | 15 | | 82 | 159 | 93% | 7,664 | 66% |
| 10. | Wilmington, DE | | 51 | 26 | 31 | 108 | 72% | 3,259 | 100% |
| 11. | Coral Springs, FL | 184 | 62 | | 35 | 281 | 91% | 9,317 | 84% |
| 12. | Deerfield Beach, FL | 198 | 33 | | 60 | 291 | 88% | 10,339 | 69% |
| 13. | Ft. Lauderdale, FL | | 109 | | | 109 | 90% | 2,096 | 100% |
| 14. | Ft. Myers, FL | | 85 | | | 85 | 90% | 2,234 | 100% |
| 15. | Palm Harbor, FL | 230 | 87 | | | 317 | 82% | 7,184 | 100% |
| 16. | West Palm Beach, FL | 276 | 64 | | | 340 | 84% | 7,220 | 100% |
| 17. | Indianapolis, IN | 117 | | 30 | 74 | 221 | 93% | 10,623 | 82% |
| 18. | Overland Park, KS | 117 | 30 | | 60 | 207 | 94% | 8,087 | 90% |
| 19. | Lexington, KY | 140 | 9 | | | 149 | 94% | 4,128 | 100% |
| 20. | Lexington, KY | | 22 | | 111 | 133 | 95% | 6,952 | 66% |
| 21. | Louisville, KY | 240 | 44 | | 40 | 324 | 97% | 10,465 | 91% |
| 22. | Winchester, MA | | 125 | | | 125 | 99% | 5,609 | 100% |
| 23. | Lakewood, NJ | 217 | 108 | 31 | 60 | 416 | 80% | 15,039 | 88% |
| 24. | Albuquerque, NM | 114 | 34 | | 60 | 208 | 99% | 9,235 | 95% |
| 25. | Columbus, OH | 143 | 87 | 25 | 60 | 315 | 93% | 13,396 | 93% |
| 26. | Myrtle Beach, SC | | 60 | 36 | 68 | 164 | 84% | 5,740 | 66% |
| 27. | Dallas, TX | 190 | 38 | | 90 | 318 | 92% | 13,067 | 83% |
| 28. | El Paso, TX | 123 | | 15 | 120 | 258 | 86% | 9,501 | 71% |
| 29. | Houston, TX | 197 | 71 | 60 | 87 | 415 | 96% | 17,500 | 93% |
| 30. | San Antonio, TX | 151 | 30 | 28 | 60 | 269 | 96% | 10,802 | 95% |
| 31. | Woodlands, TX | 239 | 100 | 16 | | 355 | 93% | 10,505 | 100% |
| | Totals: 31 facilities in 13 states | 3,981 | 1,613 | 294 | 1,599 | 7,487 | 91% | $277,461 | 88% |

## OUR LEASE FOR THE MARRIOTT FACILITIES

The lease for the Marriott facilities has been filed as an exhibit to the registration statement of which this prospectus is a part. If you want more information about lease terms, you should read the entire lease. The material terms of our lease for the Marriott facilities are substantially the same as those of our lease for the 56 facilities, except as follows:

**Minimum rent**

Our minimum rent is $63 million per year.



**Percentage rent**

Starting in 2003, we are required to pay additional rent with respect to each lease year in an amount equal to five percent (5%) of net patient revenues at each leased facility in excess of net patient revenues at the facility during 2002.

**FF&E reserves**

We are required to maintain accounts for replacements and improvements as described below in " Marriott management FF&E reserves and capital improvements".

**Term**

The initial term expires on December 31, 2017.

**Renewal options**

We have two options to renew the lease for all but not less than all the facilities: the first for 10 years ending on December 31, 2027, and the second for five years ending on December 31, 2032. We may not exercise these renewal options unless we have exercised our renewal option under the lease for the 56 facilities. The first renewal option must be exercised by notice two years prior to the expiration of the initial term. The second renewal option must be exercised by notice at least 11 months before the then current term expires.

**Events of default**

In addition to the events of default described under our lease for the 56 facilities, the lease for the Marriott facilities includes the following events of default:

> our default under any Marriott management agreement; and

> our default under the lease for the 56 facilities owned by Senior Housing.

**MARRIOTT MANAGEMENT**

The 31 Marriott facilities are each subject to a management agreement with Marriott. The following is a description of the material terms of the management agreements. If you want more information about these agreements, you should read the representative form of management agreement which has been filed as an exhibit to the registration statement of which this prospectus is a part.

**Term**

Generally each of the management agreements has an initial term expiring in 2027, with one five-year renewal term at Marriott's option.

**Facility services**

Marriott has responsibility and authority for all day-to-day operations of the managed facilities, including obtaining and maintaining all licenses necessary for operations, insurance, establishing resident care policies and procedures, carrying out and supervising all necessary repairs and maintenance, procuring food, supplies, equipment, furniture and fixtures, and establishing prices, rates and charges for services provided. Marriott also recruits, employs and directs all facility based employees, including managerial employees.

**Central services**

Marriott also furnishes certain central administrative services, which are provided on a central or regional basis to all senior living facilities managed by Marriott. Such services include: (i) marketing



and public relations; (ii) human resources program development; (iii) information systems development and support; and (iv) centralized computer payroll and accounting.

**Working capital**

We are required to maintain working capital at each of the managed facilities at levels consistent with the Marriott senior living system standard.

**FF&E reserves and capital improvements**

Marriott has established a reserve account under each management agreement, referred to as an FF&E Reserve, to cover the expected recurring cost of replacements and renewals to the furniture, furnishings, fixtures, soft goods, case goods, vehicles and equipment, and for building repairs and maintenance which are normally capitalized. The FF&E Reserve accounts are funded from the operating revenues of the managed facilities. The amount of this funding varies somewhat among the managed facilities; however, for most facilities it is currently set at 2.65% of gross revenues and is expected to gradually increase to 3.5%. In the event major capital improvements are required, or if the amounts set aside in the FF&E Reserve accounts are inadequate for required repairs, we may be required to fund such repairs and improvements. Any such funding which we provide increases the amount of our owner's priority, described below. Also, under our lease we have the option to request Senior Housing to provide such required funding in return for rent adjustments to provide Senior Housing a return on its investment according to a formula set forth in the lease.

**Fees**

For its facility services, Marriott receives a base fee generally equal to 5% of the managed facilities' gross revenues, plus an incentive fee generally equal to 20% of operating profits in excess of owner's priority amounts, as defined in the agreements. For its central services, Marriott receives a fee generally equal to 2% of gross revenues. Generally, through the earlier of (i) the end of June 2004 or (ii) the date on which certain performance criteria have been met, payment of up to one half of this central services fee (i.e., 1% of gross revenues) is conditional, and is waived if specified annual profit targets are not achieved. During 2001 management fees paid to Marriott totaled $18.1 million.

**Owner's priority**

We receive the profits of the Marriott managed facilities on a priority basis before Marriott receives any incentive fees for facility services or any conditional central services fees. The amount of the owner's priority for each managed facility is established based upon a specified rate of return on historical capital investments in these facilities, including capital investments funded in addition to the FF&E Reserve. For fiscal year 2001, the aggregate amount of owner's priority for all 31 properties was $69.4 million.

**Pooling**

Twenty-nine of the facilities are subject to pooling arrangements whereby the calculation and payment of FF&E Reserves, fees payable to Marriott and owner's priority for several groups of these 29 facilities are combined.

**Events of default**

Events of default under the management agreements include, among others, certain events relating to the insolvency or bankruptcy of either party.



**Termination**

The Marriott management agreements may be terminated as follows:

> Upon material default, by the non-defaulting party after applicable cure periods lapse.

> Starting in 2006 by us, if a specific facility, or a pooled combination of facilities, fails to achieve specified financial performance; provided, however, Marriott has the option to avoid financial performance terminations by making specified payments to us or by temporarily reducing certain of its fees.

> By us, upon 120 days notice, provided we make a termination payment to Marriott calculated according to a formula set forth in the agreements.

Our right to exercise termination options under the Marriott management agreements is subject to approval by Senior Housing under the terms of the lease for these 31 Marriott facilities.

**GOVERNMENT REGULATION AND RATE SETTING**

**Senior apartments**

Generally, government programs do not pay for housing in senior apartments. Rents are paid from the residents' private resources. Accordingly, the government regulations that apply to these types of properties are generally limited to zoning, building and fire codes, Americans with Disabilities Act requirements and other life safety type regulations applicable to residential real estate. Government rent subsidies and government assisted development financing for low income senior housing are exceptions to these general statements. The development and operation of subsidized senior housing properties are subject to numerous governmental regulations. While it is possible that we may lease some subsidized senior apartment facilities, we do not expect these facilities to be a major part of our future business, and we do not own senior apartments where rent subsidies are applicable.

**Independent living apartments**

Government benefits generally are not available for services at independent living apartments and the resident charges in these facilities are paid from private resources. However, a number of Federal Supplemental Security Income program benefits pay housing costs for elderly or disabled residents to live in these types of residential facilities. The Social Security Act requires states to certify that they will establish and enforce standards for any category of group living arrangement in which a significant number of supplemental security income residents reside or are likely to reside. Categories of living arrangements which may be subject to these state standards include independent living apartments and assisted living facilities. Because independent living apartments usually offer common dining facilities, in many locations they are required to obtain licenses applicable to food service establishments in addition to complying with land use and life safety requirements. In many states, independent living apartments are licensed by state health departments, social service agencies, or offices on aging with jurisdiction over group residential facilities for seniors. To the extent that independent living apartments include units in which assisted living or nursing services are provided, these units are subject to applicable state licensing regulations, and if the facilities receive Medicaid or Medicare funds, to certification standards. In some states, insurance or consumer protection agencies regulate independent living apartments in which residents pay entrance fees or prepay other costs.

