

HealthSpring, Inc.  
Form 10-Q  
October 29, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Quarterly Period Ended September 30, 2010  
Commission File Number: 001-32739  
HealthSpring, Inc.  
(Exact Name of Registrant as Specified in Its Charter)**

**Delaware** **20-1821898**  
(State or Other Jurisdiction of Incorporation or (I.R.S. Employer Identification No.)  
Organization)

**9009 Carothers Parkway**  
**Suite 501**  
**Franklin, Tennessee** **37067**  
(Address of Principal Executive Offices) (Zip Code)  
**(615) 291-7000**  
(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 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated Filer  Accelerated Filer  Non-accelerated Filer  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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

**Common Stock, Par Value \$0.01 Per Share**

**Outstanding at October 27, 2010**  
**57,239,061 Shares**



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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)  
(unaudited)

|                                                | September 30,<br>2010 | December 31,<br>2009 |
|------------------------------------------------|-----------------------|----------------------|
| <b>Assets</b>                                  |                       |                      |
| Current assets:                                |                       |                      |
| Cash and cash equivalents                      | \$ 238,238            | \$ 439,423           |
| Accounts receivable, net                       | 85,972                | 92,442               |
| Investment securities available for sale       |                       | 8,883                |
| Investment securities held to maturity         |                       | 13,965               |
| Funds due for the benefit of members           | 4,847                 | 4,028                |
| Deferred income taxes                          | 7,062                 | 6,973                |
| Prepaid expenses and other assets              | 8,788                 | 9,586                |
| <br>                                           |                       |                      |
| Total current assets                           | 344,907               | 575,300              |
| Investment securities available for sale       | 267,099               | 13,574               |
| Investment securities held to maturity         | 40,691                | 38,463               |
| Property and equipment, net                    | 30,015                | 30,316               |
| Goodwill                                       | 624,507               | 624,507              |
| Intangible assets, net                         | 190,368               | 203,147              |
| Restricted investments                         | 21,553                | 16,375               |
| Risk corridor receivable from CMS              | 7,008                 |                      |
| Funds due for the benefit of members           | 21,499                |                      |
| Other assets                                   | 16,867                | 6,585                |
| <br>                                           |                       |                      |
| Total assets                                   | \$ 1,564,514          | \$ 1,508,267         |
| <br><b>Liabilities and Stockholders Equity</b> |                       |                      |
| Current liabilities:                           |                       |                      |
| Medical claims liability                       | \$ 183,463            | \$ 202,308           |
| Accounts payable, accrued expenses and other   | 61,807                | 50,954               |
| Risk corridor payable to CMS                   | 2,921                 | 2,176                |
| Current portion of long-term debt              | 17,500                | 43,069               |
| <br>                                           |                       |                      |
| Total current liabilities                      | 265,691               | 298,507              |
| Long-term debt, less current portion           | 148,750               | 193,904              |
| Deferred income taxes                          | 73,762                | 80,434               |
| Other long-term liabilities                    | 5,189                 | 5,966                |
| <br>                                           |                       |                      |
| Total liabilities                              | 493,392               | 578,811              |
| <br>                                           |                       |                      |
| Stockholders equity:                           |                       |                      |
|                                                | 613                   | 608                  |

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|                                                                                                                                                                                                         |              |              |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|
| Common stock, \$.01 par value, 180,000,000 shares authorized, 61,293,809 issued and 57,239,510 outstanding at September 30, 2010, and 60,758,958 issued and 57,560,350 outstanding at December 31, 2009 |              |              |
| Additional paid-in capital                                                                                                                                                                              | 556,003      | 548,481      |
| Retained earnings                                                                                                                                                                                       | 572,121      | 428,765      |
| Accumulated other comprehensive income (loss), net                                                                                                                                                      | 4,368        | (1,044)      |
| Treasury stock, at cost, 4,054,299 shares at September 30, 2010, and 3,198,608 shares at December 31, 2009                                                                                              | (61,983)     | (47,354)     |
| Total stockholders' equity                                                                                                                                                                              | 1,071,122    | 929,456      |
| Total liabilities and stockholders' equity                                                                                                                                                              | \$ 1,564,514 | \$ 1,508,267 |

See accompanying notes to condensed consolidated financial statements.

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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(in thousands, except share data)  
(unaudited)

|                                             | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|---------------------------------------------|---------------------------|------------------|--------------------------|------------------|
|                                             | <b>September 30,</b>      |                  | <b>September 30,</b>     |                  |
|                                             | <b>2010</b>               | <b>2009</b>      | <b>2010</b>              | <b>2009</b>      |
| Revenue:                                    |                           |                  |                          |                  |
| Premium revenue                             | \$ 712,658                | \$ 649,795       | \$ 2,218,378             | \$ 1,955,842     |
| Management and other fees                   | 10,413                    | 9,108            | 31,191                   | 29,065           |
| Investment income                           | 2,151                     | 877              | 4,574                    | 3,532            |
| <b>Total revenue</b>                        | <b>725,222</b>            | <b>659,780</b>   | <b>2,254,143</b>         | <b>1,988,439</b> |
| Operating expenses:                         |                           |                  |                          |                  |
| Medical expense                             | 561,823                   | 519,478          | 1,779,275                | 1,607,481        |
| Selling, general and administrative         | 67,664                    | 65,851           | 210,410                  | 200,408          |
| Depreciation and amortization               | 7,513                     | 7,782            | 22,810                   | 22,948           |
| Interest expense                            | 3,150                     | 3,762            | 15,375                   | 12,014           |
| <b>Total operating expenses</b>             | <b>640,150</b>            | <b>596,873</b>   | <b>2,027,870</b>         | <b>1,842,851</b> |
| Income before income taxes                  | 85,072                    | 62,907           | 226,273                  | 145,588          |
| Income tax expense                          | (31,292)                  | (20,593)         | (82,917)                 | (50,772)         |
| <b>Net income</b>                           | <b>\$ 53,780</b>          | <b>\$ 42,314</b> | <b>\$ 143,356</b>        | <b>\$ 94,816</b> |
| Net income per common share:                |                           |                  |                          |                  |
| Basic                                       | \$ 0.95                   | \$ 0.78          | \$ 2.52                  | \$ 1.74          |
| Diluted                                     | \$ 0.95                   | \$ 0.77          | \$ 2.51                  | \$ 1.73          |
| Weighted average common shares outstanding: |                           |                  |                          |                  |
| Basic                                       | 56,482,679                | 54,518,162       | 56,872,071               | 54,502,081       |
| Diluted                                     | 56,577,063                | 54,700,390       | 57,058,075               | 54,653,367       |

See accompanying notes to condensed consolidated financial statements.



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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

|                                                                                   | <b>Nine Months Ended</b> |             |
|-----------------------------------------------------------------------------------|--------------------------|-------------|
|                                                                                   | <b>September 30,</b>     |             |
|                                                                                   | <b>2010</b>              | <b>2009</b> |
| Cash flows from operating activities:                                             |                          |             |
| Net income                                                                        | \$ 143,356               | \$ 94,816   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |             |
| Depreciation and amortization                                                     | 22,810                   | 22,948      |
| Amortization of deferred financing cost                                           | 1,407                    | 1,785       |
| Amortization on bond investments                                                  | 2,187                    | 749         |
| Equity in earnings of unconsolidated affiliate                                    | (277)                    | (281)       |
| Share-based compensation                                                          | 6,659                    | 7,513       |
| Deferred tax benefit                                                              | (9,883)                  | (8,794)     |
| Write-off of deferred financing fees                                              | 5,079                    |             |
| Increase (decrease) in cash due to:                                               |                          |             |
| Accounts receivable                                                               | 18,962                   | 3,446       |
| Prepaid expenses and other assets                                                 | (12,266)                 | (2,231)     |
| Medical claims liability                                                          | (18,845)                 | 10,228      |
| Accounts payable, accrued expenses, and other current liabilities                 | 1,357                    | (6,766)     |
| Risk corridor payable to/receivable from CMS                                      | (6,263)                  | (7,298)     |
| Other                                                                             | 1,485                    | 94          |
| Net cash provided by operating activities                                         | 155,768                  | 116,209     |
| Cash flows from investing activities:                                             |                          |             |
| Additional consideration paid on acquisition                                      | (610)                    | (910)       |
| Proceeds received on disposition                                                  |                          | 297         |
| Purchases of property and equipment                                               | (9,120)                  | (11,519)    |
| Purchases of investment securities                                                | (341,081)                | (39,766)    |
| Maturities of investment securities                                               | 56,591                   | 35,415      |
| Sales of investment securities                                                    | 55,898                   |             |
| Purchases of restricted investments                                               | (43,182)                 | (16,015)    |
| Maturities of restricted investments                                              | 37,973                   | 11,346      |
| Distributions received from unconsolidated affiliate                              | 262                      | 196         |
| Net cash used in investing activities                                             | (243,269)                | (20,956)    |
| Cash flows from financing activities:                                             |                          |             |
| Funds received for the benefit of the members                                     | 633,577                  | 494,591     |
| Funds withdrawn for the benefit of members                                        | (655,895)                | (458,465)   |
| Proceeds received on issuance of debt                                             | 200,000                  |             |
| Payments on long-term debt                                                        | (270,722)                | (23,859)    |
| Excess tax benefit from stock options exercised                                   | 127                      |             |

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|                                                      |            |            |
|------------------------------------------------------|------------|------------|
| Proceeds from stock options exercised                | 867        | 6          |
| Purchase of treasury stock                           | (14,304)   |            |
| Payment of debt issue costs                          | (7,334)    |            |
| Net cash (used in) provided by financing activities  | (113,684)  | 12,273     |
| Net (decrease) increase in cash and cash equivalents | (201,185)  | 107,526    |
| Cash and cash equivalents at beginning of period     | 439,423    | 282,240    |
| Cash and cash equivalents at end of period           | \$ 238,238 | \$ 389,766 |
| Supplemental disclosures:                            |            |            |
| Cash paid for interest                               | \$ 7,609   | \$ 10,454  |
| Cash paid for taxes                                  | \$ 88,893  | \$ 62,992  |

See accompanying notes to condensed consolidated financial statements.

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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**(1) Organization and Basis of Presentation**

HealthSpring, Inc., a Delaware corporation (the Company), was organized in October 2004 and began operations in March 2005 in connection with a recapitalization transaction accounted for as a purchase. The Company is a managed care organization whose primary focus is on Medicare, the federal government sponsored health insurance program for United States citizens aged 65 and older, qualifying disabled persons, and persons suffering from end-stage renal disease. Through its health maintenance organization (HMO) and regulated insurance subsidiaries, the Company operates Medicare Advantage health plans in the states of Alabama, Florida, Georgia, Illinois, Mississippi, Tennessee, and Texas and offers Medicare Part D prescription drug plans (PDP) on a national basis. The Company also provides management services to physician practices.

The accompanying condensed consolidated financial statements are unaudited and should be read in conjunction with the consolidated financial statements and notes thereto of HealthSpring, Inc. as of and for the year ended December 31, 2009, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the Securities and Exchange Commission (the SEC) on February 11, 2010 (the 2009 Form 10-K). The accompanying unaudited condensed consolidated financial statements reflect the Company's financial position as of September 30, 2010, the Company's results of operations for the three and nine months ended September 30, 2010 and 2009, and cash flows for the nine months ended September 30, 2010 and 2009. Certain 2009 amounts have been reclassified to conform to the 2010 presentation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934, as amended (the Exchange Act). Accordingly, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations applicable to interim financial statements. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments (including normally recurring accruals) necessary to present fairly the Company's financial position at September 30, 2010, its results of operations for the three and nine months ended September 30, 2010 and 2009, and its cash flows for the nine months ended September 30, 2010 and 2009. The results of operations for the 2010 interim periods are not necessarily indicative of the operating results that may be expected for the full year ending December 31, 2010.

The preparation of the condensed consolidated financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the period. The most significant item subject to estimates and assumptions is the actuarial calculation for obligations related to medical claims. Other significant items subject to estimates and assumptions include the Company's estimated risk adjustment payments receivable from the Centers for Medicare & Medicaid Services (CMS), the valuation of goodwill and intangible assets, the useful life of definite-lived intangible assets, the valuation of debt securities carried at fair value, and certain amounts recorded related to the Company's Part D operations, including risk corridor adjustments and rebates. Actual results could differ significantly from those estimates and assumptions.

The Company's regulated insurance subsidiaries are restricted from making distributions without appropriate regulatory notifications and approvals or to the extent such distributions would cause non-compliance with statutory capital requirements. At September 30, 2010, \$409.2 million of the Company's \$567.6 million of cash, cash equivalents, investment securities, and restricted investments were held by the Company's insurance subsidiaries and subject to these restrictions.

*Agreement to Acquire Bravo Health*

On August 26, 2010, the Company entered into a definitive agreement to acquire all of the outstanding capital stock of Bravo Health, Inc. (Bravo), an operator of Medicare Advantage coordinated care plans in Pennsylvania, the

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Mid-Atlantic region, and Texas, and Medicare Part D stand-alone prescription drug plans in 43 states and the District of Columbia. As of September 30, 2010, Bravo had Medicare Advantage membership of 103,044 and stand-alone PDP membership of 293,920.

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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

The Company will acquire Bravo, a privately held company, for approximately \$545.0 million in cash, subject to adjustment. The Company has agreed with its existing lenders and certain additional lenders to amend its existing credit facility to provide for, among other things, the acquisition financing. As amended, the facility will provide for the following:

\$355.0 million in term loan A indebtedness maturing in February 2015 comprised of:

\$175.0 million of term loan A indebtedness (\$166.3 million of which is currently outstanding);

\$180.0 million of new term loan A indebtedness to be funded at the closing of the acquisition;

\$175.0 million revolving credit facility (currently undrawn and maturing in February 2014); and

\$200.0 million of new six-year term loan B indebtedness to be funded at the closing of the acquisition.

