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LEXINGTON HEALTHCARE GROUP INC  
Form 10-Q  
May 15, 2001

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For The Quarter Ended March 31, 2001  
or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For The Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-22261  
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LEXINGTON HEALTHCARE GROUP, INC.  
-----

(Exact name of registrant as specified in its charter)

Delaware -----	06-1468252 -----
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer identification No.)
1577 New Britain Avenue, Farmington, CT -----	06032 -----
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: 860-674-2700  
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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

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: May 14, 2001 3,525,000 Shares of Common Stock outstanding

LEXINGTON HEALTHCARE GROUP, INC.  
MARCH 31, 2001 FORM 10-Q  
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Item 1. Financial Statements

Condensed Consolidated Balance Sheets -- March 31, 2001 and

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### LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2001 (Unaudited) -----	June 30, 2000 (Audited) -----
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 1,203,000	\$ 1,265,000
Accounts and notes receivable - net of allowance for doubtful accounts of \$2,123,000 and \$1,634,000, respectively	13,825,000	16,963,000
Inventories, prepaid expenses and other current assets	2,226,000	1,349,000
	-----	-----
Total current assets	17,254,000	19,577,000
PROPERTY, EQUIPMENT & LEASEHOLD IMPROVEMENTS, net	5,919,000	4,477,000
OTHER ASSETS		
Security deposits - related parties	2,337,000	2,337,000
Residents' funds	387,000	370,000
Goodwill, net	1,803,000	1,886,000
Bed licenses, net	1,307,000	1,394,000
Other assets, net	820,000	917,000
	-----	-----
	6,654,000	6,904,000

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	-----	-----
	\$ 29,827,000	\$ 30,958,000
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)		
CURRENT LIABILITIES		
Notes and capital leases payable (current portion)	\$ 4,490,000	\$ 4,296,000
Due to SunBridge - purchased receivables	2,067,000	2,094,000
Accounts payable and accrued expenses	15,826,000	14,423,000
Estimated third-party payor settlements	98,000	188,000
Income taxes payable	73,000	74,000
	-----	-----
Total current liabilities	22,554,000	21,075,000
OTHER LIABILITIES		
Notes and capital leases payable (less current portion)	8,662,000	7,892,000
Residents' funds payable	387,000	370,000
Deferred rent	995,000	809,000
Other liabilities	120,000	120,000
	-----	-----
	10,164,000	9,191,000
	-----	-----
Total liabilities	32,718,000	30,266,000
	-----	-----
COMMITMENTS AND CONTINGENCIES (Note F)		
MINORITY INTERESTS	565,000	565,000
STOCKHOLDERS' EQUITY (DEFICIENCY)		
Common stock, par value \$.01 per share, authorized 15,000,000 shares, issued and outstanding 3,525,000 shares	35,000	35,000
Additional paid-in capital	5,556,000	5,556,000
Deficit	(9,047,000)	(5,464,000)
	-----	-----
Total stockholders' equity (deficiency)	(3,456,000)	127,000
	-----	-----
	\$ 29,827,000	\$ 30,958,000
	=====	=====

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

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

	Nine Months Ended March 31,	Three Months Ended
	-----	-----
	2001	2001
	-----	-----

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REVENUES			
Net patient service revenue	\$ 52,302,000	\$ 55,586,000	\$ 17,530,000
Management fee revenue	4,000	4,478,000	--
Other revenue	212,000	250,000	129,000
	-----	-----	-----
Total revenues	52,518,000	60,314,000	17,659,000
EXPENSES			
Operating expenses:			
Salaries and benefits	42,054,000	44,038,000	13,834,000
Food, medical and other supplies	2,825,000	6,295,000	937,000
Other operating expenses	8,124,000	7,126,000	3,177,000
Corporate, general and administrative expenses	1,958,000	2,367,000	716,000
Interest expense	1,140,000	890,000	378,000
	-----	-----	-----
Total expenses	56,101,000	60,716,000	19,042,000
	-----	-----	-----
Loss before income taxes and minority interest	(3,583,000)	(402,000)	(1,383,000)
BENEFIT FROM INCOME TAXES	--	--	--
MINORITY INTEREST IN INCOME OF CONSOLIDATED JOINT VENTURES	--	(111,000)	--
	-----	-----	-----
Net loss	\$ (3,583,000)	\$ (513,000)	\$ (1,383,000)
	=====	=====	=====
Basic loss per share	\$ (1.02)	\$ (0.14)	\$ (0.39)
	=====	=====	=====
Weighted average number of shares outstanding	3,525,000	3,582,000	3,525,000
	=====	=====	=====