**Assisted living facilities**

According to the National Academy for State Health Policy, 39 states provide or are approved to provide Medicaid payments for residents in some assisted living facilities under waivers granted by the Federal Centers for Medicare and Medicaid Services or under Medicaid state plans, and eight other



states are planning some Medicaid funding by requesting waivers implementing assisted living pilot programs or demonstration projects. Because rates paid to assisted living facility operators are lower than rates paid to nursing home operators, some states use Medicaid funding of assisted living as a means of lowering the cost of services for residents who may not need the higher intensity of health-related services provided in nursing homes. States that administer Medicaid programs for assisted living facilities are responsible for monitoring the services at, and physical conditions of, the participating facilities. Different states apply different standards in these matters, but generally we believe these monitoring processes are similar to the concerned states' inspection processes for nursing homes.

In light of the large number of states using Medicaid to purchase services at assisted living facilities and the growth of assisted living in the 1990s, a majority of states have adopted licensing standards applicable to assisted living facilities. According to the National Academy for State Health Policy, 29 states have licensing statutes or standards specifically using the term "assisted living". The majority of states have revised their licensing regulations recently or are reviewing their policies or drafting or revising their regulations. State regulatory models vary; there is no national consensus on a definition of assisted living, and no uniform approach by the states to regulating assisted living facilities. Most state licensing standards apply to assisted living facilities whether or not they accept Medicaid funding. Also, according to the National Academy for State Health Policy, seven states require certificates of need from state health planning authorities before new assisted living facilities may be developed and two states have exempted assisted living facilities from certificate of need laws. Based on our analysis of current economic and regulatory trends, we believe that assisted living facilities that become dependent upon Medicaid payments for a majority of their revenues may decline in value because Medicaid rates may fail to keep up with increasing costs. We also believe that assisted living facilities located in states that adopt certificate of need requirements or otherwise restrict the development of new assisted living facilities may increase in value because these limitations upon development may help ensure higher occupancy and higher non-governmental rates.

Two federal government studies provide background information and make recommendations regarding the regulation of, and the possibility of increased governmental funding for, the assisted living industry. The first study, an April 1999 report by the General Accounting Office to the Senate Special Committee on Aging on assisted living facilities in four states, found a variety of residential settings serving a wide range of resident health and care needs. The General Accounting Office found that consumers often receive insufficient information to determine whether a particular facility can meet their needs and that state licensing and oversight approaches vary widely. The General Accounting Office anticipates that as the states increase the use of Medicaid to pay for assisted living, federal financing will likewise grow, and these trends will focus more public attention on the place of assisted living in the continuum of long-term care and upon state standards and compliance approaches. The second study, a National Study of Assisted Living for the Frail Elderly, was funded by the U.S. Department of Health and Human Services Assistant Secretary for Planning and Evaluation and is expected to result in a report on the effects of different service and privacy arrangements on resident satisfaction, aging in place and affordability. In 2001, the Senate Special Committee on Aging held hearings on assisted living and its role in the continuum of care and on community-based alternatives to nursing homes. We cannot predict whether these studies will result in governmental policy changes or new legislation, or what impact any changes may have. Based upon our analysis of current economic and regulatory trends, we do not believe that the federal government is likely to have a material impact upon the current regulatory environment in which the assisted living industry operates unless it also undertakes expanded funding obligations, and we do not believe a materially increased financial commitment from the federal government is presently likely. However, we do



anticipate that assisted living facilities will increasingly be licensed and regulated by the various states, and that in absence of federal standards, the states' policies will continue to vary widely.

**Nursing homes**

**Reimbursement**

About 58% of all nursing home revenues in the U.S. in 2000 came from government Medicare and Medicaid programs, including about 48% from Medicaid programs. Nursing homes are among the most highly regulated businesses in the country. The federal and state governments regularly monitor the quality of care provided at nursing homes. State health departments conduct surveys of resident care and inspect the physical condition of nursing home properties. These periodic inspections and occasional changes in life safety and physical plant requirements sometimes require nursing home operators to make significant capital improvements. These mandated capital improvements have in the past usually resulted in Medicare and Medicaid rate adjustments, albeit on the basis of amortization of expenditures over expected useful lives of the improvements. A new Medicare prospective payment system, often referred to as PPS, began being phased in over three years beginning with cost reporting years starting on or after July 1, 1998. Under this new Medicare payment system, capital costs are part of the prospective rate and are not facility specific. This new Medicare payment system and other recent legislative and regulatory actions with respect to state Medicaid rates are limiting the reimbursement levels for some nursing home and other eldercare services. At the same time federal and state enforcement and oversight of nursing homes are increasing, making licensing and certification of these facilities more rigorous. These actions have adversely affected the revenues and increased the expenses of many nursing home operators, including us. The new Medicare payment system was established by the Balanced Budget Act of 1997, and was intended to reduce the rate of growth in Medicare payments for skilled nursing facilities. Before the new Medicare payment system, Medicare rates were facility-specific and cost-based. Under the new Medicare payment system, facilities receive a fixed payment for each day of care provided to Medicare patients. Each patient is assigned to one of 44 care groups depending on that patient's medical characteristics and service needs. Per diem payment rates are based on these care groups. Medicare payments cover substantially all services provided to Medicare patients in skilled nursing facilities, including ancillary services such as rehabilitation therapies. The new Medicare payment system is intended to provide incentives to providers to furnish only necessary services and to deliver those services efficiently. During the three year phase in period, Medicare rates for skilled nursing facilities were based on a blend of facility specific costs and rates established by the new Medicare payment system. According to the General Accounting Office, between fiscal year 1998 and fiscal year 1999, the first full year of the new Medicare payment system phase-in, the average Medicare payment per day declined by about nine percent. As of September 30, 2001, all of the facilities that we currently lease from Senior Housing and that participate in the Medicare program have derived their Medicare revenues under the new payment system rates for at least six months. The new Medicare payment system rates have been applied to 34 of our 87 leased facilities since January 1, 2001.

Since November 1999, Congress has provided some relief from the impact of the Balanced Budget Act of 1997. Effective April 1, 2000, the Medicare, Medicaid and SCHIP Balanced Budget Refinement Act of 1999 temporarily boosted payments for certain skilled nursing cases by 20% and allowed nursing facilities to transition more rapidly to the federal payment system. This Act also increased the new Medicare payment rates by four percent for fiscal years 2001 and 2002 and imposed a two-year moratorium on some therapy limitations for skilled nursing patients covered under Medicare Part B.

In December 2000, the Medicare, Medicaid and SCHIP Benefits Improvement and Protection Act of 2000 was approved. Effective April 1, 2001 to October 1, 2002, this Act increases the nursing component of the payment rate for each care group by 16.6%. This Act also increased annual



inflation adjustments for fiscal year 2001, increased rehabilitation care group rates by 6.7%, and maintained the previously temporary 20% increase in the other care group rates established in 1999.

Effective October 1, 2002, the 4% across-the-board increase in Medicare payment rates, the 16.66% increase in the nursing component of the rates, and the 6.7% increase in rehabilitation care group rates, are scheduled to expire. The 20% increase for the skilled nursing care groups will expire when the current resource utilization groups are refined. The Bush administration's fiscal year 2003 budget proposal assumes that the add-ons to the Medicare rates will expire as scheduled and does not provide for additional Medicaid funding for nursing homes. The Medicare Payment Advisory Commission has recommended that Congress incorporate the 20% increases into the base rate for fiscal year 2003 and that the other add-ons expire as scheduled.

**Survey and enforcement**

The Federal Centers have begun to implement an initiative to increase the effectiveness of Medicare and Medicaid nursing facility survey and enforcement activities. The Federal Centers' initiative follows a July 1998 General Accounting Office investigation which found inadequate care in a significant proportion of California nursing homes and the Federal Centers' July 1998 report to Congress on the effectiveness of the survey and enforcement system. In 1999, the U.S. Department of Health and Human Services Office of Inspector General issued several reports concerning quality of care in nursing homes, and the General Accounting Office issued reports in 1999 and 2000 which recommended that the Federal Centers and the states strengthen their compliance and enforcement practices to better ensure that nursing homes provide adequate care. In 1998, 1999 and 2000, the Senate Special Committee on Aging held hearings on these issues. The Federal Centers are taking steps to focus more survey and enforcement efforts on nursing homes with findings of substandard care or repeat violations of Medicare and Medicaid standards and to identify chain operated facilities with patterns of noncompliance. The Federal Centers are increasing their oversight of state survey agencies and requiring state agencies to use enforcement sanctions and remedies more promptly when substandard care or repeat violations are identified, to investigate complaints more promptly, and to survey facilities more consistently. In addition, the Federal Centers have adopted regulations expanding federal and state authority to impose civil money penalties in instances of noncompliance. Medicare survey results for each nursing home are posted on the internet at http://www.medicare.gov. In 2000, the Federal Centers issued a report on their study linking nursing staffing levels with quality of care, and the Federal Centers are assessing the impact that minimum staffing requirements would have on facility costs and operations. In a report to be presented to Congress in March 2002, the Department of Health and Human Services has found that 90% of nursing homes lack the nurse and nurse aide staffing necessary to provide adequate care to residents. The Bush administration has indicated that it does not intend to impose minimum staffing levels or to increase Medicare or Medicaid rates to cover the costs of increased staff at this time, but is considering publishing the staffing level at each nursing home to increase market demand.

Federal efforts to target fraud and abuse and violations of anti-kickback laws and physician referral laws by Medicare and Medicaid providers have also increased. In March 2000, the U.S. Department of Health and Human Services Office of Inspector General issued compliance guidelines for nursing facilities, to assist them in developing voluntary compliance programs to prevent fraud and abuse. Also, new rules governing the privacy, use and disclosure of individually identified health information became final in 2001 and will require compliance by 2003, with civil and criminal sanctions for noncompliance. An adverse determination concerning any of our licenses or eligibility for Medicare or Medicaid reimbursement or compliance with applicable federal or state regulations could negatively affect our financial condition and results of operations.

**Certificates of need**

Most states also limit the number of nursing homes by requiring developers to obtain certificates of need before new facilities may be built. Even states such as California and Texas that have eliminated certificate of need laws often have retained other means of limiting new nursing home development, such as the use of moratoria, licensing laws or limitations upon participation in the state Medicaid program. We believe that these governmental limitations generally make nursing homes more valuable by limiting competition.

