

MAGELLAN HEALTH SERVICES INC
Form 10-Q
October 27, 2011

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2011

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 No. 1-6639**

MAGELLAN HEALTH SERVICES, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

58-1076937
(IRS Employer
Identification No.)

55 Nod Road, Avon, Connecticut
(Address of principal executive offices)

06001
(Zip code)

(860) 507-1900
(Registrant's telephone number, including area code)

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 twelve 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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

The number of shares of the registrant's Ordinary Common Stock outstanding as of September 30, 2011 was 28,468,410.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements.****MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In thousands, except per share amounts)**

	December 31, 2010	September 30, 2011 (unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 337,179	\$ 142,365
Restricted cash	116,734	155,559
Accounts receivable, less allowance for doubtful accounts of \$1,985 and \$2,286 at December 31, 2010 and September 30, 2011, respectively	106,934	114,436
Short-term investments (restricted investments of \$114,903 and \$140,707 at December 31, 2010 and September 30, 2011, respectively)	189,530	240,753
Deferred income taxes	28,439	33,541
Other current assets (restricted deposits of \$21,302 and \$21,716 at December 31, 2010 and September 30, 2011, respectively)	79,671	72,460
Total Current Assets	858,487	759,114
Property and equipment, net	111,814	114,904
Long-term investments (restricted investments of \$84,950 and \$13,396 at December 31, 2010 and September 30, 2011, respectively)	94,974	13,396
Deferred income taxes	825	
Other long-term assets	2,396	10,036
Goodwill	426,939	426,939
Other intangible assets, net	53,997	47,268
Total Assets	\$ 1,549,432	\$ 1,371,657
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 31,878	\$ 19,249
Accrued liabilities	105,776	108,836
Medical claims payable	142,671	140,976
Other medical liabilities	109,285	95,517
Current maturities of long-term capital lease obligation	559	559
Total Current Liabilities	390,169	365,137
Deferred income taxes		11,164
Tax contingencies	117,599	109,066
Deferred credits and other long-term liabilities	2,649	6,725
Total Liabilities	510,417	492,092
Preferred stock, par value \$.01 per share		
Authorized 10,000 shares Issued and outstanding none		
Ordinary common stock, par value \$.01 per share		
Authorized 100,000 shares at December 31, 2010 and September 30, 2011 Issued and outstanding 43,687 shares and 33,782 shares at December 31, 2010, respectively, and 45,101 and 28,468 shares at September 30, 2011, respectively	437	451
Multi-Vote common stock, par value \$.01 per share		

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Authorized 40,000 shares Issued and outstanding none

Other Stockholders' Equity:

Additional paid-in capital	725,322	794,845
Retained earnings	694,582	794,466
Warrants outstanding	420	
Accumulated other comprehensive income (loss)	9	(293)
Ordinary common stock in treasury, at cost, 9,905 shares and 16,633 shares at December 31, 2010 and September 30, 2011, respectively	(381,755)	(709,904)
Total Stockholders' Equity	1,039,015	879,565
Total Liabilities and Stockholders' Equity	\$ 1,549,432	\$ 1,371,657

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Net revenue	\$ 750,319	\$ 686,843	\$ 2,220,030	\$ 2,077,936
Cost and expenses:				
Cost of care	467,160	448,051	1,416,317	1,323,197
Cost of goods sold	55,071	57,636	166,138	167,559
Direct service costs and other operating expenses(1)	141,581	130,038	419,452	393,384
Depreciation and amortization	13,950	15,069	41,607	43,288
Interest expense	482	457	1,751	1,422
Interest income	(846)	(592)	(2,466)	(2,265)
	677,398	650,659	2,042,799	1,926,585
Income before income taxes	72,921	36,184	177,231	151,351
Provision for income taxes	28,137	4,829	71,500	51,467
Net income	44,784	31,355	105,731	99,884
Other comprehensive income (loss)	280	(380)	21	(302)
Comprehensive income	\$ 45,064	\$ 30,975	\$ 105,752	\$ 99,582
Weighted average number of common shares outstanding basic (See Note B)	33,450	29,900	33,715	31,406
Weighted average number of common shares outstanding diluted (See Note B)	34,171	30,438	34,345	31,988
Net income per common share basic:	\$ 1.34	\$ 1.05	\$ 3.14	\$ 3.18
Net income per common share diluted:	\$ 1.31	\$ 1.03	\$ 3.08	\$ 3.12

(1)

Includes stock compensation expense of \$3,596 and \$4,425 for the three months ended September 30, 2010 and 2011, respectively, and \$11,830 and \$13,408 for the nine months ended September 30, 2010 and 2011, respectively.

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30,

(Unaudited)

(In thousands)

	2010	2011
Cash flows from operating activities:		
Net income	\$ 105,731	\$ 99,884
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	41,607	43,288
Non-cash interest expense	463	320
Non-cash stock compensation expense	11,830	13,408
Non-cash income tax expense	32,260	(248)
Non-cash amortization (accretion) on investments	6,851	9,660
Cash flows from changes in assets and liabilities, net of effects from acquisitions of businesses:		
Restricted cash	62,413	(38,825)
Accounts receivable, net	10,279	(8,439)
Other assets	(4,085)	(751)
Accounts payable and accrued liabilities	889	(10,216)
Medical claims payable and other medical liabilities	(14,085)	(15,463)
Other	126	3,501
Net cash provided by operating activities	254,279	96,119
Cash flows from investing activities:		
Capital expenditures	(32,201)	(38,468)
Acquisitions and investments in businesses, net of cash acquired		(376)
Purchase of investments	(235,420)	(210,890)
Maturity of investments	154,979	231,093
Net cash used in investing activities	(112,642)	(18,641)
Cash flows from financing activities:		
Payments on long-term debt and capital lease obligations	(588)	
Payments to acquire treasury stock	(74,427)	(327,886)
Proceeds from issuance of equity		20,000
Proceeds from exercise of stock options and warrants	23,121	34,755
Other	(1,611)	839
Net cash used in financing activities	(53,505)	(272,292)
Net increase (decrease) in cash and cash equivalents	88,132	(194,814)
Cash and cash equivalents at beginning of period	196,507	337,179
Cash and cash equivalents at end of period	\$ 284,639	\$ 142,365

See accompanying notes to consolidated financial statements.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2011

(Unaudited)

NOTE A General

Basis of Presentation

The accompanying unaudited consolidated financial statements of Magellan Health Services, Inc., a Delaware corporation ("Magellan"), include the accounts of Magellan, its majority owned subsidiaries, and all variable interest entities ("VIEs") for which Magellan is the primary beneficiary (together with Magellan, the "Company"). The financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the Securities and Exchange Commission's (the "SEC") instructions to Form 10-Q. Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. The results of operations for the nine months ended September 30, 2011 are not necessarily indicative of the results to be expected for the full year. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company has evaluated subsequent events for recognition or disclosure in our consolidated financial statements filed on this Form 10-Q and no events have occurred that require disclosure.

These unaudited consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2010 and the notes thereto, which are included in the Company's Annual Report on Form 10-K filed with the SEC on February 25, 2011.

Business Overview

The Company is engaged in the specialty managed healthcare business. Through 2005, the Company predominantly operated in the managed behavioral healthcare business. As a result of certain acquisitions, the Company expanded into radiology benefits management and specialty pharmaceutical management during 2006, and into Medicaid administration during 2009. The Company provides services to health plans, insurance companies, employers, labor unions and various governmental agencies. The Company's business is divided into the following six segments, based on the services it provides and/or the customers that it serves, as described below.

Managed Behavioral Healthcare

Two of the Company's segments are in the managed behavioral healthcare business. This line of business generally reflects the Company's coordination and management of the delivery of behavioral healthcare treatment services that are provided through its contracted network of third-party treatment providers, which includes psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities. The treatment services provided through the Company's provider network include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and crisis intervention services. The Company generally does not directly provide, or own any provider of, treatment services except as related to the Company's contract to provide managed behavioral healthcare services to

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

Medicaid recipients and other beneficiaries of the Maricopa County Regional Behavioral Health Authority (the "Maricopa Contract"). Under the Maricopa Contract, effective August 31, 2007 the Company was required to assume the operations of twenty-four behavioral health direct care facilities for a transitional period and to divest itself of these facilities over a two year period. All of the direct care facilities were divested as of December 31, 2009.

The Company provides its management services primarily through: (i) risk-based products, where the Company assumes all or a substantial portion of the responsibility for the cost of providing treatment services in exchange for a fixed per member per month fee, (ii) administrative services only ("ASO") products, where the Company provides services such as utilization review, claims administration and/or provider network management, but does not assume responsibility for the cost of the treatment services, and (iii) employee assistance programs ("EAPs") where the Company provides short-term outpatient behavioral counseling services.

The managed behavioral healthcare business is managed based on the services provided and/or the customers served, through the following two segments:

Commercial. The Managed Behavioral Healthcare Commercial segment ("Commercial") generally reflects managed behavioral healthcare services and EAP services provided under contracts with health plans and insurance companies for some or all of their commercial, Medicaid and Medicare members, as well as with employers, including corporations, governmental agencies, and labor unions. Commercial's contracts encompass risk-based, ASO and EAP arrangements.

Public Sector. The Managed Behavioral Healthcare Public Sector segment ("Public Sector") generally reflects services provided to recipients under Medicaid and other state sponsored programs under contracts with state and local governmental agencies. Public Sector contracts encompass either risk-based or ASO arrangements.

Radiology Benefits Management

The Radiology Benefits Management segment ("Radiology Benefits Management") generally reflects the management of the delivery of diagnostic imaging services to ensure that such services are clinically appropriate and cost effective. The Company's radiology benefits management services currently are provided under contracts with health plans and insurance companies for some or all of their commercial, Medicaid and Medicare members. The Company also contracts with state and local governmental agencies for the provision of such services to Medicaid recipients. The Company offers its radiology benefits management services through risk-based contracts, where the Company assumes all or a substantial portion of the responsibility for the cost of providing diagnostic imaging services, and through ASO contracts, where the Company provides services such as utilization review and claims administration, but does not assume responsibility for the cost of the imaging services.

Specialty Pharmaceutical Management

The Specialty Pharmaceutical Management segment ("Specialty Pharmaceutical Management") comprises programs that manage specialty drugs used in the treatment of complex conditions such as,

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

cancer, multiple sclerosis, hemophilia, infertility, rheumatoid arthritis, chronic forms of hepatitis and other diseases. Specialty pharmaceutical drugs represent high-cost injectible, infused, oral, or inhaled drugs with sensitive handling or storage needs, many of which may be physician administered. Patients receiving these drugs require greater amounts of clinical support than those taking more traditional agents. Payors require clinical, financial and technological support to maximize the value delivered to their members using these expensive agents. The Company's specialty pharmaceutical management services are provided under contracts with health plans, insurance companies, and governmental agencies for some or all of their commercial, Medicare and Medicaid members. The Company's specialty pharmaceutical services include: (i) contracting and formulary optimization programs; (ii) specialty pharmaceutical dispensing operations; (iii) strategic consulting services; and (iv) medical pharmacy management programs.

Medicaid Administration

The Medicaid Administration segment ("Medicaid Administration") generally reflects integrated clinical management services provided to the public sector to manage Medicaid pharmacy, mental health and long-term care programs. The primary focus of the Company's Medicaid Administration unit involves providing pharmacy benefits administration ("PBA") services under contracts with states to Medicaid and other state sponsored program recipients. Medicaid Administration's contracts encompass Fee-For-Service ("FFS") arrangements. In addition to Medicaid Administration's FFS contracts, effective September 1, 2010, Public Sector has subcontracted with Medicaid Administration to provide pharmacy benefits management services on a limited risk basis for one of Public Sector's customers.

Corporate

This segment of the Company is comprised primarily of operational support functions such as sales and marketing and information technology, as well as corporate support functions such as executive, finance, human resources and legal.