The additional term loan indebtedness, availability under the existing \$175.0 million revolving credit facility, and cash on hand will be sufficient to fund the acquisition of Bravo. See Note 12 for additional information regarding the new indebtedness.

The remaining material conditions to the closing of the Bravo acquisition primarily relate to approvals by various state regulatory authorities.

**(2) Recently Adopted Accounting Pronouncements**

In June 2009, the Financial Accounting Standards Board ( FASB ) issued new guidance for determining whether an entity is a variable interest entity ( VIE ) and requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a VIE. The guidance requires an enterprise to assess whether it has an implicit financial responsibility to ensure that a VIE operates as designed when determining whether it has power to direct the activities of the VIE that most significantly impact the entity's economic performance. The guidance also requires ongoing assessments of whether an enterprise is the primary beneficiary of a VIE, requires enhanced disclosures, and eliminates the scope exclusion for qualifying special-purpose entities. The adoption of the new guidance on January 1, 2010 did not impact the Company's financial statements.

Effective January 1, 2010, the Company adopted the FASB's updated guidance related to fair value measurements and disclosures, which requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and to describe the reasons for the transfers. In addition, in the reconciliation for fair value measurements using significant unobservable inputs, or Level 3, a reporting entity should disclose separately information about purchases, sales, issuances and settlements. The updated guidance also requires that an entity should provide fair value measurement disclosures for each class of assets and liabilities and disclosures about the valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements for Level 2 and Level 3 fair value measurements. The guidance is effective for interim or annual financial reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. Therefore, the Company has not yet adopted the guidance with respect to the roll forward activity in Level 3 fair value measurements. The adoption of the updated guidance for Levels 1 and 2 fair value measurements did not have an impact on the Company's consolidated results of operations or financial condition.

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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**(3) Accounts Receivable**

Accounts receivable at September 30, 2010 and December 31, 2009 consisted of the following (in thousands):

|                                 | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---------------------------------|-----------------------------------|----------------------------------|
| Medicare premium receivables    | \$ 21,519                         | \$ 48,524                        |
| Rebates                         | 49,286                            | 34,879                           |
| Due from providers              | 15,264                            | 10,320                           |
| Other                           | 3,665                             | 2,400                            |
|                                 | 89,734                            | 96,123                           |
| Allowance for doubtful accounts | (3,762)                           | (3,681)                          |
| Total                           | \$ 85,972                         | \$ 92,442                        |

Medicare premium receivables at September 30, 2010 and December 31, 2009 include \$18.6 million and \$44.1 million, respectively, of receivables from CMS related to the accrual of retroactive risk adjustment payments. Accounts receivable relating to unpaid health plan enrollee premiums are recorded during the period the Company is obligated to provide services to enrollees and do not bear interest. The Company does not have any off-balance sheet credit exposure related to its health plan enrollees.

Rebates for drug costs represent estimated rebates owed to the Company from prescription drug companies. The Company has entered into contracts with certain drug manufacturers that provide for rebates to the Company based on the utilization of specific prescription drugs by the Company's members. Due from providers primarily includes management fees receivable as well as amounts owed to the Company for the refund of certain medical expenses paid by the Company under risk sharing agreements.

**(4) Investment Securities**

Investment securities, which consist primarily of debt securities, have been categorized as either available for sale or held to maturity. Held to maturity securities are those securities that the Company does not intend to sell, nor expect to be required to sell, prior to maturity. The Company holds no trading securities. At September 30, 2010, investment securities are classified as non-current assets based on the Company's intention to reinvest such assets upon sale or maturity and to not use such assets in current operations. At December 31, 2009, the Company classified its investment securities based upon maturity dates. Restricted investments include U.S. Government securities, money market fund investments, deposits and certificates of deposit held by the various state departments of insurance to whose jurisdiction the Company's subsidiaries are subject. These restricted assets are recorded at amortized cost and classified as long-term regardless of the contractual maturity date because of the restrictive nature of the states requirements.

Available for sale securities are recorded at fair value. Held to maturity debt securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized gains and losses (net of applicable deferred taxes) on available for sale securities are included as a component of stockholders' equity and comprehensive income until realized from a sale or other than temporary impairment. Realized gains and losses from the sale of securities are determined on a specific identification basis. Purchases and sales of investments are recorded on their trade dates. Dividend and interest income are recognized when earned.

There were no available for sale securities classified as current assets as of September 30, 2010. Available for sale securities classified as current assets at December 31, 2009 were as follows (in thousands):

|                 | <b>December 31, 2009</b>  |                                                   |                                                    |                                 |
|-----------------|---------------------------|---------------------------------------------------|----------------------------------------------------|---------------------------------|
|                 | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Holding<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Holding<br/>Losses</b> | <b>Estimated<br/>Fair Value</b> |
| Municipal bonds | \$ 8,691                  | 192                                               |                                                    | 8,883                           |

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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

Available for sale securities classified as non-current assets were as follows (in thousands):

|                                          | September 30, 2010 |                           |                            |                            | December 31, 2009 |                           |                            |                            |
|------------------------------------------|--------------------|---------------------------|----------------------------|----------------------------|-------------------|---------------------------|----------------------------|----------------------------|
|                                          | Amortized<br>Cost  | Gross<br>Holding<br>Gains | Gross<br>Holding<br>Losses | Estimated<br>Fair<br>Value | Amortized<br>Cost | Gross<br>Holding<br>Gains | Gross<br>Holding<br>Losses | Estimated<br>Fair<br>Value |
| Government obligations                   | \$ 10,196          | 187                       |                            | 10,383                     | \$                |                           |                            |                            |
| Agency obligations                       | 3,230              | 69                        |                            | 3,299                      |                   |                           |                            |                            |
| Corporate debt securities                | 88,784             | 3,279                     |                            | 92,063                     |                   |                           |                            |                            |
| Mortgage-backed securities (Residential) | 64,582             | 1,353                     |                            | 65,935                     |                   |                           |                            |                            |
| Other structured securities              | 13,343             | 489                       |                            | 13,832                     |                   |                           |                            |                            |
| Municipal bonds                          | 80,135             | 1,466                     | (14)                       | 81,587                     | 13,407            | 176                       | (9)                        | 13,574                     |
|                                          | \$ 260,270         | 6,843                     | (14)                       | 267,099                    | \$ 13,407         | 176                       | (9)                        | 13,574                     |

There were no held to maturity securities classified as current assets at September 30, 2010. Held to maturity securities classified as current assets at December 31, 2009 were as follows (in thousands):

|                           | Amortized<br>Cost | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses | Estimated<br>Fair Value |
|---------------------------|-------------------|-----------------------------------------|------------------------------------------|-------------------------|
| Government obligations    | \$ 1,154          | 1                                       |                                          | 1,155                   |
| Agency obligations        | 3,225             | 16                                      |                                          | 3,241                   |
| Corporate debt securities | 6,416             | 74                                      |                                          | 6,490                   |
| Municipal bonds           | 3,170             | 20                                      |                                          | 3,190                   |
|                           | \$ 13,965         | 111                                     |                                          | 14,076                  |

Held to maturity securities classified as non-current assets were as follows (in thousands):

|                        | September 30, 2010 |                           |                            |                            | December 31, 2009 |                           |                            |                            |
|------------------------|--------------------|---------------------------|----------------------------|----------------------------|-------------------|---------------------------|----------------------------|----------------------------|
|                        | Amortized<br>Cost  | Gross<br>Holding<br>Gains | Gross<br>Holding<br>Losses | Estimated<br>Fair<br>Value | Amortized<br>Cost | Gross<br>Holding<br>Gains | Gross<br>Holding<br>Losses | Estimated<br>Fair<br>Value |
| Government obligations | \$ 1,414           | 3                         |                            | 1,417                      | \$                |                           |                            |                            |



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|                                          |           |       |        |           |     |     |        |
|------------------------------------------|-----------|-------|--------|-----------|-----|-----|--------|
| Agency obligations                       | 3,146     | 38    | 3,184  | 1,610     | 12  |     | 1,622  |
| Corporate debt securities                | 13,375    | 306   | 13,681 | 13,505    | 325 |     | 13,830 |
| Mortgage-backed securities (Residential) |           |       |        | 1,575     | 6   |     | 1,581  |
| Municipal bonds                          | 22,756    | 828   | 23,584 | 21,773    | 546 | (1) | 22,318 |
|                                          | \$ 40,691 | 1,175 | 41,866 | \$ 38,463 | 889 | (1) | 39,351 |

Realized gains or losses related to investment securities for the three and nine months ended September 30, 2010 and 2009 were immaterial.

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Maturities of investments were as follows at September 30, 2010 (in thousands):

|                                        | Available for sale |                         | Held to maturity  |                         |
|----------------------------------------|--------------------|-------------------------|-------------------|-------------------------|
|                                        | Amortized<br>Cost  | Estimated<br>Fair Value | Amortized<br>Cost | Estimated<br>Fair Value |
| Due within one year                    | \$ 9,646           | 9,677                   | \$ 15,254         | 15,430                  |
| Due after one year through five years  | 133,708            | 137,740                 | 23,379            | 24,209                  |
| Due after five years through ten years | 29,497             | 30,377                  | 2,058             | 2,227                   |
| Due after ten years                    | 9,494              | 9,538                   |                   |                         |
| Mortgage and asset-backed securities   | 77,925             | 79,767                  |                   |                         |
|                                        | \$ 260,270         | 267,099                 | \$ 40,691         | 41,866                  |

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2010, were as follows (in thousands):

|                 | Less Than<br>12 Months |               | More Than<br>12 Months |               | Total                |               |
|-----------------|------------------------|---------------|------------------------|---------------|----------------------|---------------|
|                 | Unrealized<br>Losses   | Fair<br>Value | Unrealized<br>Losses   | Fair<br>Value | Unrealized<br>Losses | Fair<br>Value |
| Municipal bonds | \$ (14)                | 6,255         |                        |               | (14)                 | 6,255         |

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2009, were as follows (in thousands):

|                 | Less Than<br>12 Months |               | More Than<br>12 Months |               | Total                |               |
|-----------------|------------------------|---------------|------------------------|---------------|----------------------|---------------|
|                 | Unrealized<br>Losses   | Fair<br>Value | Unrealized<br>Losses   | Fair<br>Value | Unrealized<br>Losses | Fair<br>Value |
| Municipal bonds | \$ (10)                | 1,920         |                        |               | (10)                 | 1,920         |

The Company reviews fixed maturities and equity securities with a decline in fair value from cost for impairment based on criteria that include duration and severity of decline; financial viability and outlook of the issuer; and changes in the regulatory, economic and market environment of the issuer's industry or geographic region. All issuers of securities the Company owned in an unrealized loss as of September 30, 2010 remain current on all contractual payments. The unrealized losses on investments were caused by an increase in investment yields as a result of a widening of credit spreads. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. The Company determined that it did not intend to sell these investments and that it was not more-likely-than-not to be required to sell these investments prior to their recovery, thus these investments are not considered other-than-temporarily impaired.

**(5) Fair Value Measurements**

The Company's 2010 third quarter condensed consolidated balance sheet includes the following financial instruments: cash and cash equivalents, accounts receivable, investment securities, restricted investments, accounts payable, medical claims liabilities, funds due from CMS for the benefit of members, and long-term debt. The carrying amounts of accounts receivable, funds due from CMS for the benefit of members, accounts payable, and medical claims liabilities approximate their fair value because of the relatively short period of time between the origination of these instruments and their expected realization. The fair value of the Company's long-term debt (including the current portion) was \$162.9 million at September 30, 2010 and consisted solely of bank debt.

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Cash and cash equivalents consist of such items as certificates of deposit, money market funds, and certain U.S. Government securities with an original maturity of three months or less. The original cost of these assets approximates fair value due to their short-term maturity. In February 2010, the Company terminated its interest rate swap agreements in connection with the termination of the related credit agreement. See Note 8 Derivatives and Note 12 Debt . The fair value of the Company s interest rate swaps at December 31, 2009 reflected a liability of approximately \$2.1 million and was included in other long term liabilities in the accompanying condensed consolidated balance sheet. The fair values of available for sale securities is determined by quoted market prices or pricing models developed using market data provided by a third party vendor. The following are the levels of the hierarchy as and a brief description of the type of valuation information ( inputs ) that qualifies a financial asset for each level:

| <b>Level Input</b> | <b>Input Definition</b>                                                                                                                                            |
|--------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Level I            | Inputs are unadjusted quoted prices for identical assets or liabilities in active markets at the measurement date.                                                 |
| Level II           | Inputs other than quoted prices included in Level I that are observable for the asset or liability through corroboration with market data at the measurement date. |
| Level III          | Unobservable inputs that reflect management s best estimate of what market participants would use in pricing the asset or liability at the measurement date.       |

When quoted prices in active markets for identical assets are available, the Company uses these quoted market prices to determine the fair value of financial assets and classifies these assets as Level I. In other cases where a quoted market price for identical assets in an active market is either not available or not observable, the Company obtains the fair value from a third party vendor that uses pricing models, such as matrix pricing, to determine fair value. These financial assets would then be classified as Level II. In the event quoted market prices were not available, the Company would determine fair value using broker quotes or an internal analysis of each investment s financial statements and cash flow projections. In these instances, financial assets would be classified based upon the lowest level of input that is significant to the valuation. Thus, financial assets might be classified in Level III even though there could be some significant inputs that may be readily available.

