

Expert Report of John Durso

United States Securities and Exchange Commission: *In the Matter of: Laurie Bebo and John Buono, CPA*, AP File No. 3-16293

I. INTRODUCTION

The law firm of Reinhart Boerner Van Deuren s.c. (“Reinhart”) has engaged me to provide expert witness services in the proceedings the United States Securities and Exchange Commission filed against Assisted Living Concepts, Inc., captioned *In the Matter of: Laurie Bebo and John Buono, CPA*, AP File No. 3-16293 (the “Proceedings”). Reinhart represents Laurie Bebo (“Bebo”) in the Proceedings, the former CEO of Assisted Living Concepts, Inc. (“ALC”). Reinhart has asked me to assess Bebo’s actions in complying with financial covenants under a lease agreement (“Lease”) between ALC and an affiliate of Ventas, Inc. (“Ventas”) for the rental of eight assisted living facilities and one independent living facility.

I am a practicing attorney and concentrate my practice in health care law. In preparing my analysis and conclusions, I reviewed *Exhibit A*, *Exhibit B*, and various materials that *Appendix A* sets forth. I base my statements in this opinion on my review of these materials, as well as on my education, experience, and training. I present my findings as of the date of this report. I reserve the right to amend or change any of my conclusions, if information becomes available to me that might affect them. I also reserve the right, if appropriate, to rebut any opinions other individuals offer in this matter.

II. BACKGROUND AND QUALIFICATION

Education

In 1977, I graduated with a Juris Doctorate degree, *magna cum laude*, from Loyola University Chicago School of Law, where I was a member of Law Review. In 1975, I graduated with a Bachelor’s of Arts in Political Science from Northern Illinois University.

Court Admissions

- U.S. Supreme Court
- U.S. District Court for the Northern District of Illinois
- Illinois State Supreme and Circuit Courts

Memberships, Affiliations and Honors

- Editorial Advisory Board Member, Senior Living Business Interactive
- Vice Chair, Long-Term Care Task Force, American Bar Association (“ABA”) (Health Law Section), 2011-present
- Member, Leading Lawyers Network
- Member, American Health Lawyers Association (“AHLA”)
- Member, Illinois Association of Healthcare Attorneys

- Member, Chicago Bar Association (Health and Hospital Law and Health Care Law Committees)
- Member, LeadingAge, formerly the American Association of Homes and Services for the Aging (“LeadingAge”) (Legal Committee), 1979-present
- Member, Catholic Health Association
- Member, Catholic Health Association (Legal Services and Continuum of Care Committee Committees)
- Member, Board of Directors, Children’s Place, 2008-2015
- Member, Board of Directors, St. Patrick’s Residence, 1980-present
- Member, Board of Directors, American Senior Housing Association, 1997-1999
- Member, Board of Directors, Marist High School
- Special Member, American College of Health Care Administrators
- Advisory Board Member, Addolorata Villa
- Advisory Board Member, Loyola University of Chicago’s Institute for Health Law
- Member, BNA Advisory Board, 1997-2010
- Member, LeadingAge Illinois, formerly Life Services Network of Illinois (“LeadingAge Illinois”)
- Member, Life Care Facility Task Force for Life Services Network of Illinois
- Member, Diocesan Attorneys Association, 1977-1983

Distinctions

- Chambers USA: America’s Leading Lawyers for Business, 2009-2014
- Illinois Super Lawyer - Healthcare, 2005-2010
- The Best Lawyers in America, 2005-2010
- A/V Rated, Martindale-Hubbell

Representative Areas of Experience

- Representation of national and state associations serving seniors including LeadingAge, LeadingAge Illinois and LeadingAge Wisconsin.
- Representation of clients in over 500 transactions such as mergers, acquisitions, affiliations and/or joint ventures involving organizations serving seniors.
- Creation of 20 horizontal alliances of long term care providers serving seniors including, but not limited to, the following: Health Resources Alliance (Chicago), Momentum Health Solutions (Cincinnati), and Covenant (Phoenix).
- Formation of Continuing Care Insurance Company, a Cayman offshore captive Best Rated insurance company owned by approximately 29 post-acute care provider

shareholders of the captive and insuring approximately 70,000 nursing home units and senior housing units in 46 states.

- Representation of clients in the U.S. and Illinois Supreme Courts and federal and state lower level courts.
- Representation of numerous senior care organizations in default with lenders or bondholders based on national downtrends in occupancy and insufficient day's cash on hand following the recession and stock market crash in 2008; representation has included, but is not limited to, negotiation of workouts, forbearance agreements, pre-bankruptcy sales or affiliations, and post-bankruptcy sales.

Publications

I write a monthly column for McKnight's Long Term Care News, entitled "Ask the Legal Expert," where I address current senior care issues. For a complete listing of publications that I have authored for the last 10 years, see *Exhibit B*.

Additional Information

I was admitted to the Illinois Bar in 1977, and I am a partner and senior member of the Healthcare Practice Group at Nixon Peabody LLP. I have spent my 37-year legal career primarily representing organizations serving seniors. As early as law school, I was employed by Kirkland & Ellis, where I primarily represented the Archdiocese of Chicago, other church groups and the approximately 15 nursing homes operated by Catholic Charities at the time. After I graduated from law school, I was hired by Kirkland & Ellis.

During my early legal career, Illinois began to heavily regulate nursing homes with pervasive regulatory, survey and licensure laws. This state regulatory scheme served as a model for the federal OBRA law's 1987 changes and the regulatory scheme applicable to all nursing homes in every state under Medicare and Medicaid administered by CMS. I have represented nursing homes all over the country in all legal issues facing their facilities, including but not limited to, resident contracts and other third-party contracts.

