

FIVE STAR QUALITY CARE INC

Form 10-K

March 16, 2015

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 K

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

For the fiscal year ended December 31, 2014

or

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

Commission File Number 001 16817

FIVE STAR QUALITY CARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland

04 3516029

(State or Other Jurisdiction of Incorporation or (IRS Employer Identification No.)  
Organization)

400 Centre Street, Newton, Massachusetts 02458

(Address of Principal Executive Offices) (Zip Code)

(Registrant's Telephone Number, Including Area Code): 617 796 8387

Securities registered pursuant to Section 12(b) of the Act:

Title Of Each Class	Name Of Each Exchange On Which Registered
Common Stock	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

Indicate by check mark if the registrant is a well known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer   Accelerated filer   Non-accelerated filer   Smaller reporting company  
(Do not check if a smaller reporting company)

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

The aggregate market value of the voting shares of common stock, \$.01 par value, or common shares, of the registrant held by non-affiliates was \$215.6 million based on the \$5.01 closing price per common share on the New York Stock Exchange on June 30, 2014. For purposes of this calculation, an aggregate of 1,345,361.1 common shares held directly by, or by affiliates of, the directors and the officers of the registrant, plus 4,235,000 common shares held by Senior Housing Properties Trust, have been included in the number of common shares held by affiliates.

Number of the registrant's common shares outstanding as of March 13, 2015: 48,997,315.

References in this Annual Report on Form 10-K to "we," "us" or "our" mean Five Star Quality Care, Inc. and its consolidated subsidiaries unless the context indicates otherwise.

Table of Contents

DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Items 10, 11, 12, 13 and 14 of Part III of this Annual Report on Form 10-K is incorporated by reference to our definitive Proxy Statement for the 2015 Annual Meeting of Stockholders, or our definitive Proxy Statement, to be filed with the Securities and Exchange Commission, or the SEC, within 120 days after the close of the fiscal year ended December 31, 2014.

WARNING CONCERNING FORWARD LOOKING STATEMENTS

THIS ANNUAL REPORT ON FORM 10 K CONTAINS STATEMENTS THAT CONSTITUTE FORWARD LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND OTHER SECURITIES LAWS. ALSO, WHENEVER WE USE WORDS SUCH AS “BELIEVE”, “EXPECT”, “ANTICIPATE”, “INTEND”, “PLAN”, “ESTIMATE” OR SIMILAR EXPRESSIONS, WE ARE MAKING FORWARD LOOKING STATEMENTS. THESE FORWARD LOOKING STATEMENTS ARE BASED UPON OUR PRESENT INTENT, BELIEFS OR EXPECTATIONS, BUT FORWARD LOOKING STATEMENTS ARE NOT GUARANTEED TO OCCUR AND MAY NOT OCCUR. FORWARD LOOKING STATEMENTS IN THIS REPORT RELATE TO VARIOUS ASPECTS OF OUR BUSINESS, INCLUDING:

- OUR ABILITY TO OPERATE OUR SENIOR LIVING COMMUNITIES PROFITABLY,
- OUR ABILITY TO COMPLY AND TO REMAIN IN COMPLIANCE WITH APPLICABLE MEDICARE, MEDICAID AND OTHER FEDERAL AND STATE REGULATORY, RULE MAKING AND RATE SETTING REQUIREMENTS,
- OUR ABILITY TO MEET OUR RENT AND DEBT OBLIGATIONS,
- OUR ABILITY TO RAISE EQUITY OR DEBT CAPITAL,
- OUR ABILITY TO COMPETE FOR ACQUISITIONS EFFECTIVELY, TO MANAGE ADDITIONAL SENIOR LIVING COMMUNITIES AND TO SELL PROPERTIES WE OFFER FOR SALE,
- THE FUTURE AVAILABILITY OF BORROWINGS UNDER OUR CREDIT FACILITIES,
- OUR EXPECTATION THAT WE WILL BENEFIT FINANCIALLY BY PARTICIPATING IN AFFILIATES INSURANCE COMPANY, OR AIC, WITH REIT MANAGEMENT & RESEARCH LLC, OR RMR, AND COMPANIES TO WHICH RMR PROVIDES MANAGEMENT SERVICES,
- THE IMPACT OF THE PATIENT PROTECTION AND AFFORDABLE CARE ACT, AS AMENDED BY THE HEALTHCARE AND EDUCATION RECONCILIATION ACT, OR COLLECTIVELY, THE ACA, AND OTHER EXISTING OR PROPOSED LEGISLATION OR REGULATIONS ON US, AND
- OTHER MATTERS.

OUR ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE CONTAINED IN OR IMPLIED BY OUR FORWARD LOOKING STATEMENTS AS A RESULT OF VARIOUS FACTORS. FACTORS THAT COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR FORWARD LOOKING STATEMENTS AND UPON OUR BUSINESS, RESULTS OF OPERATIONS, FINANCIAL CONDITION, CASH FLOWS, LIQUIDITY AND PROSPECTS INCLUDE, BUT ARE NOT LIMITED TO:



Table of Contents

- CHANGES IN MEDICARE AND MEDICAID POLICIES, INCLUDING THOSE THAT MAY RESULT FROM THE IMPACT OF THE ACA AND OTHER RECENTLY ENACTED, ADOPTED OR PROPOSED LEGISLATION OR REGULATIONS, WHICH COULD RESULT IN REDUCED RATES OF PAYMENT TO US,
- THE IMPACT OF CHANGES IN THE ECONOMY AND THE CAPITAL MARKETS ON US AND OUR RESIDENTS AND OTHER CUSTOMERS,
- COMPETITION WITHIN THE SENIOR LIVING SERVICES BUSINESS,
- INCREASES IN INSURANCE AND TORT LIABILITY COSTS,
  - INCREASES IN OUR LABOR COSTS OR IN COSTS WE PAY FOR GOODS AND SERVICES,
- ACTUAL AND POTENTIAL CONFLICTS OF INTEREST WITH OUR MANAGING DIRECTORS, SENIOR HOUSING PROPERTIES TRUST OR ITS SUBSIDIARIES, OR SNH, RMR, AIC AND THEIR RELATED PERSONS AND ENTITIES,
- DELAYS OR NONPAYMENTS OF GOVERNMENT PAYMENTS TO US THAT COULD RESULT FROM GOVERNMENT SHUTDOWNS, PAYMENT DEFAULTS OR PAYMENT DELAYS,
- COMPLIANCE WITH, AND CHANGES TO FEDERAL, STATE AND LOCAL LAWS AND REGULATIONS THAT COULD AFFECT OUR SERVICES OR IMPOSE REQUIREMENTS, COSTS AND ADMINISTRATIVE BURDENS THAT MAY REDUCE OUR ABILITY TO PROFITABLY OPERATE OUR BUSINESS, AND
- ACTS OF TERRORISM, OUTBREAKS OF SO CALLED PANDEMICS OR OTHER MANMADE OR NATURAL DISASTERS BEYOND OUR CONTROL.

FOR EXAMPLE:

- THE VARIOUS GOVERNMENTS WHICH PAY US FOR THE SERVICES WE PROVIDE TO OUR RESIDENTS ARE CURRENTLY EXPERIENCING BUDGETARY CONSTRAINTS AND MAY LOWER THE MEDICARE, MEDICAID AND OTHER RATES THEY PAY US. BECAUSE WE OFTEN CANNOT ETHICALLY LOWER THE QUALITY OF THE SERVICES WE PROVIDE TO MATCH THE AVAILABLE MEDICARE, MEDICAID AND OTHER RATES WE ARE PAID, WE MAY EXPERIENCE LOSSES AND SUCH LOSSES MAY BE MATERIAL,
- WE MAY ENTER INTO ADDITIONAL OR CHANGED MANAGEMENT ARRANGEMENTS OR POOLING AGREEMENTS WITH SNH SIMILAR TO THOSE CURRENTLY IN EFFECT FOR US TO MANAGE ADDITIONAL SENIOR LIVING COMMUNITIES SNH MAY ACQUIRE IN THE FUTURE. HOWEVER, THERE CAN BE NO ASSURANCE THAT SNH WILL ACQUIRE ADDITIONAL COMMUNITIES OR THAT WE AND SNH WILL ENTER INTO ANY ADDITIONAL MANAGEMENT ARRANGEMENTS OR POOLING AGREEMENTS,
- OUR ABILITY TO OPERATE AND MANAGE NEW SENIOR LIVING COMMUNITIES PROFITABLY DEPENDS UPON MANY FACTORS, INCLUDING OUR ABILITY TO INTEGRATE NEW COMMUNITIES INTO OUR EXISTING OPERATIONS AND SOME FACTORS WHICH ARE BEYOND OUR CONTROL SUCH AS THE DEMAND FOR OUR SERVICES ARISING FROM ECONOMIC CONDITIONS GENERALLY AND COMPETITION FROM OTHER PROVIDERS OF SENIOR LIVING SERVICES. WE MAY NOT BE ABLE TO SUCCESSFULLY INTEGRATE NEW COMMUNITIES OR OPERATE AND MANAGE NEW COMMUNITIES PROFITABLY,

ii

Table of Contents

- OUR BELIEF THAT THE AGING OF THE U.S. POPULATION WILL INCREASE DEMAND FOR SENIOR LIVING COMMUNITIES MAY NOT BE REALIZED OR MAY NOT RESULT IN INCREASED DEMAND FOR OUR SERVICES,
- AT DECEMBER 31, 2014, WE HAD \$21.0 MILLION OF CASH AND CASH EQUIVALENTS, \$35.0 MILLION OF BORROWINGS OUTSTANDING UNDER OUR CREDIT FACILITIES AND \$139.4 MILLION OF REMAINING AVAILABILITY UNDER THESE CREDIT FACILITIES, AND WE HAVE IN THE PAST SOLD IMPROVEMENTS TO SNH AND EXPECT TO REQUEST TO SELL ADDITIONAL IMPROVEMENTS TO SNH FOR INCREASED RENT PURSUANT TO OUR LEASES WITH SNH. THESE FACTS MAY IMPLY THAT WE HAVE ABUNDANT CASH LIQUIDITY. HOWEVER, OUR OPERATIONS AND BUSINESS REQUIRE SIGNIFICANT AMOUNTS OF WORKING CASH AND REQUIRE US TO MAKE SIGNIFICANT CAPITAL EXPENDITURES TO MAINTAIN OUR COMPETITIVENESS. ACCORDINGLY, WE MAY NOT HAVE SUFFICIENT CASH LIQUIDITY,
- SPECIAL COMMITTEES OF EACH OF OUR BOARD OF DIRECTORS AND SNH'S BOARD OF TRUSTEES COMPOSED SOLELY OF OUR INDEPENDENT DIRECTORS AND SNH'S INDEPENDENT TRUSTEES WHO ARE NOT ALSO DIRECTORS OR TRUSTEES OF THE OTHER PARTY AND WHO WERE REPRESENTED BY SEPARATE COUNSEL REVIEWED AND APPROVED THE TERMS OF THE INITIAL MANAGEMENT AGREEMENTS AND POOLING AGREEMENTS BETWEEN US AND SNH AND THE TERMS OF THE SUBSEQUENT MANAGEMENT AGREEMENTS, POOLING AGREEMENTS AND AMENDMENTS WERE APPROVED BY OUR INDEPENDENT DIRECTORS AND BOARD OF DIRECTORS AND BY THE INDEPENDENT TRUSTEES OF SNH. AN IMPLICATION OF THIS STATEMENT MAY BE THAT THE TERMS OF THE AGREEMENTS ARE AS FAVORABLE TO US AS TERMS WE COULD OBTAIN FROM UNRELATED THIRD PARTIES. HOWEVER, DESPITE THESE PROCEDURAL SAFEGUARDS, WE COULD STILL BE SUBJECTED TO CLAIMS CHALLENGING THESE TRANSACTIONS OR OUR ENTRY INTO THESE AGREEMENTS BECAUSE OF THE MULTIPLE RELATIONSHIPS AMONG US, SNH AND RMR AND THEIR RELATED PERSONS AND ENTITIES, AND DEFENDING EVEN MERITLESS CLAIMS COULD BE EXPENSIVE AND DISTRACTING TO MANAGEMENT,
- DURING THE PAST SEVERAL YEARS, WEAK ECONOMIC CONDITIONS THROUGHOUT THE COUNTRY HAVE NEGATIVELY AFFECTED MANY ENTITIES BOTH IN AND OUTSIDE OF OUR INDUSTRY, AND THESE CONDITIONS HAVE RESULTED IN, AMONG OTHER THINGS, A DECREASE IN OUR COMMUNITIES' OCCUPANCY; HOWEVER, IN RECENT YEARS ECONOMIC INDICATORS REFLECT AN IMPROVING HOUSING MARKET AND MANY OF THE SERVICES WE PROVIDE ARE NEEDS-DRIVEN. THESE FACTORS MAY IMPLY THAT ECONOMIC CONDITIONS WILL IMPROVE, THAT THERE MAY BE PENT UP DEMAND FOR SERVICES THAT WE PROVIDE AND THAT OUR REVENUES AND PROFITABILITY WILL IMPROVE AS A RESULT. HOWEVER, THERE CAN BE NO ASSURANCE THAT ECONOMIC CONDITIONS WILL IMPROVE, THAT THERE EXISTS ANY PENT UP DEMAND FOR SERVICES WE PROVIDE OR THAT, EVEN IF THERE IS SUCH DEMAND, WE WOULD BE SUCCESSFUL IN ATTRACTING SUCH DEMAND, OR THAT OUR REVENUES AND PROFITS WILL IMPROVE,
- RESIDENTS WHO PAY FOR OUR SERVICES WITH THEIR PRIVATE RESOURCES MAY BECOME UNABLE TO AFFORD OUR SERVICES WHICH COULD RESULT IN DECREASED OCCUPANCY AND DECREASED REVENUES AT OUR SENIOR LIVING COMMUNITIES AND INCREASED RELIANCE ON LOWER RATES FROM GOVERNMENTS AND OTHER PAYERS,
- WE MAY BE UNABLE TO REPAY OUR DEBT OBLIGATIONS WHEN THEY BECOME DUE,



Table of Contents

- THE AMOUNT OF AVAILABLE BORROWINGS UNDER OUR CREDIT FACILITIES IS SUBJECT TO OUR HAVING QUALIFIED COLLATERAL, WHICH IS PRIMARILY BASED ON THE VALUE OF THE ACCOUNTS RECEIVABLE SECURING OUR \$25.0 MILLION CREDIT AGREEMENT AND THE VALUE OF THE PROPERTIES SECURING OUR \$150.0 MILLION CREDIT FACILITY. ACCORDINGLY, THE AVAILABILITY OF BORROWINGS UNDER OUR CREDIT FACILITIES AT ANY TIME MAY BE LESS THAN \$25.0 MILLION AND \$150.0 MILLION, RESPECTIVELY. ADDITIONALLY, THE AVAILABILITY OF BORROWINGS UNDER OUR CREDIT FACILITIES IS SUBJECT TO OUR SATISFYING CERTAIN FINANCIAL COVENANTS AND MEETING OTHER CUSTOMARY CONDITIONS,
- ACTUAL COSTS UNDER OUR CREDIT FACILITIES WILL BE HIGHER THAN LIBOR PLUS A PREMIUM BECAUSE OF OTHER FEES AND EXPENSES ASSOCIATED WITH OUR CREDIT FACILITIES,
- WE HAVE VOLUNTARILY DISCLOSED CERTAIN MEDICARE BILLING DEFICIENCIES RELATED TO MEDICAL RECORDS AND OTHER MATTERS AT ONE OF OUR SKILLED NURSING FACILITIES, OR SNFs, TO THE UNITED STATES DEPARTMENT OF HEALTH AND HUMAN SERVICES OFFICE OF THE INSPECTOR GENERAL, OR THE OIG, AND WE HAVE INFORMED THE OIG THAT WE EXPECT OUR INVESTIGATION AND ASSESSMENT OF THESE MATTERS TO BE COMPLETED BY MAY 13, 2015; HOWEVER, THERE CAN BE NO ASSURANCE THAT OUR INVESTIGATION AND ASSESSMENT OF THESE MATTERS WILL BE COMPLETED BY THAT DATE. FURTHER, ALTHOUGH WE HAVE ACCRUED A REVENUE RESERVE OF \$4.3 MILLION FOR MEDICARE REPAYMENTS AND WE HAVE ACCRUED OR EXPENSED \$3.6 MILLION FOR OTHER RELATED COSTS RESULTING FROM THE IDENTIFIED DEFICIENCIES, THERE CAN BE NO ASSURANCE THAT OUR RESERVES WILL BE ADEQUATE TO COVER THE PAYMENT OBLIGATIONS WE ARE ULTIMATELY DETERMINED TO OWE FOR THIS MATTER. ALSO, DURING OUR ONGOING INVESTIGATION AND ASSESSMENT OF THESE MATTERS WE MAY LEARN OF ADDITIONAL COMPLIANCE DEFICIENCIES THAT COULD RESULT IN ADDITIONAL PAYMENT OBLIGATIONS THAT WE OWE,
- WE AND SNH HAVE DECIDED TO OFFER FOR SALE CERTAIN SENIOR LIVING COMMUNITIES THAT WE LEASE FROM SNH, WHICH HAVE NOT YET BEEN SOLD, AND WE HAVE DECIDED TO OFFER FOR SALE ONE COMMUNITY WHICH WE OWN. WE AND SNH MAY BE UNABLE TO SELL ANY OF THOSE COMMUNITIES WE LEASE FROM SNH, AND WE MAY BE UNABLE TO SELL THE ONE COMMUNITY WE OWN, ON ACCEPTABLE TERMS. ACCORDINGLY, WE CAN PROVIDE NO ASSURANCE THAT THESE COMMUNITIES WILL BE SOLD OR WHAT THE TERMS OR TIMING OF ANY SALE WOULD BE,
- CONTINGENCIES IN OUR AND SNH'S APPLICABLE ACQUISITION AND SALE AGREEMENTS MAY NOT BE SATISFIED AND OUR AND SNH'S APPLICABLE PENDING SALES OR ACQUISITIONS AND ANY RELATED MANAGEMENT AGREEMENTS MAY NOT OCCUR, MAY BE DELAYED OR THE TERMS OF SUCH TRANSACTIONS MAY CHANGE, AND
- WE BELIEVE THAT OUR CONTINUING RELATIONSHIPS WITH SNH, RMR AND AIC AND THEIR AFFILIATED AND RELATED PERSONS AND ENTITIES MAY BENEFIT US AND PROVIDE US WITH COMPETITIVE ADVANTAGES IN OPERATING AND GROWING OUR BUSINESS. IN FACT, THE ADVANTAGES WE BELIEVE WE MAY REALIZE FROM THESE RELATIONSHIPS MAY NOT MATERIALIZE.

THESE RESULTS COULD OCCUR DUE TO MANY DIFFERENT CIRCUMSTANCES, SOME OF WHICH ARE BEYOND OUR CONTROL, SUCH AS NATURAL DISASTERS, CHANGED MEDICARE AND MEDICAID RATES, NEW LEGISLATION, REGULATIONS OR RULE MAKING AFFECTING OUR BUSINESS, OR CHANGES IN CAPITAL MARKETS OR THE ECONOMY GENERALLY.



Table of Contents

THE INFORMATION CONTAINED ELSEWHERE IN THIS ANNUAL REPORT ON FORM 10 K OR IN OUR FILINGS WITH THE SEC, INCLUDING UNDER THE CAPTION “RISK FACTORS”, OR INCORPORATED HEREIN OR THEREIN, IDENTIFIES OTHER IMPORTANT FACTORS THAT COULD CAUSE DIFFERENCES FROM OUR FORWARD LOOKING STATEMENTS. OUR FILINGS WITH THE SEC ARE AVAILABLE ON THE SEC’S WEBSITE AT [WWW.SEC.GOV](http://WWW.SEC.GOV).

YOU SHOULD NOT PLACE UNDUE RELIANCE UPON OUR FORWARD LOOKING STATEMENTS.

EXCEPT AS REQUIRED BY LAW, WE DO NOT INTEND TO UPDATE OR CHANGE ANY FORWARD LOOKING STATEMENTS AS A RESULT OF NEW INFORMATION, FUTURE EVENTS OR OTHERWISE.

v

---

Table of Contents

FIVE STAR QUALITY CARE, INC.

2014 ANNUAL REPORT ON FORM 10 K

Table of Contents

	Page
<u>PART I</u>	
<u>Item 1.</u> <u>Business</u>	1
<u>Item 1A.</u> <u>Risk Factors</u>	14
<u>Item 1B.</u> <u>Unresolved Staff Comments</u>	28
<u>Item 2.</u> <u>Properties</u>	28
<u>Item 3.</u> <u>Legal Proceedings</u>	33
<u>Item 4.</u> <u>Mine Safety Disclosures</u>	33
<u>PART II</u>	
<u>Item 5.</u> <u>Market For Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	34
<u>Item 6.</u> <u>Selected Financial Data</u>	34
<u>Item 7.</u> <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	35
<u>Item 7A.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	52
<u>Item 8.</u> <u>Financial Statements and Supplementary Data</u>	53
<u>Item 9.</u> <u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	53
<u>Item 9A.</u> <u>Controls and Procedures</u>	53
<u>Item 9B.</u> <u>Other Information</u>	55
<u>PART III</u>	
<u>Item 10.</u> <u>Directors, Executive Officers and Corporate Governance</u>	56
<u>Item 11.</u> <u>Executive Compensation</u>	56
<u>Item 12.</u> <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	56
<u>Item 13.</u> <u>Certain Relationships and Related Transactions, and Director Independence</u>	56
<u>Item 14.</u> <u>Principal Accountant Fees and Services</u>	56
<u>PART IV</u>	
<u>Item 15.</u> <u>Exhibits and Financial Statement Schedules</u>	57
	<u>Signatures</u>



## Table of Contents

### PART I

#### Item 1. Business

##### GENERAL

We operate senior living communities, including independent living communities, assisted living communities and SNFs. As of December 31, 2014, we operated 258 senior living communities located in 31 states with 30,379 living units, including 227 primarily independent and assisted living communities with 27,557 living units and 31 SNFs with 2,822 living units. As of December 31, 2014, we owned and operated 31 communities (3,061 living units), we leased and operated 181 communities (20,040 living units) and we managed 46 communities (7,278 living units). Our 258 senior living communities included 10,585 independent living apartments, 14,584 assisted living suites and 5,210 skilled nursing units. The foregoing numbers exclude, as of December 31, 2014: (i) one assisted living community with 32 living units that we own which was being offered for sale and is classified as a discontinued operation; and (ii) three SNFs and one assisted living community with a total of 265 living units that are leased by us from SNH that were being offered for sale and are classified as discontinued operations.

As of December 31, 2014, we leased from SNH 181 senior living communities (including three SNFs and one assisted living community we have classified as discontinued operations) pursuant to four long term leases. For more information about our leases with SNH see “Our SNH Leases and Management Agreements” in Item 2 of this Annual Report on Form 10 K.

Our principal executive offices are located at 400 Centre Street, Newton, Massachusetts 02458, and our telephone number is (617) 796 8387.

##### TYPES OF PROPERTIES

Our present business plan contemplates the ownership, leasing and management of independent living communities, assisted living communities and SNFs. Some of our properties combine more than one type of service in a single building or campus.

**Independent Living Communities.** Independent living communities provide high levels of privacy to residents and require residents to be capable of relatively high degrees of independence. An independent living apartment usually bundles several services as part of a regular monthly charge. For example, the base charge may include one or two meals per day in a central dining room, weekly maid service or services of a social director. Additional services are generally available from staff employees on a fee for service basis. In some independent living communities, separate parts of the community are dedicated to assisted living or nursing services. As of December 31, 2014, our continuing operations included 10,585 independent living apartments in 91 communities.

**Assisted Living Communities.** Assisted living communities are typically comprised of one bedroom units 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 community as requested or at regularly scheduled times. As of December 31, 2014, our continuing operations included 14,584 assisted living suites in 203 communities.

**Skilled Nursing Facilities.** SNFs 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 SNF generally includes one or two beds per room with a separate bathroom in each

room and shared dining facilities. SNFs are staffed by licensed nursing professionals 24 hours per day. As of December 31, 2014, our continuing operations included 5,210 skilled nursing units in 72 communities.

1

---

Table of Contents

OUR RECENT HISTORY

Senior Living

We have grown our business through acquisitions, through initiation of long term leases of independent and assisted living communities where residents' private resources account for a large majority of revenues and, beginning in 2011, through entering into long term contracts to manage independent and assisted living communities.

In 2014:

- We acquired a senior living community with 116 living units located in Alabama for approximately \$19.9 million, including the assumption of approximately \$13.9 million of mortgage debt and the assumption of approximately \$0.1 million of net working capital liabilities, but excluding closing costs.
- We began managing two communities with an aggregate of 228 living units located in Wisconsin pursuant to long term contracts with SNH, increasing the total number of our managed communities to 46 as of December 31, 2014.

Discontinued Operations

Under our leases with SNH, we may request that SNH sell certain noneconomic properties we lease from SNH, which, if sold, would reduce our rent payable to SNH, as determined pursuant to the applicable lease. For more information about our leases with SNH, see "Our SNH Leases and Management Agreements" in Item 2 of this Annual Report on Form 10 K.

We and SNH previously agreed that SNH would offer for sale 11 senior living communities we lease from SNH, which we have classified as discontinued operations. In August 2013, we and SNH sold one of these communities, a SNF with 112 living units located in Missouri, for a sale price of \$2.6 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.3 million in accordance with the terms of the applicable lease.

In 2014:

- We and SNH sold an assisted living community with 48 living units located in Texas for a sale price of \$2.4 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.2 million in accordance with the terms of the applicable lease.
- We and SNH sold two SNFs with an aggregate of 139 living units located in Wisconsin for a sale price of \$4.5 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.5 million in accordance with the terms of the applicable lease.
- We and SNH sold an assisted living community with 55 living units located in Virginia for a sale price of \$2.9 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.3 million in accordance with the terms of the applicable lease.
-

We and SNH sold an assisted living community and a SNF with an aggregate of 160 living units located in Arizona for a sale price of \$5.9 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.6 million in accordance with the terms of the applicable lease.

In 2015:

- We and SNH sold an assisted living community with 103 living units located in Pennsylvania for a sale price of \$0.3 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$22,500 in accordance with the terms of the applicable lease.

2

---



## Table of Contents

We can provide no assurance that we and SNH will be able to sell the remaining three senior living communities we lease from SNH that are being offered for sale, or what the terms or timing of any sales may be.

### OUR GROWTH STRATEGY

We believe that the aging of the U.S. population will increase demand for senior living communities. Our principal growth strategy is to profit from this anticipated demand by operating communities that provide high quality services to residents who pay with private resources.

We seek to improve the profitability of our existing operations by increasing our revenues and improving our operating margins. We attempt to increase revenues by increasing rates and occupancies. We attempt to improve margins by limiting increases in expenses and otherwise improving operating efficiencies. For example, during the recent economic recession experienced in the United States, the senior living industry generally experienced declining occupancies as a result of this slowdown in the U.S. economy. During this same period, we improved our operating margins and profitability by increasing rates and limiting increases in our expenses. As the U.S. economy and the housing market gradually improve, we expect that our occupancies may increase and our profitability may grow; however, the condition of the U.S. economy and the housing market are beyond our control and may not improve and could decline. Further, the reductions in government payments for our services, such as the reductions we experienced during 2013 and 2014 as a result of the sequestration rate cuts, negatively impacted our results of operations and may continue to do so. For more information about government payments for our services, see “Government Regulation and Reimbursement.”

We currently intend to continue to grow our business by adding to our operations primarily independent and assisted living communities where residents’ private resources account for a large majority of revenues. We expect some of these increases may be achieved by our entering leases or management agreements and some may be achieved by our purchasing communities. Since we became a public company in 2001, we have acquired or have begun to lease 181 primarily independent and assisted living communities that are included in our continuing operations as of December 31, 2014, which realized approximately 87% of their revenues from residents’ private resources, rather than from Medicare and Medicaid in the year ended December 31, 2014. Historically, we have principally expanded our operations by entering operating leases. Since 2011, we have started to expand our operations by acquiring senior living communities for our own account and entering agreements to manage senior living communities which are owned by SNH. In the future, we expect to continue to grow our business by adding communities that we either own, lease or manage.

### OPERATING STRUCTURE

We have four operating divisions. Three of our divisions are each responsible for multiple geographic regions with respect to our senior living communities that consist of independent, assisted living and skilled nursing units. One of our divisions is responsible for our rehabilitation and wellness inpatient and outpatient clinics which are associated with our senior living communities. Each division is headed by a divisional vice president with extensive experience in the senior living industry. We have several regional offices within our divisions. Each regional office is responsible for multiple communities and is headed by a regional director of operations with extensive experience in the senior living industry. Each regional office is typically supported by a clinical or wellness director, a rehabilitation services director, a regional accounts manager, a human resources specialist and a sales and marketing specialist. Regional staff are responsible for all of our senior living community operations within a geographic region, including:

- resident services;
- Medicare and Medicaid billing;
- marketing and sales;

- hiring of community personnel;
- compliance with applicable legal and regulatory requirements; and

3

---

## Table of Contents

· supporting our development and acquisition plans within their region.

Our corporate office staff, located in Massachusetts, provides services such as:

- the establishment of company wide policies and procedures relating to resident care;
- human resources policies and procedures;
- information technology;
- private pay billing for our independent living apartments and assisted living communities;
- maintenance of licensing and certification;
- legal and compliance;
- central purchasing;
- budgeting and supervision of maintenance and capital expenditures;
  - implementation of our growth strategy; and
- accounting, auditing and finance functions, including operations, budgeting, certain accounts receivable and collections functions, accounts payable, payroll, tax and financial reporting.

As described elsewhere in this Annual Report on Form 10 K, we have a business management and shared services agreement, or the business management agreement, with RMR, pursuant to which RMR provides to us certain business management, administrative and information system services, including internal audit, capital markets, legal and investor relations, among other matters.

## STAFFING

**Independent and Assisted Living Community Staffing.** Each of the independent and assisted living communities we operate has an executive director responsible for the day to day operations of the community, including quality of care, resident services, sales and marketing, financial performance and staff supervision. The executive director is supported by department heads who oversee the care and service of the residents, a wellness director who is responsible for coordinating the services necessary to meet the healthcare needs of our residents and a marketing director who is responsible for selling our services. Other important staff includes the dining services coordinator, the activities coordinator and the property maintenance coordinator.

**Skilled Nursing Facility Staffing.** Each of our SNFs is managed by a state licensed administrator who is supported by other professional personnel, including a director of nursing, an activities director, a marketing director, a social services director, a business office manager, and physical, occupational and speech therapists. Our directors of nursing are state licensed nurses who supervise our registered nurses, licensed practical nurses and nursing assistants. Staff size and composition vary depending on the size and occupancy of each SNF and on the type of care provided by the SNF. Our SNFs also contract with physicians who provide certain medical services.

## EMPLOYEES

As of March 13, 2015, we had approximately 25,000 employees, including approximately 15,500 full time equivalents. We believe our relations with our employees are good.

Table of Contents

GOVERNMENT REGULATION AND REIMBURSEMENT

The healthcare industry is subject to extensive and frequently changing federal, state and local laws and regulations. These laws and regulations vary by jurisdiction but may address, among other things, licensure, personnel training, staffing ratios, quality of medical care, physical facility requirements, government healthcare program participation, fraud and abuse, payments for patient services and patient records.

We are subject to, and our operations must comply with, these laws and regulations. From time to time, our facilities receive notices from federal, state and local agencies regarding noncompliance with such requirements. Upon receipt of these notices, we review them for correctness and, based on our review, we either take corrective action or contest the allegation of noncompliance. When corrective action is required, we work with the relevant agency to address and remediate any violations. Challenging and appealing any notices or allegations of noncompliance require the expenditure of significant legal fees and management attention. Any adverse determination concerning any of our licenses or eligibility for Medicare or Medicaid reimbursement, any penalties, repayments or sanctions, and the increasing costs of required compliance with applicable laws may adversely affect our ability to meet our financial obligations and negatively affect our financial condition and results of operations.

The healthcare industry depends significantly upon federal and state programs for revenues and, as a result, is affected by the budgetary policies of both the federal and state governments. Reimbursements under the Medicare and Medicaid programs for skilled nursing, physical therapy and rehabilitation services provided operating revenues at our outpatient clinics and some of our senior living communities (principally our SNFs). We derived approximately 23%, 23% and 24% of our consolidated revenues from continuing operations from Medicare and Medicaid programs for each of the years ended December 31, 2014, 2013 and 2012, respectively.

In addition to existing government regulation, we are aware of numerous healthcare regulatory initiatives on the federal, state and local levels, which may affect our business operations if implemented.

**Independent Living Communities.** Government benefits are not generally available for services at independent living communities, and residents in those communities use private resources to pay for their living units and the services they receive. The rates in these communities are determined by local market conditions and operating costs. However, a number of federal Supplemental Security Income program benefits pay housing costs for elderly or disabled recipients to live in these types of residential communities. 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 recipients reside or are likely to reside. Categories of living arrangements that may be subject to these state standards include independent living communities and assisted living communities. Because independent living communities usually offer common dining facilities, in many jurisdictions they are required to obtain licenses applicable to food service establishments in addition to complying with land use and life safety requirements. In addition, in many states, state or county health departments, social service agencies or offices on aging have jurisdiction over group residential communities for seniors and license independent living communities. To the extent that independent living communities include units to which assisted living or nursing services are provided, these units are subject to applicable state licensing regulations. If the communities receive Medicaid or Medicare funds, they are subject to certification standards and conditions of participation. In some states, insurance or consumer protection agencies regulate independent living communities in which residents pay entrance fees or prepay for services.

**Assisted Living Communities.** A majority of states provide or are approved to provide Medicaid payments for personal care and medical services to some residents in licensed assisted living communities under waivers granted by or under Medicaid state plans approved by the Centers for Medicare and Medicaid Services, or CMS, of the United States Department of Health and Human Services, or HHS. State Medicaid programs control costs for assisted living

and other home and community based services by various means such as restrictive financial and functional eligibility standards, enrollment limits and waiting lists. Because rates paid to assisted living community operators are generally 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 level of health services provided in SNFs. States that administer Medicaid programs for services in assisted living communities are responsible for monitoring the services at, and physical conditions of, the participating communities.

## Table of Contents

As a result of the large number of states using Medicaid funds to purchase services at assisted living communities and the growth of assisted living in recent years, states have adopted licensing standards applicable to assisted living communities. According to the National Center for Assisted Living, all states regulate assisted living and residential care communities, although states do not use a uniform approach. Most state licensing standards apply to assisted living communities regardless of whether they accept Medicaid funding. Also, a few states require certificates of need from state health planning authorities before new assisted living communities may be developed. Based on our analysis of recent economic and regulatory trends, we believe that assisted living communities that become dependent upon Medicaid or other public payments for a majority of their revenues may decline in value because Medicaid and other public rates may fail to keep up with increasing costs. We also believe that assisted living communities located in states that adopt certificate of need, or CON, requirements or other limitations on the development of new assisted living communities may increase in value because those limitations may help ensure higher non governmental rates.

HHS, the Senate Special Committee on Aging, and the Government Accountability Office, or the GAO, have studied and reported on the development of assisted living and its role in the continuum of long term care and as an alternative to SNFs. Since 2003, CMS has commenced a series of actions to increase its oversight of state quality assurance programs for assisted living facilities and has provided guidance and technical assistance to states to improve their ability to monitor and improve the quality of services paid for through Medicaid waiver programs. CMS is encouraging state Medicaid programs to expand their use of home and community based services as alternatives to institutional services, pursuant to provisions of the Deficit Reduction Act of 2005, or the DRA, the ACA (as defined and described below) and other authorities, through the use of several programs. One such program, the Community First Choice Option, or the CFC Option, grants states that choose to participate in the program a 6% increase in federal matching payments for related medical assistance expenditures. California implemented the CFC Option in fiscal year 2012 followed by Oregon in 2013, and Maryland and Montana in 2014; at least six other states have reported that they are considering implementing it in 2015. We are unable to predict the effect of the implementation of the CFC Option and other similar programs, but their impact may be adverse and material to our operations and our future financial results of operations.

**Skilled Nursing Facilities—Reimbursement.** A majority of all nursing home revenues in the United States comes from publicly funded programs. According to CMS, Medicaid is the largest source of public funding for nursing homes, followed by Medicare. In 2013, approximately 30% of nursing care facility and continuing care retirement community revenues came from Medicaid and 22% from Medicare. SNFs are highly regulated businesses. The federal and state governments regularly monitor the quality of care provided at SNFs. 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 usually resulted in Medicare and Medicaid rate adjustments, albeit on the basis of amortization of expenditures over expected useful lives of the improvements. Under the Medicare prospective payment system, or the PPS, for SNFs, capital costs are part of the prospective rate and are not community specific. The PPS and other recent legislative and regulatory actions with respect to state Medicaid rates limit the reimbursement levels for some nursing home services. At the same time, federal and state enforcement has increased oversight of SNFs, making licensing and certification of these communities more rigorous.

CMS implemented the PPS for SNFs pursuant to the Balanced Budget Act of 1997, or the BBA. Under the PPS, SNFs receive a fixed payment for each day of care provided to residents who are Medicare beneficiaries. The PPS requires SNFs to assign each resident to a care group depending on that resident's medical characteristics and service needs. These care groups are known as Resource Utilization Groups, or RUGs, and CMS establishes a per diem payment rate for each RUG. CMS currently uses the RUG IV case mix classification system and a resident assessment instrument called the Minimum Data Set 3.0, which SNFs must use to collect clinical data to assign residents to RUG IV reimbursement categories. Medicare PPS payments cover substantially all services provided to Medicare residents in SNFs, including ancillary services such as rehabilitation therapies.

CMS updates PPS payment rates each year by a market basket update to account for inflation and periodically implements changes to the RUG categories and payment rates.

6

---

## Table of Contents

In 2011, CMS adopted a final rule designed to recalibrate Medicare PPS rates for SNFs, which resulted in a reduction in aggregate Medicare payment rates for SNFs of approximately 11.1%, or \$3.87 billion, in federal fiscal year 2012.

