MAGELLAN HEALTH SERVICES INC
Form 10-Q
April 29, 2011

Use these links to rapidly review the document
TABLE OF CONTENTS

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended March 31, 2011

Or

o **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	**58-1076937**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
55 Nod Road, Avon, Connecticut	**06001**
(Address of principal executive offices)	(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 ý No o

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 ý No o

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

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

The number of shares of the registrant's Ordinary Common Stock outstanding as of March 31, 2011 was 31,970,395.

Table of Contents

FORM 10-Q

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

INDEX

		Page No.
PART I Financial Information:		
Item 1:	Financial Statements	3
	Consolidated Balance Sheets December 31, 2010 and March 31, 2011	3
	Consolidated Statements of Income For the Three Months Ended March 31, 2010 and 2011	4
	Consolidated Statements of Cash Flows For the Three Months Ended March 31, 2010 and 2011	5
	Notes to Consolidated Financial Statements	6
Item 2:	Management's Discussion and Analysis of Financial Condition and Results of Operations	23
Item 3:	Quantitative and Qualitative Disclosures About Market Risk	37
Item 4:	Controls and Procedures	37
PART II Other Information:		
Item 1:	Legal Proceedings	38
Item 1A:	Risk Factors	38
Item 2:	Unregistered Sales of Equity Securities and Use of Proceeds	38
Item 3:	Defaults Upon Senior Securities	39
Item 4:	Submission of Matters to a Vote of Security Holders	39
Item 5:	Other Information	39
Item 6:	Exhibits	40
Signatures		41

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	March 31, 2011 (unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 337,179	$ 154,708
Restricted cash	116,734	101,111
Accounts receivable, less allowance for doubtful accounts of $1,985 and $2,415 at December 31, 2010 and and March 31, 2011, respectively	106,934	112,141
Short-term investments (restricted investments of $114,903 and $138,350 at December 31, 2010 and March 31, 2011, respectively)	189,530	339,927
Deferred income taxes	28,439	30,042
Other current assets (restricted deposits of $21,302 and $23,390 at December 31, 2010 and March 31, 2011, respectively)	79,671	80,182
Total Current Assets	858,487	818,111
Property and equipment, net	111,814	110,529
Long-term investments (restricted investments of $84,950 and $48,265 at December 31, 2010 and March 31, 2011, respectively)	94,974	48,265
Deferred income taxes	825	894
Other long-term assets	2,396	5,207
Goodwill	426,939	426,939
Other intangible assets, net	53,997	52,521
Total Assets	$ 1,549,432	$ 1,462,466
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 31,878	$ 24,204
Accrued liabilities	105,776	87,335
Medical claims payable	142,671	144,364
Other medical liabilities	109,285	97,470
Current maturities of long-term capital lease obligation	559	559
Total Current Liabilities	390,169	353,932
Tax contingencies	117,599	118,985
Deferred credits and other long-term liabilities	2,649	6,488
Total Liabilities	510,417	479,405
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 March 31, 2011 Issued and outstanding 43,867 shares and 33,782 shares at December 31, 2010, respectively, and 44,393 and 31,970 shares at March 31, 2011, respectively	437	444
Multi-Vote common stock, par value $.01 per share Authorized 40,000 shares Issued and outstanding none		

Other Stockholders' Equity:				
Additional paid-in capital		725,322		757,033
Retained earnings		694,582		728,880
Warrants outstanding		420		
Accumulated other comprehensive income		9		106
Ordinary common stock in treasury, at cost, 9,905 shares and 12,423 shares at December 31, 2010 and March 31, 2011, respectively		(381,755)		(503,402)
Total Stockholders' Equity		1,039,015		983,061
Total Liabilities and Stockholders' Equity	$	1,549,432	$	1,462,466

See accompanying notes to consolidated financial statements.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE MONTHS ENDED MARCH 31,

(Unaudited)

(In thousands, except per share amounts)

	2010	2011
Net revenue	$ 728,053	$ 692,755
Cost and expenses:		
Cost of care	476,679	433,700
Cost of goods sold	56,296	56,519
Direct service costs and other operating expenses(1)	138,254	131,567
Depreciation and amortization	13,422	13,952
Interest expense	685	471
Interest income	(817)	(815)
	684,519	635,394
Income before income taxes	43,534	57,361
Provision for income taxes	18,015	23,063
Net income	25,519	34,298
Other comprehensive income	26	97
Comprehensive income	$ 25,545	$ 34,395
Weighted average number of common shares outstanding basic (See Note B)	34,382	33,051
Weighted average number of common shares outstanding diluted (See Note B)	35,074	33,656
Net income per common share basic:	$ 0.74	$ 1.04
Net income per common share diluted:	$ 0.73	$ 1.02

(1) Includes stock compensation expense of $4,528 and $4,778 for the three months ended March 31, 2010 and 2011, respectively.

