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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2000
or

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

For the transition period from ________ to ________

Commission File No. 1-6639

MAGELLAN HEALTH SERVICES, INC.

(Exact name of registrant as specified in its charter)

Delaware	**58-1076937**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6950 Columbia Gateway Drive Columbia, Maryland	**21046**
(Address of principal executive offices)	(Zip Code)

(410) 953-1000
(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 /x/ No / /

The number of shares of the registrant's common stock outstanding as of July 31, 2000 was 32,165,703.

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MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)
(In thousands, except per share amounts)

	September 30, 1999	June 30, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 37,440	$ 53,886
Accounts receivable, net	198,646	152,188
Restricted cash and investments	116,824	115,177
Refundable income taxes	3,452	2,564
Other current assets	18,565	16,148
Total current assets	374,927	339,963
Property and equipment, net of accumulated depreciation of $66,692 at September 30, 1999 and $88,859 at June 30, 2000	120,667	118,507
Deferred income taxes	91,657	108,182
Investments in unconsolidated subsidiaries	18,396	16,708
Other long-term assets	9,599	9,008
Goodwill, net	1,108,086	1,054,428
Other intangible assets, net	158,283	145,771
	$ 1,881,615	$ 1,792,567
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 44,425	$ 36,127
Accrued liabilities	209,796	167,086
Medical claims payable	189,928	217,285
Current maturities of long-term debt and capital lease obligations	30,119	32,861
Total current liabilities	474,268	453,359
Long-term debt and capital lease obligations	1,114,189	1,088,519
Deferred credits and other long-term liabilities	92,948	35,247
Minority interest	3,514	1,728
Redeemable preferred stock	—	56,531
Stockholders' equity:		
Preferred stock, without par value		
Authorized—10,000 shares at September 30, 1999 and 9,793 shares at June 30, 2000		
Issued and outstanding—none	—	—
Common stock, par value $0.25 per share		
Authorized—80,000 shares		
Issued and outstanding—34,268 shares and 34,455 shares at September 30, 1999 and June 30, 2000, respectively	8,566	8,613
Other stockholders' equity		
Additional paid-in capital	352,030	350,452
Accumulated deficit	(144,550)	(182,466)
Warrants outstanding	25,050	25,050
Common stock in treasury, 2,289 shares	(44,309)	(44,309)
Cumulative foreign currency adjustments included in comprehensive income	(91)	(157)
Total stockholders' equity	196,696	157,183
	$ 1,881,615	$ 1,792,567

The accompanying notes to Condensed Consolidated Financial Statements are an integral part of these balance sheets.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)
(In thousands, except per share amounts)

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	1999	2000	1999	2000
Net Revenue	$ 463,421	$ 515,774	$ 1,386,455	$ 1,499,756
Cost and expenses:				
Salaries, cost of care and other operating expenses	412,315	461,769	1,234,230	1,369,645
Equity in earnings of unconsolidated subsidiaries	(8,196)	(2,465)	(18,241)	(8,847)
Depreciation and amortization	19,801	20,131	55,443	59,274
Interest, net	22,662	23,956	71,013	72,202
Managed care integration costs	522	—	4,391	—
Special charges	—	—	3,354	58,173
	447,104	503,391	1,350,190	1,550,447
Income (loss) from continuing operations before provision for (benefit from) income taxes and minority interest	16,317	12,383	36,265	(50,691)
Provision for (benefit from) income taxes	8,323	7,351	19,896	(12,883)
Income (loss) from continuing operations before minority interest	7,994	5,032	16,369	(37,808)
Minority interest	189	74	565	105
Income (loss) from continuing operations	7,805	4,958	15,804	(37,913)
Income from discontinued operations (net of income tax provision of $9.129 and $9,122)	13,694	—	13,833	—
Net income (loss)	21,499	4,958	29,637	(37,913)
Preferred dividend requirement and amortization of redeemable preferred stock issuance costs	—	1,195	—	2,499
Income (loss) available to common stockholders	21,499	3,763	29,637	(40,412)
Unrealized foreign currency translation loss	(88)	(69)	(1,885)	(111)
Benefit from income taxes related to unrealized foreign currency translation loss	(35)	(28)	(754)	(44)
	(53)	(41)	(1,131)	(67)
Comprehensive income (loss)	$ 21,446	$ 3,722	$ 28,506	$ (40,479)
Average number of common shares outstanding—basic	31,778	32,166	31,710	32,067
Average number of common shares outstanding—diluted	32,041	32,578	31,822	32,067
Income (loss) per common share—basic:				
Income (loss) from continuing operations	$ 0.25	$ 0.12	$ 0.50	$ (1.26)
Income (loss) from discontinued operations	$ 0.43	$ —	$ 0.44	$ —
Net income (loss)	$ 0.68	$ 0.12	$ 0.93	$ (1.26)
Income per common share—diluted:				
Income (loss) from continuing operations	$ 0.24	$ 0.12	$ 0.50	$ (1.26)
Income (loss) from discontinued operations	$ 0.43	$ —	$ 0.43	$ —
Net income (loss)	$ 0.67	$ 0.12	$ 0.93	$ (1.26)

The accompanying notes to Condensed Consolidated Financial Statements are an integral part of these statements

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	For the Nine Months Ended June 30,	
	1999	2000
Cash flows from operating activities:		
Net income (loss)	$ 29,637	$ (37,913)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	55,443	59,274
Impairment of long-lived assets	—	58,783
Equity in earnings of unconsolidated subsidiaries	(18,241)	(8,847)
Non-cash interest expense	2,882	3,278
Gain on sale of assets	(23,623)	(610)
Non-cash portion of discontinued operations income	(1,124)	—
Cash flows from changes in assets and liabilities, net of effects from sales and acquisitions of businesses:		
Accounts receivable, net	4,706	36,669
Other assets	1,624	(2,937)
Restricted cash and investments	(22,670)	1,647
Accounts payable and other accrued liabilities	(9,397)	(38,607)
Medical claims payable	17,282	17,677
Reserve for unpaid claims	(8,914)	(78)
Income taxes payable and deferred income taxes	28,700	(15,592)
Other liabilities	8,830	(1,791)
Minority interest, net of dividends paid	1,583	262
Other	(1,292)	(114)
Total adjustments	35,789	109,014
Net cash provided by operating activities	65,426	71,101
Cash flows from investing activities:		
Capital expenditures	(36,259)	(24,845)
Acquisitions and investments in businesses, net of cash acquired and return of escrowed funds	(60,424)	(68,597)
Conversion of joint ventures from consolidation to equity method	(21,092)	—
Distributions received from unconsolidated subsidiaries	18,955	10,524
Decrease in assets restricted for settlement of unpaid claims	14,904	591
Proceeds from sale of assets, net of transaction costs	58,172	(777)
Net cash used in investing activities	(25,744)	(83,104)
Cash flows from financing activities:		
Proceeds from issuance of debt, net of issuance costs	49,347	59,642
Payments on debt and capital lease obligations	(141,917)	(86,926)
Proceeds from issuance of redeemable preferred stock, net of issuance costs	—	54,765
Proceeds from exercise of stock options and warrants	1,145	968
Net cash (used in) provided by financing activities	(91,425)	28,449
Net (decrease) increase in cash and cash equivalents	(51,743)	16,446
Cash and cash equivalents at beginning of period	92,050	37,440
Cash and cash equivalents at end of period	$ 40,307	$ 53,886

The accompanying notes to Condensed Consolidated Financial Statements are an integral part of these statements.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2000
(Unaudited)

NOTE A—Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Magellan Health Services, Inc. and Subsidiaries ("Magellan" or the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

On September 2, 1999, the Company's Board of Directors approved a formal plan to dispose of the businesses and interests that comprised the Company's healthcare provider and healthcare franchising business segments. Accordingly, the results of operations of such business segments have been reported in the condensed consolidated financial statements of which these notes are a component as discontinued operations for all periods presented. Additionally, the Company recorded a $58.2 million impairment charge related to goodwill and other long-lived assets related to its specialty managed healthcare segment during the nine months ended June 30, 2000. See Note K—"Impairment of Long-Lived Assets."

All references to fiscal years contained herein refer to periods of twelve consecutive months ending on September 30. Certain reclassifications have been made to fiscal 1999 amounts to conform to fiscal 2000 presentation.

These financial statements should be read in conjunction with the Company's audited consolidated financial statements for the fiscal year ended September 30, 1999, which are included in the Company's Annual Report on Form 10-K as amended.

NOTE B—Supplemental Cash Flow Information

Below is supplemental cash flow information related to the nine months ended June 30, 1999 and 2000 (in thousands):

	Nine Months Ended June 30,	
	1999	2000
Income taxes paid, net of refunds received	$ (585)	$ 2,639
Interest paid	$ 64,116	$ 61,404

NOTE C—Long-Term Debt and Leases

Information with regard to the Company's long-term debt and capital lease obligations at September 30, 1999 and June 30, 2000 is as follows (in thousands):

	September 30, 1999	June 30, 2000
Credit Agreement:		
Revolving Facility due through 2004 (8.938% at June 30, 2000)	$ 20,000	$ 45,000
Term Loan Facility (8.938% to 9.438% at June 30, 2000) due through 2006	492,873	444,945
9.0% Senior Subordinated Notes due 2008	625,000	625,000
11.5% notes payable through 2005	35	35
Capital lease obligations due through 2014 (4.95% at June 30, 2000)	6,400	6,400
	1,144,308	1,121,380
Less amounts due within one year	30,119	32,861
	$ 1,114,189	$ 1,088,519

NOTE D—Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	September 30, 1999	June 30, 2000
Salaries, wages and other benefits	$ 22,318	$ 13,802
CHAMPUS Adjustments	51,784	20,990
Due to providers	35,918	8,253
Other	99,776	124,041
	$ 209,796	$ 167,086

NOTE E—Income per Common Share

The following tables reconcile income (loss) (numerator) and shares (denominator) used in the Company's computations of income (loss) from continuing operations per common share (in thousands):

	Three Months Ended June 30,		Nine Months Ended June 30,	
	1999	2000	1999	2000
Numerator:				
Income (loss) from continuing operations	$ 7,805	$ 4,958	$ 15,804	$ (37,913)
Less preferred dividend requirement and amortization of redeemable preferred stock issuance costs	—	1,195	—	2,499
Income (loss) from continuing operations—basic	7,805	3,763	15,804	(40,412)
Add: presumed conversion of redeemable preferred stock	—	—	—	—
Income (loss) from continuing operations—diluted	$ 7,805	$ 3,763	$ 15,804	$ (40,412)
Denominator:				
Average number of common shares outstanding—basic	31,778	32,166	31,710	32,067
Common stock equivalents—stock options	258	52	105	—
Common stock equivalents—warrants	5	—	7	—
Common stock equivalents—unissued dividend shares	—	360	—	—
Average number of common shares outstanding—diluted	32,041	32,578	31,822	32,067
Income (loss) from continuing operations per common share:				
Basic (basic numerator/basic denominator)	$ 0.25	$ 0.12	$ 0.50	$ (1.26)
Diluted (diluted numerator/diluted denominator)	$ 0.24	$ 0.12	$ 0.50	$ (1.26)

Conversion of redeemable preferred stock, redemption of the TPG Series "A" option (see Note L), and certain stock option and warrants were not presumed outstanding for the three and nine months ended June 30, 2000 due to the anti-dilutive effect.

NOTE F—Acquisitions of Businesses and Investments in Unconsolidated Subsidiaries

Vivra acquisition. As of February 29, 2000, the Company consummated the purchase of the outstanding stock of Vivra, Inc. ("Vivra"), a specialty managed healthcare company. The Company paid $5.0 million to the former owners of Vivra at closing and will make an additional payment of $5.25 million in September 2000, for a total initial purchase price of $10.25 million, excluding transaction costs. The Company may also be required to pay the former owners of Vivra up to $10.0 million of additional consideration which is contingent upon the Company's specialty managed healthcare business segment achieving certain operating targets.

The Company accounted for the Vivra acquisition using the purchase method of accounting, and, accordingly, Vivra's results of operations subsequent to the purchase date are included in the results of operations of the Company and of its specialty managed healthcare business segment. The deferred purchase price amount of $5.25 million is included in "Deferred credits and other long-term liabilities" in the Company's condensed consolidated balance sheet at June 30, 2000. The Company initially recorded

approximately $1.2 million of identifiable intangible assets and approximately $9.1 million of goodwill associated with the Vivra acquisition and will amortize the identifiable intangible assets using the straight-line method over a weighted-average estimated useful life of ten years. The Company believes the life of the goodwill associated with Vivra to be indeterminate and, therefore, will amortize this goodwill using the straight-line method over a period of forty years. Any contingent payments which may be made with respect to Vivra would be recorded as an addition to goodwill and amortized using the straight-line method over the remaining portion of the original forty year life.