Summary of Significant Accounting Policies

Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update, ("ASU"), No. 2010-24, "Health Care Entities Presentation of Insurance Claims and Related Insurance Recoveries" ("ASU 2010-24"). ASU 2010-24 clarifies that a health care entity should not net insurance recoveries against a related claim liability. Additionally, the amount of the claim liability should be determined without consideration of insurance recoveries. This guidance is effective for fiscal years beginning after December 15, 2010. Accordingly, the Company adopted ASU 2010-24 on January 1, 2011. The adoption of this standard did not have a material impact on the consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, "Comprehensive Income (Topic 220): Presentation of Comprehensive Income" ("ASU 2011-05"). ASU 2011-05 requires an entity to present the total of comprehensive income, the components of net income, and the components of other

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements and eliminates the option to present the components of other comprehensive income as part of the statement of equity. ASU 2011-05 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2011, with early adoption permitted. While the adoption of this guidance is expected to impact the Company's disclosures for annual and interim filings for the year ending December 31, 2012, it will not have an impact on the Company's results of operations or financial condition.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates of the Company include, among other things, accounts receivable realization, valuation allowances for deferred tax assets, valuation of goodwill and intangible assets, medical claims payable, other medical liabilities, stock compensation assumptions, tax contingencies and legal liabilities. Actual results could differ from those estimates.

Managed Care Revenue

Managed care revenue, inclusive of revenue from the Company's risk, EAP and ASO contracts, is recognized over the applicable coverage period on a per member basis for covered members. The Company is paid a per member fee for all enrolled members, and this fee is recorded as revenue in the month in which members are entitled to service. The Company adjusts its revenue for retroactive membership terminations, additions and other changes, when such adjustments are identified, with the exception of retroactivity that can be reasonably estimated. The impact of retroactive rate amendments is generally recorded in the accounting period that terms to the amendment are finalized, and that the amendment is executed. Any fees paid prior to the month of service are recorded as deferred revenue. Managed care revenues approximated \$610.3 million and \$1,784.9 million for the three and nine months ended September 30, 2010, respectively, and \$533.3 million and \$1,627.9 million for the three and nine months ended September 30, 2011, respectively.

Fee-For-Service and Cost-Plus Contracts

The Company has certain FFS contracts, including cost-plus contracts, with customers under which the Company recognizes revenue as services are performed and as costs are incurred. Revenues from fee-for-service and cost-plus contracts approximated \$47.0 million and \$145.3 million for the three and nine months ended September 30, 2010, respectively, and \$45.0 million and \$131.3 million for the three and nine months ended September 30, 2011, respectively.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

Block Grant Revenues

The Maricopa Contract is partially funded by federal, state and county block grant money, which represents annual appropriations. The Company recognizes revenue from block grant activity ratably over the period to which the block grant funding applies. Block grant revenues were approximately \$26.0 million and \$82.8 million for the three and nine months ended September 30, 2010, respectively, and \$31.8 million and \$85.0 million for the three and nine months ended September 30, 2011, respectively.

Dispensing Revenue

The Company recognizes dispensing revenue, which includes the co-payments received from members of the health plans the Company serves, when the specialty pharmaceutical drugs are shipped. At the time of shipment, the earnings process is complete; the obligation of the Company's customer to pay for the specialty pharmaceutical drugs is fixed, and, due to the nature of the product, the member may neither return the specialty pharmaceutical drugs nor receive a refund. Revenues from the dispensing of specialty pharmaceutical drugs on behalf of health plans were \$58.6 million and \$178.3 million for the three and nine months ended September 30, 2010, respectively, and \$61.8 million and \$178.7 million for the three and nine months ended September 30, 2011, respectively.

Performance-Based Revenue

The Company has the ability to earn performance-based revenue under certain risk and non-risk contracts. Performance-based revenue generally is based on either the ability of the Company to manage care for its clients below specified targets, or on other operating metrics. For each such contract, the Company estimates and records performance-based revenue after considering the relevant contractual terms and the data available for the performance-based revenue calculation. Pro-rata performance-based revenue is recognized on an interim basis pursuant to the rights and obligations of each party upon termination of the contracts. Performance-based revenues were \$2.9 million and \$8.7 million for the three and nine months ended September 30, 2010, respectively, and \$2.4 million and \$15.6 million for the three and nine months ended September 30, 2011, respectively.

Significant Customers

Consolidated Company

The Maricopa Contract generated net revenues that exceeded, in the aggregate, ten percent of net revenues for the consolidated Company for the nine months ended September 30, 2010 and 2011.

Pursuant to the Maricopa Contract, the Company provides behavioral healthcare management and other related services to approximately 719,000 members in Maricopa County, Arizona. Under the Maricopa Contract, the Company is responsible for providing covered behavioral health services to persons eligible under Title XIX (Medicaid) and Title XXI (State Children's Health Insurance Program) of the Social Security Act, non-Title XIX and non-Title XXI eligible children and adults with a serious mental illness, and to certain non-Title XIX and non-Title XXI adults with behavioral health

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

or substance abuse disorders. The Maricopa Contract began on September 1, 2007 and extends through September 30, 2013 unless sooner terminated by the parties. The State of Arizona has the right to terminate the Maricopa Contract for cause, as defined, upon ten days' notice with an opportunity to cure, and without cause immediately upon notice from the State. The Maricopa Contract generated net revenues of \$602.4 million and \$570.1 million for the nine months ended September 30, 2010 and 2011, respectively.

One of the Company's top ten customers during 2010 was WellPoint, Inc. The Company recorded net revenue from contracts with WellPoint, Inc. of \$130.9 million for the nine months ended September 30, 2010. The Company's contracts with WellPoint, Inc. terminated on December 31, 2010.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

By Segment

In addition to the Maricopa Contract previously discussed, the following customers generated in excess of ten percent of net revenues for the respective segment for the nine months ended September 30, 2010 and 2011 (in thousands):

Segment	Term Date	2010	2011
Commercial			
Customer A	December 31, 2012	\$ 189,949	\$ 131,633
Customer B	June 30, 2014	54,822	50,089
Customer C	June 30, 2012 to November 30, 2013(1)	40,303*	82,695
Public Sector			
Customer D	June 30, 2012(2)	113,540	135,597
Radiology Benefits Management			
WellPoint, Inc.	December 31, 2010(3)	119,155	
Customer E	November 30, 2012 to April 30, 2013(1)	84,435	100,575
Customer F	June 30, 2011 to November 30, 2011(1)(4)	50,982	34,271
Customer G	June 30, 2014	40,203	40,928
Customer H	March 31, 2013	4,057*	25,708
Specialty Pharmaceutical Management			
Customer I	November 30, 2011 to March 31, 2012(1)	65,421	64,731
Customer J	September 1, 2011 to April 29, 2012(1)	43,246	41,704
Customer E	February 1, 2012 to April 30, 2013(1)	26,937	19,499*
Medicaid Administration			
Customer K	December 4, 2011(4)	23,531	22,193
Customer L	September 30, 2013(5)	6,647*	61,543
Customer M	September 30, 2011 to June 30, 2017(1)	17,905	18,635
Customer N	August 31, 2011 to June 30, 2013(1)	16,357	13,689*
Customer O	June 30, 2013 to September 30, 2014(1)	12,097	17,221

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*

Revenue amount did not exceed ten percent of net revenues for the respective segment for the period presented. Amount is shown for comparative purposes only.

- (1) The customer has more than one contract. The individual contracts are scheduled to terminate at various points during the time period indicated above.
- (2) Contract has options for the customer to extend the term for three additional one-year periods.
- (3) The contract has terminated.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

- (4) The customer has informed the Company that this contract will not be renewed.
- (5) This customer represents a subcontract with a Public Sector customer and is eliminated in consolidation.

Concentration of Business

The Company also has a significant concentration of business with various counties in the State of Pennsylvania (the "Pennsylvania Counties") which are part of the Pennsylvania Medicaid program, and with various areas in the State of Florida (the "Florida Areas") which are part of the Florida Medicaid program. Net revenues from the Pennsylvania Counties in the aggregate totaled \$255.0 million and \$265.1 million for the nine months ended September 30, 2010 and 2011, respectively. Net revenues from the Florida Areas in the aggregate totaled \$106.0 million and \$100.0 million for the nine months ended September 30, 2010 and 2011, respectively.

The Company's contracts with customers typically have terms of one to three years, and in certain cases contain renewal provisions (at the customer's option) for successive terms of between one and two years (unless terminated earlier). Substantially all of these contracts may be immediately terminated with cause and many of the Company's contracts are terminable without cause by the customer or the Company either upon the giving of requisite notice and the passage of a specified period of time (typically between 60 and 180 days) or upon the occurrence of other specified events. In addition, the Company's contracts with federal, state and local governmental agencies generally are conditioned on legislative appropriations. These contracts generally can be terminated or modified by the customer if such appropriations are not made.

Fair Value Measurements

The Company currently does not have non-financial assets and non-financial liabilities that are required to be measured at fair value on a recurring basis. Financial assets and liabilities are to be measured using inputs from the three levels of the fair value hierarchy, which are as follows:

Level 1 Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 Inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (i.e., interest rates, yield curves, etc.), and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).

Level 3 Unobservable inputs that reflect the Company's assumptions about the assumptions that market participants would use in pricing the asset or liability. The Company develops these inputs based on the best information available, including the Company's data.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company's financial assets and liabilities that are required to be measured at fair value as of December 31, 2010 and September 30, 2011 (in thousands):

	Fair Value Measurements			
	Level 1	Level 2	Level 3	Total
Cash and Cash Equivalents(1)	\$	\$ 68,726	\$	\$ 68,726
Restricted Cash(2)		72,698		72,698
Investments:				
U.S. Government and agency securities	2,179			2,179
Obligations of government-sponsored enterprises(3)		10,138		10,138
Corporate debt securities		268,769		268,769
Certificates of deposit		750		750
Taxable municipal bonds		2,668		2,668
December 31, 2010	\$ 2,179	\$ 423,749	\$	\$ 425,928

	Fair Value Measurements			
	Level 1	Level 2	Level 3	Total
Cash and Cash Equivalents(4)	\$	\$ 7,732	\$	\$ 7,732
Restricted Cash(5)		32,524		32,524
Investments:				
U.S. Government and agency securities	698			698
Obligations of government-sponsored enterprises(6)		11,161		11,161
Corporate debt securities		242,090		242,090
Certificates of deposit		200		200
September 30, 2011	\$ 698	\$ 293,707	\$	\$ 294,405

(1) Excludes \$268.5 million of cash held in bank accounts by the Company.

(2) Excludes \$44.0 million of restricted cash held in bank accounts by the Company.

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- (3) Includes investments in notes issued by the Federal Home Loan Mortgage Corporation and the Federal Home Loan Bank.
- (4) Excludes \$134.7 million of cash held in bank accounts by the Company.
- (5) Excludes \$123.1 million of restricted cash held in bank accounts by the Company.
- (6) Includes investments in notes issued by the Federal Home Loan Bank.

For the nine months ended September 30, 2011, the Company has not transferred any assets between fair value measurement levels.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

All of the Company's investments are classified as "available-for-sale" and are carried at fair value. Securities which have been classified as Level 1 are measured using quoted market prices while those which have been classified as Level 2 are measured using quoted prices for similar assets and liabilities in active markets. The Company's policy is to classify all investments with contractual maturities within one year as current. Investment income is recognized when earned and reported net of investment expenses. Net unrealized holding gains or losses are excluded from earnings and are reported, net of tax, as "accumulated other comprehensive income (loss)" in the accompanying consolidated balance sheets and consolidated statements of income until realized, unless the losses are deemed to be other-than-temporary. Realized gains or losses, including any provision for other-than-temporary declines in value, are included in the consolidated statements of income.