A number of legislative proposals that would affect major reforms of the healthcare system have been introduced in Congress, such as additional Medicare and Medicaid reforms and cost containment measures. We cannot predict whether any of these legislative proposals will be adopted or, if adopted, what effect, if any, these proposals would have on our business.

**LIABILITY INSURANCE**

Litigation against senior living operators has been increasing during the past few years. Several cases by nursing home patients or their families who have won large monetary awards for mistreatment have been widely publicized. The amount of such litigation in Florida and Texas has been particularly significant. As a result, liability insurance costs are rising and, in some cases, such insurance is not available to senior living operators.

We have liability insurance for the 56 properties which we now operate. None of these facilities are located in Florida or Texas. One of the five facilities we intend to purchase and operate is located in Florida; this Florida property has 186 independent living apartments and 20 assisted living suites, but it has no nursing beds. Based upon preliminary inquires which we have made, we believe that our planned operations at the five facilities we intend to acquire may be included within our existing insurance. Our current liability insurance expires in June 2002; we expect our insurance costs to increase, and we do not know the amount of any such increase. If such increased cost is not acceptable to us, we intend to explore alternatives, including possibly higher deductible or retention amounts and self insurance.

Marriott is responsible for obtaining insurance for the 31 senior living communities which we lease and Marriott manages. These 31 communities include six in Florida (888 independent living apartments, 440 assisted living suites and 95 nursing beds), and five in Texas (900 independent living apartments, 239 assisted living suites, 119 special care beds and 357 nursing beds). Liability insurance for these facilities' operations is currently provided in part by an insurance company subsidiary of Marriott. The cost of this insurance increased on October 1, 2001, and we are currently exploring with Marriott whether it may be possible to reduce this cost, but we can provide no assurance that these insurance costs can be reduced or that they will not increase further in the future.

**COMPETITION**

The senior living services business is highly competitive. We compete with service providers offering different types of services, such as home healthcare services, as well as other companies providing real estate facility based services. We believe we can compete successfully for the following reasons:

> Our acquisition of FSQ, Inc. and our shared services agreement with Reit Management provide us a depth and quality of management which we believe is equal to or stronger than most other senior living facility operators.

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> Our historical and continuing relationship with Senior Housing may provide us opportunities to expand our business by acquiring new leaseholds from Senior Housing.

> The senior living services industry has experienced severe financial distress during the past few years. Many operators of nursing homes and assisted living facilities have been forced into bankruptcy. As a new company without any material debt, we are not burdened with financial difficulties of the types which currently burden some of our competitors.

Our management team has been recently assembled within the past two years, and, although we believe it is experienced and highly talented, it does not have extensive experience working together. We expect we may expand our business with Senior Housing; however, Senior Housing is not obligated to provide us with opportunities to lease additional properties. We have no debt, but we do have large lease obligations and limited financeable assets; and many of our competitors have greater financial resources than us. For all of these reasons and others, we cannot provide you any assurance that we will be able to compete successfully for business in the senior living industry.

**TECHNOLOGY SYSTEMS**

When we began operating senior living facilities for Senior Housing in July 2000 we created new internet based data processing and management information systems for our clinical, operational and financial information. These systems currently support over 1,000 widely distributed computers in a secure and stable working environment. Because they were built in 2000 and 2001 and are internet based, we believe our technology systems are among the most up-to-date and efficient systems currently in use in the senior living industry. Moreover, these systems were designed to be readily scalable to support our growth strategy.

**ENVIRONMENTAL MATTERS**

Under various federal, state and local laws, ordinances and regulations, owners as well as tenants and operators of real estate may be required to investigate and clean up hazardous substances released at a property, and may be held liable to a governmental entity or to third parties for property damage or personal injuries and for investigation and clean-up costs incurred in connection with any contamination. Under our leases, we have also agreed to indemnify Senior Housing for any such liabilities related to the leased facilities. In addition, some environmental laws create a lien on a contaminated site in favor of the government for damages and costs it incurs in connection with the contamination, which lien may be senior in priority to our leases. We have reviewed some preliminary environmental surveys of the facilities we lease and the properties we expect to acquire in the pending acquisition. Based upon that review we do not believe that any of these properties are subject to any material environmental contamination. However, no assurances can be given that:

> a prior owner, operator or occupant of our leased facilities or the properties we intend to acquire did not create a material environmental condition not known to us which might have been revealed by more in-depth study of the properties; and

> future uses or conditions (including, without limitation, changes in applicable environmental laws and regulations) will not result in the imposition of environmental liability upon us.

**EMPLOYEES**

As of March 20, 2002, we had approximately 6,000 employees, including 5,500 full time equivalents. Approximately 690 employees, including 570 full time equivalents, are represented under seven



collective bargaining agreements, all of which have remaining terms of two to three years. We have no other employment agreements. We believe relations with our union and non-union employees to be good. The five facilities which we expect to acquire in the pending acquisition are staffed by approximately 250 employees, some of whom are represented by a union; we expect to offer to employ these people when this acquisition closes.

**LEGAL PROCEEDINGS**

From time to time, we are subject to legal actions and regulatory investigations arising in the normal course of our business. We are not aware of any currently pending material legal proceeding affecting our facilities for which we may become liable. We cannot assure you that such actions or investigations would not have a material adverse effect on our business or financial results.



# Management

The following sets forth the names, ages and positions of our executive officers and directors as of February 1, 2002:

| Name | Age | Position |
| --- | --- | --- |
| Evrett W. Benton | 53 | President, Chief Executive Officer and Secretary |
| Rosemary Esposito, RN | 59 | Senior Vice President, Chief Operating Officer |
| Gretchen A. Holtz, RN | 59 | Vice President, Chief Clinical Officer |
| Maryann Hughes | 54 | Vice President, Director of Human Resources |
| Bruce J. Mackey Jr. | 31 | Treasurer, Chief Financial Officer and Assistant Secretary |
| Barry M. Portnoy | 56 | Managing Director (term will expire in 2002) |
| Gerard M. Martin | 67 | Managing Director (term will expire in 2003) |
| Bruce M. Gans, M.D. | 55 | Director (term will expire in 2004) |
| John L. Harrington | 65 | Director (term will expire in 2002) |
| Arthur G. Koumantzelis | 71 | Director (term will expire in 2003) |

**EXECUTIVE OFFICERS**

*Evrett W. Benton* has been our President, Chief Executive Officer and Secretary since our formation. Mr. Benton served as President and Chief Executive Officer of FSQ, Inc. since it began operations in January 2000 until our acquisition of FSQ, Inc. in January 2002. From November 1999 until FSQ, Inc. began operations, Mr. Benton served as a business and legal consultant to Reit Management and Senior Housing in connection with their negotiations with former tenants of Senior Housing who filed for bankruptcy. From November 1997 to November 1999, Mr. Benton was an independent consultant working in the healthcare and real estate industries. From December 1991 to November 1997, Mr. Benton was Executive Vice President, Chief Administrative Officer, General Counsel and Secretary of GranCare, Inc., a publicly owned healthcare services company and a predecessor to Mariner Post-Acute Network, Inc. Prior to December 1991, Mr. Benton was the Managing Partner of the Los Angeles office of the law firm of Andrews & Kurth LLP. Mr. Benton has been a Vice President of Reit Management since September 2000.

*Rosemary Esposito, RN* has been our Senior Vice President and Chief Operating Officer since our spin-off from Senior Housing on December 31, 2001. Ms. Esposito served as Senior Vice President and Chief Operating Officer of FSQ, Inc. from February 2001 until our acquisition of FSQ, Inc. in January 2002. Between June 1999 and February 2001, Ms. Esposito was Vice President and Chief Operating Officer of Lenox Healthcare, Inc., a privately owned nursing home chain headquartered in Pittsfield, Massachusetts, that filed for Chapter 11 bankruptcy in November 2000. From December 1996 to June 1999, Ms. Esposito was Vice President of Clinical Services of Lenox Healthcare, Inc. Prior to 1996, Ms. Esposito held senior management positions with Berkshire Health Systems, Inc., an acute care medical center and multi-facility, long-term care company headquartered in Pittsfield, Massachusetts.



*Gretchen A. Holtz, RN* has been our Vice President and Chief Clinical Officer since our spin-off from Senior Housing on December 31, 2001. Ms. Holtz served as Vice President and Chief Clinical Officer of FSQ, Inc. from May 2000 until our acquisition of FSQ, Inc. in January 2002. From 1999 until May 2000, Ms. Holtz was a private consultant for various healthcare insurance and referral businesses specializing in elder care services. From 1997 to 1999, Ms. Holtz was Vice President for Clinical Services at the Frontier Group, Inc., a Boston, Massachusetts based private company in the nursing home business. From 1994 to November 1997, Ms. Holtz was National Director of Subacute Services for Sun Healthcare Group, Inc., a publicly owned company which provided healthcare services that filed for Chapter 11 bankruptcy in October 1999.

*Maryann Hughes* has been our Vice President and Director of Human Resources since our spin-off from Senior Housing on December 31, 2001. Ms. Hughes served as a Vice President and Director of Human Resources for FSQ, Inc. from May 2000 until our acquisition of FSQ, Inc. in January 2002. Between 1996 and May 2000, Ms. Hughes was Senior Vice President of Human Resources for Olympus Healthcare Group, Inc., a privately owned company headquartered in Waltham, Massachusetts in the business of operating nursing homes and rehabilitation hospitals. From 1994 to 1996, Ms. Hughes was Senior Vice President of Health Alliance, a partnership of two acute care hospitals, two nursing homes and other medical services businesses based in Leominster, Massachusetts.

*Bruce J. Mackey Jr.* has been our Treasurer, Chief Financial Officer and Assistant Secretary since our spin-off from Senior Housing on December 31, 2001. Mr. Mackey served as Treasurer and Chief Financial Officer of FSQ, Inc. from October 2001 until our acquisition of FSQ, Inc. in January 2002. From December 1997 to July 2000, Mr. Mackey was a Controller of Reit Management and from July 2000 to October 2001 he was an Assistant Vice President of Reit Management. Mr. Mackey was elected a Vice President of Reit Management in October 2001. From 1992 to December 1997, Mr. Mackey was an accountant with the firm of Arthur Andersen LLP. Mr. Mackey is a certified public accountant.