Approximately 30% of the voting interest in Vivra was owned by the investment firm Texas Pacific Group ("TPG") at the time of the Company's acquisition. Three of the Company's twelve board members are affiliated with TPG; however, these three Board members did not participate in the Board's approval of the Vivra acquisition. TPG is the holder of 59,063 shares of the Company's redeemable preferred stock, representing approximately 16% of the outstanding voting securities of Company at June 30, 2000. See Note L—"Redeemable Preferred Stock."

2000 Human Services acquisitions. During the nine months ended June 30, 2000, the Company acquired six businesses, in aggregate, in its human services segment for an initial aggregate purchase price of approximately $5.5 million (collectively, the "2000 Human Services Acquisitions"), excluding transaction costs. The 2000 Human Services Acquisitions were accounted for using the purchase method of accounting. The 2000 Human Services Acquisitions provide various residential day services for individuals with acquired brain injuries and for individuals with mental retardation and developmental disabilities.

Choice Behavioral Health Partnership. The Company is a 50% partner with Value Options, Inc. in Choice Behavioral Health Partnership ("Choice"), a general partnership. Choice is a managed behavioral healthcare company which derives all of its revenues from a contract with the Civilian Health and Medical Program of the Uniformed Services ("CHAMPUS"), and with TriCare, the successor to CHAMPUS. The Company accounts for its investment in Choice using the equity method.

A summary of financial information for the Company's investment in Choice is as follows (in thousands):

	September 30, 1999	June 30, 2000

Current assets	$ 19,572	$ 19,137
Property and equipment, net	228	144
Total assets	$ 19,800	$ 19,281
Current liabilities	$ 12,673	$ 14,726
Partners' capital	7,127	4,555
Total liabilities and partners' capital	$ 19,800	$ 19,281
Company investment	$ 3,563	$ 2,278

NOTE F—Acquisitions of Businesses and Investments in Unconsolidated Subsidiaries (Continued)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	1999	2000	1999	2000
Net revenue	$ 13,281	$ 13,995	$ 41,027	$ 42,069
Operating expenses	7,643	8,327	20,232	23,968
Net income	$ 5,638	$ 5,668	$ 20,795	$ 18,101
Company equity income	$ 2,819	$ 2,834	$ 10,398	$ 9,051

Premier Behavioral Systems, LLC. The Company owns a 50% interest in Premier Behavioral Systems, LLC ("Premier"). Premier was formed to manage behavioral healthcare benefits for the State of Tennessee's TennCare program. The Company accounts for its investment in Premier using the equity method. The Company's investment in Premier at September 30, 1999 and June 30, 2000 was $12.2 million and $11.0 million, respectively. The Company's equity in earnings (losses) of Premier for the three months ended June 30, 1999 and 2000 was $4.8 million and $(1.1) million, respectively, and for the nine months ended June 30, 1999 and 2000 was $7.4 million and $(1.2) million, respectively.

NOTE G—Discontinued Operations

General

On September 10, 1999, the Company consummated the transfer of assets and other interests pursuant to a Letter Agreement dated August 10, 1999 with Crescent Real Estate Equities ("Crescent"), Crescent Operating, Inc. ("COI") and Charter Behavioral Health Systems, LLC ("CBHS") that effected the Company's exit from its healthcare provider and healthcare franchising businesses (the "CBHS Transactions"). Significant terms of the CBHS Transactions are summarized as follows:

Healthcare Provider Interests

- The Company disposed of the majority of its interests in CBHS and was left with only a 10% non-voting common interest in CBHS at September 30, 1999 and June 30, 2000. The Company's interest in CBHS was valued at $0 as of September 30, 1999 and June 30, 2000.

- The Company agreed to transfer to CBHS its interests in five of its six hospital-based joint ventures and certain other provider real estate and interests as soon as practicable. These joint ventures had previously been managed by CBHS for a fee equivalent to the Company's portion of their earnings.

- The Company transferred to CBHS the right to receive approximately $7.1 million from Crescent for the sale of two psychiatric hospitals that were acquired by the Company (and leased to CBHS) in connection with CBHS' acquisition of certain businesses from Ramsay Healthcare, Inc. in fiscal 1998.

- The Company forgave receivables due from CBHS of approximately $3.3 million for payments received by CBHS for patient services prior to the formation of CBHS on June 17, 1997. The receivables related primarily to patient stays that "straddled" the formation date of CBHS.

- The Company will pay $2.0 million to CBHS in 12 equal monthly installments beginning on the first anniversary of the closing date.

- CBHS will indemnify the Company for 20% of up to the first $50 million ($10 million in total) for expenses, liabilities and settlements related to government investigations for events that occurred prior to June 17, 1997 (the "CBHS Indemnification"). CBHS will be required to pay the Company a maximum of $500,000 per year under the CBHS Indemnification.

- Crescent, COI, CBHS and Magellan have provided each other with mutual releases of claims among all of the parties with respect to the original transactions that effected the formation of CBHS and the operation of CBHS since June 17, 1997 with certain specified exceptions.

Healthcare Franchising Interests

- The Company transferred all of its healthcare franchising interests to CBHS and was released from performing any further franchise services or incurring future franchising expenses.

- The Company forgave unpaid franchise fees of approximately $115 million.

The CBHS Transactions, together with the formal plan of disposal authorized by the Company's Board of Directors on September 2, 1999, represent the disposal of the Company's healthcare provider and healthcare franchising business segments under Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" ("APB 30"). APB 30 requires that the results of continuing operations be reported separately from those of discontinued operations for all periods presented and that any gain or loss from disposal of a segment of a business be reported in conjunction with the related results of discontinued operations. Accordingly, the Company has restated its results of operations for all prior periods. The Company recorded an after-tax loss on disposal of its healthcare provider and healthcare franchising business segments of approximately $47.4 million, (primarily non-cash) in the fourth quarter of fiscal 1999. The Company's original plan of disposal contemplated that the disposition of all interest in the healthcare provider and healthcare franchising operations would take place within twelve months of the measurement date. The Company, with the cooperation of its joint venture partners and CBHS, has closed two of the five hospital-based joint ventures, is currently negotiating to sell its interest in two others and is seeking to sell the remaining joint venture. The proceeds from these sales will be transferred to CBHS subject to all rights of offset the Company has for certain amounts due from CBHS. The Company is attempting to resolve with CBHS the amounts due to and from CBHS, which resolution, if any, will be subject to approvals required by CBHS's bankruptcy proceedings (see further discussion below). Accordingly, these sales and transfers are not entirely within the control of the Company. The Company anticipates resolving these matters in fiscal 2001.

Substantially all of the Company's healthcare provider and healthcare franchising operations were either sold or assigned to CBHS during September 1999 and no income or expense related to these operations was recorded for the three months or the nine months ended June 30, 2000. Accordingly, the

following summary of discontinued operations income is for the three months and the nine months ended June 30, 1999 only (in thousands):

	Three Months Ended June 30, 1999	Nine Months Ended June 30, 1999
Net revenue (1)	$ 9,420	$ 46,844
Salaries, cost of care and other operating expenses	11,012	49,956
Equity in earnings of unconsolidated subsidiaries	(920)	(3,284)
Depreciation and amortization	448	2,160
Interest income (2)	(22)	(55)
Other income, net (3)	(23,912)	(24,974)
Other expenses (4)	9,120	9,208
Net income (loss)	$ 13,694	$ 13,833

(1) Amounts for the nine months ended June 30, 1999, include $1.3 million related to the settlement and adjustment of reimbursement issues related to prior periods ("Cost Report Settlements").

(2) Interest expense has not been allocated to discontinued operations.

(3) Includes net profit from the sale of the Company's European psychiatric provider operations of $23.9 million.

(4) Includes income taxes and minority interest.

Remaining assets and liabilities of the healthcare provider business at June 30, 2000 include, among other things, (i) hospital-based real estate of $6.5 million, (ii) long-term debt of $6.4 million related to the hospital-based real estate and (iii) liabilities resulting from the CBHS Transactions of approximately $7.2 million. The Company is also subject to inquiries and investigations from governmental agencies related to its operating and business practices prior to consummation of the Crescent Transactions (as defined) on June 17, 1997. See Note H—"Contingencies."

NOTE G—Discontinued Operations (Continued)

The following table provides a rollforward of liabilities resulting from the CBHS Transactions (in thousands):

Type of Cost	Balance September 30, 1999	Additions	(Receipts) Payments	Balance June 30, 2000
Transaction costs and legal fees	$ 7,553	$ —	$ 4,336	$ 3,217
Provider JV working capital	3,116	—	—	3,116
Other	755	—	(150)	905
	$ 11,424	$ —	$ 4,186	$ 7,238

On February 16, 2000, CBHS filed a voluntary petition for relief of indebtedness under Chapter 11 of the United States Bankruptcy Code. The Company has no material receivables from CBHS apart from any amount which may be owed in the future for indemnification claims under the previously described provisions of the CBHS Transactions. The Company does not believe that CBHS' bankruptcy will have a material impact on its financial position, results of operations or cash flows.

NOTE H—Contingencies

The management and administration of the delivery of behavorial managed healthcare services is subject to laws and regulations and entails significant risk of liability. Such laws and regulations relate to matters including, without limitation, licensure; Medicaid fraud and abuse; and administration of employee health benefit plans. From time to time, the Company is subject to various actions and claims arising from the acts or omissions of its employees, network providers or other parties, including malpractice professional negligence and other related actions and claims.

Until July 2, 1999, the Company was self-insured for a portion of its general and professional liability risks. The reserves for self-insured general and professional liability losses, including loss adjustment expenses, were included in reserve for unpaid claims in the Company's balance sheet and were based on actuarial estimates that were discounted at an average rate of 6% to their present value based on the Company's historical claims experience adjusted for current industry trends. These reserves related primarily to the professional liability risks of the Company's healthcare provider segment prior to June 1997. On July 2, 1999, the Company transferred its remaining medical malpractice claims portfolio (the "Loss Portfolio Transfer") to a third-party insurer for approximately $22.3 million. The Loss Portfolio Transfer was funded from assets restricted for settlement of unpaid claims. The insurance limit obtained through the Loss Portfolio Transfer for future medical malpractice claims is $26.3 million, and the Company believes that all claims will be settled within this limit.

Providers of healthcare services are subject to numerous laws and regulations. While it disposed of its healthcare provider segment in June 1997, the Company remains subject to these laws and regulations for operations of that business prior to June 1997 as well as with respect to certain outpatient clinics the Company continues to operate and the operations of its human services business segment. The subjects of such laws and regulations include but are not limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, government activity has increased with respect to

investigations and/or allegations concerning possible violations of fraud and abuse and false claims statutes and/or regulations by healthcare providers. Entities that are found to have violated these laws and regulations may be subjected to fines or penalties, required to repay amounts received from the government for previously billed patient services and/or excluded from participating in government healthcare programs. The Office of the Inspector General of the Department of Health and Human Services and the United States Department of Justice ("Department of Justice") and certain other governmental agencies are currently conducting inquiries and/or investigations regarding the operations and business practices of the Company's psychiatric provider operations prior to the disposition of such operations in June 1997. The Department of Justice has indicated that its inquiries are based on its belief that the Federal government has certain civil and administrative causes of action under the Civil False Claims Act, the Civil Monetary Penalties Law, other federal statutes and the common law arising from the participation in federal health benefit programs by these psychiatric facilities nationwide. The Department of Justice inquiries could relate to the following matters: (i) Medicare cost reports, (ii) Medicaid cost statements, (iii) supplemental applications to CHAMPUS/TriCare based on Medicare cost reports, (iv) medical necessity of services to patients and admissions, (v) failure to provide medically necessary treatment or admissions and (vi) submission of claims to government payors for inpatient and outpatient psychiatric services. No claims have been asserted, and the Company cannot reasonably estimate the liability, if any, associated with the Department of Justice inquiries. Accordingly, no reserve has been recorded related to this matter.

The Company is also subject to or party to other litigation, claims, and civil suits, relating to its operations and business practices. Certain of the Company's managed care litigation matters involve class action lawsuits, in which the Company has been named as a defendant. The

Company has been named in a class action lawsuit alleging that a provider affiliated with the Company violated the privacy rights of certain patients and in other lawsuits which allege among other things that; (i) the Company inappropriately denied and/or failed to authorize benefits for mental health treatment under benefit plans administered by the Company and; (ii) that certain providers were underpaid according to their provider contracts. In the opinion of management, the Company has recorded reserves which are adequate to cover litigation, claims or assessments that have been or may be asserted against the Company, and for which the outcome is probable and reasonably estimable, arising out of such other litigation, claims and civil suits. Furthermore, management believes that the resolution of such litigation, claims and civil suits will not have a material adverse effect on the Company's financial position, results of operations or cash flows; however, there can be no assurance in this regard.