There were no transfers to or from Levels I and II during the nine months ended September 30, 2010. The following tables summarize fair value measurements by level at September 30, 2010 and December 31, 2009 for assets and liabilities measured at fair value on a recurring basis (in thousands):

|                                             | <b>September 30, 2010</b> |                 |                  | <b>Total</b> |
|---------------------------------------------|---------------------------|-----------------|------------------|--------------|
|                                             | <b>Level I</b>            | <b>Level II</b> | <b>Level III</b> |              |
| <b>Assets</b>                               |                           |                 |                  |              |
| Cash and cash equivalents                   | \$ 238,238                | \$              | \$               | \$ 238,238   |
| Investments: available for sale securities: |                           |                 |                  |              |
| Government obligations                      | \$ 8,488                  | \$ 1,895        | \$               | \$ 10,383    |
| Agency obligations                          |                           | 3,299           |                  | 3,299        |
| Corporate debt securities                   |                           | 92,063          |                  | 92,063       |
| Mortgage-backed securities (Residential)    |                           | 65,935          |                  | 65,935       |
| Other structured securities                 |                           | 13,832          |                  | 13,832       |
| Municipal securities                        |                           | 81,587          |                  | 81,587       |

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\$ 8,488 \$ 258,611 \$ 267,099

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|                                             | <b>December 31, 2009</b> |                 |                  |              |
|---------------------------------------------|--------------------------|-----------------|------------------|--------------|
|                                             | <b>Level I</b>           | <b>Level II</b> | <b>Level III</b> | <b>Total</b> |
| <b>Assets</b>                               |                          |                 |                  |              |
| Cash and cash equivalents                   | \$ 439,423               | \$              | \$               | \$ 439,423   |
| Investments: available for sale securities: |                          |                 |                  |              |
| Municipal securities                        | \$                       | 22,457          |                  | 22,457       |
| <b>Liabilities</b>                          |                          |                 |                  |              |
| Derivative interest rate swaps              | \$                       | \$ 2,066        | \$               | \$ 2,066     |

**(6) Medical Liabilities**

The Company's medical liabilities at September 30, 2010 and December 31, 2009 consisted of the following (in thousands):

|                                                | <b>September 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|------------------------------------------------|-------------------------------|------------------------------|
| Incurred but not reported liabilities          | \$ 121,629                    | \$ 121,782                   |
| Pharmacy liabilities                           | 32,015                        | 45,648                       |
| Provider incentives and other medical payments | 26,129                        | 31,683                       |
| Other medical liabilities                      | 3,690                         | 3,195                        |
|                                                | <b>\$ 183,463</b>             | <b>\$ 202,308</b>            |

**(7) Medicare Part D**

Total Part D related net assets (excluding medical claims payable) of \$1.9 million at December 31, 2009 all relate to the 2009 CMS plan year. The Company's Part D related assets and liabilities (excluding medical claims payable) at September 30, 2010 were as follows (in thousands):

|                                      | <b>Related to the<br/>2009 plan<br/>year</b> | <b>Related to the<br/>2010 plan<br/>year</b> | <b>Total</b> |
|--------------------------------------|----------------------------------------------|----------------------------------------------|--------------|
| <b>Current assets (liabilities):</b> |                                              |                                              |              |
| Funds due for the benefit of members | \$ 4,847                                     | \$                                           | \$ 4,847     |
| Risk corridor payable to CMS         | \$ (2,921)                                   | \$                                           | \$ (2,921)   |
| <b>Non-current assets:</b>           |                                              |                                              |              |
| Funds due for the benefit of members | \$                                           | \$ 21,499                                    | \$ 21,499    |
| Risk corridor receivable from CMS    | \$                                           | \$ 7,008                                     | \$ 7,008     |

Balances associated with Part D related assets and liabilities are expected to be settled in the second half of the year following the year to which they relate. Current year Part D amounts are routinely updated in subsequent periods as a

result of retroactivity.

**(8) Derivatives**

In October 2008, the Company entered into two interest rate swap agreements in a total notional amount of \$100.0 million, relating to the floating interest rate component of the term loan agreement under its previous credit facility (collectively, the 2007 Credit Agreement ). In February 2010, the Company terminated its interest rate swap agreements in connection with the termination of the 2007 Credit Agreement. See Note 12 Debt . The interest rate swap agreements were classified as cash flow hedges. See Note 5 Fair Value Measurements .

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All derivatives were recognized on the balance sheet at their fair value. To the extent that the cash flow hedges were effective, changes in their fair value were recorded in other comprehensive income (loss) until earnings are affected by the variability of cash flows of the hedged transaction (e.g. until periodic settlements of a variable asset or liability are recorded in earnings). Any hedge ineffectiveness (which represents the amount by which the changes in the fair value of the derivatives differ from changes in the fair value of the hedged instrument) was recorded in current-period earnings. As a result of terminating the interest rate swap agreements, the Company settled the swap obligations with the counterparties for approximately \$2.0 million and reclassified such amount from other comprehensive income to interest expense during the first quarter of 2010.

The Company had no derivative financial instruments outstanding at September 30, 2010. A summary of the aggregate notional amounts, balance sheet location and estimated fair values of derivative financial instruments at December 31, 2009 was as follows (in thousands):

| <b>Hedging instruments</b> | <b>Notional<br/>Amount</b> | <b>Balance Sheet Location</b> | <b>Estimated Fair Value<br/>Asset</b> | <b>(Liability)</b> |
|----------------------------|----------------------------|-------------------------------|---------------------------------------|--------------------|
| Interest rate swaps        | \$ 100,000                 | Other noncurrent liabilities  |                                       | (2,066)            |

A summary of the effect of cash flow hedges on the Company's financial statements for the periods presented is as follows (in thousands):

| <b>Type of Cash Flow Hedge</b>                 | <b>Pretax<br/>Hedge<br/>Gain<br/>(Loss)<br/>Recognized<br/>in</b> | <b>Effective Portion</b>                                                                  | <b>Hedge Gain<br/>(Loss)</b>                 | <b>Ineffective Portion</b>                        |                                                 |
|------------------------------------------------|-------------------------------------------------------------------|-------------------------------------------------------------------------------------------|----------------------------------------------|---------------------------------------------------|-------------------------------------------------|
|                                                |                                                                   | <b>Income Statement<br/>Location of Gain<br/>(Loss) Reclassified<br/>from Accumulated</b> | <b>Reclassified<br/>from<br/>Accumulated</b> | <b>Location of<br/>Gain (Loss)<br/>Recognized</b> | <b>Hedge<br/>Gain<br/>(Loss)<br/>Recognized</b> |
|                                                | <b>Other<br/>Comprehensive<br/>Income</b>                         | <b>Other<br/>Comprehensive<br/>Income</b>                                                 | <b>Other<br/>Comprehensive<br/>Income</b>    | <b>Other<br/>Comprehensive<br/>Income</b>         | <b>Other<br/>Comprehensive<br/>Income</b>       |
| For the three months ended September 30, 2010: |                                                                   |                                                                                           |                                              |                                                   |                                                 |
| Interest rate swaps                            | \$                                                                | Interest Expense                                                                          | \$                                           | None                                              | \$                                              |
| For the three months ended September 30, 2009: |                                                                   |                                                                                           |                                              |                                                   |                                                 |
| Interest rate swaps                            | \$ 137                                                            | Interest Expense                                                                          | \$                                           | None                                              | \$                                              |

For the nine months ended September 30, 2010:



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|                                                  |    |     |                  |    |         |      |    |
|--------------------------------------------------|----|-----|------------------|----|---------|------|----|
| Interest rate swaps                              | \$ | 38  | Interest Expense | \$ | (1,253) | None | \$ |
| For the nine months ended<br>September 30, 2009: |    |     |                  |    |         |      |    |
| Interest rate swaps                              | \$ | 725 | Interest Expense | \$ |         | None | \$ |

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**(9) Intangible Assets**

A breakdown of the identifiable intangible assets and their assigned value and accumulated amortization at September 30, 2010 is as follows (in thousands):

|                           | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Net</b> |
|---------------------------|--------------------------------------|-------------------------------------|------------|
| Trade name                | \$ 24,497                            | \$                                  | \$ 24,497  |
| Noncompete agreements     | 800                                  | 800                                 |            |
| Provider network          | 137,679                              | 29,317                              | 108,362    |
| Medicare member network   | 93,620                               | 37,122                              | 56,498     |
| Management contract right | 1,555                                | 544                                 | 1,011      |
|                           | \$ 258,151                           | \$ 67,783                           | \$ 190,368 |

Amortization expense on identifiable intangible assets for the three months ended September 30, 2010 and 2009 was approximately \$4.5 million. Amortization expense on identifiable intangible assets for the nine months ended September 30, 2010 and 2009 was approximately \$13.4 million and \$13.8 million, respectively.

**(10) Share-Based Compensation**

In May 2010, the Company's stockholders approved an amendment and restatement of the 2006 Equity Incentive Plan. Among other items, the amendments increased the number of shares available for issuance under the plan by 3,250,000 shares.

*Stock Options*

The Company granted options to purchase 550,712 shares of common stock pursuant to the 2006 Equity Incentive Plan during the nine months ended September 30, 2010. Options to purchase 366,862 shares of common stock either were forfeited or expired during the nine months ended September 30, 2010. Options to purchase 3,997,120 shares of common stock were outstanding under this plan at September 30, 2010. The outstanding options vest and become exercisable based on time, generally over a four-year period, and expire ten years from their grant dates.

*Restricted Stock*

During the nine months ended September 30, 2010, the Company granted 420,945 shares of restricted stock to employees pursuant to the 2006 Equity Incentive Plan, the restrictions of which generally lapse over a four-year period. Additionally, 35,043 shares were purchased by certain executives pursuant to the Management Stock Purchase Plan (the "MSPP"). The restrictions on shares purchased under the MSPP generally lapse on the second anniversary of the grant date. Unvested restricted stock at September 30, 2010 totaled 733,252 shares.

During the nine months ended September 30, 2010, the Company awarded 40,683 shares of restricted stock to certain of its directors pursuant to the 2006 Equity Incentive Plan, all of which were outstanding at September 30, 2010. The restrictions relating to the restricted stock awarded to non-employee directors in 2010 generally lapse one year from the grant date. In the event a director resigns or is removed prior to the lapsing of the restriction, or if the director fails to attend 75% of the board and applicable committee meetings during the one-year period, shares will be forfeited unless resignation or failure to attend is caused by death or disability.

*Stock Repurchase Program*

In May 2010, the Company's Board of Directors authorized a stock repurchase program to buy back up to \$100.0 million of the Company's common stock through June 30, 2011. The program authorizes purchases of common stock from time to time in either the open market or through private transactions, in accordance with SEC and other applicable legal requirements. The timing, prices, and sizes of purchases depends upon prevailing stock prices, general economic and market conditions, and other considerations. Funds for the repurchase of shares have, and are expected

to, come primarily from unrestricted cash on hand and unrestricted cash generated from operations. The repurchase program does not obligate the Company to acquire any particular amount of common stock and the repurchase program may be suspended at any time at the Company's discretion. As of September 30, 2010, the Company had repurchased 837,634 shares of its common stock under the program in open market transactions for approximately \$14.3 million, or at an average cost of \$17.10 per share, and had approximately \$85.7 million in remaining repurchase authority under the program.

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**(11) Net Income Per Common Share**

The following table presents the calculation of the Company's net income per common share—basic and diluted (in thousands, except share data):

|                                                    | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|----------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                                    | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                                    | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
| <b>Numerator:</b>                                  |                           |             |                          |             |
| Net income                                         | \$ 53,780                 | \$ 42,314   | \$ 143,356               | \$ 94,816   |
| <b>Denominator:</b>                                |                           |             |                          |             |
| Weighted average common shares outstanding basic   | 56,482,679                | 54,518,162  | 56,872,071               | 54,502,081  |
| Dilutive effect of stock options                   |                           | 77,250      | 58,676                   | 75,857      |
| Dilutive effect of unvested restricted shares      | 94,384                    | 104,978     | 127,328                  | 75,429      |
| Weighted average common shares outstanding diluted | 56,577,063                | 54,700,390  | 57,058,075               | 54,653,367  |
| Net income per common share:                       |                           |             |                          |             |
| Basic                                              | \$ 0.95                   | \$ 0.78     | \$ 2.52                  | \$ 1.74     |
| Diluted                                            | \$ 0.95                   | \$ 0.77     | \$ 2.51                  | \$ 1.73     |

Diluted earnings per share (EPS) reflects the potential dilution that could occur from outstanding equity plan awards, including unexercised stock options and unvested restricted shares. The dilutive effect is computed using the treasury stock method, which assumes all share-based awards are exercised and the hypothetical proceeds from exercise are used by the Company to purchase common stock at the average market price during the period. The incremental shares (difference between shares assumed to be issued versus purchased), to the extent they would have been dilutive, are included in the denominator of the diluted EPS calculation. Options with respect to 4.2 million shares were antidilutive and therefore excluded from the computation of diluted earnings per share for the three months ended September 30, 2010 and 2009. Options with respect to 4.1 million shares and 4.2 million shares were antidilutive and therefore excluded from the computation of diluted earnings per share for the nine months ended September 30, 2010 and 2009, respectively.

**(12) Debt**

Long-term debt at September 30, 2010 and December 31, 2009 consisted of the following (in thousands):

|                                         | <b>September 30,</b> | <b>December 31,</b> |
|-----------------------------------------|----------------------|---------------------|
|                                         | <b>2010</b>          | <b>2009</b>         |
| Credit agreement                        | \$ 166,250           | \$ 236,973          |
| Less: current portion of long-term debt | (17,500)             | (43,069)            |
| Long-term debt less current portion     | \$ 148,750           | \$ 193,904          |

On February 11, 2010, the Company entered into a \$350.0 million credit agreement (the New Credit Agreement ), which, subject to the terms and conditions set forth therein, provides for a five-year \$175.0 million term loan credit facility and a four-year \$175.0 million revolving credit facility (the New Credit Facilities ). Proceeds from the New Credit Facilities, together with cash on hand, were used to fund the repayment of \$237.0 million in term loans outstanding under the 2007 Credit Agreement as well as transaction expenses related thereto.