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

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED MARCH 31, 2001 AND 2000  
(UNAUDITED)

	2001
	-----
CASH FLOWS FROM OPERATING ACTIVITIES	
Net loss	\$ (3,583,000)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities	1,160,000
Decrease in accounts and notes receivable	2,728,000
Increase (decrease) in accounts payable and accrued expenses	1,403,000
Decrease in due to SunBridge- purchased receivables	(27,000)
Changes in other operating assets and liabilities	(972,000)
	-----

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Net cash provided by (used in) operating activities	709,000 -----
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>	
Note receivable - related party	--
Increase in security deposits - other	--
Acquisition of fixed assets	(226,000)
	-----
Net cash used in investing activities	(226,000) -----
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>	
Net repayments of line of credit	(236,000)
Repayments of notes payable and capital lease obligations	(309,000)
	-----
Net cash used in financing activities	(545,000) -----
NET DECREASE IN CASH AND CASH EQUIVALENTS	(62,000)
CASH AND CASH EQUIVALENTS, beginning of period	1,265,000 -----
CASH AND CASH EQUIVALENTS, end of period	\$ 1,203,000 =====
NON-CASH INVESTING AND FINANCING ACTIVITIES:	
Certain assets acquired through assumption of mortgage note payable	\$ 1,381,000
Equipment and leasehold improvements acquired through assumption	
of notes payable and capital leases	128,000
Receipt of treasury stock in satisfaction of note receivable - related party	--

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

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Information with respect to March 31, 2001 and for the nine  
months and three months ended March 31, 2001 and 2000 is unaudited)

NOTE A - THE COMPANY

The condensed consolidated financial statements include the accounts of Lexington Healthcare Group, Inc. and all of its wholly-owned subsidiaries: Balz Medical Services, Inc. ("BALZ"), Professional Relief Nurses, Inc. ("PRN"), Lexington Highgreen Holding, Inc., and LexiCore Rehab Services, LLC ("Lexicore"), collectively, the "Company", as well as the accounts of Lexicon Pharmacy Services, LLC ("Lexicon"), a 70% owned joint venture controlled by the Company. All material intercompany balances and transactions have been eliminated in consolidation.

The Company is a long-term and subacute care provider which operates eight nursing home facilities at March 31, 2001 with 1,063 beds licensed by the State of Connecticut. PRN provides health care services in the homes of its patients. Lexicore provides rehab services to patients in the Company's and other nursing homes.

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BALZ provided medical supplies and durable medical equipment to nursing homes, but is now substantially inactive after selling its operating assets and business (exclusive of cash and accounts receivable) and ceasing operations effective June 14, 2000. Lexicon ceased operations as of March 31, 2000. Once the remaining accounts receivable have been collected and all obligations paid, the members will terminate Lexicon.

### NOTE B - BASIS OF PRESENTATION

The financial information included herein is unaudited and presented on a condensed basis; however, the information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary to present fairly the financial position, results of operations, and cash flows for the interim periods presented although the results shown for the interim periods presented herein are not necessarily indicative of the results to be obtained for a full fiscal year. The condensed balance sheet data as of June 30, 2000 is derived from audited financial statements; certain line items have been combined or condensed in their presentation herein.

Inventories consisting of food, chemicals and medical and other supplies are valued at the lower of cost or market, with cost determined on a first-in, first-out (FIFO) basis.