I have represented various organizations serving seniors, including, but not limited to the following: nursing homes, assisted living ("AL") facilities, independent living ("IL") facilities, life care communities, continuing care retirement communities ("CCRC"), an offshore captive owned by approximately 29 of the country's largest §501(c)(3) not-for-profit senior care organizations, alliances owned by §501(c)(3) not-for-profit senior care organizations. Other organizations owned by not-for-profit senior care organizations that served as joint venture platforms and bought and operated ancillary or related entities used by the owners (e.g., pharmacy, joint venture of physical therapists and an organization to contract with ACOs and managed care payors). I have also represented founding sponsoring organizations such as religious organizations or churches, not-for-profit organizations serving elders or neglected dependent or disabled children. I have represented post-acute care alliances, national and state trade associations, hospitals and health systems, integrated delivery networks, ACOs, physician and physician groups, educational institutions, social services agencies, other not-for-profit institutions serving people in need, investment bankers, insurance companies, accountants, pension funds REITs, private and other sources of capital to providers or organizations serving seniors.

Examples of the broad range of legal issues that I have addressed, include, but are not limited to: licensure; reimbursement; mergers; acquisitions; management agreements; leasing; affiliations; joint ventures; participating in or contracting with accountable care organizations; corporate restructuring; tax and tax exemption; corporate financial workouts for organizations in default with lenders, bondholders or other creditors; bankruptcy; health care finance; public finance; labor and employment; complex litigation; administrative and regulatory issues; fraud and abuse; HIPAA; survey and certification; alternative insurance and risk mechanisms (including captive insurance companies); and risk management.

From 1977 through today, I have served as general counsel for LeadingAge Illinois. In addition, I have been appointed to the Legal Committee of the national LeadingAge trade association, since 1980. I have also served as chairman of LeadingAge Legal Committee. I was appointed to the Catholic Health Association's Legal Committee in 1995, on which I served until 1997, and to its Committee on CCRCs from 2000 to 2002. When ALFA was created, I prepared their initial set of bylaws for the governance of ALFA. When ASHA was created in 1997, I was nominated to and served on its initial Board of Directors. I have been a member of ASHA since 1997 through and to the present.

I write a legal update column for McKnight's Long Term Care News, the national industry journal for organizations serving seniors, including skilled nursing facilities ("SNF") and assisted living providers. For several years, I have appeared in and produced the ABA/American Chief Health Care Executive annual television show entitled, "Health Law Progress and Legislative Update." I have also appeared on a number of other local television shows on issues affecting organizations serving seniors. I have both testified myself and prepared others to testify before congressional committees on legal issues related to health care and health care organizations serving seniors.

Presentations

I am a frequent lecturer on legal issues affecting those serving seniors and have taught courses on long term care law at Loyola University. Below is a chart listing lectures from October 2010 to present.

Date	Presentation Title	Company/Organization
10/12/10	41-A Alternative Financing Options to Maintain Growth	LeadingAge
02/08/11	MASHA's Member Rights and Perspectives	MASHA
03/10/11	Focus on Disability Discrimination	Fair Housing Compliance Training
03/11/11	Operational and Regulatory Issues in the CCRC	AHLA
03/21/11	Operational as Well as Regulatory Issues in CCRCs and Affiliation Strategies	LeadingAge Illinois
03/23/11	Obtaining and Maintaining Your Tax-Exempt Status	Legal Update for Non-Profits
03/24/11	Operational and Regulatory Issues in the	Senior Living Today, Tomorrow and

Date	Presentation Title	Company/Organization
	CCRC	Scenarios for the Future
04/18/11	New Technology, New Legal Challenges	McKnight's, Online Webinar
08/24/11	Understanding the Implications of the Provider Tax: What Facilities Can Do to Address the Financial Impact of the Increased Bed Tax	LeadingAge Illinois, Webinar
10/16/11	The Legal and Practical Implications of Technical Bond Defaults, Financial Bond Defaults, Forbearance Agreements, Permanent Debt Restructurings and Bankruptcy	LeadingAge, 2011 Annual Conference
04/24/12	Restructuring the Financially Challenged Organization	LeadingAge, PEAK Leadership Conference
05/02/12	The Legal and Practical Implications of Technical Bond Defaults, Financial Bond Defaults, Forbearance Agreements, Permanent Debt Restructurings and Bankruptcy	LeadingAge Illinois, Annual Conference
05/03/12	Non-profit Legal Update and Resident Contract Review	LeadingAge Illinois, Annual Conference
07/10/12	Tax Exemption Issues for CCRCs	AHLA
07/24/12	Post-Acute Provider Case Study: Coordinated Care Networks in the Health Care Reform Era	American Conference Institute Chicago, Illinois, Long Term Care Regulatory Boot Camp
05/01/13	How Boards Can Successfully Navigate Today's Long Term Care Risk Environment	LeadingAge Illinois, Annual Conference
05/02/13	The Legal and Practical Implications of Technical Bond Defaults, Financial Bond Defaults, Forbearance Agreements, Permanent Debt Restructurings and Bankruptcy	LeadingAge Illinois, Annual Conference
05/02/13	Post-Acute Providers in the Age of Accountable Care: ACOs, Integrated Delivery Systems, and Other Opportunities	LeadingAge Illinois, Annual Conference
10/17/13	Post-Acute Providers in the Age of Accountable Care: ACOs, Integrated Delivery Systems, and Other Opportunities	National Aging Services, 2013 Risk Management Conference