**DIRECTORS**

*Barry M. Portnoy* has been one of our directors since our reincorporation in Maryland; he was designated a Managing Director in January 2002. Mr. Portnoy has been one of the Managing Trustees of Senior Housing, HRPT Properties and Hospitality Properties, since each began business in 1999, 1986 and 1995, respectively. Mr. Portnoy has been a director and 50% owner of Reit Management since it began business in 1986. Mr. Portnoy was a director and 50% owner of FSQ, Inc. since it began business in January 2000 until it was acquired by us in January 2002. From 1978 through March 1997, Mr. Portnoy was a partner of the law firm of Sullivan & Worcester LLP, our counsel, and he was Chairman of that firm from 1994 through March 1997.

*Gerard M. Martin* has been one of our directors since our reincorporation in Maryland; he was designated a Managing Director in January 2002. Mr. Martin has been one of the Managing Trustees of Senior Housing, HRPT Properties and Hospitality Properties since each began business in 1999, 1986 and 1995, respectively. Mr. Martin has been a director and 50% owner of Reit Management since it began business in 1986. Mr. Martin was a director and 50% owner of FSQ, Inc. since it began business in January 2000 until it was acquired by us in January 2002.

*Bruce M. Gans, M.D.* has been one of our directors since our spin-off from Senior Housing on December 31, 2001. Dr. Gans has been Executive Vice President and Chief Medical Officer at Kessler Rehabilitation Corporation, a provider of healthcare services headquartered in West Orange, New Jersey, since June 1, 2001. From April 1999 to May 31, 2001, Dr. Gans was Senior Vice President for



Continuing Care and Chairman of Physical Medicine and Rehabilitation at North Shore Long Island Jewish Health System, a provider of healthcare services headquartered in New Hyde Park, New York, and Professor of Physical Medicine and Rehabilitation at the Albert Einstein College of Medicine in New York City. From 1989 through March 1999, Dr. Gans was a Professor and Chairman of the Department of Physical Medicine and Rehabilitation at Wayne State University and a Senior Vice President of the Detroit Medical Center, both located in Detroit, Michigan. Dr. Gans was a trustee of HRPT Properties from October 1995 through October 11, 1999. Dr. Gans served as a trustee of Senior Housing from October 12, 1999 until December 31, 2001, when he resigned to join our Board.

*John L. Harrington* has been one of our directors since our spin-off from Senior Housing on December 31, 2001. Mr. Harrington has been Executive Director and Trustee of the Yawkey Foundation and a Trustee of the JRY Trust for over five years, and during that period until February 27, 2002, was the Chief Executive Officer of the Boston Red Sox Baseball Club. The Yawkey Foundation and JRY Trust are not-for-profit charitable foundations headquartered in Dedham, Massachusetts. Mr. Harrington was a trustee of HRPT Properties from 1991 through August 1995 and has been a trustee of Hospitality Properties and Senior Housing since those companies became publicly owned in 1995 and 1999, respectively, through the present.

*Arthur G. Koumantzelis* has been one of our directors since our spin-off from Senior Housing on December 31, 2001. Mr. Koumantzelis has been the President and Chief Executive Officer of Gainesborough Investments LLC, a private investment company, located in Lexington, Massachusetts since June 1998. Since April 2000, he has served as the President, Chief Executive Officer and a member of the Board of Directors of Peponi Investments, LLC, a private company, also located in Lexington, Massachusetts. In addition, Mr. Koumantzelis has served as Treasurer and has been a 33% stockholder of Mosaic Communications Group, LLC, a media company, since December 2000. He is also a Trustee of Milo Trust, Milo Franklin Trust and Lemoni Trust and a member of the Board of Directors of Wang Healthcare Information Systems, Inc.; all of these private companies are headquartered in Massachusetts. From 1990 until February 1998, Mr. Koumantzelis was Senior Vice President and Chief Financial Officer of Cumberland Farms, Inc., a private company headquartered in Canton, Massachusetts, engaged in the convenience store business and the distribution and retail sale of gasoline. Mr. Koumantzelis was a trustee of HRPT Properties from 1992 to 1995, and he has been a trustee of Hospitality Properties and Senior Housing since they became publicly owned in 1995 and 1999, respectively, through the present.

**COMMITTEES OF THE BOARD OF DIRECTORS**

Our Board of Directors has three committees.

**Audit Committee**

The audit committee evaluates the performance of, and makes recommendations to the Board of Directors as to the selection of, our independent auditors; and it reviews our published financial statements and the adequacy of our internal accounting controls. The members of the audit committee are Messrs. Gans, Harrington and Koumantzelis, each of whom are independent directors as defined by the American Stock Exchange. The audit committee operates under a written charter. Mr. Koumantzelis is the current Chairman of our audit committee.

**Compensation Committee**

Our entire Board of Directors serves as our compensation committee to review the performance and establish the compensation of our executive officers. The compensation committee also serves as the administrator of our stock option and stock incentive plan described below.



**Quality of Care Committee**

Our quality of care committee consists of Dr. Gans and Mr. Martin. The quality of care committee periodically meets with our officers and other employees to evaluate the quality of services provided to residents at our facilities. Dr. Gans is the current Chairman of our quality of care committee.

**COMPENSATION OF DIRECTORS**

We pay each director other than Messrs. Martin and Portnoy an annual fee of $15,000, plus a fee of $500 for each Board meeting attended. In addition, commencing in 2002, each director will automatically receive an annual grant of 1,000 of our common shares at the first meeting of the Board of Directors following each annual meeting of shareholders. Board members are not separately compensated for serving on Board committees; however, we pay the Board member serving as Chairman of our audit committee an additional annual fee of $5,000, and the Board member serving as Chairman of our quality of care committee an additional annual fee of $10,000. We reimburse directors for reasonable out-of-pocket expenses incurred in attending meetings of the Board of Directors or Board committees on which they serve. Messrs. Portnoy and Martin do not receive any cash compensation as directors or as members of Board committees, but they do receive the annual share grants and they are reimbursed for their expenses.

**COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION**

Our entire Board of Directors serves as our compensation committee. None of our Board members are employees of ours or an employee of any of our subsidiaries.

Our Managing Directors, Messrs. Portnoy and Martin, are owners, directors and employees of Reit Management. Messrs. Benton and Mackey, our President and Treasurer, respectively, are also officers and part-time employees of Reit Management.

Messrs. Portnoy and Martin, our two Managing Directors, are Managing Trustees of Senior Housing, our landlord. All of our directors also serve as trustees of Senior Housing, except for Dr. Gans, who resigned as a trustee of Senior Housing upon completion of our spin-off. Messrs. Portnoy, Martin, Harrington and Koumantzelis are also trustees of Hospitality Properties; Messrs. Portnoy and Martin are also Managing Trustees of HRPT Properties; and Messrs. Harrington and Koumantzelis and Dr. Gans formerly served as trustees of HRPT Properties. Reit Management is the investment manager for Senior Housing, Hospitality Properties and HRPT Properties, and is a party to a shared services agreement with us. Messrs. Portnoy and Martin also own the building where we rent space for our headquarters.

For more information about possible relationships which might impact compensation decisions see below at "Certain relationships".



**EXECUTIVE COMPENSATION**

Our five highest paid executive officers and the amount of their annual cash compensation are as follows:

| | Position | Annual Cash Compensation |
|---|---|---|

| | Position | | Annual Cash Compensation |
|---|---|---|---|
| Evrett W. Benton | President, Chief Executive Officer and Secretary | $ | 420,000 |
| Rosemary Esposito, RN | Senior Vice President, Chief Operating Officer | $ | 255,000 |
| Gretchen A. Holtz, RN | Vice President, Chief Clinical Officer | $ | 157,500 |
| Maryann Hughes | Vice President, Director of Human Resources | $ | 157,500 |
| Bruce J. Mackey Jr. | Treasurer, Chief Financial Officer and Assistant Secretary | $ | 120,000 |

We have no employment agreements with any of our executive officers.

Messrs. Benton and Mackey each devote a substantial majority of their business time to providing services to us as officers and employees; however, Messrs. Benton and Mackey also devote some of their business time to providing services to Reit Management unrelated to us. Therefore, in addition to receiving compensation paid by us, Reit Management pays each of Messrs. Benton and Mackey compensation for their services to Reit Management. Neither of Messrs. Benton nor Mackey have employment agreements with us or Reit Management.

Except with respect to incentive share awards under Senior Housing's 1999 Incentive Share Award Plan, neither we nor Senior Housing paid during 2000 and 2001, compensation to our executive officers. Their compensation for services to us and Senior Housing was paid by FSQ, Inc. and Reit Management. In each of 2000 and 2001, Mr. Benton, our President and Chief Executive Officer, received a grant of 2,000 restricted shares of Senior Housing, having a value of $17,250 and $26,040, respectively, based upon the share closing prices for Senior Housing's common shares on the New York Stock Exchange on the grant dates. At December 31, 2001, the 4,000 incentive shares granted to Mr. Benton had a value of $55,640, based upon a $13.91 per share closing price for Senior Housing's common shares on the New York Stock Exchange on that date. Each share award provided that one-third of the award vested immediately upon grant and one-third vests on the first and second anniversaries of the grant. Under Senior Housing's plan, if Mr. Benton ceases to be an officer or employee of Reit Management during the vesting period, the Senior Housing common shares which have not yet vested may be repurchased by Senior Housing for nominal consideration. Vested and unvested common shares under Senior Housing's plan are entitled to distributions paid by Senior Housing.

**OUR STOCK OPTION AND STOCK INCENTIVE PLAN**

We have adopted the Five Star Quality Care, Inc. 2001 Stock Option and Stock Incentive Plan, or the Plan. Under the Plan, we are authorized to grant our employees, officers, directors and other individuals rendering services to us and our subsidiaries equity based awards, including incentive stock options, nonqualified stock options, common shares, restricted common shares and stock appreciation rights. The Plan is administered by our Board compensation committee. The Plan provides that the compensation committee has the authority to select the participants and determine the terms of the stock options and other awards granted under the Plan.