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
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### NOTE C - ACQUISITIONS AND DISPOSITIONS OF BUSINESSES

#### MANAGEMENT OF SUN HOMES, ACQUISITION OF ADAMS AND HERITAGE AND TERMINATION OF MANAGEMENT AGREEMENT

On November 1, 1998 the Company began providing management services for four skilled nursing facilities in Connecticut under an interim Management Agreement with SunBridge Healthcare Corporation ("SunBridge"), a New Mexico corporation and nation-wide healthcare provider.

As consideration for the services provided under this Management Agreement, the Company was entitled to retain the excess of any revenues earned in the delivery of patient services over the expenses incurred during the term and was responsible for any excess of expenses incurred over revenues earned in the operation of the facilities during the term. Under the terms of the agreement SunBridge retained responsibility for all building lease costs. In addition, the Company purchased substantially all of SunBridge's accounts receivable for these facilities. As of March 31, 2001, the balance owed is presented as "Due to SunBridge - purchased receivables" in the accompanying condensed consolidated balance sheet.

Effective September 1, 1999, the Company finalized agreements to acquire the operations of two of the managed facilities, Adams House and Heritage Heights. The related real property was leased with options to purchase which expire August 30, 2001; these facilities have a total of 240 skilled nursing beds. Management contracts covering the two other SunBridge facilities with a total of 239 skilled nursing beds were terminated as of August 31, 1999 and the operations of those facilities were returned to SunBridge. Under the terms of the management agreement, which terminated on August 31, 1999, the Company

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earned management fees of \$4,422,000 and incurred costs and expenses of \$4,407,000 during the two months ended August 31, 1999.

### SALE OF BUSINESS

On June 14, 2000 BALZ sold its operating assets and business (exclusive of cash and accounts receivable) to an unrelated company, for \$539,000 plus assumption of certain liabilities relating to financed equipment and leases. The agreement provided for a \$40,000 cash payment at closing, a \$260,000 note receivable requiring twelve equal monthly installments of principal and interest of \$22,000 beginning July 1, 2000, and a payment of \$239,000 for the book value of inventory due 90 days after closing.

As of March 31, 2001 the Company has received substantially all the payments due it under the note receivable, but has not received the payment for the book value of the inventory. However, the Company believes that its credit risk is minimal since it has the right to offset payables for goods purchased from the unrelated company in an amount sufficient to cover any unpaid amounts owing to the Company.

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
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### NOTE C - ACQUISITIONS AND DISPOSITIONS OF BUSINESSES (Continued)

#### SALE OF BUSINESS (Continued)

Prior to the sale of the business later in the fiscal year, BALZ had revenues of \$2,491,000, expenses of \$2,191,000 and net income of \$300,000 during the nine months ended March 31, 2000.

### NOTE D - RENEGOTIATION OF RELATED PARTY OPERATING LEASE

The Company leases four of its nursing facilities (including certain equipment) under an operating lease with a partnership related through common ownership. The lease agreement, as amended, commenced on July 1, 1995 and is for an eighteen-year period, with renewal options for up to thirteen years. Annual rentals under the lease are currently \$2.5 million.

The Company renegotiated the required rent payments covering the period of October 1999 through February 2001 which reduced the rent due during that period by approximately \$800,000. However, recognition of that rent reduction has been accounted for by increasing deferred rent which equalizes the annual rent expense over the remaining fourteen-year term of the lease.

Rent expense charged to operations under this related party operating lease aggregated \$1,837,000 and \$1,840,000 for the nine months ended March 31, 2001 and 2000, respectively.

### NOTE E - THIRD-PARTY REVENUE ADJUSTMENTS AND SETTLEMENTS

Revenues are recognized at the time the service is provided to the patient. A substantial amount of the Company's revenues are billed to third party payors, i.e., Medicaid, Medicare and others under the provisions of reimbursement formulas and regulations in effect.