If a debt security is in an unrealized loss position and the Company has the intent to sell the debt security, or it is more likely than not that the Company will have to sell the debt security before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is recorded to other-than-temporary impairment losses recognized in income in the consolidated statements of income. For impaired debt securities that the Company does not intend to sell or it is more likely than not that the Company will not have to sell such securities, but the Company expects that it will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses recognized in income in the consolidated statements of income and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income.

The credit component of an other-than-temporary impairment is determined by comparing the net present value of projected future cash flows with the amortized cost basis of the debt security. The net present value is calculated by discounting the best estimate of projected future cash flows at the effective interest rate implicit in the debt security at the date of acquisition. Cash flow estimates are driven by assumptions regarding probability of default, including changes in credit ratings, and estimates regarding timing and amount of recoveries associated with a default. Furthermore, unrealized losses entirely caused by non-credit related factors related to debt securities for which the Company expects to fully recover the amortized cost basis continue to be recognized in accumulated other comprehensive income.

As of December 31, 2010 and September 30, 2011, there were no unrealized losses that the Company believed to be other-than-temporary. No realized gains or losses were recorded for the nine

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

months ended September 30, 2010 or 2011. The following is a summary of short-term and long-term investments at December 31, 2010 and September 30, 2011 (in thousands):

	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and agency securities	\$ 2,178	\$ 1	\$	\$ 2,179
Obligations of government-sponsored enterprises(1)	10,142	7	(11)	10,138
Corporate debt securities	268,739	245	(215)	268,769
Certificates of deposit	750			750
Taxable municipal bonds	2,680		(12)	2,668
Total investments at December 31, 2010	\$ 284,489	\$ 253	\$ (238)	\$ 284,504

	September 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and agency securities	\$ 698	\$	\$	\$ 698
Obligations of government-sponsored enterprises(2)	11,160	4	(3)	11,161
Corporate debt securities	242,569	53	(532)	242,090
Certificates of deposit	200			200
Total investments at September 30, 2011	\$ 254,627	\$ 57	\$ (535)	\$ 254,149

(1) Includes investments in notes issued by the Federal Home Loan Mortgage Corporation and the Federal Home Loan Bank.

(2) Includes investments in notes issued by the Federal Home Loan Bank.

The maturity dates of the Company's investments as of September 30, 2011 are summarized below (in thousands):

	Amortized Cost	Estimated Fair Value
2011	\$ 92,150	\$ 92,062
2012	159,009	158,644
2013	3,468	3,443

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Total investments at September 30, 2011 \$ 254,627 \$ 254,149

Income Taxes

The Company's effective income tax rates were 40.3 percent and 34.0 percent for the nine months ended September 30, 2010 and 2011, respectively. These rates differ from the federal statutory income

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

tax rate primarily due to state income taxes, permanent differences between book and tax income, and changes to recorded tax contingencies. The Company also accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The effective income tax rate for the nine months ended September 30, 2011 is lower than the effective rate for the nine months ended September 30, 2010 mainly due to more significant reversals of tax contingencies in the current year as a result of closure of statutes of limitation.

The Company files a consolidated federal income tax return for the Company and its eighty percent or more owned subsidiaries, and the Company and its subsidiaries file income tax returns in various states and local jurisdictions. With few exceptions, the Company is no longer subject to state or local income tax assessments by tax authorities for years ended prior to December 31, 2007. Further, the statutes of limitation regarding the assessment of federal and certain state and local income taxes for the year ended December 31, 2007 expired during the current quarter. As a result, \$9.6 million of unrecognized tax benefits (excluding interest costs) recorded as of December 31, 2010 was reversed in the current quarter as a result of statute expirations, \$8.1 million of which is reflected as a discrete adjustment to the effective rate.

Stock Compensation

At December 31, 2010 and September 30, 2011, the Company had equity-based employee incentive plans, which are described more fully in Note 6 in the Company's Annual Report on Form 10-K for the year ended December 31, 2010. The Company recorded stock compensation expense of \$3.6 million and \$11.8 million for the three and nine months ended September 30, 2010, respectively, and \$4.4 million and \$13.4 million for the three and nine months ended September 30, 2011, respectively. Stock compensation expense recognized in the consolidated statements of income for the three and nine months ended September 30, 2010 and 2011 has been reduced for estimated forfeitures, estimated at five percent and four percent, respectively.

The weighted average grant date fair value of all stock options granted during the nine months ended September 30, 2011 was \$12.94 as estimated using the Black-Scholes-Merton option pricing model, which also assumed an expected volatility of 29.9 percent based on the historical volatility of the Company's stock price.

The benefits of tax deductions in excess of recognized stock compensation expense are reported as a financing cash flow, rather than as an operating cash flow. In the nine months ended September 30, 2010 and 2011, \$0 million and \$2.1 million of benefits of such tax deductions related to stock compensation expense were realized and as such were reported as financing cash flows, respectively. For the nine months ended September 30, 2010 the change to additional paid in capital related to tax benefits (deficiencies) was \$(0.8) million. For the nine months ended September 30, 2011, the change to additional paid in capital related to tax benefits (deficiencies) was \$1.8 million which includes the \$2.1 million of excess tax benefits offset by \$(0.3) million of tax deficiencies.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

Summarized information related to the Company's stock options for the nine months ended September 30, 2011 is as follows:

	Options	Weighted Average Exercise Price
Outstanding, beginning of period	3,775,586	\$ 39.27
Granted	1,120,716	49.25
Forfeited	(29,306)	42.98
Exercised	(881,362)	38.35
Outstanding, end of period	3,985,634	42.26
Vested and expected to vest, end of period	3,891,114	42.16
Exercisable, end of period	1,835,319	\$ 39.84

All of the Company's options granted during the nine months ended September 30, 2011 vest ratably on each anniversary date over the three years subsequent to grant, and all have a ten year life.

Summarized information related to the Company's nonvested restricted stock awards for the nine months ended September 30, 2011 is as follows:

	Shares	Weighted Average Grant Fair Value
Outstanding, beginning of period	22,309	\$ 39.23
Awarded	18,748	52.11
Vested	(22,309)	39.23
Forfeited		
Outstanding, ending of period	18,748	\$ 52.11

Restricted stock awards granted during the nine months ended September 30, 2011 generally vest on the anniversary of the date of grant.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE A General (Continued)

Summarized information related to the Company's nonvested restricted stock units for the nine months ended September 30, 2011 is as follows:

	Shares	Weighted Average Grant Fair Value
Outstanding, beginning of period	190,488	\$ 38.43
Awarded	112,543	49.10
Vested	(90,853)	37.50
Forfeited	(2,856)	45.12
Outstanding, ending of period	209,322	\$ 44.49

Restricted stock units granted during the nine months ended September 30, 2011 generally vest ratably on each anniversary date over the three years subsequent to grant.

Long Term Debt and Capital Lease Obligations

On April 28, 2010, the Company entered into an amendment to its credit facility with Deutsche Bank AG, Citibank, N.A., and Bank of America, N.A. that provided for an \$80.0 million Revolving Loan Commitment for the issuance of letters of credit for the account of the Company with a sublimit of up to \$30.0 million for revolving loans (the "2010 Credit Facility"). Borrowings under the 2010 Credit Facility mature on April 28, 2013. The 2010 Credit Facility is guaranteed by substantially all of the subsidiaries of the Company and is secured by substantially all of the assets of the Company and the subsidiary guarantors.

Under the 2010 Credit Facility, the annual interest rate on Revolving Loan borrowings is equal to (i) in the case of U.S. dollar denominated loans, the sum of a borrowing margin of 1.75 percent plus the higher of the prime rate or one-half of one percent in excess of the overnight "federal funds" rate, or (ii) in the case of Eurodollar denominated loans, the sum of a borrowing margin of 2.75 percent plus the Eurodollar rate for the selected interest period. The Company has the option to borrow in U.S. dollar denominated loans or Eurodollar denominated loans at its discretion. Letters of Credit issued under the Revolving Loan Commitment bear interest at the rate of 2.875 percent. The commitment commission on the 2010 Credit Facility is 0.50 percent of the unused Revolving Loan Commitment.

There were \$0.6 million of capital lease obligations at December 31, 2010 and September 30, 2011, respectively, \$44.9 million and \$36.2 million of letters of credit outstanding at December 31, 2010 and September 30, 2011, respectively, and no Revolving Loan borrowings at December 31, 2010 or September 30, 2011.

Table of Contents**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2011****(Unaudited)****NOTE B Net Income per Common Share**

The following tables reconcile income (numerator) and shares (denominator) used in the computations of net income per common share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Numerator:				
Net income	\$ 44,784	\$ 31,355	\$ 105,731	\$ 99,884
Denominator:				
Weighted average number of common shares outstanding basic	33,450	29,900	33,715	31,406
Common stock equivalents stock options	475	446	389	487
Common stock equivalents warrants	157		150	
Common stock equivalents restricted stock	6	4	13	10
Common stock equivalents restricted stock units	83	88	78	85
Common stock equivalents employee stock purchase plan				
Weighted average number of common shares outstanding diluted	34,171	30,438	34,345	31,988
Net income per common share basic	\$ 1.34	\$ 1.05	\$ 3.14	\$ 3.18
Net income per common share diluted	\$ 1.31	\$ 1.03	\$ 3.08	\$ 3.12

The weighted average number of common shares outstanding for the three and nine months ended September 30, 2010 and 2011 were calculated using outstanding shares of the Company's Ordinary Common Stock. Common stock equivalents included in the calculation of diluted weighted average common shares outstanding for the three and nine months ended September 30, 2010 and 2011 represent stock options to purchase shares of the Company's Ordinary Common Stock, restricted stock awards and restricted stock units, stock to be purchased under the Employee Stock Purchase Plan and shares of Ordinary Common Stock related to certain warrants issued on January 5, 2004.

The Company had additional potential dilutive securities outstanding representing 1.2 million and 1.9 million options, respectively, for the three and nine months ended September 30, 2010, and 1.1 million and 0.9 million options for the three and nine months ended September 30, 2011, respectively, that were not included in the computation of dilutive securities because they were anti-dilutive for the period. Had these shares not been anti-dilutive, all of these shares would not have been included in the net income per common share calculation as the Company uses the treasury stock method of calculating diluted shares.

NOTE C Business Segment Information

The accounting policies of the Company's segments are the same as those described in Note A "General." The Company evaluates performance of its segments based on profit or loss from operations before stock compensation expense, depreciation and amortization, interest expense, interest

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE C Business Segment Information (Continued)

income, gain on sale of assets, special charges or benefits, and income taxes ("Segment Profit"). Management uses Segment Profit information for internal reporting and control purposes and considers it important in making decisions regarding the allocation of capital and other resources, risk assessment and employee compensation, among other matters. Effective September 1, 2010, Public Sector has subcontracted with Medicaid Administration to provide pharmacy benefits management services on a limited risk basis for one of Public Sector's customers. As such, revenue and cost of care related to this intersegment arrangement are eliminated. The Company's segments are defined above.