For federal fiscal year 2013, CMS adopted a final rule updating Medicare PPS rates for SNFs which resulted in an increase in aggregate Medicare payment rates of approximately 1.8%. CMS estimated this update resulted in an overall increase of \$670 million in Medicare payments to SNFs in federal fiscal year 2013 as compared to federal fiscal year 2012. On October 1, 2013, CMS adopted a final rule updating Medicare payments to SNFs for federal fiscal year 2014, which CMS estimated would increase payments to SNFs by an aggregate of 1.3%, or approximately \$470 million, compared to federal fiscal year 2013. On July 31, 2014, CMS released a final rule updating Medicare payments to SNFs for federal fiscal year 2015, which CMS estimates will increase payments to SNFs by an aggregate of 2.0%, or approximately \$750 million, compared to federal fiscal year 2014. Due to the previous reduction of Medicare payment rates of approximately 11.1% for federal fiscal year 2012 discussed above, however, Medicare payment rates will be lower for federal fiscal year 2015 than they were in federal fiscal year 2011.

The Middle Class Tax Relief and Job Creation Act of 2012, enacted in February 2012, incrementally reduces the SNF reimbursement rate for Medicare bad debt from 100% to 65% by federal fiscal year 2015 for beneficiaries dually eligible for Medicare and Medicaid. Because nearly 90% of SNF bad debt is related to dual eligible beneficiaries, this rule has a substantial negative effect on SNFs. The Middle Class Tax Relief and Job Creation Act of 2012 also reduced the SNF Medicare bad debt reimbursement rate for Medicare beneficiaries not eligible for Medicaid from 70% to 65% in federal fiscal year 2013 and going forward.

In addition, the Budget Control Act of 2011 and the Bipartisan Budget Act of 2013 allow for automatic reductions in federal spending by means of a process called sequestration, which reduces Medicare payment rates by up to 2% through 2023. In February 2014, Congress approved an additional one year extension of Medicare sequestration, through 2024. Medicaid is exempt from the automatic reductions, as are certain Medicare benefits. The automatic 2% payment cuts took effect on April 1, 2013, and had an adverse effect on our operations and financial results during 2014. We are unable to predict the future financial impact on us of those automatic payment cuts; however, they may continue to have similar or worse impacts in the future.

The federal government is seeking to slow the growth of Medicare and Medicaid payments for nursing home services by several methods. In 2006, the government implemented limits on Medicare payments for outpatient therapies and then, pursuant to the DRA, created an exception process under which beneficiaries could request an exception from the cap and be granted the amount of services deemed medically necessary by Medicare. On April 1, 2014, the Protecting Access to Medicare Act of 2014, or PAMA, extended the Medicare outpatient therapy cap exception process through March 31, 2015, further postponing the implementation of firm limits on Medicare payments for outpatient therapies. PAMA also extended the 0.5% increase to the Medicare Physician Fee Schedule, or MPFS, rates through December 31, 2014 and provided no increase in the MPFS rates, to which our Medicare outpatient therapy rates are tied, in the period between January 1, 2015 and March 31, 2015. Unless further delayed, the MPFS rates are scheduled to be reduced by 21.2% effective April 1, 2015. Additionally, PAMA established a SNF value based purchasing program. Under this program, HHS will assess SNFs based on hospital readmissions measures and make these assessments available to the public no later than October 1, 2017. Beginning in federal fiscal year 2019, SNFs will face a 2% withholding of SNF payments and will receive incentive payments based on either their performance or improvement in certain hospital readmission measures. The collective amount of incentive payments to all SNFs are anticipated to be between 50% and 70% of the total payment amounts withheld. In addition, the DRA increased the “look back” period for prohibited asset transfers that disqualify individuals from Medicaid nursing home benefits from three to five years. The period of Medicaid ineligibility begins on the date of the prohibited transfer or the date an individual has entered the nursing home and would otherwise be eligible for Medicaid coverage, whichever occurs later, rather than on the date of the prohibited transfer, effectively extending the Medicaid penalty period and placing added burdens on SNFs to collect charges directly from residents and their transferees.



The DRA also established the five year Money Follows the Person demonstration project in 2007 to award competitive grants to 30 states to provide home and community based long term care services to qualified individuals relocated from SNFs, and to increase federal medical assistance for each qualifying beneficiary for a limited time period.

7

---

Table of Contents

The ACA expanded eligibility for this program and extended this program for an additional five years through 2016. According to the Henry J. Kaiser Family Foundation, as of November 2014, 44 states and the District of Columbia had operational Money Follows the Person programs, one state had an inactive program and one state had withdrawn its program. The DRA also established the Post Acute Care Payment Reform demonstration project under which CMS compared and assessed patient care needs, costs and outcomes of services at different post acute care sites over three years. In January 2012 CMS issued a report to Congress regarding the project stating that CMS successfully used a new uniform patient assessment tool to measure patient acuity in acute care hospitals and post acute settings, providing the basis for the potential development of new standardized information reporting requirements and more uniform post acute case mix payment systems. States are also permitted to include home and community based services as optional services under their Medicaid state plans or through Medicaid waiver programs, and states opting to do so may establish more stringent needs based criteria for nursing home services than for home and community based services. The ACA expands the services that states may provide and limits their ability to set caps on enrollment, waiting lists or geographic limitations on home and community based services.

On October 6, 2014, President Obama signed into law the Improving Medicare Post-Acute Care Transformation Act of 2014, or the IMPACT Act, which requires certain post-acute care providers, including SNFs, to begin collecting and reporting various types of data. Specifically, the Secretary of HHS will require SNFs to begin reporting certain quality measures and resource use measures in a standardized and interoperable format by October 1, 2016 and begin reporting certain patient assessment data in such a format by October 1, 2018. Beginning in federal fiscal year 2018, SNFs that fail to comply with the reporting requirements by the established times will be subject to a 2% reduction in their Medicare payment rates for that fiscal year. Beginning October 1, 2018, the Secretary of HHS will make this data publicly available pursuant to certain procedures to be established. The IMPACT Act also requires the Secretary of HHS and the Medicare Payment Advisory Commission to submit reports to Congress recommending a future Medicare PPS for post-acute care providers and analyzing both its effects on the reported metrics and financial effect on post-acute care providers. We are unable to predict the impact on us of these or other recent legislative and regulatory actions or proposed actions with respect to federal Medicare rates, state Medicaid rates, and the federal payments to states for Medicaid programs.

Skilled Nursing Facilities—Survey and Enforcement. Pursuant to the Omnibus Reconciliation Act of 1987, Congress enacted major reforms to federal and state regulatory systems for SNFs that participate in the Medicare and Medicaid programs. Since then, the GAO has reported that, although much progress has been made, substantial problems remain in the effectiveness of federal and state regulatory activities. The HHS Office of Inspector General, or OIG, has issued several reports concerning quality of care in SNFs, and the GAO has issued several reports recommending that CMS and states strengthen their compliance and enforcement practices, including federal oversight of state actions and to ensure that SNFs provide adequate care and states act more consistently.

The Senate Special Committee on Aging and other congressional committees have also held hearings on these issues. As a result, CMS has undertaken several initiatives to increase the effectiveness of Medicare and Medicaid nursing home survey and enforcement activities. CMS has been taking steps to identify and focus enforcement efforts on SNFs and chains of SNF operators with findings of substandard care or repeat violations of Medicare and Medicaid standards. CMS has increased its oversight of state survey agencies and has improved the process by which data is captured from these surveys. As an added measure of improving patient care, the ACA provides for the funding of a state background check system for job applicants to long term care providers who will have direct access to patients. CMS has begun the administration of this program, to which approximately half of the states have already applied.

In addition, CMS adopted regulations expanding federal and state authority to impose civil monetary penalties in instances of noncompliance. When CMS or state agencies identify deficiencies under state licensing and Medicare and Medicaid standards, they may impose sanctions and remedies such as denials of payment for new Medicare and Medicaid admissions, civil monetary penalties, state oversight, temporary management or receivership and loss of

Medicare and Medicaid participation or licensure on nursing home operators. Our communities may incur sanctions and penalties from time to time. If we are unable to cure deficiencies that have been identified or that are identified in the future, or if appeals of proposed sanctions or penalties are not successful, decertification or additional sanctions or penalties may be imposed. These consequences may adversely affect our ability to meet our financial obligations and negatively affect our financial condition and results of operations.

8

---

## Table of Contents

Inpatient Rehabilitation Facility Regulation and Rate Setting. We transferred our operations at our inpatient rehabilitation facilities, or IRFs, and affiliated clinics in the fourth quarter of 2013 to third parties in connection with SNH's sale of those IRFs. Our IRFs were subject to federal, state and local regulation that affected their business activities and determined the rates they received for services. CMS certified these facilities to participate in the Medicare program, and these facilities received a significant portion of their revenues from that program.

CMS establishes standards that facilities must meet in order to be classified as IRFs under the Medicare program. One such standard is known as the "60% Rule." As amended by the Medicare, Medicaid and the SCHIP Extension Act of 2007, the 60% Rule provides that, to be considered an IRF and receive reimbursement under the IRF PPS, at least 60% of a facility's total inpatient population must receive the facility's services for treatment of at least one of 13 designated medical conditions. To comply with the 60% Rule and maintain revenue levels, many IRFs have reduced the number of non-qualifying patients treated and replaced them with qualifying patients, established other sources of revenues or both. We believe that we operated our IRFs in compliance with the 60% Rule during the period in which we operated them; however, we can provide no assurance that CMS will not make a determination that we were non-compliant during this period.

Medicare reimburses IRFs under a PPS implemented in 2002 pursuant to the BBA. Under the IRF PPS, reimbursement is paid at a predetermined per-discharge rate. CMS updates IRF Medicare payment rates each year. Medicare revenues realized at our IRFs in the years ended December 31, 2012 and 2013 were approximately \$71.1 million and \$71.3 million, respectively. IRF Medicare payments may be subject to subsequent upwards or downwards adjustments as part of the cost report settlement process. As previously noted, in the fourth quarter of 2013, we transferred our operations at our IRFs and affiliated clinics to third parties in connection with SNH's sale of those IRFs.

Certificates of Need. As a mechanism to prevent overbuilding and subsequent healthcare price inflation, most states limit the number of SNFs and hospitals by requiring developers to obtain certificates of need before new facilities may be built or additional beds may be added to existing facilities. A few states also limit the number of assisted living facilities by requiring certificates of need. In addition, some states (such as California and Texas) that have eliminated CON laws have retained other means of limiting new development, including moratoria, licensing laws or limitations upon participation in the state Medicaid program. These governmental requirements limit expansion, which we believe may make existing SNFs more valuable by limiting competition.

Healthcare Reform. The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act, or collectively the ACA, signed into law in March 2010, has resulted in changes to insurance, payment systems and healthcare delivery systems. The ACA is intended to expand access to health insurance coverage and reduce the growth of healthcare expenditures while simultaneously maintaining or improving the quality of healthcare. Some of the provisions of the ACA took effect immediately, whereas others will take effect at later dates. Due to the complexity of the ACA, its ramifications may only become apparent through later regulatory and judicial interpretations.

Beginning in federal fiscal year 2012, the ACA reduced the SNF PPS annual adjustment for inflation by a productivity adjustment based on national economic productivity statistics. We are unable to predict the impact of this reduction on Medicare rates for SNFs, but its impact may be adverse and material to our operations and our future financial results of operations.

The ACA establishes an Independent Payment Advisory Board to submit legislative proposals to Congress and take other actions with a goal of reducing Medicare spending growth. When and if such spending reductions take effect they may be adverse and material to our financial results. The ACA also provides for the National Pilot Program on Payment Bundling to develop and evaluate making bundled payments for services provided during an episode of care,

to include hospital and physician services and post acute care such as SNF and IRF services. The pilot program can be expanded in January 2016 if it meets its goals. The ACA also includes the development of Medicare value based purchasing plans to include quality measures as a basis for bonuses and several initiatives to encourage states to develop and expand home and community based services under Medicaid.

## Table of Contents

The ACA includes various other provisions affecting Medicare and Medicaid providers, including expanded public disclosure requirements for SNFs and other providers, enforcement reforms and increased funding for Medicare and Medicaid program integrity control initiatives. The ACA has resulted in several changes to existing healthcare fraud and abuse laws, established additional enforcement tools and funding to the government, and provided for increased cooperation between agencies by establishing mechanisms for sharing information relating to noncompliance. Furthermore, the ACA has resulted in enhanced criminal and administrative penalties for noncompliance. For example, the ACA amended the Anti Kickback Statute to provide that a claim that includes items or services resulting from a violation of the Anti Kickback Statute now constitutes a false or fraudulent claim for purposes of the False Claims Act.

In June 2012, the U.S. Supreme Court upheld two major provisions of the ACA—the individual mandate, which requires most Americans to maintain health insurance or to pay a penalty, and the Medicaid expansion, which requires states to expand their Medicaid programs by 2014 to cover all individuals under the age of 65 with incomes not exceeding 133% of the federal poverty level. In upholding the Medicaid expansion, the Supreme Court held that it violated the U.S. Constitution as drafted but remedied the violation by modifying the expansion to preclude the Secretary of HHS from withholding existing federal Medicaid funds from states that fail to comply with Medicaid expansion, instead allowing the Secretary only to deny new expansion funding. Under the ACA, the federal government will pay for 100% of a state's Medicaid expansion costs for the first three years (2014–2016) and gradually reduce its subsidy to 90% for 2020 and future years. As of January 27, 2015, 15 states had elected not to broaden Medicaid eligibility under the ACA, and seven remained undecided; those states that ultimately choose not to participate in Medicaid expansion will forgo the federal funds that would otherwise be available for that purpose. We are unable to predict the impact of these or other recent legislative and regulatory actions or proposed actions with respect to state Medicaid rates and payments to states for Medicaid programs on us.

In addition, on November 7, 2014, the Supreme Court agreed to hear a lawsuit challenging the legality of an Internal Revenue Service, or IRS, regulation that allows eligible individuals in all states to receive subsidies for health insurance under the ACA, even in states that have not established their own health exchanges. Such subsidies have provided certain eligible taxpayers with the ability to purchase or maintain health insurance. We are unable to predict the outcome of that challenge or its impact on our business.

We cannot estimate the type and magnitude of the potential Medicare and Medicaid policy changes, rate reductions or other changes and the impact on us of the possible failure of these programs to increase rates to match our increasing expenses, but they may be material to and adversely affect our future results of operations. Similarly, we are unable to predict the impact on us of the insurance reforms, payment reforms, and healthcare delivery systems reforms contained in and to be developed pursuant to the ACA. Expanded insurance availability may provide more paying customers for the services we provide. If the changes to be implemented under the ACA result in reduced payments for our services or the failure of Medicare, Medicaid or insurance payment rates to cover our costs, however, our future financial results could be adversely and materially affected.

In addition, other aspects of the ACA that affect employers generally, including the employer shared responsibility provisions that the IRS began enforcing on January 1, 2015, may have an impact on the design and cost of the health coverage that we offer to our employees. Due to the scope and complexity of the provisions of the ACA that apply to employers and employer group health plans, it is difficult to predict the overall impact of the ACA on our employee benefit plans and our cost of doing business over the coming years. We will continue to analyze how to provide our employees with cost effective coverage, taking into account the various requirements of the ACA and the impact of any changes on our ability to attract and retain employees. For information on some recent changes that we have made to the health insurance coverage we offer employees in response to the rising cost of health insurance generally, please see the information contained below under the caption “Insurance” in this Business section of this Annual Report on Form 10-K.

Other Matters. Federal and state efforts to target false claims, fraud and abuse and violations of anti kickback laws, physician referral laws (including the Ethics in Patient Referrals Act of 1989), privacy laws and consumer protection laws by Medicare and Medicaid providers and providers under other public and private programs have increased in recent years, as have civil monetary penalties, treble damages, repayment requirements and criminal sanctions for noncompliance. The federal False Claims Act, as amended and expanded by the Fraud Enforcement and

Table of Contents

Recovery Act of 2009, and the ACA, provides significant civil money penalties and treble damages for false claims and authorizes individuals to bring claims on behalf of the federal government for false claims. The federal Civil Monetary Penalties Law authorizes the Secretary of HHS to impose substantial civil penalties, treble damages, and program exclusions administratively for false claims or violations of the federal Anti Kickback Statute. In addition, the ACA increased penalties under federal sentencing guidelines by between 20% and 50% for healthcare fraud offenses involving more than \$1.0 million. State Attorneys General typically enforce consumer protection laws relating to senior living services, clinics and other healthcare facilities.

Governmental authorities are devoting increasing attention and resources to the prevention, detection, and prosecution of healthcare fraud and abuse. The HHS OIG has guidelines for SNFs intended to assist them in developing voluntary compliance programs to prevent fraud and abuse; these guidelines recommend that CMS identify SNFs that are billing for higher paying RUGs and more closely monitor compliance with patient therapy assessments as methods of fraud prevention. CMS contractors are expanding the retroactive audits of Medicare claims submitted by SNFs and other providers, and recouping alleged overpayments for services determined by auditors not to have been medically necessary or not to meet Medicare coverage criteria as billed. State Medicaid programs and other third party payers are conducting similar medical necessity and compliance audits. The ACA facilitates the Department of Justice's, or the DOJ's, ability to investigate allegations of wrongdoing or fraud at SNFs, in part because of increased cooperation and data sharing among CMS, OIG, DOJ and the states. In addition, the ACA requires all states to terminate the Medicaid participation of any provider that has been terminated under Medicare or any Medicaid state plan. Moreover, state Medicaid fraud control agencies may investigate and prosecute assisted living communities and SNFs, clinics and other healthcare facilities under fraud and patient abuse and neglect laws.

Current state laws and regulations allow enforcement officials to make determinations as to whether the care provided at our healthcare facilities exceeds the level of care for which a particular facility is licensed. A finding that a facility is delivering care beyond the scope of its license could result in the immediate discharge and transfer of residents. Some states and the federal government allow certain citations of one facility to impact other facilities operated by the same entity or a related entity, including facilities in other states. Revocation of a license or certification at one facility could therefore impact our ability to obtain new licenses or certifications or to maintain or renew existing licenses at other facilities. In addition, an adverse finding by state officials could serve as the basis for lawsuits by private plaintiffs and lead to investigations under federal and state laws, which could result in civil and/or criminal penalties against the facility as well as a related entity.

Our communities must comply with laws designed to protect the confidentiality and security of individually identifiable patient information. Under the federal Health Insurance Portability and Accountability Act of 1996, or HIPAA, and the Health Information Technology for Economic and Clinical Health Act, or the HITECH Act, our facilities that are "covered entities" within the meaning of HIPAA must comply with rules adopted by HHS governing the privacy, security, use and disclosure of individually identifiable information, including financial information and protected health information, or PHI, and security rules for electronic PHI. HIPAA and the HITECH Act are intended to ensure patient privacy and the efficiency of healthcare claims and payment transactions. There may be both civil monetary penalties and criminal sanctions for noncompliance with such federal laws. Under the HITECH Act, penalties for violation of certain provisions may be as high as \$50,000 per violation for a maximum civil penalty of \$1.5 million per calendar year. On January 17, 2013, HHS released the HIPAA Omnibus Rule, or the Omnibus Rule, which went into effect on March 26, 2013 and required compliance with most provisions by September 23, 2013. Pursuant to the Omnibus Rule, "covered entities" were required to make certain modifications to any business associate agreements that they have in place with their "business associates" within the meaning of HIPAA, depending on the circumstances. In addition, the Omnibus Rule required "covered entities" to modify and redistribute their notices of privacy practices to include certain provisions relating to the use of PHI. Further, the Omnibus Rule modified the standard for providing breach notices, which was previously based on an analysis of the harm resulting from any disclosure, to a more objective analysis on whether any PHI was actually acquired or viewed as a result of the breach.



In addition to HIPAA, many states have enacted their own security and privacy laws relating to individually identifiable information, including financial information and PHI. In some states, these laws are more burdensome than HIPAA. In instances in which the state provisions are more stringent than or differ from HIPAA, our facilities must comply with applicable federal and state standards.

## Table of Contents

Our communities must comply with the Americans with Disabilities Act, or the ADA, and similar state and local laws to the extent that such facilities are “public accommodations” as defined in those statutes. The obligation to comply with the ADA and other similar laws is an ongoing obligation, and we continue to assess our communities and make appropriate modifications.

Other legislative proposals introduced in Congress, proposed by federal or state agencies or under consideration by some state governments include the option of block grants for states rather than federal matching money for certain state Medicaid services, laws authorizing or directing Medicare to negotiate rate reductions for prescription drugs, additional Medicare and Medicaid enforcement procedures and federal and state cost containment measures, such as freezing Medicare or Medicaid SNF payment rates at their current levels and reducing or eliminating annual Medicare or Medicaid inflation allowances or gradually reducing rates for SNFs.

Some of the states in which we operate either have not raised Medicaid rates by amounts sufficient to offset increased costs or have frozen or reduced, or are likely to freeze or reduce, Medicaid rates. Despite these freezes, Medicaid expenditures are projected to have increased by 12.8% in 2014 and to increase by 6.7% in 2015 and 8.6% in 2016, due in part to the expansion in Medicaid eligibility under the ACA, which began in 2014. From 2016 through 2023, Medicaid spending is expected to grow by an average annual rate of 6.8% per year, mainly driven by increased spending for aged and disabled beneficiaries and higher provider reimbursement rates. Effective June 30, 2011, Congress ended certain temporary increases in federal payments to states for Medicaid programs that had been in effect since 2008. We expect the ending of these temporary federal payments, combined with other state budgetary pressures, to result in continued challenging state fiscal conditions, particularly in those states that are not participating in Medicaid expansion. As a result, some state budget deficits may increase, and certain states may continue to reduce Medicaid payments to healthcare services providers like us as part of an effort to balance their budgets. Despite these freezes and reduced payments to states, according to the 2013 Actuarial Report on the Financial Outlook for Medicaid, Medicaid enrollment is projected to increase at an average annual rate of 3.3% through 2022, due in part to the expansion in Medicaid eligibility under the ACA, beginning in 2014. These state-level cuts have the potential to negatively impact our revenue from Medicaid sources.

## INSURANCE

Litigation against senior living and healthcare companies continues to increase. As a result, liability insurance costs have risen. Also, our insurance costs for workers’ compensation and employee healthcare have increased. To partially offset these insurance cost increases, we have taken a number of actions including the following:

- we have become fully self insured for all health related claims of covered employees;
- we have increased the deductible or retention amounts for which we are liable under our liability insurance;
- we have established an offshore captive insurance company which participates in our liability, workers’ compensation and automobile insurance programs. These programs may allow us to reduce our net insurance costs by allowing us to retain the earnings on our reserves, provided that our claims experience matches that projected by various statutory and actuarial formulas;
- we have increased the amounts that some of our employees are required to pay for health insurance coverage and co payments for health services and pharmaceutical prescriptions and decreased the amount of certain healthcare benefits as well as adding a high deductible health insurance plan as an option for our employees;
- we have hired professional advisors to help us establish programs to reduce our insured workers’ compensation and professional and general liabilities, including a program to monitor and proactively settle liability claims and to reduce workplace injuries;
- we have hired insurance and other professionals to help us establish appropriate reserves for our retained liabilities and captive insurance programs; and



## Table of Contents

· in order to obtain more control over our insurance costs, we, RMR and other companies, including SNH, to which RMR provides management services, organized AIC. We and the other six current shareholders of AIC have property insurance providing \$500.0 million of coverage pursuant to an insurance program arranged by AIC and with respect to which AIC is a reinsurer of certain coverage amounts. In June 2014, we and the other shareholders of AIC renewed our participation in this program and paid AIC a premium, including taxes and fees, of approximately \$3.9 million in connection with that policy, which amount may be adjusted from time to time as we acquire or dispose of properties that are included in the policy. We periodically consider the possibilities for expanding our insurance relationships with AIC to include other types of insurance and may in the future participate in additional insurance offerings AIC may provide or arrange.

We partially self insure up to certain limits for workers' compensation, professional liability and property coverage. Claims in excess of these limits are insured up to contractual limits, over which we are self insured. Our current insurance arrangements are generally renewable annually in June. We do not know if our insurance charges and self insurance reserve requirements will increase, and we cannot now predict the amount of any such increase, or to what extent, if at all, we may be able to offset any increase through use of higher deductibles, retention amounts, self insurance or other means in the future. For more information about certain of our insurance initiatives see Note 15 to the Notes to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10 K.

## COMPETITION

The senior living services business is highly competitive. We compete with numerous other companies that provide senior living services, including home healthcare companies and other real estate based service providers. We have large lease obligations and limited financeable assets. Many of our existing competitors are larger than us and have greater financial resources than we do. We may expand our business with SNH and our relationships with SNH and RMR may provide us with competitive advantages; however, SNH is not obligated to provide us with opportunities to lease or manage additional properties. Some of our competitors are not for profit entities which have endowment income and may not have the same financial pressures that we face. We cannot provide any assurance that we will be able to compete successfully for business. For additional information on competition and the risks associated with our business, please see "Risk Factors" of this Annual Report on Form 10 K.

## ENVIRONMENTAL AND CLIMATE CHANGE MATTERS

Under various laws, owners as well as tenants and operators of real estate may be required to investigate and clean up or remove hazardous substances present at or migrating from properties they own, lease or operate and may be held liable for property damage or personal injuries that result from hazardous substances. These laws also expose us to the possibility that we may become liable to reimburse governments or third parties for damages and costs they incur in connection with hazardous substances. Under our leases with SNH, we have also agreed to indemnify SNH for any such liabilities related to the properties we lease from SNH. We reviewed environmental conditions surveys of certain of our leased and owned communities. Based upon those surveys, we do not believe that there are environmental conditions at any of our properties that have had or will have a material adverse effect on us. However, no assurances can be given that conditions are not present at our properties or that costs we may be required to incur in the future to remediate contamination will not have a material adverse effect on our business or financial condition and results of operations.

The current political debate about global climate change has resulted in various treaties, laws and regulations which are intended to limit carbon emissions. We believe these laws being enacted or proposed may cause energy costs at our communities to increase in the future. In the long term, we believe any such increased costs will be passed through and paid by our residents and other customers in higher charges for our services. However, in the short term, these increased costs, if material in amount, could materially and adversely affect our financial condition and results of

operations. For more information regarding climate change matters and their possible adverse impact on us, please see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Impact of Climate Change.”

Table of Contents

INTERNET WEBSITE

Our internet website address is [www.fivestarseniorliving.com](http://www.fivestarseniorliving.com). Copies of our governance guidelines, or Governance Guidelines, code of business conduct and ethics, or Code of Conduct, our policy outlining procedures for handling concerns or complaints about internal accounting controls or auditing matters and the charters of our audit, quality of care, compensation and nominating and governance committees are posted on our website and may be obtained free of charge by writing to our Secretary, Five Star Quality Care, Inc., 400 Centre Street, Newton, Massachusetts, 02458 or at our website. We make available, free of charge, on our website, our Annual Reports on Form 10 K, our Quarterly Reports on Form 10 Q, our Current Reports on Form 8 K and amendments to these reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, as soon as reasonably practicable after these forms are filed with, or furnished to, the SEC. Any stockholder or other interested party who desires to communicate with our non management Directors, individually or as a group, may do so by filling out a report on our website. Our Board of Directors also provides a process for security holders to send communications to our entire Board of Directors. Information about the process for sending communications to our Board of Directors can be found on our website. Our website address and website addresses of one or more unrelated third parties are included several times in this Annual Report on Form 10 K as textual references only and the information in any such website is not incorporated by reference into this Annual Report on Form 10 K.

Item 1A. Risk Factors

Our business faces many risks. The risks described below may not be the only risks we face but are the risks we know of that we believe may be material at this time. Additional risks that we do not yet know of, or that we currently think are immaterial, may also impair our business operations or financial results. If any of the events or circumstances described in the following risks occurs, our business, financial condition or results of operations could suffer and the trading price of our securities could decline. Investors and prospective investors should consider the following risks and the information contained under the heading “Warning Concerning Forward Looking Statements” before deciding whether to invest in our securities.

RISKS RELATED TO OUR BUSINESS

A small percentage decline in our revenues or increase in our expenses could have a material negative impact upon our operating results.

For the year ended December 31, 2014, our revenues were \$1.33 billion and our operating expenses were \$1.35 billion. A small percentage decline in our revenues or increase in our expenses could have a material negative impact on our operating results because some of our fixed costs, such as our base rent, would not decrease during times of lower revenues and could not be reduced to offset other expenses which may be increasing.

The failure of Medicare and Medicaid rates to match our costs will reduce our income or create losses.

Some of our current operations, especially our SNFs, receive significant revenues from Medicare and Medicaid. During the years ended December 31, 2014 and 2013, we derived approximately 23% of our senior living revenues from continuing operations from these programs. The Obama Administration and some members of Congress have proposed Medicare and Medicaid policy changes and rate reductions to take effect during the next several years. The ACA includes provisions that may result in future payment rates for a fiscal year being less than payment rates for a preceding fiscal year for SNFs. Effective as of October 1, 2011, CMS reduced aggregate Medicare payment rates for SNFs by approximately 11.1% for federal fiscal year 2012. Even with the increases in Medicare payment rates to SNFs for federal fiscal years 2013, 2014 and 2015, Medicare payment rates to SNFs will be lower for federal fiscal year 2015 than they were in federal fiscal year 2011. We are unable to predict how the continued Medicare rate

reductions under the ACA will affect our future financial results of operations.

In addition, our revenues received from Medicare and Medicaid may be subject to statutory and regulatory changes, retroactive rate adjustments, recovery of program overpayments or set offs, administrative rulings and policy interpretations, and payment delays.

14

---

Table of Contents

The Middle Class Tax Relief and Job Creation Act of 2012, which was enacted in February 2012, gradually reduces the SNF reimbursement rate for Medicare bad debt from 100% to 65% by federal fiscal year 2015 for beneficiaries dually eligible for Medicare and Medicaid. Because nearly 90% of SNF bad debt has historically been related to dual-eligible beneficiaries, this rule has a substantial adverse effect on SNFs, including some of those we operate. The same law also reduced the SNF Medicare bad debt reimbursement rate for Medicare beneficiaries not eligible for Medicaid from 70% to 65% in federal fiscal year 2013. In addition, pursuant to the Budget Control Act of 2011 and the Bipartisan Budget Act of 2013, the federal budget includes automatic spending reductions through 2023, including reductions of up to 2% to Medicare providers, but exempting reductions to Medicaid and certain Medicare benefits. In February 2014, Congress approved an additional one year extension of Medicare sequestration, through 2024. We are unable to predict the future financial impact on us of the automatic payments cuts; however, these payment cuts had an adverse and material impact on our operations and financial results during 2013 and may continue to have similar or worse impacts in the future.

Congress extended the process to allow medically necessary exceptions to annual caps on Medicare Part B payments for outpatient rehabilitation services to individual patients through March 31, 2015, but strict caps on reimbursement for these services will go into effect on April 1, 2015 if another extension is not granted. In addition, our Medicare Part B outpatient therapy revenue rates are tied to the MPFS. Although the MPFS had previously been scheduled to be reduced by more than 25% in 2013, MPFS rates remained fixed at the 2012 level throughout 2013 and increased 0.5% for the period between January 1, 2014 and December 31, 2014. On April 1, 2014, PAMA, as defined above, extended the Medicare outpatient therapy cap exception process through March 31, 2015, further postponing the implementation of limits on Medicare payments for outpatient therapies. PAMA also extended the 0.5% increase to MPFS rates through December 31, 2014 and provided no increase in the MPFS rates in the period between January 1, 2015 and March 31, 2015. The MPFS rates are scheduled to be reduced by 21.2% effective April 1, 2015. Unless the reduction is once again delayed, it will likely result in a reduction of our Medicare Part B rates for outpatient therapy services and could be materially adverse to our future financial results of operations.

On October 6, 2014, President Obama signed into law the IMPACT Act, as defined above, which requires certain post-acute care providers, including SNFs, to begin collecting and reporting various types of data. Specifically, the Secretary of HHS will require SNFs to begin reporting certain quality measures and resource use measures in a standardized and interoperable format by October 1, 2016 and begin reporting certain patient assessment data in such a format by October 1, 2018. Beginning in federal fiscal year 2018, SNFs that fail to comply with the reporting requirements by the established times will be subject to a 2% reduction in their Medicare payment rates for that fiscal year. Beginning October 1, 2018, the Secretary of HHS will make this data publicly available pursuant to certain procedures to be established. The IMPACT Act also requires the Secretary of HHS and the Medicare Payment Advisory Commission to submit reports to Congress recommending a future Medicare PPS for post-acute care providers and analyzing both its effects on the reported metrics and financial effect on post-acute care providers.

Some of the states in which we operate either have not raised Medicaid rates by amounts sufficient to offset increasing costs, have frozen or reduced Medicaid rates, or are likely to freeze or reduce Medicaid rates. Many states are experiencing difficult fiscal conditions or budgetary constraints, thus increasing the likelihood of Medicaid rate reductions, freezes or increases that are insufficient to offset increased operating costs. Also, certain temporary increases in federal payments to states for Medicaid programs ended on June 30, 2011. The ending of these temporary federal payments, combined with the anticipated slow recovery of state revenues, has resulted in and is expected to result in continued challenging state fiscal conditions. Some state budget deficits will likely increase, and it is possible that certain states will reduce Medicaid payments to healthcare service providers like us as part of an effort to balance their budgets. The ACA authorized an expansion of Medicaid eligibility beginning in 2014, which has the potential to increase Medicaid enrollment. The U.S. Supreme Court has held, however, that states may choose not to participate in the Medicaid expansion program without risking the loss of federal Medicaid funding. As of December 17, 2014, 16 states had elected not to broaden Medicaid eligibility and, instead, forgo the federal funds that would otherwise be



available for Medicaid expansion, and seven remained undecided. Despite these freezes and reduced payments to states, according to the 2013 Actuarial Report on the Financial Outlook for Medicaid, Medicaid enrollment is projected to increase at an average annual rate of 3.3% through 2022, due in part to the expansion in Medicaid eligibility under the ACA, beginning in 2014.

15

---

Table of Contents

We cannot currently estimate the magnitude of the potential Medicare and Medicaid rate reductions, the impact of the failure of these programs to increase rates to match increasing expenses, the impact of states that choose not to expand Medicaid eligibility and the impact on us of potential Medicare and Medicaid policy changes proposed by members of Congress and the Obama Administration, but they may be material to our operations and may affect our future results of operations. We cannot predict whether future Medicare and Medicaid rates will be sufficient to cover our costs. Future Medicare and Medicaid rate declines or a failure of these rates to cover our costs could result in our experiencing materially lower earnings or losses.

Circumstances that adversely affect the ability of seniors or their families to pay for our services could have a material adverse effect on us.

Our residents paid approximately 77% of our senior living revenues from continuing operations during the year ended December 31, 2014 from their private resources. We expect to continue to rely on the ability of our residents to pay for our services from their own financial resources. Inflation, continued high levels of unemployment, market declines affecting the value and liquidity of personal assets, or other circumstances that adversely affect the ability of the elderly or their families to pay for our services could have a material adverse effect on our business, financial condition and results of operations.

Seniors' inability to sell real estate may delay their moving into senior living facilities.

Housing price declines and reduced home mortgage financing availability have negatively affected the U.S. housing market. Although home prices and sales activity have recently been generally increasing, they continue to be generally below levels experienced prior to the recent economic recession in the United States. Further, although mortgage financing availability has improved since the recession, there are market expectations that interest rates in the United States will increase in the near term; if interest rates rise sharply, the prices for homes or home sales activity may decline. Difficulties in the U.S. housing market may have a negative effect on our revenues or lead to increased reliance on Medicare and Medicaid for our revenues. Specifically, if seniors have a difficult time selling their homes, fewer seniors may relocate to our senior living communities or finance their stays at our facilities with private resources.

Private third party payers continue to try to reduce healthcare costs.

Private third party payers such as insurance companies continue their efforts to control healthcare costs through direct contracts with healthcare providers, increased utilization review practices and greater enrollment in managed care programs and preferred provider organizations. These third party payers increasingly demand discounted fee structures and the assumption by healthcare providers of all or a portion of the financial risk. These efforts of third party payers to limit the amount of payments we receive for healthcare services could adversely affect us. Reimbursement payments under third party payer programs may not remain at levels comparable to present levels or be sufficient to cover the costs allocable to patients participating in such programs. Future changes in, or renegotiations of, the reimbursement rates or methods of third party payers, or the implementation of other measures to reduce payments for our services could result in a substantial reduction in our net operating revenues. At the same time, as a result of competitive pressures, our ability to maintain operating margins through price increases to private pay residents may be limited.

Provisions of the Patient Protection and Affordable Care Act could reduce our income and increase our costs.

The ACA contains insurance changes, payment changes and healthcare delivery systems changes that have affected, and will continue to affect, us. The ACA provides for multiple reductions to the annual market basket updates for inflation that may result in reductions in SNF Medicare payment rates. In addition, certain provisions of the ACA that

affect employers generally, including the employer shared responsibility provisions that went into effect on January 1, 2015, may have an impact on the design and cost of the health coverage that we offer to our employees. We are unable to predict the impact of the ACA on our future financial results of operations, but it may be adverse and material. In addition, maintaining compliance with the ACA will require us to expend management time and financial resources.

The ACA also established an Independent Payment Advisory Board to submit legislative proposals to Congress and take other actions with a goal of reducing Medicare spending growth. When and if such spending reductions take effect, they may be adverse and material to our financial results. The ACA includes other changes that may affect us, such as enforcement reforms and Medicare and Medicaid program integrity control initiatives, new compliance, ethics and public disclosure requirements, initiatives to encourage the development of home and community based long term

Table of Contents

care services rather than institutional services under Medicaid, value based purchasing plans and a Medicare post acute care pilot program to develop and evaluate making a bundled payment for services, including physician and SNF services, provided during an episode of care. In addition, on November 7, 2014, the Supreme Court agreed to hear a lawsuit challenging the legality of an IRS regulation that allows eligible individuals in all states to receive subsidies for health insurance under the ACA, even in states that have not established their own health exchanges. Such subsidies have provided certain eligible taxpayers with the ability to purchase or maintain health insurance. We are unable to predict the impact on us of the insurance, payment, and healthcare delivery systems reforms contained in and to be developed pursuant to the ACA, as well as the pending legal challenge to the health insurance subsidies under the ACA. If the changes to be implemented under the ACA result in reduced payments for our services or the failure of Medicare, Medicaid or insurance payment rates to cover our increasing costs, our future financial results could be adversely and materially affected.