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Patient service revenue is reported at the estimated net realizable amount from residents, third-party payors, and others for services rendered. Revenue received under cost reimbursement agreements is subject to audit and retroactive adjustment by third-party payors. Provisions for estimated adjustments have been reflected in patient service revenue. Differences between estimated adjustments and final settlements are recorded in the year of settlement.

The Company has recorded reductions in patient service revenue of \$430,000 during the nine months ended March 31, 2001 in connection with adjustment of 1997 and 1998 estimated Medicare settlements.

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
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months and three months ended March 31, 2001 and 2000 is unaudited)

### NOTE E - THIRD-PARTY REVENUE ADJUSTMENTS AND SETTLEMENTS (Continued)

Estimated third-party payor settlements payable represent management's best estimates of the amounts expected to be due and are based on anticipated results of ongoing negotiations, interpretation of applicable regulations and other assumptions. It is reasonably possible that the amounts the Company will ultimately be obligated to pay could differ materially in the near term.

### NOTE F - COMMITMENTS AND CONTINGENCIES

#### GOVERNMENT INVESTIGATION

In October 1999, Federal officials (the "government") seized records and documents from the Company and subpoenaed current and former employees to provide testimony in connection with a grand jury investigation being conducted by the Office of the U.S. Attorney. The Company and certain members of present and former senior management have been named as targets of the government's investigation. However, the government has not provided the Company with any documentation from which it may determine the nature and scope of the investigation.

The Company is cooperating fully with the government investigation, has provided all requested records and information, and management is confident that the Company has not committed any wrongdoings. In addition, the Company has established an independent committee of the Board of Directors to supervise its own investigation. The ultimate outcome of this uncertainty cannot presently be determined. Accordingly, no provision for any liability that may result has been made in the accompanying condensed consolidated financial statements. Since the inception of the government action through March 31, 2001 the Company has recorded charges to expense of \$425,000 consisting primarily of legal fees relating to this matter.

#### OTHER CONTINGENCIES

The Company is involved in other legal proceedings and is subject to certain lawsuits and claims in the ordinary course of its business. Although the ultimate effect of these matters is often difficult to predict, management believes that their resolution will not have a material adverse effect on the Company's condensed consolidated financial statements.

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Information with respect to March 31, 2001 and for the nine  
months and three months ended March 31, 2001 and 2000 is unaudited)

### NOTE G - RISKS AND UNCERTAINTIES

#### PATIENT SERVICE REVENUE

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is in compliance with all applicable laws and regulations and is not aware of any significant pending or threatened investigations involving allegations of potential wrongdoing, except for the investigation discussed in Note F.

Compliance with such laws and regulations are subject to government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs. Changes in the Medicare and Medicaid programs and/or the reduction of funding levels could have an adverse impact on the Company.

#### LEGISLATION, REGULATIONS AND MARKET CONDITIONS

The Company is subject to extensive federal, state and local government regulation relating to licensure, conduct of operations, ownership of facilities, expansion of facilities and services and reimbursement for services. As such, in the ordinary course of business, the Company's operations are continuously subject to state and federal regulatory scrutiny, supervision and control. Such regulatory scrutiny often includes inquiries, investigations, examinations, audits, site visits and surveys, some of which may be non-routine. The Company believes that it is in substantial compliance with the applicable laws and regulations. However, if the Company is ever found to have engaged in improper practices, it could be subjected to civil, administrative or criminal fines, penalties or restitutionary relief which may have a material adverse impact on the Company's financial results and operations.

### NOTE H - OPERATIONS

The Company reported a loss of \$3,583,000 for the nine months ended March 31, 2001 and as of March 31, 2001 has a working capital deficiency of \$5,300,000 and a stockholders' deficiency of \$3,456,000. The loss for the nine months ended March 31, 2001 includes a reduction of patient service revenue of \$430,000 as discussed in Note E, a \$489,000 increase to the provision for doubtful accounts as a result of estimated uncollectable trade accounts receivable, and \$150,000 in unreimbursed costs relating to a unionized labor action in March, 2001 as discussed in Note I.