Date	Presentation Title	Company/Organization
11/21/13	Post-Acute Providers in the Age of Accountable Care: ACOs, Integrated Delivery Systems, and Other Opportunities	Financial Issues for Senior Services Providers Seminar
12/17/13	Renewing Your Charitable Sales-Tax Exemption: Steps to Protect Both Your Sales-Tax and Property-Tax Exemptions	LeadingAge Illinois, Webinar
01/23/14	Build or Join an ACO – Don't Let the Opportunity Pass You By!	Senior Living Business, Interactive Webcast Series
01/28/14	Post-Acute Providers in the Age of Accountable Care: ACOs, Integrated Delivery Systems, and Other Opportunities	Alliance Leadership Forum 2014
03/19/14	Contracting with ACOs and Other Multi-provider Arrangements	LeadingAge, 2014 PEAK Leadership Summit
04/29/14	Illinois Charitable Tax Exempt Panel Discussion	LeadingAge Illinois
04/30/14	Current Trends in Long Term Care Mergers and Acquisitions	LeadingAge Illinois, 2014 Annual Meeting & Exhibition
04/30/14	Post-Acute Providers in the Age of Accountable Care: ACOs, Integrated Delivery Systems, and Other Emerging Coordinated Care Models	LeadingAge Illinois, 2014 Annual Meeting & Exhibition
05/01/14	Encountering & Overcoming Financial Distress in the Seniors Housing Industry	LeadingAge Illinois, 2014 Annual Meeting & Exhibition
05/20/14	Contracting with ACOs and Other Multi-provider Arrangements	LeadingAge, Webinar Presentation
06/06/14	Contracting with ACOs and Other Multi-provider Arrangements	Presby's Inspired Life Board Retreat
07/01/14	Contracting with ACOs and Other Multi-provider Arrangements	AHLA, Annual Meeting Luncheon - Post-Acute and Long Term Services Practice Group Annual Luncheon
07/09/14	Contracting with ACOs and Other Multi-provider Arrangements	ABA Health Law Section Webinar
09/17/14	Contracting with ACOs and Other Multi-provider Arrangements	LeadingAge Iowa 2014 Fall Leadership Conference
09/25/14	Renewing Your Charitable Sales-Tax Exemption: Steps to Protect Both Your Sales-Tax and Property-Tax Exemptions	LeadingAge Illinois Social Accountability & Community Workshop at Snyder Village

Date	Presentation Title	Company/Organization
12/11/2014	Renewing Your Charitable Sales-Tax Exemption: Steps to Protect Both Your Sales-Tax and Property-Tax Exemptions	LeadingAge Illinois Social Accountability & Community workshop at Friendship Village
02/19/2015	LeadingAge Illinois	Social accountability workshop at Apt. Community/Our Lady of Snows - 726 Community Drive, Belleville, IL
03/03-07/2015	Legal and Regulatory Hot Topics in Long Term Care	ABA, Long Term Care Task Force, Annual Conference on Emerging Issues in Healthcare Law
03/16-17/2015	Forum: Legal strategies aging services providers are using to develop formal and informal relationships with ACOs	LeadingAge, PEAK Leadership Conference

III. MATERIALS REVIEWED

In preparing this report, I reviewed *Exhibit A*, *Exhibit B*, and the materials *Appendix A* identifies.

IV. OVERVIEW OF AMENDED AND MASTER LEASE AGREEMENT

The Lease is for eight properties in the southern part of the country. Five of the properties are in Georgia, one is in Alabama, one is in Florida, and one is in South Carolina. An assisted living facility is located on each of the eight properties, and, in addition to an assisted living facility, an independent living facility is also located on the property in Alabama.

The body of the Lease is 87 pages long, and it is organized into 48 sections. The table of contents lists only 47 sections, however, leaving out Section 5 (“No Effect or Impairment, etc.”), and mis-numbers the sections after Section 5. The Lease also contains six schedules (Schedules 1.3, 2, 3.1.1, 3.1.2, 3.3.2, and 7.3) and eight exhibits (Exhibits A through K). The Lease is ambiguous, with numerous provisions that do not apply to ALC’s operations (that is, operating market rate rentals of units to “private pay” persons). Many of the Lease provisions are immaterial to the leased facilities and more akin to leasing or managing skilled nursing facilities (“SNFs”) participating in, and receiving funds from, Medicare and/or Medicaid.

For purposes of this report, I set forth below an overview of relevant sections of the Lease. Capitalized terms below, but not otherwise defined, have the meanings ascribed to them in the Lease.

In Section 1.4, ALC represents that none of the facilities participate in Medicare or Medicaid and that no Governmental Authorities or Persons administering Third Party Payor Programs regulate or inspect the facilities to the same extent as hospitals or skilled nursing facilities, including issuing certificates of need (except for one facility’s Alzheimer’s program in Alabama) and conducting periodic surveys.

Section 3 sets forth the rent ALC must pay, which includes fixed rent (Section 3.1), subject to increase from year to year (Section 3.1.3); additional rent (Section 3.2) for

utilities (Section 3.2.2), insurance premiums (Section 3.2.3), etc.; and escrow deposits (Section 3.3). Nowhere in the Lease does it provide that Ventas is entitled to any payments relative to the facilities' profits or other revenue.

Section 8 sets forth negative and affirmative covenants within its subsections.

Section 8.1.3 disallows ALC from entering into any transaction with a partner, member, shareholder, or affiliate of ALC, except in the ordinary course of business, on terms no less favorable than it would obtain in an arm's-length transaction, and with full disclosure to Ventas.

Section 8.1.11 sets forth a number of use-specific negative covenants that prohibit ALC from the following:

- a) transferring any Authorization to another location or pledge an Authorization as collateral;
- b) altering the nature, tenor, or scope of an Authorization or Facility Provider Agreement;
- c) changing a Facility's licensed bed capacity, and/or the number or types of beds participating in governmental payment programs. However, ALC may remove beds from service so long as the number of beds in service is at least 90% of the number of operational beds for the Facility and such removal does not impair the licensure of such beds;
- d) replacing or transferring, or applying to replace or transfer, a Facility's licensed bed to another location;
- e) jeopardizing its participation in Medicare, Medicaid, or any third-party payer program to which ALC may become subject;
- f) entering into a resident care agreement with residents or other Persons that do not qualify as Approved Residency Agreements or that materially deviate from ALC's standard form resident agreement, unless (i) such deviation satisfies clauses (i) through (v) in the definition of "Approved Residency Agreement" and would not have a Material Adverse Effect on the Facility, any ALC, or any Guarantor and (ii) applicable Governmental Authority requires such deviation or the deviation is then customary in the industry in the area of the Facility. [Please note: As drafted in the Lease, the provisions in this section are confusing and ambiguous, as the numbering within the section is inconsistent. I believe the above summary is a fair interpretation of the provisions.];
- g) changing any Facility Provider Agreement, Third-Party Payor Program, or its normal billing, payment, or reimbursement policies, unless such change does not have a material adverse effect on the Facility; and
- h) assigning or transferring its interest in any Authorization or from assigning or removing, or permitting another Person to assign or remove, patient records or medical and clinical records.