Increases in our labor costs may have a material adverse effect on us.

Wages and employee benefits associated with our continuing operations were approximately 42% of our 2014 total operating costs. We compete with other operators of senior living communities to attract and retain qualified personnel responsible for the day to day operations of our communities. The market for qualified nurses, therapists and other healthcare professionals is highly competitive. Periodic and geographic area shortages of nurses or other trained personnel may require us to increase the wages and benefits offered to our employees in order to attract and retain these personnel or to hire more expensive temporary personnel. Also, we may have to compete with numerous other employers for lesser skilled workers. Further, when we acquire new communities (or enter into leases or management agreements for new communities) we may be required to pay increased compensation or offer other incentives to retain key personnel and other employees. Employee benefits costs, including employee health insurance and workers' compensation insurance costs, have materially increased in recent years and, as discussed above, we cannot predict the future impact of the ACA on the cost of employee health insurance. Although we have determined our self insurance reserves with guidance from third party professionals, our reserves may be inadequate. Increasing employee health and workers' compensation insurance costs and increasing self insurance reserves for labor related insurance may materially and adversely affect our earnings. We cannot assure that our labor costs will not increase or that any increase will be matched by corresponding increases in rates we charge to residents or other revenues. Any significant failure by us to control labor costs or to pass on any such increased labor costs to residents through rate increases could have a material adverse effect on our business, financial condition and results of operations.

Our business is subject to extensive regulation which increases our costs and may result in losses.

Licensing and Medicare and Medicaid laws require operators of senior living communities and rehabilitation and wellness clinics to comply with extensive standards governing operations and physical environments. Federal and state laws also prohibit fraud and abuse by senior living providers and rehabilitation and wellness clinic operators, including civil and criminal laws that prohibit false claims and that regulate patient referrals in Medicare, Medicaid and other programs. In recent years, federal and state governments have devoted increased resources to monitoring the quality of care at senior living communities and to anti fraud investigations in healthcare generally. CMS contractors are expanding the retroactive audits of Medicare claims submitted by SNFs and other providers, and recouping alleged overpayments for services determined by auditors not to have been medically necessary or not to meet Medicare coverage criteria as billed. State Medicaid programs and other third party payers are conducting similar medical necessity and compliance audits. When federal or state agencies identify violations of anti fraud, false claims, anti kickback and physician referral laws, they may impose or seek civil or criminal penalties, treble damages and other governmental sanctions, and may revoke the healthcare facility's license or make conditional or exclude the healthcare facility from Medicare or Medicaid participation. The ACA amended the federal Anti Kickback Statute and

the False Claims Act, making it easier for government agencies and private plaintiffs to prevail in lawsuits brought against healthcare providers, and for severe fines and penalties to be imposed on healthcare providers that violate applicable laws and regulations. In addition, when these agencies determine that there have been quality of care deficiencies or improper billing, they may impose or seek various remedies or sanctions, including denial of new admissions, exclusion from Medicare or Medicaid program participation, monetary penalties, restitution of overpayments, governmental oversight, temporary management, loss of licensure and criminal penalties. Current state laws and regulations allow enforcement officials to make determinations as to whether the care provided at our healthcare facilities exceeds the

Table of Contents

level of care for which a particular facility is licensed. A finding that a facility is delivering care beyond the scope of its license could result in the immediate discharge and transfer of residents. Certain states and the federal government may determine that citations relating to one facility affect other facilities operated by the same entity or related entities, which may negatively impact an operator's ability to maintain or renew other licenses or Medicare or Medicaid certifications or to secure new licenses or certifications.

Our communities incur sanctions and penalties from time to time. As a result of the healthcare industry's extensive regulatory system and increasing enforcement initiatives, we have experienced increased costs for monitoring quality of care compliance, billing procedures, and compliance with referral laws and other laws that apply to us, and we expect these costs may continue to increase. For example, as disclosed elsewhere in this Annual Report on Form 10-K, as a result of our compliance program to review medical records related to our Medicare billing practices, during 2014, we discovered potentially inadequate documentation and other issues at one of our leased SNFs, and as a result of these discoveries, we have made a voluntary disclosure of deficiencies to the OIG pursuant to the OIG's Provider Self-Disclosure Protocol. As of December 31, 2014, we have accrued a revenue reserve of \$4.3 million to account for historical Medicare payments we expect to repay and we have accrued or expensed compliance costs of \$3.6 million including an expected penalty amount and certain costs of the investigation of this matter. As a result of the continuing investigation and assessment of these deficiencies, additional deficiencies may be discovered which could increase our liability to the OIG and other costs.

If we become subject to additional regulatory sanctions or repayment obligations at any of our existing communities (or at any of our newly acquired communities with prior deficiencies that we are unable to correct or resolve), our business may be adversely affected, and we might experience financial losses. Any adverse determination concerning any of our licenses or eligibility for Medicare or Medicaid reimbursement or any penalties, repayments, or sanctions, and the increasing costs of required compliance with applicable federal and state laws, may adversely affect our ability to meet our financial obligations and negatively affect our financial condition and results of operations.

Successful union organization of our employees may adversely affect our business, financial condition and results of operations.

From time to time labor unions attempt to organize our employees. If federal legislation modifies the labor laws to make it easier for employee groups to unionize, then additional groups of employees may seek union representation. If more of our employees unionize it could result in business interruptions, work stoppages, the degradation of service levels due to work rules, or increased operating expenses that may adversely affect our results of operations.

The nature of our business exposes us to litigation risks.

The nature of our business exposes us to litigation, and we are subject to lawsuits in the ordinary course of our business. In several well publicized instances, private litigation by residents of senior living communities for alleged abuses has resulted in large damage awards against other senior living companies. Some lawyers and law firms specialize in bringing litigation against senior living companies. As a result of this litigation and potential litigation, the cost of our liability insurance continues to increase. Medical liability insurance reform has become a topic of political debate and some states have enacted legislation to limit future liability awards. However, such reforms have not generally been adopted and we expect our insurance costs may continue to increase. Although our reserves for liability self insurance have been determined with guidance from third party professionals, our reserves may prove inadequate. Increasing liability insurance costs and increasing self insurance reserves could have a material adverse effect on our business, financial condition and results of operations.

Our growth strategy may not succeed.

We have grown our business through acquisitions, through initiation of long term leases of senior living communities and through entering into long term contracts to manage senior living communities where residents' private resources account for a large majority of revenues. Our business plan includes seeking to take advantage of an expected

Table of Contents

increase in demand for senior living communities and acquiring, leasing or managing additional senior living communities. Our growth strategy involves risks, including the following:

- we may be unable to identify and operate additional senior living communities that receive a large percentage of their revenues from residents' private resources;
- we may be unable to identify and operate senior living communities available for purchase at acceptable prices or lease or manage such senior living communities on acceptable terms;
- we may be unable to access capital to make acquisitions or operate acquired businesses;
- acquired, leased or managed additional operations may not perform in accordance with our expectations;
- we may be required to make significant capital expenditures to improve acquired or additional leased or managed facilities, including capital expenditures that may not have been anticipated by us at the time of the acquisition;
- we may have difficulty retaining key employees and other personnel at acquired, leased or managed facilities;
- acquired, leased or managed additional operations may subject us to unanticipated contingent liabilities or regulatory problems;
- to the extent we incur acquisition debt or leases, our operating leverage and resulting risks of debt defaults may increase; and, to the extent we issue additional equity to fund our acquisitions, our stockholders' percentage of ownership of us will be diluted;
- combining our present operations with newly acquired, leased or managed operations may disrupt operations or cost more than anticipated; and
- we may acquire properties subject to liabilities and without any recourse, or with only limited recourse, for unknown liabilities such as liabilities for cleanup of undisclosed environmental contamination, claims by vendors, or other persons dealing with the former owners of the properties and claims for indemnification by general partners, directors, officers and others indemnified by the former owners of the properties.

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;
- we may suffer declines in profitability or suffer recurring losses; and
- our existing operations may suffer from a lack of management attention or financial resources if such attention and resources are devoted to a failed growth strategy.

When we acquire, lease or manage new communities, we sometimes experience a decline in community occupancy and it may take a period of time for us to stabilize acquired, leased or managed community operations. Our efforts to restore occupancy or stabilize acquired, leased or managed community operations may not be successful.

We may be unable to use our federal and state tax credits or net operating loss carry forwards, or NOLs, before they expire or our ability to use our tax credits and NOLs may be limited.



Table of Contents

As of December 31, 2014, our federal NOLs were approximately \$112.2 million and our tax credit carry forwards were approximately \$17.2 million. As of December 31, 2014, and after conferring with our accounting experts, we have established a full valuation allowance against these net deferred tax assets because we may not generate sufficient taxable income in time to use these NOLs or tax credits prior to their expiration beginning in 2026 and 2022, respectively. Also, if we use our NOLs or tax credits to reduce our future tax liabilities, the existence and amounts of these NOLs and tax credits may be subject to audit by the federal (and any applicable state) tax authorities and the amounts of these NOLs or tax credits may be reduced.

Our past failure to timely file periodic reports with the SEC limits us from quickly accessing the public markets to raise debt or equity capital.

We did not file our Annual Report on Form 10-K for the year ended December 31, 2013 or our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2014, June 30, 2014 and September 30, 2014 by the filing dates required by the SEC; therefore, we are not eligible to use our current shelf registration statement on Form S-3 (or file a new Form S-3 registration statement) to conduct public offerings of our securities until our filings with the SEC have been timely made for a full year. Our ineligibility to use Form S-3 during this time period will have a negative impact on our ability to quickly access the public capital markets because we would be required to file a long form registration statement, which would be subject to an extended filing and possible SEC review period.

Our credit agreements contain terms limiting our ability to incur additional debt. These terms, or our failure or inability to meet them, could adversely affect our business.

Our \$25.0 million Credit Agreement and our \$150.0 million Credit Facility agreement, or together, our credit agreements, include various conditions to our borrowing and various financial and other covenants, including covenants requiring us to maintain certain minimum debt service coverage and leverage ratios, and events of default. We may not be able to satisfy all of these conditions or may default on some of these covenants for various reasons, including matters which are beyond our control. Further, maintaining compliance with these covenants may limit our ability to pursue actions that may otherwise be beneficial to us and our stockholders.

If we are unable to borrow under our credit agreements, we may be unable to meet our business obligations or to grow by buying additional properties, or we may be required to sell some of our properties. If we default under our credit agreements, our lenders may demand immediate payment and may elect not to make further borrowings available to us. Any default under our credit agreements that resulted in our obligations to repay outstanding indebtedness being accelerated or in our no longer being permitted to borrow under our credit agreements would likely have serious and adverse consequences to us and would likely cause the market price of our common shares to materially decline.

In the future, we may obtain additional debt financing, and the covenants and conditions which apply to any such additional indebtedness may be more restrictive than the covenants and conditions contained in our credit agreements. Defaults under our future debt could likely have the same consequences as described above.

We have determined that we have material weaknesses in our internal control over financial reporting because we lacked sufficient personnel with requisite accounting competencies and had an insufficient level of oversight in the financial statement close process. Failure to establish and maintain effective internal control over financial reporting could have a material adverse effect on our business, results of operations and the value of our common shares.

We have determined that we have material weaknesses in our internal control over financial reporting because we lacked sufficient personnel with requisite accounting competencies and had an insufficient level of oversight in the financial statement close process. As a result, we concluded that our internal control over financial reporting was ineffective. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our financial statements will not be prevented or detected on a timely basis. We are continuing to develop our remediation plan for the material weaknesses described above, which currently includes recruitment of additional experienced personnel for certain accounting positions, restructuring of our accounting department and providing enhanced training for employees regarding our

Table of Contents

accounting policies and procedures. We have begun to implement this remediation plan while we are continuing to develop it. Successful remediation of the material weaknesses described above requires review and evidence of the effectiveness of the related internal control processes as part of our periodic assessments of our internal controls over financial reporting. As we continue to evaluate and work to enhance our internal control over financial reporting, we may determine that additional measures should be taken to address the material weaknesses described above or other control deficiencies, or that we should modify the remediation plan. We expect that the remediation of the material weaknesses described above will be completed by December 31, 2015.

If we fail to remediate these material weaknesses or to design, implement and maintain new or improved controls and procedures designed to prevent additional material weaknesses, or if our management or our independent registered public accounting firm were to conclude in their future reports that our internal control over financial reporting was not effective, our ability to meet our periodic reporting obligations may be adversely affected, and may result in additional errors and material misstatements or omissions not detected by management in our financial statements. Any such failure could adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding the effectiveness of our internal control over financial reporting. Any such failure could also cause investors to lose confidence in our reported financial information and could therefore adversely affect our business, results of operations and the value of our common shares.

Failure to comply with laws governing the privacy and security of personal information, including relating to health, could materially and adversely affect our business, financial condition and results of operations.

We are required to comply with federal and state laws governing the privacy, security, use and disclosure of personally identifiable information, including information relating to health. Under HIPAA and the HITECH Act, as updated by the HIPAA Omnibus Rule, we are required to comply with the HIPAA privacy rule, security standards, and standards for electronic healthcare transactions. State laws also govern the privacy of individual health information, and rules regarding state privacy rights may be more stringent than HIPAA. Other federal and state laws govern the privacy of other personal information. If we fail to comply with applicable federal or state standards, we could be subject to civil sanctions and criminal penalties, which could materially and adversely affect our business, financial condition and results of operations.

We rely on information technology in our operations, and any material failure, inadequacy, interruption or security failure of that technology could harm our business.

We rely on information technology networks and systems, including the Internet, to process, transmit and store electronic information and to manage or support a variety of our business processes, including medical records, financial transactions and maintenance of records, which may include personal identifying information of residents and other customers, payroll data and workforce scheduling information. We rely on commercially available systems, software, tools and monitoring to provide security for processing, transmitting and storing this confidential information, such as individually identifiable information relating to health and financial accounts. Although we have taken steps to protect the security of the data maintained in our information systems, it is possible that our security measures will not be able to prevent the systems' improper functioning, or the improper disclosure of personally identifiable information such as in the event of cyber attacks. Security breaches, including physical or electronic break ins, computer viruses, attacks by hackers and similar breaches, can create system disruptions, shutdowns or unauthorized disclosure of confidential information. Any failure to maintain proper function, security and availability of our information systems could interrupt our operations, damage our reputation, subject us to liability claims or regulatory penalties and could materially and adversely affect us.

Termination of assisted living resident agreements and resident attrition could adversely affect our revenues and earnings.

State regulations governing assisted living facilities typically require a written resident agreement with each resident. Most of these regulations also require that each resident have the right to terminate these assisted living resident agreements for any reason on reasonable notice. Consistent with these regulations, most of our resident agreements allow residents to terminate their agreements on 30 days' notice. Thus, we may be unable to contract with assisted living residents to stay for longer periods of time, unlike typical apartment leasing arrangements that involve lease agreements with terms of up to a year or longer. If a large number of residents elected to terminate their resident agreements at or

Table of Contents

around the same time, our revenues and earnings could be materially and adversely affected. In addition, the advanced ages of our senior living residents make the resident turnover rate in our senior living communities difficult to predict.

Our former rehabilitation hospitals may be subject to retroactive Medicare reclassifications or repayments.

During the period we operated our rehabilitation hospitals, which were sold in the fourth quarter of 2013, Medicare payments accounted for a significant amount of the rehabilitation hospitals' revenues. CMS has established a standard known as the "60% Rule," which provides that at least 60% of an IRF's total inpatient population must require intensive rehabilitation services associated with treatment of at least one of 13 designated medical conditions in order for the facility to be classified as an IRF by the Medicare program. Although we believe that our IRFs were operated in compliance with the 60% Rule during the period in which we operated them, CMS could determine that we were non-compliant in a prior year. Such an event would result in these rehabilitation hospitals being subject to Medicare reclassification to a different type of provider and our receiving lower Medicare payment rates retroactively. Reductions in our Medicare payments as a result of the reclassification of our rehabilitation hospitals could materially and adversely affect our financial condition and results of operations. Also, retroactive audits of Medicare claims submitted by IRFs and other providers are expanding, and CMS is recouping amounts paid for services determined by auditors not to have been medically necessary or not to meet Medicare criteria for coverage as billed. If our facilities were required to make substantial retroactive repayments to Medicare, our financial condition and results of operations could be materially and adversely affected.

Our business requires us to make significant capital expenditures to maintain and improve our communities.

Our communities sometimes require significant expenditures to address ongoing required maintenance and to make them attractive to residents. Physical characteristics of senior living communities are mandated by various governmental authorities; changes in these regulations may require us to make significant expenditures. In addition, we often are required to make significant capital expenditures when we acquire new communities. Our available financial resources may be insufficient to fund these expenditures. SNH has historically provided most of the capital we need to improve the communities we lease from them; however, whenever SNH provides such capital, our rent increases and we may be unable to pay the increased rent without experiencing losses. In addition, for properties we manage for SNH, SNH funds these capital expenditures, resulting in the invested capital on which its returns are based increasing, which may reduce or prevent our receipt of incentive fees.

We face significant competition and we may be unable to operate profitably.

We compete with numerous other companies that provide senior living services, including home healthcare companies and other real estate based service providers. Although some states require certificates of need to develop new SNFs and assisted living communities, there are fewer barriers to competition for home healthcare or for independent and assisted living services. Many of our existing competitors are larger and have greater financial resources than us. Some of our competitors are not for profit entities which have endowment income and may not have the same financial pressures that we face. We cannot assure that we will be able to attract a sufficient number of residents to our communities or that we will be able to attract employees and keep wages and other employee benefits, insurance costs and other operating expenses at levels which will allow us to compete successfully or to operate profitably.

Increased leverage may harm our financial condition and results of operations.

Our total consolidated long term debt as of December 31, 2014 was approximately \$49.4 million and represented approximately 16% of our total book capitalization as of that date. In addition to our indebtedness, we have substantial lease and other obligations.

Our level of indebtedness and substantial lease and other obligations could have important consequences to our business, because:

- it could affect our ability to satisfy our debt obligations;

22

---

Table of Contents

- the portion of our cash flows from operations required to make interest and principal payments will not be available for operations, working capital, capital expenditures, expansion, acquisitions or general corporate or other purposes;
- it may impair our ability to obtain additional financing in the future;
- it may limit our flexibility in planning for, or reacting to, changes in our business and industry; and
- it may make us more vulnerable to downturns in our business, our industry or the economy in general than a company with less debt leverage.

Increasing interest rates may adversely affect us.

Interest rates have been at historically low levels for an extended period of time and it is unclear how long rates will remain low. Increasing interest rates may adversely affect us, including in the following ways:

- Amounts outstanding under our credit facilities bear interest at variable interest rates. When interest rates increase, so will our interest costs, which could adversely affect our cash flow, our ability to pay principal and interest on our debt, our cost of refinancing our debt when it becomes due and our ability to fund our operations and working capital. Additionally, if we choose to hedge our interest rate risk, we cannot assure that the hedge will be effective or that our hedging counterparty will meet its obligations to us.
- An increase in interest rates could adversely affect the housing market and reduce demand for our services and communities. Further, increased interest rates may increase the rent we pay for new leases of senior living communities due to the landlord setting rent based on a required return on the landlord's investment. Similarly, increased interest rates may reduce the likelihood that we earn incentive fees for senior living communities we may manage due to the owners of the communities requiring a minimum return on their investment prior to our being eligible to receive an incentive fee.
- Interest rates may negatively impact the value of our shares, which may increase our cost of capital, including decreasing the amount of equity and debt we may be able to raise, increasing the extent of dilution from any equity offering we may make or increasing the costs to us for any such equity or debt offering.

Ownership and leasing of real estate is subject to environmental and climate change risks.

Ownership and leasing of real estate is subject to risks associated with environmental hazards. We may be liable for environmental hazards at, or migrating from, our properties, including properties we lease, including those created by prior owners or occupants, abutters or other persons. Various federal and state laws impose liabilities upon property owners, such as us, for any environmental damages arising at, or migrating from, properties they own, and we cannot assure that we will not be held liable for environmental investigation and clean up at, or near, our properties. As an owner or previous owner of properties which contain environmental hazards, we also may be liable to pay damages to governmental agencies or third parties for costs and damages they incur arising from environmental hazards at, or migrating from, our properties. Under our leases with SNH, we have also agreed to indemnify SNH for any such liabilities related to the properties we lease from SNH. Moreover, the costs and damages which may arise from environmental hazards are often difficult to project and may be substantial.

We believe any asbestos in our communities is contained in accordance with current regulations, and we have no current plans to remove it. If we removed the asbestos or demolished these communities, certain environmental regulations govern the manner in which the asbestos must be handled and removed, and we could incur substantial costs complying with such regulations.

Table of Contents

There have recently been severe weather activities in different parts of the country that some observers believe evidence global climate change. Such severe weather that may result from climate change may have an adverse effect on individual properties we own, lease or operate. Further, the current political debate about climate change has resulted in various treaties, laws and regulations which are intended to limit carbon emissions. We believe these laws being enacted or proposed may cause energy costs at our properties to increase. In the long term, we believe any such increased costs will be passed through and paid by our residents and other customers in higher charges for our services. However, in the short term, these increased costs, if material in amount, could materially and adversely affect our financial condition and results of operations. For more information regarding climate change matters and their possible adverse impact on us, please see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Impact of Climate Change.”

**RISKS ARISING FROM CERTAIN RELATIONSHIPS OF OURS AND OUR ORGANIZATION AND STRUCTURE**

We are subject to possible conflicts of interest; our agreements and relationships with SNH and RMR may restrict our ability to grow our business; and we have engaged in, and expect to continue to engage in, transactions with parties that may be considered related parties.

Our business is subject to possible conflicts of interest as follows:

- as of December 31, 2014, we leased from SNH 181 of our 263 senior living communities (including four that we have classified as discontinued operations) for total annual rent of approximately \$190.7 million plus percentage rent based on increases in gross revenues at certain properties;
- as of December 31, 2014, we managed 46 senior living communities which are owned by SNH, and during 2014, we realized \$9.8 million in management fees from SNH;
- we manage a portion of a senior living community for D&R Yonkers LLC, which is owned by SNH’s President and Chief Operating Officer and its Treasurer and Chief Financial Officer and to which a subsidiary of SNH subleases that portion of the community;
  - RMR, the manager of SNH, provides business management and shared services to us;
- our President and Chief Executive Officer, Bruce J. Mackey Jr., and our Treasurer and Chief Financial Officer, Paul V. Hoagland, are also officers and employees of RMR; our Managing Directors, Barry Portnoy and Gerard M. Martin, are directors of RMR; and Mr. Barry Portnoy is a managing trustee of SNH and is also the majority beneficial owner and the chairman of RMR;
- RMR’s simultaneous contractual obligations to us and SNH create potential conflicts of interest, or the appearance of such conflicts of interest, and under the business management agreement with RMR, in the event of a conflict between SNH and us, RMR may act on behalf of SNH rather than on our behalf; and
- we lease our headquarters from an affiliate of RMR.

On December 31, 2001, SNH distributed substantially all of its ownership of our common shares to its shareholders. Simultaneously with the spin off, we entered into agreements with SNH and RMR which, among other things, limit (subject to certain exceptions) ownership of more than 9.8% of our voting shares, restrict our ability to take any action that could jeopardize the tax status of SNH as a real estate investment trust and limit our ability to acquire real estate of types which are owned by SNH or other businesses managed by RMR. As a result of these agreements, our leases and management agreements with SNH, and our business management agreement with RMR, SNH, RMR and their respective affiliates have significant roles in our business and we do not anticipate any changes to those roles in the future. In addition, as of December 31, 2014, SNH owned 4.2 million of our common shares, or approximately 8.6% of our outstanding common shares, and SNH is our largest stockholder.





## Table of Contents

We believe that our historical and ongoing business dealings with SNH, RMR and D&R Yonkers LLC have benefited us and that, despite these possible conflicts of interest, the transactions we have entered with SNH, RMR and D&R Yonkers LLC have been commercially reasonable and not less favorable than otherwise available to us. Nonetheless, in the past, in particular following periods of volatility in the overall market or declines in the market price of a company's securities, stockholder litigation, dissident stockholder director nominations and dissident stockholder proposals have often been instituted against companies alleging conflicts of interest in business dealings with affiliated and related persons and entities. Our relationships with SNH, RMR, D&R Yonkers LLC, AIC, the other businesses and entities to which RMR provides management services, Messrs. Portnoy and Martin and with other related parties of RMR may precipitate such activities. These activities, if instituted against us, could result in substantial costs and a diversion of our management's attention, even if the action is unfounded.

Our leases of certain of our senior living communities are subordinated to mortgage debt of SNH, and a default by SNH could result in the termination of those leases.

As of December 31, 2014, our leases with SNH for 27 of our senior living communities, which had 2014 revenues totaling \$188.6 million, were subordinated to mortgage financing secured by such communities. As a result, in the event SNH was to default on such mortgage financing, by reason of our default under our leases or for reasons unrelated to us or beyond our control, and its lender were to foreclose on those properties, our leases would terminate as a matter of law. While we may be able to enter into new leases with the lenders or the purchaser or purchasers of such properties, or they may elect to continue our occupancy under the terms of the lease as if there had been no foreclosure, they would not be obligated to pursue either of those options and, if we are able to retain possession, the terms of our continued occupancy may not be as favorable to us as those contained in our leases with SNH. If we do not enter into new leases of such communities following a foreclosure, we would lose the right to continue to operate these communities and we may incur material obligations to residents, employees and other parties as a result of such loss, each of which could have a material and adverse effect on our results of operations.

Ownership limitations and certain provisions in our charter, bylaws and certain material agreements, as well as certain provisions of Maryland law, may deter, delay or prevent a change in our control or unsolicited acquisition proposals.

Our charter and bylaws contain separate provisions which prohibit any stockholder from owning more than 9.8% and 5% of the number or value of any class or series of our outstanding shares of stock. The 9.8% ownership limitation in our charter is consistent with our contractual obligation with SNH to not take actions that may conflict with SNH's status as a real estate investment trust under the Internal Revenue Code. The 5% ownership limitation in our bylaws is intended to help us preserve the tax treatment of our NOLs and other tax benefits. We also believe these provisions promote good orderly governance. These provisions inhibit acquisitions of a significant stake in us and may deter, delay or prevent a change in control of us or unsolicited acquisition proposals that a stockholder may consider favorable. Additionally, provisions contained in our charter and bylaws or under Maryland law may have a similar impact, including, for example, provisions relating to:

- the division of our Directors into three classes, with the term of one class expiring each year, which could delay a change of control;
- stockholder voting rights and standards for the election of Directors and other provisions which require larger majorities for approval of actions which are not approved by our Directors than for actions which are approved by our Directors;
- the authority of our Board of Directors, and not our stockholders, to adopt, amend or repeal our bylaws and to fill vacancies on our Board of Directors;
- required qualifications for an individual to serve as a Director and a requirement that certain of our Directors be "Independent Directors" and other Directors be "Managing Directors", as defined in our bylaws;



Table of Contents

- limitations on the ability of our stockholders to propose nominees for election as Directors and propose other business to be considered at a meeting of stockholders;
- limitations on the ability of our stockholders to remove our Directors; and
- the authority of our Board of Directors to create and issue new classes or series of stock (including stock with voting rights and other rights and privileges that may deter a change in control) and issue additional common stock.

In addition, our shareholders agreement with respect to AIC provides that AIC and the other shareholders of AIC may have rights to acquire our interests in AIC in the event that anyone acquires more than 9.8% of our shares or we experience some other change in control. The terms of our leases and management contracts with SNH provide that our rights under these agreements may be cancelled by SNH upon the acquisition by any person or group of more than 9.8% of our voting stock, and upon other change in control events, as defined in those documents including, in certain of the leases and management agreements, the adoption of any proposal (other than a precatory proposal) or the election to our Board of Directors of any individual if such proposal or individual was not approved, nominated or appointed, as the case may be, by vote of a majority of our Directors in office immediately prior to the making of such proposal or the nomination or appointment of such individual. In addition, a termination of our business management agreement with RMR is a default under our Credit Agreement, and a change in control event of us, including upon the acquisition by any person or group of more than 9.8% (or 35% for the purposes of our Credit Facility) of our voting stock, is a default under our Credit Agreement and our Credit Facility, unless approved by our lenders.

Our ownership interest in AIC may prevent stockholders from accumulating large share ownership, from nominating or serving as Directors, or from taking actions to otherwise control our business.

As an owner of AIC, we are licensed and approved as an insurance holding company; and any stockholder who owns or controls 10% or more of our securities or anyone who wishes to solicit proxies for election of, or to serve as, one of our Directors or for another proposal of business not approved by our Board of Directors may be required to receive pre-clearance from the concerned insurance regulators. These pre-approval procedures may discourage or prevent investors from purchasing our securities, from nominating persons to serve as our Directors or from taking other actions.

Our rights and the rights of our stockholders to take action against our Directors and officers are limited.

Our charter limits the liability of our Directors and officers to us and our stockholders for money damages to the maximum extent permitted under Maryland law. Under current Maryland law, our Directors and officers will not have any liability to us and our stockholders for money damages other than liability resulting from:

- actual receipt of an improper benefit or profit in money, property or services; or
- active and deliberate dishonesty by such director or officer that was established by a final judgment as being material to the cause of action adjudicated.

Our charter and contractual obligations authorize and may require us to indemnify our present and former Directors and officers for actions taken by them in those capacities to the maximum extent permitted by Maryland law. However, except with respect to proceedings to enforce rights to indemnification, we will indemnify any person referenced in the previous sentence in connection with a proceeding initiated by such person against us only if such proceeding is authorized by our charter or bylaws or by our Board of Directors or stockholders. In addition, we may be obligated to pay or reimburse the expenses incurred by our present and former Directors and officers without requiring a preliminary determination of their ultimate entitlement to indemnification. As a result, we and our stockholders may have more limited rights against our present and former Directors and officers than might otherwise exist absent the provisions in our charter and contracts or that might exist with other companies, which could limit your recourse in the event of actions not in your best interest.



## Table of Contents

Disputes with SNH and RMR and stockholder litigation against us or our Directors and officers may be referred to binding arbitration proceedings.

Our contracts with SNH and RMR provide that any dispute arising under those contracts may be referred to binding arbitration proceedings. Similarly, our bylaws provide that actions by our stockholders against us or against our Directors and officers, including derivative and class actions, may be referred to binding arbitration proceedings. As a result, we and our stockholders would not be able to pursue litigation for these disputes in courts against SNH, RMR or our Directors and officers if the disputes were referred to arbitration. In addition, the ability to collect attorneys' fees or other damages may be limited in the arbitration proceedings, which may discourage attorneys from agreeing to represent parties wishing to commence such a proceeding.

We may experience losses from our business dealings with AIC.

We have invested approximately \$6.0 million in AIC, we have purchased substantially all our property insurance in a program designed and reinsured in part by AIC, and we periodically consider the possibilities for expanding our relationship with AIC to other types of insurance. We, RMR and five other companies to which RMR provides management services each own approximately 14.3% of AIC, and we and those other AIC shareholders participate in a combined insurance program designed and reinsured in part by AIC. Our principal reason for investing in AIC and for purchasing insurance in these programs is to seek to improve our financial results by obtaining improved insurance coverages at lower costs than may be otherwise available to us or by participating in any profits which we may realize as an owner of AIC. While we believe we have in the past benefitted from these arrangements, these beneficial financial results may not occur in the future, and we may need to invest additional capital in order to continue to pursue these results. AIC's business involves the risks typical of an insurance business, including the risk that it may not operate profitably. Accordingly, financial benefits from our business dealings with AIC may not be achieved in the future, and we may experience losses from these dealings.

## RISKS RELATED TO OUR SECURITIES

We do not intend to pay cash dividends on our common shares in the foreseeable future.

We have never declared or paid any cash dividends on our common shares, and we currently do not anticipate paying any cash dividends in the foreseeable future.

Changes in market conditions, our operating results and investors' perception of our prospects could adversely affect the market price of our common shares.

As with other publicly traded equity securities, the value of our common shares depends on various market conditions and other factors that may change from time to time, including:

- the liquidity of the market for our common shares;
- changes in our operating results;
- changes in analysts' expectations;
- the extent of investor interest in our common shares;
- market interest rates;
- national economic conditions; and
- general market conditions.



Table of Contents

In addition, the stock market in recent years has experienced broad price and volume fluctuations that often have been unrelated to the operating performance of particular companies. These market fluctuations may also cause the market price of our common shares to decline. Stockholders may be unable to resell our common shares at or above the price at which they purchased our common shares.

## Item 1B. Unresolved Staff Comments

None.

## Item 2. Properties

## OUR SENIOR LIVING COMMUNITIES

As of December 31, 2014, we owned or leased and operated as continuing operations 212 senior living communities which we have categorized into two groups as follows:

Type of community	No. of communities	Type of units			Total living units	Average occupancy for the year ended Dec. 31, 2014	Revenues for the year ended Dec. 31, 2014 (in thousands)	Percent of revenues from private resources
		Indep. living apts.	Assist. living suites	Skilled nursing beds				
Independent and assisted living communities	181	7,091	11,204	1,984	20,279	86.8	% \$ 909,230	87.4
SNFs	31	68	—	2,754	2,822	79.7	% 179,049	25.6
Totals:	212	7,159	11,204	4,738	23,101	86.0	% \$ 1,088,279	77.2

Excluded from the preceding and following data are 46 independent and assisted living communities with 3,426 independent living apartments, 3,380 assisted living suites and 472 skilled nursing beds that we manage for the account of SNH. Also excluded is one assisted living community with 32 living units that we own and three SNFs and one assisted living community with an aggregate of 265 living units that we lease from SNH that we have classified as discontinued operations, each as of December 31, 2014. Unless specifically provided below or unless the context provides otherwise, the discussion and analysis provided below does not include the senior living communities that we have classified as discontinued operations.



Table of Contents

## Independent and Assisted Living Communities

As of December 31, 2014, we owned or leased and operated 181 independent and assisted living communities. We leased 146 of these communities from SNH and four of these communities from HCP, Inc., or HCP. We own the remaining 31 communities. These communities have 20,279 living units and are located in 26 states. The following table provides additional information about these communities and their operations as of December 31, 2014:

Location	No. of communities	Type of units			Total living units	Average occupancy for the year ended Dec. 31, 2014		Percent of revenues from private resources		
		Indep. living apts.	Assist. living suites	Skilled nursing beds				Revenues for the year ended Dec. 31, 2014	(in thousands)	
Alabama	8	67	373	—	440	87.6	%	\$ 14,221	100.0	%
Arizona	4	512	309	199	1,020	76.4	%	43,325	80.2	%
California	9	495	424	59	978	84.0	%	46,357	91.2	%
Delaware	6	336	322	341	999	80.2	%	64,868	68.6	%
Florida	9	1,179	712	155	2,046	96.0	%	84,943	78.8	%
Georgia	11	111	524	40	675	88.8	%	27,370	91.8	%
Illinois	2	112	73	—	185	95.9	%	5,408	100.0	%
Indiana	16	950	577	140	1,667	85.9	%	63,645	88.3	%
Kansas	3	334	67	198	599	87.6	%	29,289	74.1	%
Kentucky	9	491	281	183	955	89.4	%	44,849	84.7	%
Maryland	10	239	692	—	931	90.0	%	54,009	99.8	%
Massachusetts	1	123	—	—	123	89.6	%	8,445	100.0	%
Minnesota	1	—	230	—	230	87.2	%	13,090	95.9	%
Mississippi	2	—	113	—	113	85.7	%	3,555	100.0	%
Missouri	1	110	—	—	110	87.7	%	2,714	100.0	%
Nebraska	2	27	111	62	200	91.0	%	9,511	54.4	%
New Jersey	5	215	555	60	830	89.4	%	40,755	84.0	%
New Mexico	1	114	35	60	209	84.3	%	13,217	85.1	%
North Carolina	15	143	1,293	—	1,436	87.0	%	65,517	99.5	%
Ohio	1	143	115	57	315	87.2	%	18,843	82.9	%
Pennsylvania	10	—	1,011	—	1,011	87.0	%	39,958	100.0	%
South Carolina	18	101	887	58	1,046	85.7	%	43,421	91.2	%
Tennessee	11	7	672	—	679	94.4	%	25,924	100.0	%
Texas	9	898	590	298	1,786	80.2	%	81,690	85.0	%
Virginia	11	284	718	—	1,002	91.5	%	39,977	100.0	%
Wisconsin	6	100	520	74	694	77.5	%	24,329	74.3	%
Totals:	181	7,091	11,204	1,984	20,279	86.8	%	\$ 909,230	87.4	%

## Skilled Nursing Facilities

As of December 31, 2014, we operated 31 SNFs that we lease from SNH. These facilities have 2,822 living units and are located in seven states. The following table provides additional information about these facilities and their operations as of December 31, 2014:

Location	No. of communities	Type of units			Total living units	Average occupancy for the year ended Dec. 31, 2014		Percent of Revenues for the year ended Dec. 31, 2014		
		living apts.	living suites	skilled nursing beds				from private resources		
1. California	4	—	—	373	373	84.5	%	33,009	11.6	%
2. Colorado	7	45	—	756	801	80.1	%	55,022	29.7	%
3. Iowa	4	19	—	283	302	82.5	%	16,580	34.9	%
4. Kansas	1	4	—	56	60	86.9	%	3,332	20.9	%
5. Nebraska	10	—	—	611	611	83.2	%	33,897	27.9	%
6. Wisconsin	3	—	—	484	484	70.0	%	26,116	26.9	%
7. Wyoming	2	—	—	191	191	74.8	%	11,093	24.3	%
Totals:	31	68	—	2,754	2,822	79.7	%	\$ 179,049	25.6	%

Table of Contents

## OUR SNH LEASES AND MANAGEMENT AGREEMENTS

## SNH Leases

The following table provides a summary of our leases as of December 31, 2014 (including with respect to four senior living communities that we have classified as discontinued operations) and is followed by a summary of the material terms of our leases as of December 31, 2014 with SNH. Because it is a summary, it does not contain all of the information that may be important to you. If you would like more information, you should read the leases which are among the exhibits listed in Part IV, Item 15 of this Annual Report on Form 10 K and incorporated herein by reference.