The following tables summarize, for the periods indicated, operating results by business segment (in thousands):

Three Months Ended September 30, 2010	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	Consolidated
Net revenue	\$ 165,270	\$ 364,102	\$ 116,379	\$ 68,609	\$ 42,606	\$ (6,647)	\$ 750,319
Cost of care	(84,485)	(310,261)	(72,980)		(6,081)	6,647	(467,160)
Cost of goods sold				(55,071)			(55,071)
Direct service costs	(40,156)	(17,554)	(17,366)	(8,064)	(27,928)		(111,068)
Other operating expenses						(30,513)	(30,513)
Stock compensation expense(1)	124	181	362	108	36	2,785	3,596
Segment profit (loss)	\$ 40,753	\$ 36,468	\$ 26,395	\$ 5,582	\$ 8,633	\$ (27,728)	\$ 90,103

Three Months Ended September 30, 2011	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	Consolidated
Net revenue	\$ 135,365	\$ 362,104	\$ 78,659	\$ 73,792	\$ 57,692	\$ (20,769)	\$ 686,843
Cost of care	(81,503)	(318,807)	(49,186)		(19,324)	20,769	(448,051)
Cost of goods sold				(57,636)			(57,636)
Direct service costs	(36,582)	(16,741)	(14,717)	(6,563)	(26,221)		(100,824)
Other operating expenses						(29,214)	(29,214)
Stock compensation expense(1)	208	218	355	380	36	3,228	4,425
Segment profit (loss)	\$ 17,488	\$ 26,774	\$ 15,111	\$ 9,973	\$ 12,183	\$ (25,986)	\$ 55,543

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE C Business Segment Information (Continued)

Nine Months Ended September 30, 2010	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	Consolidated
Net revenue	\$ 487,954	\$ 1,081,581	\$ 331,099	\$ 204,740	\$ 121,303	\$ (6,647)	\$ 2,220,030
Cost of care	(265,740)	(930,932)	(220,211)		(6,081)	6,647	(1,416,317)
Cost of goods sold				(166,138)			(166,138)
Direct service costs	(115,340)	(50,559)	(47,605)	(19,537)	(94,555)		(327,596)
Other operating expenses						(91,856)	(91,856)
Stock compensation expense(1)	556	554	1,123	365	76	9,156	11,830
Segment profit (loss)	\$ 107,430	\$ 100,644	\$ 64,406	\$ 19,430	\$ 20,743	\$ (82,700)	\$ 229,953

Nine Months Ended September 30, 2011	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	Consolidated
Net revenue	\$ 425,086	\$ 1,074,904	\$ 258,479	\$ 213,388	\$ 167,622	\$ (61,543)	\$ 2,077,936
Cost of care	(235,938)	(933,662)	(157,731)		(57,409)	61,543	(1,323,197)
Cost of goods sold				(167,559)			(167,559)
Direct service costs	(113,502)	(50,203)	(47,280)	(18,658)	(78,056)		(307,699)
Other operating expenses						(85,685)	(85,685)
Stock compensation expense(1)	677	654	1,238	639	100	10,100	13,408
Segment profit (loss)	\$ 76,323	\$ 91,693	\$ 54,706	\$ 27,810	\$ 32,257	\$ (75,585)	\$ 207,204

(1)

Stock compensation expense is included in direct service costs and other operating expenses, however this amount is excluded from the computation of Segment Profit since it is managed on a consolidated basis.

The following table reconciles Segment Profit to income before income taxes (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Segment profit	\$ 90,103	\$ 55,543	\$ 229,953	\$ 207,204
Stock compensation expense	(3,596)	(4,425)	(11,830)	(13,408)
Depreciation and amortization	(13,950)	(15,069)	(41,607)	(43,288)
Interest expense	(482)	(457)	(1,751)	(1,422)
Interest income	846	592	2,466	2,265

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Income before income taxes	\$	72,921	\$	36,184	\$	177,231	\$	151,351
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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE D Commitments and Contingencies

Legal

The management and administration of the delivery of specialty managed healthcare entails significant risks of liability. From time to time, the Company is subject to various actions and claims arising from the acts or omissions of its employees, network providers or other parties. In the normal course of business, the Company receives reports relating to deaths and other serious incidents involving patients whose care is being managed by the Company. Such incidents occasionally give rise to malpractice, professional negligence and other related actions and claims against the Company or its network providers. Many of these actions and claims received by the Company seek substantial damages and therefore require the Company to incur significant fees and costs related to their defense. The Company is also subject to or party to certain class actions, litigation and claims relating to its operations and business practices. In the opinion of management, the Company has recorded reserves that are adequate to cover litigation, claims or assessments that have been or may be asserted against the Company, and for which the outcome is probable and reasonably estimable. Management believes that the resolution of such litigation and claims will not have a material adverse effect on the Company's financial condition or results of operations; however, there can be no assurance in this regard.

Stock Repurchases

On July 27, 2010 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$350 million of its outstanding common stock through July 28, 2012. On February 18, 2011, the Company's board of directors increased the stock repurchase program by an additional \$100 million, to a total of \$450 million.

Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice. Pursuant to this program, the Company made open market purchases of 1,684,510 shares of the Company's common stock at an average price of \$48.36 per share for an aggregate cost of \$81.5 million (excluding broker commissions) during the period from November 3, 2010 through December 31, 2010.

Pursuant to this program, the Company made open market purchases of 6,728,222 shares of the Company's common stock at an average price of \$48.74 per share for an aggregate cost of \$327.9 million (excluding broker commissions) during the period January 1, 2011 through September 30, 2011.

During the period from October 1, 2011 through October 24, 2011, the Company made additional open market purchases of 517,705 shares of the Company's common stock at an aggregate cost of \$25.6 million, excluding broker commissions.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

NOTE E Subsequent Event

On October 25, 2011 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$200 million of its outstanding common stock through October 25, 2013. Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice.

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

The following discussion and analysis of the financial condition and results of operations of Magellan and its majority-owned subsidiaries and all VIEs for which Magellan is the primary beneficiary should be read together with the Consolidated Financial Statements and the notes to the Consolidated Financial Statements included elsewhere in this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2010, which was filed with the SEC on February 25, 2011.

Forward-Looking Statements

This Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Although the Company believes that its plans, intentions and expectations as reflected in such forward-looking statements are reasonable, it can give no assurance that such plans, intentions or expectations will be achieved. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those contemplated by such forward-looking statements. Important factors currently known to management that could cause actual results to differ materially from those in forward-looking statements include:

the Company's inability to renegotiate or extend expiring customer contracts, or the termination of customer contracts;

the Company's inability to integrate acquisitions in a timely and effective manner;

changes in business practices of the industry, including the possibility that certain of the Company's managed care customers could seek to provide managed healthcare services directly to their subscribers, instead of contracting with the Company for such services, particularly as a result of further consolidation in the managed care industry and especially regarding managed healthcare customers that have already done so with a portion of their membership;

the impact of changes in the contracting model for Medicaid contracts, including certain changes in the contracting model used by states for managed healthcare services contracts relating to Medicaid lives;

Fluctuation in quarterly operating results due to seasonal and other factors;

the Company's ability to accurately predict and control healthcare costs, and to properly price the Company's services;

the Company's dependence on government spending for managed healthcare, including changes in federal, state and local healthcare policies;

restrictive covenants in the Company's debt instruments;

present or future state regulations and contractual requirements that the Company provide financial assurance of its ability to meet its obligations;

the impact of the competitive environment in the managed healthcare services industry which may limit the Company's ability to maintain or obtain contracts, as well as its ability to maintain or increase its rates;

the impact of healthcare reform legislation;

the Mental and Substance Abuse Benefit Parity Law and Regulations;

government regulation;

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the possible impact of additional regulatory scrutiny and liability associated with the Company's Specialty Pharmaceutical Management segment;

the inability to realize the value of goodwill and intangible assets;

pending or future actions or claims for professional liability;

claims brought against the Company that either exceed the scope of the Company's liability coverage or result in denial of coverage;

class action suits and other legal proceedings;

the impact of governmental investigations;

the impact of varying economic and market conditions on the Company's investment portfolio; and

the state of the national economy and adverse changes in economic conditions.

Further discussion of factors currently known to management that could cause actual results to differ materially from those in forward-looking statements is set forth under the heading "Risk Factors" in Item 1A of Magellan's Annual Report on Form 10-K for the year ended December 31, 2010. When used in this Quarterly Report on Form 10-Q, the words "estimate," "anticipate," "expect," "believe," "should," and similar expressions are intended to be forward-looking statements. Magellan undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results over time, except as required by law.

Business Overview

The Company is engaged in the specialty managed healthcare business. Through 2005, the Company predominantly operated in the managed behavioral healthcare business. As a result of certain acquisitions, the Company expanded into radiology benefits management and specialty pharmaceutical management during 2006, and into Medicaid administration during 2009. The Company provides services to health plans, insurance companies, employers, labor unions and various governmental agencies. The Company's business is divided into the following six segments, based on the services it provides and/or the customers that it serves, as described below.

Managed Behavioral Healthcare

Two of the Company's segments are in the managed behavioral healthcare business. This line of business generally reflects the Company's coordination and management of the delivery of behavioral healthcare treatment services that are provided through its contracted network of third-party treatment providers, which includes psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities. The treatment services provided through the Company's provider network include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and crisis intervention services. The Company generally does not directly provide, or own any provider of, treatment services except as related to the Company's Maricopa Contract. Under the Maricopa Contract, effective August 31, 2007 the Company was required to assume the operations of twenty-four behavioral health direct care facilities for a transitional period and to divest itself of these facilities over a two year period. All of the direct care facilities were divested as of December 31, 2009.

The Company provides its management services primarily through: (i) risk-based products, where the Company assumes all or a substantial portion of the responsibility for the cost of providing

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treatment services in exchange for a fixed per member per month fee, (ii) ASO products, where the Company provides services such as utilization review, claims administration and/or provider network management, but does not assume responsibility for the cost of the treatment services, and (iii) EAPs where the Company provides short-term outpatient behavioral counseling services.

The managed behavioral healthcare business is managed based on the services provided and/or the customers served, through the following two segments:

Commercial. The Commercial segment generally reflects managed behavioral healthcare services and EAP services provided under contracts with health plans and insurance companies for some or all of their commercial, Medicaid and Medicare members, as well as with employers, including corporations, governmental agencies, and labor unions. Commercial's contracts encompass risk-based, ASO and EAP arrangements. As of September 30, 2011, Commercial's covered lives were 3.7 million, 12.9 million and 12.6 million for risk-based, ASO and EAP products, respectively. For the nine months ended September 30, 2011, Commercial's revenue was \$281.5 million, \$73.0 million and \$70.6 million for risk-based, ASO and EAP products, respectively.

Public Sector. The Public Sector segment generally reflects services provided to recipients under Medicaid and other state sponsored programs under contracts with state and local governmental agencies. Public Sector contracts encompass either risk-based or ASO arrangements. As of September 30, 2011, Public Sector's covered lives were 1.7 million and 0.3 million for risk-based and ASO products, respectively. For the nine months ended September 30, 2011, Public Sector's revenue was \$1.1 billion and \$4.4 million for risk-based and ASO products, respectively.

Radiology Benefits Management

The Radiology Benefits Management segment generally reflects the management of the delivery of diagnostic imaging services to ensure that such services are clinically appropriate and cost effective. The Company's radiology benefits management services currently are provided under contracts with health plans and insurance companies for some or all of their commercial, Medicaid and Medicare members. The Company also contracts with state and local governmental agencies for the provision of such services to Medicaid recipients. The Company offers its radiology benefits management services through risk-based contracts, where the Company assumes all or a substantial portion of the responsibility for the cost of providing diagnostic imaging services, and through ASO contracts, where the Company provides services such as utilization review and claims administration, but does not assume responsibility for the cost of the imaging services. As of September 30, 2011, covered lives for Radiology Benefits Management were 4.3 million and 12.0 million for risk-based and ASO products, respectively. For the nine months ended September 30, 2011, revenue for Radiology Benefits Management was \$222.5 million and \$36.0 million for risk-based and ASO products, respectively.

Specialty Pharmaceutical Management

The Specialty Pharmaceutical Management segment comprises programs that manage specialty drugs used in the treatment of complex conditions such as, cancer, multiple sclerosis, hemophilia, infertility, rheumatoid arthritis, chronic forms of hepatitis and other diseases. Specialty pharmaceutical drugs represent high-cost injectible, infused, oral, or inhaled drugs with sensitive handling or storage needs, many of which may be physician administered. Patients receiving these drugs require greater amounts of clinical support than those taking more traditional agents. Payors require clinical, financial and technological support to maximize the value delivered to their members using these expensive agents. The Company's specialty pharmaceutical management services are provided under contracts with health plans, insurance companies, and governmental agencies for some or all of their commercial, Medicare and Medicaid members. The Company's specialty pharmaceutical services include: (i) contracting and formulary optimization programs; (ii) specialty pharmaceutical dispensing

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operations; (iii) strategic consulting services; and (iv) medical pharmacy management programs. The Company's Specialty Pharmaceutical Management segment had contracts with 41 health plans and several pharmaceutical manufacturers and state Medicaid programs as of September 30, 2011.