Section 8.2 sets forth a number of affirmative covenants that require the following of ALC:

- a) promptly (i) supply Ventas with information on its financial condition, licensing, and property that Ventas may reasonably request, and (ii) notify

- Ventas in writing of (a) any condition or event that constitutes a breach of the Lease or any other agreement between Ventas or its Affiliates and ALC; (b) any event or condition having a Material Adverse Effect on any Facility, ALC, Guarantor, or Affiliate; and (c) any Event of Default;
- b) send to Ventas any correspondence related to an “immediate jeopardy” event or alleged patient abuse or neglect that has allegedly resulted in serious injury or death and other material communication affecting a Facility;
 - c) meet financial covenants, including (i) maintaining a facility coverage ratio of 0.8 to 1.0 for the 12-month period ending as of the end of each fiscal quarter; (ii) maintaining a portfolio coverage ratio of 1.0 to 1.0 for the 12 month period ending as of the end of each fiscal quarter; and (iii) as of the end of each fiscal quarter, maintaining the minimum average occupancy of (a) 65% at the end of each quarter for each Facility; (b) 75% per trailing 12-month period then ended for each Facility; and (c) 82% per trailing 12-month period then ended for all Facilities in the aggregate.

Section 10 sets forth a number of ALC representations and warranties. Notably, in Section 10.5, ALC represents that neither it nor its representative has been disqualified from participating in, engaged in conduct that is cause for it to be excluded from, or is subject to pending or threatened action that threatens its participation in Medicare or Medicaid programs.

Section 17.1 sets forth Events of Default. Such defaults include: failure to pay rent (Section 17.1.1); failure to observe or perform the requirements of Section 8.1.1, Section 8.2.5, Section 8.3, Section 12, Section 13(vi), Section 14.1, Section 14.2, Section 14.5, or Section 24 (Section 17.1.2); failure to comply with any reporting term, covenant, or other obligation in Section 25, and ALC does not cure such failure within 10 days after receiving notice of such failure from Ventas (Section 17.1.3); failure to comply with any term, covenant, or condition that Section 17.1 does not specify, and ALC does not cure such failure within 30 days after receiving notice of such failure from Ventas (Section 17.1.4); bankruptcy or liquidation (Sections 17.1.7, 17.1.8, 17.1.9); actions against a ALC’s license or other Authorization that may cause ALC to cease, suspend, or materially affect its operations at a facility (Sections 17.1.12, 17.1.15); unpermitted change in the number of licensed beds (Section 17.1.13).

Section 17.4 requires ALC to pay to Ventas, to the extent law permits, liquidated damages in the sum of (i) the unpaid rent at the time of termination of the Lease, and (ii) the net present value of the unpaid rent for the balance of the term of the Lease, with no obligation on Ventas’ s part to mitigate damages. However, if Ventas does relet all or some of the facilities and the rent is less than that under the Lease, then ALC must pay the rent shortfall.

Section 25 sets forth requirements for ALC to report to Ventas certain financial information. ALC must maintain books and records in accordance to generally accepted accounting principles (“GAAP”) (Section 25.1) and provide Ventas annual financial information (Section 25.2), quarterly financial information (Section 25.3), annual budgets (Section 25.5), and Medicare and Medicaid cost reports, if applicable (Section 25.11), SEC reports (Section 25.15), among other reports. On a quarterly basis, ALC must also

allow and make arrangements for Ventas to discuss, with ALC's senior officers and financial advisors, the affairs, operations, finances, and accounts of each ALC and Guarantor and their respective representatives.

V. THE IMPACT OF THE GREAT RECESSION ON OCCUPANCY IN SENIOR CARE ORGANIZATIONS, INCLUDING ASSISTED LIVING FACILITIES

From 2008 to 2012, the U.S. experienced a severe economic downturn, labeled "The Great Recession." During this timeframe, the economy experienced the most significant recession since the Great Depression of 1929. Gross domestic product fell 2.6 percent in 2009, the greatest single-year decline since 1938. While the Great Recession affected all age groups, older adults nearing retirement faced a greater burden, because they lacked the capability to recover from its effects, having insufficient time to rebuild depleted retirement savings or recover home values. Although the National Bureau of Economic Research declared that the recession had ended in 2009, its effects continue to linger.

The market crash resulted in three important outcomes that affected retiree preparedness: (1) a decline in home equity, (2) a decline in other wealth, and (3) decreased consumer confidence. In September 2008, failures of large U.S. financial institutions rapidly devolved into sharp losses in the value of stocks and commodities worldwide. Declines in stock prices when workers are in their 50s and 60s resulted in lower investment income for those retiring between age 70 and 79, and, consequently, seniors struggled to absorb severe investment losses. Simultaneously, the subprime mortgage crisis forced many homeowners into foreclosure, and, as supply skyrocketed, property values began to decline. Many homeowners held off on selling their homes to avoid losing their homes' earlier value and diminishing the value of their estates. Consumer confidence also plummeted in the wake of the market decline. Decisions involving new expenditures or significant financial commitments became more difficult, especially for seniors who sought more security in lieu of higher returns.

Sharp investment declines affected those who relied on their investments to subsidize their monthly income. Approximately seven out of every ten people who live in an assisted living facility depend on their personal wealth or their family members to pay for their residences and services. These individuals rely on income from their investment portfolios, money in their personal savings accounts, and revenue from selling their homes. Due to portfolio losses, many seniors postponed their transition into organizations serving seniors, including independent living and assisted living facilities. In 2008 and 2009, the industry growth rate for assisted living facilities slowed to about one percent. Rental independent living facilities saw their occupancy rates plummet from 91% in 2006 to 84% in 2009. See *Exhibit A*.