An incentive stock option is not transferable by the recipient except by will or by the laws of descent and distribution. Nonqualified stock options and other awards are transferable only to the extent



provided in the agreement relating to such option or award. In the event that termination of employment is due to death or disability, the stock option is exercisable for a maximum of 12 months after such termination. The aggregate number of shares which may be issued under the Plan is 650,000. No awards have been made to date under the Plan and none are expected to be made before the first meeting of the Board of Directors following the annual meeting of our shareholders in 2002.

If you want more information about this plan you should review the copy of the Plan which has been filed as an exhibit to the registration statement of which this prospectus is a part.

**OUR SHARED SERVICES AGREEMENT WITH REIT MANAGEMENT**

In order that we may have the benefit of certain shared services from Reit Management, including certain services that Reit Management historically provided to FSQ, Inc., we entered a shared services agreement with Reit Management. The following is a summary of the material provisions of the shared services agreement between us and Reit Management. If you want more information, you should read the entire shared services agreement, which has been filed as an exhibit to the registration statement of which this prospectus is a part.

**General**

Under this agreement, Reit Management provides, or assists us with, certain services relating to human resources, management information systems, tax, accounting, property maintenance and repairs, investor relations, acquisitions, dispositions, capital markets advice, office support, cash management, SEC compliance and supervision of our relationship with Marriott.

**Compensation to Reit Management**

For Reit Management's services rendered to us pursuant to the shared services agreement, we pay Reit Management a fee equal to 0.6% of our total revenues. The fee is paid monthly in advance based upon the prior month's revenues. We also reimburse Reit Management for its reasonable out-of-pocket expenses.

**Subordination of Reit Management fees to Senior Housing rent**

No fee is paid to Reit Management if any rent we owe Senior Housing is past due or if the fee payment would leave us with insufficient cash, credit facilities or current accounts receivable to make our next scheduled rent payment under our leases with Senior Housing. Unpaid fees accrue, together with interest at the prime rate, and are payable when the condition preventing their payment is no longer in effect or upon termination of, or the occurrence of certain events of default by us under, the shared services agreement. The fees due Reit Management are not subordinated to any of our other obligations.

**Conflicts of interest with Senior Housing**

We have acknowledged that Reit Management may continue to serve as the investment manager for Senior Housing and we have agreed that, regarding issues and in circumstances where there is a conflict of interest between us and Senior Housing, Reit Management will serve as the investment manager for Senior Housing and will not be required to consider our interests.

**Non-competition with Reit Management**

We have agreed to afford any public real estate entity Reit Management manages during the term of the shared services agreement the opportunity to acquire or finance any real estate investments of the types in which such entity invests before we do.



**Terminations**

The initial term of the agreement expires on December 31, 2002, and it renews automatically from year to year unless either we or Reit Management terminate due to default, or provide written notice of termination at least 90 days prior to the termination date.

**Indemnification, default and damages**

We have agreed to indemnify Reit Management, its owners, directors, officers and employees for any damages, liabilities, losses or out-of-pocket expenses incurred by them in the course of performing services other than any such damage, liability or loss resulting from Reit Management's gross negligence or bad faith. In the event of a termination because of our default we must pay the fees due Reit Management for the remainder of the current term. In the event of Reit Management's default, our remedy is limited to termination of the agreement and we cannot collect damages, except when Reit Management has taken action willfully and in bad faith.



# Principal shareholders

The following table sets forth certain information regarding beneficial ownership of our common shares as of February 28, 2002 and as adjusted for this offering (assuming the underwriters do not exercise their over allotment option) of:

>

> each named executive officer;

> each of our directors;

> all directors and executive officers as a group; and

> each person or group known to us to be the beneficial owner of more than 5% of our common shares based on information available to us on February 28, 2002.

Unless otherwise noted, the address of each beneficial owner listed on the table is c/o Five Star Quality Care, Inc., 400 Centre Street, Newton, Massachusetts 02458, and each beneficial owner has sole voting and investing power over the shares shown as beneficially owned except to the extent authority is shared by spouses under applicable law and except as set forth in the footnotes to the table.

| | | Percentage of Shares Outstanding | |
|---|---|---|---|
| **Name** | **Number of Shares** | **Before Offering** | **After Offering** |
| Barry M. Portnoy(1) | 172,371.9 | 3.7% | 2.3% |
| Gerard M. Martin(1) | 172,371.9 | 3.7% | 2.3% |
| Bruce M. Gans, MD | 190 | * | * |
| John L. Harrington | 150 | * | * |
| Arthur G. Koumantzelis | 225.6 | * | * |
| Evrett W. Benton | 405 | * | * |
| All directors and executive officers as a group | 310,732.6 | 6.7% | 4.1% |

* *Less than 1%*

(1) *Mr. Martin is the sole stockholder of a corporation which owns 12,371.9 common shares. Mr. Portnoy is the sole stockholder of a separate corporation which owns 12,371.9 common shares. Messrs. Martin and Portnoy are each 50% owners and directors of Reit Management, the investment manager to Senior Housing. Senior Housing, of which Messrs. Martin and Portnoy are*

*Managing Trustees, owns 35,000 common shares. Under some interpretations of applicable law, Messrs. Martin and Portnoy may be deemed to have beneficial ownership of our shares owned by Senior Housing; however, Messrs. Martin and Portnoy disclaim beneficial ownership of the common shares owned by Senior Housing. The numbers in this table include these 35,000 shares.*



# Certain relationships

Our creation was, and our continuing business operations are, subject to possible conflicts of interest. These conflicts may have caused, and in the future may cause, our business to be adversely affected. These conflicts and their possible adverse effects upon us include the following:

> All of the persons serving as our directors were trustees of Senior Housing at the time we were created, and four of our directors remain trustees of Senior Housing. We lease 87 facilities from Senior Housing. We believe that our lease terms with Senior Housing are commercially reasonable. Nonetheless, it is possible that, if these leases had been negotiated on an arm's length basis, the rent and other lease terms might be more favorable to us. We also believe that our historical and continuing relationships with Senior Housing will provide us with a competitive advantage in locating business expansion opportunities. Nonetheless, we must afford Senior Housing, HRPT Properties and Hospitality Properties the opportunity to acquire or finance any real estate investments of the type in

which Senior Housing, HRPT Properties and Hospitality Properties, respectively, invest before we do. Also, future business dealings between Senior Housing and us could be on less favorable terms than would be possible if there were no historical or continuing management relationships between Senior Housing and us.

>

As part of the spin off transaction, HRPT Properties purchased 7,163.7 of our shares for $7.26 per share. HRPT Properties purchased these shares so that it would make a distribution of our shares which it received as a shareholder of Senior Housing on a round lot basis of one of our shares for every 100 shares of HRPT Properties owned. The price paid to us by HRPT Properties was the average of the high and low trading prices of our shares on the day of the spin off, and we believe it represented fair value at that time. Nonetheless, were it not for the relationships among us, Senior Housing and HRPT Properties, it is possible that we may have been able to realize a higher price for this sale.

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Messrs. Portnoy and Martin are our two Managing Directors, and they are the Managing Trustees of Senior Housing. Messrs. Portnoy and Martin formed FSQ, Inc. to manage properties for Senior Housing. Messrs. Portnoy and Martin each received 125,000 of our shares as consideration in the FSQ, Inc. merger. The Board of Trustees of Senior Housing received an opinion dated December 5, 2001 from UBS Warburg LLC, an internationally recognized investment banking firm and one of the underwriters of this offering, to the effect that, as of the date of the opinion and based on and subject to various assumptions, matters considered and limitations described in the opinion, the consideration provided for in the merger was fair, from a financial point of view, to us. The terms of this merger were approved by Senior Housing's trustees other than Messrs. Portnoy and Martin. Nonetheless, it is possible that, if this merger had been negotiated on an arm's length basis, different terms more favorable to us might have been achieved.

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Our Chief Executive Officer and our Chief Financial Officer are currently also officers and employees of Reit Management. These officers devote a substantial majority of their business time to our affairs and the remainder of their business time to Reit Management's business which is separate from us. The current compensation which we pay to these officers reflects their division of business time. Periodically hereafter these individuals may devote a larger percentage of their time to our or Reit Management's affairs and the compensation they receive from us may become disproportionate to their efforts on our behalf. Also, because of this dual employment arrangement we may have to compete with Reit Management for the time and attention of these officers.

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Messrs. Portnoy and Martin own Reit Management. Reit Management is the investment manager for Senior Housing, HRPT Properties and Hospitality Properties, and has other business interests. We have entered a shared services agreement with Reit Management under which Reit Management



provides certain administrative services to us similar to the services it provided to FSQ, Inc. before our acquisition of FSQ, Inc. as well as other services which we may require. Under this shared services agreement, we pay Reit Management a fee equal to 0.6% of our total revenues. On a pro forma basis, after giving effect to the spin-off, the new lease for 31 Marriott facilities and the pending acquisition of five facilities, this fee would be $3.1 million for the year ended December 31, 2001. We believe we do, and in the future will, receive fair value for the fee paid to Reit Management. The shared services agreement is terminable upon at least 90 days notice prior to the expiration date of the then current term. However, despite our beliefs and this termination provision, equivalent services might be available from parties other than Reit Management on more favorable terms to us, including for a lesser fee. Also, the fact that Reit Management has responsibilities to other entities, including our landlord, Senior Housing, could create conflicts; and, in the event of such conflicts between Senior Housing and us, the shared services agreement allows Reit Management to prefer its responsibilities to Senior Housing. See "Management  Our Shared Services Agreement with Reit Management".

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Messrs. Portnoy and Martin own the building in which our headquarters is located. As a result of our acquisition of FSQ, Inc. we became obligated for a lease in this building. This lease expires in 2011 and requires rent of $531,069 per year, subject to annual increases of $16,093 per year. We believe that the terms of this lease are commercially reasonable. However, this lease was negotiated at a time when Messrs. Portnoy and Martin simultaneously owned the building and FSQ, Inc., and, accordingly, it was not done on an arm's length basis. If the lease were negotiated on an arm's length basis it is possible that the lease might have been more favorable to FSQ, Inc., and to us after the merger, including for a lesser rent.