Management has prepared plans which contemplate a significant turnaround in ongoing operations and profitability and has plans to address the Company's equity, working capital and cash flow needs so that operations may continue in a normal manner.

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LEXINGTON HEALTHCARE GROUP, INC. AND SUBSIDIARIES  
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### NOTE H - OPERATIONS (Continued)

Commencing in April 2001, the Company engaged unrelated professional service firms to perform the dietary, laundry and housekeeping and maintenance services for the nursing homes. Management anticipates that these contracts should generate approximately \$1,500,000 in positive cash flow based upon sixty-day payment terms in place. Further, the total contract costs for the outsourced departments are less than the costs the Company is currently incurring for such services.

Management has implemented an aggressive marketing plan, which includes patient sharing arrangements with local hospitals, to improve the patient mix and generate revenue from higher rate paying sources. In addition, the facilities are undergoing a major redecoration program to attract more patients and Medicare consultants have been engaged to improve nursing diagnoses skills and patient admission procedures which should result in higher revenue and lower bad debt write-offs in the future.

### NOTE I - UNIONIZED LABOR STRIKE

Approximately 45% of the Company's employees were previously covered by eight collective bargaining agreements with New England Health Care Employees Union, District 1199, AFL-CIO ("union") six of which expired as of March 31, 2001.

Union employees of the Company commenced a one day job action in March 2001 and commenced another strike for an indefinite period on May 5, 2001. The Company executed an Expedited Medicaid Reimbursement Agreement with the State of Connecticut (the "State") whereby the State will reimburse the Company for certain strike related incremented costs related to Medicaid patients, which approximates 80% of costs incurred.

The Company has engaged nursing staffing firms to replace the striking workers and continues to maintain compliance with applicable State of Connecticut patient care and staffing regulations. Management is confident that the Company will receive appropriate Medicaid rate reimbursement to offset any labor cost increases that may result from the job action.

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### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis provides information which management believes is relevant to an assessment and understanding of the Company's consolidated results of operations and financial condition. The discussion should be read in conjunction with the condensed consolidated financial statements and notes thereto.

#### Overview

In the first nine months of the fiscal year ending June 30, 2001, the Company continued to operate eight nursing homes, a home health agency and therapy company.

During the fiscal year ended June 30, 2000, the Company's operations were affected when the management contract for two nursing homes was terminated, when certain assets and the business of BALZ were sold, when the Company's joint venture pharmacy ceased operations, and when settlements were negotiated on employment agreements with two executives. The two remaining nursing homes under

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management contract were leased and are now operated by the Company. Further, the Company experienced a government investigation during the year ended June 30, 2000 which resulted in certain costs.

The long term care industry has experienced many changes in recent years including the implementation of the Balanced Budget Act of 1997 ("BBA") which resulted in a new Medicare Prospective Payment System (known as PPS). Under PPS, Medicare revenues are substantially less than those earned under the former cost-based reimbursement system. Some of the Company's Medicare rate cuts were restored in October 1999 and April 2000; in addition, a 4% federal rate increase became effective October 1, 2000.

In Connecticut, multiple long term care entities have undergone financial reorganization in 1999 and 2000 due to reduced occupancy and PPS-related revenue reductions and increasing cost pressures (including union costs), and have experienced considerable losses in the market value of their own securities.

The Company believes its continued emphasis on cost controls and development of ancillary businesses remains the most appropriate strategy. Further, the Company is encouraged by the above-noted Medicare rate increases and recently proposed legislation to fund staffing increases for nursing homes, although it cannot be estimated what effect, if any, this proposed legislation may have on the Company's revenues in the near term.

The Company continues to believe that the demand for long-term care and specialty medical services will increase substantially over the next decade due primarily to favorable demographic trends, advances in medical technology and emphasis on healthcare cost containment. At the same time, government restrictions and high construction and start-up costs are expected to limit the supply of long-term care facilities and home care agencies. In addition, the Company anticipates that recent trends toward industry consolidation will continue.