Borrowings under the New Credit Agreement accrue interest on the basis of either a base rate or a LIBOR rate plus, in each case, an applicable margin depending on the Company s debt-to-EBITDA leverage ratio (275 basis points for LIBOR borrowings at September 30, 2010). The Company also pays a commitment fee of 0.375% on the actual daily unused portions of the New Credit Facilities. The revolving credit facility under the New Credit Agreement matures, the commitments thereunder terminate, and all amounts then outstanding thereunder will be payable on February 11, 2014. As of September 30, 2010, the revolving credit facility was undrawn.

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The term loans under the New Credit Agreement are payable in equal quarterly principal installments aggregating 10% of the aggregate initial principal amount of the term loans in the first year, with the remaining outstanding principal balance of the term loans being payable in equal quarterly installments aggregating 10%, 10%, 15%, and 55% in the second, third, fourth, and fifth years, respectively. The net proceeds from certain asset sales, casualty/condemnation events, and certain incurrences of indebtedness (subject, in the cases of asset sales and casualty/condemnation events, to certain reinvestment rights), and a portion of the net proceeds from equity issuances and, under certain circumstances, the Company's excess cash flow, are required to be used to make prepayments in respect of loans outstanding under the New Credit Facilities. The term loans made under the New Credit Agreement mature, and all amounts then outstanding thereunder will be payable on February 11, 2015.

In connection with entering into the New Credit Agreement, the Company wrote-off unamortized deferred financing costs of approximately \$5.1 million incurred in connection with the 2007 Credit Agreement. The Company also terminated its outstanding interest rate swap agreements, which resulted in a payment of approximately \$2.0 million to the swap counterparties. Such amounts are reflected as interest expense in the financial results of the Company for the nine months ending September 30, 2010.

In connection with the acquisition of Bravo (which is expected to close in the fourth quarter of 2010), the Company has agreed with its existing lenders and certain additional lenders to amend the New Credit Agreement to provide for, among other things, the acquisition financing. As amended, the facility will provide for the following:

\$355.0 million in term loan A indebtedness maturing in February 2015 comprised of:

\$175.0 million of term loan A indebtedness (\$166.3 million of which is currently outstanding);

\$180.0 million of new term loan A indebtedness to be funded at the closing of the acquisition;

\$175.0 million revolving credit facility (currently undrawn and maturing in February 2014); and

\$200.0 million of new six-year term loan B indebtedness to be funded at the closing of the acquisition.

Maturities of principal amounts under the new term A borrowings will mirror the maturities of the existing term loan A borrowings. The Company currently expects that outstanding loans under the new credit facility will bear interest at a spread over LIBOR (initially 375 basis points for term loan A indebtedness and 450 basis points for term loan B indebtedness), and will step down depending on the Company's total leverage ratio. With respect to the term loan B indebtedness, the terms of the facility include a contractual minimum LIBOR of 1.5%. See Agreement to Acquire Bravo Health included above in Note 1 for additional information related thereto.

As of September 30, 2010, the Company had incurred \$8.8 million in debt issue costs associated with the amended credit facility. Such amounts are included in other non-current assets on the Company's balance sheet at September 30, 2010.

**(13) Comprehensive Income**

The following table presents details supporting the determination of comprehensive income for the three and nine months ended September 30, 2010 and 2009 (in thousands):

|                                                                                                    | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|----------------------------------------------------------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                                                                                    | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                                                                                    | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
| Net income                                                                                         | \$ 53,780                 | \$ 42,314   | \$ 143,356               | \$ 94,816   |
| Net unrealized gain on available for sale investment securities, net of tax                        | 2,144                     | 51          | 4,136                    | 189         |
| Net gain on interest rate swaps, net of tax                                                        |                           | 84          | 23                       | 478         |
| Reclass of accumulated other comprehensive income on interest rate swap termination <sup>(1)</sup> |                           |             | 1,253                    |             |

|                                  |           |           |            |           |
|----------------------------------|-----------|-----------|------------|-----------|
| Comprehensive income, net of tax | \$ 55,924 | \$ 42,449 | \$ 148,768 | \$ 95,483 |
|----------------------------------|-----------|-----------|------------|-----------|

(1) Accumulated other comprehensive income balances related to interest rate swap derivatives that were reclassified to interest expense and recognized in the three months ended March 31, 2010. See Note 8, Derivatives .

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**(14) Segment Information**

The Company reports its business in three segments: Medicare Advantage, stand-alone PDP, and Corporate. Medicare Advantage ( MA-PD ) consists of Medicare-eligible beneficiaries receiving healthcare benefits, including prescription drugs, through a coordinated care plan qualifying under Part C and Part D of the Medicare Program. Stand-alone PDP ( PDP ) consists of Medicare-eligible beneficiaries receiving prescription drug benefits on a stand-alone basis in accordance with Medicare Part D. The Corporate segment consists primarily of corporate expenses not allocated to the other reportable segments. These segment groupings are also consistent with information used by the Company's chief executive officer in making operating decisions.

The accounting policies of each segment are the same and are described in Note 1 to the 2009 Form 10-K. The results of each segment are measured and evaluated by earnings before interest expense, depreciation and amortization expense, and income taxes ( EBITDA ). The Company does not allocate certain corporate overhead amounts (classified as selling, general and administrative expenses, or SG&A ) or interest expense to the segments. The Company evaluates interest expense, income taxes, and asset and liability details on a consolidated basis as these items are managed in a corporate shared service environment and are not the responsibility of segment operating management. Revenue includes premium revenue, management and other fee income, and investment income.

Asset and equity details by reportable segment have not been disclosed, as the Company does not internally report such information.

Financial data by reportable segment for the three and nine months ended September 30 is as follows (in thousands):

|                                              | <b>MA-PD</b> | <b>PDP</b> | <b>Corporate</b> | <b>Total</b> |
|----------------------------------------------|--------------|------------|------------------|--------------|
| <b>Three months ended September 30, 2010</b> |              |            |                  |              |
| Revenue                                      | \$ 631,758   | \$ 93,452  | \$ 12            | \$ 725,222   |
| EBITDA                                       | 91,593       | 11,938     | (7,796)          | 95,735       |
| Depreciation and amortization expense        | 6,166        | 14         | 1,333            | 7,513        |
| <b>Three months ended September 30, 2009</b> |              |            |                  |              |
| Revenue                                      | \$ 590,720   | \$ 69,044  | \$ 16            | \$ 659,780   |
| EBITDA                                       | 75,721       | 8,039      | (9,309)          | 74,451       |
| Depreciation and amortization expense        | 6,330        | 20         | 1,432            | 7,782        |
| <b>Nine months ended September 30, 2010</b>  |              |            |                  |              |
| Revenue                                      | \$ 1,915,782 | \$ 338,323 | \$ 38            | \$ 2,254,143 |
| EBITDA                                       | 273,415      | 11,337     | (20,294)         | 264,458      |
| Depreciation and amortization expense        | 18,596       | 45         | 4,169            | 22,810       |
| <b>Nine months ended September 30, 2009</b>  |              |            |                  |              |
| Revenue                                      | \$ 1,739,239 | \$ 249,158 | \$ 42            | \$ 1,988,439 |
| EBITDA                                       | 191,961      | 10,295     | (21,706)         | 180,550      |
| Depreciation and amortization expense        | 19,052       | 60         | 3,836            | 22,948       |



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**HEALTHSPRING, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

As of January 1, 2010, the Company revised its methodology for allocating SG&A expenses within its prescription drug operations to its MA-PD and PDP segments, which resulted in allocating a greater share of such expenses to its PDP segment. As a result of these revisions, the segment EBITDA amounts for the 2009 period include reclassification adjustments between segments such that the periods presented are comparable.

The Company uses segment EBITDA as an analytical indicator for purposes of assessing segment performance, as is common in the healthcare industry. Segment EBITDA should not be considered as a measure of financial performance under generally accepted accounting principles and segment EBITDA, as presented, may not be comparable to other companies.

A reconciliation of reportable segment EBITDA to net income included in the consolidated statements of income for the three and nine months ended September 30 is as follows (in thousands):

|                               | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-------------------------------|---------------------------|-------------|--------------------------|-------------|
|                               | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                               | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
| EBITDA                        | \$ 95,735                 | \$ 74,451   | \$ 264,458               | \$ 180,550  |
| Income tax expense            | (31,292)                  | (20,593)    | (82,917)                 | (50,772)    |
| Interest expense              | (3,150)                   | (3,762)     | (15,375)                 | (12,014)    |
| Depreciation and amortization | (7,513)                   | (7,782)     | (22,810)                 | (22,948)    |
| Net Income                    | \$ 53,780                 | \$ 42,314   | \$ 143,356               | \$ 94,816   |

**Table of Contents****Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations**

You should read the following discussion and analysis in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this report and our audited consolidated financial statements and the notes thereto for the year ended December 31, 2009, appearing in our Annual Report on Form 10-K that was filed with the Securities and Exchange Commission ( SEC ) on February 11, 2010 (the 2009 Form 10-K ). Statements contained in this Quarterly Report on Form 10-Q that are not historical fact are forward-looking statements that the company intends to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Statements that are predictive in nature, that depend on or refer to future events or conditions, or that include words such as anticipates, believes, could, estimates, expects, intends, potential, predicts, projects, should, will, would, and similar expressions are forward-looking statements. The company cautions that forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause our actual results, performance, or achievements to be materially different from any future results, performance, or achievements expressed or implied by the forward-looking statements. Forward-looking statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. In evaluating any forward-looking statement, you should specifically consider the information set forth under the captions Special Note Regarding Forward-Looking Statements and Item 1A. Risk Factors in the 2009 Form 10-K and the information set forth under Cautionary Statement Regarding Forward-Looking Statements in our earnings and other press releases, as well as other cautionary statements contained elsewhere in this report, including the matters discussed in Part II, Item 1A. Risk Factors below and Critical Accounting Policies and Estimates. We undertake no obligation beyond that required by law to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future. You should read this report and the documents that we reference in this report and have filed as exhibits to this report completely and with the understanding that our actual future results may be materially different from what we expect.

**Overview****General**

HealthSpring, Inc. (the company or HealthSpring ) is one of the country's largest coordinated care plans whose primary focus is Medicare, the federal government-sponsored health insurance program for U.S. citizens aged 65 and older, qualifying disabled persons, and persons suffering from end-stage renal disease. We operate Medicare Advantage plans in Alabama, Florida, Georgia, Illinois, Mississippi, Tennessee, and Texas and offer Medicare Part D prescription drug plans on a national basis. The company also provides management services to physician practices. We sometimes refer to our Medicare Advantage plans, including plans providing prescription drug benefits, or MA-PD, collectively as Medicare Advantage plans and our stand-alone prescription drug plan as our PDP. For purposes of additional analysis, the company provides membership and certain financial information, including premium revenue and medical expense, for our Medicare Advantage (including MA-PD) and PDP plans.

Medicare premiums, including premiums paid to our PDP, account for substantially all of our revenue. As a consequence, our profitability is dependent on government funding levels for Medicare programs. The Centers for Medicare and Medicaid Services ( CMS ) is the federal agency responsible for overseeing the Medicare program. The company's Tennessee Medicare Advantage plan was selected by CMS for a RADV Audit of the 2006 risk adjustment data used to determine 2007 premium rates (sometimes referred to as RADV Audits ). In February 2010, the company responded to the RADV Audit information request, including retrieving and providing medical records that support diagnosis codes and risk scores relating to 2006 dates of service and 2007 plan premiums. The company is currently unable to predict the outcome of the RADV Audit, or to predict the amount of premiums, if any, that may be subject to repayment by the Tennessee plan to CMS.

Recent health insurance reform, as embodied in the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act (collectively, PPACA ) signed by the President into law in March 2010, is projected to result in a significant reduction in federal spending on the Medicare Advantage program. In addition to Medicare Advantage funding cuts, PPACA reduces enrollment periods, establishes medical loss ratio, or MLR, minimum levels, ties certain rate and rebate benefits to quality ratings, and imposes federal premium taxes. These

changes may have a significant adverse impact on our business, including member growth prospects and financial results. Most of the provisions of PPACA that are material to our business phase in over a number of years and regulations defining and implementing key provisions of PPACA applicable to us are not yet developed. Consequently, we are currently unable to predict with any reasonable certainty or otherwise quantify the likely impact of PPACA on our business model, financial condition, or results of operations.

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We report our business in three segments: Medicare Advantage; PDP; and Corporate. The following discussion of our results of operations includes a discussion of revenue and certain expenses by reportable segment. See Segment Information below for additional information related thereto.

***Agreement to Acquire Bravo Health***

On August 26, 2010, the company entered into a definitive agreement to acquire all of the outstanding capital stock of Bravo Health, Inc. ( Bravo ), an operator of Medicare Advantage coordinated care plans in Pennsylvania, the Mid-Atlantic region, and Texas, and Medicare Part D stand-alone prescription drug plans in 43 states. The company will acquire Bravo, a privately held company, for approximately \$545.0 million in cash, subject to adjustment. The company has agreed with its existing lenders and certain additional lenders to amend its existing credit facility to provide for, among other things, the acquisition financing. As amended, the facility will provide for the following:

- \$355.0 million in term loan A indebtedness maturing in February 2015 comprised of:
  - \$175.0 million of term loan A indebtedness (\$166.3 million of which is currently outstanding);
  - \$180.0 million of new term loan A indebtedness to be funded at the closing of the acquisition;
- \$175.0 million revolving credit facility (currently undrawn and maturing in February 2014); and
- \$200.0 million of new six-year term loan B indebtedness to be funded at the closing of the acquisition.

The additional term loan indebtedness, availability under the existing \$175.0 million revolving credit facility, and cash on hand will be sufficient to fund the acquisition of Bravo. See Indebtedness .

The remaining material conditions to the closing of the Bravo acquisition primarily relate to approvals by various state regulatory authorities.

Other than financing commitments accounted for as interest expenses, Bravo-related transaction expenses were insignificant for the 2010 third quarter. Assuming the transaction closes in 2010, the company expects to incur approximately \$8.5 million, or \$0.11 per share, of transaction expenses in 2010. As of September 30, 2010, Bravo had Medicare Advantage membership of 103,044 and stand-alone PDP membership of 293,920. Based upon recent data released by CMS, Bravo estimates it will have approximately 390,000-400,000 PDP members as of January 1, 2011.