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During 2001 FSQ, Inc. provided management services to Five Star. FSQ, Inc., which was owned by Messrs. Portnoy and Martin, received fees under the management agreements of $11.5 million. As a result of our acquisition of FSQ, Inc., we have terminated these management agreements.

>

Until March 31, 1997, Mr. Portnoy was a partner in the law firm Sullivan & Worcester LLP, our counsel and counsel to Senior Housing, HRPT Properties, Hospitality Properties, FSQ, Inc., Reit Management and certain of their affiliates. Mr. Portnoy receives payments from Sullivan & Worcester LLP in respect of his retirement.

# Federal income tax considerations for non-U.S. persons

The following summary of federal income tax considerations for non-U.S. persons is based on existing law, and is limited to investors who own our common shares as investment assets rather than as inventory or as property used in a trade or business.

The summary does not discuss the particular tax consequences that might be relevant to you if you are subject to special rules under the federal income tax law, for example if you are:

> a bank, life insurance company, regulated investment company, or other financial institution,

> a broker or dealer in securities or foreign currency,

> a person who has a functional currency other than the U.S. dollar,

> a person who acquires our common shares in connection with employment or other performance of services,

> a person subject to alternative minimum tax,

> a controlled foreign corporation, a passive foreign investment company, or a foreign personal holding company,

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> a person who owns our common shares as part of a straddle, hedging transaction, constructive sale transaction, or conversion transaction, or

> except as specifically described in the following summary, a tax-exempt entity or an expatriate.

This summary is based on applicable Internal Revenue Code, or IRC, provisions, related rules and regulations and administrative and judicial interpretations, all of which are subject to change, possibly with retroactive effect. Future legislative, judicial, or administrative actions or decisions could affect the accuracy of statements made in this summary. We have not sought a ruling from the IRS with respect to this offering, and we can not assure you that the IRS or a court will agree with the statements made in this summary. In addition, the following summary is not exhaustive of all possible tax consequences, and does not discuss any state, local or foreign tax consequences. For all these reasons, we urge you to consult with a tax advisor about the federal, state, local and non-U.S. income tax and other tax consequences of your acquisition, ownership and disposition of our common shares.

For purposes of this summary, a non-U.S. person for federal income tax purposes is a person other than:

> a citizen or resident of the United States, including an alien individual who is a lawful permanent resident of the United States or meets the substantial presence residency test under the federal income tax laws,

> a corporation, partnership or other entity treated as a corporation or partnership for federal income tax purposes, that is created or organized in or under the laws of the United States, any state thereof or the District of Columbia, unless otherwise provided by Treasury regulations,

> an estate the income of which is subject to federal income taxation regardless of its source, or

> a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust, or electing trusts in existence on August 20, 1996 to the extent provided in Treasury regulations,

whose status as a non-U.S. person is not overridden by an applicable tax treaty.

**DISTRIBUTIONS AND DISPOSITIONS**

**Distributions on our common shares**

At the present time, we do not expect to pay any dividends on our common shares. However, if we do later decide to do so, your tax consequences would generally be as follows.

Dividends paid to you will be subject to withholding of federal income tax at a 30% rate or a lower rate as may be specified by an applicable income tax treaty. If you are eligible for a reduced rate of withholding tax pursuant to a tax treaty, you may obtain a refund of any excess amounts previously withheld by filing an appropriate claim for refund with the IRS. To claim the benefits of an income tax treaty, you are required to satisfy the applicable certification requirements, generally by executing an applicable IRS Form W-8 or substantially similar form.

If the dividends paid to you are effectively connected with the conduct of a trade or business within the United States or, if a treaty so provides, attributable to a permanent establishment of a non-U.S. person within the United States, you will be exempt from withholding tax, provided you provide us or our paying agent with an applicable IRS Form W-8 or a substantially similar form containing your taxpayer identification number. Effectively connected dividend income will be subject to U.S. federal income tax on a net basis at applicable graduated rates. If you are a corporation with effectively



connected dividend income you may be subject to an additional branch profits tax at a rate of 30% or a lower rate specified by an applicable income tax treaty.

**Dispositions of our common shares**

You will generally not be subject to United States federal income tax in respect of gain you recognize on your disposition of our common shares unless:

- the gain is effectively connected with a trade or business carried on within the United States (in which case the branch profits tax discussed above may also apply if you are a corporation) or the gain is attributable to a permanent establishment maintained in the United States if that is required by an applicable income tax treaty as a condition to subjecting you to United States income tax on a net basis;
- you are an individual and are present in the United States for 183 days or more in the taxable year of disposition and certain other tests are met;
- you are subject to tax pursuant to the provisions of the Code regarding the taxation of U.S. expatriates; or
- we are or have been a "United States real property holding corporation" for U.S. federal income tax purposes at any time within the shorter of the five-year period preceding such disposition or your holding period (in which case the branch profits tax discussed above may also apply if you are a corporation). However, your gain on a disposition of our common shares will not be subject to tax under this rule, if that class of common shares is "regularly traded" as defined by applicable Treasury regulations on an established securities market like the American Stock Exchange, and if you have at all times during the preceding five years owned 5% or less by value of that class of common shares. At this time, we believe that upon completion of our pending acquisition, we will likely become a "United States real property holding corporation" for federal income tax purposes, but can provide no assurance in this regard.

**INFORMATION REPORTING AND BACKUP WITHHOLDING**

Information reporting and backup withholding may apply to distributions or proceeds paid to our shareholders in the circumstances discussed below. Amounts withheld under backup withholding are generally not an additional tax and may be refunded or credited against your federal income tax liability, provided that you furnish the required information to the IRS. The current backup withholding rate is 30% for the calendar years 2002 and 2003, and is scheduled to gradually decrease to 28% by calendar year 2006.

Distributions on our common shares paid to you during each calendar year, and the amount of tax withheld if any, will generally be reported to you and to the IRS. This information reporting requirement applies regardless of whether you were subject to withholding, or whether the withholding was reduced or eliminated by an applicable tax treaty. Also, distributions and other payments to you on our common shares may be subject to backup withholding, unless you have properly certified your non-U.S. person status on an IRS Form W-8 or substantially similar form. Similarly, information reporting and backup withholding will not apply to proceeds you receive upon the sale, exchange, redemption, retirement or other disposition of our common shares if you have properly certified your non-U.S. person status on an IRS Form W-8 or substantially similar form. Even without having executed an IRS Form W-8 or substantially similar form, however, in some cases information reporting and backup withholding will not apply to proceeds that you receive upon the sale, exchange, redemption, retirement or other disposition of our common shares if you receive those proceeds through a broker's foreign office.



# Shares eligible for future sale

Upon completion of this offering, we will have 7,624,334 outstanding shares, assuming the issuance of 3,000,000 shares in this offering. Our shares being sold in this offering and substantially all of our currently outstanding shares will be freely transferable, except for shares held by persons that are "affiliates" as defined in the Securities Act of 1933. The Securities Act of 1933 generally defines affiliates as individuals or entities that control, are controlled by, or are under common control with us and may include our officers, directors and principal shareholders. Shares held by affiliates may only be sold pursuant to an effective registration statement under the Securities Act of 1933 or Rule 144 of the Securities Act of 1933. We cannot predict whether substantial amounts of our shares will be sold in the open market following this offering. Under our charter and applicable provisions of Maryland law our Board of Directors may authorize the issuance of an unlimited number of our shares without a vote of shareholders. Sales of substantial amounts of our shares in the public market, or the perception that substantial sales may occur, could adversely affect the market price of our shares.



# Description of capital stock

The following description of our capital stock and certain provisions of our charter and bylaws are summaries and are qualified by reference to our charter and our bylaws. Copies of these documents have been filed as exhibits to the registration statement of which this prospectus is a part.

**Common shares**

Upon completion of the offering, we will have only one class of common shares, $.01 par value per share, of which ten million shares will be authorized and 7,624,334 shares will have been issued. Our charter provides that our Board of Directors, without any action by the shareholders, may amend the charter to increase or decrease the number of our authorized common shares. All of our shares issued in the offering will be duly authorized, fully paid and non-assessable.

The holders of common shares are entitled to one vote for each share held of record on our books for the election of directors and on all matters submitted to a vote of shareholders. The holders of common shares are entitled to receive ratably dividends, if any, when, as and if authorized by our Board of Directors out of assets legally available therefor, subject to any preferential dividend rights of any outstanding preferred shares. Upon our dissolution, liquidation or winding up, the holders of common shares are entitled to receive ratably our net assets available after the payment of all debts and other liabilities, subject to the preferential rights of any outstanding preferred shares. Holders of common shares have no preemptive, subscription, redemption or conversion rights. The rights, preferences and privileges of holders of common shares are subject to, and may be adversely affected by, the rights of the holders of shares of any series of preferred shares that we may designate and issue in the future. Our charter authorizes our Board of Directors to reclassify any unissued common shares into other classes or series of stock and to establish the number of shares in each class or series and to set the preferences, conversion and other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications or terms or conditions of redemption for each such class or series. Our charter and our bylaws contain certain provisions that could have the effect of delaying, deferring or preventing a change in our control. See " Material provisions of Maryland law, our charter and bylaws" below for a description of these provisions.

**Preferred shares**

We have one million preferred shares authorized. Our Board of Directors is authorized, without further vote or action by the shareholders, to issue from time to time preferred shares in one or more series and to classify or reclassify any unissued preferred shares and to reclassify any previously classified but unissued preferred shares of any series. Prior to issuance of shares of each series, our Board of Directors is required by Maryland law and our charter to set, subject to the provisions of our charter regarding the restrictions on transfer of shares, the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each such series. Our charter provides that our Board of Directors, without any action by the shareholders, may amend the charter to increase or decrease the number of our authorized preferred shares. The issuance of preferred shares could adversely affect the voting power of holders of common shares and the likelihood that such holders will receive dividend payments or payments upon liquidation and could have the effect of delaying, deferring or preventing a change in control. We believe that the ability of our Board of Directors to issue one or more series of preferred shares provides us with flexibility in structuring possible future financings and acquisitions, and in meeting other corporate needs that may arise.