	Number of Properties	Annual Minimum Rent as of December 31, 2014	Current Expiration date	Remaining Renewal Options
1. Lease No. 1 for SNFs and independent and assisted living communities(1)	86	\$ 58.5 million	December 31, 2024	Two 15-year renewal options.
2. Lease No. 2 for SNFs, independent and assisted living communities	49	62.9 million	June 30, 2026	Two 10-year renewal options.
3. Lease No. 3 for independent and assisted living communities(2)	17	34.4 million	December 31, 2028	Two 15-year renewal options.
4. Lease No. 4 for SNFs and independent and assisted living communities(3)	29	34.9 million	April 30, 2032	Two 15-year renewal options.
Totals	181	\$ 190.7 million		

(1) Lease No. 1 is comprised of two separate leases. One of these two leases exists to accommodate a mortgage financing in effect at the time SNH acquired the property; we have agreed with SNH to combine these two leases into one lease when this mortgage financing is paid in full.

(2) Lease No. 3 exists to accommodate certain mortgage financing by SNH.

(3) Lease No. 4 is comprised of two separate leases. One of these two leases exists to accommodate a mortgage financing in effect at the time SNH acquired the property; we have agreed with SNH to combine these two leases into one lease when the mortgage financing is paid in full.

Percentage Rent. Our leases with SNH require us to pay percentage rent at 174 of the 181 senior living communities we lease from SNH (including four that we have classified as discontinued operations) equal to 4% of the amount by which gross revenues, as defined in our leases, of each property exceeds gross revenues in a specific base year. These amounts are in addition to the minimum annual rent amounts payable by us to SNH. We paid total percentage rent of \$5.8 million in 2014. Different base years apply to those communities that pay percentage rent. The base year is usually the first full calendar year after each community is leased.

**Operating Costs.** Each lease is a so called “triple net” lease which requires us to pay all costs incurred in the operation of the properties, including the costs of maintenance, personnel, services to residents, insurance and real estate and personal property taxes.

**Rent During Renewal Term.** For all but seven of the properties we lease from SNH, rent during each applicable renewal term is the same as the minimum rent and percentage rent payable during the initial term. For the remaining seven properties, rent during the second renewal term is based on the fair market rental value of such properties.

**Licenses.** Our leases require us to obtain, maintain and comply with all applicable permits and licenses necessary to operate the leased properties.

**Maintenance and Alterations.** We are required to operate continuously and maintain, at our expense, the leased properties in good order and repair, including structural and nonstructural components. We may request that SNH fund amounts needed for repairs and renovations in return for rent increases according to formulas in the leases; however, SNH is not obligated to fund such requests and we are not required to sell them to SNH. At the end of each lease term, we are required to surrender the leased properties in substantially the same condition as existed on the commencement date of the lease, subject to any permitted alterations and ordinary wear and tear.

Table of Contents

Assignment and Subletting. SNH's consent is generally required for any direct or indirect assignment or sublease of any of the properties. Also, in the event of any assignment or subletting, we remain liable under the terms of the applicable lease.

Indemnification and Insurance. With limited exceptions, we are required to indemnify SNH from all liabilities which may arise from the ownership or operation of the leased properties. We generally are required to maintain insurance against such risks and in such amounts as SNH shall reasonably require and may be commercially reasonable. Each lease requires that SNH be named as an additional insured under these insurance policies.

Damage, Destruction, Condemnation and Environmental Matters. If any of the leased properties is damaged by fire or other casualty or taken for a public use, we are generally obligated to rebuild it unless the property cannot be restored. If the property cannot be restored, SNH will generally receive all insurance or taking proceeds and we are liable to SNH for the amount of any deductible or deficiency between the replacement cost and the insurance proceeds, and our rent will be adjusted pro rata. We are also required to remove and dispose of any hazardous substance at the leased properties in compliance with all applicable environmental laws and regulations.

Events of Default. Events of default under each lease generally include the following:

- our failure to pay rent or any money due under the lease when it is due, which failure continues for five business days;
- our failure to maintain the insurance required under such lease;
- any person or group acquiring ownership of 9.8% or more of our outstanding voting stock or any change in our control, the adoption of any stockholder proposal (other than a precatory proposal) or the election to our Board of Directors of any individual if such proposal or individual was not approved, nominated or appointed, as the case may be, by vote of a majority of our Directors in office immediately prior to the making of such proposal or the nomination or appointment of such individual;
- the occurrence of certain events with respect to our insolvency or dissolution;
- our default under indebtedness which gives the holder the right to accelerate our repayment of the indebtedness;
- our being declared ineligible to receive reimbursement under Medicare or Medicaid programs for any of the leased properties which participate in such programs or the revocation of any material license required for our operations; and
- our failure to perform any terms, covenants or agreements of such lease and the continuance thereof for a specified period of time after written notice.

Remedies. Upon the occurrence of any event of default, each lease provides that, among other things, SNH may, to the extent legally permitted:

- accelerate the rents;
- terminate the leases in whole or in part;
- 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;
- make any payment or perform any act required to be performed by us under the leases; and

## Table of Contents

· rent the property and recover from us the difference between the amount of rent which would have been due under the lease and the rent received from the re letting.

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

Management. We may not enter into any new management agreement affecting any leased property without the prior written consent of SNH.

Lease Subordination. Our leases may be subordinated to any mortgages on properties leased from SNH. As of December 31, 2014, SNH had mortgages on 27 of our communities to which our leases were subordinated. These 27 communities had 4,001 living units and 2014 revenues totaling \$188.6 million. SNH's outstanding borrowing secured by mortgages on these 27 communities totaled \$340.8 million as of December 31, 2014.

Financing Limitations; Security. Our leases subject to mortgage financings of SNH require SNH's consent before we incur debt secured by our investments in our tenant subsidiaries that lease or operate the properties subject to these leases. Further, our leases subject to mortgage financings prohibit our tenant subsidiaries from incurring liabilities, other than operating liabilities incurred in the ordinary course of business, secured by our accounts receivable or purchase money debt. We may pledge interests in our leases only if the pledge is approved by SNH. In addition, in connection with our leases subject to mortgage financings with SNH, certain of our subsidiaries pledged to the lenders under such mortgage financings certain tangible and intangible personal property, such as accounts receivable and contract rights, located at, or arising from the operations of, the properties subject to such leases to secure their obligations under such leases and certain of their obligations relating to such mortgage financings.

Non Economic Circumstances. If we determine that continued operations of one or more properties is not economical, we may negotiate with SNH to close or sell that community, including SNH's ownership in the property. In the event of such a sale, SNH receives the net proceeds and our rent for the remaining properties in the applicable lease is reduced according to formulas contained in the applicable lease.

Our Relationship with SNH. SNH is our largest landlord. We were a 100% owned subsidiary of SNH before December 31, 2001. On December 31, 2001, SNH distributed substantially all of our then outstanding common shares to its shareholders. Both we and SNH receive management services from RMR. SNH owns 4,235,000, or 8.6%, of our outstanding common shares as of December 31, 2014. For more information about our dealings with SNH, and about the risks which may arise as a result of these related person transactions, see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Related Person Transactions" of this Annual Report on Form 10 K.

## Management Contracts

We began managing communities for SNH's account in June 2011 in connection with SNH's acquisition of certain senior living communities at that time. We have since begun managing additional communities that SNH has acquired. With the exception of the management agreement for the senior living community in New York, described in Note 15 to the Notes to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10 K, or Note 15, which is incorporated herein by reference, the management agreements for the communities we manage for SNH's account provide us with a management fee equal to 3% of the gross revenues realized at the communities, plus reimbursement for our direct costs and expenses related to the communities and an incentive fee equal to 35% of the annual net operating income of the communities after SNH realizes an annual return equal to 8% of its invested capital. The management agreements provide that we and SNH each have the option to terminate the contracts upon the acquisition by a person or group of more than 9.8% of the other's voting stock and upon other change in control events affecting the other party, as defined in those documents, including the adoption of any shareholder proposal (other than a precatory proposal) or the election to the board of directors or board of trustees of

any individual if such proposal or individual was not approved, nominated or appointed, as the case may be, by vote of a majority of the board of directors or board of trustees in office immediately prior to the making of such proposal or the nomination or appointment of such individual.

## Table of Contents

In connection with the management agreements, we and SNH have entered into four combination agreements, or pooling agreements, three of which combine certain of our management agreements with SNH for communities that include assisted living units, or the AL Pooling Agreements, and the fourth of which combines our management agreements with SNH for communities consisting only of independent living units, or the IL Pooling Agreement. The management agreements that are included in each of the pooling agreements are on substantially similar terms. The first AL Pooling Agreement, which we entered into in May 2011, includes 20 identified communities and the second AL Pooling Agreement, which we entered into in October 2012, includes 19 identified communities. We and SNH entered into our third AL Pooling Agreement in November 2013 and that pooling agreement currently includes three identified communities, as further discussed in Note 15. We entered into the IL Pooling Agreement in August 2012 and that agreement currently includes two identified communities that have only independent living units. Each of the AL Pooling Agreements and the IL Pooling Agreement aggregates the determination of fees and expenses of the various communities that are subject to such pooling agreement, including determinations of our incentive fees and SNH's return of its invested capital. Under each of the pooling agreements, SNH has the right, after the period of time specified in the agreement has elapsed and subject to our cure rights, to terminate all, but not less than all, of the management agreements that are subject to the pooling agreement if SNH does not receive its minimum return in each of three consecutive years. In addition, under each of the pooling agreements, we have a limited right to require the sale of underperforming communities. Also, under each of the pooling agreements, any nonrenewal notice given by us with respect to a community is deemed a nonrenewal with respect to all the communities that are the subject of the agreement. We also manage for the accounts of SNH and an entity owned by SNH's executive officers a senior living community in New York, and we manage for the account of SNH a senior living community in California; the management agreements for these communities are not included in any of our pooling agreements. The term of each of the management agreements between us and SNH for the 20 assisted living communities currently included in the first AL Pooling Agreement and for the portion of the senior living community in New York that we manage for SNH, referenced in the preceding sentence expires on December 31, 2031, the term of each of the management agreements for the two independent living communities currently included in the IL Pooling Agreement expires on December 31, 2032, the term of each of the management agreements between us and SNH for the senior living community in California referenced in the preceding sentence and the 19 assisted living communities currently included in the second AL Pooling Agreement expires on December 31, 2033, and the term of each of the management agreements between us and SNH for the senior living communities included in the third AL Pooling Agreement expires December 31, 2035. Special committees of each of our Board of Directors and SNH's board of trustees composed solely of our Independent Directors and SNH's independent trustees who are not also directors or trustees of the other party and who were represented by separate counsel reviewed and approved the terms of the initial management agreements and pooling agreements and the terms of subsequent management agreements, pooling agreements and amendments were approved by our Independent Directors and Board of Directors and by the Independent Trustees and Board of Trustees of SNH. Please see Note 15 to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10-K for further information relating to our management arrangements with SNH.

### Item 3. Legal Proceedings

We are routinely involved in various legal and administrative proceedings incidental to the ordinary course of business, none of which we expect, individually or in the aggregate, to have a material adverse effect on our business, financial condition, results of operations or cash flows.

### Item 4. Mine Safety Disclosures

Not applicable.





Table of Contents

## PART II

## Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common shares are traded on the NYSE (symbol: FVE). The following table sets forth for the periods indicated the high and low sale prices for our common shares as reported by the NYSE:

	High	Low
2013		
First Quarter	\$ 6.72	\$ 4.97
Second Quarter	6.87	4.44
Third Quarter	6.20	5.04
Fourth Quarter	5.66	4.41
2014		
First Quarter	\$ 6.09	\$ 4.71
Second Quarter	5.35	4.59
Third Quarter	5.21	3.23
Fourth Quarter	4.67	3.68

The closing price of our common shares on the NYSE on March 13, 2015 was \$3.57 per share.

As of March 13, 2015, there were approximately 2,200 stockholders of record of our common shares.

We have never paid or declared any cash dividends on our common shares. At present, we intend to retain our future earnings, if any, to fund our operations and the growth of our business. Furthermore, our credit agreements restrict our payment of cash dividends on our common shares, unless certain requirements are met. Our future decisions concerning the payment of dividends on our common shares will depend upon our results of operations, financial condition, and capital expenditure and investment plans, as well as other factors as our Board of Directors, in its discretion, may consider relevant, and the extent to which the declaration or payment of dividends may be limited by agreements we have entered or cause us to lose the benefits of certain of our agreements.

On December 15, 2014, pursuant to our 2014 equity compensation plan, or our Share Award Plan, we granted an aggregate of 353,050 of our common shares, valued at \$4.40 per share, the closing price of our common shares on the NYSE on that day, to our officers and certain employees of RMR. We made these grants pursuant to an exemption from registration contained in Section 4(a)(2) of the Securities Act of 1933, as amended.

In 2014, employees and officers of ours who are recipients of our share awards were permitted to elect to have us withhold the number of their then vesting common shares with a fair market value equal to, but not greater than, the minimum required tax withholding obligations with respect to their vesting share awards in satisfaction of those withholding obligations. In December 2014, we acquired through this share withholding process an aggregate of 11,377 common shares with an aggregate value of approximately \$47,000.

Item 6. Selected Financial Data

The following table sets forth selected financial data for the periods and dates indicated. Our comparative results are impacted by community acquisitions and dispositions during the periods shown. This data should be read in conjunction with, and is qualified in its entirety by reference to “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Annual Report on Form 10 K and our Consolidated Financial Statements and accompanying notes included in Part IV, Item 15 of this Annual Report on Form 10 K.

Table of Contents

	Year ended December 31,				
	2014	2013	2012	2011	2010
	(in thousands, except per share data)				
<b>Operating data:</b>					
Total revenues	\$ 1,328,075	\$ 1,296,787	\$ 1,207,806	\$ 1,060,602	\$ 991,195
Net (loss) income from continuing operations	(79,350)	3,449	10,590	75,555	23,566
Net (loss) income from discontinued operations	(6,056)	(5,789)	11,717	(3,381)	(1,213)
Net (loss) income	(85,406)	(2,340)	22,307	72,174	22,353
<b>Basic net (loss) income per share:</b>					
(Loss) income from continuing operations	(1.65)	0.07	0.23	1.79	0.65
(Loss) income from discontinued operations	(0.13)	(0.12)	0.24	(0.08)	(0.03)
Net (loss) income	(1.78)	(0.05)	0.47	1.71	0.62
<b>Diluted net (loss) income per share:</b>					
(Loss) income from continuing operations	(1.65)	0.07	0.23	1.70	0.63
(Loss) income from discontinued operations	(0.13)	(0.12)	0.23	(0.08)	(0.03)
Net (loss) income	(1.78)	(0.05)	0.46	1.62	0.60
<b>Balance sheet data (as of December 31):</b>					
Total assets	534,973	590,183	594,991	600,301	379,897
Total long term indebtedness	49,373	36,461	37,621	75,996	37,905
Other long term obligations	43,426	44,816	43,067	38,039	39,211

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

## GENERAL INDUSTRY TRENDS

The senior living industry generally is experiencing growth as a result of demographic factors. According to census data, the population in the United States over age 75 is growing much faster than the general population. A large number of independent and assisted living communities were built in the 1990s. This development activity caused an excess supply of new, high priced communities. Longer than projected fill up periods resulted in low occupancy, price discounting and financial distress for many independent and assisted living operators. Development activity was significantly reduced beginning in the early part of the last decade. We believe that the nationwide supply and demand for these types of facilities is about balanced today. We believe that the aging of the United States population and the significant reliance of independent and assisted living services upon revenues from residents' private resources may enable these types of facilities to be profitably operated.

The increasing availability of assisted living facilities in the 1990s caused occupancy at many SNFs to decline. This fact, together with restrictions on development of new SNFs by most states and assisted living facilities in some states, has generally caused nursing care to be delivered in older facilities. We believe that many SNFs currently in operation are becoming physically obsolete and that political pressures from an aging population will eventually cause

governmental authorities to permit increased new construction.

Beginning in 2007, problems in certain domestic credit markets presaged a global credit crisis that led to a recession in the United States. The recession resulted in aggressive government spending in the United States, significant employee layoffs, reduced availability of credit on reasonable terms in most markets, and lower real estate prices. The weakened economic conditions created by the recession negatively affected our occupancy. While the economy continued to grow and the housing market continued to improve in 2014, it is unclear whether that growth and improvement will continue or be sustained, in light of the modest, variable and unsteady economic improvements experienced since the end of the recent U.S. economic recession. Although many of the services we provide are needs driven, some of those needs may be deferred during recessions; for example, relocating to a senior living community may be delayed when sales of houses are delayed. Also, we believe we experience greater pricing pressures from competition during periods when the industry as a whole has lower occupancy as a result of macro economic conditions, such as those which occurred during the recent recession.

## OPERATIONS

We earn our senior living revenue primarily by providing housing and services to our senior living residents. During 2014, approximately 23% of our senior living revenues from continuing operations came from the Medicare and

## Table of Contents

Medicaid programs and approximately 77% of our senior living revenues from continuing operations came from residents' private resources. We bill all private pay residents in advance for the housing and services to be provided in the following month.

Our material expenses are:

- Wages and benefits—includes wages and wage related expenses, such as health insurance, workers' compensation insurance and other benefits for our employees working at our senior living communities.
- Other senior living operating expenses—includes utilities, housekeeping, dietary, maintenance, marketing, insurance and community level administrative costs at our senior living communities.
- Rent expense—as of December 31, 2014, we lease 181 senior living communities (including four that we have classified as discontinued operations) from SNH and four senior living communities from HCP.
- General and administrative expenses—principally wage related costs for headquarters and regional staff supporting our communities.
- Costs incurred on behalf of managed communities—includes wages and benefits for staff and other operating expenses related to the communities that we manage for the account of SNH, which are reimbursed to us by SNH, including from revenues we receive from the applicable managed communities, pursuant to our management agreements with SNH.
- Depreciation and amortization expense—we incur depreciation expense on buildings and furniture and equipment that we own and we incur amortization expense on certain identifiable intangible assets.
- Interest and other expenses—primarily includes interest on outstanding debt and amortization of deferred financing costs.

We have two operating segments: senior living communities and rehabilitation and wellness. In the senior living community segment, we operate for our own account or manage for the account of third parties independent living communities, assisted living communities and SNFs that are subject to centralized oversight and provide housing and services to elderly residents. Our rehabilitation and wellness operating segment does not meet any of the quantitative thresholds of a reportable segment as prescribed under Financial Accounting Standards Board, or FASB, Accounting Standards Codification™, or ASC, Topic 280, and therefore, we have determined that our business is comprised of one reportable segment, senior living. All of our operations and assets are located in the United States, except for the operations of our captive insurance company subsidiary, which participates in our workers' compensation, professional liability and automobile insurance programs and which is organized in the Cayman Islands.

## INVESTMENT AND DISPOSITION ACTIVITIES

In September 2012, we completed the sale of our pharmacy business to Omnicare. We received \$34.3 million in sale proceeds, which included \$3.8 million in working capital. We recorded a pre tax capital gain on sale of the pharmacy business of \$23.3 million. In connection with the sale, Omnicare did not acquire the real estate we own associated with one pharmacy located in South Carolina. In July 2014, we sold this real estate for a sales price of \$0.2 million.

In April 2013, we sold two SNFs we owned with a total of 271 living units located in Michigan for an aggregate sale price of \$8.0 million, which included the prepayment by the buyer of the then outstanding \$7.5 million of HUD mortgage debt that encumbered those SNFs.

In June 2013, we decided to offer for sale an assisted living community we own with 32 living units located in Alabama.

Table of Contents

In December 2013, we and SNH completed the sale of the real estate and the transfer of operations at two rehabilitation hospitals and 13 out-patient clinics affiliated with those rehabilitation hospitals to unrelated third parties. We previously leased the rehabilitation hospitals from SNH and the out-patient clinics from others. As a result of this transaction, SNH received proceeds of approximately \$90.0 million for the sale of the real estate associated with the rehabilitation hospitals, we retained certain net assets of approximately \$9.6 million and our annual rent payable to SNH and others decreased by approximately \$11.5 million. In 2013, we recorded losses of \$2.2 million relating to closing costs and legal fees associated with this transaction and we incurred \$2.6 million of non-cash asset impairment charges to reduce the fixed assets we owned which are related to the rehabilitation hospitals to their estimated fair market values.

We and SNH previously agreed that SNH would offer for sale 11 senior living communities we lease from SNH. We and SNH have completed the following sales related to these properties:

In August 2013, we and SNH sold a SNF with 112 living units located in Missouri for a sale price of \$2.6 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.3 million, or 10% of the net proceeds of the sale to SNH, in accordance with the terms of the applicable lease.

In January 2014, we and SNH sold an assisted living community with 48 living units located in Texas for a sale price of \$2.4 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.2 million in accordance with the terms of the applicable lease.

In June 2014, we and SNH sold two SNFs with an aggregate of 139 living units located in Wisconsin for a sale price of \$4.5 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.5 million in accordance with the terms of the applicable lease.

In October 2014, we and SNH sold an assisted living community with 55 living units located in Virginia for a sale price of \$2.9 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.3 million in accordance with the terms of the applicable lease.

Also in October 2014, we and SNH sold an assisted living community and a SNF with an aggregate of 160 living units located in Arizona for a sale price of \$5.9 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$0.6 million in accordance with the terms of the applicable lease.

In February 2015, we and SNH sold an assisted living community with 103 living units located in Pennsylvania for a sale price of \$0.3 million, and as a result of this sale, our annual minimum rent payable to SNH decreased by approximately \$22,500 in accordance with the terms of the applicable lease.

We recorded \$1.3 million of asset impairment charges during 2013 to reduce the assets we own relating to these 11 communities to their estimated fair market values, less costs to sell.

We can provide no assurance that we will be able to sell the senior living community that we are offering for sale, or that we and SNH will be able to sell the remaining three senior living communities we lease from SNH that are being offered for sale, or what the terms or timing of any sales may be.

In May 2014, we acquired a senior living community with 116 living units located in Alabama for approximately \$19.9 million, including the assumption of approximately \$13.9 million of mortgage debt and the assumption of approximately \$0.1 million of net working capital liabilities, but excluding closing costs.

In December 2014, we began managing two senior living communities in Wisconsin. We manage these communities for SNH's account pursuant to separate long term management agreements for communities that include assisted living units.

In March 2015, we entered into agreements to acquire two independent living communities with 68 and 84 living units, respectively, located in Tennessee for approximately \$26.0 million, including the assumption of

37

---



Table of Contents

approximately \$17.0 million of mortgage debt. We expect to fund this acquisition with cash on hand and borrowings under our Credit Facility. We expect this transaction to close during the second quarter of 2015.

During 2014 and 2013, we made capital expenditures for property, plant and equipment related to our continuing operations, on a net basis after considering the proceeds from sales of property and equipment to SNH, of \$24.1 million and \$29.1 million, respectively.

During 2014 and 2013, we received gross proceeds of \$10.9 million and \$6.3 million, respectively, in connection with the sale of available for sale securities and recorded a net realized gain of \$0.4 million and a net realized loss of \$5,000, respectively.

## Key Statistical Data For the Years Ended December 31, 2014 and 2013

The following tables present a summary of our operations for the years ended December 31, 2014 and 2013:

(dollars in thousands, except average monthly rate)	Year Ended December 31,				
	2014	2013	Change	%/bps	Change
Senior living revenue	\$ 1,099,228	\$ 1,077,062	\$ 22,166	2.1	%
Management fee revenue	9,765	9,234	531	5.8	%
Reimbursed costs incurred on behalf of managed communities	219,082	210,491	8,591	4.1	%
Total revenue	1,328,075	1,296,787	31,288	2.4	%
Senior living wages and benefits	(533,549)	(525,733)	(7,816)	(1.5)	%
Other senior living operating expenses	(292,457)	(265,945)	(26,512)	(10.0)	%
Costs incurred on behalf of managed communities	(219,082)	(210,491)	(8,591)	(4.1)	%
Rent expense	(197,359)	(193,820)	(3,539)	(1.8)	%
General and administrative expenses	(72,385)	(63,509)	(8,876)	(14.0)	%
Depreciation and amortization expense	(31,834)	(27,022)	(4,812)	(17.8)	%
Impairment of long-lived assets	(589)	(186)	(403)	(216.7)	%
Interest, dividend and other income	867	781	86	11.0	%
Interest and other expense	(5,131)	(5,227)	96	1.8	%
Loss on early extinguishment of debt	—	(599)	599	100.0	%
Gain (loss) on sale of available for sale securities	392	(5)	397	7,940.0	%
Provision for income taxes	(56,385)	(1,916)	(54,469)	(2,842.8)	%
Equity in earnings of an investee	87	334	(247)	(74.0)	%
(Loss) income from continuing operations	\$ (79,350)	\$ 3,449	\$ (82,799)	(2400.7)	%
Total number of communities (end of period):					
Owned and leased communities	212	211	1	0.5	%
Managed communities	46	44	2	4.5	%
Number of total communities(1)	258	255	3	1.2	%

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

Total number of living units (end of period):							
Owned and leased living units	23,101		22,986		115	0.5	%
Managed living units	7,278		7,051		227	3.2	%
Number of total living units	30,379		30,037		342	1.1	%
Owned and leased communities:							
Occupancy %	86.0	%	85.9	%	n/a	10	bps
Average monthly rate(2)	\$ 4,516		\$ 4,433		\$ 83	1.9	%
Percent of senior living revenue from Medicaid	10.9	%	10.9	%	n/a	—	bps
Percent of senior living revenue from Medicare	11.9	%	12.5	%	n/a	(60)	bps
Percent of senior living revenue from private and other sources	77.2	%	76.6	%	n/a	60	bps

---

(1) Excludes those senior living communities we have classified as discontinued operations.

(2) Average monthly rate is calculated as total operating revenues divided by occupied units during the period, multiplied by 30 days.

Table of Contents

Comparable communities (senior living communities that we have owned or leased and operated continuously since January 1, 2013):

(dollars in thousands, except average monthly rate)	Year Ended December 31,		Change	%/bps Change	
	2014	2013			
Senior living revenue	\$ 1,095,917	\$ 1,077,062	\$ 18,855	1.8	%
Management fee revenue	9,249	9,234	15	0.2	%
Senior living wages and benefits	(532,256)	(525,733)	(6,523)	(1.2)	%
Other senior living operating expenses	(291,656)	(265,945)	(25,711)	(9.7)	%
Total number of communities (end of period):					
Owned and leased communities	211	211	n/a	—	
Managed communities	39	39	n/a	—	
Number of total communities(1)	250	250	n/a	—	
Total number of living units (end of period):					
Owned and leased living units	22,948	22,948	n/a	—	
Managed living units	6,678	6,678	n/a	—	
Number of total living units(2)	29,626	29,626	n/a	—	
Owned and leased communities:					
Occupancy %	86.0	% 85.9	% n/a	10	bps
Average monthly rate(3)	\$ 4,519	\$ 4,433	\$ 86	1.9	%
Percent of senior living revenue from Medicaid	10.9	% 10.9	% n/a	—	bps
Percent of senior living revenue from Medicare	11.9	% 12.5	% n/a	(60)	bps
Percent of senior living revenue from private and other sources	77.2	% 76.6	% n/a	60	bps

(1) Excludes those senior living communities we have classified as discontinued operations.

(2) Excludes 38 living units in one senior living community that was temporarily closed for a major renovation during part of 2013 and 2014.

(3) Average monthly rate is calculated as total operating revenues divided by occupied units during the period, multiplied by 30 days.

Year ended December 31, 2014 Compared to year ended December 31, 2013

Our senior living revenue increased by 2.1% for the year ended December 31, 2014 compared to the year ended December 31, 2013 primarily due to increased average monthly rates to residents who pay privately for our services and a modest increase in occupancy, partially offset by a \$4.3 million revenue reserve to account for the repayment of Medicare payments that we have discovered were not received in compliance with applicable Medicare regulations.

Our management fee revenue and reimbursed costs at our managed communities increased 5.8% and 4.1%, respectively, during the year ended December 31, 2014 compared to the year ended December 31, 2013 due to an increase during 2014 in the number of communities we managed from 44 to 46, the senior living communities we began managing during the year ended December 31, 2013 being reflected for the full period for the year ended December 31, 2014, and increases in our management fee revenues and reimbursed costs at our comparable managed communities, which was primarily due to increases in occupancy.

Our senior living wages and benefits increased by 1.5% for the year ended December 31, 2014 compared to the year ended December 31, 2013 primarily due to increased employee health insurance costs.

Our other senior living operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, increased by 10.0% due to increased professional fees and estimated penalties and other costs we have incurred or expect to incur in connection with an ongoing compliance related assessment at one of our SNFs, increased charges related to outsourcing certain of our housekeeping services, increased reserves and claims paid relating to our professional and general liability insurance program and increased utility and maintenance costs due to severe weather conditions experienced during the first quarter of 2014.

Our rent expense increased by 1.8% compared to the year ended December 31, 2013 primarily due to additional rent resulting from senior living community capital improvements we sold to SNH since January 1, 2014, in accordance with the terms of the applicable leases.

Table of Contents

General and administrative expenses increased by 14.0% for the year ended December 31, 2014 compared to the year ended December 31, 2013 primarily due to costs incurred in connection with the restatement of certain of our previously issued financial statements and the delayed preparation of our 2013 and 2014 financial statements.

Our depreciation and amortization expense increased by 17.8% for the year ended December 31, 2014 compared to the year ended December 31, 2013 primarily due to capital expenditures (net of our sales of capital improvements to SNH), including depreciation costs arising from our purchase of furniture and fixtures for our owned communities.

Impairment of long-lived assets increased for the year ended December 31, 2014 compared to the year ended December 31, 2013 due to larger impairment charges recognized for 2014 than 2013 to reduce the carrying values of certain of our long-lived assets in continuing operations to their estimated fair values.

Our interest, dividend and other income increased by 11.0% for the year ended December 31, 2014 compared to the year ended December 31, 2013 primarily due to increased dividends realized on our investments.

Our interest and other expense decreased by 1.8% for the year ended December 31, 2014 compared to the year ended December 31, 2013 primarily due to our redemption in July 2013 of all of the \$24.9 million in principal amount of the Notes then outstanding and the prepayment by the buyer of two of our SNFs we sold in April 2013 of our then outstanding mortgage debt that encumbered those SNFs, partially offset by increased costs incurred under our Credit Facility for the year ended December 31, 2014 compared to the year ended December 31, 2013. We recorded a loss on early extinguishment of debt, net of unamortized issuance costs, of \$0.6 million related to the redemption of the Notes in 2013.

Gain (loss) on available for sale securities represents our realized gain or loss on investments.

For the year ended December 31, 2014, we recognized income tax expense from continuing operations of \$56.4 million, of which \$0.8 million represents current state tax expense that is payable without regard to our tax loss carry forwards. The increase in our provision for income taxes compared to the year ended December 31, 2013 is a result of our establishing a valuation allowance of \$73.3 million against our net deferred tax assets. See Note 5 to the Notes to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10-K for additional information. We also recognized in the year ended December 31, 2014 income tax expense from discontinued operations of \$0.1 million. As of December 31, 2014, our federal NOLs, which begin expiring in 2026 if unused, were approximately \$112.2 million, and our tax credit carry forward, which begins to expire in 2022 if unused, was approximately \$17.2 million.

Equity in earnings of an investee represents our proportionate share of earnings from AIC.

Discontinued operations:

We recorded a loss from discontinued operations for the year ended December 31, 2014 of \$6.1 million, compared to loss of \$5.8 million for the year ended December 31, 2013. The loss for 2014 was primarily due to losses incurred at assisted living communities and SNFs that we have sold or expect to sell. Loss from discontinued operations for the year ended December 31, 2013 is primarily due to losses we incurred at assisted living communities, SNFs and our rehabilitation hospital business that we have sold or expect to sell. The loss for the year ended December 31, 2014 included income tax expense of \$0.1 million that we recognized in that period related to our discontinued operations.



Table of Contents

## Key Statistical Data For the Years Ended December 31, 2013 and 2012

The following tables present a summary of our operations for the years ended December 31, 2013 and 2012:

(dollars in thousands, except average monthly rate)	For the years ended December 31,						
	2013	2012	Change	%/bps	Change		
Senior living revenue	\$ 1,077,062	\$ 1,074,333	\$ 2,729	0.3	%		
Management fee revenue	9,234	5,817	3,417	58.7	%		
Reimbursed costs incurred on behalf of managed communities	210,491	127,656	82,835	64.9	%		
Total revenue	1,296,787	1,207,806	88,981	7.4	%		
Senior living wages and benefits	(525,733)	(522,444)	(3,289)	(0.6)	%		
Other senior living operating expenses	(265,945)	(261,857)	(4,088)	(1.6)	%		
Costs incurred on behalf of managed communities	(210,491)	(127,656)	(82,835)	(64.9)	%		
Rent expense	(193,820)	(190,184)	(3,636)	(1.9)	%		
General and administrative expenses	(63,509)	(61,817)	(1,692)	(2.7)	%		
Depreciation and amortization expense	(27,022)	(24,480)	(2,542)	(10.4)	%		
Impairment of long-lived assets	(186)	—	(186)	(100.0)	%		
Gain on settlement	—	3,365	(3,365)	(100.0)	%		
Interest, dividend and other income	781	881	(100)	(11.4)	%		
Interest and other expense	(5,227)	(6,268)	1,041	16.6	%		
(Loss) gain on early extinguishment of debt	(599)	45	(644)	(1,431.1)	%		
Loss on sale of available for sale securities	(5)	(19)	14	73.7	%		
Provision for income taxes	(1,916)	(7,098)	5,182	73.0	%		
Equity in earnings of Affiliates Insurance Company	334	316	18	5.7	%		
Income from continuing operations	\$ 3,449	\$ 10,590	\$ (7,141)	(67.4)	%		
Total number of communities (end of period):							
Owned and leased communities	211	211	—	—			
Managed communities	44	39	5	12.8	%		
Number of total communities(1)	255	250	5	2.0	%		
Total number of living units (end of period):							
Owned and leased living units	22,986	22,986	—	—			
Managed living units	7,051	6,678	373	5.6	%		
Number of total living units	30,037	29,664	373	1.3	%		
Occupancy %	85.9	%	86.4	%	n/a	(50)	bps
Average monthly rate(2)	\$ 4,433		\$ 4,373		\$ 60	1.4	%
Percent of senior living revenue from Medicaid	10.9	%	11.2	%	n/a	(30)	bps
Percent of senior living revenue from Medicare	12.5	%	12.7	%	n/a	(20)	bps
Percent of senior living revenue from private and other sources	76.6	%	76.1	%	n/a	50	bps

- (1) Excludes those senior living communities we have classified as discontinued operations.
- (2) Average monthly rate is calculated as total operating revenue divided by occupied units during the period, multiplied by 30 days.

41

---



Table of Contents

Comparable communities (senior living communities that we have owned or leased and operated continuously since January 1, 2012):

(dollars in thousands, except average monthly rate)	2013	2012	Change	%/bps	Change
Senior living revenue	\$ 1,077,062	\$ 1,074,333	\$ 2,729	0.3	%
Management fee revenue	4,462	3,228	1,234	38.2	%
Senior living wages and benefits	(525,733)	(522,444)	(3,289)	(0.6)	%
Other senior living operating expenses	(265,945)	(261,857)	(4,088)	(1.6)	%
Total number of communities (end of period):					
Owned and leased communities	211	211	n/a	—	
Managed communities	23	23	n/a	—	
Number of total communities(1)	234	234	n/a	—	
Total number of living units (end of period):					
Owned and leased living units	22,948	22,948	n/a	—	
Managed living units	3,390	3,390	n/a	—	
Number of total living units(2)	26,338	26,338	n/a	—	
Owned and leased communities:					
Occupancy %	85.9	% 86.3	% n/a	(40)	bps
Average monthly rate(3)	\$ 4,433	\$ 4,373	\$ 60	1.4	%
Percent of senior living revenue from Medicaid	10.9	% 11.2	% n/a	(30)	bps
Percent of senior living revenue from Medicare	12.5	% 12.7	% n/a	(20)	bps
Percent of senior living revenue from private and other sources	76.6	% 76.1	% n/a	50	bps

(1) Excludes those senior living communities we have classified as discontinued operations.

(2) Excludes 38 living units in one senior living community that was temporarily closed for a major renovation during part of 2013.

(3) Average monthly rate is calculated as total operating revenue divided by occupied units during the period, multiplied by 30 days.

Year ended December 31, 2013 Compared to year ended December 31, 2012

Our senior living revenue increased by 0.3% for the year ended December 31, 2013 compared to the year ended December 31, 2012 primarily due to increased per diem charges to private pay residents, partially offset by a decrease in occupancy and federal government sequestration rate cuts which negatively impacted our Medicare rates.

Our management fee revenue and reimbursed costs at our managed communities increased during the year ended December 31, 2013 compared to the year ended December 31, 2012 due to an increase during 2013 in the number of

communities we managed from 39 to 44, the senior living communities we began managing during the year ended December 31, 2012 being reflected for the full period for the year ended December 31, 2013, and increases in our management fee revenues and reimbursed costs at our comparable managed communities, primarily due to increases in occupancy.

Our senior living wages and benefits increased by 0.6% for the year ended December 31, 2013 compared to the year ended December 31, 2012 primarily due to increased employee health insurance and workers' compensation costs, partially offset by certain lower wage costs.

Our other senior living operating expenses, which include utilities, housekeeping, dietary, maintenance, insurance and community level administrative costs, increased by 1.6% due to increased charges from various service providers, increased costs relating to our professional liability insurance program, increased utility costs due to severe weather conditions and general maintenance expenses.

Our rent expense increased by 1.9% compared to the year ended December 31, 2012 primarily due to additional rent resulting from senior living community capital improvements we sold to SNH since January 1, 2012, in accordance with the terms of the applicable lease.