Medicaid Administration

The Medicaid Administration segment generally reflects integrated clinical management services provided to the public sector to manage Medicaid pharmacy, mental health and long-term care programs. The primary focus of the Company's Medicaid Administration unit involves providing PBA services under contracts with states to Medicaid and other state sponsored program recipients. Medicaid Administration's contracts encompass FFS arrangements. In addition to Medicaid Administration's FFS contracts, effective September 1, 2010, Public Sector has subcontracted with Medicaid Administration to provide pharmacy benefits management services on a limited risk basis for one of Public Sector's customers.

Corporate

This segment of the Company is comprised primarily of operational support functions such as sales and marketing and information technology, as well as corporate support functions such as executive, finance, human resources and legal.

Significant Customers

Consolidated Company

The Maricopa Contract generated net revenues that exceeded, in the aggregate, ten percent of net revenues for the consolidated Company for the nine months ended September 30, 2010 and 2011.

Pursuant to the Maricopa Contract, the Company provides behavioral healthcare management and other related services to approximately 719,000 members in Maricopa County, Arizona. Under the Maricopa Contract, the Company is responsible for providing covered behavioral health services to persons eligible under Title XIX (Medicaid) and Title XXI (State Children's Health Insurance Program) of the Social Security Act, non-Title XIX and non-Title XXI eligible children and adults with a serious mental illness, and to certain non-Title XIX and non-Title XXI adults with behavioral health or substance abuse disorders. The Maricopa Contract began on September 1, 2007 and extends through September 30, 2013 unless sooner terminated by the parties. The State of Arizona has the right to terminate the Maricopa Contract for cause, as defined, upon ten days' notice with an opportunity to cure, and without cause immediately upon notice from the State. The Maricopa Contract generated net revenues of \$602.4 million and \$570.1 million for the nine months ended September 30, 2010 and 2011, respectively.

One of the Company's top ten customers during 2010 was WellPoint, Inc. The Company recorded net revenue from contracts with WellPoint, Inc. of \$130.9 million for the nine months ended September 30, 2010. The Company's contracts with WellPoint, Inc. terminated on December 31, 2010.

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By Segment

In addition to the Maricopa Contract previously discussed, the following customers generated in excess of ten percent of net revenues for the respective segment for the nine months ended September 30, 2010 and 2011 (in thousands):

Segment	Term Date	2010	2011
Commercial			
Customer A	December 31, 2012		
		\$ 189,949	\$ 131,633
Customer B	June 30, 2014	54,822	50,089
Customer C	June 30, 2012 to November 30, 2013(1)	40,303*	82,695
Public Sector			
Customer D	June 30, 2012(2)		
		113,540	135,597
Radiology Benefits Management			
WellPoint, Inc.	December 31, 2010(3)		
		119,155	
Customer E	November 30, 2012 to April 30, 2013(1)	84,435	100,575
Customer F	June 30, 2011 to November 30, 2011(1)(4)	50,982	34,271
Customer G	June 30, 2014	40,203	40,928
Customer H	March 31, 2013	4,057*	25,708
Specialty Pharmaceutical Management			
Customer I	November 30, 2011 to March 31, 2012(1)	65,421	64,731
Customer J	September 1, 2011 to April 29, 2012(1)	43,246	41,704
Customer E	February 1, 2012 to April 30, 2013(1)	26,937	19,499*
Medicaid Administration			
Customer K	December 4, 2011(4)		
		23,531	22,193
Customer L	September 30, 2013(5)	6,647*	61,543
Customer M	September 30, 2011 to June 30, 2017(1)	17,905	18,635
Customer N	August 31, 2011 to June 30, 2013(1)	16,357	13,689*
Customer O	June 30, 2013 to September 30, 2014(1)	12,097	17,221

*

Revenue amount did not exceed ten percent of net revenues for the respective segment for the period presented. Amount is shown for comparative purposes only.

- (1) The customer has more than one contract. The individual contracts are scheduled to terminate at various points during the time period indicated above.
- (2) Contract has options for the customer to extend the term for three additional one-year periods.
- (3)

The contract has terminated.

(4)

The customer has informed the Company that this contract will not be renewed.

(5)

This customer represents a subcontract with a Public Sector customer and is eliminated in consolidation.

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Concentration of Business

The Company also has a significant concentration of business with the Pennsylvania Counties which are part of the Pennsylvania Medicaid program, and with the Florida Areas which are part of the Florida Medicaid program. Net revenues from the Pennsylvania Counties in the aggregate totaled \$255.0 million and \$265.1 million for the nine months ended September 30, 2010 and 2011, respectively. Net revenues from the Florida Areas in the aggregate totaled \$106.0 million and \$100.0 million for the nine months ended September 30, 2010 and 2011, respectively.

The Company's contracts with customers typically have terms of one to three years, and in certain cases contain renewal provisions (at the customer's option) for successive terms of between one and two years (unless terminated earlier). Substantially all of these contracts may be immediately terminated with cause and many of the Company's contracts are terminable without cause by the customer or the Company either upon the giving of requisite notice and the passage of a specified period of time (typically between 60 and 180 days) or upon the occurrence of other specified events. In addition, the Company's contracts with federal, state and local governmental agencies generally are conditioned on legislative appropriations. These contracts generally can be terminated or modified by the customer if such appropriations are not made.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates of the Company include, among other things, accounts receivable realization, valuation allowances for deferred tax assets, valuation of goodwill and intangible assets, medical claims payable, other medical liabilities, stock compensation assumptions, tax contingencies and legal liabilities. Actual results could differ from those estimates. Except as noted below, the Company's critical accounting policies are summarized in the Company's Annual Report on Form 10-K, filed with the SEC on February 25, 2011.

Income Taxes

The Company's effective income tax rates were 40.3 percent and 34.0 percent for the nine months ended September 30, 2010 and 2011, respectively. These rates differ from the federal statutory income tax rate primarily due to state income taxes, permanent differences between book and tax income, and changes to recorded tax contingencies. The Company also accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The effective income tax rate for the nine months ended September 30, 2011 is lower than the effective rate for the nine months ended September 30, 2010 mainly due to more significant reversals of tax contingencies in the current year as a result of closure of statutes of limitation.

The Company files a consolidated federal income tax return for the Company and its eighty percent or more owned subsidiaries, and the Company and its subsidiaries file income tax returns in various states and local jurisdictions. With few exceptions, the Company is no longer subject to state or local income tax assessments by tax authorities for years ended prior to December 31, 2007. Further, the statutes of limitation regarding the assessment of federal and certain state and local income taxes for the year ended December 31, 2007 expired during the current quarter. As a result, \$9.6 million of unrecognized tax benefits (excluding interest costs) recorded as of December 31, 2010 was reversed in the current quarter as a result of statute expirations, \$8.1 million of which is reflected as a discrete adjustment to the effective rate.

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Results of Operations

The accounting policies of the Company's segments are the same as those described in Note A "General." The Company evaluates performance of its segments based on Segment Profit. Management uses Segment Profit information for internal reporting and control purposes and considers it important in making decisions regarding the allocation of capital and other resources, risk assessment and employee compensation, among other matters. Effective September 1, 2010, Public Sector has subcontracted with Medicaid Administration to provide pharmacy benefits management services on a limited risk basis for one of Public Sector's customers. As such, revenue and cost of care related to this intersegment arrangement are eliminated. The Company's segments are defined above. The following tables summarize, for the periods indicated, operating results by business segment (in thousands):

Three Months Ended September 30, 2010	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	Consolidated
Net revenue	\$ 165,270	\$ 364,102	\$ 116,379	\$ 68,609	\$ 42,606	\$ (6,647)	\$ 750,319
Cost of care	(84,485)	(310,261)	(72,980)		(6,081)	6,647	(467,160)
Cost of goods sold				(55,071)			(55,071)
Direct service costs	(40,156)	(17,554)	(17,366)	(8,064)	(27,928)		(111,068)
Other operating expenses						(30,513)	(30,513)
Stock compensation expense(1)	124	181	362	108	36	2,785	3,596
Segment profit (loss)	\$ 40,753	\$ 36,468	\$ 26,395	\$ 5,582	\$ 8,633	\$ (27,728)	\$ 90,103

Three Months Ended September 30, 2011	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	Consolidated
Net revenue	\$ 135,365	\$ 362,104	\$ 78,659	\$ 73,792	\$ 57,692	\$ (20,769)	\$ 686,843
Cost of care	(81,503)	(318,807)	(49,186)		(19,324)	20,769	(448,051)
Cost of goods sold				(57,636)			(57,636)
Direct service costs	(36,582)	(16,741)	(14,717)	(6,563)	(26,221)		(100,824)
Other operating expenses						(29,214)	(29,214)
Stock compensation expense(1)	208	218	355	380	36	3,228	4,425
Segment profit (loss)	\$ 17,488	\$ 26,774	\$ 15,111	\$ 9,973	\$ 12,183	\$ (25,986)	\$ 55,543

Nine Months Ended September 30, 2010	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	Consolidated
Net revenue	\$ 487,954	\$ 1,081,581	\$ 331,099	\$ 204,740	\$ 121,303	\$ (6,647)	\$ 2,220,030
Cost of care	(265,740)	(930,932)	(220,211)		(6,081)	6,647	(1,416,317)
Cost of goods sold				(166,138)			(166,138)
Direct service costs	(115,340)	(50,559)	(47,605)	(19,537)	(94,555)		(327,596)
Other operating expenses						(91,856)	(91,856)
Stock compensation expense(1)	556	554	1,123	365	76	9,156	11,830
Segment profit (loss)	\$ 107,430	\$ 100,644	\$ 64,406	\$ 19,430	\$ 20,743	\$ (82,700)	\$ 229,953

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Nine Months Ended September 30, 2011							Consolidated
	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Medicaid Administration	Corporate and Elimination	
Net revenue	\$ 425,086	\$ 1,074,904	\$ 258,479	\$ 213,388	\$ 167,622	\$ (61,543)	\$ 2,077,936
Cost of care	(235,938)	(933,662)	(157,731)		(57,409)	61,543	(1,323,197)
Cost of goods sold				(167,559)			(167,559)
Direct service costs	(113,502)	(50,203)	(47,280)	(18,658)	(78,056)		(307,699)
Other operating expenses						(85,685)	(85,685)
Stock compensation expense(1)	677	654	1,238	639	100	10,100	13,408
Segment profit (loss)	\$ 76,323	\$ 91,693	\$ 54,706	\$ 27,810	\$ 32,257	\$ (75,585)	\$ 207,204

(1)

Stock compensation expense is included in direct service costs and other operating expenses, however this amount is excluded from the computation of Segment Profit since it is managed on a consolidated basis.

The following table reconciles Segment Profit to income before income taxes (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Segment profit	\$ 90,103	\$ 55,543	\$ 229,953	\$ 207,204
Stock compensation expense	(3,596)	(4,425)	(11,830)	(13,408)
Depreciation and amortization	(13,950)	(15,069)	(41,607)	(43,288)
Interest expense	(482)	(457)	(1,751)	(1,422)
Interest income	846	592	2,466	2,265
Income before income taxes	\$ 72,921	\$ 36,184	\$ 177,231	\$ 151,351

Quarter ended September 30, 2011 ("Current Year Quarter"), compared to the quarter ended September 30, 2010 ("Prior Year Quarter")

Commercial

Net Revenue

Net revenue related to Commercial decreased by 18.1 percent or \$29.9 million from the Prior Year Quarter to the Current Year Quarter. The decrease in revenue is mainly due to program changes of \$22.6 million, terminated contracts of \$14.5 million, net decreased membership from existing customers of \$4.9 million, and other net decreases of \$5.5 million, which decreases were partially offset by new contracts implemented after (or during) the Prior Year Quarter of \$10.8 million, favorable rate changes of \$5.0 million, and unfavorable retroactive rate adjustments of \$1.8 million recorded in the Prior Year Quarter.