The Company provides mental health and substance abuse services, as a subcontractor, to beneficiaries of CHAMPUS. The fixed monthly amounts that the Company receives for medical costs under CHAMPUS contracts are subject to retroactive adjustment ("CHAMPUS Adjustments") based upon actual healthcare utilization during the period known as the "data collection period". The Company has recorded reserves of approximately $51.8 million and $21.0 million as of September 30, 1999 and June 30, 2000, respectively for CHAMPUS Adjustments. During the quarter ended December 31, 1999, the Company reached a settlement agreement with a contractor under one of its CHAMPUS contracts whereby the Company paid approximately $38.1 million to the contractor during such quarter. The Company and the contractor under this CHAMPUS contract are in the process of appealing the Department of Defense's retroactive adjustment. While management believes that the present reserve for

CHAMPUS Adjustments is reasonable, ultimate settlement resulting from the adjustment and available appeal process may vary from the amount provided.

NOTE I—Managed Care Integration Plan and Costs

Integration Plan

The Company integrated three behavioral managed care organizations ("BMCOs"), Green Spring, HAI and Merit, as a result of acquisitions consummated in fiscal 1996 (Green Spring) and fiscal 1998 (HAI and Merit). The Company also integrated two specialty managed care organizations, Allied and Care Management Resources, Inc. ("CMR"). During fiscal 1998, management committed the Company to a plan to combine and integrate the operations of its BMCOs and specialty managed care organizations (the "Integration Plan") that resulted in the elimination of duplicative functions and standardized business practices and information technology platforms. The Integration Plan was completed on September 30, 1999.

The Integration Plan resulted in the elimination of approximately 1,000 positions during fiscal 1998 and fiscal 1999. Approximately 510 employees were involuntarily terminated pursuant to the Integration Plan.

The employee groups of the BMCOs that were primarily affected include executive management, finance, human resources, information systems and legal personnel at the various BMCOs corporate headquarters and regional offices and credentialing, claims processing, contracting and marketing personnel at various operating locations.

The Integration Plan resulted in the closure of approximately 20 leased facilities at the BMCOs, Allied and CMR during fiscal 1998 and 1999.

The Company recorded approximately $21.0 million of liabilities related to the Integration Plan, of which $11.6 million was recorded as part of the Merit purchase price allocation and $9.4 million ($8.9 million in fiscal 1998 and $0.5 million in fiscal 1999) was recorded in the statement of operations under "Managed care integration costs."

The following table provides a rollforward of liabilities resulting from the Integration Plan (in thousands):

Type of Cost	Balance September 30, 1999	Adjustments	Payments	Balance June 30, 2000
Employee termination benefits	$ 769	$ 150	$ 722	$ 197
Facility closing costs	3,094	(150)	937	2,007
	$ 3,863	$ —	$ 1,659	$ 2,204

Other Integration Costs

The Integration Plan resulted in additional incremental costs that were expensed as incurred in accordance with Emerging Issues Task Force Consensus 94-3, "Liability Recognition for Certain Employee

Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)" that are not described above and certain other charges. Other integration costs include, but are not limited to, outside consultants, costs to relocate closed office contents and long-lived asset impairments. Other integration costs are reflected in the statement of operations under "Managed care integration costs".

During the quarter and the nine months ended June 30, 1999, the Company incurred approximately $0.5 million and $3.5 million in other integration costs, respectively, primarily for outside consulting costs and employee and office relocation costs.

The Company discontinued its practice of classifying other integration costs separately in its consolidated statements of operations for fiscal periods ending after September 30, 1999, on which date the Integration Plan was completed. The Company will continue to incur costs for activities which are similar in nature to those which would have been reported as integration costs prior to the completion of the Integration Plan.

NOTE J—Business Segment Information

The Company operates through three reportable segments which are engaged in various aspects of the healthcare industry. The Company evaluates performance of its segments based on profit or loss from continuing operations before depreciation and amortization; interest, net; managed care integration costs; special charges, income taxes and minority interest ("Segment Profit"). Intersegment sales and transfers are not significant.

The following tables summarize, for the periods indicated, net revenue and Segment Profit by continuing business segment (in thousands):

	Behavioral Managed Healthcare	Human Services	Specialty Managed Healthcare	Corporate Overhead and other	Consolidated
Three Months ended June 30, 1999					
Net revenue	$ 370,038	$ 48,642	$ 44,741	$ —	$ 463,421
Segment Profit	$ 55,556	$ 6,036	$ 797	$ (3,087)	$ 59,302
Three Months ended June 30, 2000					
Net revenue	$ 422,431	$ 56,743	$ 36,600	$ —	$ 515,774
Segment Profit(1)	$ 56,107	$ 6,249	$ (2,760)	$ (3,126)	$ 56,470
Nine Months ended June 30, 1999					
Net revenue	$ 1,108,949	$ 141,363	$ 136,143	$ —	$ 1,386,455
Segment Profit	$ 161,692	$ 16,850	$ 2,180	$ (10,256)	$ 170,466
Nine Months ended June 30, 2000					
Net revenue	$ 1,219,937	$ 162,406	$ 117,413	$ —	$ 1,499,756
Segment Profit(1)	$ 163,966	$ 17,611	$ (32,488)	$ (10,131)	$ 138,958
Total assets, September 30, 1999	$ 1,472,539	$ 127,348	$ 88,535	$ 193,193	$ 1,881,615
Total assets, June 30, 2000	$ 1,445,462	$ 132,273	$ 32,247	$ 182,585	$ 1,792,567

(1) These results exclude the impact of the $58.2 million impairment of long-lived assets during the the nine months ended June 30, 2000, related to its specialty managed healthcare segment (see Note K—"Impairment of Long-Lived Assets").

The following tables reconcile Segment Profit to consolidated income from continuing operations before provision for income taxes and minority interest (in thousands):

	Three Months Ended June 30,		Nine Months Ended June 30,	
	1999	2000	1999	2000
Segment Profit	$ 59,302	$ 56,470	$ 170,466	$ 138,958
Depreciation and amortization	(19,801)	(20,131)	(55,443)	(59,274)
Interest, net	(22,662)	(23,956)	(71,013)	(72,202)
Managed care integration costs	(522)	—	(4,391)	—
Special charges	—	—	(3,354)	(58,173)
Income (loss) from continuing operations before provision for income taxes and minority interest	$ 16,317	$ 12,383	$ 36,265	$ (50,691)

NOTE K—Impairment of Long-Lived Assets

The Company recorded a charge of approximately $58.2 million during the nine months ended June 30, 2000, related to the impairment of certain long-lived assets in accordance with Statement of Financial Accounting Standards No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" ("FAS 121"). This amount is included in "Special charges" in the Company's condensed consolidated statements of operations for such periods and is related to the goodwill, property and equipment and identifiable intangible assets (collectively, the "Allied Assets") of Allied Specialty Care Services, Inc. ("Allied"), which, prior to the Vivra acquisition, was the principal component of the Company's specialty managed healthcare business segment.

During the quarter ended March 31, 2000, Allied recorded significant losses associated primarily with the termination or restructuring of various customer contracts. These events and the resulting expectation of lower future earnings and cash flows from Allied represent a change in circumstances with respect to the business of Allied. The Company estimates that the future undiscounted cash flows expected to be generated by Allied are insufficient to fully recover the recorded cost of the Allied Assets.

Accordingly, the Company adjusted the Allied Assets to their estimated fair value as of March 31, 2000. Based upon the circumstances described above, the Company estimated that the fair value of the Allied Assets was approximately $6.3 million at March 31, 2000. This value reflects the Company's estimate of the recoverable fair value of Allied's property and equipment through sale or continued use.

The Company will continually monitor events and changes in circumstances regarding the recoverability of the remaining value of the Allied Assets.

NOTE L—Redeemable Preferred Stock

On July 19, 1999, the Company entered into a definitive agreement to issue approximately $75.4 million of cumulative convertible preferred stock to TPG Magellan, LLC, an affiliate of TPG (the "TPG Investment"). On December 15, 1999, the Company and TPG amended and restated the definitive agreement and consummated the TPG Investment.

Pursuant to the amended and restated definitive agreement, TPG purchased approximately $59.1 million of the Company's Series A Cumulative Convertible Preferred Stock (the "Series A Preferred Stock") and an Option (the "Option") to purchase approximately $21.0 million of additional Series A Preferred Stock. Net proceeds from issuance of Series A Preferred Stock were $54.0 million. Approximately 50% of such net proceeds were used to reduce debt outstanding under the Term Loan Facility, with the remaining 50% being used for general corporate purposes. The Series A Preferred Stock carries a dividend of 6.5% per annum, payable in quarterly installments in cash or common stock, subject to certain conditions. Dividends not paid in cash or common stock will accumulate. The Series A Preferred Stock is convertible at any time by the holder into approximately 6.3 million shares of the Company's common stock at a conversion price of $9.375 per share and carries "as converted" voting rights. The Company may, under certain circumstances, require the holders of the Series A Preferred Stock to convert such stock into common stock. The Series A Preferred Stock, plus accrued and unpaid dividends thereon, must be redeemed by the Company on December 15, 2009. The Option will expire unless exercised by August 19, 2002. TPG may exercise the Option in whole or in part. The Company may, under certain circumstances, require TPG to exercise the Option. The terms of the shares of Series A Preferred Stock issuable pursuant

to the Option are identical to the terms of the shares of Series A Preferred Stock issued to TPG at the closing of the TPG Investment.

TPG has three representatives on the Company's twelve-member Board of Directors.

The TPG Investment is reflected under the caption "Redeemable preferred stock" in the Company's condensed consolidated balance sheet as follows (in thousands):

	June 30, 2000
Redeemable convertible preferred stock:	
Series A - stated value $1, 87 shares authorized, 59 shares issued and outstanding	$ 59,063
Series B - stated value $1, 60 shares authorized, none issued and outstanding	—
Series C - stated value $1, 60 shares authorized, none issued and outstanding	—
	59,063
Less: Fair value of Series A Option	(3,366)
Total redeemable convertible preferred stock	56,387
Accretion and accumulated unpaid dividends on Series A Preferred Stock	2,224
Fair value of Series A Option	3,366
Issuance costs, net of amortization of $275	(4,756)
	$ 56,531

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

This quarterly report on Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Although the Company believes that its plans, intentions and expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such plans, intentions or expectations will be achieved. Important factors that could cause actual results to differ materially from the Company's forward-looking statements are set forth in the Company's Annual Report on Form 10-K/A for the fiscal year ended September 30, 1999. All forward-looking statements attributable to the Company or persons acting on behalf of the Company are expressly qualified in their entirety by the cautionary statements set forth in the Company's Annual Report on Form 10-K/A for the fiscal year ended September 30, 1999.

Overview

The Company currently operates through three principal business segments which are engaged in:

- *The behavioral managed healthcare business*. The Company's Magellan Behavioral Health division coordinates and manages the delivery of behavioral healthcare treatment services through its network of providers, which includes psychiatrists, psychologists and other medical professionals. The treatment services provided through these provider networks include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and alternative care services (such as residential treatment and home or community-based programs). The Company provides these services primarily through: (i) risk-based products, where the Company assumes all or a portion of the responsibility for the cost of providing treatment services in exchange for a fixed per member per month fee, (ii) administrative services only ("ASO") products, where the Company provides services such as utilization review, claims administration or provider network management, (iii) employee assistance programs ("EAP") and (iv) products which combine features of some or all of the Company's risk-based, ASO, or EAP products. At June 30, 2000, the Magellan Behavioral Health division managed the behavioral healthcare benefits of approximately 70.1 million individuals.
- *The human services business*. The Company provides various human services through its National MENTOR, Inc. ("Mentor") subsidiary. These human services include specialty home-based healthcare services provided through "mentor" homes as well as residential and day treatment services for individuals with acquired brain injuries and for individuals with mental retardation and developmental disabilities. The Company acquired six businesses in its human services business segment for an aggregate purchase price of approximately $5.5 million during the nine months ended June 30, 2000. At June 30, 2000, Mentor provided community-based services to approximately 7,400 individuals.
- *The specialty managed healthcare business*. The Company's Magellan Specialty Health division provides specialty risk-based and ASO services to a variety of health insurance companies and other customers. As of February 29, 2000, the Company acquired Vivra, Inc. for an initial purchase price of approximately $10.25 million. See Note F—"Acquisitions of Businesses and Investments in Unconsolidated Subsidiaries" to the Company's condensed consolidated financial statements set forth elsewhere herein.

On September 10, 1999, the Company consummated a series of related transactions which are more fully described as the CBHS Transactions in Note G—"Discontinued Operations" to the Company's condensed consolidated financial statements set forth elsewhere herein. The CBHS Transactions, together

with the formal plan of disposal authorized by the Company's Board of Directors on September 2, 1999, represented the disposal of the Company's healthcare provider and healthcare franchising business segments under Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" ("APB 30"). APB 30 requires that the results of continuing operations be reported separately from those of discontinued operations for all periods presented and that any gain or loss from disposal of a segment of a business be reported in conjunction with the related results of discontinued operations. Accordingly, the Company has restated its results of operations for all periods prior to the fourth quarter of fiscal 1999. The Company recorded an after-tax loss on the disposal of its healthcare provider and healthcare franchising business segments of approximately $47.4 million (primarily non-cash) in the fourth quarter of fiscal 1999.