General and administrative expenses increased by 2.7% for the year ended December 31, 2013 compared to the year ended December 31, 2012 primarily due to costs incurred in connection with the restatement of certain of our

Table of Contents

previously issued financial statements and increased business management fees resulting from the increased size of our business, partially offset by lower costs associated with certain third party services.

Our depreciation and amortization expense increased by 10.4% for the year ended December 31, 2013 compared to the year ended December 31, 2012 primarily due to capital expenditures (net of our sales of capital improvements to SNH), including depreciation costs arising from our purchase of furniture and fixtures for our owned communities.

Impairment of long-lived assets increased for the year ended December 31, 2013 compared to the year ended December 31, 2012 due to impairment charges recognized for 2013 to reduce the carrying values of certain of our long-lived assets in continuing operations to their estimated fair values.

Gain on settlement represents our gain recorded, net of legal fees, pursuant a settlement agreement, or the Settlement Agreement, with subsidiaries of Sunrise Senior Living Inc., or Sunrise.

Our interest, dividend and other income decreased by 11.4% for the year ended December 31, 2013 compared to the year ended December 31, 2012 due to lower investable cash balances and lower yields realized on our investments.

Our interest and other expense decreased by 16.6% for the year ended December 31, 2013 compared to the year ended December 31, 2012 primarily due to our redemption of \$12.4 million in principal amount of the Notes then outstanding and our repayment and subsequent termination of the bridge loan from SNH, or the Bridge Loan, in 2012 and our redemption of all of the \$24.9 in million principal amount of the Notes then outstanding in 2013.

Loss on available for sale securities represents our realized loss on investments.

For the year ended December 31, 2013, we recognized tax expense from continuing operations of \$1.9 million of which \$1.1 million represents current state tax expense that is payable without regard to our tax loss carry forwards. The 2013 tax provision also includes a tax benefit of \$1.5 million relating to a work opportunity tax credit program that expired in 2012 and which was retroactively reinstated on January 3, 2013 and extended by the American Taxpayer Relief Act of 2012, which was enacted on January 2, 2013. As prescribed by FASB ASC Topic 740, Accounting for Income Taxes, the effects of tax law changes are recognized in the period in which new legislation is enacted; and the total effect of the reinstatement of the work opportunity tax credit program relating to 2012 employee wages was recorded as a component of income tax expense in continuing operations during the first quarter of 2013. We also recognized in the year ended December 31, 2013 a tax benefit from discontinued operations of \$3.5 million. As of December 31, 2013, our federal net operating loss carry forward, which begins to expire in 2026 if unused, was approximately \$81.6 million, and our tax credit carry forward, which begins to expire in 2022 if unused, was

approximately \$15.3 million.

Equity in earnings of an investee represents our proportionate share of earnings from AIC.

Discontinued operations:

We recorded a loss from discontinued operations for the year ended December 31, 2013 of \$5.8 million, compared to income of \$11.7 million for the year ended December 31, 2012. The loss in 2013 is primarily due to losses incurred at assisted living communities, SNFs and our rehabilitation hospitals that we have sold or expect to sell, which includes an impairment charge for long-lived assets of \$4.2 million. Income from discontinued operations for the year ended December 31, 2012 is primarily due to the \$23.3 million gain on sale that we recorded relating to the sale of our pharmacy business, partially offset by income tax expense of \$5.4 million and losses we incurred at assisted living communities, SNFs and our rehabilitation hospital business that we have sold or expect to sell. The loss for the year ended December 31, 2013 is after giving effect to a tax benefit of \$3.5 million that we recognized in that period related to our discontinued operations.

Table of Contents

## LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2014, we had \$21.0 million of unrestricted cash and cash equivalents and \$25.0 million and \$114.4 million available to borrow under our Credit Agreement and our Credit Facility, respectively. We expect to use the cash flow from our operations, our cash balances, borrowings under our Credit Agreement and our Credit Facility and proceeds from our sales to SNH of qualified capital improvements we may make to properties that we lease from SNH for increased rent pursuant to our leases with SNH to fund our operations, debt repayments, investments in and maintenance of our properties, future property acquisitions and other general business purposes. We have also in the past assumed mortgage debt in connection with certain of our acquisitions and we may do so in the future. We believe such amounts will be sufficient to fund these activities for the next 12 months and for the foreseeable future thereafter. If, however, our occupancies decline from historic levels, the non government rates we receive for our services decline or government reimbursement rates are reduced and we are unable to generate positive cash flow for an extended period, we expect that we would explore alternatives to fund our operations. Such alternatives may include reducing our costs, incurring debt under, and perhaps in addition to, our Credit Agreement and our Credit Facility, engaging in sale leaseback transactions of our owned communities, mortgage financing our owned communities that are not subject to existing mortgages and issuing new debt or equity securities.

## Available for Sale Securities

We routinely evaluate our available for sale investments to determine if they have been impaired. If the fair value of an investment is less than its book or carrying value and we expect that situation to continue for a more than a temporary period, we will record an “other than temporary impairment” loss in our consolidated statements of operations. We evaluate the fair value of our available for sale investments by reviewing each security’s current market price, the ratings of the security, the financial condition of the issuer, and our intent and ability to retain the investment during temporary market price fluctuations or until maturity. In evaluating the factors described above, we presume a decline in value to be an “other than temporary impairment” if the quoted market price of the security is below the security’s cost basis for an extended period. However, this presumption may be overcome if there is persuasive evidence indicating the value decline is temporary in nature, such as when the operating performance of the obligor is strong or if the market price of the security is historically volatile. Additionally, there may be instances in which impairment losses are recognized even if the decline in value does not fall within the criteria described above, such as if we plan to sell the security in the near term and the fair value is below our cost basis. When we believe that a change in fair value of an available for sale security is temporary, we record a corresponding credit or charge to other comprehensive income for any unrealized gains and losses. When we determine that impairment in the fair value of an available for sale security is an “other than temporary impairment”, we record a charge to earnings. We did not record an impairment charge for the years ended December 31, 2014, 2013 or 2012 for our available for sale securities.

## Assets and Liabilities

At December 31, 2014, we had cash and cash equivalents of \$21.0 million compared to \$23.6 million at December 31, 2013. Our total current assets at December 31, 2014 were \$121.8 million, compared to \$150.9 million at December 31, 2013. The decrease in our total current assets at December 31, 2014 compared to December 31, 2013 primarily resulted from a decrease in our assets of discontinued operations, specifically the collection of accounts receivable from our former rehabilitation hospitals and the establishment of a full valuation allowance against our current deferred tax assets. Our current and long term liabilities were \$215.4 million and \$92.8 million, respectively, at December 31, 2014 compared to \$198.5 million and \$81.3 million, respectively, at December 31, 2013. The increase in our total current liabilities was primarily due to timing of certain accounts payable and accrued expenses, including reserves we have established in connection with our ongoing investigation and assessment of certain Medicare billing deficiencies. The increase in our total long term liabilities was primarily due to the assumption of mortgage debt in connection with our acquisition of a senior living community in the second quarter of 2014.

We had net cash flows from continuing operations of \$22.3 million for the year ended December 31, 2014 compared to \$35.8 million for the year ended December 31, 2013. Acquisitions of property and equipment, on a net basis after considering the proceeds from sales of such assets to SNH, were \$24.1 million and \$29.1 million for the years

## Table of Contents

ended December 31, 2014 and 2013, respectively. During 2013, we redeemed and retired all of the \$24.9 million in principal amount of the Notes then outstanding for \$24.9 million, plus accrued interest.

### Litigation Settlement

On May 29, 2012, we entered into the Settlement Agreement with Sunrise, pursuant to which we agreed to settle our long running litigation with Sunrise, involving amounts charged by Sunrise to us for certain insurance programs for senior living communities managed by Sunrise for us. Pursuant to the Settlement Agreement, Sunrise paid us \$4.0 million in cash and we recorded a gain of \$3.4 million, net of legal fees, in our consolidated statements of operations.

### Compliance Matters

During 2014, as a result of our compliance program to review medical records related to our Medicare billing practices, we discovered potentially inadequate documentation and other issues at one leased SNF. This compliance review was not initiated in response to any specific complaint or allegation, but it was a review of the type that we periodically undertake to test our compliance with applicable Medicare billing rules. As a result of these discoveries, we have made a voluntary disclosure of deficiencies to the U.S. Department of Health and Human Services Office of the Inspector General, or the OIG, pursuant to the OIG's Provider Self-Disclosure Protocol. While our assessment of these matters is ongoing, we have informed the OIG that we expect our investigation and assessment to be completed by May 13, 2015. As of December 31, 2014, we have accrued a revenue reserve of \$4.3 million to account for historical Medicare payments we expect to repay and we have accrued or expensed compliance costs of \$3.6 million including an expected penalty amount and certain costs of the investigation of this matter. As a result of the continuing investigation and assessment of these deficiencies, additional deficiencies may be discovered which could increase our liability to the OIG and other costs.

### Our Leases and Management Agreements with SNH

As of December 31, 2014, we leased 181 senior living communities (including four that we have classified as discontinued operations) from SNH under four leases. Our total annual rent payable to SNH as of December 31, 2014 was \$190.7 million, excluding percentage rent based on increases in gross revenues at certain properties. We paid approximately \$5.8 million, \$5.1 million and \$4.9 million in percentage rent to SNH for the years ended December 31, 2014, 2013 and 2012, respectively.

Upon our request, SNH may purchase capital improvements made at the properties we lease from SNH and increase our rent pursuant to contractual formulas; however, SNH is not obligated to purchase these improvements from us and we are not obligated to sell them to SNH. During the year ended December 31, 2014, SNH reimbursed us \$25.8 million for capital expenditures made at the properties leased from SNH and these purchases resulted in our annual rent being increased by approximately \$2.1 million.

Since January 1, 2014, we have entered into several management agreements, pooling agreements and lease amendments with SNH and its affiliates. For more information regarding these activities and our leases and management agreements with SNH, see Note 15 to our Consolidated Financial Statements for the year ended December 31, 2014, in Part IV, Item 15 in this Annual Report on Form 10-K, which is incorporated herein by reference.

### Our Revenues

Our revenues from services to residents at our senior living communities are our primary source of cash to fund our operating expenses, including rent, capital expenditures (net of capital improvements that we sell to SNH for increased rent pursuant to our leases with SNH) and principal and interest payments on our debt.

During the past several years, weak economic conditions throughout the country have negatively affected many businesses both in and outside of our industry. These conditions have resulted in, among other things, a decrease in our communities' occupancy, and it is unclear when these conditions, especially in the housing market, may materially



Table of Contents

improve. Although many of the services that we provide are needs-driven, some of our prospective residents may be deferring their decisions to relocate to senior living communities in light of current economic circumstances. In recent years, economic indicators reflect an improving housing market; however, even with these improvements, housing sales activity remains below pre-recession levels and it is unclear how sustainable the improvements will be and whether any such improvements will result in any increased demand for our services.

At some of our senior living communities (principally our SNFs) and our rehabilitation and wellness clinics, Medicare and Medicaid programs provide operating revenues for skilled nursing and rehabilitation services. We derived approximately 23%, 23% and 24% of our consolidated revenues from continuing operations from these programs for each of the years ended December 31, 2014, 2013 and 2012, respectively.

Our net Medicare revenues from services to senior living community residents from continuing operations totaled \$129.2 million, \$132.8 million and \$134.2 million for the years ended December 31, 2014, 2013 and 2012, respectively. Our net Medicaid revenues from services to senior living community residents from continuing operations totaled \$118.5 million, \$116.2 million and \$118.5 million for the years ended December 31, 2014, 2013 and 2012, respectively.

On July 31, 2014, CMS released its final rule for the Medicare PPS for SNFs for federal fiscal year 2015, which went into effect on October 1, 2014. As part of this rule, CMS will apply a net increase of 2% to Medicare payment rates for SNFs.

On April 1, 2014, PAMA extended the Medicare outpatient therapy cap exception process through March 31, 2015, further postponing the implementation of certain limits on Medicare payments for outpatient therapies. PAMA also extended the 0.5% increase to the MPFS rates through December 31, 2014 and provided no increase in the MPFS rates, to which Medicare outpatient therapy rates are tied, in the period between January 1, 2015 and March 31, 2015. Unless further delayed, the MPFS rates are scheduled to be reduced by 21.2% effective April 1, 2015.

Although Medicaid is exempt from the sequestration process described above, some of the states in which we operate either have not raised Medicaid rates by amounts sufficient to offset increasing costs or have frozen or reduced, or are expected to freeze or reduce Medicaid rates. Despite these freezes and reduced payments to states, according to the 2013 Actuarial Report on the Financial Outlook for Medicaid, Medicaid enrollment is projected to increase at an average annual rate of 3.3% through 2022, due in part to the expansion in Medicaid eligibility under the ACA beginning in 2014.

In addition, on November 7, 2014, the Supreme Court agreed to hear a lawsuit challenging the legality of an IRS regulation that allows eligible individuals in all states to receive subsidies for health insurance under the ACA, even in states that have not established their own health exchanges. Such subsidies have provided certain eligible taxpayers with the ability to purchase or maintain health insurance. We are unable to predict the outcome of that challenge or the impact on our business.

Medicare and Medicaid programs provided approximately 68% and 70% of our revenues from our rehabilitation hospitals, which are included in our discontinued operations, for the years ended December 31, 2013 and 2012, respectively. IRF Medicare payments may be subject to subsequent upwards or downwards adjustments as part of the cost report settlement process.

In addition, our rehabilitation hospitals were required to satisfy the 60% Rule in order to be classified as an IRF by the Medicare program. Pursuant to the 60% Rule, at least 60% of a facility's inpatient population must require intensive rehabilitation services for at least one of CMS's 13 designated medical conditions. An IRF that fails to meet the requirements of the 60% Rule is subject to reclassification as a different type of healthcare provider, the effect of

which would be to lower that IRF's Medicare payment rates. We believe that we operated our IRFs in compliance with the 60% Rule during the period in which we operated them; however, we can provide no assurance that CMS will not make a determination that we were non-compliant during this period. As previously noted, in the fourth quarter of 2013, we transferred our operations at our IRFs and affiliated clinics to third parties in connection with SNH's sale of those IRFs.

We cannot currently predict the type and magnitude of the potential Medicare and Medicaid policy changes, rate reductions or other changes and the impact on us of the possible failure of these programs to increase rates to match

Table of Contents

our increasing expenses, but they may be adverse and material to our operations and to our future financial results of operations. Similarly, we are unable to predict the impact on us of the insurance changes, payment changes, and healthcare delivery systems changes contained in and to be developed pursuant to the ACA. If the changes to be implemented under the ACA result in reduced payments for our services, or the failure of Medicare, Medicaid or insurance payment rates to cover our costs of providing required services to residents, our future financial results could be materially and adversely affected.

For further information regarding government regulation and their possible impact on us and our business, revenues and operations, see “Business - Government Regulation and Reimbursement” of this Annual Report on Form 10-K.

Insurance

Increases over time in the costs of insurance, especially professional liability insurance, workers’ compensation and employee health insurance, have had an adverse impact upon our results of operations. Although we self insure a large portion of these costs, our costs have increased as a result of the higher costs that we incur to settle claims and to purchase re insurance for claims in excess of the self insure amounts. These increased costs may continue in the future. We, RMR and other companies to which RMR provides management services are the shareholders of an insurance company which has designed and reinsured a property insurance program in which we and the other shareholders participate. For more information about our existing insurance see “Business—Insurance” of this Annual Report on Form 10 K.

Discontinued Operations

We have reclassified our consolidated balance sheets and our consolidated statements of operations for all periods presented in our financial statements to show the financial position and results of operations of our rehabilitation hospitals, pharmacies and the communities which have been sold or are expected to be sold as discontinued operations. Below is a summary of the operating results of these discontinued operations included in the consolidated financial statements for the years ended December 31, 2014, 2013 and 2012 (dollars in thousands):

	2014	2013	2012
Revenues	\$ 22,051	\$ 151,600	\$ 213,020
Expenses	(28,028)	(154,578)	(218,565)
Impairment on assets	—	(4,153)	(644)
(Provision for) benefit from income taxes	(79)	3,539	(5,441)
(Loss) gain on sale	—	(2,197)	23,347
(Loss) income from discontinued operations	\$ (6,056)	\$ (5,789)	\$ 11,717

Contractual Obligations Table

As of December 31, 2014, our contractual obligations from continuing and discontinued operations were as follows (dollars in thousands):

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

	Payment due by period				More than 5 years
	Total	Less than 1 year	1-3 years	3-5 years	
Contractual Obligations					
Long term debt obligations(1)	\$ 51,159	\$ 1,786	\$ 3,869	\$ 16,190	\$ 29,314
Projected interest on long term debt obligations(2)	20,029	2,692	5,086	4,011	8,240
Operating lease obligations(3)	2,433,556	193,247	386,649	386,864	1,466,796
Continuing care contracts(4)	1,370	—	673	410	287
Accrued self-insurance obligations(5)	37,268	—	26,474	8,318	2,476
Purchase commitments(6)	3,667	1,223	2,340	104	-
Total	\$ 2,547,049	\$ 198,948	\$ 425,091	\$ 415,897	\$ 1,507,113

---

(1) Long term debt obligations consist of the amounts due under two Federal National Mortgage Association, or FNMA, and three Federal Home Loan Mortgage Corporation, or FMCC, mortgages.

## Table of Contents

- (2) Projected interest on long term obligations is interest attributable to only the long term debt obligations listed above at existing rates and is not intended to project future interest costs which may result from debt prepayments, new debt issuances or change in interest rates.
- (3) Operating lease obligations consist of the annual lease payments to SNH and HCP through the lease terms ending between 2017 and 2028. These amounts do not include percentage rent that may become payable under these leases.
- (4) Non refundable resident continuing care contracts. See Note 2 to the Notes to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10 K for further information regarding these contracts.
- (5) Accrued self insurance obligations reflected on our balance sheet are insurance reserves related to workers' compensation and professional liability insurance.
- (6) Purchase commitments consist of information technology related support and hosting contracts we have with unrelated third party vendors.

### Debt Financings and Covenants

As of December 31, 2014, we had no outstanding borrowings under our Credit Agreement and \$35.0 million outstanding under our Credit Facility. As of December 31, 2014, we had \$51.2 million aggregate principal amount of mortgage notes outstanding. After giving effect to the amendment to our Credit Agreement discussed in Item 9B of this Annual Report on Form 10-K, as of December 31, 2014, we believe we were in compliance with all applicable covenants under our debt agreements. Our Credit Agreement matures in March 2016 and our Credit Facility matures April 2015. In March 2015, we notified the lenders under our Credit Facility of our intent to exercise our first one-year option to extend the maturity date of our Credit Facility to April 13, 2016. Subject to the payment of an extension fee and meeting certain other conditions, the lenders under our Credit Facility have agreed to extend our maturity date one year to April 13, 2016. There can be no assurance that we will be successful in renewing, refinancing or replacing either facility and any such renewal, refinancing or replacement may be on terms less favorable to us than the current terms. For more information regarding our debt financings and covenants, including terms governing such debt financings and their maturities, see Note 8 to the Notes to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10 K, which is incorporated herein by reference.

### Off Balance Sheet Arrangements

We have pledged certain of our assets, such as accounts receivable, with a carrying value, as of December 31, 2014, of \$13.7 million arising from our operation of 26 properties owned by SNH and leased to us to secure SNH's borrowings from its lender, FNMA. As of December 31, 2014, we had no other off balance sheet arrangements that have had or that we expect would be reasonably likely to have a future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### Related Person Transactions

We have historical and continuing transactions with certain related persons, including: SNH which is our former parent company, our largest shareholder, our largest landlord and the owner of senior living communities that we manage; RMR which provides management services to both us and to SNH and employs our President and Chief Executive Officer and our Treasurer and Chief Financial Officer and one of our Managing Directors who is the majority owner of RMR; D&R Yongers LLC which is owned by officers of SNH and for which we provide management services; and AIC which we, SNH, RMR and four other companies to which RMR provides management services, jointly own and through which we and other AIC shareholders have arranged certain insurance. Also, both our Managing Directors are directors of RMR, all of our Independent Directors also serve as independent directors or independent trustees of other companies managed by RMR and we lease our headquarters building from

an affiliate of RMR. For further information about these and other such relationships and related person transactions, please see Note 15 to the Notes to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10-K, which is incorporated herein by reference, and the section captioned "Business" above in Part I, Item 1 of this Annual Report on Form 10-K. In addition, for more information about these transactions and relationships and about the risks that may arise as a result of these and other related person transactions and relationships, please see elsewhere in this Annual Report on Form 10-K, including "Warning Concerning Forward Looking Statements" and Part I, Item 1A, "Risk Factors." Copies of certain of our agreements with these related parties, including our leases, forms of management agreements and related pooling agreements and former Bridge Loan

## Table of Contents

agreement with SNH, our management agreement with D&R Yonkers LLC, our business management agreement with RMR, our headquarters lease with an affiliate of RMR and our shareholders agreement with AIC and its six other shareholders, are publicly available as exhibits to our public filings with the SEC and accessible at the SEC's website, [www.sec.gov](http://www.sec.gov).

We believe that our agreements with SNH, RMR, D&R Yonkers LLC and AIC are on commercially reasonable terms. We also believe that our relationships with SNH, RMR, D&R Yonkers LLC and AIC and their affiliated and related persons and entities benefit us and, in fact, provide us with competitive advantages in operating and growing our business.

## Critical Accounting Policies

Our critical accounting policies concern revenue recognition, our assessments of the net realizable value of our accounts receivable and contractual allowances, reserves related to our self insurance programs, our valuations of our goodwill, other intangibles and long lived assets and our judgments and estimates concerning our provisions for income taxes.

Our revenue recognition policies involve judgments about Medicare and Medicaid rate calculations. These judgments are based principally upon our experience with these programs and our knowledge of current rules and regulations applicable to these programs. We recognize revenues when services are provided and these amounts are reported at their estimated net realizable amounts. Some Medicare and Medicaid revenues are subject to audit and retroactive adjustment and sometimes retroactive legislative changes.

Our policies for valuing accounts receivable involve significant judgments based upon our experience, including consideration of the age of the receivables, the terms of the agreements with our residents, their third party payers or other obligors, the residents' or payers' stated intent to pay, the residents' or payers' financial capacity and other factors which may include litigation or rate and payment appeal proceedings.

Determining reserves for Medicare repayment obligations and related costs including penalties, and the casualty, liability, workers' compensation and healthcare losses and costs that we have incurred as of the end of a reporting period involves significant judgments based upon our experience and our expectations of future events, including projected settlements for pending claims, known incidents which we expect may result in claims, estimates of incurred but not yet reported claims, expected changes in premiums for insurance provided by insurers whose policies provide for retroactive adjustments, estimated litigation costs and other factors. Since these reserves are based on estimates, the actual expenses we incur may differ from the amount reserved. We regularly adjust these estimates to reflect changes in the foregoing factors, our actual claims experience, recommendations from our professional consultants, changes in market conditions and other factors; it is possible that such adjustments may be material.

We review goodwill annually during the fourth quarter, or more frequently, if events or changes in circumstances exist, for impairment. If our review indicates that the carrying amount of goodwill exceeds its fair value, we reduce the carrying amount to fair value. We evaluate goodwill for impairment at the reporting unit level; our reporting units are equivalent to our operating segments. All of our goodwill is located in our senior living reporting unit. We evaluated goodwill for impairment by comparing the fair value of the senior living reporting unit, as determined by discounted cash flows and market approaches, with its carrying value. The key assumptions used in the discounted cash flow analysis include expected future revenue growth, gross margins and our weighted average cost of capital.

The key assumption in the market approach is the selection of guideline companies and the determination of earnings multiples. If the carrying value of the reporting unit exceeds our estimate of its fair value, we compare the implied fair value of the reporting unit's goodwill with its carrying amount to measure the amount of impairment loss. Our estimates of discounted cash flows as reflected in our baseline forecast may differ from actual cash flows due to, among other things, changes in economic conditions that adversely affect occupancy, reductions in government or third party reimbursement rates, changes to our business model or changes in operating performance affecting our gross margins. As a result of our annual goodwill impairment review, we believe that our goodwill was not impaired as of December 31, 2014.

As of our evaluation date, the fair value of the senior living reporting unit exceeds its carrying value by approximately 13%. As of December 31, 2014, our carrying amount of goodwill was \$25.3 million. The key variables



Table of Contents

that affect the cash flows of our senior living reporting unit are estimated revenue growth rates, estimated operating expenses excluding interest and taxes, estimated capital expenditures, growth rate assumptions and the weighted average cost of our capital. We select the revenue growth rate based on our view of the growth prospects of the senior living reporting unit considering expected occupancy and private pay and government and third party payment rates. Estimated operating expenses and capital expenditures are based upon our historical and expected future operations. These assumptions are subject to uncertainty, including uncertainties related to our ability to increase the reporting unit's revenue and improve its profitability. For the senior living reporting unit, relatively small declines in the future occupancy, payment rates or expenses and cash flows or small changes in other key assumptions may result in goodwill impairment charges. Future events that could have a negative effect on the fair value of our senior living reporting unit include, but are not limited to:

- Decreases in revenues due to decreases in occupancy or our rates,
- Decreases in revenues and profitability at our senior living communities due to the inability of residents who pay for our services with their private resources to afford our services,
- Future Medicare and Medicaid rate reductions and other changes from the ACA or other regulations or regulatory rulemaking that impact our revenues,
- Decreases in the reporting unit's gross margins and profitability due to increased labor or other costs, or our inability to successfully stabilize a newly acquired, leased or managed community's operations,
- Increases in the weighted average cost of our capital including changes in market interest rates, and
- Changes in the structure of our business as a result of changes in relationships with our related parties.

Changes in one or more of these factors could result in an impairment charge.

We review the carrying value of intangibles and long lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If there is an indication that the carrying value of an asset is not recoverable, we determine the amount of impairment loss, if any, by comparing the historical carrying value of the asset to its estimated fair value. We determine estimated fair value through an evaluation of recent financial performance, recent sales of similar assets, market conditions and projected undiscounted cash flows that our asset or asset groups are expected to generate. This process requires that estimates be made and if we misjudge or estimate incorrectly this could have a material effect on our financial statements. As a result of our intangibles and long lived assets impairment review, we recorded \$0.6 million of impairment charges to our intangibles and long lived assets related to our continuing operations as of December 31, 2014.

Our income tax expense, deferred tax assets and liabilities, and liabilities for unrecognized tax benefits reflect our assessment of estimated current and future taxes to be paid. We are subject to income taxes in the United States. Significant judgments and estimates are required in determining our income tax expense.

Deferred income taxes arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements, which will result in taxable or deductible amounts in the future. In evaluating our ability to recover our deferred tax assets, we consider all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax-planning strategies, and results of recent operations. In projecting future taxable income, we begin with historical results adjusted for the results of discontinued operations and incorporate assumptions about the amount of future state and federal pretax operating income adjusted for items that do not have tax consequences. The assumptions about future taxable income require significant judgment and are consistent with the plans and estimates we use to manage the underlying business. In evaluating the objective evidence that historical results provide, we consider three years of cumulative operating income or loss.



## Table of Contents

As of December 31, 2014, we established a valuation allowance against our deferred tax assets. The decision to establish the valuation allowance was due to our assessment of the available positive and negative evidence to estimate if sufficient future taxable income will be generated to realize the existing deferred tax assets. An important aspect of objective negative evidence evaluated was the significant losses incurred over the two-year period ending December 31, 2014 and, as a result of those losses, we expect to be in a cumulative loss position for the three-year period ending December 31, 2015. This objective negative evidence is difficult to overcome and would require a substantial amount of objectively verifiable positive evidence of future income to support the realizability of our deferred tax assets. For these reasons, we concluded that a full valuation allowance is required.

Some of our judgments and estimates are based upon published industry statistics and in some cases third party professionals. Any misjudgments or incorrect estimates affecting our critical accounting policy could have a material effect on our financial statements.

In the future we may need to revise the judgments, estimates and assessments we use to formulate our critical accounting policies to incorporate information which is not now known. We cannot predict the effect changes to the premises underlying our critical accounting policies may have on our future results of operations, although such changes could be material and adverse.

### Impact of Inflation and Deflation

Inflation in the past several years in the United States has been modest. Future inflation might have both positive and negative impacts on our business. Rising price levels may allow us to increase occupancy charges to residents, but may cause our operating costs, including our percentage rent, to increase. Also, our ability to realize rate increases paid by Medicare and Medicaid programs may be limited despite inflation.

Deflation would likely have a negative impact upon us. A large component of our expenses consists of our fixed minimum rental obligations. 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.

### Seasonality

Our senior living 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 relocations 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 lower 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.

### Impact of Climate Change

The current political debate about global climate change has resulted in various treaties, laws and regulations which are intended to limit carbon emissions. We believe these laws being enacted or proposed may cause energy costs at our communities to increase in the future. In the long term, we believe any such increased costs will be passed through and paid by our residents and other customers in higher charges for our services. However, in the short term, these increased costs, if material in amount, could materially and adversely affect our financial condition and results of operations.

There have recently been severe weather activities in different parts of the country that some observers believe evidence global climate change. Such severe weather that may result from climate change may have an adverse effect on individual properties we own or lease. We mitigate these risks by owning and leasing a diversified portfolio of properties and by procuring insurance coverage we believe adequate to protect us from material damages and losses from such activities. However, there can be no assurance that our mitigation efforts will be sufficient or that storms that may occur due to future climate change or otherwise could not have a material adverse effect on our business.

Table of Contents

## Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to risks associated with market changes in interest rates. We manage our exposure to this market risk by monitoring available financing alternatives. Other than as described below, we do not currently foresee any significant changes in our exposure to fluctuations in interest rates or in how we manage this exposure in the near future.

At December 31, 2014, our outstanding fixed rate debt consisted of the following (dollars in thousands, except per share data):

Debt	Principal Balance(1)	Annual Interest Rate(1)		Annual Interest Expense(1)	Maturity	Interest Payments Due
Mortgages	\$ 15,048	6.47	%	\$ 974	2018	Monthly
Mortgages	18,563	6.64	%	1,233	2023	Monthly
Mortgages	5,832	8.99	%	524	2025	Monthly
Mortgages	2,699	6.36	%	172	2028	Monthly
Mortgages	9,017	6.20	%	559	2032	Monthly
	\$ 51,159			\$ 3,461		

(1) The principal balances, annual interest rates and annual interest expense are, or are determined based upon, the amounts stated in the applicable contracts. In accordance with generally accepted accounting principles in the United States, our carrying values and recorded interest expense may differ from these amounts because of market conditions at the time we assumed certain of these debts.

Our mortgages require principal and interest payments through maturity pursuant to amortization schedules.

Because these debts bear interest at a fixed rate, changes in market interest rates during the term of these debts will not affect our interest obligations. If these debts were refinanced at interest rates which are 100 basis points higher or lower than shown above our per annum interest costs would increase or decrease by approximately \$0.5 million.

Changes in market interest rates would affect the fair value of our fixed rate debt obligations; increases in market interest rates decrease the fair value of our fixed rate debt, while decreases in market interest rates increase the fair value of our fixed rate debt. Based on the balances outstanding at December 31, 2014, and discounted cash flow analyses through the respective maturity dates, and assuming no other changes in factors that may affect the fair value of our fixed rate debt obligations, a hypothetical immediate 100 basis point change in interest rates would increase or decrease the fair value of those obligations by approximately \$2.7 million and \$2.5 million, respectively.

Our mortgages generally contain provisions that allow us to make repayments earlier than the stated maturity date. In some cases, we are not allowed to make early repayment prior to a cutoff date. Where prepayment is permitted, we are generally allowed to make prepayments only at a premium which is often designed to preserve a stated yield to the note holder. These prepayment rights may afford us opportunities to mitigate the risk of refinancing our debts at maturity at higher rates by refinancing prior to maturity.

At December 31, 2014, our floating rate debt consisted of \$35.0 million outstanding under our Credit Facility and no amounts outstanding under our Credit Agreement. Our Credit Facility matures in April 2016, subject to the payment

of an extension fee and meeting certain other conditions, and our Credit Agreement matures in March 2016. No principal repayments are required under our Credit Facility or our Credit Agreement prior to maturity, and prepayments may be made, and redrawn, subject to conditions, at any time without penalty. Borrowings under our Credit Facility and our Credit Agreement are in U.S. dollars and typically bear interest at LIBOR plus a premium. Accordingly, we are vulnerable to changes in U.S. dollar based short term interest rates, specifically LIBOR. In addition, upon renewal or refinancing of our Credit Facility or our Credit Agreement, we are vulnerable to increases in interest rate premiums due to market conditions or our perceived credit risk. A change in interest rates generally would not affect the value of debt outstanding under our Credit Facility and our Credit Agreement but would affect our operating results.

Table of Contents

The following table presents the impact a 100 basis point increase in interest rates would have on our annual floating rate interest expense at December 31, 2014 (dollars in thousands):

	Impact of Increase in Interest Rates				
	Weighted			Total Interest	Annual Per
	Average			Expense Per	Common
	Interest Rate	Outstanding		Year	Share
	Per Year	Debt			Impact(1)
At December 31, 2014	2.76	% \$ 35,000		\$ 966	\$ 0.02
100 basis point increase	3.76	% \$ 35,000		\$ 1,316	\$ 0.03

---

(1)Based on the diluted weighted average shares outstanding for the year ended December 31, 2014.

The following table presents the impact a 100 basis point increase in interest rates would have on our annual floating rate interest expense as of December 31, 2014 if we were fully drawn on our Credit Facility and our Credit Agreement (dollars in thousands):

	Impact of Increase in Interest Rates				
	Weighted			Total Interest	Annual Per
	Average			Expense Per	Common
	Interest Rate	Outstanding		Year	Share
	Per Year	Debt			Impact(1)
At December 31, 2014	2.76	% \$ 174,370		\$ 4,813	\$ 0.10
100 basis point increase	3.76	% \$ 174,370		\$ 6,556	\$ 0.14

---

(1) Based on the diluted weighted average shares outstanding for the year ended December 31, 2014.

The foregoing table shows the impact of an immediate increase in the interest rates on our Credit Facility and Credit Agreement. If interest rates were to change gradually over time, the impact would be spread over time. Our exposure to fluctuations in interest rates may increase or decrease in the future with increases or decreases in the outstanding amount under our Credit Facility or our Credit Agreement.

Although we have no present plans to do so, we may in the future enter into hedge arrangements from time to time to mitigate our exposure to changes in interest rates.

#### Item 8. Financial Statements and Supplementary Data

The information required by this Item is included in Part IV, Item 15 of this Annual Report on Form 10 K.

#### Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Treasurer and Chief Financial Officer of the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rules 13a-15 and 15d-15. Based upon that evaluation, our management, including our President and Chief Executive Officer and our Treasurer and Chief Financial Officer, identified material weaknesses, described below, in our internal control over financial reporting as of December 31, 2014. As a result, our management concluded that our disclosure controls and procedures were not effective as of December 31, 2014 because of the material weaknesses described below.

53

---



## Table of Contents

### Management Report on Assessment of Internal Control Over Financial Reporting

We are responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system is designed to provide reasonable assurance to our management and Board of Directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

In connection with preparing this Annual Report on Form 10 K, our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2014 based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control—Integrated Framework (2013 Framework) and concluded that our internal control over financial reporting was not effective as of December 31, 2014 because of the material weaknesses described below.

We determined that we had material weaknesses in our internal controls due to a lack of sufficient personnel with requisite accounting competencies and that we had an insufficient level of oversight in the financial statement close process. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our financial statements will not be prevented or detected on a timely basis.

McGladrey LLP, the independent registered public accounting firm that audited the consolidated financial statements included in this Annual Report on Form 10 K, has issued an attestation report on our internal control over financial reporting. Their report appears elsewhere herein.

### Remediation of Material Weaknesses in Internal Control Over Financial Reporting

We are continuing to develop our remediation plan for the material weaknesses described above, which currently includes:

- recruitment of additional experienced personnel for certain accounting positions;
- restructuring of our accounting department; and
  - providing enhanced training for employees regarding our accounting policies and procedures.

We have begun to implement this remediation plan while we are continuing to develop it. To date, we have:

- added qualified and experienced personnel by filling a newly created senior level accounting position and hiring additional personnel who are qualified as certified public accountants;
- engaged consultants to supplement our existing accounting staff and to provide additional layers of review by qualified persons; and
- begun restructuring our accounting and tax functions.

Successful remediation of the material weaknesses described above requires review and evidence of the effectiveness of the related internal control processes as part of our periodic assessments of our internal controls over financial reporting. As we continue to evaluate and work to enhance our internal control over financial reporting, we may determine that additional measures should be taken to address the material weaknesses described above or other control deficiencies, or that we should modify the remediation plan. We expect that the remediation of the material weaknesses described above will be completed by December 31, 2015.



Table of Contents

Changes in Internal Control Over Financial Reporting

Except as noted above under “Remediation of Material Weaknesses in Internal Control Over Financial Reporting” there have been no changes in our internal control over financial reporting during the quarter ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

**Amendment and Restatement of Business Management Agreement.** On March 16, 2015, we and RMR entered into an amended and restated business management and shared services agreement. The current term of the business management agreement ends on December 31, 2015 and automatically renews for successive one year terms unless we or RMR gives notice of non-renewal before the end of an applicable term. As amended, RMR may terminate the business management agreement upon 120 days’ written notice. Prior to the amendment, RMR could terminate the business management agreement upon 60 days’ written notice and could also terminate the business management agreement upon five business days’ notice if we underwent a change of control. Both prior to and after giving effect to the amendment, we have the right to terminate the business management agreement upon 60 days’ written notice, subject to approval by a majority vote of our Independent Directors.