**Recently Issued Accounting Pronouncements*****Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts***

In September 2010, the Emerging Issues Task Force issued EITF Issue 09-G, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts ( EITF Issue 09-G ), which modifies the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal insurance contracts. The Task Force reached a final consensus that requires costs to be incremental or directly related to the successful acquisition of new or renewal contracts to be capitalized as a deferred acquisition cost. EITF Issue 09-G is effective for the company beginning with its interim period ended March 31, 2012 with either prospective or retrospective application permitted. Early adoption is permitted. We are currently evaluating the impact that EITF Issue 09-G will have on our consolidated financial statements.

**Table of Contents****Results of Operations**

The consolidated results of operations include the accounts of HealthSpring and its subsidiaries. The following table sets forth the consolidated statements of income data expressed in dollars (in thousands) and as a percentage of total revenue for each period indicated:

|                                     | <b>Three Months Ended September 30,</b> |               |                  |               |
|-------------------------------------|-----------------------------------------|---------------|------------------|---------------|
|                                     | <b>2010</b>                             |               | <b>2009</b>      |               |
| Revenue:                            |                                         |               |                  |               |
| Premium revenue                     | \$ 712,658                              | 98.3%         | \$ 649,795       | 98.5%         |
| Management and other fees           | 10,413                                  | 1.4           | 9,108            | 1.4           |
| Investment income                   | 2,151                                   | 0.3           | 877              | 0.1           |
| <b>Total revenue</b>                | <b>725,222</b>                          | <b>100.0%</b> | <b>659,780</b>   | <b>100.0%</b> |
| Operating expenses:                 |                                         |               |                  |               |
| Medical expense                     | 561,823                                 | 77.5          | 519,478          | 78.7          |
| Selling, general and administrative | 67,664                                  | 9.3           | 65,851           | 10.0          |
| Depreciation and amortization       | 7,513                                   | 1.0           | 7,782            | 1.2           |
| Interest expense                    | 3,150                                   | 0.5           | 3,762            | 0.6           |
| <b>Total operating expenses</b>     | <b>640,150</b>                          | <b>88.3</b>   | <b>596,873</b>   | <b>90.5</b>   |
| Income before income taxes          | 85,072                                  | 11.7          | 62,907           | 9.5           |
| Income tax expense                  | (31,292)                                | (4.3)         | (20,593)         | (3.1)         |
| <b>Net income</b>                   | <b>\$ 53,780</b>                        | <b>7.4%</b>   | <b>\$ 42,314</b> | <b>6.4%</b>   |

|                                     | <b>Nine Months Ended September 30,</b> |               |                  |               |
|-------------------------------------|----------------------------------------|---------------|------------------|---------------|
|                                     | <b>2010</b>                            |               | <b>2009</b>      |               |
| Revenue:                            |                                        |               |                  |               |
| Premium revenue                     | \$ 2,218,378                           | 98.4%         | \$ 1,955,842     | 98.3%         |
| Management and other fees           | 31,191                                 | 1.4           | 29,065           | 1.5           |
| Investment income                   | 4,574                                  | 0.2           | 3,532            | 0.2           |
| <b>Total revenue</b>                | <b>2,254,143</b>                       | <b>100.0%</b> | <b>1,988,439</b> | <b>100.0%</b> |
| Operating expenses:                 |                                        |               |                  |               |
| Medical expense                     | 1,779,275                              | 78.9          | 1,607,481        | 80.8          |
| Selling, general and administrative | 210,410                                | 9.3           | 200,408          | 10.1          |
| Depreciation and amortization       | 22,810                                 | 1.0           | 22,948           | 1.2           |
| Interest expense                    | 15,375                                 | 0.8           | 12,014           | 0.6           |
| <b>Total operating expenses</b>     | <b>2,027,870</b>                       | <b>90.0</b>   | <b>1,842,851</b> | <b>92.7</b>   |
| Income before income taxes          | 226,273                                | 10.0          | 145,588          | 7.3           |
| Income tax expense                  | (82,917)                               | (3.6)         | (50,772)         | (2.5)         |
| <b>Net income</b>                   | <b>\$ 143,356</b>                      | <b>6.4%</b>   | <b>\$ 94,816</b> | <b>4.8%</b>   |



**Table of Contents****Membership**

Our primary source of revenue is monthly premium payments we receive based on membership enrolled in Medicare. The following table summarizes our membership as of the dates specified:

|                                      | <b>September<br/>30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> | <b>September<br/>30,<br/>2009</b> |
|--------------------------------------|-----------------------------------|----------------------------------|-----------------------------------|
| <i>Medicare Advantage Membership</i> |                                   |                                  |                                   |
| Alabama                              | 30,397                            | 31,330                           | 31,007                            |
| Florida                              | 36,472                            | 32,606                           | 31,513                            |
| Georgia                              | 769                               |                                  |                                   |
| Illinois                             | 11,730                            | 11,261                           | 11,077                            |
| Mississippi                          | 5,328                             | 4,591                            | 4,473                             |
| Tennessee                            | 65,334                            | 58,252                           | 57,240                            |
| Texas                                | 48,025                            | 51,201                           | 51,325                            |
| Total                                | 198,055                           | 189,241                          | 186,635                           |
| <i>Medicare PDP Membership</i>       | 409,239                           | 313,045                          | 303,975                           |

**Medicare Advantage.** Our Medicare Advantage membership increased by 6.1% to 198,055 members at September 30, 2010, as compared to 186,635 members at September 30, 2009, with membership gains in all our health plans except our Alabama and Texas plans. Our Medicare Advantage net membership gain of 11,420 members since September 30, 2009 reflects both focused sales and marketing efforts through the annual open enrollment and election periods and better retention rates resulting from, we believe, the relative attractiveness of our various plans' benefits. Effective as of January 1, 2010, we began operating Medicare Advantage plans in three counties in Northern Georgia.

**PDP.** PDP membership increased by 34.6% to 409,239 members at September 30, 2010 as compared to 303,975 at September 30, 2009, primarily as a result of the auto-assignment of members at the beginning of the year. We do not actively market our PDP and have relied on CMS auto-assignments of dual-eligible beneficiaries for membership. We have continued to receive assignments or otherwise enroll dual-eligible beneficiaries in our PDP plans during lock-in and expect incremental growth for the balance of the year.

According to CMS, we are below the relevant benchmarks and will retain existing membership and be qualified for auto-assignment of new members in 18 of the 34 CMS PDP regions for 2011. In addition, under CMS's new de minimus rules, we will retain existing membership in 8 of the regions. Based upon recent data released by CMS, the company now estimates it will have approximately 425,000-435,000 members in these 26 regions as of January 1, 2011 (excluding any members acquired in the Bravo acquisition).

### **Comparison of the Three-Month Period Ended September 30, 2010 to the Three-Month Period Ended September 30, 2009**

#### **Revenue**

Total revenue was \$725.2 million in the three-month period ended September 30, 2010 as compared with \$659.8 million for the same period in 2009, representing an increase of \$65.4 million, or 9.9%. The components of revenue were as follows:

**Premium Revenue:** Total premium revenue for the three months ended September 30, 2010 was \$712.7 million as compared with \$649.8 million in the same period in 2009, representing an increase of \$62.9 million, or 9.7%. The components of premium revenue and the primary reasons for changes were as follows:

**Medicare Advantage:** Medicare Advantage (including MA-PD) premiums were \$618.9 million for the three months ended September 30, 2010 as compared to \$580.0 million in the third quarter of 2009, representing an increase of \$38.9 million, or 6.7%. The increase in Medicare Advantage premiums in 2010 is primarily attributable to increases in

membership. Per member per month ( PMPM ) premiums for the 2010 third quarter averaged \$1,042, and were level compared to the 2009 third quarter, as expected. PMPM premiums in the current quarter reflect increases in the PMPM premium for the drug component of our plans and increases related to member risk scores, offset by decreases in CMS-calculated base rates.



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**PDP:** PDP premiums (after risk corridor adjustments) were \$93.4 million in the three months ended September 30, 2010 compared to \$69.0 million in the same period of 2009, an increase of \$24.4 million, or 35.4%. The increase in premiums for the 2010 third quarter is primarily the result of increases in membership. Our average PMPM premiums (after risk corridor adjustments) were \$77 in the 2010 third quarter, compared with \$76 in the 2009 third quarter.

**Investment Income:** Investment income in the 2010 third quarter increased \$1.3 million compared with the 2009 third quarter as a result of increases in invested balances, as the company has moved substantial amounts out of cash and cash equivalents into investments since the 2009 third quarter, and in the average duration and yield on invested assets in the portfolio.

***Medical Expense***

**Medicare Advantage.** Medicare Advantage (including MA-PD) medical expense for the three months ended September 30, 2010 increased \$23.9 million, or 5.2%, to \$486.1 million from \$462.2 million for the comparable period of 2009, which is primarily attributable to membership increases in the 2010 period as compared to the 2009 period. For the three months ended September 30, 2010, the Medicare Advantage MLR was 78.5% versus 79.7% for the same period of 2009. Changes in benefit design and decreases in inpatient utilization contributed to the decrease in the current period MLR. Moreover, improved results for the drug component of our Medicare Advantage plans contributed to the improved MLR. This improvement in the drug component of our Medicare Advantage MLR was attributable to both higher PMPM premiums and to lower drug expenses as a result of increased pharmacy rebates. Our Medicare Advantage medical expense calculated on a PMPM basis was \$818 for the three months ended September 30, 2010, compared with \$831 for the comparable 2009 quarter.

**PDP.** PDP medical expense for the three months ended September 30, 2010 increased \$19.1 million to \$75.4 million, compared to \$56.3 million in the same period last year. PDP MLR for the 2010 third quarter was 80.7%, compared to 81.5% in the 2009 third quarter. The improvement in MLR for the 2010 third quarter was primarily the result of increased levels of rebates from drug manufacturers compared to the 2009 third quarter.

***Selling, General, and Administrative Expense***

Selling, general, and administrative, or SG&A, expense for the three months ended September 30, 2010 was \$67.7 million as compared with \$65.9 million for the same prior year period, an increase of \$1.8 million, or 2.8%. The increase in the 2010 third quarter as compared to the prior year period is primarily the result of increases in printing and advertising. As a percentage of revenue, SG&A expense decreased approximately 70 basis points for the three months ended September 30, 2010 compared to the prior year period. As a result of the shortened 2011 enrollment period, which will no longer permit enrollment elections after the calendar year end, the company will accelerate marketing expenses typically spread over the fourth quarter of the current year and first quarter of the subsequent year into the fourth quarter of 2010.

***Interest Expense***

Interest expense was \$3.1 million in the 2010 third quarter, compared with \$3.8 million in the 2009 third quarter. The decrease in the current quarter was the result of lower average debt amounts outstanding and lower interest rates compared to the 2009 third quarter. Interest expense in the 2010 third quarter includes approximately \$1.0 million of fees associated with amending the existing credit facility (see **Indebtedness** below). The weighted average interest rate incurred on our borrowings during the three months ended September 30, 2010 and 2009 was 7.2% and 5.9%, respectively (3.2% and 4.7%, respectively, exclusive of amortization of deferred financing costs and credit facility fees).

***Income Tax Expense***

For the three months ended September 30, 2010, income tax expense was \$31.3 million, reflecting an effective tax rate of 36.8%, as compared to \$20.6 million, reflecting an effective tax rate of 32.7%, for the same period of 2009. The difference in tax rates was principally driven from the tax impact related to business combination accounting during both periods. The Company expects the effective tax rate for the full 2010 year will approximate 36.5% (exclusive of any impact associated with the Bravo acquisition).



**Table of Contents****Comparison of the Nine-Month Period Ended September 30, 2010 to the Nine-Month Period Ended September 30, 2009*****Revenue***

Total revenue was \$2.3 billion in the nine-month period ended September 30, 2010 as compared with \$2.0 billion for the same period in 2009, representing an increase of \$265.7 million, or 13.4%. The components of revenue were as follows:

***Premium Revenue:*** Total premium revenue for the nine months ended September 30, 2010 was \$2.2 billion as compared with \$2.0 billion in the same period in 2009, representing an increase of \$262.5 million, or 13.4%. The components of premium revenue and the primary reasons for changes were as follows:

***Medicare Advantage:*** Medicare Advantage (including MA-PD) premiums increased \$174.4 million, or 10.2%, to \$1.9 billion for the nine months ended September 30, 2010 as compared to the same period of 2009. The increase in Medicare Advantage premiums in 2010 is primarily attributable to increases in membership. PMPM premiums for the current nine month period averaged \$1,062, which reflects an increase of 0.7% as compared to the 2009 comparable period. The PMPM premium increase in the current period is primarily the result of increases in the drug component portion of the premium and increases related to member risk scores, which were partially offset by decreases in CMS-calculated base rates.

***PDP:*** PDP premiums (after risk corridor adjustments) were \$338.3 million in the nine months ended September 30, 2010 compared to \$248.9 million in the same period of 2009, an increase of \$89.4 million, or 35.9%. The increase in premiums for the current nine month period is primarily the result of increases in membership. Our average PMPM premiums (after risk corridor adjustments) were \$95 in the current nine month period, which is flat compared to the 2009 comparable period.

***Medical Expense***

***Medicare Advantage.*** Medicare Advantage (including MA-PD) medical expense for the nine months ended September 30, 2010 increased \$89.5 million, or 6.5%, to \$1.5 billion from \$1.4 billion for the comparable period of 2009, which is primarily attributable to membership increases in the 2010 period as compared to the 2009 period. For the nine months ended September 30, 2010, the Medicare Advantage MLR was 78.2% versus 81.0% for the same period of 2009. The MLR improvement in the current period is primarily attributable to changes in benefit design and lower inpatient utilization, combined with premium revenue increases. Our Medicare Advantage medical expense calculated on a PMPM basis was \$831 for the nine months ended September 30, 2010, compared with \$854 for the comparable 2009 period.