The CBHS Transactions represented the final step in the Company's transformation from being a provider of behavioral healthcare services to patients in primarily an inpatient setting to being primarily a manager of specialty healthcare services. The Company undertook the initial steps of this transformation with the belief that becoming a fully integrated manager/provider of specialty healthcare services would simultaneously position it to take advantage of opportunities in the growing managed care industry while enhancing its ability to effectively treat patients in its inpatient psychiatric hospitals. As the Company's managed care business grew; however, it was believed that the opportunities available to the Company through consolidating the then-fractured managed specialty healthcare industry were superior to those available to a fully integrated manager/provider company; therefore, it decided to sell its provider interests and invest the proceeds in expansion of its managed specialty healthcare business.

A brief timeline of the significant steps in this transformation is as follows:

- *December 1995*. The Company acquired a 61% ownership interest in Green Spring Health Services, Inc. ("Green Spring"). At this time, the Company was the largest operator of freestanding psychiatric hospitals in the United States and was not significantly engaged in the managed specialty healthcare business.
- *February 1997*. The Company acquired an 85% interest in Care Management Resources, Inc. ("CMR"), signaling the Company's first significant involvement in a component of the managed healthcare industry not related to behavioral care.
- *June 1997*. The Company sold substantially all of the real estate and other property used in its domestic psychiatric hospital business and contributed the operations of the hospitals to Charter Behavioral Health Systems, LLC ("CBHS"). The Company retained a 50% ownership interest in CBHS, which continued to operate the Company's former hospital-based provider business. The Company also retained certain intellectual property which it licensed to CBHS under a franchise agreement.
- *December 1997*. The Company used the net proceeds from the sale of the psychiatric hospital real estate to finance the acquisitions of Human Affairs International, Incorporated ("HAI") and Allied Specialty Care Services, Inc. ("Allied").
-

- *January 1998*. The former owners of Green Spring exchanged their collective 39% ownership interest in Green Spring to the Company for 2,831,516 shares of the Company's common stock.
- *February 1998*. The Company acquired Merit Behavioral Care Corporation, Inc. ("Merit"), for approximately $750 million, which was provided primarily through issuance of long-term debt. The Company implemented the Integration Plan, which is more fully described in Note I—"Managed Care Integration Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein, and organized operations around a divisional structure. The Magellan Behavioral Health division was formed from Green Spring, HAI and Merit, and the Magellan Specialty Health division was formed from CMR and Allied.
- *April 1999*. The Company sold its European psychiatric hospitals.

- *September 1999*. The Company disposed of its healthcare franchising operations and 80% of its remaining interest in CBHS. The Company completed the Integration Plan.
- *February 2000*. The Company acquired Vivra, Inc. under the Magellan Specialty Health division.

Results of Operations

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

	Behavioral Managed Healthcare	Human Services	Specialty Managed Healthcare	Corporate Overhead and other	Consolidated
Three Months Ended June 30, 1999					
Net revenue	$ 370,038	$ 48,642	$ 44,741	$ —	$ 463,421
Salaries, cost of care and other operating expenses	322,678	42,606	43,944	3,087	412,315
Equity in earnings of unconsolidated subsidiaries	(8,196)	—	—	—	(8,196)
	314,482	42,606	43,944	3,087	404,119
Segment Profit (1)	$ 55,556	$ 6,036	$ 797	$ (3,087)	$ 59,302
Three Months Ended June 30, 2000					
Net revenue	$ 422,431	$ 56,743	$ 36,600	$ —	$ 515,774
Salaries, cost of care and other operating expenses	368,789	50,494	39,360	3,126	461,769
Equity in earnings of unconsolidated subsidiaries	(2,465)	—	—	—	(2,465)
	366,324	50,494	39,360	3,126	459,304
Segment Profit (1)	$ 56,107	$ 6,249	$ (2,760)	$ (3,126)	$ 56,470
Nine Months Ended June 30, 1999					
Net revenue	$ 1,108,949	$ 141,363	$ 136,143	$ —	$ 1,386,455
Salaries, cost of care and other operating expenses	965,498	124,513	133,963	10,256	1,234,230
Equity in earnings of unconsolidated subsidiaries	(18,241)	—	—	—	(18,241)
	947,257	124,513	133,963	10,256	1,215,989
Segment Profit(1)	$ 161,692	$ 16,850	$ 2,180	$ (10,256)	$ 170,466
Nine Months Ended June 30, 2000					
Net revenue	$ 1,219,937	$ 162,406	$ 117,413	$ —	$ 1,499,756
Salaries, cost of care and other operating expenses	1,064,818	144,795	149,901	10,131	1,369,645
Equity in earnings of unconsolidated subsidiaries	(8,847)	—	—	—	(8,847)
	1,055,971	144,795	149,901	10,131	1,360,798
Segment Profit(1)	$ 163,966	$ 17,611	$ (32,488)	$ (10,131)	$ 138,958

(1)

Segment Profit is the measure of profitability used by management to assess the operating performance of each business segment. See Note J—"Business Segment Information" to the Company's condensed consolidated financial statements set forth elsewhere herein.

Quarter ended June 30, 2000 ("Current Year Quarter"), compared to the same period in fiscal 1999 ("Prior Year Quarter")

Behavioral Managed Healthcare. Revenue increased 14.2% or $52.4 million, to $422.4 million for the Current Year Quarter. Salaries, cost of care and other operating expenses increased 14.2% or $46.1 million, to $368.8 million for the Current Year Quarter. Equity in earnings of unconsolidated subsidiaries

decreased approximately $5.7 million, or 69.9% to $2.5 million for the Current Year Quarter due primarily to fluctuations in the profitability of Choice and increased care cost at Premier. The increases in revenue and salaries, cost of care and other operating expenses resulted primarily from (i) increased enrollment related to existing health plan customers, (ii) expanded services and lives under management with certain public sector customers, and (iii) new business development. Total covered lives increased 8.0% to approximately 70.1 million at June 30, 2000 from 64.9 million at June 30, 1999.

Human Services. Revenue increased 16.7% or $8.1 million, to $56.7 million for the Current Year Quarter. Salaries, cost of care and other operating expenses increased 18.5% or $7.9 million, to $50.5 million for the Current Year Quarter. The increases in revenue and salaries, cost of care and other operating expenses resulted primarily from (i) growth in placements, (ii) acquisition of businesses and (iii) increased spending related to new business starts.

Specialty Managed Healthcare Revenue decreased 18.2% or $8.1 million, to $36.6 million for the Current Year Quarter, primarily related to changes in contractual relationships. Salaries, cost of care and other operating expenses decreased 10.4% or $4.6 million, to $39.4 million for the Current Year Quarter. During the three months ended June 30, 2000, the segment recorded a Segment Profit loss of approximately $2.8 million. This loss is primarily attributable to the continued administrative expenses related to the exiting of certain contractual relationships and to $0.7 million of severance liabilities incurred during the three months ended June 30, 2000. See "Outlook—Liquidity and Capital Resources" for further discussion of the specialty managed healthcare segment.

Depreciation and Amortization. Depreciation and amortization increased 1.7%, or $0.3 million, to $20.1 million for the Current Year Quarter from $19.8 million in the Prior Year Quarter. The increase is primarily attibutable to amortization of contingent consideration paid to Aetna for the purchase of HAI and depreciation of capital expenditures made during fiscal 1999, offset by the reduction of amortization related to the write-off of Allied intangibles during the Quarter ended March 31, 2000.

Interest, net. Interest expense, net increased 5.7%, or $1.3 million, to $24.0 million for the Current Year Quarter from $22.7 million in the Prior Year's Quarter. This is primarily attributable to higher average outstanding debt during the Current Year Quarter and increased interest rates.

Other Items. The Company recorded managed care integration costs of $.5 million during the Prior Year Quarter and recorded no such cost during the Current Year Quarter due to the completion of the Integration Plan. For a more complete discussion of managed care integration costs, see Note I—"Managed Care Integation Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein.

The Company's effective income tax rate increased to 59.4% for the Current Year Quarter, from 51.0% for Prior Year Quarter. The increase is primarily attributable to the Company's income from continuing operations in the Current Year Quarter relative to the amount of non-deductible goodwill amortization expense associated with the certain acquisitions.

Nine Months ended June 30, 2000 ("Current Year To Date"), compared to the same period in fiscal 1999 ("Prior Year To Date")

Behavioral Managed Healthcare. Revenue increased 10.0% or $111.0 million, to $1,220.0 million for the Current Year To Date. Salaries, cost of care and other operating expenses increased 10.3% or $99.0 million, to $1,064.8 million for the Current Year To Date. Equity in earnings of unconsolidated subsidiaries decreased approximately $9.4 million, or 51.4% to $8.8 million for the Current Year To Date due primarily to fluctuations in the profitability of Choice and increased care cost at Premier. The increases in revenue and salaries, cost of care and other operating expenses resulted primarily from (i) increased enrollment related to existing health plan customers, (ii) expanded services and lives under management with certain public sector customers, and (iii) new business development.

Human Services. Revenue increased 14.9% or $21.0 million, to $162.4 million for the Current Year To Date. Salaries, cost of care and other operating expenses increased 16.3% or $20.3 million, to $144.8 million for the Current Year To Date. The increases in revenue and salaries, cost of care and other operating expenses resulted primarily from (i) growth in placements, (ii) acquisition of businesses and (iii) increased spending related to new business starts.

Specialty Managed Healthcare Revenue decreased 13.8% or $18.7 million, to $117.4 million for the Current Year To Date, primarily due to changes in contractual relationships. Salaries, cost of care and other operating expenses increased 11.9% or $15.9 million, to $149.9 million for the Current Year To Date. During the nine months ended June 30, 2000, the segment had Segment Profit losses of $32.5 million. A significant portion of this loss relates to certain risk-based contracts that have been terminated as of March 31, 2000 and is comprised primarily of provisions for uncollectible receivables and estimated contractual expenses under such contracts. The Company also incurred segment administrative expenses which were not otherwise covered by contractual gross margins. Further, the Company recorded approximately $1.7 million of severance liabilities related to individuals severed during the nine months ended June 30, 2000. The Company also recorded a $58.2 million impairment of long-lived assets, including certain intangible assets, during the nine months ended June 30, 2000 related to its specialty managed healthcare segment. See Note K—"Impairment of Long-lived Assets" to the Company's condensed consolidated financial statements set forth elsewhere herein and see "Outlook—Liquidity and Capital Resources" for further discussion of the specialty managed healthcare segment.

Depreciation and Amortization. Depreciation and amortization increased 6.9%, or $3.8 million, to $59.3 million for the Current Year To Date from $55.4 million in the Prior Year To Date. The increase is primarily attibutable to the factors mentioned in the comparison of the Current Year Quarter to the Prior Year Quarter.

Interest, net. Interest expense, net was $72.2 million and $71.0 million for the nine months ended June 30, 2000 and 1999 respectively. The increase from the Prior Year to date is primarily attributable to the factors mentioned in the comparison of the Current Year Quarter to the Prior Year Quarter.

Other Items. The Company recorded managed care integration costs of $4.4 million during the Prior Year To Date and recorded no such cost during the Current Year To Date due to the completion of the Integration Plan. For a more complete discussion of managed care integration costs, see Note I—"Managed Care Integration Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein.

Special charges. The Company recorded special charges of $58.2 million in the Current Year to Date period related to the impairment of Allied's long-lived assets, including certain intangible assets, compared to a $3.4 million special charge recorded in the Prior Year to Date which was primarily related to the loss on sale of the Company's former corporate headquarters. For a more complete discussion of the special charge in the Current Year To Date, see Note K—"Impairment of Long-Lived Assets" to the Company's condensed consolidated financial statements set forth elsewhere herein.

The Company's effective income tax rate decreased to 25.0% for the Current Year To Date, from 54.9% for Prior Year To Date. The decrease is primarily attributable to the Company's loss from continuing operations in the Current Year To Date relative to the amount of non-deductible goodwill amortization expense associated with the certain acquisitions.

Discontinued Operations. The Company recorded income from discontinued operations of $13.8 million, net of tax, during the Prior Year To Date. During September 1999 the Company exited its healthcare provider and healthcare franchising operations, see Note G—"Discontinued Operations" to the Company's condensed consolidated financial statements set forth elsewhere herein.

Historical Liquidity and Capital Resources

Operating Activities The Company's net cash provided by operating activities was $71.1 million and $65.4 million for the nine months ended June 30, 2000 and 1999, respectively. The increase in cash provided by operating activities in fiscal 2000 compared to fiscal 1999 was primarily the result of (i) timing of working capital receipts and payments; (ii) payments of managed care integration costs in the fiscal 1999 period and (iii) the decrease in Segment Profit of the speciality segment in the 2000 Period. During the fiscal 2000 period, non-recurring cash inflows of approximately $24.0 million related to cost report settlements and non-recurring cash payments totaling $38.1 million related to CHAMPUS Adjustments were incurred.