As amended, if we terminate or elect not to renew the business management agreement other than for cause, as defined, we are obligated to pay RMR a termination fee equal to 2.875 times the sum of the annual base management fee and the annual internal audit services expense, which amounts are based on averages during the 24 consecutive calendar months prior to the date of notice of nonrenewal or termination. Further, as amended, the business management agreement provides for certain proportional adjustments to the termination fee if we merge with another company to which RMR is providing business management and/or shared services or if we spin-off a subsidiary of ours to which we contributed assets and to which RMR is providing business management and/or shared services both at the time of the spin-off and on the date of the expiration or termination of the business management agreement. Also, as amended, RMR agrees to provide certain transition services to us for 120 days following termination by us or notice of termination by RMR. Certain other administrative, clarifying and conforming changes were also included in the amendment and restatement. The business management agreement includes arbitration provisions for resolution of disputes.

The amendments to the business management agreement described above were negotiated, reviewed, approved and adopted by our Compensation Committee, which is comprised solely of Independent Directors. The foregoing descriptions of provisions of the business management agreement are not complete and are subject to and qualified in their entirety by reference to the amended and restated business management and shared services agreement, a copy of which is filed as Exhibit 10.51 to this Annual Report on Form 10-K, which is incorporated herein by reference.

For further information about our relationships and transactions with RMR, including the business management agreement, and the other entities to which RMR provides management services, and other related person transactions, please see Note 15 to the Notes to our Consolidated Financial Statements included in Part IV, Item 15 of this Annual Report on Form 10-K.

Amended Credit Agreement. On March 13, 2015, we and the lenders under our \$25.0 million Credit Agreement entered into Amendment No. 3 to the Credit and Security Agreement, or the Amendment, which amended the defined term for EBITDA set forth in the Credit Agreement by excluding from the calculation of EBITDA certain costs associated with Medicare compliance deficiencies and made certain changes to the representations and warranties in the Credit Agreement to except certain failures to comply with Medicare billing, recordkeeping, reporting and related practices. The foregoing description of the Amendment is not complete and is subject to and qualified in its entirety by reference to the Amendment, a copy of which is attached hereto as Exhibit 10.10, which is incorporated herein by reference.

Table of Contents

## PART III

## Item 10. Directors, Executive Officers and Corporate Governance

We have a Code of Business Conduct and Ethics that applies to all our representatives, including our officers, Directors and employees and employees of RMR. Our Code of Business Conduct and Ethics is posted on our website, [www.fivestarseniorliving.com](http://www.fivestarseniorliving.com). A printed copy of our Code of Business Conduct and Ethics is also available free of charge to any person who requests a copy by writing to our Secretary, Five Star Quality Care, Inc., 400 Centre Street, Newton, MA 02458. We intend to disclose any amendments or waivers to our Code of Business Conduct and Ethics applicable to our principal executive officer, principal financial officer, principal accounting officer or controller (or any person performing similar functions) on our website.

The remainder of the information required by Item 10 is incorporated by reference to our definitive Proxy Statement.

## Item 11. Executive Compensation

The information required by Item 11 is incorporated by reference to our definitive Proxy Statement.

## Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

## Equity Compensation Plan Information

We may grant options and common shares to our officers, Directors, employees and other individuals who render services to us under our Share Award Plan. In addition, each of our Directors received 10,000 shares in 2014 under the Share Award Plan as part of his or her annual compensation for serving as a Director. The terms of grants made under the Share Award Plan are determined by the Board of Directors, or a committee thereof, at the time of the grant. The following table is as of December 31, 2014.

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders—Share Award Plan	None	None	4,518,940
Equity compensation plans not approved by security holders	None	None	None
Total	None	None	4,518,940

The remainder of the information required by Item 12 is incorporated by reference to our definitive Proxy Statement.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by Item 13 is incorporated by reference to our definitive Proxy Statement.

Item 14. Principal Accountant Fees and Services

The information required by Item 14 is incorporated by reference to our definitive Proxy Statement.

56

---

Table of Contents

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a)Index to Financial Statements

	Page
Consolidated Financial Statements of Five Star Quality Care, Inc.	
<u>Reports of Independent Registered Public Accounting Firms</u>	F 1 / F 3
<u>Consolidated Balance Sheets at December 31, 2014 and 2013</u>	F 4
<u>Consolidated Statements of Operations for the years ended December 31, 2014, 2013 and 2012</u>	F 5
<u>Consolidated Statements of Comprehensive Income (Loss) for the years ended December 31, 2014, 2013 and 2012</u>	F 6
<u>Consolidated Statements of Shareholders' Equity for the years ended December 31, 2014, 2013 and 2012</u>	F 7
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2014, 2013 and 2012</u>	F 8
<u>Notes to Consolidated Financial Statements</u>	F 9

All other schedules for which provision is made in the applicable accounting regulations of the SEC are not required under the related instructions, or are inapplicable, and therefore have been omitted.

Table of Contents

(b)Exhibits

Exhibit

NumberDescription

- 3.1 Composite Copy of Articles of Amendment and Restatement, dated December 5, 2001, as amended to date. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 3.2 Articles Supplementary, as corrected by Certificate of Correction, dated March 19, 2004. (Incorporated by reference to the Company's registration statement on Form 8 A dated March 19, 2004 and the Company's Quarterly Report on Form 10 Q for the quarter ended March 31, 2004, respectively, File Number 001 16817.)
- 3.3 Articles Supplementary, dated April 16, 2014. (Incorporated by reference to the Company's Current Report on Form 8 K dated April 16, 2014.)
- 3.4 Amended and Restated Bylaws of the Company, adopted February 14, 2012, as amended to date. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended March 31, 2014.)
- 4.1 Form of Common Stock Certificate. (Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2013.)
- 10.1 2001 Stock Option and Stock Incentive Plan of the Company, as amended. (+) (Incorporated by reference to the Company's Current Report on Form 8 K dated May 25, 2006, File Number 001 16817.)
- 10.2 Form of Restricted Share Agreement. (+) (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2013.)
- 10.3 Five Star Quality Care, Inc. 2014 Equity Compensation Plan. (Incorporated by reference to the Company's Current Report on Form 8-K dated September 30, 2014.)
- 10.4 Form of Restricted Share Agreement. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014.)
- 10.5 Representative form of Indemnification Agreement. (+) (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 10.6 Summary of Director Compensation. (+) (Incorporated by reference to the Company's Current Report on Form 8-K dated September 30, 2014.)
- 10.7 Credit and Security Agreement, dated as of March 18, 2010, among the Company, each of the Guarantors party thereto, Jefferies Finance LLC, as Arranger, Administrative Agent and Collateral Agent, and Jefferies Group Inc., as Issuing Bank. (Incorporated by reference to the Company's Current Report on Form 8 K dated March 24, 2010.)
- 10.8 Amendment and Consent under Credit and Security Agreement, dated as of April 13, 2012, among the Company, the Guarantors party thereto, Jefferies Finance LLC, Jefferies Group, Inc. and the other parties thereto. (Incorporated by reference to the Company's Current Report on Form 8 K dated April 13, 2012.)
- 10.9 Amendment No. 2 to the Credit and Security Agreement, dated as March 15, 2013, among the Company, the Guarantors named therein, and Jefferies Finance LLC. (Incorporated by reference to the Company's Current Report on Form 8 K dated March 15, 2013.)
- 10.10 Amendment No. 3 to the Credit and Security Agreement, dated as of March 13, 2015, among the Company, the Guarantors named therein, each of the Lenders named therein and Jefferies Finance LLC. (Filed herewith.)
- 10.11 Credit Agreement, dated as of April 13, 2012, among the Company, the Guarantors party thereto, Citibank, N.A. and the other parties thereto. (Incorporated by reference to the Company's Current Report on Form 8 K dated April 13, 2012.)
- 10.12 Transaction Agreement, dated December 7, 2001, among Senior Housing Properties Trust, certain subsidiaries of Senior Housing Properties Trust, the Company, certain subsidiaries of the Company, FSQ, Inc., Hospitality Properties Trust, Equity Commonwealth (formerly known as HRPT Properties Trust)



and Reit Management & Research LLC. (Incorporated by reference to Senior Housing Properties Trust's Current Report on Form 8 K dated December 13, 2001, File Number 001 15319.)

Table of Contents

- 10.13 Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.14 Partial Termination of and First Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of October 1, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2009.)
- 10.15 Second Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of November 17, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Annual Report on Form 10 K for the year ended December 31, 2009.)
- 10.16 Third Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of December 10, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Annual Report on Form 10 K for the year ended December 31, 2009.)
- 10.17 Partial Termination of and Fourth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 1, 2010, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2010.)
- 10.18 Fifth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of May 1, 2011, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Current Report on Form 8 K dated June 8, 2011.)
- 10.19 Partial Termination of and Sixth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of June 1, 2011, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Current Report on Form 8 K dated June 8, 2011.)
- 10.20 Seventh Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of June 20, 2011, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 10.21 Eighth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 31, 2012, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 10.22 Partial Termination of and Ninth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 1, 2013, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2013.)
- 10.23 Partial Termination of and Tenth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of January 22, 2014, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2013.)
- 10.24 Partial Termination of and Eleventh Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of October 1, 2014, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014.)
- 10.25 Partial Termination of and Twelfth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of October 31, 2014, among certain subsidiaries of Senior Housing Properties Trust, as Landlord,

and the Company, as Tenant. (Filed herewith.)

Table of Contents

- 10.26 Partial Termination of and Thirteenth Amendment to Amended and Restated Master Lease Agreement (Lease No. 1), dated as of February 17, 2015, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and the Company, as Tenant. (Filed herewith.)
- 10.27 Amended and Restated Guaranty Agreement (Lease No. 1), dated as of August 4, 2009, made by the Company, as Guarantor, for the benefit of certain subsidiaries of Senior Housing Properties Trust, relating to the Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.28 Amended and Restated Master Lease Agreement (Lease No. 2), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.29 Partial Termination of and First Amendment to Amended and Restated Master Lease Agreement (Lease No. 2), dated as of November 1, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Annual Report on Form 10 K for the year ended December 31, 2009.)
- 10.30 Partial Termination of and Second Amendment to Amended and Restated Master Lease Agreement (Lease No. 2), dated as of August 1, 2010, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2010.)
- 10.31 Third Amendment to Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 20, 2011, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 10.32 Fourth Amendment to Amended and Restated Master Lease Agreement (Lease No. 2), dated as of July 22, 2011, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 10.33 Fifth Amendment to Amended and Restated Master Lease Agreement (Lease No. 2), dated as of August 31, 2012, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 10.34 Partial Termination of and Sixth Amendment to Amended and Restated Master Lease Agreement (Lease No. 2), dated as of September 19, 2013, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Current Report on Form 8 K dated September 19, 2013.)
- 10.35 Partial Termination of and Seventh Amendment to Amended and Restated Master Lease Agreement (Lease No. 2), dated as of June 1, 2014, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2013.)
- 10.36 Amended and Restated Guaranty Agreement (Lease No. 2), dated as of August 4, 2009, made by the Company, as Guarantor, for the benefit of certain subsidiaries of Senior Housing Properties Trust, relating to the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.37 Amended and Restated Master Lease Agreement (Lease No. 4), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended

June 30, 2009.)

60

---

Table of Contents

- 10.38 First Amendment to Amended and Restated Master Lease Agreement (Lease No. 4), dated as of October 1, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Annual Report on Form 10 K for the year ended December 31, 2009.)
- 10.39 Partial Termination of and Second Amendment to Amended and Restated Master Lease Agreement (Lease No. 4), dated as of May 1, 2011, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Current Report on Form 8 K dated June 8, 2011.)
- 10.40 Third Amendment to Amended and Restated Master Lease Agreement (Lease No. 4), dated as of June 20, 2011, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 10.41 Fourth Amendment to Amended and Restated Master Lease Agreement (Lease No. 4), dated as of August 31, 2012, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 10.42 Fifth Amendment to Amended and Restated Master Lease Agreement (Lease No. 4), dated July 10, 2014, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Current Report on Form 8 K dated July 10, 2014.)
- 10.43 Amended and Restated Guaranty Agreement (Lease No. 4), dated as of August 4, 2009, made by the Company, as Guarantor, for the benefit of certain subsidiaries of Senior Housing Properties Trust, relating to the Amended and Restated Master Lease Agreement (Lease No. 4), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.44 Amended and Restated Master Lease Agreement, dated as of August 4, 2009, among SNH FM Financing LLC, SNH FM Financing Trust and Ellicott City Land I, LLC, as Landlord, and FVE FM Financing, Inc., as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.45 Amendment No. 1 to Amended and Restated Master Lease Agreement, dated as of August 4, 2009, among SNH FM Financing LLC, SNH FM Financing Trust and Ellicott City Land I, LLC, as Landlord, and FVE FM Financing, Inc., as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.46 Partial Termination of and Amendment No. 2 to Amended and Restated Master Lease Agreement, dated as of August 31, 2012, among SNH FM Financing LLC, SNH FM Financing Trust and Ellicott City Land I, LLC, as Landlord, and FVE FM Financing, Inc., as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 10.47 Amended and Restated Guaranty Agreement, dated as of August 4, 2009, made by the Company, as Guarantor, for the benefit of SNH FM Financing LLC, SNH FM Financing Trust and Ellicott City Land I, LLC, relating to the Amended and Restated Master Lease Agreement, dated as of August 4, 2009, among SNH FM Financing LLC, SNH FM Financing Trust and Ellicott City Land I, LLC, as Landlord, and FVE FM Financing, Inc., as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.48 Representative form of Subordination, Assignment and Security Agreement. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.49 Lease Realignment Agreement, dated as of August 4, 2009, among Senior Housing Properties Trust and certain of its subsidiaries and the Company and certain of its subsidiaries. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)



Table of Contents

- 10.50 Registration Rights Agreement, dated as of August 4, 2009, between the Company and Senior Housing Properties Trust. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 10.51 Amended and Restated Shareholders Agreement, dated May 21, 2012, among Affiliates Insurance Company, the Company, Hospitality Properties Trust, Equity Commonwealth (formerly known as CommonWealth REIT), Senior Housing Properties Trust, TravelCenters of America LLC, Reit Management & Research LLC, Government Properties Income Trust and Select Income REIT. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2012.)
- 10.52 Amended and Restated Business Management and Shared Services Agreement, dated as of March 16, 2015, between the Company and Reit Management & Research LLC. (+) (Filed herewith.)
- 10.53 Amended and Restated Pooling Agreement No. 1, dated October 30, 2012, between FVE Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust, amending and restating the Pooling Agreement, dated as of May 12, 2011, between such parties. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 10.54 Pooling Agreement No. 2, dated October 30, 2012, between FVE Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 10.55 Pooling Agreement No. 3, dated as of November 1, 2013, between FVE Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2013.)
- 10.56 Representative form of Accession Agreement, dated as of November 1, 2012, by SNH SE Tenant TRS, Inc. in favor of FVE Managers, Inc., relating to Pooling Agreement No. 2, dated as of October 30, 2012, between FVE Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2013.)
- 10.57 Representative form of Accession Agreement, dated as of December 1, 2014, by SNH SE Tenant TRS, Inc. in favor of FVE Managers, Inc., relating to Pooling Agreement No. 3, dated as of November 1, 2013, between FVE Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014.)
- 10.58 Representative form of Management Agreement for assisted living communities, dated as of May 12, 2011, between FVE Managers, Inc., as Manager, and SNH SE Burlington Tenant LLC, as Owner. (Incorporated by reference to the Company's Current Report on Form 8 K dated May 13, 2011.)
- 10.59 Amendment to AL Management Agreements, dated July 10, 2014, between FVE Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Current Report on Form 8 K dated July 10, 2014.)
- 10.60 Villa Valencia Agreement, dated July 10, 2014, between SNH SE Tenant Inc. and certain other subsidiaries of Senior Housing Properties Trust and FVE Managers, Inc. (Incorporated by reference to the Company's Current Report on Form 8 K dated July 10, 2014.)
- 21.1 Subsidiaries of the Company. (Filed herewith.)
- 23.1 Consent of McGladrey LLP. (Filed herewith.)
- 23.2 Consent of Ernst & Young LLP. (Filed herewith.)
- 31.1 Rule 13a 14(a) Certification of Chief Executive Officer. (Filed herewith.)
- 31.2 Rule 13a 14(a) Certification of Chief Financial Officer. (Filed herewith.)
- 32.1 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer. (Furnished herewith.)
- 99.1 Amended and Restated Security Agreement (Lease No. 1), dated as of August 4, 2009, among Five Star Quality Care Trust, as Tenant, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)





Table of Contents

- 99.2 Amended and Restated Subtenant Guaranty Agreement (Lease No. 1), dated as of August 4, 2009, made by certain subsidiaries of the Company, each a Subtenant Guarantor, for the benefit of the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.3 Amended and Restated Subtenant Security Agreement (Lease No. 1), dated as of August 4, 2009, made by certain subsidiaries of the Company, as Subtenants, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 1), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care Trust, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.4 Amended and Restated Security Agreement (Lease No. 2), dated as of August 4, 2009, made by certain subsidiaries of the Company, as Tenant, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.5 Amended and Restated Subtenant Guaranty Agreement (Lease No. 2), dated as of August 4, 2009, made by certain subsidiaries of the Company, each a Subtenant Guarantor, for the benefit of the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.6 Amended and Restated Subtenant Security Agreement (Lease No. 2), dated as of August 4, 2009, made by certain subsidiaries of the Company, as Subtenants, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 2), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.7 Amended and Restated Security Agreement (Lease No. 4), dated as of August 4, 2009, made by certain subsidiaries of the Company, as Tenant, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 4), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.8 Amended and Restated Subtenant Guaranty Agreement (Lease No. 4), dated as of August 4, 2009, made by certain subsidiaries of the Company, each a Subtenant Guarantor, for the benefit of the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 4), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.9 Amended and Restated Subtenant Security Agreement (Lease No. 4), dated as of August 4, 2009, made by certain subsidiaries of the Company, as Subtenants, and the Landlord under the Amended and Restated Master Lease Agreement (Lease No. 4), dated as of August 4, 2009, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and certain subsidiaries of the Company, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2009.)
- 99.10 Amendment to Subtenant Security Agreement, dated as of August 1, 2010, among certain subsidiaries of Senior Housing Properties Trust and certain subsidiaries of the Company. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2010.)
- 99.11 Master Lease Agreement, dated as of September 1, 2008, among certain subsidiaries of Senior Housing Properties Trust, as Landlord, and Five Star Quality Care RMI, LLC, as Tenant. (Incorporated by reference to the Company's Annual Report on Form 10 K for the year ended December 31, 2008, File Number 001 16817.)



Table of Contents

- 99.12 Guaranty Agreement, dated as of September 1, 2008, made by the Company for the benefit of certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Annual Report on Form 10 K for the year ended December 31, 2008, File Number 001 16817.)
- 99.13 Lease Agreement, dated as of May 12, 2011, between 400 Centre Street LLC and the Company. (Incorporated by reference to the Company's Current Report on Form 8 K dated May 13, 2011.)
- 99.14 First Amendment to Lease, dated as of December 23, 2014, between 400 Centre Street LLC and the Company. (Filed herewith.)
- 99.15 Lease Agreement, dated as of June 20, 2011, between SNH/LTA SE McCarthy New Bern LLC, as Landlord, and FVE SE McCarthy New Bern LLC, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 99.16 Guaranty Agreement, dated as of June 20, 2011, from the Company in favor of SNH/LTA SE McCarthy New Bern LLC. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 99.17 Lease Agreement, dated as of June 23, 2011, between SNH/LTA SE Wilson LLC, as Landlord, and FVE SE Wilson LLC, as Tenant. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 99.18 Guaranty Agreement, dated as of June 23, 2011, from the Company in favor of SNH/LTA SE Wilson LLC. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2011.)
- 99.19 Amended and Restated Reimbursement Agreement, dated May 1, 2012, among Reit Management & Research LLC, TravelCenters of America LLC and the Company. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended June 30, 2012.)
- 99.20 Operations Transfer Agreement, dated as of May 29, 2012, among FVE Managers, Inc., certain subsidiaries of Sunrise Senior Living, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Current Report on Form 8 K dated May 29, 2012.)
- 99.21 Pooling Agreement, dated August 31, 2012, between FVE IL Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 99.22 Representative form of Management Agreement for independent living communities, dated as of December 15, 2011, between FVE IL Managers, Inc., as Manager, and SNH IL Properties Trust, as Owner. (Incorporated by reference to the Company's Annual Report on Form 10 K for the year ended December 31, 2011.)
- 99.23 Amendment to IL Management Agreements, dated July 10, 2014, between FVE IL Managers, Inc. and certain subsidiaries of Senior Housing Properties Trust. (Incorporated by reference to the Company's Current Report on Form 8 K dated July 10, 2014.)
- 99.24 Management Agreement, dated as of August 31, 2012, between FVE Managers, Inc., as Manager, and D&R Yonkers LLC, as Licensee. (Incorporated by reference to the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2012.)
- 99.25 First Amendment to Management Agreement, dated as of August 31, 2012, between FVE Managers, Inc., as Manager, and D&R Yonkers LLC, as Licensee. (Filed herewith.)
- 101.1 The following materials from the Company's Annual Report on Form 10 K for the year ended December 31, 2014 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Income (Loss), (iv) the Consolidated Statements of Shareholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) related notes to these financial statements, tagged as blocks of text and in detail. (Filed herewith.)

(+) Management contract or compensatory plan or arrangement.

64

---

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders  
Five Star Quality Care, Inc.

We have audited the accompanying consolidated balance sheet of Five Star Quality Care, Inc. as of December 31, 2014, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Five Star Quality Care, Inc. as of December 31, 2014, and the results of their operations and their cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Five Star Quality Care, Inc.'s internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. Our report dated March 16, 2015 expressed an opinion that Five Star Quality Care, Inc. had not maintained effective internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

/s/ McGladrey LLP

Boston, Massachusetts  
March 16, 2015

F-1



Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Five Star Quality Care, Inc.

We have audited the accompanying consolidated balance sheet of Five Star Quality Care, Inc. as of December 31, 2013, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity and cash flows for each of the two years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Five Star Quality Care, Inc. at December 31, 2013, and the consolidated results of its operations and its cash flows for each of the two years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Boston, Massachusetts  
September 17, 2014

F-2



Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders

Five Star Quality Care, Inc.

We have audited Five Star Quality Care, Inc.'s internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. Five Star Quality Care, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management Report on Assessment of Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in management's assessment. As of December 31, 2014, there were material weaknesses in the Company's internal controls over financial reporting due to a lack of sufficient personnel with requisite accounting competencies and an insufficient level of oversight in the financial statement close process. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2014 financial statements, and this report does not affect our report dated March 16, 2015 on those financial statements.

In our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, Five Star Quality Care, Inc. has not maintained effective internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of Five Star Quality Care, Inc. and our report dated March 16, 2015 expressed an unqualified opinion.

/s/ McGladrey LLP

Boston, Massachusetts

March 16, 2015

F-3

---

Table of Contents

FIVE STAR QUALITY CARE, INC.

## CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	December 31,	
	2014	2013
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 20,988	\$ 23,628
Accounts receivable, net of allowance of \$3,416 and \$4,281 at December 31, 2014 and 2013, respectively	38,814	36,940
Due from related persons	12,641	11,659
Prepaid expenses	16,463	13,838
Investments in available for sale securities, of which \$8,352 and \$4,690 are restricted as of December 31, 2014 and 2013, respectively	23,436	19,150
Restricted cash	2,945	9,003
Current net deferred tax assets	—	13,289
Other current assets	5,031	6,672
Assets of discontinued operations	1,463	16,705
Total current assets	121,781	150,884
Property and equipment, net	357,186	340,276
Equity investment of an investee	6,827	5,913
Restricted cash	2,170	9,795
Restricted investments in available for sale securities	19,835	11,905
Goodwill and other intangible assets	25,904	26,407
Long term net deferred tax assets	—	41,830
Other long term assets	1,270	3,173
	\$ 534,973	\$ 590,183
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Revolving credit facility, secured, principally by real estate	\$ 35,000	\$ 35,000
Accounts payable and accrued expenses	85,606	69,343
Accrued compensation and benefits	34,171	31,888
Due to related persons	20,338	20,587
Mortgage notes payable	1,786	1,159
Accrued real estate taxes	11,282	9,934
Security deposits and current portion of continuing care contracts	7,235	8,025
Other current liabilities	19,470	18,607
Liabilities of discontinued operations	504	3,985
Total current liabilities	215,392	198,528
Long term liabilities:		
Mortgage notes payable	49,373	36,461
Continuing care contracts	1,370	1,531
Accrued self-insurance obligations	37,268	38,002

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

Other long term liabilities	4,788	5,283
Total long term liabilities	92,799	81,277

Commitments and contingencies

Shareholders' equity:

Common stock, par value \$.01: 75,000,000 shares authorized, 48,997,315 and 48,613,442 shares issued and outstanding at December 31, 2014 and 2013, respectively

	490	486
Additional paid in capital	357,051	355,570
Accumulated deficit	(134,449)	(48,996)
Accumulated other comprehensive income	3,690	3,318
Total shareholders' equity	226,782	310,378
	\$ 534,973	\$ 590,183

See accompanying notes.

F-4

Table of Contents

FIVE STAR QUALITY CARE, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	For the year ended December 31,		
	2014	2013	2012
Revenues:			
Senior living revenue	\$ 1,099,228	\$ 1,077,062	\$ 1,074,333
Management fee revenue	9,765	9,234	5,817
Reimbursed costs incurred on behalf of managed communities	219,082	210,491	127,656
Total revenues	1,328,075	1,296,787	1,207,806
Operating expenses:			
Senior living wages and benefits	533,549	525,733	522,444
Other senior living operating expenses	292,457	265,945	261,857
Costs incurred on behalf of managed communities	219,082	210,491	127,656
Rent expense	197,359	193,820	190,184
General and administrative	72,385	63,509	61,817
Depreciation and amortization	31,834	27,022	24,480
Impairment of long-lived assets	589	186	—
Gain on settlement	—	—	(3,365)
Total operating expenses	1,347,255	1,286,706	1,185,073
Operating (loss) income	(19,180)	10,081	22,733
Interest, dividend and other income	867	781	881
Interest and other expense	(5,131)	(5,227)	(6,268)
(Loss) gain on early extinguishment of debt	—	(599)	45
Gain (loss) on sale of available for sale securities reclassified from other comprehensive income (loss)	392	(5)	(19)
(Loss) income from continuing operations before income taxes and equity in earnings of an investee	(23,052)	5,031	17,372
Provision for income taxes	(56,385)	(1,916)	(7,098)
Equity in earnings of an investee	87	334	316
(Loss) income from continuing operations	(79,350)	3,449	10,590
(Loss) income from discontinued operations	(6,056)	(5,789)	11,717
Net (loss) income	\$ (85,406)	\$ (2,340)	\$ 22,307
Weighted average shares outstanding—basic	48,028	48,277	47,952

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

Weighted average shares outstanding—diluted	48,028	49,263	50,134
Basic (loss) income per share from:			
Continuing operations	\$ (1.65)	\$ 0.07	\$ 0.23
Discontinued operations	(0.13)	(0.12)	0.24
Net (loss) income per share—basic	\$ (1.78)	\$ (0.05)	\$ 0.47
Diluted (loss) income per share from:			
Continuing operations	\$ (1.65)	\$ 0.07	\$ 0.23
Discontinued operations	(0.13)	(0.12)	0.23
Net (loss) income per share—diluted	\$ (1.78)	\$ (0.05)	\$ 0.46

F-5

---

Table of Contents

See accompanying notes.

## FIVE STAR QUALITY CARE, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

	For the year ended December 31,		
	2014	2013	2012
Net (loss) income	\$ (85,406)	\$ (2,340)	\$ 22,307
Other comprehensive income (loss):			
Unrealized gain on investments in available for sale securities, net of tax of \$151, \$138 and \$144, respectively	612	4	214
Equity in unrealized gain (loss) of an investee, net of tax	2	(51)	22
Realized (gain) loss on investments in available for sale securities reclassified and included in net income (loss), net of tax of \$150, \$3 and \$8, respectively	(242)	2	11
Other comprehensive income (loss)	372	(45)	247
Comprehensive (loss) income	\$ (85,034)	\$ (2,385)	\$ 22,554

See accompanying notes.

Table of Contents

## FIVE STAR QUALITY CARE, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands, except share data)

	Number of Shares	Common Stock	Additional Paid in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2011	47,899,312	\$ 479	\$ 352,722	\$ (68,963)	\$ 3,116	\$ 287,354
Comprehensive income:						
Net income	—	—	—	22,307	—	22,307
Unrealized gain on investments in available for sale securities, net of tax	—	—	—	—	214	214
Realized loss on investments in available for sale securities reclassified and included in net income, net of tax	—	—	—	—	11	11
Equity in unrealized gain of an investee, net of tax	—	—	—	—	22	22
Total comprehensive income	—	—	—	22,307	247	22,554
Grants under share award plan and share based compensation	347,050	3	1,442	—	—	1,445
Repurchases under share award plan	(12,340)	—	—	—	—	—
Balance at December 31, 2012	48,234,022	482	354,164	(46,656)	3,363	311,353
Comprehensive loss:						
Net loss	—	—	—	(2,340)	—	(2,340)
Unrealized gain on investments in available for sale securities, net of tax	—	—	—	—	4	4
Realized loss on investments in available	—	—	—	—	2	2



for sale securities reclassified and included in net income, net of tax						
Equity in unrealized loss of an investee, net of tax	—	—	—	—	(51)	(51)
Total comprehensive loss	—	—	—	(2,340)	(45)	(2,385)
Grants under share award plan and share based compensation	385,400	4	1,406	—	—	1,410
Repurchases under share award plan	(5,980)	—	—	—	—	—
Balance at December 31, 2013	48,613,442	\$ 486	\$ 355,570	\$ (48,996)	\$ 3,318	\$ 310,378
Comprehensive loss:						
Net loss	—	—	—	(85,406)	—	(85,406)
Unrealized gain on investments in available for sale securities, net of tax	—	—	—	—	612	612
Realized gain on investments in available for sale securities reclassified and included in net income, net of tax	—	—	—	—	(242)	(242)
Equity in unrealized gain of an investee, net of tax	—	—	—	—	2	2
Total comprehensive loss	—	—	—	(85,406)	372	(85,034)
Grants under share award plan and share based compensation	403,050	4	1,481	—	—	1,485
Repurchases under share award plan	(19,177)	—	—	(47)	—	(47)
Balance at December 31, 2014	48,997,315	\$ 490	\$ 357,051	\$ (134,449)	\$ 3,690	\$ 226,782
See accompanying notes.						

Table of Contents

FIVE STAR QUALITY CARE, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the year ended December 31,		
	2014	2013	2012
Cash flows from operating activities:			
Net (loss) income	\$ (85,406)	\$ (2,340)	\$ 22,307
Adjustments to reconcile net (loss) income to cash provided by operating activities:			
Depreciation and amortization	33,470	28,109	24,480
Loss (gain) on early extinguishment of debt	—	599	(45)
Loss (gain) from discontinued operations before income tax	5,977	9,327	(17,158)
(Gain) loss on sale of available for sale securities	(392)	5	19
Impairment of long-lived assets	589	186	—
Equity in earnings of an investee	(87)	(334)	(316)
Stock-based compensation	1,485	1,410	1,445
Deferred income taxes	55,334	(2,793)	10,560
Provision for losses on receivables	4,777	6,412	4,446
Changes in assets and liabilities:			
Accounts receivable	(6,651)	(4,147)	(2,431)
Prepaid expenses and other assets	(279)	2,334	(11,357)
Accounts payable and accrued expenses	13,387	(2,565)	18,623
Accrued compensation and benefits	2,283	(3,414)	1,403
Due to related persons, net	(1,601)	(1,074)	(6,773)
Other current and long term liabilities	(549)	4,062	2,305
Cash provided by operating activities	22,337	35,777	47,508
Cash flows from investing activities:			
Deposits into (payments from) restricted cash and investment accounts, net	13,683	(84)	(9,784)
Acquisition of property and equipment	(49,916)	(53,766)	(51,805)
Acquisition of senior living communities, net of liabilities assumed	(5,926)	—	—
Purchase of available for sale securities	(22,431)	(13,974)	(5,076)
Investment in an investee	(825)	—	—
Proceeds from sale of property and equipment to Senior Housing Properties Trust	25,804	24,641	24,818
Proceeds from sale of available for sale securities	10,876	6,285	4,163
Cash used in investing activities	(28,735)	(36,898)	(37,684)
Cash flows from financing activities:			
Proceeds from borrowings on credit facilities	20,000	85,000	62,500
Repayments of borrowings on credit facilities	(20,000)	(50,000)	(62,500)
Repayments of borrowings on a bridge loan from SNH	—	—	(38,000)

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

Purchase and retirement of convertible senior notes	—	(24,872)	(12,038)
Repayments of mortgage notes payable	(1,979)	(1,093)	(1,028)
Payment of employee tax obligations on withheld shares	(47)	—	—
Cash (used in) provided by financing activities	(2,026)	9,035	(51,066)
Cash flows from discontinued operations:			
Net cash provided by (used in) operating activities	5,519	(7,000)	1,763
Net cash provided by investing activities	265	5,610	35,885
Net cash used in financing activities	—	(7,534)	(142)
Net cash flows provided by (used in) discontinued operations	5,784	(8,924)	37,506
Change in cash and cash equivalents			
Cash and cash equivalents at beginning of period	23,628	24,638	28,374
Cash and cash equivalents at end of period	\$ 20,988	\$ 23,628	\$ 24,638
Supplemental cash flow information:			
Cash paid for interest	\$ 3,557	\$ 3,361	\$ 4,921
Cash paid for income taxes, net	\$ 1,179	\$ 1,884	\$ 2,132
Non-cash activities:			
Real estate acquisition	\$ (15,518)	\$ —	\$ —
Assumption of mortgage note payable	\$ 15,518	\$ —	\$ —

See accompanying notes.

F-8

---

Table of Contents

FIVE STAR QUALITY CARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar amounts in thousands, except per share amounts)

1. Organization and Business

We operate senior living communities, including independent living communities, assisted living communities and skilled nursing facilities, or SNFs. As of December 31, 2014, we operated 258 senior living communities located in 31 states with 30,379 living units, including 227 primarily independent and assisted living communities with 27,557 living units and 31 SNFs with 2,822 living units. As of December 31, 2014, we own and operate 31 communities (3,061 living units), we lease and operate 181 communities (20,040 living units) and we manage 46 communities (7,278 living units). Our 258 senior living communities, as of December 31, 2014, included 10,585 independent living apartments, 14,584 assisted living suites and 5,210 skilled nursing units. The foregoing numbers exclude: (i) one assisted living community with 32 living units that we own which is being offered for sale and is classified as a discontinued operation; and (ii) three SNFs and one assisted living community with a total of 265 living units that are leased by us from SNH that are being offered for sale and are classified as discontinued operations.

2. Summary of Significant Accounting Policies

**Basis of Presentation.** The accompanying consolidated financial statements include our accounts and those of all of our consolidated subsidiaries. All intercompany transactions and balances with or among our consolidated subsidiaries have been eliminated.

**Use of Estimates.** Preparation of these financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that may affect the amounts reported in these financial statements and related notes. Some significant estimates are included in our revenue recognition, self insurance reserves, the allowance for doubtful accounts, goodwill and long lived assets and contractual allowances.

We are required to estimate income taxes payable in each of the jurisdictions in which we operate. The process involves estimating actual current tax expense along with assessing temporary differences resulting from differing treatment of items for financial statement and tax purposes. These timing differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheets. We are required to record a valuation allowance to reduce deferred tax assets if we are not able to conclude that it is more likely than not these assets will be realized.

Our actual results could differ from our estimates. We periodically review estimates and assumptions and we reflect the effects of changes, if any, in the consolidated financial statements in the period that they are determined.

**Earnings Per Share.** We calculate basic earnings per common share, or EPS, by dividing net income (loss) (and income (loss) from continuing operations and income (loss) from discontinued operations) by the weighted average number of common shares outstanding during the year. We calculate diluted EPS using the more dilutive of the two class method or the treasury stock method.

**Cash and Cash Equivalents.** Cash and cash equivalents, consisting of short term, highly liquid investments and money market funds with original maturities of three months or less at the date of purchase, are carried at cost plus accrued interest, which approximates market.

Equity Method Investments. As of December 31, 2014, we and six other shareholders each owned approximately 14.3% of the outstanding equity of Affiliates Insurance Company, or AIC. Although we owned less than 20% of AIC, we use the equity method to account for this investment because we believe that we have significant influence over AIC as all of our Directors are also directors of AIC. Under the equity method, we recorded our percentage share of net earnings from AIC in our consolidated statements of operations. If we determine there is an “other than temporary impairment” in the fair value of this investment, we would record a charge to earnings. In evaluating the fair value of this investment, we have considered, among other things, the assets and liabilities held by AIC, AIC’s overall financial condition and earning trends, and the financial condition and prospects for the insurance industry generally. As of December 31, 2014, we have invested \$6,034 in AIC.

Investment Securities. Investment securities that are held principally for resale in the near term are classified as “trading” and are carried at fair value with changes in fair value recorded in earnings. We did not hold any trading securities at December 31, 2014 or 2013.

F-9

---

Table of Contents

Securities not classified as “trading” are classified as “available for sale” and carried at fair value, with unrealized gains and losses reported as a separate component of shareholders’ equity and “other than temporary impairment” losses recorded in our consolidated statements of operations. Realized gains and losses on all available for sale securities are recognized based on specific identification. Our available for sale investments at December 31, 2014 and 2013 consisted primarily of debt securities and equities. Restricted investments are kept as security for obligations arising from our self insurance programs. At December 31, 2014, these investments had a fair value of \$43,271 and an unrealized holding gain of \$2,298. At December 31, 2013, these investments had a fair value of \$31,055 and an unrealized holding gain of \$1,928.

In 2014, 2013 and 2012, our available for sale securities generated interest and dividend income of \$788, \$693 and \$799, respectively, which is included in interest, dividend and other income in our consolidated statements of operations.