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### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### Overview (Continued)

The Company's operating strategy is to increase nursing home profitability levels through aggressive marketing and by offering rehabilitation therapies and other specialized services; by adhering to strict cost standards at the Facility level while providing effective patient care and containing corporate overhead expenses; and by increasing marketing of rehabilitative services and nursing services to affiliated and non-affiliated nursing homes as well as to patients at home.

By concentrating its facilities and ancillary service operations within a selected geographic region, the Company's strategy is to achieve operating efficiencies through economies of scale, reduced corporate overhead, more effective management supervision and financial controls. In addition, the Company believes that geographic concentration also enhances the Company's ability to establish more effective relationships with referral sources and regulatory authorities in the areas of the State of Connecticut where the Company operates.

#### Results of Operations

Nine months ended March 31, 2001 ("2001 period") vs. nine months ended March 31,

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2000 ("2000 period")

Revenues in the 2001 period decreased from the 2000 period by \$7,796,000 or by 13% largely as a result of the termination of the management agreement for two nursing homes, and due to the sale of the assets and the business of BALZ, and the termination of Lexicon's operations.

The Company had a net loss of \$3,583,000 or (1.02) per share for the 2001 period and a net loss of \$513,000 or (.14) per share for the 2000 period. The increased losses is due primarily to a \$430,000 reduction in patient service revenue resulting from adjustments to 1997 and 1998 Medicare settlements, a \$489,000 increase to the provision for doubtful accounts as a result of estimated uncollectable trade accounts receivable from discontinued operations of subsidiaries, reductions in net revenue from Medicare under the prospective payment systems (PPS), and \$150,000 in unreimbursed costs relating to unionized labor action in March, 2001. Further, profitability was negatively impacted with the sale of the assets and the business of BALZ, and the termination of Lexicon's operations.

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### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview (Continued)

Three months ended March 31, 2001 ("2001 period") vs. three months ended March 31, 2000 ("2000 period")

Revenues in the 2001 period declined from the 2000 period by \$1,817,000 or by 10% largely as a result of the sale of the assets and the business of BALZ and the termination of Lexicon's operations.

The Company had a net loss of \$1,383,000 or (.39) per share for the 2001 period and a net loss of \$518,000 or (.15) per share for the 2000 period. The increase in losses is primarily due to strike related losses of \$150,000 in the 2001 period, and higher payroll and benefits. Further, profitability was negatively impacted with the sale of the assets and the business of BALZ, and the termination of Lexicon's operations.

Liquidity and Capital Resources

The Company has primarily financed its operations through operating revenues, borrowings from banks, the prior operator of certain of the facilities and other private lenders including stockholders, by financing its accounts receivable, through a public offering of its common stock, and through the sale of bed licenses.

During the nine months ended March 31, 2001, the Company expended approximately \$1,735,000 in capital improvements to its owned and its leased facilities of which \$1,509,000 was funded by the mortgagor, banks or capital lease financing.

At March 31, 2001, the Company had a working capital deficit of \$5,300,000 as compared to a working capital deficit of \$1,498,000 at June 30, 2000. The increase in the working capital deficit is due primarily to the \$3,583,000 operating loss reported for the 2001 period.

In December 1998, the Company entered into a financing agreement with a healthcare lender for up to \$4,500,000, subsequently increased to \$6,000,000, which is secured by its accounts receivable and certain other assets. As of

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March 31, 2001, \$3,819,000 was borrowed under this agreement. The Company has increased its utilization of this line of credit to finance working capital needs as a result of payback of Medicare and Medicaid settlements, costs of the government investigation, and operating losses.

Management has prepared plans, as discussed in Note H, which contemplate a significant turnaround in ongoing operations and profitability of the Company and has plans to address the Company's equity, working capital and cash flow needs so that operations may continue in a normal manner.

Inflation has not had, nor is it expected to have, a material impact on the operations and financial condition of the Company.