Investing Activities Capital expenditures decreased 31.4%, or $11.4 million, to $24.9 million for the Current Year to Date, compared to $36.3 million in the Prior Year to Date. The decrease was primarily a result of (i) increased capital requirements in the fiscal 1999 period related to integration activities, (ii) reduction of capital expenditures related to year 2000 preparedness and (iii) deferral of capital projects in the fiscal 2000 period.

The Company acquired businesses in its specialty managed healthcare and human services segments and paid contingent purchase consideration of $60.0 million to Aetna in connection with the HAI Acquisition during the fiscal 2000 period. During the fiscal 1999 period, the cash paid for acquisition of businesses was offset by the return of approximately $20.0 million of escrowed amounts related to the acquisition of Allied. Additionally, during the 1999 Period, the Company received $58.2 million in proceeds from the sale of its European hospital operations.

The Company's cash flow for the fiscal 1999 period reflects a reduction of cash and cash equivalents of $21.1 million which is related to the conversion of eight joint ventures from consolidation to the equity method. See "—Recent Accounting Pronouncements—EITF 96-16". This reduction does not represent an actual reduction of cash and cash equivalents at the affected subsidiaries.

Financing Activities The Company repaid $47.9 million of indebtedness outstanding under the Term Loan Facility during the nine months ended June 30, 2000, including a payment of $27.0 million from the proceeds from issuance of redeemable preferred stock to TPG. Borrowings outstanding under the Revolving Facility increased by $25.0 million over the same period. As of June 30, 2000 the Company had $75.4 million of availability under the Revolving Facility, excluding $29.6 million of availability reserved for certain letters of credit. During the fiscal 2000 period the Company reduced amounts outstanding under its Credit Agreement and other obligations by an net amount of $22.9 million.

The Company completed the sale of 59,063 shares of Series A Redeemable Preferred Stock to TPG during the quarter ended December 31, 1999, for a total price of approximately $54.0 million, net of issuance costs. Approximately 50% of the net proceeds were used to reduce debt outstanding under the Term Loan Facility with the remaining 50% being used for general corporate purposes. See Note L—"Redeemable Preferred Stock" to the Company's condensed consolidated financial statements set forth elsewhere herein.

Outlook-Liquidity and Capital Resources

Debt Service Obligations. The interest payments on the Company's $625.0 million 9% Series A Senior Subordinated Notes due 2008 (the "Notes") and interest and principal payments on indebtedness outstanding pursuant to the Company's $700.0 million senior secured bank credit agreement (the "Credit Agreement") represent significant liquidity requirements for the Company. Borrowings under the Credit Agreement bear interest at floating rates and require interest payments on varying dates depending on the interest rate option selected by the Company. Borrowings pursuant to the Credit Agreement include $444.9 million, as of June 30, 2000, under a term loan facility (the "Term Loan Facility") and up to $150.0 million under a revolving facility (the "Revolving Facility"). The Company is required to repay the

principal amount of borrowings outstanding under the Term Loan Facility and the principal amount of the Notes in the years and amounts set forth in the following table (in millions):

Fiscal Year	Remaining Principal Amount

2000	$	7.5
2001		34.2
2002		43.4
2003		80.8
2004		137.6
2005		115.8
2006		25.6
2007		—
2008		625.0

In addition, any amounts outstanding under the Revolving Facility mature in February 2004. The Company had $45.0 million of borrowings outstanding under the Revolving Facility as of August 14, 2000.

Potential Purchase Price Adjustments. In December 1997, the Company purchased HAI from Aetna for approximately $122.1 million, excluding transaction costs. In addition, the Company incurred the obligation to make contingent payments to Aetna which may total up to $60.0 million annually over the five-year period subsequent to closing. The Company is obligated to make contingent payments under two separate calculations as follows: In respect of each Contract Year (as defined), the Company may be required to pay to Aetna the "Tranche 1 Payments" (as defined) and the "Tranche 2 Payments" (as defined). "Contract Year" means each of the twelve-month periods ending on the last day of December in 1998, 1999, 2000, 2001, and 2002.

Upon the expiration of each Contract Year, the Tranche 1 Payment shall vest with respect to such Contract Year in an amount equal to the product of (i) the Tranche 1 Cumulative Incremental Members (as defined) for such Contract Year and (ii) the Tranche 1 Multiplier (as defined) for such Contract Year. The vested amount of Tranche 1 Payment shall be zero with respect to any Contract Year in which the Tranche 1 Cumulative Incremental Members is a negative number. Furthermore, in the event that the number of Tranche 1 Cumulative Incremental Members with respect to any Contract Year is a negative number due to a decrease in the number of Tranche 1 Cumulative Incremental Members for such Contract Year (as compared to the immediately preceding Contract Year), Aetna will forfeit the right to receive a certain portion (which may be none or all) of the vested and unpaid amounts of the Tranche 1 Payment relating to preceding Contract Years.

"Tranche 1 Cumulative Incremental Members" means, with respect to any Contract Year, (i) the number of Equivalent Members (as defined) serviced by the Company during such Contract Year for Tranche 1 Members, minus (ii) (A) for each Contract Year other than the initial Contract Year, the number of Equivalent Members serviced by the Company for Tranche 1 Members during the immediately preceding Contract Year or (B) for the initial Contract Year, the number of Tranche 1 Members as of September 30, 1997, subject to certain upward adjustments. There were 3,761,253 Tranche 1 Members for the initial Contract Year, prior to such upward adjustments. "Tranche 1 Members" are members of managed behavioral healthcare plans for whom the Company provides services in any of specified categories of products or services. "Equivalent Members" for any Contract Year equals the aggregate Member Months for which the Company provides services to a designated category or categories of members during the applicable Contract Year divided by 12. "Member Months" means, for each member, the number of months for which the Company provides services and is compensated. The "Tranche 1 Multiplier" is $80, $50, $40, $25, and $20 for the Contract Years 1998, 1999, 2000, 2001, and 2002, respectively.

For each Contract Year, the Company is obligated to pay to Aetna the lesser of (i) the vested portion of the Tranche 1 Payment for such Contract Year and the vested and unpaid amount relating to prior Contract Years as of the end of the immediately preceding Contract Year and (ii) $25.0 million. To the

extent that the vested and unpaid portion of the Tranche 1 Payment exceeds $25.0 million, the Tranche 1 Payment remitted to Aetna shall be deemed to have been paid first from any vested but unpaid amounts from previous Contract Years in order from the earliest Contract Year for which vested amounts remain unpaid to the most recent Contract Year at the time of such calculation. Except with respect to the Contract Year ending in 2002, any vested but unpaid portion of the Tranche 1 Payment shall be available for payment to Aetna in future Contract Years, subject to certain exceptions. All vested but unpaid amounts of Tranche 1 Payments shall expire following the payment of the Tranche 1 Payment in respect to the Contract Year ending in 2002, subject to certain exceptions. In no event shall the aggregate Tranche 1 Payments to Aetna exceed $125.0 million.

Upon the expiration of each Contract Year, the Tranche 2 payment shall be an amount equal to the lesser of: (a) (i) the product of (A) the Tranche 2 Cumulative Members (as defined) for such Contract Year and (B) the Tranche 2 Multiplier (as defined) applicable to such number of Tranche 2 Cumulative Members, minus (ii) the aggregate of the Tranche 2 Payments paid to Aetna for all previous Contract Years and (b) $35.0 million. The amount shall be zero with respect to any Contract Year in which the Tranche 2 Cumulative Members is a negative number.

"Tranche 2 Cumulative Members" means, with respect to any Contract Year, (i) the Equivalent Members serviced by the Company during such Contract Year for Tranche 2 Members, minus (ii) the Tranche 2 Members as of September 30, 1997, subject to certain upward adjustments. There were 936,391 Tranche 2 Members prior to such upward adjustments. "Tranche 2 Members" means Members for whom the Company provides products or services in the HMO category. The "Tranche 2 Multiplier" with respect to each Contract Year is $65 in the event that the Tranche 2 Cumulative Members are less than 2,100,000 and $70 if more than or equal to 2,100,000.

For each Contract Year, the Company shall pay to Aetna the amount of Tranche 2 Payment payable for such Contract Year. All rights to receive Tranche 2 Payment shall expire following the payment of the Tranche 2 Payment in respect to the Contract Year ending in 2002, subject to certain exceptions. Notwithstanding anything herein to the contrary, in no event shall the aggregate Tranche 2 Payment to Aetna exceed $175.0 million, subject to certain exceptions.

The Company paid $60.0 million to Aetna during March, 1999 for both the full Tranche 1 Payment and the full Tranche 2 Payment for the Contract Year ended December 31, 1998. This payment was recorded as an additional $60.0 million of goodwill and other intangible assets related to the purchase of HAI.

Also, based upon the membership enrollment data related to the Contract Year ended December 31, 1999 ("Contract Year 2"), the Company, prior to the issuance of its September 30, 1999, financial statements, believed beyond a reasonable doubt that it would be required to make both the full Tranche 1 Payment and the full Tranche 2 Payment ($60.0 million in aggregate) related to Contract Year 2. Accordingly, the Company recorded an additional $60.0 million of goodwill and other intangible assets related to the purchase of HAI, for a total increase of $120.0 million during fiscal 1999. The Contract Year 2 liability of $60.0 million is included in "Deferred credits and other long-term liabilities" in the Company's condensed consolidated balance sheets as of September 30, 1999. The Company paid $60.0 million to Aetna during February, 2000 for both the full Tranche 1 Payment and the full Tranche 2 Payment for Contract Year 2.

By virtue of acquiring Merit, the Company may be required to make certain payments to the former shareholders of CMG Health, Inc. ("CMG") a managed behavioral healthcare company that was acquired by Merit in September, 1997. Such contingent payments are subject to an aggregate maximum of $23.5 million. The Company has initiated legal proceedings against certain former owners of CMG with respect to representations made by such former owners in conjunction with Merit's acquisition of CMG. Whether any contingent payments will be made to the former shareholders of CMG and the amount and timing of contingent payments, if any, may be subject to the outcome of these proceedings.

Restrictive Financing Covenants. On August 11, 2000, the Company was successful in amending certain financial covenants and terms of the Credit Agreement. The Amended Credit Agreement will enable the Company to comply with all future financial covenants so long as the Company's operating performance meets Company expectations and no unanticipated material adverse events occur. The Company incurred approximately $2.5 million in fees to obtain this amendment and the Company's borrowing rate on its term debt will be increased by 1.25%, resulting in increased interest cost in future periods. The Credit Agreement continues to impose restrictions on the Company's ability to make capital expenditures, and both the Credit Agreement and the indenture governing the Notes (the "Indenture") limit the Company's ability to incur additional indebtedness. Such restrictions, together with the highly leveraged financial condition of the Company, may limit the Company's ability to respond to market opportunities and conditions. The covenants contained in the Credit Agreement also, among other things, restrict the ability of the Company to dispose of assets; repay other indebtedness; amend other debt instruments (including the Indenture); pay dividends; create liens on assets; enter into sale and leaseback transactions; make investments, loans or advances; redeem or repurchase common stock and make acquisitions.

Revolving Facility and Liquidity. The Revolving Facility provides the Company with revolving loans and letters of credit in an aggregate principal amount at any time not to exceed $150.0 million. At August 14, 2000, the Company had approximately $75.4 million of availability under the Revolving Facility. The Company estimates that it will spend less than the approximately $19.7 million originally budgeted for capital expenditures over the remainder of fiscal 2000, in addition to the $24.8 million spent to-date. The majority of the Company's anticipated capital expenditures relate to management information systems and related equipment. The Company has borrowed under the Revolving Facility to help meet significant commitments during fiscal 2000 including, but not limited to, the semi-annual interest payment on the Notes of $28.1 million and contingent consideration for the Company's purchase of HAI of $60.0 million, which were paid in February, 2000. The Company expects its borrowing capacity under the Revolving Facility to decline to approximately $50 million to $70 million by September 30, 2000 depending primarily on (i) the operating and cash flow performance of the Company, (ii) capital resources needed to pursue certain new risk-based managed care business and (iii) the timing and amount of acquisition-related spending. Management intends to delay or forego certain investing activities, including capital expenditures and acquisitions, attempt to sell non-core business assets, and possibly forego certain new business opportunities in order to improve liquidity. The Company's future operating performance and ability to service or refinance the Notes or to extend or refinance the indebtedness outstanding pursuant to the Credit Agreement will be subject to future economic conditions and to financial, business, regulatory and other factors, many of which are beyond the Company's control. The Company believes that the cash flows generated from its operations, together with amounts available for borrowing under the Revolving Facility, will be sufficient to fund its debt service requirements; anticipated capital expenditures; contingent payments, if any, with respect to HAI and CMG and other investing and financing activities over the next year.