**Transfer agent and registrar**

Our transfer agent and registrar for our common shares is EquiServe Trust Company, N.A.



# Material provisions of Maryland law, our charter and bylaws

We are organized as a Maryland corporation. The following is a summary of our charter and bylaws and several provisions of Maryland law. Because it is a summary, it does not contain all the information that may be important to you. If you want more information, you should read our entire charter and bylaws, copies of which we have filed as exhibits to the registration statement of which this prospectus is a part, or refer to the provisions of applicable Maryland corporate law summarized below.

**RESTRICTIONS ON SHARE OWNERSHIP AND TRANSFER**

Our charter restricts the amount of shares that shareholders may own. These restrictions are intended to assist Senior Housing with REIT compliance under the IRC, and otherwise to promote our orderly governance. All certificates representing our shares will bear a legend referring to these restrictions.

Our charter provides that no person or group of persons acting in concert may own, or be deemed to own by virtue of the attribution provisions of the IRC, more than 9.8% of the number or value of any class or series of our outstanding shares of capital stock. Any person who acquires, or attempts or intends to acquire, actual or constructive ownership of shares of our capital stock that will or may violate this 9.8% ownership limitation must give notice to us and provide us with other information that we may request.

The ownership limitations in our charter are effective against all of our shareholders. However, with the written consent of Senior Housing, our Board of Directors may grant an exemption from the ownership limitation if it is satisfied that: (i) the shareholder's ownership will not cause us or any of our subsidiaries that are tenants of Senior Housing to be deemed a "related party tenant" under the IRC rules applicable to REITs; (ii) the shareholder's ownership will not cause a default under any lease we have outstanding; and (iii) the shareholder's ownership is otherwise in our interest as determined by our Board of Directors in the exercise of its business judgment.

If a person attempts a transfer of our shares in violation of the ownership limitations described above, then that number of shares which would cause the violation will be automatically transferred to a trust for the exclusive benefit of one or more charitable beneficiaries designated by us. The prohibited owner will not acquire any rights in the shares held in trust, will not benefit economically from ownership of the shares held in trust, will have no rights to distributions and will not possess any rights to vote the shares held in trust. This automatic transfer will be deemed to be effective as of the close of business on the business day prior to the date of the violative transfer.

Within 20 days after receiving notice from us that shares have been transferred to the trust, the trustee will sell the shares held in the trust to a person selected by the trustee whose ownership of the shares will not violate the ownership limitations. Upon this sale, the interest of the charitable beneficiary in the shares sold will terminate and the trustee will distribute the net proceeds of the sale to the prohibited owner and to the charitable beneficiary as follows:

> The prohibited owner will receive the lesser of:

(1) the net price paid by the prohibited owner for the shares or, if the prohibited owner did not give value for the shares in connection with the event causing the shares to be held in the trust (e.g., a gift, devise or other similar transaction), the market price of the shares on the day of the event causing the shares to be transferred to the trust; and

(2) the net price received by the trustee from the sale of the shares held in the trust.

> Any net sale proceeds in excess of the amount payable to the prohibited owner shall be paid to the charitable beneficiary.

If, prior to our discovery that shares of our capital stock have been transferred to the trust, a prohibited owner sells those shares, then:

> those shares will be deemed to have been sold on behalf of the trust; and

> to the extent that the prohibited owner received an amount for those shares that exceeds the amount that the prohibited owner was entitled to receive from a sale by the trustee, the prohibited owner must pay the excess to the trustee upon demand.

Also, shares of capital stock held in the trust will be offered for sale to us, or our designee, at a price per share equal to the lesser of:

> the price per share in the transaction that resulted in the transfer to the trust or, in the case of a devise or gift, the market price at the time of the devise or gift; and

> the market price on the date we or our designee accepts the offer.

We will have the right to accept the offer until the trustee has sold the shares held in the trust. The net proceeds of the sale to us will be distributed similar to any other sale by the trustee.

Every owner of 5% or more of any class or series of our shares may be required to give written notice to us within 30 days after the end of each taxable year stating the name and address of the owner, the number of shares of each class and series of our shares which the owner beneficially owns, and a description of the manner in which those shares are held. In addition, each shareholder is required to provide us upon demand with any additional information that we may request in order to assist us and Senior Housing in its determination of its status as a REIT and to determine and ensure compliance with the foregoing share ownership limitations.

The restrictions described above will not preclude the settlement of any transaction entered into through the facilities of the American Stock Exchange or any other national securities exchange or automated inter-dealer quotation system. Our charter provides, however, that the fact that the settlement of any transaction occurs will not negate the effect of any of the foregoing limitations and any transferee in this kind of transaction will be subject to all of the provisions and limitations described above.

These ownership limitations could have the effect of delaying, deferring or preventing a takeover or other transaction in which holders of some, or a majority, of our common shares might receive a premium for their shares over the then prevailing market price or which such holders might believe to be otherwise in their best interest.

**POSSIBLE LIABILITY OF SHAREHOLDERS FOR BREACH OF RESTRICTIONS ON OWNERSHIP**

Our facility leases and our shared services agreement are terminable by Senior Housing and Reit Management, respectively, in the event that any shareholder or group of shareholders acting in concert becomes the owner of more than 9.8% of our voting stock without Senior Housing's consent. If a breach of the ownership limitations results in a lease default, the shareholders causing the default may become liable to us or to our other shareholders for damages. These damages may be in addition to the loss of beneficial ownership and voting rights, the transfer to a trust and the forced sale of excess shares described above. These damages may be for material amounts.



**DIRECTORS**

Our charter and bylaws provide that our Board of Directors establishes the number of directors. However, there may not be less than the minimum number required by Maryland law nor more than seven directors. In the event of a vacancy, a majority of the remaining directors will fill the vacancy and the director elected to fill the vacancy will serve for the remainder of the full term of the directorship in which the vacancy occurred.

Our charter divides our Board of Directors into three classes. The initial term of the first class will expire in 2002; the initial term of the second class will expire in 2003; and the initial term of the third class will expire in 2004. Beginning in 2002, shareholders will elect directors of each class for three-year terms upon the expiration of their current terms. Shareholders will elect only one class of directors each year. There is no cumulative voting in the election of directors. Consequently, at each annual meeting of shareholders, a majority of the votes entitled to be cast will be able to elect all of the successors of the class of directors whose term expires at that meeting.

We believe that classification of our Board will help to assure the continuity of our business strategies and policies. However, our classified Board will also have the effect of making the replacement of our incumbent directors more time consuming and difficult. At least two annual meetings of shareholders are generally required to effect a change in a majority of our Board of Directors.

Our charter provides that a director may be removed only for cause by the affirmative vote of at least 75% of the shares entitled to vote in the election of directors. This provision precludes shareholders from removing incumbent directors unless they can obtain a substantial affirmative vote of shares.

**ADVANCE NOTICE OF DIRECTOR NOMINATIONS AND OTHER BUSINESS**

Our bylaws provide that nominations of persons for election to our Board of Directors and other business may only be considered at our shareholders meetings if the nominations or other business are included in the notice of the meeting, made or proposed by our Board of Directors or made or proposed by a shareholder who:

> is a shareholder of record at the time of giving notice of the nomination or the business to be considered;

> is a shareholder of record entitled to vote at the meeting at which the nomination or business is to be considered;

> is a shareholder of record at the time of the meeting and physically present in person or by proxy at the meeting to answer questions about the nomination or business; and

> has complied in all respects with the advance notice provisions for shareholder nominations and other business set forth in our bylaws.

Under our bylaws, a shareholder's notice of nominations for director or business to be transacted at an annual meeting of shareholders must be delivered to our secretary at our principal office not later than the close of business on the 90th day and not earlier than the close of business on the 120th day prior to the first anniversary of the date of mailing of our notice for the preceding year's annual meeting. In the event that the date of mailing of our notice of the annual meeting is advanced or delayed by more than 30 days from the anniversary date of the mailing of our notice for the preceding year's annual meeting, a shareholder's notice must be delivered to us not earlier than the close of business on the 120th day prior to the mailing of notice of such annual meeting and not later than the close of business on the later of: (1) the 90th day prior to the date of mailing of the notice for an annual

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meeting, or (2) the 10th day following the day on which we first make a public announcement of the date of mailing of our notice for such meeting. The public announcement of a postponement of the mailing of the notice for an annual meeting or of an adjournment or postponement of an annual meeting to a later date or time will not commence a new time period for the giving of a shareholder's notice. If the number of directors to be elected to our Board of Directors at a shareholders meeting is increased and we make no public announcement of such action or do not specify the size of the increased Board of Directors at least 100 days prior to the first anniversary of the date of mailing of notice for our preceding year's annual meeting, a shareholder's notice also will be considered timely, but only with respect to nominees for any new positions created by such increase, if the notice is delivered to our secretary at our principal office not later than the close of business on the 10th day following the day on which such public announcement is made. This provision does not apply to new directors who are elected by the Board of Directors to fill a vacancy, including a vacancy created by Board action which increases the number of directors.

For special meetings of shareholders, our bylaws require a shareholder who is nominating a person for election to our Board of Directors at a special meeting at which directors are to be elected to give notice of such nomination to our secretary at our principal office not earlier than the close of business on the 120th day prior to such special meeting and not later than the close of business on the later of: (1) the 90th day prior to such special meeting or (2) the 10th day following the day on which public announcement is first made of the date of the special meeting and of the nominees proposed by the directors to be elected at such meeting. The public announcement of a postponement or adjournment of a special meeting to a later date or time will not commence a new time period for the giving of a shareholder's notice as described above.