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### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### Forward Looking Statements

This quarterly report contains certain forward-looking statements regarding the Company, its business prospects and results of operations that are subject to certain risks and uncertainties posed by many factors and events that could cause the Company's actual business, prospects and results of operations to differ materially from those that may be anticipated by such forward-looking statements.

Factors that may affect such forward-looking statements include, without limitations: the Company's ability to successfully and timely develop and finance new projects, the impact of competition on the Company's revenues, and changes in reimbursement rates, patient mix, and demand for the Company's services.

When used, words such as "believes," "anticipates," "expects," "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company undertakes no obligation to revise any forward-looking statements in order to reflect events or circumstances that may subsequently arise.

Readers are urged to carefully review and consider the various disclosures made by the Company in this report, news releases, and other reports filed with the Securities and Exchange Commission that attempt to advise interested parties of the risks and factors that may affect the Company's business.

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### PART II - OTHER INFORMATION

#### Item 1. Legal Proceedings

In October 1999, Federal officials (the "government") seized records and documents from the Company and subpoenaed current and former employees to provide testimony in connection with a grand jury investigation being conducted by the Office of the U.S. Attorney. The Company and certain members of present and former senior management have been named as targets of the government's investigation. However, the government has not provided the Company with any

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documentation from which it may determine the nature and scope of the investigation.

The Company is cooperating fully with the government investigation, has provided all requested records and information, and management is confident that the Company has not committed any wrongdoings. In addition, the Company has established an independent committee of the Board of Directors to supervise its own investigation. The ultimate outcome of this uncertainty cannot presently be determined. Accordingly, no provision for any liability that may result has been made in the accompanying condensed consolidated financial statements. Since inception through March 31, 2001 the Company has incurred expenses of \$425,000 relating to this matter.

An independent committee of the Board of Directors approved a formal Corporate Compliance Plan which was submitted to the Connecticut Department of Social Services in February 2000. The following actions have been taken in support of that plan:

- o An experienced operations executive was named Corporate Compliance Officer
- o An 800 "hot line" phone number to report questions or problems has been set up and communicated to employees and others
- o A Management Compliance Committee has held seven monthly meetings, resulting in a number of formal policies being written and distributed including a Corporate Compliance Handbook for employees which includes disciplinary guidelines, an offense detection plan, and corrective action initiatives
- o Corporate compliance training for employees has been conducted
- o Written policies and procedures have been prepared relating to State of CT reimbursement (including related party transactions and cost report preparation); training was completed before preparing the 2000 cost reports
- o Quarterly audits of management costs, related party transactions and rent payments have been completed and submitted to the State of Connecticut

The Company has received notice of lawsuits initiated against it in April 2000 concerning four nursing homes which it was managing for SunBridge Healthcare Corporation; the claims are being made by affiliates of SunBridge for therapy and pharmacy services rendered. The total claimed is \$1.2 million of which \$1.1 million is reflected by invoices recorded on the Company's books. The Company believes that the claim includes overbillings, payments and credits not applied, and amounts charged in excess of contract rates. The Company settled a portion of the lawsuit for \$212,000 payable over ten months. This amount represents invoices previously recorded on the Company's books. The Company intends to vigorously contest the lawsuits as it works out arrangements to pay appropriate charges.

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The Company is involved in other legal proceedings and is subject to certain lawsuits and claims in the ordinary course of its business. Although the ultimate effect of these matters is often difficult to predict, management believes that their resolution will not have a material adverse effect on the Company.

Item 2. Change in Securities

NONE

Item 3. Defaults Upon Senior Securities

NONE

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Item 4. Submission of Matters to a Vote of Security Holders  
NONE

Item 5. Other Information  
NONE.

Item 6. Exhibits and Reports on Form 8-K  
NONE.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

/s/ Barry Feldscher

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(Barry Feldscher, Chief Operating Officer)  
(Duly Authorized Officer)

Date 5/15/2001

/s/ Michael D. Logan

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(Michael D. Logan, Chief Financial Officer)  
(Principal Financial Officer)

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