Strategic Alternatives to Reduce Long-Term Debt and Improve Liquidity. The Company is currently evaluating the potential to divest certain assets and businesses, including National MENTOR, and is currently involved in discussions with various parties. There can be no assurance that the Company will be able to divest any asset or businesses or that such divestiture would result in significant reductions of long-term debt or improvements in liquidity. The Company is also in process of implementing reductions in administrative overhead and consolidation or closure of certain operations. These actions may result in the Company incurring approximately $3 to $5 million of additional cash charges during the fourth quarter of fiscal 2000. The Company is also reviewing additional strategic alternatives to improve its capital structure and liquidity, however there can be no assurance that the Company will be able to consummate any transaction that will improve its capital structure or liquidity.

Net Operating Loss Carryforwards. During June 1999, the Company received an assessment from the Internal Revenue Service (the "IRS Assessment") related to its federal income tax returns for the fiscal years ended September 30, 1992 and 1993. The IRS Assessment disallowed approximately $162 million of deductions that relate primarily to interest expense in fiscal 1992. The Company filed an appeal of the IRS Assessment during September 1999. The Company had previously recorded a valuation allowance for the full amount of the $162 million of deductions disallowed in the IRS Assessment. The IRS Assessment is not expected to result in a material cash payment for income taxes related to prior years; however, the Company's federal income tax net operating loss carryforwards would be reduced if the Company's appeal is unsuccessful.

Speciality Managed Healthcare Segment Impact

The $32 million of Segment Profit losses incurred in the specialty managed healthcare segment during the nine months ended June 30, 2000, had the impact of reducing the Company's working capital by the same amount. Management has and continues to implement administrative cost reductions and exit unprofitable customer relationships. During the nine months ended June 30, 2000 the Company incurred approximately $1.7 million of severance related costs and anticipates it may incur minimal additional costs during the next two quarters. Management's objective, as in the previous quarters, is to achieve at least a break-even Segment Profit for the specialty managed healthcare segment by the first quarter of Fiscal 2001. There can be no assurances that the initiatives management is undertaking will be sufficient to achieve their objective. Management will continue to monitor the results of operations, and if necessary, the Company may completely exit the specialty managed care segment for minimal additional cash charges.

Recent Accounting Pronouncements

Emerging Issues Task Force Issue 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but a Minority Shareholder or Shareholders Have Certain Approval or Veto Rights" ("EITF 96-16") supplements the guidance contained in AICPA

Accounting Research Bulletin 51, "Consolidated Financial Statements", and in Statement of Financial Accounting Standards No. 94, "Consolidation of All Majority-Owned Subsidiaries" ("ARB 51/FAS 94"), about the conditions under which the Company's consolidated financial statements should include the financial position, results of operations and cash flows of subsidiaries which are less than wholly-owned along with those of the Company and its wholly-owned subsidiaries.

In general, ARB 51/FAS 94 requires consolidation of all majority-owned subsidiaries except those for which control is temporary or does not rest with the majority owner. Under the ARB 51/FAS 94 approach, instances of control not resting with the majority owner were generally regarded to arise from such events as the legal reorganization or bankruptcy of the majority-owned subsidiary. EITF 96-16 expands the definition of instances in which control does not rest with the majority owner to include those where significant approval or veto rights, other than those which are merely protective of the minority shareholder's interest, are held by the minority shareholder or shareholders ("Substantive Participating Rights"). Substantive Participating Rights include, but are not limited to: (i) selecting, terminating and setting the compensation of management responsible for implementing the majority-owned subsidiary's policies and procedures and (ii) establishing operating and capital decisions of the majority-owned subsidiary, including budgets, in the ordinary course of business.

The provisions of EITF 96-16 apply to new investment agreements made after July 24, 1997, and to existing agreements which are modified after such date. The Company has made no new investments, and has modified no existing investments, to which the provisions of EITF 96-16 would have applied.

In addition, the transition provisions of EITF 96-16 must be applied to majority-owned subsidiaries previously consolidated under ARB 51/FAS 94 for which the underlying agreements have not been modified in financial statements issued for years ending after December 15, 1998 (fiscal 1999 for the

Company). The adoption of the transition provisions of EITF 96-16 on October 1, 1998 had the following effect on the Company's consolidated financial position (in thousands):

	October 1, 1998
Increase (decrease) in:	
Cash and cash equivalents	$ (21,092)
Other current assets	(9,538)
Long-term assets	(30,049)
Investment in unconsolidated subsidiaries	26,498
Total assets	$ (34,181)
Current liabilities	$ (10,381)
Minority interest	(23,800)
Total liabilities	$ (34,181)

Year 2000 Computer Issues

Overview. The year 2000 computer problem is the inability of computer systems which store dates by using the last two digits of the year (i.e. "98" for "1998") to reliably recognize that dates after December 31, 1999 are later than, and not before, 1999. For instance, the date January 1, 2000, may be mistakenly interpreted as January 1, 1900, in calculations involving dates on systems which are non-year 2000 compliant.

The Company relies on information technology ("IT") systems and other systems and facilities such as telephones, building access control systems and heating and ventilation equipment ("Embedded Systems") to conduct its business. These systems are potentially vulnerable to year 2000 problems due to their use of the date information.

The Company also has business relationships with customers and healthcare providers and other critical vendors who are themselves reliant on IT and Embedded Systems to conduct their businesses.

State of Readiness. The Company completed its year 2000 remediation efforts prior to December 31, 1999, including the implementation of a company-wide year-end transition strategy. Corporate offices and regional service center teams worked diligently before,during and after the rollover to see that systems and processes were ready and that our members were able to access the quality of care they needed. The Company organized three command centers in different regions of the country, overseeing the millennium rollover of centrally and locally supported mission-critical systems. In addition, key vendors (e.g. utilities, banks, telecommunications providers, hardware and software vendors, etc.), providers and business partners were monitored for status and performance. The Company did not encounter any year 2000 related issues resulting in any disruption of service to its customers, nor did it implement any year 2000 contingency plans to continue operation of mission critical systems.

External Relationships. The Company completed its risk assessment of all External Relationships and developed contingency plans to mitigate risk. Action plans were implemented to monitor key vendors for status and performance during the millenium rollover period. The Company did not encounter any disruption of service and did not implement any of its contingency plans.

Year 2000 Costs. Total costs incurred solely for remediation of potential year 2000 problems were approximately $4.3 million in fiscal 1999. The Company incurred no significant year 2000-related costs subsequent to September 30, 1999. A large majority of these costs were incremental expenses that will not recur in calendar 2000 or thereafter. The Company expenses these costs as incurred and funds these costs through operating cash flows. In addition, the Company estimates that it accelerated approximately $5.5 million of capital expenditures that would have been budgeted for future periods into fiscal 1999 to ensure year 2000 readiness for outdated systems.

PART II—OTHER INFORMATION

Item 6.—Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit No.	Description of Exhibit
4(a)	Amendment No. 6, dated as of August 10, 2000, to the Credit Agreement dated as of February 12, 1998, among the Company, certain of the Company's subsidiaries listed therein and the Chase Manhattan Bank, as administrative agent.
27	Financial Data Schedule.

(b) Reports on Form 8-K

None.

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* Constitutes a management contract or compensatory plan arrangement.

FORM 10-Q
MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

SIGNATURES

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

MAGELLAN HEALTH SERVICES, INC.
(Registrant)

Date: August 14, 2000	/s/ CLIFFORD W. DONNELLY
	Clifford W. Donnelly *Executive Vice President and* *Chief Financial Officer*
Date: August 14, 2000	/s/ THOMAS C. HOFMEISTER
	Thomas C. Hofmeister *Senior Vice President and* *Chief Accounting Officer*

QuickLinks

Exhibit 4(a)

EXECUTION COPY

AMENDMENT No. 6 entered into as of August 10, 2000 (this "AMENDMENT"), to the Credit Agreement dated as of February 12, 1998 (as amended, supplemented or otherwise modified from time to time, the "CREDIT AGREEMENT"), among Magellan Health Services, Inc., a Delaware corporation (the "PARENT BORROWER"); Charter Behavioral Health System of New Mexico, Inc., a New Mexico corporation; Merit Behavioral Care Corporation, a Delaware corporation; each other wholly owned domestic subsidiary of the Parent Borrower that becomes a "Subsidiary Borrower" pursuant to Section 2.23 of the Credit Agreement (each, a "SUBSIDIARY BORROWER" and, collectively, the "SUBSIDIARY BORROWERS" (such term is used herein as modified in Article I of the Credit Agreement); the Parent Borrower and the Subsidiary Borrowers are collectively referred to herein as the "BORROWERS"); the Lenders (as defined in Article I of the Credit Agreement); The Chase Manhattan Bank, a New York banking corporation, as administrative agent (in such capacity, the "ADMINISTRATIVE AGENT") for the Lenders, as collateral agent (in such capacity, the "COLLATERAL AGENT") for the Lenders and as an issuing bank (in such capacity, an "ISSUING BANK"); First Union National Bank, a national banking corporation, as syndication agent (in such capacity, the "SYNDICATION AGENT") for the Lenders and as an issuing bank (in such capacity, an "ISSUING BANK"); and Credit Lyonnais New York Branch, a licensed branch of a bank organized and existing under the laws of the Republic of France, as documentation agent (in such capacity, the "DOCUMENTATION AGENT") for the Lenders and as an issuing bank (in such capacity, an "ISSUING BANK" and, together with The Chase Manhattan Bank and First Union National Bank, each in its capacity as an issuing bank, the "ISSUING BANKS").

A. The Lenders and the Issuing Banks have extended credit to the Borrowers, and have agreed to extend credit to the Borrowers, in each case pursuant to the terms and subject to the conditions set forth in the Credit Agreement.

B. The Parent Borrower has requested that the Required Lenders amend certain provisions of the Credit Agreement as set forth herein, and the requisite Lenders are willing so to amend such provisions of the Credit Agreement, on the terms and subject to the conditions set forth in this Amendment.

C. Capitalized terms used but not defined herein have the meanings assigned to them in the Credit Agreement (as amended hereby).

Accordingly, in consideration of the mutual agreements herein contained and other good and valuable consideration, the sufficiency and receipt of which are hereby acknowledged, the parties hereto agree as follows:

SECTION 1. AMENDMENTS TO SECTION 1.01. (a) The definition of the term "Applicable Percentage" in Section 1.01 of the Credit Agreement is hereby amended by:

(i) replacing the text "(i) until the date that is six months following the Closing Date, (ii)" in the last sentence of such definition with the following text:

> (a) until the delivery (THE "DELIVERY TIME") to the Administrative Agent, pursuant to Section 5.04(a), of the Parent Borrower's consolidated financial statements for the Parent Borrower's fiscal year ending on September 30, 2001, the Applicable Percentage shall be (i) with respect to any Eurodollar Loan, 3.50%, (ii) with respect to any ABR Loan, 2.50% and (iii) with respect to the Commitment Fees, 0.5000% and (b) after the Delivery Time (i)

; (ii) replacing the text "(iii)" in the last sentence of such definition with the text "(ii)"; and (iii) replacing the table therein with the following table (with the changes in the Applicable Percentages effected by this Amendment becoming effective on August 10, 2000):

Leverage Ratio	Eurodollar Spread	ABR Spread	Fee Percentage
CATEGORY 1 Greater than or equal to 4.75 to 1.00	3.00%	2.00%	0.500%
CATEGORY 2 Less than 4.75 to 1.00 but greater than or equal to 4.00 to 1.00	2.75%	1.75%	0.500%
CATEGORY 3 Less than 4.00 to 1.00 but greater than or equal to 3.50 to 1.00	2.50%	1.50%	0.500%
CATEGORY 4 Less than 3.50 to 1.00 but greater than or equal to 3.00 to 1.00	2.25%	1.25%	0.500%
CATEGORY 5 Less than 3.00 to 1.00 but greater than or equal to 2.50 to 1.00	2.00%	1.00%	0.375%
CATEGORY 6 Less than 2.50 to 1.00	1.75%	0.75%	0.375%

(b) The definition of the term "Asset Sale" in Section 1.01 of the Credit Agreement is hereby amended by adding the following proviso immediately after the text "Real Estate for Sale" in clause (c)(i) of such definition:

> , PROVIDED that no Default with respect to paragraph (c) of Article VII or Event of Default has occurred and is continuing at the time of such sale, transfer or other disposition and each such sale, transfer or other disposition is for fair market value.