Cost of Care

Cost of care decreased by 3.5 percent or \$3.0 million from the Prior Year Quarter to the Current Year Quarter. The decrease in cost of care is primarily due to program changes of \$23.0 million, decreased membership from existing customers of \$3.0 million, and terminated contracts of \$2.7 million, which decreases were partially offset by new contracts implemented after (or during) the Prior Year Quarter of \$9.4 million, favorable prior period medical claims development recorded in the Prior Year Quarter of \$6.7 million, unfavorable prior period medical claims development recorded in the Current Year Quarter of \$3.1 million, and care trends and other net variances of \$6.5 million. Cost of care as a percentage of risk revenue (excluding EAP business) increased from 70.1 percent in the

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Prior Year Quarter to 84.7 percent in the Current Year Quarter, mainly due to unfavorable care development and care trends.

Direct Service Costs

Direct service costs decreased by 8.9 percent or \$3.6 million from the Prior Year Quarter to the Current Year Quarter. The decrease in direct service costs is mainly attributable to terminated contracts. Direct service costs increased as a percentage of revenue from 24.3 percent in the Prior Year Quarter to 27.0 percent in the Current Year Quarter, mainly due to changes in business mix.

Public Sector

Net Revenue

Net revenue related to Public Sector decreased by 0.5 percent or \$2.0 million from the Prior Year Quarter to the Current Year Quarter. This decrease is primarily due to unfavorable rate changes of \$17.9 million, the revenue impact for favorable medical claims development for the Prior Year Quarter which was recorded after the Prior Year Quarter of \$7.5 million, the recognition in the Prior Year Quarter of \$6.8 million of previously deferred revenue on the Maricopa Contract, and the revenue impact for favorable prior period medical claims development in the Current Year Quarter of \$3.0 million, which decreases were partially offset by increased membership from existing customers of \$29.5 million, the revenue impact for favorable prior period medical claims development recorded in the Prior Year Quarter of \$1.4 million, and other net increases of \$2.3 million.

Cost of Care

Cost of care increased by 2.8 percent or \$8.5 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to care associated with rate changes for contracts with minimum care requirements of \$13.2 million, favorable medical claims development for the Prior Year Quarter which was recorded after the Prior Year Quarter of \$7.5 million, and favorable prior period medical claims development recorded in the Current Year Quarter of \$3.3 million, which decreases were partially offset by increased membership from existing customers of \$26.0 million, favorable prior period medical claims development recorded in the Prior Year Quarter of \$3.7 million, and care trends and other net unfavorable variances of \$2.8 million. Cost of care increased as a percentage of risk revenue from 85.5 percent in the Prior Year Quarter to 88.4 percent in the Current Year Quarter mainly due to the recognition in the Prior Year Quarter of previously deferred revenue on the Maricopa Contract.

Direct Service Costs

Direct service costs decreased by 4.6 percent or \$0.8 million from the Prior Year Quarter to the Current Year Quarter. Direct service costs decreased as a percentage of revenue from 4.8 percent for the Prior Year Quarter to 4.6 percent in the Current Year Quarter mainly due changes in business mix.

Radiology Benefits Management

Net Revenue

Net revenue related to Radiology Benefits Management decreased by 32.4 percent or \$37.7 million from the Prior Year Quarter to the Current Year Quarter. This decrease is primarily due to terminated contracts of \$54.4 million, which decrease was partially offset by program changes of \$7.2 million, new contracts implemented after (or during) the Prior Year Quarter of \$3.8 million, increased membership from existing customers of \$2.0 million, favorable rate changes of \$1.1 million, and other net increases of \$2.6 million.

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Cost of Care

Cost of care decreased by 32.6 percent or \$23.8 million from the Prior Year Quarter to the Current Year Quarter. This decrease is primarily attributed to the impact of care associated with terminated contracts of \$37.5 million, favorable medical claims development for the Prior Year Quarter which was recorded after the Prior Year Quarter of \$2.1 million, favorable prior period medical claims development recorded in the Current Year Quarter of \$1.5 million, and favorable care trends and other net variances of \$1.0 million, which decreases were partially offset by program changes of \$7.7 million, favorable prior period medical claims development recorded in the Prior Year Quarter of \$5.4 million, new business of \$3.5 million, and increased membership from existing customers of \$1.7 million. Cost of care increased as a percentage of risk revenue from 70.3 percent in the Prior Year Quarter to 71.5 percent in the Current Year Quarter, mainly due to changes in business mix.

Direct Service Costs

Direct service costs decreased by 15.3 percent or \$2.6 million from the Prior Year Quarter to the Current Year Quarter. The decrease in direct service costs is mainly attributable to terminated contracts. As a percentage of revenue, direct service costs increased from 14.9 percent in the Prior Year Quarter to 18.7 percent in the Current Year Quarter, mainly due to changes in business mix.

Specialty Pharmaceutical Management

Net Revenue

Net revenue related to Specialty Pharmaceutical Management increased by 7.6 percent or \$5.2 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to net increased dispensing activity of \$3.4 million and formulary optimization revenue of \$1.9 million, which increases were partially offset by other net decreases of \$0.1 million.

Cost of Goods Sold

Cost of goods sold increased by 4.7 percent or \$2.6 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to net increased dispensing activity. As a percentage of the portion of net revenue that relates to dispensing activity, cost of goods sold decreased from 94.0 percent in the Prior Year Quarter to 93.3 percent in the Current Year Quarter, mainly due to business mix.

Direct Service Costs

Direct service costs decreased by 18.6 percent or \$1.5 million from the Prior Year Quarter to the Current Year Quarter. This decrease is primarily due to decreased employee compensation and benefits. As a percentage of revenue, direct service costs decreased from 11.8 percent in the Prior Year Quarter to 8.9 percent in the Current Year Quarter, mainly due to decreased employee compensation and benefits, and changes in business mix.

Medicaid Administration

Net Revenue

Net revenue related to Medicaid Administration increased by 35.4 percent or \$15.1 million from the Prior Year Quarter to the Current Year Quarter. This increase is primarily due to a subcontract with Public Sector for Medicaid Administration to provide pharmacy benefits management services on a limited risk basis for one of Public Sector's customers which started September 1, 2010, partially offset by terminated contracts.

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Cost of Care

Cost of care increased by \$13.2 million from the Prior Year Quarter to the Current Year Quarter. This increase is attributed to the subcontract with Public Sector. Cost of care increased as a percentage of risk revenue from 91.5 percent in the Prior Year Quarter to 93.0 percent in the Current Year Quarter, mainly due to unfavorable care trends.

Direct Service Costs

Direct service costs decreased by 6.1 percent or \$1.7 million. This decrease was primarily due to terminated contracts and operating efficiencies. As a percentage of revenue, direct service costs decreased from 65.5 percent in the Prior Year Quarter to 45.4 percent in the Current Year Quarter, mainly due to changes in business mix, including the new risk-based subcontract discussed above.

Corporate and Other

Other Operating Expenses

Other operating expenses related to the Corporate and Other Segment decreased by 4.3 percent or \$1.3 million from the Prior Year Quarter to the Current Year Quarter. The decrease results primarily due to net one-time unfavorable adjustments recorded in the Prior Year Quarter of \$0.9 million and other net favorable variances of \$0.4 million. As a percentage of total net revenue, other operating expenses increased from 4.1 percent for the Prior Year Quarter to 4.3 percent for the Current Year Quarter, primarily due to changes in business mix.

Depreciation and Amortization

Depreciation and amortization expense increased by 8.0 percent or \$1.1 million from the Prior Year Quarter to the Current Year Quarter, mainly due to asset additions after the Prior Year Quarter.

Interest Expense

Interest expense was \$0.5 million in the Current Year Quarter, which is consistent with the Prior Year Quarter.

Interest Income

Interest income decreased by \$0.3 million from the Prior Year Quarter to the Current Year Quarter, mainly due to lower yields.

Income Taxes

The Company's effective income tax rate was 38.6 percent in the Prior Year Quarter and 13.3 percent in the Current Year Quarter. These rates differ from the federal statutory income tax rate primarily due to state income taxes, permanent differences between book and tax income, and changes to recorded tax contingencies. The Company also accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The effective income tax rate for the Current Year Quarter is lower than the Prior Year Quarter mainly due to more significant reversals of tax contingencies in the Current Year Quarter as a result of closure of statutes of limitation.

The statutes of limitation regarding the assessment of federal and certain state and local income taxes for the year ended December 31, 2007 expired during the Current Year Quarter. As a result, \$9.6 million of unrecognized tax benefits (excluding interest costs) recorded as of December 31, 2010 was reversed in the Current Year Quarter as a result of statute expirations, \$8.1 million of which is reflected as a discrete adjustment to the effective rate.

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Nine months ended September 30, 2011 ("Current Year Period"), compared to the nine months ended September 30, 2010 ("Prior Year Period")

Commercial

Net Revenue

Net revenue related to Commercial decreased by 12.9 percent or \$62.9 million from the Prior Year Period to the Current Year Period. The decrease in revenue is mainly due to program changes of \$69.8 million, terminated contracts of \$43.0 million, net decreased membership from existing customers of \$10.8 million, favorable retroactive membership adjustments recorded in the Prior Year Period of \$1.6 million, net retroactive incentive revenue recorded in the Prior Year Period of \$1.5 million, and other net unfavorable variances of \$2.3 million, which decreases were partially offset by new contracts implemented after (or during) the Prior Year Period of \$39.9 million, favorable rate changes of \$17.8 million, favorable retroactive membership and rate adjustments recorded in the Current Year Period of \$6.6 million, and unfavorable retroactive rate adjustments recorded in the Prior Year Period of \$1.8 million.

Cost of Care

Cost of care decreased by 11.2 percent or \$29.8 million from the Prior Year Period to the Current Year Period. The decrease in cost of care is primarily due to program changes of \$74.4 million, terminated contracts of \$8.2 million, and decreased membership from existing customers of \$6.1 million, which decreases were partially offset by new business of \$35.1 million, favorable prior period medical claims development recorded in the Prior Year Period of \$2.3 million, and care trends and other net variances of \$21.5 million. Cost of care increased as a percentage of risk revenue (excluding EAP business) from 75.4 percent in the Prior Year Period to 76.2 percent in the Current Year Period, mainly due to unfavorable care development and care trends.

Direct Service Costs

Direct service costs decreased by 1.6 percent or \$1.8 million from the Prior Year Period to the Current Year Period. The decrease in direct service costs is mainly attributable to terminated contracts. Direct service costs increased as a percentage of revenue from 23.6 percent in the Prior Year Period to 26.7 percent in the Current Year Period, mainly due to changes in business mix.

Public Sector

Net Revenue

Net revenue related to Public Sector decreased by 0.6 percent or \$6.7 million from the Prior Year Period to the Current Year Period. This decrease is primarily due to unfavorable rate changes of \$23.5 million, the recognition in the Prior Year Period of \$12.5 million of previously deferred revenue on the Maricopa Contract, unfavorable retroactive contract funding adjustments in the Current Year Period of \$11.8 million, the revenue impact for favorable prior period medical claims development for the Prior Year Period which was recorded after the Prior Year Period of \$9.7 million, and the revenue impact for favorable prior period medical claims development recorded in the Current Year Period of \$2.3 million, which decreases were partially offset by increased membership from existing customers of \$41.3 million, net retroactive incentive revenue recorded in the Current Year Period of \$6.8 million, and other net increases of \$5.0 million.