See accompanying notes to consolidated financial statements.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31,

(Unaudited)

(In thousands)

	2010	2011
Cash flows from operating activities:		
Net income	$ 25,519	$ 34,298
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	13,422	13,952
Non-cash interest expense	219	107
Non-cash stock compensation expense	4,528	4,778
Non-cash income tax expense	7,880	(472)
Cash flows from changes in assets and liabilities, net of effects from acquisitions of businesses:		
Restricted cash	38,208	15,623
Accounts receivable, net	(764)	(6,144)
Other assets	4,217	(3,430)
Accounts payable and accrued liabilities	(21,561)	(25,792)
Medical claims payable and other medical liabilities	(13,397)	(10,122)
Other	2,001	6,470
Net cash provided by operating activities	60,272	29,268
Cash flows from investing activities:		
Capital expenditures	(10,005)	(10,090)
Purchase of investments	(30,942)	(179,772)
Maturity of investments	37,035	73,015
Acquisitions and investments in businesses, net of cash acquired		(274)
Net cash used in investing activities	(3,912)	(117,121)
Cash flows from financing activities:		
Payments on long-term debt and capital lease obligations	(499)	
Proceeds from issuance of equity		20,000
Payments to acquire treasury stock	(59,279)	(122,071)
Proceeds from exercise of stock options and warrants	14,510	8,016
Other	(1,331)	(563)
Net cash used in financing activities	(46,599)	(94,618)
Net increase (decrease) in cash and cash equivalents	9,761	(182,471)
Cash and cash equivalents at beginning of period	196,507	337,179
Cash and cash equivalents at end of period	$ 206,268	$ 154,708

See accompanying notes to consolidated financial statements.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 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 three months ended March 31, 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 the 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

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 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

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 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.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

NOTE A General (Continued)

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 in which the terms of the amendment are finalized and the amendment is executed. Any fees paid prior to the month of service are recorded as deferred revenue. Managed care revenues approximated $583.3 million and $550.0 million for the three months ended March 31, 2010 and 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 these contracts approximated $49.4 million and $42.4 million for the three months ended March 31, 2010 and 2011, respectively.

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 $26.2 million for each of the three months ended March 31, 2010 and 2011.

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

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

NOTE A General (Continued)

dispensing of specialty pharmaceutical drugs on behalf of health plans were $61.0 million and $60.4 million for the three months ended March 31, 2010 and 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, the data available for the performance-based revenue calculation, and communications with the customer, as appropriate. 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 $0.9 million and $3.1 million for the three months ended March 31, 2010 and 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 three months ended March 31, 2010 and 2011.

Pursuant to the Maricopa Contract, the Company provides behavioral healthcare management and other related services to approximately 713,000 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 June 30, 2012 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 $192.0 million and $191.0 million for the three months ended March 31, 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 $44.0 million for the three months ended March 31, 2010. The Company's contracts with WellPoint, Inc. terminated on December 31, 2010.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 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 three months ended March 31, 2010 and 2011 (in thousands):

Segment	Term Date	2010	2011
Commercial			
Customer A	December 31, 2012	$ 64,463	$ 50,438
Customer B	June 30, 2014	18,162	17,008
Customer C	June 30, 2012 to November 30, 2013(1)	11,546*	27,552
Public Sector			
Customer D	June 30, 2012(2)	36,036	40,318
Radiology Benefits Management			
WellPoint, Inc.	December 31, 2010(3)	40,148	
Customer E	November 30, 2012 to April 30, 2013(1)	26,208	33,247
Customer F	June 30, 2011 to November 30, 2011(1)(4)	19,619	16,663
Customer G	June 30, 2014	12,832	13,340
Specialty Pharmaceutical Management			
Customer H	November 30, 2011 to March 31, 2012(1)	22,222	22,004
Customer I	September 1, 2011 to April 29, 2012(1)	15,139	14,760
Customer E	February 1, 2012 to April 30, 2013(1)	7,882	5,963*
Customer J	December 31, 2011	7,911	6,458*
Medicaid Administration			
Customer K	September 30, 2012(5)	7,456	7,221
Customer L	June 30, 2012		20,531
Customer M	June 30, 2011 to September 30, 2011(1)	6,455	6,019
Customer N	August 31, 2011 to June 30, 2013(1)	5,618	3,693*
Customer O	June 30, 2010(3)	4,809	

* Revenue amount did not exceed ten percent of net revenues for the respective segment for the year 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.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

NOTE A General (Continued)

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

(5) The Company anticipates that this contract will not terminate before June 30, 2011, however it is expected to terminate in the second half of 2011.