***PDP.*** PDP medical expense for the nine months ended September 30, 2010 increased \$83.7 million to \$308.2 million, compared to \$224.5 million in the same period last year. PDP MLR for the 2010 nine month period was 91.1%, compared to 90.2% in the same period in 2009. The increase in PDP MLR for the current period was primarily attributable to changes in benefit design and increased transition prescription drug costs offset by favorable levels of pharmacy rebates in the 2010 period.

***Selling, General, and Administrative Expense***

SG&A expense for the nine months ended September 30, 2010 was \$210.4 million as compared with \$200.4 million for the same prior year period, an increase of \$10.0 million, or 5.0%. The increase in the 2010 period as compared to the prior year period is primarily the result of additional personnel, increases in sales commissions attributable to membership growth, and increases in printing. As a percentage of revenue, SG&A expense decreased approximately 80 basis points for the nine months ended September 30, 2010 compared to the prior year period.

***Interest Expense***

Interest expense was \$15.4 million in the 2010 nine month period, compared with \$12.0 million in the 2009 same period. The company's interest expense in the 2010 period includes debt extinguishment costs of \$7.1 million resulting from the company's entering into a new credit facility and terminating its prior credit facility during the first quarter. Net of extinguishment costs, interest expense decreased \$3.7 million in the 2010 period, reflecting lower average debt amounts outstanding and lower interest rates compared to the 2009 period. The weighted average interest rate incurred on our borrowings during the nine month periods ended September 30, 2010 and 2009 was 5.9% and 6.1%, respectively (3.5% and 4.9%, respectively, exclusive of amortization of deferred financing costs and credit facility

fees).

**Table of Contents****Income Tax Expense**

For the nine months ended September 30, 2010, income tax expense was \$82.9 million, reflecting an effective tax rate of 36.6%, as compared to \$50.8 million, reflecting an effective tax rate of 34.9%, for the same period of 2009. The difference in tax rates was principally driven by business combination accounting, as well as the reversal of tax benefits on cancelled stock compensation awards and state tax credits.

**Segment Information**

We report our business in three segments: Medicare Advantage, stand-alone PDP, and Corporate. Medicare Advantage ( MA-PD ) consists of Medicare-eligible beneficiaries receiving healthcare benefits, including prescription drugs, through a coordinated care plan qualifying under Part C and Part D of the Medicare Program. Stand-alone PDP consists of Medicare-eligible beneficiaries receiving prescription drug benefits on a stand-alone basis in accordance with Medicare Part D. The Corporate segment consists primarily of corporate expenses not allocated to the other reportable segments. These segment groupings are also consistent with information used by our chief executive officer in making operating decisions.

The results of each segment are measured and evaluated by earnings before interest expense, depreciation and amortization expense, and income taxes ( EBITDA ). We do not allocate certain corporate overhead amounts (classified as SG&A expense) or interest expense to our segments. We evaluate interest expense, income taxes, and asset and liability details on a consolidated basis as these items are managed in a corporate shared service environment and are not the responsibility of segment operating management.

Revenue includes premium revenue, management and other fee income, and investment income.

Asset and equity details by reportable segment have not been disclosed, as the company does not internally report such information.

Financial data by reportable segment for the three and nine months ended September 30 is as follows (in thousands):

|                                              | MA-PD        | PDP        | Corporate | Total        |
|----------------------------------------------|--------------|------------|-----------|--------------|
| <b>Three months ended September 30, 2010</b> |              |            |           |              |
| Revenue                                      | \$ 631,758   | \$ 93,452  | \$ 12     | \$ 725,222   |
| EBITDA                                       | 91,593       | 11,938     | (7,796)   | 95,735       |
| Depreciation and amortization expense        | 6,166        | 14         | 1,333     | 7,513        |
| <b>Three months ended September 30, 2009</b> |              |            |           |              |
| Revenue                                      | \$ 590,720   | \$ 69,044  | \$ 16     | \$ 659,780   |
| EBITDA                                       | 75,721       | 8,039      | (9,309)   | 74,451       |
| Depreciation and amortization expense        | 6,330        | 20         | 1,432     | 7,782        |
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| Revenue                                      | \$ 1,915,782 | \$ 338,323 | \$ 38     | \$ 2,254,143 |
| EBITDA                                       | 273,415      | 11,337     | (20,294)  | 264,458      |
| Depreciation and amortization expense        | 18,596       | 45         | 4,169     | 22,810       |
| <b>Nine months ended September 30, 2009</b>  |              |            |           |              |
| Revenue                                      | \$ 1,739,239 | \$ 249,158 | \$ 42     | \$ 1,988,439 |
| EBITDA                                       | 191,961      | 10,295     | (21,706)  | 180,550      |
| Depreciation and amortization expense        | 19,052       | 60         | 3,836     | 22,948       |

As of January 1, 2010, the company revised its methodology for allocating selling, general, and administrative expenses within its prescription drug operations to its MA-PD and PDP segments, which resulted in allocating a greater share of such expenses to its PDP segment. As a result of these revisions, the segment EBITDA amounts for the 2009 period includes reclassification adjustments between segments such that the periods presented are comparable.



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We use segment EBITDA as an analytical indicator for purposes of assessing segment performance, as is common in the healthcare industry. Segment EBITDA should not be considered as a measure of financial performance under generally accepted accounting principles and segment EBITDA, as presented, may not be comparable to other companies.

A reconciliation of reportable segment EBITDA to net income included in the consolidated statements of income for the three and nine months ended September 30 is as follows (in thousands):

|                               | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-------------------------------|---------------------------|-------------|--------------------------|-------------|
|                               | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                               | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
| EBITDA                        | \$ 95,735                 | \$ 74,451   | \$ 264,458               | \$ 180,550  |
| Income tax expense            | (31,292)                  | (20,593)    | (82,917)                 | (50,772)    |
| Interest expense              | (3,150)                   | (3,762)     | (15,375)                 | (12,014)    |
| Depreciation and amortization | (7,513)                   | (7,782)     | (22,810)                 | (22,948)    |
| Net Income                    | \$ 53,780                 | \$ 42,314   | \$ 143,356               | \$ 94,816   |

***Liquidity and Capital Resources***

We finance our operations primarily through internally generated funds. We generate cash primarily from premium revenue and our primary uses of cash are payment of medical and SG&A expenses and principal and interest on indebtedness. We anticipate that our current level of cash on hand, internally generated cash flows, and borrowings available under our revolving credit facility will be sufficient to fund our working capital needs, our debt service, and anticipated capital expenditures over at least the next twelve months.

The reported changes in cash and cash equivalents for the nine month period ended September 30, 2010, compared to the same period of 2009, were as follows (in thousands):

|                                                      | <b>Nine Months Ended</b> |             |
|------------------------------------------------------|--------------------------|-------------|
|                                                      | <b>September 30,</b>     |             |
|                                                      | <b>2010</b>              | <b>2009</b> |
| Net cash provided by operating activities            | \$ 155,768               | \$ 116,209  |
| Net cash used in investing activities                | (243,269)                | (20,956)    |
| Net cash (used in) provided by financing activities  | (113,684)                | 12,273      |
| Net (decrease) increase in cash and cash equivalents | \$ (201,185)             | \$ 107,526  |

***Cash Flows from Operating Activities***

Our primary sources of liquidity are cash flows provided by our operations and available cash on hand, although the company's access to and use of internally generated cash flows may be limited by regulatory requirements which stipulate that the company's regulated insurance subsidiaries maintain minimum levels of capital. See Statutory Capital Requirements. To date, we have not had to borrow under our \$175.0 million revolving credit facility to fund operating activities. See Indebtedness for a discussion of borrowings under the revolving credit facility in connection with the Bravo acquisition. We generated cash from operating activities of \$155.8 million during the nine months ended September 30, 2010, compared to generating cash of \$116.2 million during the nine months ended September 30, 2009. Cash flows from operations for the 2010 period was favorably impacted by increased earnings driven primarily by favorable trends in Medicare Advantage medical expenses in the current period compared to the 2009 period and by the receipt of \$50.2 million of prior year final CMS settlements compared to similar amounts received in the 2009 period of \$31.8 million.

***Cash Flows from Investing and Financing Activities***

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For the nine months ended September 30, 2010, the primary investing activities consisted of expenditures of \$384.3 million to purchase investment securities and restricted investments, the receipt of \$150.5 million in proceeds from the sale or maturity of investment securities and restricted investments, and \$9.1 million spent on property and equipment additions. The investing activity in the prior year period consisted primarily of \$55.8 million to purchase investment securities, the receipt of \$46.8 million in proceeds from the maturity of investment securities, and \$11.5 million in property and equipment additions.



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During the nine months ended September 30, 2010, the company's financing activities consisted primarily of the receipt of \$200.0 million in proceeds from the issuance of debt, the expenditure of \$270.7 million for the repayment of existing long-term debt, and \$22.3 million of funds withdrawn in excess of funds received from CMS for the benefit of members. The financing activity in the prior year period consisted primarily of \$36.1 million of funds received in excess of funds withdrawn from CMS for the benefit of members, and \$23.9 million for the repayment of long-term debt. Funds due for the benefit of members from CMS are recorded on our balance sheet at September 30, 2010 and at December 31, 2009. We settled approximately \$1.9 million of such Part D related amounts (including risk corridor settlements) relating to 2009 with CMS during the fourth quarter of 2010 as part of the final settlement of Part D payments for the 2009 plan year.

**Cash and Cash Equivalents**

At September 30, 2010, the company's cash and cash equivalents were \$238.2 million, \$158.4 million of which was held in unregulated subsidiaries. Substantially all of the company's liquidity is in the form of cash and cash equivalents, a portion of which (\$79.8 million at September 30, 2010) is held by the company's regulated insurance subsidiaries, which amounts are required by law and by our credit agreement to be invested in low-risk, short-term, highly-liquid investments (such as government securities, money market funds, deposit accounts, and overnight repurchase agreements). The company also invests in securities (\$329.3 million at September 30, 2010), primarily corporate, asset-backed and government debt securities, that it generally intends, and has the ability, to hold to maturity. Because the company is not relying on these investment securities for near-term liquidity, short term fluctuations in market pricing generally do not affect the company's ability to meet its liquidity needs. To date, the company has not experienced any material issuer defaults on its investment securities.

**Statutory Capital Requirements**

The company's regulated insurance subsidiaries are required to maintain satisfactory minimum net worth requirements established by their respective state departments of insurance. At September 30, 2010, the statutory minimum net worth requirements and actual statutory net worth were \$18.5 million and \$83.0 million for the Tennessee HMO; \$1.1 million and \$54.8 million for the Alabama HMO; \$10.8 million and \$38.3 million for the Florida HMO; \$38.4 million (at 200% of authorized control level) and \$64.1 million for the Texas HMO; and \$14.6 million (at 200% of authorized control level) and \$42.7 million for the accident and health subsidiary, respectively. Each of these subsidiaries was in compliance with applicable statutory requirements as of September 30, 2010. Notwithstanding the foregoing, the state departments of insurance can require our regulated insurance subsidiaries to maintain minimum levels of statutory capital in excess of amounts required under the applicable state law if they determine that maintaining additional statutory capital is in the best interest of the company's members.

The regulated insurance subsidiaries are restricted from making distributions without appropriate regulatory notifications and approvals or to the extent such dividends would put them out of compliance with statutory net worth requirements. During the three months ended September 30, 2010, our insurance subsidiaries distributed \$68.0 million in cash to the parent company.

**Indebtedness**

Long-term debt at September 30, 2010 and December 31, 2009 consists of the following (in thousands):

|                                         | <b>September 30,<br/>2010</b> | <b>December 31,<br/>2008</b> |
|-----------------------------------------|-------------------------------|------------------------------|
| Senior secured term loan                | \$ 166,250                    | \$ 236,973                   |
| Less: current portion of long-term debt | (17,500)                      | (43,069)                     |
| Long-term debt less current portion     | \$ 148,750                    | \$ 193,904                   |

On February 11, 2010, the company entered into a \$350.0 million credit agreement (the "New Credit Agreement"), which, subject to the terms and conditions set forth therein, provides for a five-year, \$175.0 million term loan credit facility and a four-year, \$175.0 million revolving credit facility (the "New Credit Facilities"). Proceeds from the New Credit Facilities, together with cash on hand, were used to fund the repayment of \$237.0 million in term loans

outstanding under the company's 2007 credit agreement as well as transaction expenses related thereto. Borrowings under the New Credit Agreement accrue interest on the basis of either a base rate or a LIBOR rate plus, in each case, an applicable margin depending on the company's debt-to-EBITDA leverage ratio (275 basis points for LIBOR borrowings at September 30, 2010). The company also pays a commitment fee of 0.375% on the actual daily unused portions of the New Credit Facilities. The revolving credit facility under the New Credit Agreement matures, the commitments thereunder terminate, and all amounts then outstanding thereunder will be payable on February 11, 2014. As of the date of this report the revolving credit agreement was undrawn.

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In connection with entering into the New Credit Agreement, the company wrote-off unamortized deferred financing costs of approximately \$5.1 million incurred in connection with the 2007 credit agreement. The company also terminated both interest rate swap agreements, which resulted in a payment of approximately \$2.0 million to the swap counterparties. Such amounts are classified as interest expense and are reflected in the financial results of the company for the nine months ended September 30, 2010.