The following table summarizes the fair value and gross unrealized losses related to our “available for sale” securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position for the years ending:

	December 31, 2014					
	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Investments	\$ 7,761	\$ 97	\$ 1,797	\$ 60	\$ 9,558	\$ 157

	December 31, 2013					
	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Investments	\$ 7,392	\$ 257	\$ —	\$ —	\$ 7,392	\$ 257

We routinely evaluate our available for sale investments to determine if they have been impaired. If the fair value of an investment is less than its book or carrying value and we expect that situation to continue for a more than temporary period, we will record an “other than temporary impairment” loss in our consolidated statements of operations. We evaluate the fair value of our available for sale investments by reviewing each security’s current market price, the ratings of the security, the financial condition of the issuer and our intent and ability to retain the investment during temporary market price fluctuations or until maturity. In evaluating the factors described above, we presume a decline in value to be an “other than temporary impairment” if the quoted market price of the security is below the security’s cost basis for an extended period. However, this presumption may be overcome if there is persuasive evidence indicating the value decline is temporary in nature, such as when the operating performance of the obligor is strong or if the market price of the security is historically volatile. Additionally, there may be instances in which impairment losses are recognized even if the decline in value does not fall within the criteria described above, such as if we plan to sell the security in the near term and the fair value is below our cost basis. When we believe that a

change in fair value of an available for sale security is temporary, we record a corresponding credit or charge to other comprehensive income for any unrealized gains and losses. When we determine that impairment in the fair value of an available for sale security is an “other than temporary impairment”, we record a charge to earnings. We did not record such an impairment charge for the years ended December 31, 2014, 2013 and 2012.

Restricted Cash. Restricted cash as of December 31, 2014 and 2013 includes cash that we deposited as security for obligations arising from our self insurance programs and other amounts for which we are required to establish escrows, including: real estate taxes and capital expenditures as required by our mortgages, indemnification obligations associated with the sale of our pharmacy business and certain resident security deposits.

	2014		2013	
	Current	Long term	Current	Long term
Insurance reserves	\$ 913	\$ 2,170	\$ 3,859	\$ 9,795
Real estate taxes and capital expenditures as required by our mortgages	1,376	—	1,182	—
Indemnification obligations associated with the sale of our pharmacy business	—	—	3,248	—
Resident security deposits	656	—	714	—
Total	\$ 2,945	\$ 2,170	\$ 9,003	\$ 9,795

Accounts Receivable and Allowance for Doubtful Accounts. We record accounts receivable at their estimated net realizable value. Included in accounts receivable as of December 31, 2014 and 2013 are amounts due from the Medicare program of \$12,409 and \$11,173, respectively, and amounts due from various state Medicaid programs of \$11,384 and \$10,234, respectively.

We estimate allowances for uncollectible amounts and contractual allowances based upon factors which include, but are not limited to, the age of the receivable and the terms of the agreements, the residents’ or third party payers’ stated intent to pay, the payers’ financial capacity to pay and other factors which may include likelihood and cost of litigation. Accounts receivable allowances

Table of Contents

are estimates. We periodically review and revise these estimates based on new information and these revisions may be material. Our SNFs record their provision for doubtful accounts as a reduction of revenue, and during 2014, 2013 and 2012, we recorded a provision for doubtful accounts of \$1,321, \$2,005 and \$1,346, respectively. Allowance for doubtful accounts consists of the following:

Balance January 1, 2012	\$ 3,160
Provision for doubtful accounts	4,446
Write-offs	(4,814)
Balance December 31, 2012	2,792
Provision for doubtful accounts	6,412
Write-offs	(4,923)
Balance December 31, 2013	4,281
Provision for doubtful accounts	4,777
Write-offs	(5,642)
Balance December 31, 2014	\$ 3,416

**Deferred Finance Costs.** We capitalize issuance costs related to borrowings and amortize the deferred costs over the terms of the respective loans. Our unamortized balance of deferred finance costs was \$373 and \$2,077 at December 31, 2014 and 2013, respectively. Accumulated amortization related to deferred finance costs was \$3,414 and \$2,263 at December 31, 2014 and 2013, respectively. At December 31, 2014, the weighted average amortization period remaining is approximately 1 year. The amortization expenses to be incurred during the next five years as of December 31, 2014 are \$348 in 2015, \$15 in 2016 and \$2 in 2017, 2018 and 2019.

**Property and Equipment.** Property and equipment is stated at cost, less accumulated depreciation. We record depreciation on property and equipment on a straight line basis over estimated useful lives of up to 40 years for buildings, up to 15 years for building improvements and up to seven years for personal property. We regularly evaluate whether events or changes in circumstances have occurred that could indicate impairment in the value of our long lived assets. If there is an indication that the carrying value of an asset is not recoverable, we determine the amount of impairment loss, if any, by comparing the historical carrying value of the asset to its estimated fair value. We determine estimated fair value through an evaluation of recent financial performance, recent sales of similar assets, market conditions and projected cash flows of properties using standard industry valuation techniques.

**Goodwill and Other Intangible Assets.** Goodwill represents the costs of business acquisitions in excess of the fair value of identifiable net assets acquired. We review goodwill for impairment annually during the fourth quarter, or more frequently, if events or changes in circumstances exist. If our review indicates that the carrying amount of goodwill exceeds its fair value, we reduce the carrying amount of goodwill to fair value. We evaluate goodwill for impairment at the reporting unit level, which we determined to be the operating segments we operate, by comparing the fair value of the reporting unit as determined by its discounted cash flows and market approaches with its carrying value. The key assumptions used in the discounted cash flow analysis include future revenue growth, gross margins and our weighted average cost of capital. We select a growth rate based on our view of the growth prospect of each of our reporting units. If the carrying value of the reporting unit exceeds its fair value, we compare the implied fair value of the reporting unit's goodwill with its carrying amount to measure the amount of the potential impairment loss.

At acquisition, we estimate and record the fair value of purchased intangible assets primarily using discounted cash flow analysis of anticipated cash flows reflecting incremental revenues and/or cost savings resulting from the acquired



intangible asset, reflecting market participant assumptions. Amortization of intangible assets with finite lives is recognized over their estimated useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise realized.

Other intangible assets are periodically reviewed for impairment whenever circumstances and situations change such that there is an indication that the carrying amounts may not be recoverable. If the carrying value of the asset held for use exceeds the sum of the undiscounted expected future cash flows, the carrying value of the asset is generally written down to fair value.

**Legal Proceedings and Claims.** We have been, are currently, and expect in the future to be involved in claims, lawsuits, and regulatory and other governmental audits, investigations and proceedings arising in the ordinary course of our business, some of which may involve material amounts. Also, the defense and resolution of these claims, lawsuits, and regulatory and other governmental audits, investigations and proceedings may require us to incur significant expense. We account for claims and litigation losses in accordance with Financial Accounting Standards Board, or FASB, Accounting Standards Codification<sup>TM</sup>, or ASC, Topic 450, Contingencies. Under ASC 450, loss contingency provisions are recorded for probable and estimable losses at our best estimate of a loss or, when a best estimate cannot be made, at our estimate of the minimum loss. These estimates are often developed prior to knowing the amount of the ultimate loss, require the application of considerable judgment, and are refined as additional information becomes known. Accordingly, we are often initially unable to develop a best estimate of loss and therefore the estimated minimum loss amount, which could be zero, is recorded; then, as information becomes known, the minimum loss amount is updated, as

Table of Contents

appropriate. Occasionally, a minimum or best estimate amount may be increased or decreased when events result in a changed expectation.

**Compliance Matters.** As previously disclosed, as a result of our compliance program to review medical records related to our Medicare billing practices, during 2014 we discovered potentially inadequate documentation and other issues at one of our leased SNFs. This compliance review was not initiated in response to any specific complaint or allegation, but was a review of the type that we periodically undertake to test our compliance with applicable Medicare billing rules. As a result of these discoveries, we have made a voluntary disclosure of deficiencies to the United States Department of Health and Human Services Office of the Inspector General (the "OIG") pursuant to the OIG's Provider Self-Disclosure Protocol. While our assessment of these matters is ongoing, we have informed the OIG that we expect our investigation and assessment to be completed by May 13, 2015. As of December 31, 2014, we have accrued a revenue reserve of \$4.3 million to account for historical Medicare payments we expect to repay and we have expensed (\$1.4 million) and accrued (\$2.2 million) to account for additional costs we have incurred or we expect to incur, including OIG imposed penalties as a result of this matter. As a result of the continuing investigation and assessment of these deficiencies, additional deficiencies may be discovered which could increase our liability to the OIG and other costs. Potential losses associated with such additional compliance deficiencies are reasonably possible but cannot be reasonably estimated at this time.

**Self Insurance.** We self insure up to certain limits for workers' compensation, professional liability claims, automobile claims and property losses. Claims in excess of these limits are insured up to contractual limits, over which we are self insured. We fully self insure all health related claims for our covered employees. Determining reserves for the casualty, liability, workers' compensation and healthcare losses and costs that we have incurred as of the end of a reporting period involves significant judgments based upon our experience and our expectations of future events, including projected settlements for pending claims, known incidents that we expect may result in claims, estimates of incurred but not yet reported claims, expected changes in premiums for insurance provided by insurers whose policies provide for retroactive adjustments, estimated litigation costs and other factors. Since these reserves are based on estimates, the actual expenses we incur may differ from the amount reserved. We regularly adjust these estimates to reflect changes in the foregoing factors, our actual claims experience, recommendations from our professional consultants, changes in market conditions and other factors; it is possible that such adjustments may be material. Our total self-insurance reserves were \$59,333 and \$59,707 as of the year ended December 31, 2014 and 2013, respectively, and are included in accrued compensation and benefits, other current liabilities and accrued self-insurance obligations in our consolidated balance sheets.

**Continuing Care Contracts.** Residents at one of our communities may enter into continuing care contracts with us. We offer two forms of continuing care contracts to new residents at this community. One form of contract provides that 10% of the resident admission fee becomes non refundable upon occupancy, and the remaining 90% becomes non refundable at the rate of 1.5% per month of the original amount over the subsequent 60 months. The second form of contract provides that 30% of the resident admission fee is non refundable upon occupancy and 70% is refundable. Three other forms of continuing care contracts are in effect for existing residents but are not offered to new residents. One historical form of contract provides that the resident admission fee is 10% non refundable upon occupancy and 90% refundable. A second historical form of contract provides that the resident admission fee is 100% refundable. A third historical form of contract provides that the resident admission fee is 1% refundable and 99% non refundable upon admission. In each case, we amortize the non refundable part of these fees into revenue over the actuarially determined remaining life of the resident, which is the expected period of occupancy by the resident. We pay refunds of our admission fees when residents relocate from our communities. We report the refundable amount of these admission fees as current liabilities and the non refundable amount as deferred revenue, a portion of which is classified as a current liability. The balance of refundable admission fees as of December 31, 2014 and 2013 were \$3,425 and \$3,863, respectively.

Leases. On the inception date of a lease and upon any relevant amendments to such lease, we test the classification of such lease as either a capital lease or an operating lease. None of our leases have met any of the criteria to be classified as a capital lease under FASB ASC Topic 840, Leases, and, therefore, we have accounted for all of our leases as operating leases.

Taxes. FASB ASC Topic 740, Income Taxes, prescribes how we should recognize, measure and present in our consolidated financial statements uncertain tax positions that have been taken or are expected to be taken in a tax return. We can recognize a tax benefit only if it is “more likely than not” that a particular tax position will be sustained upon examination or audit. To the extent the “more likely than not” standard has been satisfied, the benefit associated with a tax position is measured as the largest amount that has a greater than 50% likelihood of being realized. At December 31, 2014, our tax returns filed for the 2005 through 2014 tax years are subject to examination by taxing authorities.

We pay franchise taxes in certain states in which we have operations. We have included franchise taxes in general and administrative and other senior living operating expenses in our consolidated statements of operations.

We account for income taxes under the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences to be included in our financial statements. Under this method, deferred tax assets and liabilities are determined on the basis of the differences between the financial statement and tax bases of assets and liabilities

## Table of Contents

using enacted tax rates in effect for the year in which the differences are expected to reverse, while the effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

We recognize deferred tax assets to the extent that we believe these assets are more likely than not to be realized. In making such a determination, we consider all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax-planning strategies, and results of recent operations. In the future, if we determine that we would be able to realize our deferred tax assets in excess of their net recorded amount, we would make an adjustment to the deferred tax asset valuation allowance and record an income tax benefit.

**Fair Value of Financial Instruments.** Our financial instruments are limited to cash and cash equivalents, accounts receivable, available for sale securities, accounts payable and mortgage notes payable. Except for our mortgage notes payable, the fair value of these financial instruments was not materially different from their carrying values at December 31, 2014 and 2013. We estimate the fair values using market quotes when available, discounted cash flow analysis and current prevailing interest rates.

**Revenue Recognition.** We derive our revenues primarily from services to residents at our senior living communities and we record revenues when services are provided. We receive payment from governments or other third party payers for some of our services. We derived approximately 23%, 23% and 24% of our senior living revenues in 2014, 2013 and 2012, respectively, from payments under Medicare and Medicaid programs. Revenues under some of these programs are subject to audit and retroactive adjustment.

Medicare revenues from continuing operations at our senior living communities totaled \$129,212, \$132,751 and \$134,254 during 2014, 2013 and 2012, respectively. Medicaid revenues from continuing operations at our senior living communities totaled \$118,536, \$116,220, and \$118,505 during 2014, 2013 and 2012, respectively.

Substantially all community fees received are non refundable and are recorded initially as deferred revenue and are included in other current liabilities in our consolidated balance sheets. The deferred amounts are amortized over the life of the contract.

**Reclassifications.** We have made reclassifications to the prior years' financial statements to conform to the current year's presentation. These reclassifications had no effect on net income or shareholders' equity.

**Recently Issued Accounting Pronouncements.** In June 2014, the FASB issued Accounting Standards Update 2014 09, Revenue from Contracts with Customers (Topic 606), or ASU 2014 09. ASU 2014 09 aims to clarify the principles for recognizing revenue by, among other things, removing inconsistencies in revenue requirements, improving comparability of revenue recognition practices across entities and industries and providing improved disclosure requirements. We are required to retrospectively adopt ASU 2014 09 for fiscal periods beginning after December 15, 2016 and are currently evaluating the impact the adoption of this ASU will have on our consolidated financial statements.

**Segment Information.** We have two operating segments: senior living communities and rehabilitation and wellness. In the senior living community segment, we operate for our own account or manage for the account of third parties independent living communities, assisted living communities and SNFs that are subject to centralized oversight and provide housing and services to elderly residents. Our rehabilitation and wellness operating segment does not meet any of the quantitative thresholds of a reportable segment as prescribed under FASB ASC Topic 280, and therefore, we have determined that our business is comprised of one reportable segment, senior living. All of our operations and assets are located in the United States, except for the operations of our captive insurance company subsidiary, which

participates in our workers' compensation, professional liability and automobile insurance programs and which is organized in the Cayman Islands.

### 3. Property and Equipment

Property and equipment consists of the following:

	December 31, 2014	December 31, 2013
Land	\$ 24,172	\$ 22,214
Buildings and improvements	308,779	286,467
Furniture, fixtures and equipment	136,839	114,765
Property and equipment, at cost	469,790	423,446
Accumulated depreciation	(112,604)	(83,170)
Property and equipment, net	\$ 357,186	\$ 340,276

For the years ended December 31, 2014, 2013 and 2012, we recorded depreciation expense of \$29,434, \$25,871 and \$22,882, respectively, relating to our property and equipment.

Table of Contents

We review the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If there is an indication that the carrying value of an asset is not recoverable, we determine the amount of impairment loss, if any, by comparing the historical carrying value of the asset to its estimated fair value. As a result of our long-lived assets impairment review, we recorded \$589 and \$186 of impairment charges to certain of our long-lived assets in continuing operations for the years ended December 31, 2014 and 2013, respectively. We did not incur any impairment charges for the year ended December 31, 2012. We determine estimated fair value based on input from market participants, our experience selling similar assets, market conditions and internally developed cash flow models that our asset or asset groups are expected to generate. The fair values of the impaired assets were \$478 and \$137 as of December 31, 2014 and 2013, respectively, and are considered to be a Level 3 fair value measurement.

As of December 31, 2013, we had assets of \$9,342 included in our property and equipment that we subsequently sold during the year ended December 31, 2014 to SNH for increased rent pursuant to the terms of our leases with SNH. As of December 31, 2014, we had \$7,799 of assets included in our property and equipment that we currently expect to request that SNH purchase from us for an increase in future rent; however, we are not obligated to make these sales and SNH is not obligated to fund such amounts.

#### 4. Goodwill and Other Intangible Assets

The goodwill and other intangible assets balance relates to management agreements and trademarks we acquired in connection with a lease we entered into with SNH in 2009, goodwill and resident agreements we acquired in connection with our purchase of senior living communities in 2011 and 2014, and goodwill we recorded in connection with our other senior living community acquisitions in previous years. The changes in the carrying amount of goodwill and other intangible assets for the years ended December 31, 2014 and 2013 are as follows:

	As of December 31,	
	2014	2013
Goodwill	\$ 25,344	\$ 25,344
Other intangible assets, net of accumulated amortization of \$5,441 and \$3,001 respectively	560	1,063
	\$ 25,904	\$ 26,407

**Goodwill.** We review goodwill for impairment annually during our fourth quarter or more frequently if events or changes in circumstances exist. We evaluate goodwill for impairment at the reporting unit level; our reporting units are equivalent to our operating segments. All of our goodwill is located in our senior living reporting unit. As of October 1, 2014, we evaluated our goodwill for impairment and determined that the fair value of our reporting units exceeded their carrying values on that date. As December 31, 2014, no events or changes in circumstances had occurred that would trigger the need for an additional impairment review.

**Intangible assets.** We amortize intangible assets using the straight line method over the useful lives of the assets which have identifiable useful lives commencing on the date of acquisition. Total amortization expense for amortizable intangible assets for the years ended December 31, 2014, 2013 and 2012 was \$2,440, \$1,172 and \$1,626, respectively. At December 31, 2014, the weighted average amortization period remaining for these intangible assets is approximately two years. Amortization expense is estimated to be approximately \$306 in 2015, \$91 in 2016, \$84 in 2017, and \$80 in 2018.



Table of Contents

## 5. Income Taxes

Significant components of our deferred tax assets and liabilities at December 31, 2014 and 2013, were as follows:

	2014	2013
Current deferred tax assets:		
Continuing care contracts	\$ 124	\$ 134
Allowance for doubtful accounts	1,467	2,376
Deferred gains on sale lease back transactions	1,525	1,383
Insurance reserves	1,226	1,188
Tax credits	30	352
Tax loss carry forwards	610	6,679
Other	2,794	1,746
Total current deferred tax assets before valuation allowance	7,776	13,858
Valuation allowance:	(6,528)	(454)
Total current deferred tax assets	1,248	13,404
Non-current deferred tax assets:		
Continuing care contracts	565	592
Deferred gains on sale lease back transactions	579	735
Insurance reserves	2,773	2,880
Tax credits	17,160	14,883
Tax loss carry forwards	56,479	32,139
Impairment of securities	377	470
Depreciable assets	3,954	5,990
Other	800	1,054
Total non-current deferred tax assets before valuation allowance	82,687	58,743
Valuation allowance:	(70,392)	(3,149)
Total non-current deferred tax assets	12,295	55,594
Current deferred tax liabilities:		
Employee stock grants	(75)	(115)
Non-current deferred tax liabilities:		
Lease expense	(11,414)	(11,401)
Goodwill	(977)	(1,173)
Identifiable intangibles/other liabilities	(1,292)	(1,190)
Total non-current deferred tax liabilities	(13,683)	(13,764)
Net deferred tax asset (liabilities)	\$ (215)	\$ 55,119

As of December 31, 2014, our federal net operating loss carry forwards, which are scheduled to begin expiring in 2026 if unused, were approximately \$112,182, and our tax credit carry forwards, which begin expiring in 2022 if unused, were approximately \$17,191. We have an additional \$333 of federal net operating loss carry forwards not reflected in the deferred taxes table above, that are attributable to unvested stock grants which will be recorded as an increase to additional paid in capital once they are realized in accordance with FASB ASC Topic 718. Our net operating loss carry forwards and tax credit carry forwards are subject to audit and adjustments by the Internal Revenue Service.



Management assessed the available positive and negative evidence to estimate if sufficient future taxable income will be generated to realize the existing deferred tax assets. An important piece of objective negative evidence evaluated was the significant losses incurred over the two-year period ending December 31, 2014 and that, as a result of those losses, we expect to be in a cumulative loss position for the three-year period ending December 31, 2015. This objective negative evidence is difficult to overcome and would require a substantial amount of objectively verifiable positive evidence beyond our projections of future income to support the realizability of our deferred tax assets. Accordingly, on the basis of this assessment, as of December 31, 2014, we determined it is more likely than not that our net deferred tax assets will not be realized and concluded that a full valuation allowance is required, and we recorded increases to our valuation allowance totaling \$73,318 during the year ended December 31, 2014. In the future, if we believe that we will more likely than not realize the benefit of these deferred tax assets, we will adjust our valuation allowance and recognize an income tax benefit, which may affect our results of operations.

The changes in our valuation allowance for deferred tax assets were as follows:

	Balance at Beginning of Period	Amounts Charged/ (Credited) To Expense	Amounts Charged Off, Net of Recoveries	Amounts Charged to Equity	Balance at End of Period
Year Ended December 31, 2012	\$ 3,363	\$ (1,175)	\$ —	\$ —	\$ 2,188
Year Ended December 31, 2013	\$ 2,188	\$ 1,415	\$ —	\$ —	\$ 3,603
Year Ended December 31, 2014	\$ 3,603	\$ 73,470	\$ —	\$ (152)	\$ 76,921

Table of Contents

For the year ended December 31, 2014, we recognized a provision for income taxes from continuing operations of \$56,385, of which \$848 represents current state tax expense that is payable without regard to our tax loss carry forwards. We also recognized a provision for income taxes from discontinued operations of \$79.

The provision for income taxes from continuing operations is as follows:

	Years Ended December 31,		
	2014	2013	2012
Current tax provision:			
State	\$ 848	\$ 1,141	\$ 1,183
Total current tax provision	848	1,141	1,183
Deferred tax (benefit) provision:			
Federal	43,040	(1,042)	4,775
State	12,497	1,817	1,140
Total deferred tax provision	55,537	775	5,915
Total tax provision	\$ 56,385	\$ 1,916	\$ 7,098

The principal reasons for the difference between our effective tax rate on continuing operations and the U.S. federal statutory income tax rate are as follows:

	For the years ended December 31,					
	2014		2013		2012	
Taxes at statutory U.S. federal income tax rate	(35.0)	%	35.0	%	35.0	%
State and local income taxes, net of federal tax benefit	(6.5)	%	35.9	%	8.7	%
Tax credits	(5.4)	%	(42.1)	%	(4.2)	%
Change in valuation allowance	287.5	%	2.6	%	0.1	%
Nondeductible meals and entertainment	0.5	%	1.7	%	0.5	%
Nondeductible penalties	4.0	%	1.7	%	0.7	%
Dividend received deduction	(0.3)	%	(1.1)	%	(0.8)	%
Executive compensation	0.3	%	1.6	%	0.3	%
Stock based compensation	0.2	%	0.6	%	0.1	%
Other differences, net	0.3	%	(0.2)	%	(0.3)	%
Effective tax rate	245.6	%	35.7	%	40.1	%

We utilize a two step process for the measurement of uncertain tax positions that have been taken or are expected to be taken on a tax return. The first step is a determination of whether the tax position should be recognized in the financial statements. The second step determines the measurement of the tax position. A reconciliation of the beginning and ending amount of unrecognized tax benefits is summarized as follows for the years ended December 31, 2014, 2013 and 2012:

	For the years ended December 31,		
	2014	2013	2012
Unrecognized tax benefits at January 1	\$ 1,245	\$ 1,086	\$ 893
Additions for tax positions of prior years	—	—	—
Additions for tax positions of current year	134	159	193
Unrecognized tax benefits at December 31	\$ 1,379	\$ 1,245	\$ 1,086

As of December 31, 2014, the total amount of unrecognized tax benefits totaled \$1,379. It is reasonably possible the entire portion will be recognized in the next 12 months; an insignificant amount of which would impact the effective tax rate.

We recognize interest and penalties related to uncertain tax positions in income tax expense and such amounts were not material for the years ended December 31, 2014, 2013 and 2012.

## 6. Earnings Per Share

We computed basic EPS for the years ended December 31, 2014, 2013 and 2012 using the weighted average number of shares outstanding during the periods. Diluted EPS reflects the more dilutive earnings per common share amount calculated using the two class method or the treasury stock method. Unvested shares issued under our equity compensation plan are deemed participating securities because they participate equally in earnings with all of our other common shares and are included in the calculation of diluted EPS. The effect of our former convertible senior notes due 2026, or the Notes, for the year ended December 31, 2013 was not included in the calculation of diluted EPS because to do so would have been antidilutive.

Table of Contents

The following table provides a reconciliation of income (loss) from continuing operations and income (loss) from discontinued operations and the number of common shares used in the computations of diluted EPS:

	Year Ended December 31, 2014			2013			2012		
	Income (loss)	Shares	Per Share	Income (loss)	Shares	Per Share	Income (loss)	Shares	Per Share
(Loss) income from continuing operations	\$ (79,350)	48,028	\$ (1.65)	\$ 3,449	48,277	\$ 0.07	\$ 10,590	47,952	\$ 0.23
Effect of the Notes	—	—		344	986		677	2,182	
Diluted (loss) income from continuing operations	\$ (79,350)	48,028	\$ (1.65)	\$ 3,449	48,277	\$ 0.07	\$ 11,267	50,134	\$ 0.23
Diluted (loss) income from discontinued operations	\$ (6,056)	48,028	\$ (0.13)	\$ (5,789)	48,277	\$ (0.12)	\$ 11,717	50,134	\$ 0.23

## 7. Fair Values of Assets and Liabilities

Our assets recorded at fair value have been categorized based upon a fair value hierarchy in accordance with FASB ASC Topic 820, Fair Value Measurements and Disclosures. We apply the following fair value hierarchy, which prioritizes the inputs used to measure fair value into three levels.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that we have the ability to access at the measurement date.

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets and quoted prices in inactive markets.

Level 3 inputs are unobservable inputs for the asset or liability in which there is little, if any, market activity for the asset or liability at the measurement date.

### Recurring Fair Value Measures

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

The table below presents the assets measured at fair value at December 31, 2014 and 2013 categorized by the level of inputs used in the valuation of each asset.

Description	As of December 31, 2014			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents(1)	\$ 4,632	\$ 4,632	\$ —	\$ —
Available for sale securities:(2)				
Equity securities				
Financial services industry	4,059	4,059	—	—
REIT industry	330	330	—	—
Other	3,841	3,841	—	—
Total equity securities	8,230	8,230	—	—
Debt securities				
International bond fund(3)	2,385	—	2,385	—
High yield fund(4)	2,352	—	2,352	—
Industrial bonds	6,577	—	6,577	—
Government bonds	11,371	5,683	5,688	—
Financial bonds	2,704	—	2,704	—
Other	9,652	—	9,652	—
Total debt securities	35,041	5,683	29,358	—
Total available for sale securities	43,271	13,913	29,358	—
Total	\$ 47,903	\$ 18,545	\$ 29,358	\$ —

Table of Contents

Description	As of December 31, 2013			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents(1)	\$ 14,866	\$ 14,866	\$ —	\$ —
Available for sale securities:(2)				
Equity securities				
Financial services industry	3,668	3,668	—	—
REIT industry	704	704	—	—
Other	3,875	3,875	—	—
Total equity securities	8,247	8,247	—	—
Debt securities				
International bond fund(3)	2,329	—	2,329	—
High yield fund(4)	2,309	—	2,309	—
Industrial bonds	5,234	—	5,234	—
Government bonds	7,075	4,558	2,517	—
Financial bonds	1,154	—	1,154	—
Other	4,706	—	4,706	—
Total debt securities	22,807	4,558	18,249	—
Total available for sale securities	31,054	12,805	18,249	—
Total	\$ 45,920	\$ 27,671	\$ 18,249	\$ —

- (1) Cash equivalents, consisting of short term, highly liquid investments and money market funds held principally for obligations arising from our self-insurance programs. Cash equivalents are reported on our balance sheet as cash and cash equivalents and current and long term restricted cash. Cash equivalents include \$2,792 and \$13,181 of balances that are restricted at December 31, 2014 and 2013, respectively.
- (2) Investments in available for sale securities are reported on our balance sheet as current and long term investments in available for sale securities and are reported at fair value of \$23,436 and \$19,835, respectively, at December 31, 2014 and \$19,150 and \$11,905, respectively, at December 31, 2013. Our investments in available for sale securities had amortized costs of \$40,974 and \$29,127 as of December 31, 2014 and 2013, respectively, had unrealized gains of \$2,455 and \$2,185 as of December 31, 2014 and 2013, respectively, and had unrealized losses of \$157 and \$257 as of December 31, 2014 and 2013, respectively. At December 31, 2014, 23 of the securities we hold, with a fair value of \$7,761, have been in a loss position for less than 12 months and 10 of the securities we hold, with a fair value of \$1,797, have been in a loss position for greater than 12 months. We do not believe these securities are impaired primarily because they have not been in a loss position for an extended period of time, the financial conditions of the issuers of these securities remain strong with solid fundamentals, or we intend to hold these securities until recovery, and other factors that support our conclusion that the loss is temporary. During the years ended December 31, 2014, 2013 and 2012, we received gross proceeds of \$10,876, \$6,285 and \$4,163, respectively, in connection with the sales of available for sale securities and recorded gross realized gains totaling \$478, \$329 and \$63, respectively, and gross realized losses totaling \$86, \$334 and \$82, respectively. We record gains and losses on the sales of our available for sale securities using the specific identification method.
- (3) The investment strategy of this fund is to invest principally in fixed income securities. The fund invests in such securities or investment vehicles as it considers appropriate to achieve the fund's investment objective, which is to provide an above average rate of total return while attempting to limit investment risk by investing in a diversified portfolio of U.S. dollar investment grade fixed income securities. There are no unfunded commitments and the

investment can be redeemed weekly.

- (4) The investment strategy of this fund is to invest principally in fixed income securities. The fund invests in such securities or investment vehicles as it considers appropriate to achieve the fund's investment objective, which is to provide an above average rate of total return while attempting to limit investment risk by investing in a diversified portfolio of primarily fixed income securities issued by companies with below investment grade ratings. There are no unfunded commitments and the investment can be redeemed weekly.

During the year ended December 31, 2014, we did not change the type of inputs used to determine the fair value of any of our assets and liabilities that we measure at fair value. Accordingly, there were no transfers of assets or liabilities between levels of the fair value hierarchy during the year ended December 31, 2014.

The carrying values of accounts receivable and accounts payable approximate fair value as of December 31, 2014 and December 31, 2013. The carrying value and fair value of our mortgage notes payable were \$51,159 and \$56,099, respectively, as of December 31, 2014 and \$37,620 and \$41,113, respectively, as of December 31, 2013, and are categorized in Level 3 of the fair value hierarchy in their entirety. We estimate the fair values of our mortgage notes payable by using discounted cash flow analyses and currently prevailing market terms as of the measurement date.

#### Non-Recurring Fair Value Measures

We review the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset or asset group may not be recoverable. See Note 3 for discussion of fair value measurements related to impairments of our long-lived assets.

## Table of Contents

We evaluate the recoverability of goodwill assets on October 1 of each fiscal year, or more frequently if events or changes in circumstances indicate that goodwill or other intangible assets may be impaired. See Note 4 for discussion of our annual review of goodwill impairment.

The fair value of assets held for sale is determined based on the use of appraisals, input from market participants, our experience selling similar assets and/or internally developed cash flow models, all of which are considered to be Level 3 fair value measurements.

See Note 11 for discussion of fair value measurements related to an acquisition that occurred during the second quarter of 2014.

### 8. Indebtedness

We have a \$25,000 revolving secured line of credit, or our Credit Agreement, that is available for general business purposes, including acquisitions. The maturity date of our Credit Agreement is March 18, 2016. Borrowings under our Credit Agreement typically bear interest at LIBOR plus a premium of 250 basis points, or 2.66% as of December 31, 2014. We are also required to pay a quarterly commitment fee of 0.35% per annum on the unused part of our borrowing availability under the Credit Agreement. We may draw, repay and redraw funds until maturity, and no principal repayment is due until maturity. We made no borrowings under our Credit Agreement during the years ended December 31, 2014 and 2013 and, as of December 31, 2014, we had no amounts outstanding under our Credit Agreement. We incurred interest expense and other associated costs related to our Credit Agreement of \$192, \$386 and \$676 for the years ended December 31, 2014, 2013 and 2012, respectively.

We are the borrower under our Credit Agreement and certain of our subsidiaries guarantee our obligations under our Credit Agreement, which is secured by our and our guarantor subsidiaries' accounts receivable and related collateral. Our Credit Agreement provides for acceleration of payment of all amounts outstanding upon the occurrence and continuation of certain events of default, such as a change of control of us, which includes termination of our business management and shared services agreement, or our business management agreement, with Reit Management & Research LLC, or RMR.

We also have a \$150,000 secured revolving credit facility, or our Credit Facility, that is available for general business purposes, including acquisitions. The maturity date of our Credit Facility was initially April 13, 2015, but, subject to the payment of extension fees and meeting certain other conditions, our Credit Facility includes options for us to extend its stated maturity date for two consecutive one-year periods. In March 2015, we notified the lenders under our Credit Facility of our intent to exercise our first one-year option to extend the maturity date of our Credit Facility to April 13, 2016. Subject to the payment of an extension fee and meeting certain other conditions, the lenders under our Credit Facility have agreed to extend our maturity date one year to April 13, 2016. Borrowings under our Credit Facility typically bear interest at LIBOR plus a premium of 250 basis points, or 2.66% as of December 31, 2014. We are also required to pay a quarterly commitment fee of 0.35% per annum on the unused part of the Credit Facility. We may draw, repay and redraw funds until maturity, and no principal repayment is due until maturity. The weighted average interest rate for borrowings under our Credit Facility was 2.76% and 3.05% for the years ended December 31, 2014 and 2013, respectively. As of December 31, 2014, we had \$35,000 outstanding under our Credit Facility. We incurred interest expense and other associated costs related to our Credit Facility of \$2,272, \$1,985 and \$1,746 for the



years ended December 31, 2014, 2013 and 2012, respectively.

We are the borrower under our Credit Facility, and certain of our subsidiaries guarantee our obligations under our Credit Facility, which is secured by real estate mortgages on 15 senior living communities with 1,549 living units owned by our guarantor subsidiaries and our guarantor subsidiaries' accounts receivable and related collateral. Our Credit Facility provides for acceleration of payment of all amounts outstanding upon the occurrence and continuation of certain events of default, such as a change of control of us.

Our Credit Agreement and our Credit Facility contain a number of financial and other covenants, including covenants that restrict our ability to incur indebtedness or to pay dividends or make other distributions under certain circumstances and require us to maintain financial ratios and a minimum net worth. On March 13, 2015, we and the lenders under our Credit Agreement entered into Amendment No. 3 to the Credit and Security Agreement, which amended the defined term for EBITDA set forth in the Credit Agreement by excluding from the calculation of EBITDA certain costs associated with Medicare compliance deficiencies and made certain changes to the representations and warranties in the Credit Agreement to except certain failures to comply with Medicare billing, recordkeeping, reporting and related practices.

In May 2011, we entered into the bridge loan from SNH, or the Bridge Loan, under which SNH agreed to lend us up to \$80,000 to fund a part of the purchase price for our acquisitions of certain assets of six senior living communities located in Indiana, or the Indiana Communities. During 2011, we completed our acquisitions of the assets of the Indiana Communities and, in connection

Table of Contents

with the acquisitions, borrowed \$80,000 under the Bridge Loan. During 2011, we repaid \$42,000 of this advance with proceeds from a public offering of our common shares and cash generated by operations. In April 2012, we repaid in full the principal amount then outstanding under the Bridge Loan, resulting in termination of the Bridge Loan. We funded the April 2012 repayment of the Bridge Loan with borrowings under our Credit Facility and cash on hand. We incurred interest expense and other associated costs related to the Bridge Loan of \$314 for the year ended December 31, 2012.

At December 31, 2014, we had six irrevocable standby letters of credit outstanding totaling \$963. The six letters of credit are security for our lease obligation to HCP, Inc., or HCP, to an automobile maintenance company and to a mortgagee of our property encumbered by a Federal National Mortgage Association, or FNMA, insured mortgage. The letters of credit are renewed annually. The maturity dates for these letters of credit range from April 2015 to August 2015. Our obligations under these letters of credit are secured by cash.

In October 2006, we issued \$126,500 principal amount of the Notes. Our net proceeds from this issuance were approximately \$122,600. The Notes bore interest at a rate of 3.75% per annum and were convertible into our common shares at any time. The conversion rate, which was subject to adjustment, was 76.9231 common shares per \$1 principal amount of the Notes, which represented a conversion price of \$13.00 per share. The Notes were guaranteed by certain of our wholly owned subsidiaries. The Notes were scheduled to mature on October 15, 2026. We were entitled to prepay the Notes at any time and the holders were entitled to require us to purchase all or a portion of these Notes on each of October 15, 2013, 2016 and 2021 at a repurchase price equal to 100% of the principal amount of the Notes to be repurchased, plus any accrued and unpaid interest. We have periodically repurchased Notes in open market transactions or in privately negotiated transactions. During 2012, we purchased and retired \$12,410 par value of the outstanding Notes and recorded a gain on early extinguishment of debt, net of unamortized issuance costs, of \$45. On July 8, 2013, we redeemed all of the \$24,872 principal amount of the Notes then outstanding at a redemption price equal to the principal amount, plus accrued and unpaid interest. We recorded a loss on early extinguishment of debt, net of unamortized issuance costs, of \$599. We funded these purchases principally with available cash and borrowings under our Credit Facility. Interest expense and other associated costs related to the Notes was \$511 and \$1,124 for the years ended December 31, 2013 and 2012, respectively.