Any notice from a shareholder of nominations for director or business to be transacted at a shareholders meeting must be in writing and include the following:

> as to each person nominated for election or reelection as a director, (1) the person's name, age, business and residence addresses, (2) the principal occupation or employment of the person for the past five years, (3) the class and number of shares beneficially owned or owned of record by the person and (4) all other information relating to the person that is required to be disclosed in solicitations of proxies for election of directors or otherwise required by Regulation 14A under the Securities Exchange Act of 1934, as amended, together with the nominee's written consent to being named in the proxy statement as a nominee and to serving as a director if elected;

> as to other business that the shareholder proposes to bring before the meeting, a brief description of the business, the reasons for considering the business and any interest in the business of the shareholder giving the notice and of the beneficial owner, if any, on whose behalf the proposal is made; and

> as to the shareholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or proposal is made, the name and address of the shareholder and beneficial owner and the class and number of each class of our shares of capital stock which (s) he or they own beneficially and of record.

We may request that any shareholder proposing a nominee for election to our Board of Directors provide, within three business days of such request, written verification of the accuracy of the information submitted by the shareholder.

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**MEETINGS OF SHAREHOLDERS**

The Board of Directors determines the place and time of the annual meeting of shareholders. Special meetings of shareholders may only be called by the majority of the Board of Directors, the chairman of the Board of Directors, if any, the President, or, if permitted under Maryland law, upon the written request of shareholders entitled to cast not less than a majority of all the votes entitled to be cast at that meeting (or such greater proportion we are permitted to specify under Maryland law).

**LIABILITY AND INDEMNIFICATION OF DIRECTORS AND OFFICERS**

Maryland corporate law permits a Maryland corporation to include in its charter a provision limiting the liability of its directors and officers to the corporation and its shareholders for money damages except for liability resulting from (i) actual receipt of an improper benefit or profit in money, property or services or (ii) acts committed in bad faith or active and deliberate dishonesty established by a final judgment as being material to the cause of action. Our charter contains such a provision which eliminates such liability to the maximum extent permitted by Maryland law. In accordance with Maryland corporate law, our charter authorizes us, to the maximum extent permitted by Maryland law, to obligate ourselves to indemnify and to pay or reimburse reasonable expenses in advance of final disposition of a proceeding to (i) any present or former director or officer or (ii) any individual who, while a director and at our request, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise, from and against any claim or liability to which he or she may become subject or which he or she may incur by reason of his or her status as a present or former director or officer of ours. Our bylaws obligate us, to the maximum extent permitted by Maryland law, to indemnify and to pay or reimburse reasonable expenses in advance of final disposition of a proceeding to (a) any present or former director or officer who is made party to the proceeding by reason of his service in that capacity or (b) any individual who, while a director, at our request, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or any other enterprise as a director, officer, partner or trustee of such corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise and who is made a party to the proceeding by reason of his service in that capacity. Our charter and bylaws also permit us to indemnify and advance expenses to any person who served a predecessor of ours in any of the capacities described above and to any employee or agent of ours or a predecessor of ours.

The Maryland corporation statutes require a corporation (unless its charter provides otherwise, which our charter does not) to indemnify a director or officer who has been successful, on the merits or otherwise, in the defense of any proceeding to which he or she is made a party by reason of his or her service in that capacity. The Maryland corporation statutes permit a corporation to indemnify its directors and officers, among others, against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceedings to which they may be made a party by reason of their service in those or other capacities unless it is established that:

- the act or omission of the director or officer was material to the matter giving rise to the proceedings and (a) was committed in bad faith or (b) was the result of active and deliberate dishonesty;
- the director or officer actually received an improper personal benefit in money, property or services; or
- in the case of any criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful.



However, under the corporation statutes of Maryland, a Maryland corporation may not indemnify for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that personal benefit was improperly received, unless in either case a court orders indemnification and then only for expenses. In accordance with Maryland corporate law, our bylaws require us, as a condition to advancing expenses, to obtain:

- a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification by us as authorized by our bylaws; and
- a written statement by him or her or on his or her behalf to repay the amount paid or reimbursed by us if it shall ultimately be determined that the standard of conduct was not met.

**CHARTER AMENDMENTS AND EXTRAORDINARY TRANSACTIONS**

Under Maryland corporate law, a Maryland corporation generally cannot dissolve, amend its charter, merge, sell all or substantially all of its assets, engage in a share exchange or engage in similar transactions outside the ordinary course of business unless the transaction or amendment is declared advisable by the board of directors and then approved by the affirmative vote of stockholders holding at least two-thirds of the shares entitled to vote on the matter unless a lesser percentage (but not less than a majority of all of the votes entitled to be cast on the matter) is set forth in the corporation's charter. Our charter provides for approval of such matters when they are first declared advisable by our Board of Directors and then approved by the affirmative vote of stockholders holding a majority of the shares entitled to vote on the matter (or such lesser proportion, as is permitted by Maryland law).

**BYLAW AMENDMENTS**

As permitted under Maryland corporate law, our bylaws provide that our Board of Directors has the exclusive power to amend the bylaws.

**BUSINESS COMBINATIONS**

The Maryland corporation statutes contain a provision which regulates business combinations with interested shareholders. Under Maryland corporate law, business combinations such as mergers, consolidations, share exchanges and the like between a Maryland corporation and an interested shareholder or an affiliate of the interested shareholder are prohibited for five years after the most recent date on which the shareholder becomes an interested shareholder. Under the statute, the following persons are deemed to be interested shareholders:

- any person who beneficially owns 10% or more of the voting power of the corporation's shares of capital stock; or
- an affiliate or associate of the corporation who, at any time within the two-year period prior to the date in question, was the beneficial owner of 10% or more of the voting power of the then outstanding voting shares of the corporation.

A person is not an interested shareholder under the statute if the board of directors approved in advance the transaction by which the person otherwise would have become an interested shareholder. The board of directors may provide that its approval is subject to compliance with any terms and conditions determined by the board of directors.



After the five-year prohibition period has ended, a business combination between a corporation and an interested shareholder or an affiliate of the interested shareholder must be recommended by the board of directors of the corporation and must receive the following shareholder approvals:

- the affirmative vote of at least 80% of the votes entitled to be cast; and

- the affirmative vote of at least two-thirds of the votes entitled to be cast by holders of shares other than shares held by the interested shareholder with whom or with whose affiliate the business combination is to be effected or by an affiliate or associate of the interested shareholder.

This shareholder approval is not required if the corporation's shareholders receive the minimum price set forth in the Maryland corporation statute for their shares of capital stock and the consideration is received in cash or in the same form as previously paid by the interested shareholder for its shares of capital stock.

The foregoing provisions of Maryland corporate law do not apply, however, to business combinations that are approved or exempted by the board of directors of the corporation prior to the time that the interested shareholder becomes an interested shareholder. Our Board of Directors has adopted a resolution that any business combination between us and any other person is exempted from the provisions of the Maryland corporation statutes described in the preceding paragraph, provided that the business combination is first approved by our Board of Directors, including the approval of a majority of the members of our Board of Directors who are not affiliates or associates of such person. This resolution, however, may be altered or repealed in whole or in part at any time.

**CONTROL SHARE ACQUISITIONS**

Maryland law provides that control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent that the acquisition is approved by a vote of two-thirds of the votes entitled to be cast on the matter, excluding shares of capital stock owned by the acquiror, by employees who are also directors of the corporation or by officers of the corporation. Control shares are voting shares of capital stock which, if aggregated with all other shares of capital stock previously acquired by the acquiror, or in respect of which the acquiror is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of voting power:

- one-tenth or more but less than one-third;

- one-third or more but less than a majority; or

- a majority or more of all voting power.

An acquiror must obtain the necessary shareholder approval each time he acquires control shares in an amount sufficient to cross one of the thresholds noted above.

Control shares do not include shares which the acquiring person is entitled to vote as a result of having previously obtained shareholder approval. A control share acquisition means the acquisition of control shares. There is a statutory list of exceptions from the definition of control share acquisition.

A person who has made or proposes to make a control share acquisition, upon satisfaction of the conditions set forth in the statute, including an undertaking to pay expenses, may compel the board of directors of the corporation to call a special meeting of shareholders to be held within 50 days after demand to consider the voting rights of the shares. If no request for a meeting is made, the corporation may itself present the matter at a shareholders meeting.



If voting rights are not approved at the meeting or if the acquiring person does not deliver an acquiring person statement as required by the statute, then the corporation may redeem any or all of the control shares for fair value determined as of the date of the last control share acquisition by the acquiror or of any meeting of shareholders at which the voting rights of those shares are considered and not approved. The right of the corporation to redeem any or all of the control shares is subject to conditions and limitations listed in the statute. The corporation may not redeem shares for which voting rights have previously been approved. Fair value is determined without regard to the absence of voting rights for the control shares. If voting rights for control shares are approved at a shareholders meeting and the acquiror becomes entitled to vote a majority of the shares entitled to vote, all other shareholders may exercise appraisal rights. The fair value of the shares as determined for purposes of these appraisal rights may not be less than the highest price per share paid by the acquiror in the control share acquisition.

The control share acquisition statute does not apply to the following:

- shares acquired in a merger, consolidation or share exchange if the corporation is a party to the transaction; or
- acquisitions approved or exempted by a provision in the charter or bylaws of the corporation adopted before the acquisition of shares.

Our bylaws contain a provision exempting any and all acquisitions by any person of our shares of capital stock from the control share acquisition statute. However, this provision may be amended or eliminated at any time in the future.

**ANTI-TAKEOVER EFFECT OF MARYLAND LAW AND OF OUR CHARTER AND BYLAWS**

The following provisions in our charter and bylaws and in Maryland law could delay or prevent a change in our control:

- the limitation on ownership and acquisition of more than 9.8% of our shares of capital stock;
- the ability of our Board of Directors, without a shareholders' vote, to authorize and issue additional shares, including additional classes of shares with rights defined at the time of issuance;
- the classification of our Board of Directors into classes and the election of each class for three-year staggered terms;
- the requirement of cause and a 75% vote of shareholders for removal of our directors;
- the provision that the number of our directors may be fixed only by vote of our Board of Directors and that a vacancy on our Board of Directors may be filled by a majority of our remaining directors;
- the advance notice requirements for shareholder nominations for directors and other proposals; and
- the business combination provisions of Maryland law, if the applicable resolution of our Board of Directors is rescinded or if our Board of Directors' approval of a combination is not obtained.