In connection with the acquisition of Bravo (which is expected to close in the fourth quarter of 2010), the company has agreed with its existing lenders and certain additional lenders to amend the New Credit Agreement to provide for, among other things, the acquisition financing. As amended, the facility will provide for the following:

\$355.0 million in term loan A indebtedness maturing in February 2015 comprised of:

\$175.0 million of term loan A indebtedness (\$166.3 million of which is currently outstanding)

\$180.0 million of new term loan A indebtedness to be funded at the closing of the acquisition

\$175.0 million revolving credit facility (currently undrawn and maturing in February 2014)

\$200.0 million of new six-year term loan B indebtedness to be funded at the closing of the acquisition

Maturities of principal amounts under the new term A borrowings will mirror the maturities of the existing term loan A borrowings. The company currently expects that outstanding loans under the new credit facility will bear interest at a spread over LIBOR (initially 375 basis points for term loan A indebtedness and 450 basis points for term loan B indebtedness), and will step down depending on the company's total leverage ratio. With respect to the term loan B indebtedness, the terms of the facility include a contractual minimum LIBOR of 1.5%. See Agreement to Acquire Bravo Health above for additional information related thereto.

***Off-Balance Sheet Arrangements***

At September 30, 2010, we did not have any off-balance sheet arrangement requiring disclosure.

***Contractual Obligations***

We did not experience any material changes to contractual obligations outside the ordinary course of business during the nine months ended September 30, 2010.

***Critical Accounting Policies and Estimates***

The preparation of our consolidated financial statements requires our management to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Our estimates are based on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Changes in estimates are recorded if and when better information becomes available. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in estimates resulting from continuing changes in the economic environment will be reflected in the financial statements in future periods.

We believe that the accounting policies discussed below are those that are most important to the presentation of our financial condition and results of operations and that require our management's most difficult, subjective, and complex judgments. For a more complete discussion of these and other critical accounting policies and estimates of the company, see our 2009 Form 10-K.

***Medical Expense and Medical Claims Liability***

Medical expense is recognized in the period in which services are provided and includes an estimate of the cost of medical expense that has been incurred but not yet reported, or IBNR. Medical expense includes claim payments, capitation payments, risk sharing payments and pharmacy costs, net of rebates, as well as estimates of future payments of claims incurred, net of reinsurance. Capitation payments represent monthly contractual fees disbursed to physicians and other providers who are responsible for providing medical care to members. Pharmacy costs represent payments for members' prescription drug benefits, net of rebates from drug manufacturers. Rebates are recognized when earned, according to the contractual arrangements with the respective vendors.

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Medical claims liability includes medical claims reported to the plans but not yet paid as well as an actuarially determined estimate of claims that have been incurred but not yet reported.

The IBNR component of total medical claims liability is based on our historical claims data, current enrollment, health service utilization statistics, and other related information. Estimating IBNR is complex and involves a significant amount of judgment. Accordingly, it represents our most critical accounting estimate. The development of IBNR includes the use of standard actuarial developmental methodologies, including completion factors and claims trends, which take into account the potential for adverse claims developments, and considers favorable and unfavorable prior period developments. Actual claims payments will differ, however, from our estimates. A worsening or improvement of our claims trend or changes in completion factors from those that we assumed in estimating medical claims liabilities at September 30, 2010 would cause these estimates to change in the near term and such a change could be material.

As discussed above, actual claim payments will differ from our estimates. The period between incurrence of the expense and payment is, as with most health insurance companies, relatively short, however, with over 90% of claims typically paid within 60 days of the month in which the claim is incurred. Although there is a risk of material variances in the amounts of estimated and actual claims, the variance is known quickly. Accordingly, we expect that substantially all of the estimated medical claims payable as of the end of any fiscal period (whether a quarter or year end) will be known and paid during the next fiscal period.

Our policy is to record the best estimate of medical expense IBNR. Using actuarial models, we calculate a minimum amount and maximum amount of the IBNR component. To most accurately determine the best estimate, our actuaries determine the point estimate within their minimum and maximum range by similar medical expense categories within lines of business. The medical expense categories we use are in-patient facility, outpatient facility, all professional expense, and pharmacy.

We apply different estimation methods depending on the month of service for which incurred claims are being estimated. For the more recent months, which account for the majority of the amount of IBNR, we estimate our claims incurred by applying the observed trend factors to the trailing twelve-month PMPM costs. For prior months, costs have been estimated using completion factors. In order to estimate the PMPMs for the most recent months, we validate our estimates of the most recent months' utilization levels to the utilization levels in older months using actuarial techniques that incorporate a historical analysis of claim payments, including trends in cost of care provided, and timeliness of submission and processing of claims.

The following table illustrates the sensitivity of the completion and claims trend factors and the impact on our operating results caused by changes in these factors that management believes are reasonably likely based on our historical experience and September 30, 2010 data (dollars in thousands):

|                                              | <b>Completion Factor (a)</b>               |                                | <b>Claims Trend Factor (b)</b>             |                                |
|----------------------------------------------|--------------------------------------------|--------------------------------|--------------------------------------------|--------------------------------|
|                                              | <b>Increase<br/>(Decrease)</b>             | <b>Increase<br/>(Decrease)</b> | <b>Increase<br/>(Decrease)</b>             | <b>Increase<br/>(Decrease)</b> |
| <b>Increase<br/>(Decrease)<br/>in Factor</b> | <b>in Medical<br/>Claims<br/>Liability</b> | <b>in Factor</b>               | <b>in Medical<br/>Claims<br/>Liability</b> |                                |
| 3%                                           | \$ (5,068)                                 | (3)%                           | \$ (2,801)                                 |                                |
| 2                                            | (3,417)                                    | (2)                            | (1,865)                                    |                                |
| 1                                            | (1,728)                                    | (1)                            | (931)                                      |                                |
| (1)                                          | 1,769                                      | 1                              | 929                                        |                                |

(a) Impact due to change in completion factor for the

most recent three months. Completion factors indicate how complete claims paid to date are in relation to estimates for a given reporting period. Accordingly, an increase in completion factor results in a decrease in the remaining estimated liability for medical claims.

- (b) Impact due to change in annualized medical cost trends used to estimate PMPM costs for the most recent three months.

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Each month, we re-examine the previously established medical claims liability estimates based on actual claim submissions and other relevant changes in facts and circumstances. As the liability estimates recorded in prior periods become more exact, we increase or decrease the amount of the estimates, and include the changes in medical expenses in the period in which the change is identified. In every reporting period, our operating results include the effects of more completely developed medical claims liability estimates associated with prior periods.

In establishing medical claims liability, we also consider premium deficiency situations and evaluate the necessity for additional related liabilities. There were no required premium deficiency accruals at September 30, 2010 or December 31, 2009.

***Premium Revenue Recognition***

We generate revenues primarily from premiums we receive from CMS to provide healthcare benefits to our members. We receive premium payments on a PMPM basis from CMS to provide healthcare benefits to our Medicare members, which premiums are fixed (subject to retroactive risk adjustment) on an annual basis by contracts with CMS.

Although the amount we receive from CMS for each member is fixed, the amount varies among Medicare plans according to, among other things, plan benefits, demographics, geographic location, age, gender, and the relative risk score of the membership.

We generally receive premiums on a monthly basis in advance of providing services. Premiums collected in advance are deferred and reported as deferred revenue. We recognize premium revenue during the period in which we are obligated to provide services to our members. Any amounts that have not been received are recorded on the balance sheet as accounts receivable.

Our Medicare premium revenue is subject to periodic adjustment under what is referred to as CMS's risk adjustment payment methodology based on the health risk of our members. Risk adjustment uses health status indicators to correlate the payments to the health acuity of the member, and consequently establishes incentives for plans to enroll and treat less healthy Medicare beneficiaries. Under the risk adjustment payment methodology, coordinated care plans must capture, collect, and report diagnosis code information to CMS. After reviewing the respective submissions, CMS establishes the payments to Medicare plans generally at the beginning of the calendar year, and then adjusts premium levels on two separate occasions on a retroactive basis. The first retroactive risk premium adjustment for a given fiscal year generally occurs during the third quarter of such fiscal year. This initial settlement (the Initial CMS Settlement) represents the updating of risk scores for the current year based on the prior year's dates of service. CMS then issues a final retroactive risk premium adjustment settlement for that fiscal year in the following year (the Final CMS Settlement). We estimate and record on a monthly basis both the Initial CMS Settlement and the Final CMS Settlement.

We develop our estimates for risk premium adjustment settlement utilizing historical experience and predictive actuarial models as sufficient member risk score data becomes available over the course of each CMS plan year. Our actuarial models are populated with available risk score data on our members. Risk premium adjustments are based on member risk score data from the previous year. Risk score data for members who entered our plans during the current plan year, however, is not available for use in our models; therefore, we make assumptions regarding the risk scores of this subset of our member population.

All such estimated amounts are periodically updated as additional diagnosis code information is reported to CMS and adjusted to actual amounts when the ultimate adjustment settlements are either received from CMS or the company receives notification from CMS of such settlement amounts.

As a result of the variability of factors, including plan risk scores, that determine such estimations, the actual amount of CMS's retroactive risk premium settlement adjustments could be materially more or less than our estimates.

Consequently, our estimate of our plans' risk scores for any period and our accrual of settlement premiums related thereto, may result in favorable or unfavorable adjustments to our Medicare premium revenue and, accordingly, our profitability. There can be no assurance that any such differences will not have a material effect on any future quarterly or annual results of operations.



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The following table illustrates the sensitivity of the Final CMS Settlements and the impact on premium revenue caused by differences between actual and estimated settlement amounts that management believes are reasonably likely, based on our historical experience and premium revenue for the nine months ending September 30, 2010 (dollars in thousands):

| <b>Increase<br/>(Decrease)<br/>in Estimate</b> | <b>Increase<br/>(Decrease)<br/>In Settlement<br/>Receivable</b> |
|------------------------------------------------|-----------------------------------------------------------------|
| 1.5%                                           | \$ 27,795                                                       |
| 1.0                                            | 18,530                                                          |
| 0.5                                            | 9,265                                                           |
| (0.5)                                          | (9,265)                                                         |

**Goodwill and Indefinite-Life Intangible Assets**

Goodwill represents the excess of cost over fair value of assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment at least annually. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. This determination is made at the reporting unit level and consists of two steps. First, the company determines the fair value of the reporting unit and compares it to its carrying amount. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting units in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit's goodwill. Goodwill currently exists at four of our reporting units—Alabama, Florida, Tennessee and Texas.

Goodwill valuations have been determined using an income approach based on the present value of future cash flows of each reporting unit. In assessing the recoverability of goodwill, we consider historical results, current operating trends and results, and we make estimates and assumptions about premiums, medical cost trends, margins and discount rates based on our budgets, business plans, economic projections, anticipated future cash flows and regulatory data. Each of these factors contains inherent uncertainties and management exercises substantial judgment and discretion in evaluating and applying these factors.

Although we believe we have sufficient current and historical information available to us to test for impairment, it is possible that actual cash flows could differ from the estimated cash flows used in our impairment tests. We could also be required to evaluate the recoverability of goodwill prior to the annual assessment if we experience various triggering events, including significant declines in margins or sustained and significant market capitalization declines. These types of events and the resulting analyses could result in goodwill impairment charges in the future. Impairment charges, although non-cash in nature, could adversely affect our financial results in the periods of such charges. In addition, impairment charges may limit our ability to obtain financing in the future.

**Item 3: Quantitative and Qualitative Disclosures About Market Risk**

As of September 30, 2010 and December 31, 2009, we had the following assets that may be sensitive to changes in interest rates:

| <b>Asset Class</b>                         | <b>September<br/>30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--------------------------------------------|-----------------------------------|------------------------------|
|                                            | <b>(in thousands)</b>             |                              |
| Investment securities, available for sale: |                                   |                              |
| Current portion                            | \$                                | \$ 8,883                     |
| Non-current portion                        | 267,099                           | 13,574                       |
| Investment securities, held to maturity:   |                                   |                              |



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|                        |        |        |
|------------------------|--------|--------|
| Current portion        |        | 13,965 |
| Non-current portion    | 40,691 | 38,463 |
| Restricted investments | 21,553 | 16,375 |

We have not purchased any of our investments for trading purposes. Investment securities, which consist primarily of debt securities, have been categorized as either available for sale or held to maturity. Held to maturity securities are those securities that the company does not intend to sell, nor expect to be required to sell, prior to maturity. At September 30, 2010, investment securities are classified as non-current assets based on the company's intention to reinvest such assets upon sale or maturity and to not use such assets in current operations. At December 31, 2009, the company classified its investment securities based upon maturity dates. These investment securities consist of highly liquid government and corporate debt obligations, the majority of which mature in five years or

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less. The investments are subject to interest rate risk and will decrease in value if market rates increase. Because of the relatively short-term nature of our investments and our portfolio mix of variable and fixed rate investments, however, we would not expect the value of these investments to decline significantly as a result of a sudden change in market interest rates. Moreover, because of our intention not to sell these investments prior to their maturity, we would not expect foreseeable changes in interest rates to materially impair their carrying value. Restricted investments consist of deposits, certificates of deposit, government securities, and mortgage backed securities, deposited or pledged to state departments of insurance in accordance with state rules and regulations. At September 30, 2010 and December 31, 2009, these restricted assets are recorded at amortized cost and classified as long-term regardless of the contractual maturity date because of the restrictive nature of the states' requirements.

Assuming a hypothetical and immediate 1% increase in market interest rates at September 30, 2010, the fair value of our fixed income investments would decrease by approximately \$7.7 million. Similarly, a 1% decrease in market interest rates at September 30, 2010 would result in an increase of the fair value of our investments of approximately \$7.9 million. Unless we determined, however, that the increase in interest rates caused more than a temporary impairment in our investments, or unless we were compelled by a currently unforeseen reason to sell securities, such a change should not affect our future earnings or cash flows.

We are subject to market risk from exposure to changes in interest rates based on our financing, investing, and cash management activities. At September 30, 2010, we had \$166.3 million of outstanding indebtedness, bearing interest at variable rates at specified margins above either the agent bank's alternate base rate or its LIBOR rate, at our election. Holding other variables constant, including levels of indebtedness, a 0.125% increase in interest rates would have an estimated negative impact on pre-tax earnings and cash flows for the next twelve month period of \$207,813. Although changes in the alternate base rate or the LIBOR rate would affect the costs of funds borrowed in the future, we believe the effect, if any, of reasonably possible near-term changes in interest rates on our consolidated financial position, results of operations or cash flow would not be material.