At December 31, 2014, five of our senior living communities were encumbered by mortgage notes with an aggregate outstanding principal balance of \$51,159: (1) two of our communities were encumbered by FNMA mortgage notes and (2) three of our communities were encumbered by Federal Home Loan Mortgage Corporation, or FMCC, mortgage notes. These mortgages contain FNMA and FMCC, respectively, standard mortgage covenants. We recorded a mortgage premium in connection with our assumption of the FNMA and FMCC mortgage notes as part of our acquisitions of the encumbered communities in order to record the assumed mortgage notes at their estimated fair value. We are amortizing the mortgage premiums as a reduction of interest expense until the maturity of the respective mortgage notes. The following table is a summary of these mortgage notes as of December 31, 2014:

Balance as of December 31, 2014	Contractual Stated Interest Rate		Effective Interest Rate		Maturity Date	Monthly Payment
\$ 15,048	6.47	%	3.45	%	June 2018	95
18,563	6.64	%	5.86	%	June 2023	\$ 123
5,832	8.99	%	5.46	%	February 2025	63
2,699	6.36	%	6.70	%	September 2028	25
9,017	6.20	%	6.70	%	September 2032	72
\$ 51,159	6.77	%(1)	5.30	%(1)		\$ 378

(1) Weighted average interest rate.

We incurred mortgage interest expense, including premium amortization, of \$2,665, \$3,010 and \$2,843 for the years ended December 31, 2014, 2013 and 2012, respectively, including interest expense recorded in discontinued operations. Our mortgages require monthly payments into escrows for taxes, insurance and property replacement funds; withdrawals from these escrows require applicable FNMA and FMCC approval. As of December 31, 2014, we believe we were in compliance with all applicable covenants under these mortgages.

Principal payments due under the terms of these mortgages are as follows:

F-20

---

Table of Contents

2015	1,786
2016	1,883
2017	1,986
2018	14,660
2019	1,530
Thereafter	29,314
	\$ 51,159

## 9. Leases

As of December 31, 2014, we leased 181 senior living communities from SNH under four leases (including four that we have classified as discontinued operations). As of December 31, 2014, we also leased four senior living communities under a lease with HCP. These leases are “triple net” leases which require that we pay all costs incurred in the operation of the communities, including the cost of insurance and real estate taxes, maintaining the communities, and indemnifying the landlord for any liability which may arise from the operations during the lease term.

Our leases with SNH require us to pay percentage rent at 174 of the senior living communities we lease from SNH equal to 4% of the amount by which gross revenues, as defined in our leases, exceeds gross revenues in a base year. We recorded approximately \$5,775, \$5,149 and \$4,888 in percentage rent to SNH for the years ended December 31, 2014, 2013 and 2012, respectively. Our lease with HCP contains a minimum annual escalator of 2%, but not greater than 4%, depending on increases in certain cost of living indexes.

At our request, SNH may purchase renovations and improvements to communities we lease from SNH in return for rent increases according to formulas in the leases; however, SNH is not obligated to purchase these renovations and improvements from us and we are not required to sell them to SNH. In 2014, 2013 and 2012, SNH funded \$25,804, \$27,208 and \$30,520, respectively, for renovations and improvements to some of our communities and, as a result, our annual rent increased by \$2,066, \$2,177 and \$2,456, respectively.

The following table is a summary of our real property leases as of December 31, 2014 (including four senior living communities that we have classified as discontinued operations):

	Number of Properties	Annual Minimum Rent as of December 31, 2014	Current Expiration date	Remaining Renewal Options
1. Lease No. 1 for SNFs and independent and assisted living communities(1)	86	\$ 58,475	December 31, 2024	Two 15-year renewal options.
2. Lease No. 2 for SNFs and independent and assisted living communities	49	62,889	June 30, 2026	Two 10-year renewal options.
	17	34,388		

Edgar Filing: FIVE STAR QUALITY CARE INC - Form 10-K

3. Lease No. 3 for independent and assisted living communities (2)			December 31, 2028	Two 15-year renewal options.
4. Lease No. 4 for SNFs and independent and assisted living communities (3)	29	34,911	April 30, 2032	Two 15-year renewal options. One 10-year renewal option.
5. One HCP lease	4	2,550	April 30, 2028	
Totals	185	\$ 193,213		

- (1) Lease No. 1 is comprised of two separate leases. One of these two leases exists to accommodate a mortgage financing in effect at the time SNH acquired the property; we have agreed with SNH to combine these two leases into one lease when this mortgage financing is paid in full.
- (2) Lease No. 3 exists to accommodate certain mortgage financing by SNH.
- (3) Lease No. 4 is comprised of two separate leases. One of these two leases exists to accommodate a mortgage financing in effect at the time SNH acquired the property; we have agreed with SNH to combine these two leases into one lease when the mortgage financing is paid in full.

Table of Contents

The future minimum rents required by our leases as of December 31, 2014, are as follows:

2015	193,247
2016	193,298
2017	193,351
2018	193,405
2019	193,459
Thereafter	1,466,796
	\$ 2,433,556

#### 10. Shareholders' Equity

We have common shares available for issuance under the terms of our equity compensation plan, or our Share Award Plan. We issued 403,050, 385,400 and 347,050 of our common shares in 2014, 2013 and 2012, respectively, to our Directors, officers and others who provide services to us. We valued these shares at the average price of our common shares on the exchange on which they were listed on the dates of issue, or \$1,742 in 2014, based on a \$4.32 weighted average share price, \$1,758 in 2013, based on a \$4.56 weighted average share price, and \$1,638 in 2012, based on a \$4.72 weighted average share price. Shares issued to Directors vest immediately; one fifth of the shares issued to our officers and others (other than our Directors) vest on the date of grant and on the four succeeding anniversaries of the date of grant. Our unvested common shares totaled 647,330, 611,220 and 546,920 as of the years ended December 31, 2014, 2013 and 2012, respectively. Share based compensation expense is recognized ratably over the vesting period and is included in general and administrative expenses in our consolidated statements of operations. We recorded share based compensation expense of \$1,485, \$1,410 and \$1,445 for the years ended December 31, 2014, 2013 and 2012, respectively. As of December 31, 2014, the estimated future stock compensation expense for unvested shares was \$2,789 based on the grant date closing share price for awards granted to our Directors, officers and others, and based on the closing share price of \$4.15 on December 31, 2014 for awards granted to non-employees. The weighted average period over which the stock compensation expense will be recorded is approximately 2.1 years. As of December 31, 2014, 4,518,940 of our common shares remain available for issuance under our Share Award Plan.

In 2014, employees and officers of ours who are recipients of our share awards were permitted to elect to have us withhold the number of their then vesting common shares with a fair market value equal to, but not greater than, the minimum required tax withholding obligations with respect to their vesting share awards in satisfaction of those withholding obligations. During 2014, we acquired through this share withholding process an aggregate of 11,377 common shares with an aggregate value of \$47, which is reflected as an increase to accumulated deficit in our consolidated balance sheet.

#### 11. Acquisition

In May 2014, we acquired a senior living community with 116 living units located in Alabama for approximately \$19,914, including the assumption of approximately \$13,920 of mortgage debt and the assumption of approximately \$68 of net working capital liabilities, but excluding closing costs. This community primarily offers independent and

assisted living services that are currently 100% paid by residents from their private resources. We funded this acquisition with cash on hand and borrowings under our Credit Facility. We incurred acquisition related costs of \$81 during the second quarter of 2014. These costs include transaction costs, professional fees and other acquisition related expenses. The allocation of the purchase price was based on management's judgment after evaluating several factors, including valuation assessments of tangible and intangible assets, and estimates of the fair value of liabilities assumed. The definite lived intangible assets were valued using the income approach and are categorized in Level 3 of the fair value hierarchy. The valuation of certain tangible assets and liabilities acquired was determined using the cost approach. For personal property, we primarily used the cost approach to estimate reproduction or replacement cost. The fair value of these assets and liabilities are also categorized in Level 3 of the fair value hierarchy. The following table summarizes the allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed:

Land	\$ 1,208
Buildings and improvements	17,946
Furniture, fixtures and equipment	421
Total property, plant and equipment	19,575
Intangible assets	1,937
Premium on assumed mortgage debt	(1,598)
	\$ 19,914

Table of Contents

## 12. Discontinued Operations

In 2011, we decided to offer for sale two SNFs we owned located in Michigan with a total of 271 living units. On April 30, 2013, we sold these two SNFs for an aggregate sales price of \$8,000, which included as part of the sales price the prepayment by the buyer of the then outstanding \$7,510 of United States Department of Housing and Urban Development mortgage debt that encumbered these SNFs.

In September 2012, we completed the sale of our pharmacy business to Omnicare, Inc., or Omnicare. We received \$34,298 in sale proceeds from Omnicare, which included \$3,789 in working capital. We recorded a pre tax capital gain on sale of the pharmacy business of \$23,347. In connection with the sale, Omnicare did not acquire the real estate we own associated with one pharmacy located in South Carolina. In July 2014, we sold this real estate for a sales price of \$205. We recorded an asset impairment charge of \$57 during the fourth quarter of 2013 to reduce the carrying value of this real estate to its estimated fair value, less costs to sell.

In June 2013, we decided to offer for sale an assisted living community we own with 32 living units located in Alabama. We are in the process of offering this community for sale.

Please see Note 15 below for a discussion of 11 senior living communities and two rehabilitation hospitals that we lease or had leased from SNH which are included in discontinued operations for all of the periods presented in these consolidated financial statements; seven of which had been sold as of December 31, 2014 and one additional of which was sold in February 2015.

We can provide no assurance that we will be able to sell the senior living community that we are offering for sale, or that we and SNH will be able to sell the remaining three senior living communities that we lease from SNH that are being offered for sale, or what the terms or timing of any sales may be.

We have reclassified our consolidated balance sheets and consolidated statements of operations for all periods presented to show the financial position and results of operations of our pharmacies, rehabilitation hospitals and the communities which have been sold or are expected to be sold as discontinued. Below is a summary of the operating results of these discontinued operations included in the consolidated financial statements for the years ended December 31, 2014, 2013 and 2012:

	2014	2013	2012
Revenues	\$ 22,051	\$ 151,600	\$ 213,020
Expenses	(28,028)	(154,578)	(218,565)
Impairment on discontinued assets	—	(4,153)	(644)
(Provision for) benefit from income taxes	(79)	3,539	(5,441)
(Loss) gain on sale	—	(2,197)	23,347
(Loss) income from discontinued operations	\$ (6,056)	\$ (5,789)	\$ 11,717



### 13. Off Balance Sheet Arrangement

We have pledged our accounts receivable and certain other assets, with a carrying value, as of December 31, 2014, of \$13,744, arising from our operation of 26 properties owned by SNH and leased to us to secure SNH's borrowings from its lender, FNMA. As of December 31, 2014, we had no other off balance sheet arrangements that have had or that we expect would be reasonably likely to have a future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### 14. Litigation Settlement

On May 29, 2012, we entered into a settlement agreement, or the Settlement Agreement, with subsidiaries of Sunrise Senior Living Inc., or Sunrise, pursuant to which we agreed to settle our long running litigation with Sunrise, involving amounts charged by Sunrise to us for certain insurance programs for senior living communities managed by Sunrise for us. Pursuant to the Settlement Agreement, Sunrise paid us \$4,000 in cash and we recorded a gain of \$3,365, net of legal fees, in our consolidated statements of operations.

### 15. Related Person Transactions

We have adopted written Governance Guidelines that describe the consideration and approval of any related person

F-23

---

Table of Contents

transactions. Under these Governance Guidelines, we may not enter into any transaction in which any Director or executive officer, any member of the immediate family of any Director or executive officer or any other related person, has or will have a direct or indirect material interest unless that transaction has been disclosed or made known to our Board of Directors and our Board of Directors reviews and approves or ratifies the transaction by the affirmative vote of a majority of the disinterested Directors, even if the disinterested Directors constitute less than a quorum. If there are no disinterested Directors, the transaction must be reviewed, authorized and approved or ratified by both (i) the affirmative vote of a majority of our Board of Directors and (ii) the affirmative vote of a majority of our Independent Directors. In determining whether to approve or ratify a transaction, our Board of Directors, or disinterested Directors or Independent Directors, as the case may be, also act in accordance with any applicable provisions of our charter and bylaws, consider all of the relevant facts and circumstances and approve only those transactions that are fair and reasonable to us and our stockholders. All related person transactions described below were reviewed and approved or ratified by a majority of the disinterested Directors or otherwise in accordance with our policies, charter and bylaws, each as described above. In the case of any transaction with us in which any other employee of ours who is subject to our Code of Business Conduct and Ethics and who has a direct or indirect material interest in the transaction, the employee must seek approval from an executive officer who has no interest in the matter for which approval is being requested. Copies of our Governance Guidelines and Code of Business Conduct and Ethics are available on our website, [www.fivestarseniorliving.com](http://www.fivestarseniorliving.com).

SNH

We were formerly a 100% owned subsidiary of SNH, SNH is our largest landlord and our largest stockholder and we manage senior living communities for SNH. In 2001, SNH distributed substantially all of our then outstanding common shares to its shareholders. As of December 31, 2014, SNH owned 4,235,000 of our common shares, or approximately 8.6% of our outstanding common shares. One of our Managing Directors, Mr. Barry Portnoy, is a managing trustee of SNH. Mr. Barry Portnoy's son, Mr. Adam Portnoy, also serves as a managing trustee of SNH. SNH's executive officers are officers of RMR and SNH's President and Chief Operating Officer is a director of RMR. In order to effect this spin off and to govern relations after the spin off, we entered into agreements with SNH and others. We have entered into various leases with SNH and other agreements that include provisions that confirm and modify these undertakings. Among other matters, these agreements provide that:

- so long as SNH remains a real estate investment trust, we may not waive the share ownership restrictions in our charter on the ability of any person or group to acquire more than 9.8% of any class of our equity shares without the consent of SNH;
- so long as we are a tenant of, or manager for, SNH, we will not permit nor take any action that, in the reasonable judgment of SNH, might jeopardize the tax status of SNH as a real estate investment trust;
- SNH has the option to cancel all of our rights under the leases and management agreements we have with SNH upon the acquisition by a person or group of more than 9.8% of our voting stock and upon other change in control events affecting us, as defined in those documents, including the adoption of any stockholder proposal (other than a precatory proposal) or the election to our Board of Directors of any individual if such proposal or individual was not approved, nominated or appointed, as the case may be, by vote of a majority of our Directors in office immediately prior to the making of such proposal or the nomination or appointment of such individual; and
- the resolution of disputes arising from our leases and other agreements with SNH may be resolved by binding arbitration; and
- so long as we are a tenant of, or manager for, SNH or so long as we have a business management agreement with RMR, we will not acquire or finance any real estate of a type then owned or financed by SNH or any other company managed by RMR without first giving SNH or the other company managed by RMR, as applicable, the opportunity to acquire or finance that real estate.

As of December 31, 2014, we leased 181 senior living communities (including four that we have classified as discontinued operations) from SNH under four combination leases. Under our leases with SNH, we pay SNH minimum rent plus percentage rent based on increases in gross revenues at certain properties. Our total minimum annual rent payable to SNH as of December 31, 2014 was \$190,663, excluding percentage rent. Our total rent expense (which includes rent for all properties we lease from SNH, including properties we have classified as discontinued operations) under all of our leases with SNH, net of lease inducement amortization, was \$195,538, \$202,868 and \$200,036 for the years ended December 31, 2014, 2013 and 2012, respectively. As of December 31, 2014 and 2013, we had outstanding rent due and payable to SNH of \$17,310 and \$17,960, respectively. During the years ended December 31, 2014, 2013 and 2012, pursuant to the terms of our leases with SNH, we sold \$25,804, \$27,208 and \$30,520, respectively, of

F-24

---

Table of Contents

improvements made to properties leased from SNH and, as a result, our annual rent payable to SNH increased by approximately \$2,066, \$2,177 and \$2,456, respectively. As of December 31, 2014, our property and equipment included \$7,799 for similar improvements we have made to properties we lease from SNH that we expected to request that SNH purchase from us for an increase in future rent; however, SNH is not obligated to purchase these improvements.

In December 2013, pursuant to the Purchase Agreement, we and SNH sold the real estate and transferred the operations at two rehabilitation hospitals and 13 out patient clinics affiliated with those rehabilitation hospitals to unrelated third parties. As a result of this transaction, SNH received proceeds of approximately \$90,000 for the sale of the real estate associated with those rehabilitation hospitals and we retained certain net assets of approximately \$9,591. These rehabilitation hospitals were previously leased to us by SNH under one of our combination leases with SNH, Lease No. 2, and the affiliated clinics were leased to us by third parties. Pursuant to an amendment to Lease No. 2 that we entered into in September 2013 in connection with our and SNH's agreement to sell the real estate and transfer the operations at the rehabilitation hospitals, Lease No. 2 terminated with respect to the rehabilitation hospitals and our annual rent paid to SNH under Lease No. 2 was reduced by \$9,500 upon the closing of this transaction. The lease amendment also provides for an allocation of indemnification obligations under the Purchase Agreement between SNH and us.

We and SNH previously agreed that SNH would offer for sale 11 senior living communities we lease from SNH, which we have classified as discontinued operations. Our rent payable to SNH is reduced as these sales occur pursuant to terms set in our leases with SNH. In August 2013, we and SNH sold one of these communities, a SNF located in Missouri with 112 living units, for a sale price of \$2,550, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$255 in accordance with the terms of the applicable lease. In January 2014, we and SNH sold one of these communities, an assisted living community located in Texas with 48 assisted living units, for a sale price of \$2,400, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$210 in accordance with the terms of the applicable lease. In June 2014, we and SNH sold two of these communities, both of which are SNFs located in Wisconsin, with an aggregate of 139 living units, for a sale price of \$4,500, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$450 in accordance with the terms of the applicable lease. In October 2014, we and SNH sold one of these communities, an assisted living community in Virginia with 55 assisted living units, for a sale price of \$2,850, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$285 in accordance with the terms of the applicable lease. Also in October 2014, we and SNH sold an assisted living community and a SNF located in Arizona with an aggregate of 160 living units, for a sale price of \$5,900, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$590 in accordance with the terms of the applicable lease. In February 2015, we and SNH sold an assisted living community located in Pennsylvania with 103 living units, for a sale price of \$250, and as a result of this sale, our annual minimum rent payable to SNH decreased by \$23 in accordance with the terms of the applicable lease. We can provide no assurance that we and SNH will be able to sell the remaining three senior living communities we lease from SNH that are being offered for sale, or what the terms or timing of any sales may be.

In July 2014, we and SNH entered into the Fifth Amendment to the Amended and Restated Master Lease Agreement (Lease No. 4), or Lease No. 4, pursuant to which we exercised the first of our existing lease extension options under Lease No. 4, extending the term from April 30, 2017 to April 30, 2032, and SNH granted us a third option for us to extend the term of Lease No. 4 from May 1, 2047 to April 30, 2062.

As of December 31, 2014, we managed 46 senior living communities for the account of SNH, each pursuant to long term management agreements on substantially similar terms. With the exception of the management agreement for the senior living community in New York described below, the management agreements for the communities we manage

for SNH's account provide us with a management fee equal to 3% of the gross revenues realized at the communities, plus reimbursement for our direct costs and expenses related to the communities and an incentive fee equal to 35% of the annual net operating income of the communities after SNH realizes an annual return equal to 8% of its invested capital. The management agreements generally expire on December 31, 2031, 2032, 2033 or 2035, and are subject to automatic renewal for two consecutive 15 year terms, unless earlier terminated or timely notice of nonrenewal is delivered. The management agreements provide that we and SNH each have the option to terminate the agreements upon the acquisition by a person or group of more than 9.8% of the other's voting stock and upon other change in control events affecting the other party, as defined in those documents, including the adoption of any shareholder proposal (other than a precatory proposal) or the election to the board of directors or board of trustees of any individual if such proposal or individual was not approved, nominated or appointed, as the case may be, by vote of a majority of the board of directors or board of trustees in office immediately prior to the making of such proposal or the nomination or appointment of such individual.

In connection with these management agreements, we and SNH have entered into four combination agreements, or pooling agreements: three pooling agreements combine certain of our management agreements with SNH for communities that include assisted living units, or the AL Pooling Agreements; and a fourth pooling agreement combines our management agreements with SNH for communities that include only independent living units, or the IL Pooling Agreement. The management agreements that are included in each of the pooling agreements are on substantially similar terms. The first AL Pooling Agreement, which we entered into in May 2011, includes 20 identified communities and the second AL Pooling Agreement, which we entered into in October 2012, includes 19 identified

Table of Contents

communities. We and SNH entered into our third AL Pooling Agreement in November 2013 and that pooling agreement currently includes three identified communities. We entered into the IL Pooling Agreement in August 2012 and that agreement currently includes two identified communities that have only independent living units. The senior living community in New York and the senior living community in California described below that we manage for the account of SNH are not included in any of our pooling agreements. Each of the AL Pooling Agreements and the IL Pooling Agreement aggregates the determination of fees and expenses of the various communities that are subject to such pooling agreement, including determinations of our incentive fees and SNH's return of its invested capital. Under each of the pooling agreements, SNH has the right, after the period of time specified in the agreement has elapsed and subject to our cure rights, to terminate all, but not less than all, of the management agreements that are subject to the pooling agreement if SNH does not receive its minimum return in each of three consecutive years. In addition, under each of the pooling agreements, we have a limited right to require the sale of underperforming communities. Also, under each of the pooling agreements, any nonrenewal notice given by us with respect to a community is deemed a nonrenewal with respect to all the communities that are the subject of the agreement. We earned management fees from SNH \$9,765, \$9,229 and \$5,582 for the years ended December 31, 2014, 2013 and 2012, respectively, with respect to the communities we manage.

In July 2014, we entered into an agreement with SNH, pursuant to which the management agreement for the assisted living community known as Villa Valencia, which is located in California, was removed from the second AL Pooling Agreement as of July 1, 2014. We expect that the management agreement affecting the Villa Valencia community will not be included in any pooling agreement until after extensive renovations planned at that community are completed.

In July 2014, we entered into an amendment to the management agreements with SNH that include assisted living units to (i) extend the term of each of the management agreements between us and SNH for Villa Valencia and the 19 assisted living communities currently included in the second AL Pooling Agreement from December 31, 2031 to December 31, 2033 and (ii) extend the term of the management agreement between us and SNH for the senior living community known as Willow Pointe, which is currently included in the third AL Pooling Agreement, from December 31, 2031 to December 31, 2035. In July 2014, we also entered into an amendment to our management agreements with SNH that include only independent living units to extend the term of the management agreements between us and SNH for two independent living communities from December 31, 2031 to December 31, 2032. All of the management agreements that are currently included in the third AL Pooling Agreement expire on December 31, 2035.

In December 2014, we began managing two senior living communities in Wisconsin. We manage these communities for SNH's account pursuant to separate long term management agreements for communities that include assisted living units and these agreements are included in the third AL Pooling Agreement below.

We expect that we may enter into additional management arrangements with SNH for senior living communities that SNH may acquire in the future on terms similar to those management arrangements we currently have with SNH, including management agreements for some of the 38 senior living communities that SNH has recently announced that it expects to acquire, in the event SNH is unable to reach mutually acceptable agreements with the current managers of these properties.

We manage a portion of a senior living community in New York that is not subject to the requirements of New York healthcare licensing laws, consisting of 199 living units, pursuant to a long term management agreement with SNH. The terms of this management agreement are substantially consistent with the terms of our other management agreements with SNH for communities that include assisted living units, except that the management fee payable to us is equal to 5% of the gross revenues realized at that portion of the community, and there is no incentive fee payable to us under this management agreement. This management agreement expires on December 31, 2031. In order to accommodate certain requirements of New York healthcare licensing laws, SNH subleases a portion of this senior living community that is subject to those requirements, consisting of 111 living units, to an entity, D&R Yonkers LLC, which is owned by SNH's President and Chief Operating Officer and its Treasurer and Chief Financial Officer. We manage this portion of the community pursuant to a long term management agreement with D&R Yonkers LLC. Pursuant to that management agreement, D&R Yonkers LLC pays us a management fee equal to 3% of the gross revenues realized at that portion of the community and we are not entitled to any incentive fee under that agreement. Our management agreement with D&R Yonkers LLC expires on August 31, 2017, and is subject to renewal for nine consecutive five year terms, unless earlier terminated or timely notice of nonrenewal is delivered.

As discussed above in Note 8, in May 2011, we and SNH entered into the Bridge Loan, under which SNH loaned us \$80,000. In April 2012, we repaid in full the then outstanding principal amount under the Bridge Loan, resulting in termination of the Bridge Loan. The Bridge Loan bore interest at a rate equal to the annual rates of interest applicable to SNH's borrowings under its revolving credit facility, plus 1%. We incurred interest expense on the Bridge Loan of \$314 for the year ended December 31, 2012, which amount is included in interest and other expense in our consolidated statements of operations.

In August 2012, SNH prepaid certain outstanding debt it had borrowed from FNMA, which debt was secured by certain properties we lease from SNH and other assets relating to those properties. As a result of this prepayment, 11 of the 28 properties

Table of Contents

securing that debt were released from the mortgage and, in connection with that release, we entered into amendments to our leases with SNH so that these 11 properties were removed from the lease created to accommodate this debt and were added to our other multi property leases with SNH.

RMR

RMR provides business management and shared services to us pursuant to a business management and shared services agreement, or our business management agreement. One of our Managing Directors, Mr. Barry Portnoy, is Chairman, majority owner and an employee of RMR. Mr. Barry Portnoy's son, Mr. Adam Portnoy, is an owner of RMR and serves as President, Chief Executive Officer and a director of RMR. Our other Managing Director, Mr. Gerard Martin, is a director of RMR. Mr. Bruce Mackey, our President and Chief Executive Officer, and Mr. Paul Hoagland, our Treasurer and Chief Financial Officer, are officers and employees of RMR. Our Independent Directors also serve as independent directors or independent trustees of other public companies to which RMR or its affiliates provide management services. Mr. Barry Portnoy serves as a managing director or managing trustee of those companies and Mr. Adam Portnoy serves as a managing trustee of a majority of those companies. In addition, officers of RMR serve as officers of us and of other companies to which RMR or its affiliates provide management services.

Because at least 80% of Messrs. Mackey's and Hoagland's business time is devoted to services to us, 80% of Messrs. Mackey's and Hoagland's total cash compensation (that is, the combined base salary and cash bonus paid by us and RMR) was paid by us and the remainder was paid by RMR. Messrs. Mackey and Hoagland are also eligible to participate in certain RMR benefit plans. We believe the compensation we paid to these officers reasonably reflected their division of business time; however, periodically, these individuals may divide their business time differently than they do currently and their compensation from us may become disproportionate to this division.

Our Board of Directors has given our Compensation Committee, which is comprised exclusively of our Independent Directors, authority to act on our behalf with respect to our business management agreement with RMR. The charter of our Compensation Committee requires the committee to annually review the terms of the business management agreement, evaluate RMR's performance under this agreement and determine whether to renew, amend or terminate the business management agreement.

Pursuant to the business management agreement, RMR assists us with various aspects of our business, which may include, but are not limited to, compliance with various laws and rules applicable to our status as a publicly owned company, maintenance of our facilities, evaluation of business opportunities, accounting and financial reporting, capital markets and financing activities, investor relations and general oversight of our daily business activities, including legal and tax matters, human resources, insurance programs, management information systems and the like. Under our business management agreement, we pay RMR an annual business management fee equal to 0.6% of our revenues. Revenues are defined as our total revenues from all sources reportable under generally accepted accounting principles in the United States, or GAAP, less any revenues reportable by us with respect to communities for which we provide management services plus the gross revenues at those communities determined in accordance with GAAP. Additionally, under the business management agreement, RMR has provided information technology services to us until October 1, 2014 in return for our reimbursement of RMR for a percentage of RMR's information technology employee expenses (other than RMR's Chief Information Officer), which percentage was subject to approval by our Compensation Committee. The fees we paid to RMR under the business management agreement, including for information technology services, totaled \$12,485, \$13,965 and \$13,226 for the years ended December 31, 2014, 2013 and 2012, respectively.



RMR also provides internal audit services to us in return for our share of the total internal audit costs incurred by RMR for us and other companies managed by RMR and its affiliates, which amounts are subject to approval by our Compensation Committee. Our Audit Committee appoints our Director of Internal Audit. Our share of RMR's costs of providing this internal audit function was approximately \$286, \$203 and \$209 for 2014, 2013 and 2012, respectively. These allocated costs are in addition to the business management fees earned by RMR.

The current term of the business management agreement ends on December 31, 2015 and automatically renews for successive one year terms unless we or RMR gives notice of non-renewal before the end of an applicable term. On March 16, 2015, we and RMR entered into an amended and restated business management and shared services agreement, which was approved by our Compensation Committee, comprised solely of our Independent Directors. As amended, RMR may terminate the business management agreement upon 120 days' written notice, and we continue to have the right to terminate the business management agreement upon 60 days' written notice, subject to approval by a majority vote of our Independent Directors. As amended, if we terminate or elect not to renew the business management agreement other than for cause, as defined, we are obligated to pay RMR a termination fee equal to 2.875 times the sum of the annual base management fee and the annual internal audit services expense, which amounts are based on averages during the 24 consecutive calendar months prior to the date of notice of nonrenewal or termination. Also, as amended, RMR agrees to provide certain transition services to us for 120 days following termination by us or notice of termination by RMR. The business management agreement includes arbitration provisions for resolution of disputes.

F-27

---

## Table of Contents

Under our business management agreement with RMR, we acknowledge that RMR also provides management services to other companies, including SNH. The fact that RMR has responsibilities to other entities, including our largest landlord and largest stockholder, SNH, could create conflicts; and in the event of such conflicts between us and RMR, any affiliate of RMR or any other publicly owned entity with which RMR has a relationship, including SNH, our business management agreement allows RMR to act on its own behalf and on behalf of SNH or such other entity rather than on our behalf. Under the business management agreement, we afford SNH and any other company that is managed by RMR a right of first refusal to invest in or finance any real estate of a type then owned or financed by any of them before we do. Under the business management agreement, RMR has agreed not to provide business management services to any other business or enterprise, other than SNH, competitive with our business.

We are generally responsible for all of our expenses and certain expenses incurred by RMR on our behalf. Pursuant to our business management agreement, RMR may from time to time negotiate on our behalf with certain third party vendors and suppliers for the procurement of services to us. As part of this arrangement, we may enter agreements with RMR and other companies to which RMR provides management services for the purpose of obtaining more favorable terms from such vendors and suppliers.

We lease our headquarters building from an affiliate of RMR. In December 2014, we and this affiliate agreed to amend this lease to add additional rental space to this lease for increased rent. As amended, this lease requires us to pay current annual rent of approximately \$882, which amount is subject to fixed increases. Our rent expense for our headquarters, which included our utilities and real estate taxes that we are required to pay as additional rent, was \$1,402, \$1,386, and \$1,426 for 2014, 2013 and 2012, respectively. We believe the terms of our headquarters' lease with this affiliate of RMR are commercially reasonable.

Under our Share Award Plan, we grant restricted shares to certain employees of RMR who are not also Directors, officers or employees of ours. We granted a total of 81,150, 82,300, and 81,050 shares with an aggregate value of \$357, \$373 and \$399 to such persons in 2014, 2013 and 2012, respectively, based upon the price of our common shares on the dates of grants on the New York Stock Exchange. One fifth of those shares vested on the grant dates and one fifth vests on each of the next four anniversaries of the grant dates. These share grants to RMR employees are in addition to both the fees we pay to RMR and our share grants to our Directors, officers and employees. On occasion, we have entered into arrangements with former employees of ours or RMR in connection with the termination of their employment with us or RMR, providing for the acceleration of vesting of restricted shares previously granted to them under our Share Award Plan. Additionally, each of our President and Chief Executive Officer and Treasurer and Chief Financial Officer received grants of restricted shares of other companies to which RMR provides management services, including SNH, in their capacities as officers of RMR.

## AIC

We, RMR, SNH and four other companies to which RMR provides management services currently own AIC, an Indiana insurance company, and are parties to an amended and restated shareholders agreement regarding AIC. On May 9, 2014, as a result of a change in control of Equity Commonwealth (formerly CommonWealth REIT), or EQC, as defined in the amended and restated shareholders agreement, we and the other AIC shareholders purchased pro rata the AIC shares EQC owned in accordance with the terms of that agreement. Pursuant to that purchase, we purchased 2,857 AIC shares from EQC for \$825. Following these purchases, we and the other remaining six AIC shareholders each own approximately 14.3% of AIC. As of December 31, 2014, we have invested \$6,034 in AIC since its formation in 2008.

All of our Directors and most of the trustees and directors of the other AIC shareholders currently serve on the board of directors of AIC. RMR provides management and administrative services to AIC pursuant to a management and administrative services agreement with AIC. Our Governance Guidelines provide that any material transaction between us and AIC shall be reviewed, authorized and approved or ratified by the affirmative votes of both a majority of our Board of Directors and a majority of our Independent Directors. The shareholders agreement among us, the other shareholders of AIC and AIC includes arbitration provisions for the resolution of disputes.

In 2013 and 2012, we and the other shareholders of AIC purchased a one year property insurance policy providing \$500,000 of coverage pursuant to an insurance program arranged by AIC and with respect to which AIC is a reinsurer of certain coverage amounts. Our annual premium for this property insurance was \$5,428 and \$6,264 in 2013 and 2012, before adjustments made for acquisitions or dispositions we made during that period. In June 2014, we and the other shareholders of AIC renewed our participation in this program. In connection with that renewal, we purchased a one year property insurance policy providing \$500,000 of coverage, with respect to which AIC is a reinsurer of certain coverage amounts and we paid a premium, including taxes and fees, of approximately \$3,901 in connection with that policy. Although we own less than 20% of AIC, we use the equity method to account for this investment because we believe that we have significant influence over AIC as all of our Directors are also directors of AIC. Our investment in AIC had a carrying value of \$6,827 and \$5,913 as of December 31, 2014 and 2013, respectively. We recognized income of \$87, \$334 and \$316 related to our investment in AIC for 2014, 2013 and 2012, respectively.

Table of Contents

We periodically consider the possibilities for expanding our insurance relationships with AIC to include other types of insurance and may in the future participate in additional insurance offerings AIC may provide or arrange. We may invest additional amounts in AIC in the future if the expansion of this insurance business requires additional capital, but we are not obligated to do so. By participating in this insurance business with RMR and the other companies to which RMR provides management services, we expect that we may benefit financially by possibly reducing our insurance expenses or by realizing our pro rata share of any profits of this insurance business.

**Directors' and Officers' Liability Insurance:** In July 2013, we, RMR, SNH and four other companies to which RMR provides management services purchased a combined directors' and officers' liability insurance policy providing \$10,000 in aggregate primary non indemnifiable coverage and \$5,000 in aggregate excess coverage. We paid a premium of approximately \$133 in connection with this policy. In June 2014, we, RMR, SNH and three other companies to which RMR provides management services extended this combined directors' and officers' liability insurance policy through August 31, 2014. We paid a premium of approximately \$15 for this extension. In September 2014, we purchased a two year combined directors' and officers' insurance policy with SNH, RMR and four other companies to which RMR provides management services that provides \$10,000 in aggregate primary coverage, including certain errors and omission coverage. At that time, we also purchased separate additional one year directors' and officers' liability insurance policies that provide \$20,000 of aggregate excess coverage plus \$5,000 of excess non indemnifiable coverage. The total premium payable by us for these policies purchased in September 2014 was approximately \$357.

## 16. Employee Benefit Plans

We have several employee savings plans under the provisions of Section 401(k) of the Internal Revenue Code. All of our employees are eligible to participate in at least one of our plans and are entitled upon termination or retirement to receive their vested portion of the plan assets. For some of our plans, we match a certain amount of employee contributions. We also pay certain expenses related to all of our plans. Expenses for all our plans, including our contributions, were \$1,635, \$1,617 and \$1,565 for the years ended December 31, 2014, 2013 and 2012, respectively.

## 17. Selected Quarterly Financial Data (Unaudited)

The following is a summary of unaudited quarterly results of operations for the years ended December 31, 2014 and 2013:

	2014			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues	\$ 328,411	\$ 332,799	\$ 334,339	\$ 332,526
Operating loss	(7,492)	(444)	(3,088)	(8,156)
Net loss from continuing operations	(5,867)	(997)	(2,374)	(70,112)
Net loss	(6,759)	(1,891)	(3,008)	(73,748)
Net loss per common share—Basic	\$ (0.14)	\$ (0.04)	\$ (0.06)	\$ (1.53)
Net loss per common share—Diluted	\$ (0.14)	\$ (0.04)	\$ (0.06)	\$ (1.53)

	2013			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues	\$ 323,852	\$ 323,447	\$ 324,263	\$ 325,225
Operating income (loss)	3,668	5,670	2,276	(1,533)
Net income (loss) from continuing operations	3,193	2,955	625	(3,324)
Net income (loss)	2,392	1,456	(758)	(5,430)
Net income (loss) per common share—Basic	\$ 0.05	\$ 0.03	\$ (0.02)	\$ (0.11)
Net income (loss) per common share—Diluted	\$ 0.05	\$ 0.03	\$ (0.02)	\$ (0.11)

#### 18. Subsequent Event

In March 2015, we entered into agreements to acquire two independent living communities with 68 and 84 living units, respectively, located in Tennessee for approximately \$26,000, including the assumption of approximately \$17,000 of mortgage debt. We expect to fund this acquisition with cash on hand and borrowings under our Credit

Facility. We expect this transaction to close during the second quarter of 2015.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIVE STAR QUALITY CARE, INC.

By: /s/ Bruce J. Mackey Jr.

Bruce J. Mackey Jr.  
President and Chief Executive Officer

Dated: March 16, 2015

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Bruce J. Mackey Jr. Bruce J. Mackey Jr.	President and Chief Executive Officer (Principal Executive Officer)	March 16, 2015
/s/ Paul V. Hoagland Paul V. Hoagland	Chief Financial Officer and Treasurer (Principal Financial Officer and Accounting Officer)	March 16, 2015
/s/ Barry M. Portnoy Barry M. Portnoy	Managing Director	March 16, 2015
/s/ Gerard M. Martin Gerard M. Martin	Managing Director	March 16, 2015
/s/ Bruce M. Gans Bruce M. Gans	Independent Director	March 16, 2015

/s/ Barbara D. Gilmore

Barbara D. Gilmore      Independent Director

March 16,  
2015

/s/ Donna D. Fraiche

Donna D. Fraiche

Independent Director

March 16,  
2015