Based on the foregoing factors, the economic conditions during the period from 2008 through 2012 posed a significant hardship on the senior demographic in the United States, which indirectly resulted in the financial, value, and occupancy declines of assisted living facilities nationwide. The combination of reduction in the resale value of real estate and the devaluation of stocks on the market meant that the majority of funding that seniors use for assisted living facilities had diminished significantly. Consequently, the depleted value of the average senior's assets acted as a direct impediment in transitioning to the assisted living home model. It is important to reiterate that the primary causes of the occupancy decline did not reflect distressed conditions within the senior care industry; the decline was a result of unforeseen external market conditions that devastated the overall economy and the entire senior care industry.

Importantly, these conditions affected senior care facilities industrywide and demanded flexibility between the landlords and tenants of the facilities. The alternative would have been disastrous. ALC's and Ventas' actions and conduct in addressing and clarifying the Financial Covenants were consistent with the actions taking place between landlords and tenants of senior care facilities nationwide, as they all reacted and adjusted to the consequences of the Great Recession.

VI. OPINIONS

A. **The Lease Terms Are Often Ambiguous, Internally Inconsistent, and Immaterial; Asserting Compliance with Its Terms Is Extremely Complicated and Subject to Various Reasonable Interpretations; Laurie Bebo's Reliance on Joseph Solari's Agreement to ALC's Determinations of the Financial Covenants Was Reasonable**

At 87 pages, the Lease is long for the lease of assisted living facilities and an independent living facility. A number of the Lease provisions are subject to multiple interpretations, provisions in certain sections of the Lease contradict or are inconsistent with other sections, many provisions are either immaterial or of minor importance, and/or provisions are unusual for a lease of assisted living facilities, and they are even less applicable to independent living facilities. (For purposes of this report, I reference only assisted living facilities, but the report and analyses would apply, for the most part, to the independent living facility, too.)

In regard to the relative importance of certain provisions in the Lease, many of them do not pertain to ALC's operation of the facilities. ALC did not accept Medicare or Medicaid in relationship to the facilities under the Lease, which the Lease clearly sets forth in Section 1.4. In fact, Medicare does not pay for a stay in an assisted living facility or for the provision of assisted living services. Medicaid does not pay for such a stay or services, unless CMS has waived certain Medicaid requirements and allowed a state to establish a program to provide such services, usually in facilities other than assisted living facilities. However, there are no Medicaid waiver programs in Georgia, Florida, Alabama, or South Carolina that would pay for stays and services in any of the leased facilities.

Despite these facts, the Lease contains numerous provisions in relation to facilities that do participate in Medicare or Medicaid. For instance, Section 5 provides that any withholding, nonpayment, reduction, or other adverse change respecting Medicare or Medicaid, if applicable, or any admissions hold under Medicare or Medicaid, if applicable, will not affect ALC's obligations. Section 7.2.1 requires ALC to operate each Facility in a manner consistent with its current operation as a quality healthcare facility and, if and when applicable, sound reimbursement principles under Medicare, Medicaid, and any other applicable Third Party Payor Programs. Section 8.1.11(e) prohibits ALC from jeopardizing its participation in Medicare, Medicaid, or any other Third Party Payor Programs to which any ALC may become subject. Section 8.3 requires ALC to notify Ventas if it receives notice from a Governmental Authority, asserting that ALC is not in compliance with any certification for reimbursement under Medicare or Medicaid. Section 10.5 contains ALC's representation that neither it nor its representative has been disqualified from participating in, engaged in conduct that is cause for it to be excluded from, or is subject to pending or threatened action that threatens its participation in Medicare or Medicaid programs. This list is not exhaustive. Not only are these provisions inconsistent with Section 1.4, they are immaterial to the operations of the facilities. The provisions are appropriate

for a lease or management agreement for a SNF that receives Medicare and/or Medicaid payments, but they are inapplicable to the leased facilities that receive no such payments.

In addition, certain covenants in the Lease are unusual and with little value for lease agreements, though they are commonly found in management agreements. As a general matter, management agreements are between an owner of income-producing property and a manager, who will manage the property and provide other services for which it often charges a percentage of the property's operating revenue. Under a management agreement, an owner retains significant control over the manager and its operations to assure that the owner maximizes the return on owner's investment and that the manager maintains the value of the property. Leases are between the owner and a lessee, who will operate the property for the lessee's gain and pay the owner rent. Under a lease, an owner retains certain controls over the lessee for purposes of protecting the property (requiring lessee to maintaining the improvements, pay taxes, prevent liens upon the property, etc.), but the owner's return on investment is fixed. Therefore, leases generally give the owner much less control over the lessee and its operations, leaving to the lessee how to best to maximize revenue over expenses.

In the Lease, many of the provisions are more applicable to management agreements. For example, Section 8.1 limits certain ALC actions, such as issuing equity interests (Section 8.1.1), changing its organizational status (Section 8.1.2), entering into transactions with affiliates (Section 8.1.3), engaging in transactions that would create an ERISA obligation (Section 8.1.4), cancelling debt (Section 8.1.5), purchasing property (Section 8.1.6), and executing or modifying contracts (Section 8.1.9). These restrictions have little or nothing to do with ALCs actual operation of the facilities. In addition, Section 8.2.3 requires ALC to furnish extensive documentation to Ventas in relation to ALC's financial condition, to notify Ventas of its need to increase its reserves for expenses relating to malpractice or professional liability claims or any material increase in the costs for such insurance, to provide Ventas copies of census information, cost reports, surveys, etc. These obligations, too, have little or nothing to do with ALC's operation of the facilities; they relate to ALC's financial circumstances and ability to pay the rent under the Lease.

Though some of the above restrictions and obligations might be useful to a landlord to monitor a tenant's resources to continue to pay rent, they are of little importance here, particularly when ALC's ability to pay its rent was never in question, it timely made all of its rent payments, and its financially strong parent organization guaranteed those payments. Under the Lease, of much more importance are provisions that assure that ALC keeps the improvements on the property in good repair, maintains the facilities' licenses, maintains its number of licensed beds, etc.