At December 31, 2009, we had interest rate swap agreements to manage a portion of our exposure to these fluctuations. The interest rate swaps converted a portion of our indebtedness to a fixed rate with a notional amount of \$100.0 million. The company designated its interest rate swaps as cash flow hedges which were recorded in the company's consolidated balance sheet at their fair value. The fair value of the company's interest rate swaps at December 31, 2009 were reflected as a liability of approximately \$2.1 million and were included in other current liabilities in the accompanying consolidated balance sheet. In connection with the New Credit Agreement, the interest rate swap agreements were terminated and approximately \$2.0 million was paid by us to the swap counterparties to settle the terminations. As of September 30, 2010, we had not taken any other action to cover interest rate risk and were not a party to any interest rate market risk management activities. We may re-enter into interest rate swap agreements in the future depending on market conditions and other factors.

**Item 4: Controls and Procedures**

Our senior management carried out the evaluation required by Rule 13a-15 under the Exchange Act, under the supervision and with the participation of our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act ( Disclosure Controls ). Based on the evaluation, our senior management, including our CEO and CFO, concluded that, as of September 30, 2010, our Disclosure Controls were effective.

There has been no change in our internal control over financial reporting identified in connection with the evaluation that occurred during the quarter ended September 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Our management, including our CEO and CFO, does not expect that our Disclosure Controls and internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, with the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur

because of simple error and mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of controls.

The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, a control may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings.**

We are not currently involved in any pending legal proceeding that we believe is material to our financial condition or results of operations. We are, however, involved from time to time in routine legal matters and other claims incidental to our business, including employment-related claims; claims relating to our health plans' contractual relationships with providers, members, and vendors; and claims relating to marketing practices of sales agents and agencies that are employed by, or independent contractors to, our health plans.

**Item 1A. Risk Factors.**

In addition to the other information set forth in this report, you should consider carefully the risks and uncertainties previously reported and described under the captions Part I Item 1A. Risk Factors in the 2009 Form 10-K and Part II Item 1A. Risk Factors in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 ( 2010 First Quarter 10-Q ), the occurrence of any of which could materially and adversely affect our business, prospects, financial condition, and operating results. The risks identified below and previously reported and described in our 2009 Form 10-K and 2010 First Quarter 10-Q are not the only risks facing our business. Additional risks and uncertainties not currently known to us or that we currently consider to be immaterial also could materially and adversely affect our business, prospects, financial condition, and operating results.

The following risk factors are updated or otherwise revised from the 2009 Form 10-K and 2010 First Quarter 10-Q to reflect new or additional risks and uncertainties:

***Our Records and Submissions to CMS May Contain Inaccurate or Unsupportable Information Regarding the Risk Adjustment Scores of Our Members, Which Could Cause Us to Overstate or Understate Our Revenue.***

We maintain claims and encounter data that support the risk adjustment scores of our members, which determine, in part, the revenue to which we are entitled for these members. This data is submitted to CMS by us based on medical charts and diagnosis codes prepared and submitted to us by providers of medical care. We generally rely on providers to appropriately document and support such risk-adjustment data in their medical records and appropriately code their claims. We sometimes experience errors in information and data reporting systems relating to claims, encounters, and diagnoses. Inaccurate or unsupported coding by medical providers, inaccurate records for new members in our plans, and erroneous claims and encounter recording and submissions could result in inaccurate premium revenue and risk adjustment payments, which are subject to correction or retroactive adjustment in later periods. Payments that we receive in connection with this corrected or adjusted information may be reflected in financial statements for periods subsequent to the period in which the revenue was recorded. We, or CMS through a medical records review and risk adjustment validation, may also find that data regarding our members' risk scores, when reconciled, requires that we refund a portion of the revenue that we received, which refund, depending on its magnitude, could have a material adverse effect on our results of operations or cash flows.

In connection with CMS' continuing statutory obligation to review risk score coding practices by Medicare Advantage plans, CMS announced that it would regularly audit Medicare Advantage plans, primarily targeted based on risk score growth, for compliance by the plans and their providers with proper coding practices (sometimes referred to as Risk Adjustment Data Validation Audits or RADV Audits). The Company's Tennessee Medicare Advantage plan was selected by CMS for a RADV Audit of the 2006 risk adjustment data used to determine 2007 premium rates. In late 2009, the Company's Tennessee plan received from CMS the RADV Audit member sample, which CMS will use to calculate a payment error rate for 2007 Tennessee plan premiums. In February 2010, the Company responded to the RADV Audit request by retrieving and submitting medical records supporting diagnoses codes and risk scores and, where appropriate, provider attestations. CMS has not indicated a schedule for processing or otherwise responding to the Company's submissions.

CMS has indicated that payment adjustments resulting from its RADV Audits will not be limited to risk scores for the specific beneficiaries for which errors are found but will be extrapolated to the relevant plan population. CMS' methodology for extrapolation remains unclear, however. Because of this lack of clarity from CMS, the Company is also currently unable to calculate with any reasonable confidence a coding or payment error rate or predict the impact of extrapolating an applicable error rate to 2007 Tennessee plan premiums. There can be no assurance, however, that the conclusion of the Tennessee RADV Audit will not result in an adverse impact to the Company's results of

operations or cash flows (which may or may not be material), or that the Company's other plans will not be randomly selected or targeted for a RADV Audit by CMS or, in the event that another plan is so selected, that the outcome of such RADV Audit will not result in a material adverse impact to the Company's results of operations or cash flows.

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***We May Be Unsuccessful in Implementing Our Growth Strategy If We Are Unable to Complete Acquisitions on Favorable Terms or Integrate the Businesses We Acquire into Our Existing Operations.***

Opportunistic acquisitions of contract rights and other health plans are an important element of our growth strategy. We may be unable to identify and complete appropriate acquisitions in a timely manner and in accordance with our or our investors' expectations for future growth. Some of our competitors have greater financial resources than we have and may be willing to pay more for these businesses. In addition, we are generally required to obtain regulatory approval from one or more state agencies when making acquisitions, which may require a public hearing, regardless of whether we already operate a plan in the state in which the business to be acquired is located. We may be unable to comply with these regulatory requirements for an acquisition in a timely manner, or at all. Moreover, some sellers may insist on selling assets that we may not want or transferring their liabilities to us as part of the sale of their companies or assets. Even if we identify suitable acquisition targets, we may be unable to complete acquisitions or obtain the necessary financing for these acquisitions on terms favorable to us, or at all.

To the extent we complete acquisitions, we may be unable to realize the anticipated benefits from acquisitions because of operational factors or difficulties in integrating the acquisitions with our existing businesses. This may include the integration of:

- additional employees who are not familiar with our operations;
- new provider networks, which may operate on terms different from our existing networks;
- additional members, who may decide to transfer to other healthcare providers or health plans;
- disparate information technology, claims processing, and record-keeping systems; and
- actuarial and accounting policies, including those that require a high degree of judgment or complex estimation processes, including estimates of IBNR claims, estimates of risk adjustment payments, accounting for goodwill and, intangible assets, stock-based compensation, and income tax matters.

In the event of an acquisition or investment, we may issue stock that would dilute existing stock ownership or incur additional debt that would restrict our cash flow. We may also assume known and unknown liabilities, not (or only partially) covered by acquisition agreement indemnification provisions, incur large and immediate write-offs, incur unanticipated costs, divert management's attention from our existing business, experience risks associated with entering markets in which we have no or limited prior experience, or lose key employees from the acquired entities. Additionally, with respect to the recently announced proposed acquisition of Bravo, our specific integration and execution risks in addition to those outlined above include:

- our inexperience in the Philadelphia and Mid-Atlantic Medicare Advantage markets;
- our inexperience with the Star+Plus program in Texas;
- our understanding of Bravo's regulatory compliance status, including with respect to risk scores and RADV Audits, and mitigating risks and liabilities associated therewith;
- our ability to timely achieve anticipated cost savings through the identification and elimination of redundant personnel and systems or otherwise; and
- our pre-acquisition review of Bravo Health's operations, books, and records may have failed to adequately identify existing or potential risks and liabilities or our post-acquisition contractual indemnification protections, including amounts held in escrow, may be insufficient to cover such risks and liabilities.

**Table of Contents*****Our Substantial Debt Obligations Pursuant to Our Amended Credit Facilities Could Restrict Our Operations.***

In connection with, and conditional on, the acquisition of Bravo, we have entered into an amended and restated credit agreement (the New Credit Agreement ) providing for an aggregate of \$550.0 million in term loans and a \$175.0 million revolving credit facility. Borrowings of \$380.0 million under the term facilities and availability under the existing \$175.0 million revolving credit facility, together with our cash on hand, will be used to fund the acquisition and expenses related thereto. This will result in substantial additional indebtedness for the Company. As of September 30, 2010, \$166.3 million of debt was outstanding under the existing term loan facility and no amounts were outstanding under the revolver.

The New Credit Agreement contains conditions precedent to extensions of credit and representations, warranties, and covenants, including financial covenants, customary for transactions of this type. Financial covenants include (i) a maximum leverage ratio comparing total indebtedness to consolidated adjusted EBITDA, (ii) minimum net worth requirements for each HMO subsidiary calculated by reference to applicable regulatory requirements, and (iii) maximum capital expenditures, in each case as more specifically provided in the New Credit Agreement.

This indebtedness could have adverse consequences on us, including:

- limiting our ability to compete and our flexibility in planning for, or reacting to, changes in our business and industry
- increasing our vulnerability to general economic and industry conditions; and
- requiring a substantial portion of cash flows from operating activities to be dedicated to debt repayment, reducing our ability to use such cash flow to fund our operations, expenditures, and future business or acquisition opportunities.

The New Credit Agreement contains customary events of default and, if we fail to comply with specified financial and operating ratios, we could be in breach of the New Credit Agreement. Any breach or default could allow our lenders to accelerate our indebtedness, charge a default interest rate, and terminate all commitments to extend additional credit.

Our ability to maintain specified financial and operating ratios and operate within the contractual limitations can be affected by a number of factors, many of which are beyond our control, and we cannot assure you that we will be able to satisfy them.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.*****Issuer Purchases of Equity Securities***

During the quarter ended September 30, 2010, the Company repurchased the following shares of its common stock:

| Period            | Total<br>Number of<br>Shares<br>Purchased | Average Price<br>Paid<br>per Share (\$) | Total Number<br>of<br>Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Approximate<br>Dollar<br>Value of<br>Shares<br>that May Yet<br>Be<br>Purchased<br>Under the<br>Plans or<br>Programs (\$) |
|-------------------|-------------------------------------------|-----------------------------------------|----------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------|
| 07/01/10 07/31/10 | 201                                       | 16.53                                   |                                                                                                          |                                                                                                                          |
| 08/01/10 08/31/10 | 166                                       | 18.60                                   |                                                                                                          |                                                                                                                          |
| 09/01/10 09/30/10 |                                           |                                         |                                                                                                          |                                                                                                                          |
| Total             | 367                                       | 17.47                                   |                                                                                                          |                                                                                                                          |

Shares reflected as purchased in the table above are shares withheld by the Company to satisfy the payment of tax obligations related to the vesting of shares of restricted stock.



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In May 2010, the Company's Board of Directors authorized a stock repurchase program to repurchase up to \$100.0 million of the Company's common stock. The program authorizes purchases made from time to time in either the open market or through privately negotiated transactions, in accordance with SEC and other applicable legal requirements. The timing, prices, and sizes of purchases depend upon prevailing stock prices, general economic and market conditions, and other factors. Funds for the repurchase of shares have, and are expected to, come primarily from unrestricted cash on hand and unrestricted cash generated from operations. The repurchase program does not obligate the Company to acquire any particular amount of common stock and the repurchase program may be suspended at any time at the Company's discretion. The program is scheduled to expire on June 30, 2011. During the quarter ended September 30, 2010, the Company did not repurchase any shares pursuant to the repurchase program. As of September 30, 2010, the Company had repurchased 837,634 shares of its common stock under the program in open market transactions for approximately \$14.3 million, or at an average cost of \$17.10 per share, and had approximately \$85.7 million in remaining repurchase authority under the program.

Our ability to purchase common stock and to pay cash dividends is limited by our credit agreements, including the New Credit Agreement, as amended in anticipation of the Bravo acquisition. As a holding company, our ability to repurchase common stock and to pay cash dividends is also dependent on the availability of cash dividends from our regulated insurance subsidiaries, which are restricted by the laws of the states in which we operate and CMS, as well as limitations under our credit agreement.

**Item 3. Defaults Upon Senior Securities.**

Inapplicable.

**Item 5. Other Information.**

Inapplicable.

**Item 6. Exhibits.**

See Exhibit Index following signature page.

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**SIGNATURE**

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.

HEALTHSPRING, INC.

Date: October 29, 2010

By: /s/ Karey L. Witty  
Karey L. Witty  
Executive Vice President and Chief Financial  
Officer  
(Principal Financial and Accounting Officer)

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**EXHIBIT INDEX**

- 2.1 Agreement and Plan of Merger, dated as of August 26, 2010, by and among the Company, BHI Acquisition Corporation, Bravo Health, Inc., and Shareholder Representative Services, LLC (1)
- 10.1 Amendment and Restatement Agreement, dated as of October 22, 2010, by and among HealthSpring, Inc., as borrower, certain subsidiaries of HealthSpring, Inc., as guarantors, the lenders party thereto, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A., as administrative agent, including the Restated Credit Agreement attached as Exhibit A thereto (2)
- 31.1 Certifications of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certifications of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Previously filed as an Exhibit to the Company's Current Report on Form 8-K, filed August 31, 2010.

(2) Previously filed as an Exhibit to the Company's Current Report on Form 8-K, filed October 28, 2010.