(c) The definition of the term "Change in Control" in Section 1.01 of the Credit Agreement is hereby amended by (i) adding the text "(i)" immediately after the text "other than" in clause (a) of such definition, (ii) adding the text "and (ii) TPG"

immediately after the text "on the Closing Date" at the end of clause (a) of such definition, (iii) adding the text "or by TPG" immediately after the text "Parent Borrower" in subclause (i) of clause (b) of such definition, (iv) adding the text ", unless in any such case described in clause (a) or (b) such persons were nominated, appointed or elected by, or at the direction of, TPG" immediately before the period at the end of the last sentence of such definition and (v) adding the following new sentence at the end of such definition:

> For purposes of the foregoing, any shares of capital stock of the Borrower that are held by any Person shall, to the extent that TPG has the power to direct the voting of such shares, be deemed to be owned, beneficially and of record, by TPG.

(d) The definition of the term "Consolidated EBITDA" in Section 1.01 of the Credit Agreement is hereby amended by adding the following text at the end of the first sentence of such definition:

> MINUS, without duplication, (e) any Sold Entity EBITDA during such period, calculated on a PRO FORMA basis as of the first day of such period, and PLUS (f) without duplication of any amounts added to Consolidated Net Income pursuant to any other clause of this definition, any charges, writeoffs or losses for such period of the

types described on Schedule 1.01(e) up to the maximum amounts set forth in such Schedule, to the extent such charges, writeoffs or losses were deducted in determining Consolidated Net Income for such period

(e) The definition of the term "Consolidated Interest Expense" in Section 1.01 of the Credit Agreement is hereby amended by adding the following text at the end of such definition:

, MINUS (without duplication) gross interest expense (including interest expense attributable to Capital Lease Obligations and Interest Rate Protection Agreements but excluding any non-cash interest expense, including amortization of deferred loan costs) relating to Indebtedness repaid, extinguished or otherwise ceasing to be an obligation of the Parent Borrower or any of the Subsidiaries after giving effect to the sale or other disposition of any Sold Entity during such period, calculated on a PRO FORMA basis as of the first day of such period.

(f) The definition of the term "Consolidated Net Worth" in Section 1.01 of the Credit Agreement is hereby amended by adding the following proviso at the end of such definition:

;PROVIDED, HOWEVER, that, in determining Consolidated Net Worth as of the end of any fiscal quarter of the Parent Borrower, the aggregate amount of any charges, writeoffs and losses for such fiscal quarter (or any prior fiscal quarter) that at any time were added to Consolidated Net Income pursuant to clause (f) of the definition of the term Consolidated EBITDA shall be added to

Consolidated Net Worth to the extent such items otherwise resulted in a reduction of Consolidated Net Worth.

(g) Section 1.01 of the Credit Agreement is hereby amended by adding the defined terms "Mentor", "Mentor Sale", "Sold Entity", "Sold Entity EBITDA", "Specified Assets" and "TPG" in the appropriate alphabetical order, to read in their entirety as follows:

"MENTOR" shall mean National Mentor, Inc., a Delaware corporation.

"MENTOR SALE" shall mean the sale of all or a substantial portion of the business of Mentor and its subsidiaries (whether such sale is effected through a sale of a majority of the common stock of Mentor or all or a substantial portion of the assets of Mentor and its subsidiaries, or any combination thereof) for aggregate consideration in the forms and amounts specified in the Agent's Transmittal Letter (as defined below) and otherwise in accordance with the terms of a purchase agreement to be entered into in respect of such sale, PROVIDED that (a) the terms and conditions of such purchase agreement (as amended, waived or otherwise modified from time to time) shall not, without the written consent of the Required Lenders, be inconsistent in any manner materially adverse to the Lenders with the terms of the letter dated July 31, 2000, from the Administrative Agent addressed to the Lenders (the "Agent's Transmittal Letter") and previously delivered to the Lenders and (b) the assets of Mentor and its subsidiaries at the time of such sale do not include any material assets owned by the Parent Borrower or its other Subsidiaries on August 10, 2000.

"SOLD ENTITY" shall mean the assets, in the case of a sale of assets, or the capital stock or other equity interests (or, if the context requires, the person that is the issuer of such capital stock or other equity interests), in the case of a sale of capital stock or other equity interests, of Mentor and its subsidiaries to the extent such assets and/or capital stock or other equity interests are sold or otherwise transferred as a part of the Mentor Sale.

"SOLD ENTITY EBITDA" shall mean, with respect to the Sold Entity for any period, the consolidated net income of such Sold Entity for such period PLUS to the extent deducted in the determination of such Sold Entity's consolidated net income, the sum of such Sold Entity's (a) aggregate amount of income tax expense for such period, (b) aggregate amount of interest expense for such period and (c) aggregate amount of amortization, depreciation and other non-cash charges (including employee stock owner-ship plan expense, stock option expense, and amortization of goodwill, transaction expenses, excess reorganization expense, covenants not to compete and other intangible assets) for such period, all as determined on a consolidated basis in accordance with GAAP, PROVIDED that

(i) all extraordinary gains or losses of such Sold Entity and its consolidated subsidiaries for such period and (ii) the gain (or loss) for such period attributable to the sale of any assets of such Sold Entity and its consolidated subsidiaries outside the ordinary course of business shall not be included in such Sold Entity's consolidated net income.

"SPECIFIED ASSETS" shall mean the assets described on Schedule 1.01(d) that are denoted in such Schedule as Specified Assets.

"TPG" shall mean TPG Partners II, L.P., TPG Advisors II, Inc., TPG GenPar II, L.P., and their Affiliates, PROVIDED that no such Affiliate shall be deemed a member of TPG to the extent it ceases to be Controlled by, or under common Control with, TPG Partners II, L.P, TPG Advisors II, Inc. and /or TPG GenPar II, L.P., as the case may be.

(h) Section 1.01 of the Credit Agreement is hereby amended by deleting the defined term "GPA Sale".

SECTION 2. AMENDMENT TO SECTION 2.06(a). Section 2.06(a) of the Credit Agreement is hereby amended by: (a) replacing the text "1.50%" in such Section with the text "2.75%" and (b) replacing the text "1.75%" in such Section with the text "3.00%".

SECTION 3. AMENDMENT TO SECTION 2.06(b). Section 2.06(b) of the Credit Agreement is hereby amended by: (a) replacing the text "2.50%" in such Section with the text "3.75%" and (b) replacing the text "2.75%" in such Section with the text "4.00%".

SECTION 4. AMENDMENT TO SECTION 2.13(a). Section 2.13(a) of the Credit Agreement is hereby amended by:

(a) deleting the text preceding the text "PROVIDED, HOWEVER" in its entirety and substituting in lieu thereof the following text:

> Not later than the third Business Day following the completion of any Asset Sale, any transaction described in Section 6.05(f) or any sale or other disposition of any Specified Assets, the Borrowers shall apply (1) if such transaction is the Mentor Sale or a sale or other disposition of Specified Assets, 50% of the Net Cash Proceeds received with respect thereto, and (2) if such transaction is neither the Mentor Sale nor a sale or other disposition of Specified Assets, 100% of the Net Cash Proceeds received with respect thereto to prepay outstanding Loans in accordance with Sections 2.13(e) and 2.13(f);

and

(b) replacing the text "$5,000,000" in such Section with the text "$2,500,000".

SECTION 5. AMENDMENT TO SECTION 2.13(b). Section 2.13(b) of the Credit Agreement is hereby amended by substituting the date "September 30, 2002" for the date "September 30, 1999" in clause (i) of such Section.

SECTION 6. AMENDMENT TO SECTION 2.13(e). Section 2.13(e) of the Credit Agreement is hereby amended by adding the following proviso at the end of such Section:

> ; PROVIDED, HOWEVER, that the portion of any mandatory prepayments resulting from the Mentor Sale that are allocated pursuant to the foregoing to prepay Tranche A Term Loans shall be applied in order of maturity against the remaining scheduled installments of principal due in respect of Tranche A Term Loans under 2.12(a).

SECTION 7. AMENDMENT TO SECTION 5.04. Section 5.04 of the Credit Agreement is hereby amended as follows:

(a) by deleting clause (ii) of paragraph (a) thereof in its entirety and substituting in lieu thereof the following clause (ii):

(ii) prior to the Mentor Sale, an unaudited consolidated balance sheet and statement of operations for the Behavioral Managed Care and Human Services business segments of the Parent Borrower and such other material business segments of the Parent Borrower as are reasonably requested by the Administrative Agent;

and

(b) by deleting clause (ii) of paragraph (b) thereof in its entirety and substituting in lieu thereof the following clause (ii):

(ii) prior to the Mentor Sale, a consolidated balance sheet and statement of operations for the Behavioral Managed Care and Human Services business segments of the Parent Borrower and such other material business segments of the Parent Borrower as are reasonably requested by the Administrative Agent showing the financial condition of the Behavioral Managed Care and Human Services business segments of the Parent Borrower and such other material business segments of the Parent Borrower as are reasonably requested by the Administrative Agent, in the cases of (i) and (ii) of this paragraph as of the close of such fiscal quarter and the results of its operations during such fiscal quarter and the then elapsed portion of the fiscal year;

SECTION 8. AMENDMENT TO SECTION 6.04. Section 6.04 of the Credit Agreement is hereby amended by adding a new paragraph (r) at the end of such Section, to read in its entirety as follows:

(r) investments by the Parent Borrower or its Subsidiaries in Mentor and/or its subsidiaries obtained or retained pursuant to the Mentor Sale, PROVIDED that all such investments shall be pledged to the Collateral Agent in accordance with Section 5.11.

SECTION 9. AMENDMENT TO SECTION 6.05. Section 6.05 of the Credit Agreement is hereby amended by (i) deleting the text "the GPA Sale," from the first parenthetical phrase in such Section, (ii) deleting the word "and" immediately after the semicolon in paragraph (j) of such Section, (iii) deleting the period at the end of paragraph (k) of such Section and substituting in lieu thereof the text "; and" and (iv) adding a new paragraph (l) at the end of such Section, to read in its entirety as follows:

(l) the Parent Borrower may effect the Mentor Sale, PROVIDED that no Default (other than a Default with respect to paragraph (e) of Article VII)

or Event of Default has occurred and is continuing at the time of sale and the Net Cash Proceeds from the Mentor Sale shall be applied as required by Section 2.13(a).

SECTION 10. AMENDMENT TO SECTION 6.10. The table set forth in Section 6.10 of the Credit Agreement is hereby amended and restated in its entirety to read as follows:

Fiscal Quarter Ending Dates	Ratio
September 30, 2000, through March 31, 2002	1.85:1:00
April 1, 2002, through March 31, 2003	1.95:1.00
April 1, 2003 through March 31, 2004	2.10:1.00
April 1, 2004, through March 31, 2005	2.40:1.00
April 1, 2005, and thereafter	2.75:1.00

SECTION 11. AMENDMENT TO SECTION 6.11. The table set forth in Section 6.11 of the Credit Agreement is hereby amended and restated in its entirety to read as follows:

Fiscal Quarter Ending Dates	Ratio
September 30, 2000, through June 30, 2001	5.50:1.00
July 1, 2001, through March 31, 2002	5.25:1:00
April 1, 2002, through March 31, 2003	5.00:1:00
April 1, 2003, through March 31, 2004	4.50:1:00
April 1, 2004, through March 31, 2005	4.00:1:00
April 1, 2005, and thereafter	3.50:1.00

SECTION 12. AMENDMENT TO SECTION 6.12. The table set forth in Section 6.12 of the Credit Agreement is hereby amended and restated in its entirety to read as follows:

Fiscal Quarter Ending Dates	Ratio
September 30, 2000, through March 31, 2001	2.75:1.00
April 1, 2001, through March 31, 2002	2.50:1.00
April 1, 2002, through March 31, 2003	2.25:1.00
April 1, 2003, and thereafter	2.00:1.00

SECTION 13. AMENDMENT TO SECTION 6.13. Section 6.13 of the Credit Agreement is hereby amended and restated in its entirety to read as follows:

SECTION 6.13. MAINTENANCE OF CONSOLIDATED EBITDA. Permit the Consolidated EBITDA for the Parent Borrower for any period of four consecutive fiscal quarters ending on the last day of any fiscal quarter, commencing with the fiscal quarter ending on September 30, 2000, to be less than the amount set forth below opposite such period in Table A, if the Mentor Sale has not been consummated on or before such last day of the fiscal quarter, or in Table B, if the Mentor Sale has been consummated on or before such last day of the fiscal quarter:

Table A

Fiscal Quarter Ending Dates	Ratio
September 30, 2000, through December 30, 2000	$200,000,000
December 31, 2001, through March 30, 2001	$205,000,000
March 31, 2001, through June 29, 2001	$207,500,000
June 30, 2001, through September 29, 2001	$212,500,000
September 30, 2001, through March 31, 2002	$217,500,000
April 1, 2002, through March 31, 2003	$225,000,000
April 1, 2003, through March 31, 2004	$235,000,000
April 1, 2004, through March 31, 2005	$245,000,000
April 1, 2005, and thereafter	$260,000,000

Table B

Fiscal Quarter Ending Dates	Ratio
September 30, 2000, through December 30, 2000	$180,000,000
December 31, 2001, through March 30, 2001	$182,500,000
March 31, 2001, through June 29, 2001	$185,000,000
June 30, 2001, through September 29, 2001	$190,000,000
September 30, 2001, through March 31, 2002	$195,000,000
April 1, 2002, through March 31, 2003	$200,000,000
April 1, 2003, through March 31, 2004	$210,000,000
April 1, 2004, through March 31, 2005	$220,000,000
April 1, 2005, and thereafter	$230,000,000

SECTION 14. Amendment to Schedule 1.01(d). Schedule 1.01(d) is hereby amended by deleting such Schedule in its entirety and replacing it with the attached new Schedule 1.01(d).