In my opinion, the terms in the Lease are often ambiguous, internally inconsistent, and immaterial. As a result, determining what the Lease requires ALC to do is overly difficult, and it makes asserting compliance with its terms extremely complicated and subject to various reasonable interpretations. It is also longer than it needs to be. In fact, it is the longest lease of a senior living facility that I have reviewed. As I set forth below, Laurie Bebo's efforts to obtain clarification of its requirements was understandable, and her reliance on the response she obtained from Joseph Solari, as agent for Ventas, was reasonable. Unless Ventas later notified her that ALC failed to comply with a term or was in breach of the Lease, no document that I have reviewed indicates that Bebo knew or should have known that ALC was not complying with the terms of the Lease.

B. ALC Complied with the Financial Covenants

The financial covenants under Section 8.2.5 require ALC to meet the following covenants throughout the Term of the Lease.

(a) Coverage Ratio. ALC shall maintain a Coverage Ratio with respect to each Facility for the 12 month period ending as of the end of each fiscal quarter of not less than 0.8 to 1.0;

(b) Intentionally Omitted;

(c) Portfolio Coverage Ratio. ALC shall maintain a Portfolio Coverage Ratio for the 12 month period ending as of the end of each fiscal quarter of not less than 1.0 to 1.0;

(d) Minimum Average Occupancy. As of the end of each fiscal quarter, the minimum average occupancy rate (i) for the quarter then ended for each Facility shall be greater than or equal to 65%, (ii) for the trailing 12 months then ended (1) for each Facility shall be greater than or equal to 75% and (2) for all Facilities in aggregate shall be greater than or equal to 82%.

(the "Financial Covenants"). Nowhere in the Lease, including the schedules and exhibits, does it define "occupancy rate," "occupant," "occupancy," or "occupied unit." It is a widely accepted industry standard to treat a unit as occupied once a facility receives a commitment to pay for the unit. It is also common for persons who reside in an assisted living unit to live somewhere else for periods of time, for example, with a family member and in another location, but facilities treat those units as occupied.

The SEC alleges that ALC violated the Financial Covenants, by counting units rentals that related to ALC employees and others who had a reason to visit or stay in at a leased facility. ALC calculated the occupancy rate in this way, in accordance with disclosures it made to and approvals it received from Ventas. Ventas never complained of or rejected ALC's calculation methods or its inclusion of units in which employees and others could stay in its calculation of occupancy rates. In my opinion, ALC's calculations of occupancy rates complied with and did not violate the Financial Covenants. However, even if ALC did somehow violate the Financial Covenants, it was inconsequential to ALC's overall compliance with the Lease.

1. *Counting Rooms Designated for Employees and Others as Occupied Was Reasonable and Complied with the Lease*

The Lease is silent as to how ALC must calculate the occupancy rate, under the Financial Covenants, and it provides no guidelines, limitations, or recommendations. It does not define "occupancy rate" or any term that ALC would use in its calculations. There are different reasonable methods for calculating an occupancy rate of which I am familiar. One method is the ratio of total occupants to total units, even if individual units can and do accommodate more than one occupant. As an example, if the facility has 75 occupants and 100 units (75 single occupancy units and 25 double occupancy units, for a total available occupancy of 125 persons), the occupancy rate is 75% (75 occupants/ 100 units), even if 20 of those occupants are in 10 units. Another method is the ratio of total occupants to the total available occupancy. Using the same facts from the example above, the occupancy rate is 60% under this method (75 occupants/ 125 available occupancy). Another method is the ratio of units occupied to total units. Pursuant to the same facts, the occupancy rate is 65% (65 units occupied (10 units with 2 occupants and

55 units with a single occupant))/ 100). Obviously, how one calculates the occupancy rate has a significant impact on the resulting percentage of occupancy.

Likewise, the Lease does not define “occupant” or “occupancy” and provides no guidance or limitations on defining the terms. Instead, construing the Lease as a whole, it is apparent that the meanings of the terms are broad and apply to a range of persons or entities. For example, Section 24.3 provides, in part:

If this Lease is assigned, or if the Premises (or any part thereof) are sublet or used or occupied by anyone other than Tenant ... Landlord may ... collect rent from the assignee, subtenant or *occupant* [emphasis provided].

Here, the Lease groups the term occupant with the terms assignee and subtenant and treats the terms similarly for purposes of who would be responsible for paying rent due. Additionally, Section 17.3, Certain Remedies, provides, in part:

If an Event of Default shall have occurred and be continuing, Tenant shall, if and to the extent required by Landlord so to do, immediately surrender to Landlord the Leased Property(ies) specified by Landlord and as to which the Lease (or, if applicable, Tenant's right of possession) has been or may be terminated pursuant to Section 17.2 or otherwise, and Landlord may enter upon and repossess such Leased Property(ies) by reasonable force, summary proceedings, ejectment or otherwise, and may remove Tenant and all other Persons and all personal property from such Leased Property(ies) subject to the rights of any *occupants or patients* and to any requirement of law [emphasis added].

Again, the Lease uses terminology that indicates the terms “patients” and “occupants” are not synonymous, by using the disjunctive “or” to distinguish them.

Given the ambiguity in the Lease, ALC could reasonably count employees and others, who have some occupancy relationship to the facilities, as occupants for purposes of calculating the occupancy rate, even if such occupancy was not under an assisted living agreement; or it could reasonably count a unit as occupied if employees or others had some occupancy right to the units; or it could reasonably count a unit as occupied if it somehow designated them for employees’ or others’ use. In my opinion, for purposes of calculating the occupancy rate at the facilities, ALC reasonably counted as occupied those units that it designated for employees’ or others’ use, and ALC did not violate the terms of the Lease in doing so.

This same analysis applies to the coverage ratios. Because ALC reasonably calculated the occupancy rates, it necessarily reasonably calculated the coverage ratios.