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 $84.1 million and $84.6 million for the three months ended March 31, 2010 and 2011, respectively. Net revenues from the Florida Areas in the aggregate totaled $35.8 million and $33.4 million for the three months ended March 31, 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.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 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 March 31, 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

	Level 1	Level 2	Level 3	Total
Cash and Cash Equivalents(4)	$	$ 85,680	$	$ 85,680
Restricted Cash(5)		73,336		73,336
Investments:				
U.S. Government and agency securities	378			378
Obligations of government-sponsored enterprises(3)		12,422		12,422
Corporate debt securities		372,548		372,548
Certificates of deposit		200		200
Taxable municipal bonds		2,644		2,644
March 31, 2011	$ 378	$ 546,830	$	$ 547,208

(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.

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

(4) Excludes $69.1 million of cash held in bank accounts by the Company.

(5) Excludes $27.8 million of restricted cash held in bank accounts by the Company.

For the three months ended March 31, 2011, the Company has not transferred any assets between fair value measurement levels.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 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 March 31, 2011, there were no unrealized losses that the Company believed to be other-than-temporary. No realized gains or losses were recorded for the three months

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

NOTE A General (Continued)

ended March 31, 2010 or 2011. The following is a summary of short-term and long-term investments at December 31, 2010 and March 31, 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

	March 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and agency securities	$ 378	$	$	$ 378
Obligations of government-sponsored enterprises(1)	12,418	6	(2)	12,422
Corporate debt securities	372,373	413	(238)	372,548
Certificates of deposit	200			200
Taxable municipal bonds	2,650		(6)	2,644
Total investments at March 31, 2011	$ 388,019	$ 419	$ (246)	$ 388,192

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

The maturity dates of the Company's investments as of March 31, 2011 are summarized below (in thousands):

	Amortized Cost	Estimated Fair Value
2011	$ 242,043	$ 242,123
2012	145,976	146,069
Total investments at March 31, 2011	$ 388,019	$ 388,192

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

NOTE A General (Continued)

Income Taxes

The Company's effective income tax rates were 41.4 percent and 40.2 percent for the three months ended March 31, 2010 and 2011, respectively. These rates differ from the federal statutory income tax rate primarily due to state income taxes and permanent differences between book and tax income. The Company also accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes.

Stock Compensation

At December 31, 2010 and March 31, 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 $4.5 million and $4.8 million for the three months ended March 31, 2010 and 2011, respectively. Stock compensation expense recognized in the consolidated statements of income for the three months ended March 31, 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 three months ended March 31, 2011 was $12.95 as estimated using the Black-Scholes-Merton option pricing model, which also assumed an expected volatility of 29.99 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 three months ended March 31, 2010 and 2011, approximately $0 million and $0.5 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 quarter ended March 31, 2010 the change to additional paid in capital related to tax benefits (deficiencies) was $(0.2) million. For the quarter ended March 31, 2011, the change to additional paid in capital related to tax benefits (deficiencies) was $0.5 million which includes the $0.6 million of excess tax benefits offset by $(0.1) million of tax deficiencies.

Table of Contents

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

NOTE A General (Continued)

Summarized information related to the Company's stock options for the three months ended March 31, 2011 is as follows:

	Options	Weighted Average Exercise Price
Outstanding, beginning of period	3,775,586	$ 39.27
Granted	1,002,466	49.11
Forfeited	(8,804)	39.68
Exercised	(191,798)	36.81
Outstanding, end of period	4,577,450	41.53
Vested and expected to vest at end of period	4,448,519	41.42
Exercisable, end of period	2,363,231	$ 39.67

All of the Company's options granted during the three months ended March 31, 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 three months ended March 31, 2011 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of period	22,309	$ 39.23
Awarded		
Vested		
Forfeited		