Cost of Care

Cost of care increased by 0.3 percent or \$2.7 million from the Prior Year Period to the Current Year Period. This decrease is primarily due to increased membership from existing customers of

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\$36.1 million, favorable prior period medical claims development recorded in the Prior Year Period of \$6.4 million, and care trends and other net variances of \$3.7 million, which increases were partially offset by care associated with rate changes for contracts with minimum care requirements of \$17.9 million, care associated with retroactive contract funding adjustments of \$13.4 million, favorable prior period medical claims development for the Prior Year Period which was recorded after the Prior Year Period of \$9.7 million, and favorable prior period medical claims development recorded in the Current Year Period of \$2.5 million. Cost of care increased as a percentage of risk revenue from 86.4 percent in the Prior Year Period to 87.2 percent in the Current Year Period mainly due to unfavorable rate changes.

Direct Service Costs

Direct service costs decreased by 0.7 percent or \$0.4 million from the Prior Year Period to the Current Year Period. Direct service costs as a percentage of revenue was 4.7 percent in the Current Year Period, which is consistent with the Prior Year Period.

Radiology Benefits Management

Net Revenue

Net revenue related to Radiology Benefits Management decreased by 21.9 percent or \$72.6 million from the Prior Year Period to the Current Year Period. This decrease is primarily due to terminated contracts of \$133.5 million and decreased membership from existing customers of \$3.5 million. These decreases were partially offset by new contracts implemented after (or during) the Prior Year Period of \$28.5 million, program changes of \$22.5 million, favorable rate changes of \$5.9 million, higher profit share impact in the Prior Year Period of \$5.2 million related to timing, and other net increases of \$2.3 million.

Cost of Care

Cost of care decreased by 28.4 percent or \$62.5 million from the Prior Year Period to the Current Year Period. This decrease is primarily attributed to terminated contracts of \$95.2 million, favorable medical claims development for the Prior Year Period which was recorded after the Prior Year Period of \$4.6 million, favorable prior period medical claims development recorded in the Current Year Period of \$2.6 million, decreased membership from existing customers of \$2.1 million, and care trends and other net variances of \$8.4 million. These decreases were partially offset by new contracts implemented after (or during) the Prior Year Period of \$26.0 million, program changes of \$22.4 million, and favorable prior period medical claims development recorded in the Prior Year Period of \$2.0 million. Cost of care decreased as a percentage of risk revenue from 74.9 percent in the Prior Year Period to 70.9 percent in the Current Year Period mainly due to net favorable care development and business mix.

Direct Service Costs

Direct service costs decreased by 0.7 percent or \$0.3 million from the Prior Year Period to the Current Year Period. The decrease in direct service costs is mainly attributable to terminated contracts. As a percentage of revenue, direct service costs increased from 14.4 percent in the Prior Year Period to 18.3 percent in the Current Year Period, mainly due to changes in business mix.

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Specialty Pharmaceutical Management

Net Revenue

Net revenue related to Specialty Pharmaceutical Management increased by 4.2 percent or \$8.6 million from the Prior Year Period to the Current Year Period. This increase is primarily due to net increased formulary optimization revenue of \$4.7 million, the recognition in the Current Year Period of medical pharmacy management revenue which was previously deferred of \$2.5 million, increased dispensing activity of \$1.0 million, and other net increases of \$0.4 million.

Cost of Goods Sold

Cost of goods sold increased by 0.9 percent or \$1.4 million from the Prior Year Period to the Current Year Period. This increase is primarily due to net increased dispensing activity. As a percentage of the portion of net revenue that relates to dispensing activity, cost of goods sold increased from 93.2 percent in the Prior Year Period to 93.7 percent in the Current Year Period, mainly due to changes in business mix.

Direct Service Costs

Direct service costs decreased by 4.5 percent or \$0.9 million from the Prior Year Period to the Current Year Period. This decrease is primarily due to decreased employee compensation and benefits. As a percentage of revenue, direct service costs decreased from 9.5 percent in the Prior Year Period to 8.7 percent in the Current Year Period, mainly due to decreased employee compensation and benefits, and changes in business mix.

Medicaid Administration

Net Revenue

Net revenue related to Medicaid Administration increased by 38.2 percent or \$46.3 million from the Prior Year Period to the Current Year Period. This increase is primarily due to a subcontract with Public Sector for Medicaid Administration to provide pharmacy benefits management services on a limited risk basis for one of Public Sector's customers which started September 1, 2010, partially offset by terminated contracts.

Cost of Care

Cost of care increased by \$51.3 million from the Prior Year Period to the Current Year Period. This increase is attributed to the subcontract with Public Sector. Cost of care increased as a percentage of risk revenue from 91.5 percent in the Prior Year Period to 93.3 percent in the Current Year Period, mainly due to unfavorable care trends.

Direct Service Costs

Direct service costs decreased by 17.4 percent or \$16.5 million. This decrease was primarily due to terminated contracts and operating efficiencies. As a percentage of revenue, direct service costs decreased from 77.9 percent in the Prior Year Period to 46.6 percent in the Current Year Period, mainly due to changes in business mix, including the new risk-based subcontract discussed above.

Corporate and Other

Other Operating Expenses

Other operating expenses related to the Corporate and Other Segment decreased by 6.7 percent or \$6.2 million from the Prior Year Period to the Current Year Period. The decrease results primarily

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from net one-time unfavorable adjustments recorded in the Prior Year Period of \$3.1 million, net one-time favorable adjustments recorded in the Current Year Period of \$0.8 million, and other net favorable variances of \$2.3 million. As a percentage of total net revenue, other operating expenses were 4.1 percent for the Current Year Period, which is consistent with the Prior Year Period.

Depreciation and Amortization

Depreciation and amortization expense increased by 4.0 percent or \$1.7 million from the Prior Year Period to the Current Year Period, primarily due to asset additions after the Prior Year Period.

Interest Expense

Interest expense decreased by \$0.3 million from the Prior Year Period to the Current Year Period, mainly due to lower costs associated with the 2010 Credit Facility.

Interest Income

Interest income decreased by \$0.2 million from the Prior Year Period to the Current Year Period, mainly due to lower yields.

Income Taxes

The Company's effective income tax rate was 40.3 percent in the Prior Year Period and 34.0 percent in the Current Year Period. These rates differ from the federal statutory income tax rate primarily due to state income taxes, permanent differences between book and tax income, and changes to recorded tax contingencies. The Company also accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The effective income tax rate for the Current Year Period is lower than the Prior Year Period mainly due to more significant reversals of tax contingencies in the Current Year Period as a result of closure of statutes of limitation.

The statutes of limitation regarding the assessment of federal and certain state and local income taxes for the year ended December 31, 2007 expired during the Current Year Period. As a result, \$9.6 million of unrecognized tax benefits (excluding interest costs) recorded as of December 31, 2010 was reversed in the Current Year Period as a result of statute expirations, \$8.1 million of which is reflected as a discrete adjustment to the effective rate.

Outlook Results of Operations

The Company's Segment Profit and net income are subject to significant fluctuations from period to period. These fluctuations may result from a variety of factors such as those set forth under Item 1A "Risk Factors" as well as a variety of other factors including: (i) changes in utilization levels by enrolled members of the Company's risk-based contracts, including seasonal utilization patterns; (ii) contractual adjustments and settlements; (iii) retrospective membership adjustments; (iv) timing of implementation of new contracts, enrollment changes and contract terminations; (v) pricing adjustments upon contract renewals (and price competition in general); and (vi) changes in estimates regarding medical costs and IBNR.

A portion of the Company's business is subject to rising care costs due to an increase in the number and frequency of covered members seeking behavioral healthcare or radiology services, and higher costs per inpatient day or outpatient visit for behavioral services, and higher costs per scan for radiology services. Many of these factors are beyond the Company's control. Future results of operations will be heavily dependent on management's ability to obtain customer rate increases that are consistent with care cost increases and/or to reduce operating expenses.

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In relation to the managed behavioral healthcare business, the Company is a market leader in a mature market with many viable competitors. The Company is continuing its attempts to grow its business in the managed behavioral healthcare industry through aggressive marketing and development of new products; however, due to the maturity of the market, the Company believes that the ability to grow its current business lines may be limited. In addition, as previously discussed, substantially all of the Company's Commercial segment revenues are derived from Blue Cross Blue Shield health plans and other managed care companies, health insurers and health plans. Certain of the managed care customers of the Company have decided not to renew all or part of their contracts with the Company, and to instead manage the behavioral healthcare services directly for their subscribers.

Care Trends. The Company expects that the care trend factors for 2011 will be approximately 9 percent, 0 percent and 0 percent for Commercial, Public Sector and Radiology Benefits Management, respectively.

Interest Rate Risk. Changes in interest rates affect interest income earned on the Company's cash equivalents and investments, as well as interest expense on variable interest rate borrowings under the Company's 2010 Credit Facility. Based on the amount of cash equivalents and investments and the borrowing levels under the 2010 Credit Facility as of September 30, 2011, a hypothetical 10 percent increase or decrease in the interest rate associated with these instruments, with all other variables held constant, would not materially affect the Company's future earnings and cash outflows.

Historical Liquidity and Capital Resources

Operating Activities. The Company reported net cash provided by operating activities of \$254.3 million and \$96.1 million for the Prior Year Period and Current Year Period, respectively. The \$158.2 million decrease in operating cash flows from the Prior Year Period to the Current Year Period is primarily attributable to the decrease in Segment Profit, the net shift of restricted funds between cash and investments that results in an operating cash flow change that is directly offset by an investing cash flow change, and other net unfavorable items primarily associated with working capital changes, partially offset by a reduction in tax payments.

Segment Profit for the Current Year Period decreased \$22.8 million from the Prior Year Period. During the Prior Year Period, \$29.1 million of restricted cash was shifted to restricted investments as compared to the Current Year Period, in which \$45.7 million of restricted investments were shifted to restricted cash, resulting in a net decrease in operating cash flows between periods of \$74.8 million. Operating cash flows for the Prior Year Period were impacted by net favorable working capital changes of \$46.2 million as compared to net unfavorable working capital changes of \$30.3 million for the Current Year Period. During the Prior Year Period, Radiology Benefits Management had favorable working capital changes associated with the build-up of medical claims payable for new risk business, while Specialty Pharmaceutical Management had favorable working capital changes due to reductions in accounts receivable and inventory balances primarily attributable to timing. During the Current Year Period, Specialty Pharmaceutical Management had unfavorable working capital changes due to increases in account receivable and inventory balances and a reduction in payables primarily attributable to timing. Tax payments for the Current Year Period totaled \$35.1 million, which is a reduction of \$15.9 million from the Prior Year Period.

During the Current Year Period, the Company's restricted cash increased \$38.8 million. The increase is attributable to the shift of restricted investments of \$45.7 million to restricted cash, partially offset by a reduction in restricted cash of \$6.6 million associated with the Company's regulated entities and other net decreases of \$0.3 million. The net change in restricted cash for the Company's regulated entities is attributable to a reduction in restricted cash of \$7.3 million that is offset by changes in other assets and liabilities, primarily accounts receivable, accrued liabilities, medical claims payable and other

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medical liabilities, thus having no impact on operating cash flows, partially offset by a net increase of \$0.7 million in restricted cash requirements that resulted in an operating cash flow use.

Investing Activities. The Company utilized \$32.2 million and \$38.5 million during the Prior Year Period and Current Year Period, respectively, for capital expenditures. The additions related to hard assets (equipment, furniture, leaseholds) and capitalized software for the prior year period were \$15.6 million and \$16.6 million, respectively, as compared to additions for the current year period related to hard assets and capitalized software of \$15.5 million and \$23.0 million, respectively. During the Prior Year Period, the Company used net cash of \$80.4 million for the net purchase of "available for sale" securities, with the Company receiving net cash of \$20.2 million during the Current Year Period from the net maturity of "available for sale" investments.

During the Current Year Period, the Company purchased provider network contracts for \$1.3 million that resulted in the establishment of an intangible asset. In addition, during the Current Year Period, the Company received the final working capital settlement of \$0.9 million from Coventry in relationship to the Company's acquisition of First Health, Inc.