SECTION 15. Addition of Schedule 1.01(e). Schedule 1.01(e) hereto is hereby added as a new Schedule to the Credit Agreement.

SECTION 16. REPRESENTATIONS AND WARRANTIES. Each Borrower represents and warrants to the Administrative Agent and to each of the Lenders that:

(a) This Amendment has been duly authorized, executed and delivered by it and constitutes a legal, valid and binding obligation of each Loan Party party hereto, enforceable against such Loan Party in accordance with its terms.

(b) Before and after giving effect to this Amendment, the representations and warranties set forth in Article III of the Credit Agreement are true and correct in all material respects on and as of the date hereof with the same effect as if made on and as of the date hereof, except to the extent such representations and warranties expressly relate to an earlier date.

(c) Before and after giving effect to this Amendment, no Event of Default or Default has occurred and is continuing.

SECTION 17. AMENDMENT FEE. In consideration of the agreements of the Lenders contained in this Amendment, the Parent Borrower agrees to pay to the Administrative Agent, for the account of each Lender that delivers an executed counterpart of this Amendment prior to 5:00 p.m., New York City time, on August 10, 2000, an amendment fee (the "AMENDMENT FEE") in an amount equal to 0.375% of the sum of such Lender's outstanding Term Loans and Revolving Credit Commitment as of such date.

SECTION 18. CONDITIONS TO EFFECTIVENESS. This Amendment shall become effective as of August 10, 2000, when (a) the Administrative Agent shall have received (i) counterparts of this Amendment that, when taken together, bear the signatures of the Borrowers and the requisite Lenders and (ii) the Amendment Fees, (b) the representations and warranties set forth in Section 16 hereof are true and correct and (c) all fees and expenses required to be paid or reimbursed by the Borrowers pursuant hereto or to the Credit Agreement shall have been paid or reimbursed, as applicable.

SECTION 19. CREDIT AGREEMENT. Except as specifically amended hereby, the Credit Agreement shall continue in full force and effect in accordance with the provisions thereof as in existence on the date hereof. After the date hereof, any reference to the Credit Agreement shall mean the Credit Agreement as amended hereby. This Amendment shall be a Loan Document for all purposes.

SECTION 20. APPLICABLE LAW. THIS AMENDMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF NEW YORK.

SECTION 21. COUNTERPARTS. This Amendment may be executed in two or more counterparts, each of which shall constitute an original but all of which when taken together shall constitute but one agreement. Delivery of an executed signature page to this Amendment by facsimile transmission shall be effective as delivery of a manually signed counterpart of this Amendment.

SECTION 22. EXPENSES. The Parent Borrower agrees to reimburse the Administrative Agent for its out-of-pocket expenses in connection with this

Amendment,

including the reasonable fees, charges and disbursements of Cravath, Swaine & Moore, counsel for the Administrative Agent.

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed by their respective authorized officers as of the day and year first written above.

MAGELLAN HEALTH SERVICES, INC.,

by
____
Name:
Title:

CHARTER BEHAVIORAL HEALTH
SYSTEM OF NEW MEXICO, INC.,

by
____
Name:
Title:

MERIT BEHAVIORAL CARE
CORPORATION,

by
____
Name:
Title:

THE CHASE MANHATTAN BANK,
individually and as Administrative Agent,
Collateral Agent and an Issuing Bank,

by /s/ Stephen P. Rockford
____
Name: Stephen P. Rockford
Title: Vice President

FIRST UNION NATIONAL BANK,
individually and as Syndication Agent and
an Issuing Bank,

by
____
Name:
Title:

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed by their respective authorized officers as of the day and year first written above.

MAGELLAN HEALTH SERVICES, INC.,

by
____
Name:
Title:

CHARTER BEHAVIORAL HEALTH
SYSTEM OF NEW MEXICO, INC.,

by
____
Name:

Title:

MERIT BEHAVIORAL CARE
CORPORATION,

by

Name:
Title:

THE CHASE MANHATTAN BANK,
individually and as Administrative Agent,
Collateral Agent and an Issuing Bank,

by

Name:
Title:

FIRST UNION NATIONAL BANK,
individually and as Syndication Agent and
an Issuing Bank,

by /s/ JOYCE L BARRY

Name: JOYCE L BARRY
Title:SVP

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed by their respective authorized officers as of the day and year first written above.

MAGELLAN HEALTH SERVICES, INC.,

by /s/ JAMES R. BENDENBAUGH

Name: JAMES R. BENDENBAUGH
Title: SENIOR VICE PRESIDENT & TREASURER

CHARTER BEHAVIORAL HEALTH
SYSTEM OF NEW MEXICO, INC.,

by /s/ CHARLOTTE A. SANFORD

Name: CHARLOTTE A. SANFORD
Title: TREASURER

MERIT BEHAVIORAL CARE
CORPORATION,

by /s/ CHARLOTTE A. SANFORD

Name: CHARLOTTE A. SANFORD
Title: TREASURER

THE CHASE MANHATTAN BANK,
individually and as Administrative Agent,
Collateral Agent and an Issuing Bank,

by

Name:
Title:

FIRST UNION NATIONAL BANK,
individually and as Syndication Agent and
an Issuing Bank,

by

Name:
Title:

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION:

BATTERSON PARK CBOI

By: General Re-New England Asset Management, Inc. as Collateral Manager

By: /s/ SUSAN [ILLEGIBLE]

Name: SUSAN [ILLEGIBLE]
Title: VICE PRESIDENT
8/10/00

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: BANK POLSKA KASA OPIEKI S.A., NEW YORK BRANCH

by /s/ HUSSEIN B. EL-TAWIL

Name: HUSSEIN B. EL-TAWIL
Title: VICE PRESIDENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION:

by /s/ JOHN G. POPP

Name: JOHN G. POPP
Title: MANAGING DIRECTOR
FIRST DOMINION FUNDING I

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: MORGAN STATE DEAN WITTER ***** INCOME TRUST

by /S/ PETER GEWINTZ

Name: PETER GEWINTZ
Title: VICE PRESIDENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: CREDIT LYONNAIS NEW YORK BRANCH

by /s/ JOHN C. OBERLE

Name: JOHN C. OBERLE
Title: VICE PRESIDENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: PACIFICA PARTNER I. LP
By: IMPERIAL CREDIT ASSET MANAGEMENT, INC
AS ITS INVESTMENT MANAGER

by /s/ DEAN K. KAWAI

Name: DEAN K. KAWAI

Title: VICE PRESIDENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: TORONTO DOMINION (NEW YORK), INC.

by /s/ JORGE A. GARCIA

Name: JORGE A. GARCIA
Title: VICE PRESIDENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: PARIBAS CAPITAL FUNDING LLC

by /s/ M. STEVEN ALEXANDER

Name: M. STEVEN ALEXANDER
Title: DIRECTOR

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: GENERAL ELECTRIC CAPITAL CORPORATION

by /s/ WILLIAM E. MAGEE

Name: WILLIAM E. MAGEE
Title: DULY AUTHORIZED SIGNATORY

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

TCW LEVERAGED INCOME TRUST, L.P. BY:
TCW ADVISERS, LTD AS GENERAL PARTNER

By: /s/ MARK L. GOLD

Name: MARK L. GOLD
Title: MANAGING DIRECTOR

By: TCW INVESTMENT MANAGEMENT COMPANY
AS INVESTMENT ADVISOR

By: /s/ JOHNATHAN BERG

Name: JOHNATHAN BERG
Title:

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

TCW ADVISORS, INC. AS
ITS COLLATERAL MANAGER

By: /s/ [ILLEGIBLE]

Name:
Title:

By: /s/ [ILLEGIBLE]

Name:
Title:

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL

CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: THE BANK OF NOVA SCOTIA

by /s/ W.J. BROWN

Name: W.J. BROWN
Title: VICE PRESIDENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: KZH CRESENT - 2 LLC

by /s/ PETER CHIN

Name: PETER CHIN
Title: AUTHORIZED AGENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: KZH PONDVIEW LLC

by /s/ PETER CHIN

Name: PETER CHIN
Title: AUTHORIZED AGENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL

BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: KZH SOLEIL LLC

by /s/ PETER CHIN

Name: PETER CHIN
Title: AUTHORIZED AGENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: SUMMIT BANK

by /s/ CHRISTOPHER [ILLEGIBLE]

Name: CHRISTOPHER [ILLEGIBLE]
Title: SENIOR VICE PRESIDENT

SIGNATURE PAGE TO AMENDMENT NO. 6 DATED AS OF AUGUST 10, 2000, TO THE CREDIT AGREEMENT DATED AS OF FEBRUARY 12, 1998 (AS PREVIOUSLY AMENDED, SUPPLEMENTED OR OTHERWISE MODIFIED FROM TIME TO TIME), AMONG MAGELLAN HEALTH SERVICES, INC., CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC., MERIT BEHAVIORAL CARE CORPORATION, THE SUBSIDIARY BORROWERS, THE LENDERS, THE CHASE MANHATTAN BANK, AS ADMINISTRATIVE AGENT, AS COLLATERAL AGENT AND AS AN ISSUING BANK, FIRST UNION NATIONAL BANK, AS SYNDICATION AGENT AND AS AN ISSUING BANK, AND CREDIT LYONNAIS NEW YORK BRANCH, AS DOCUMENTATION AGENT.

NAME OF INSTITUTION: BANK OF TOKYO-MITSUBISHI TRUST CO.

by /s/ SPENCER [ILLEGIBLE]

Name: SPENCER [ILLEGIBLE]
Title: VICE PRESIDENT

Schedule 1.01(e)

MAXIMUM ADDITIONS TO CONSOLIDATED EBITDA

1. All charges, writeoffs and losses for any fiscal quarter of the Parent Borrower's fiscal year ending September 30, 2000, and the fiscal quarter ending December 31, 2000, attributable to the Magellan Specialty Health division (PROVIDED that the aggregate amount of such charges, writeoffs and losses during such fiscal year and fiscal quarter combined that are permitted to be added in determining Consolidated EBITDA shall not exceed $117,400,000, and PROVIDED FURTHER that any future net cash outflows after August 10, 2000, resulting from the exit by the Parent Borrower from the business of the Magellan Specialty Health division in excess of $28,800,000

shall not be added in determining Consolidated EBITDA).

2. All restructuring, severance, lease termination and reorganization charges for any fiscal quarters ending on or before September 30, 2001, relating to the reorganization and/or consolidation of Magellan Health Services and/or Magellan Behavioral Health and their respective subsidiaries (PROVIDED that the aggregate amount of such charges permitted to be added in determining Consolidated EBITDA shall not exceed $6,000,000).

3. The writeoff of goodwill, intangibles and other long-lived assets related to Group Practice Affiliates, Inc. and its subsidiaries (PROVIDED that the aggregate amount of such writeoffs permitted to be added in determining Consolidated EBITDA shall not exceed $15,000,000).

<ARTICLE> 5

<PERIOD-TYPE>	3-MOS	
<FISCAL-YEAR-END>		SEP-30-2000
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<CASH>		53,886
<SECURITIES>		0
<RECEIVABLES>		152,188
<ALLOWANCES>		0
<INVENTORY>		0
<CURRENT-ASSETS>		339,963
<PP&E>		207,366
<DEPRECIATION>		88,859
<TOTAL-ASSETS>		1,792,567
<CURRENT-LIABILITIES>		453,359
<BONDS>		1,088,519
<PREFERRED-MANDATORY>		56,531
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<COMMON>		8,613
<OTHER-SE>		157,183
<TOTAL-LIABILITY-AND-EQUITY>		1,792,567
<SALES>		1,499,756
<TOTAL-REVENUES>		1,499,756
<CGS>		0
<TOTAL-COSTS>		1,369,645
<OTHER-EXPENSES>		50,427
<LOSS-PROVISION>		0
<INTEREST-EXPENSE>		72,202
<INCOME-PRETAX>		(50,691)
<INCOME-TAX>		(12,883)
<INCOME-CONTINUING>		(37,913)
<DISCONTINUED>		0
<EXTRAORDINARY>		0
<CHANGES>		0
<NET-INCOME>		(37,913)
<EPS-BASIC>		(1.26)
<EPS-DILUTED>		(1.26)