2. *Even if the Lease Somehow Disallowed ALC from Counting Employees and Others as Occupants, ALC Had Ventas’ Approval To Do So*

When Bebo asked Ventas’ representative, Joseph Solari, if ALC could count as occupied units it designated for its employees use, Mr. Solari authorized ALC to do so, which Bebo confirmed in an email. Ms. Bebo’s and ALC’s reliance on Ventas’ verbal approval and lack of an objection to ALC’s written confirmation of its counting of employee units as occupied was particularly appropriate in light of the fact that the senior living market was experiencing lower overall occupancy rates, between 2008 and 2012, due to the Great Recession. That is, ALC was not alone in facing occupancy issues. Though ALC’s update to its earlier method for calculating occupancy rate did not require Ventas’ approval, for whatever reason, Bebo asked Ventas for it. ALC then relied on Mr. Solari’s authorization and approval to adjust its calculation to include

designated units for employees who had reason to stay in the units. There was no reason for ALC to revisit the issue after that, and it was reasonable to continue using its calculation, until Ventas notified ALC that it had an issue with the calculations. Even at that point, the calculations would still be correct, though they would be subject to further clarification. However, Ventas never notified ALC that it had an issue with them.

In my opinion, Mr. Solari's approval and other Ventas' executives' silence in relation to ALC's written confirmation was understandable; it was a small accommodation of the earlier calculation method, and this related to minor covenants under the Lease. Though a high occupancy rate would likely contribute to the value of the property upon selling it after the Lease term, Ventas and ALC had already determined the value of the property through the term of the Lease to be the amount of the rent. In the remote event ALC defaulted on the rent and Ventas looked to lease the property to another entity before the expiration of the Lease, the Lease provided that ALC was still responsible for paying any loss of rent through the end of the Lease, with the guaranty of ALC's very financially healthy parent organization to assure that it did, and Ventas was assured of being made whole. If Ventas sold the facilities during the Lease term, the facilities would still be subject to ALC's lease interest, and the rent payments determined the value of the facilities through the end of the Lease. The occupancy rate as a measure of value would become of significant importance only when the Lease expired and Ventas sought to lease or sell the property to another entity. However, it is clear from the February 2009 correspondence to Ventas that ALC disclosed it was using rentals related to employees to meet the Financial Covenants, without any stated caps on the number. Thus, it is equally clear that Ventas was aware that any employee units in the calculation would end after ALC's tenancy, which information, it is safe to assume, Ventas would make known to a future lessee or buyer. Therefore, ALC's calculation methods had little effect, if any, on the value of the facilities.

ALC's reliance on Mr. Solari's authorization was reasonable. Since Mr. Solari's authorization did not amend the Lease, it did not require a written amendment signed by the parties. Mr. Solari's verbal consent, which Bebo confirmed in an email, was sufficient proof to show that Ventas was aware that ALC was updating its calculation method. Even if Bebo thought that she needed to amend the Lease in order to update the calculation method, it was reasonable for Bebo and ALC to conclude that the parties amended it properly, that ALC complied with the amendment, and that ALC was not in violation of the Financial Covenants or the Lease.

Moreover, as the emails between Ms. Bebo and Mr. Solari show, Ventas was aware of ALC's updated calculation method for determining the occupancy rate, ALC provided the reports with the updated calculation method to Ventas, and Ventas did not challenge any of the occupancy rates in the reports. Ventas' s original and amended complaints against ALC for violation of the Lease, based on the threats of the loss of its license, did not even allege violation of the Financial Covenants on occupancy rates. In addition, at no time did a court rule or the parties agree that ALC violated the Financial Covenants. Additionally, the parties resolved any and all alleged or potential Lease violations, when ALC bought the leased properties and other Ventas properties.

3. *Even if ALC Did Not Have Ventas' Approval To Count as Occupied Units Designated for Employees and Others To Use, Doing So Was Inconsequential to ALC's Overall Compliance with the Lease*

As I have stated above, the Financial Covenants were minor covenants under the Lease. The occupancy rate did not affect the rent that ALC would pay to Ventas. Ventas set the rent payments over the term, and the occupancy rate had no bearing on that amount. The occupancy calculations were revenue neutral. ALC did not use the occupancy calculations as part of its reported financial information, and they did not exaggerate its revenues from the facilities.

At most, the occupancy rate might bear on the amount of rent or the sale price Ventas could receive after the Lease term expired. However, the method ALC used to calculate the Financial Covenants complied with the Lease and other factors would affect market rental to an equal or greater extent. These would include, for example, overall assisted living market strength, location, condition of improvements, population demographics, etc. In addition, Ventas was well aware of ALC's calculation method and of the fact that counting the employee units as occupied would end with ALC's operation of the leased facilities. Even if Ventas looked to lease the property to another entity before the expiration of the Lease, the Lease provided that ALC was still responsible for making Ventas whole through the end of the Lease. As a measure of ALC's ability to continue to pay rent, the occupancy rate provided minimal insight, particularly in light of the fact that ALC's parent organization was very financially healthy and had guaranteed the rent payments.

In addition, the Lease allowed ALC to remove beds from service so long as the number of beds in service was at least 90% of the number of operational beds, which provided ALC another method to increase the occupancy rate. Using the calculation examples above, if ALC decreased the number of units by 10% (100 units to 90 units), the occupancy rates would change as follows. Using the ratio of total occupants to total units, the occupancy rate is 83.33% (75 occupants/ 90 units), which is over 13.63% higher. Under the ratio of total occupants to the total available occupancy, the occupancy rate is 68.18 (75 occupants/ 110 available occupancy), which is 5.96% higher. With the ratio of units occupied to total units, the occupancy rate is 72.22% (65 units occupied (10 units with 2 occupants and 55 units with a single occupant)/ 90), which is 11.10% higher.

In my opinion, even if ALC did not have Ventas' approval to count units set aside for employees and others as being occupied, doing so was inconsequential to ALC's overall compliance with the Lease.