Financing Activities. During the Prior Year Period, the Company paid \$74.4 million for the repurchase of treasury stock under the Company's share repurchase program, paid \$0.6 million related to capital lease obligations and had other net unfavorable items of \$1.6 million. In addition, the Company received \$23.1 million from the exercise of stock options and warrants.

During the Current Year Period, the Company paid \$327.9 million for the repurchase of treasury stock under the Company's share repurchase program. In addition, the Company received \$20.0 million under a share purchase agreement pursuant to which Blue Shield of California purchased shares of the Company's common stock, received \$34.8 million from the exercise of stock options and warrants and had other net favorable items of \$0.8 million.

Outlook Liquidity and Capital Resources

Liquidity. During the remainder of 2011, the Company expects to fund its additional estimated capital expenditures of \$12 to \$22 million with cash from operations. The Company does not anticipate that it will need to draw on amounts available under the 2010 Credit Facility for cash flow needs related to its operations, capital needs or debt service in 2011. The Company also currently expects to have adequate liquidity to satisfy its existing financial commitments over the periods in which they will become due. The Company plans to maintain its current investment strategy of investing in a diversified, high quality, liquid portfolio of investments and continues to closely monitor the situation in the financial markets. The Company estimates that it has no risk of any material permanent loss on its investment portfolio; however, there can be no assurance that the Company will not experience any such losses in the future.

Stock Repurchases

On July 27, 2010 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$350 million of its outstanding common stock through July 28, 2012. On February 18, 2011, the Company's board of directors increased the stock repurchase program by an additional \$100 million, to a total of \$450 million.

Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice. Pursuant to this program, the Company made open market purchases of 1,684,510 shares of the Company's common stock at an average price

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of \$48.36 per share for an aggregate cost of \$81.5 million (excluding broker commissions) during the period from November 3, 2010 through December 31, 2010.

Pursuant to this program, the Company made open market purchases of 6,728,222 shares of the Company's common stock at an average price of \$48.74 per share for an aggregate cost of \$327.9 million (excluding broker commissions) during the period January 1, 2011 through September 30, 2011.

During the period from October 1, 2011 through October 24, 2011, the Company made additional open market purchases of 517,705 shares of the Company's common stock at an aggregate cost of \$25.6 million, excluding broker commissions.

On October 25, 2011 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$200 million of its outstanding common stock through October 25, 2013. Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice.

Off-Balance Sheet Arrangements. As of September 30, 2011, the Company has no material off-balance sheet arrangements.

2010 Credit Facility. On April 28, 2010, the Company entered into an amendment to the 2010 Credit Facility that provided for an \$80.0 million Revolving Loan Commitment for the issuance of letters of credit for the account of the Company with a sublimit of up to \$30.0 million for revolving loans. Borrowings under the 2010 Credit Facility mature on April 28, 2013. The 2010 Credit Facility is guaranteed by substantially all of the subsidiaries of the Company and is secured by substantially all of the assets of the Company and the subsidiary guarantors.

Under the 2010 Credit Facility, the annual interest rate on Revolving Loan borrowings is equal to (i) in the case of U.S. dollar denominated loans, the sum of a borrowing margin of 1.75 percent plus the higher of the prime rate or one-half of one percent in excess of the overnight "federal funds" rate, or (ii) in the case of Eurodollar denominated loans, the sum of a borrowing margin of 2.75 percent plus the Eurodollar rate for the selected interest period. The Company has the option to borrow in U.S. dollar denominated loans or Eurodollar denominated loans at its discretion. Letters of Credit issued under the Revolving Loan Commitment bear interest at the rate of 2.875 percent. The commitment commission on the 2010 Credit Facility is 0.50 percent of the unused Revolving Loan Commitment.

Restrictive Covenants in Debt Agreements. The 2010 Credit Facility contains covenants that limit management's discretion in operating the Company's business by restricting or limiting the Company's ability, among other things, to:

incur or guarantee additional indebtedness or issue preferred or redeemable stock;

pay dividends and make other distributions;

repurchase equity interests;

make certain advances, investments and loans;

enter into sale and leaseback transactions;

create liens;

sell and otherwise dispose of assets;

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acquire or merge or consolidate with another company; and

enter into some types of transactions with affiliates.

These restrictions could adversely affect the Company's ability to finance future operations or capital needs or engage in other business activities that may be in the Company's interest.

The 2010 Credit Facility also requires the Company to comply with specified financial ratios and tests. Failure to do so, unless waived by the lenders under the 2010 Credit Facility pursuant to its terms, would result in an event of default under the 2010 Credit Facility. As of September 30, 2011, the Company was in compliance with all covenants, including financial covenants, under the 2010 Credit Facility.

Net Operating Loss Carryforwards. As of December 31, 2010, the Company had federal net operating loss carryforwards ("NOLs") of \$5.5 million available to reduce future federal taxable income. These estimated NOLs, if not used, expire in 2011 through 2019 and are subject to examination and adjustment by the IRS. In addition, the Company's utilization of such NOLs is subject to limitation under Section 382, which affects the timing of the use of these NOLs. At this time, the Company does not believe these limitations will limit the Company's ability to use any federal NOLs before they expire.

As of December 31, 2010, the Company's valuation allowances against deferred tax assets were \$5.3 million, mostly relating to uncertainties regarding the eventual realization of certain state NOLs. Determination of the amount of deferred tax assets considered realizable requires significant judgment and estimation. Changes in these estimates in the future could materially affect the Company's financial condition and results of operations.

Recent Accounting Pronouncements

In January 2010, the FASB issued ASU 2010-24, which clarifies that a health care entity should not net insurance recoveries against a related claim liability. Additionally, the amount of the claim liability should be determined without consideration of insurance recoveries. This guidance is effective for fiscal years beginning after December 15, 2010. Accordingly, the Company adopted ASU 2010-24 on January 1, 2011. The adoption of this standard did not have a material impact on the consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, which requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements and eliminates the option to present the components of other comprehensive income as part of the statement of equity. ASU 2011-05 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2011, with early adoption permitted. While the adoption of this guidance is expected to impact the Company's disclosures for annual and interim filings for the year ending December 31, 2012, it will not have an impact on the Company's results of operations or financial condition.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Changes in interest rates affect interest income earned on the Company's cash equivalents and restricted cash and investments, as well as interest expense on variable interest rate borrowings under the 2010 Credit Facility. Based on the Company's investment balances, and the borrowing levels under the 2010 Credit Facility as of September 30, 2011, a hypothetical 10 percent increase or decrease in the interest rate associated with these instruments, with all other variables held constant, would not materially affect the Company's future earnings and cash outflows.

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Item 4. Controls and Procedures.

a) The Company's management evaluated, with the participation of the Company's principal executive and principal financial officers, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) under the Exchange Act), as of September 30, 2011. Based on their evaluation, the Company's principal executive and principal financial officers concluded that the Company's disclosure controls and procedures were effective as of September 30, 2011.

b) Under the supervision and with the participation of management, including the Company's principal executive and principal financial officers, the Company has determined that there has been no change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the Company's quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings.

The management and administration of the delivery of specialty managed healthcare entails significant risks of liability. From time to time, the Company is subject to various actions and claims arising from the acts or omissions of its employees, network providers or other parties. In the normal course of business, the Company receives reports relating to deaths and other serious incidents involving patients whose care is being managed by the Company. Such incidents occasionally give rise to malpractice, professional negligence and other related actions and claims against the Company or its network providers. Many of these actions and claims received by the Company seek substantial damages and therefore require the Company to incur significant fees and costs related to their defense. The Company is also subject to or party to certain class actions, litigation and claims relating to its operations or business practices. In the opinion of management, the Company has recorded reserves that are adequate to cover litigation, claims or assessments that have been or may be asserted against the Company, and for which the outcome is probable and reasonably estimable. Management believes that the resolution of such litigation and claims will not have a material adverse effect on the Company's financial condition or results of operations; however, there can be no assurance in this regard.

Item 1A. Risk Factors.

None.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On July 30, 2008 the Company's board of directors approved a stock repurchase plan which authorized the Company to purchase up to \$200 million of its outstanding common stock through January 31, 2010. Stock repurchases under the program could be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions under the program from time to time and in such amounts and via such methods as management deemed appropriate. The stock repurchase program could be limited or terminated at any time without prior notice. Pursuant to this program, the Company made open market purchases of 3,866,505 shares of the Company's common stock at an average price of \$35.18 per share for an aggregate cost of \$136.0 million (excluding broker commissions) during the year ended December 31, 2008 and made open market purchases of 1,859,959 shares of the Company's common stock at an average share price of \$34.39 per share for an aggregate cost of \$64.0 million (excluding broker commissions) during the period January 1, 2009 through April 7, 2009, which was the date that the repurchase program was completed, the \$200 million authorization having been exhausted.

On July 28, 2009 the Company's board of directors approved a stock repurchase plan which authorized the Company to purchase up to \$100 million of its outstanding common stock through July 28, 2011. Stock repurchases under the program could be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions under the program from time to time and in such amounts and via such methods as management deemed appropriate. The stock repurchase program could be limited or terminated at any time without prior notice. Pursuant to this program, the Company made open market purchases of 782,400 shares of the Company's common stock at an average price of \$32.75 per share for an aggregate cost of \$25.6 million (excluding broker commissions) during the period from August 17, 2009 through December 31, 2009. Pursuant to this program, the Company made open market purchases of 1,711,881 shares of the Company's common stock at an average price of \$43.46 per share for an aggregate cost of \$74.4 million (excluding broker

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commissions) during the period January 1, 2010 through April 1, 2010, which was the date that the repurchase program was completed, the \$100 million authorization having been exhausted.

On July 27, 2010 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$350 million of its outstanding common stock through July 28, 2012. On February 18, 2011, the Company's board of directors increased the stock repurchase program by an additional \$100 million, to a total of \$450 million. Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice. Pursuant to this program, the Company made open market purchases of 1,684,510 shares of the Company's common stock at an average price of \$48.36 per share for an aggregate cost of \$81.5 million (excluding broker commissions) during the period from November 3, 2010 through December 31, 2010. Pursuant to this program, the Company made open market purchases of 6,728,222 shares of the Company's common stock at an average price of \$48.74 per share for an aggregate cost of \$327.9 million (excluding broker commissions) during the period January 1, 2011 through September 30, 2011.

Following is a summary of stock repurchases made during the three months ended September 30, 2011:

Period	Total number of Shares Purchased	Average Price Paid per Share(2)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan(1)(2)
July 2011	339,995	\$ 54.92	339,995	\$ 141,883
August 2011	1,112,786	\$ 46.53	1,112,786	90,106
September 2011	1,047,443	\$ 47.27	1,047,443	40,594
	2,500,224		2,500,224	

- (1) Excludes amounts that could be used to repurchase shares acquired under the Company's equity incentive plans to satisfy withholding tax obligations of employees and non-employee directors upon the vesting of restricted stock units.
- (2) Excludes broker commissions.

During the period from October 1, 2011 through October 24, 2011, the Company made additional open market purchases of 517,705 shares of the Company's common stock at an aggregate cost of \$25.6 million, excluding broker commissions.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

On October 25, 2011 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$200 million of its outstanding common stock through October 25, 2013. Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized

management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice.

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Item 6. Exhibits.

Exhibit No.	Description
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished).
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished).
101	The following materials from the Company's Annual Report on Form 10-Q for the quarter ended September 30, 2011 formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Statements of Income, (ii) the Consolidated Balance Sheets, (iii) the Consolidated Statements of Cash Flows and (iv) related notes.

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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.

Date: October 27, 2011

MAGELLAN HEALTH SERVICES, INC.
(Registrant)

By: /s/ JONATHAN N. RUBIN

Jonathan N. Rubin
*Executive Vice President and Chief Financial Officer (Principal
Financial Officer and Duly Authorized Officer)*