C. Purchase Price for Facilities Was Within Industry Standards

The appraised value of the leased facilities:

1. Cara Vita Village, Montgomery, Alabama	\$10.47 million
2. Highland Terrace, Inverness, Florida	\$5.97 million
3. The Sanctuary, Acworth, Georgia	\$5.85 million
4. Tara Plantation, Cumming, Georgia	\$6.25 million
5. Peachtree Estates, Dalton, Georgia	\$6.0 million
6. Greenwood Gardens, Marietta, Georgia	\$5.2 million

7. Winterville Retirement Center, Winterville, Georgia	\$3.45 million
8. The Inn at Seneca, Seneca, South Carolina	<u>\$5.97 million</u>
Total Appraisals	\$49.16 million

In addition to the leased facilities, the purchase included four additional facilities:

1. Moorehead House, Pennsylvania
2. Langston House, Clinton, South Carolina
3. Pinewood House, Goose Creek, South Carolina
4. Ashley House, Greenwood, South Carolina

Total Purchase Price	\$97,000,000.00
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The appraisals for the eight facilities ALC operated failed to take into account the significant value added for a purchaser due to the composition and size of the entire portfolio in this transaction. This would include, for example, the value of having numerous facilities in one geographic region and operational cost savings derived from economies of scale. Thus, the purchase price in excess of the appraised value is a more appropriate value for what ALC purchased.

In addition, the transaction was advantageous for ALC from a cash flow prospective. The acquisition caused termination of the Lease, coupled with settlement of *Ventas Realty Limited Partnership v. ALC CUMA, LLC*, 12 CV 03107, in which Ventas agreed to release all past, present, and future claims against ALC under the Lease. This also allowed ALC to replace \$6.4 million of money allocated for cash rent payments for 2011 with a \$3.2 million interest charge in ALC's revolving line of credit.

VII. CONCLUSIONS

In summary, ALC complied with the Financial Covenants that it and Ventas agreed on in executing the Lease, and the actions ALC took under the Lease were appropriate and did not disadvantage or devalue the leased facilities in any way. ALC reasonably interpreted ambiguous terms, adhered to the intent of the Lease even with its inconsistencies, and complied with those terms on its face. Further, ALC complied with the lease under the mutual interpretation of the contracting parties: ALC and Ventas had agreed on an appropriate interpretation of those provisions that could not be gleaned by a plain reading of the document, including the determination that individuals occupying the residence are "occupants." Following this clarification, ALC complied with the covenants and maintained occupancy requirements as the parties had defined. Even if an individual not a party to the contract construes the inclusion of non-patient residents as an impermissible interpretation, resulting in ALC's failure to comply with the occupancy threshold, the 10% reduction in operated beds provision would have prevented or mitigated a breach regardless. It is important to note further that the provision at issue is both minor and inconsequential, far from an action that would render a material breach. In this case, the value of the facilities were maintained at all times: the rent was always timely paid, and guaranteed by its strong parent company, and at the end of the timeframe the facilities were purchased outright for a price within industry standards, as there are numerous reasons to

have paid more than their appraised value. Therefore, the interpretation of the lease is feasible, legally compliant, and did not cause harm to any party involved in the transaction.

VIII. COMPENSATION AND PRIOR TESTIMONY

I have not testified as an expert witness in any legal matter. I do not represent ALC. I have never owned any stock in ALC or its related companies. I will be compensated at my regular hourly rate for all time spent preparing to be an expert witness.

Respectfully submitted,



John Durso

Exhibit A

Occupancy Rises in All Campus Types

Occupancy by Campus Type; Primary Markets
4Q05 – 1Q14

*Includes all CCRCs and other entrance-fee properties



Source: NICMAP® Data & Analytics Service

Exhibit B

Ask the legal expert - December 2014, *McKnight's Long Term Care News*, 12/01/14.

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Ask The Legal Expert - March 2005, McKnight's Long-Term Care News, 03/01/05.

Ask The Legal Expert - February 2005, Ask the Legal Expert - February 2005, 02/01/05.

Appendix A

- 1) Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice ("SEC Proceedings")
- 2) Wells Submission on behalf of Laurie A. Bebo
- 3) Amended and Restated Lease Agreement, Commission Exhibit 172
- 4) Ventas complaint against Assisted Living Concepts, Inc. ("ALC"), In re the Matter of: Laurie Bebo ("Complaint") and its Amended Complaint against ALC.
- 5) Transcripts of testimony, exhibits, and other documentation pertaining to the SEC Proceedings.
- 6) Jim Moore, *Management Companies and Fees, The Changing Dynamics Between Ownership & Management*, AMERICAN SENIORS HOUSING ASSOCIATION, Special Issue Brief (Fall 2013).
- 7) National Research Council, *Assessing the Impact of Severe Economic Recession on the Elderly: Summary of a Workshop*, Washington, DC (The National Academies Press 2011).
- 8) Jesse Ortiz, *Assisted Living Facilities Business Report*, SBDC CLEARINGHOUSE, available at <http://www.sbdnet.org/small-business-research-reports/assisted-living-facilities>.
- 9) Cameron Kathleen, *The Impact of the Economic Downturn on Consumers and Providers* (June 23, 2009), available at <http://www.theceal.org/column.php?>.
- 10) Senior Housing Industry Outlook & Trends for 2009, Senior Housing News (June 8, 2009), available at <http://seniorhousingnews.com/2009/01/05/senior-housing-industry-outlook-trends-for-2009/>.
- 11) Rappaport, Julia, *Assisted-living Centers Offer Assist New residents get help to make move* THE BOSTON GLOBE (Jan. 11, 2009), available at http://www.boston.com/news/local/articles/2009/01/11/assisted_living_centers_offer_assist/.
- 12) Seniors Housing Fundamentals and Trends, National Investment Center for the Seniors Housing and Care Industry, ALFA 2014 Conference & Exposition, Phoenix,

Arizona (May 21, 2014), available at <http://www.alfa.org/News/3200/Housing-Fundamentals-and-Trends-in-Senior-Housing>.

13) Chuck Harry, *Housing Market Fundamentals & Trends in Senior Housing*, National Review and Outlook, ALFA Conference & Expo (2012).

14) Barbara A. Butrica, Richard W. Johnson, and Karen E. Smith, *How Will the Great Recession Affect Future Retirement Incomes?*, URBAN INSTITUTE, available at <http://www.urban.org/uploadedpdf/412339-Future-Retirement-Incomes.pdf>.