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 DECEMBER 31, 1998

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.)
3414 PEACHTREE ROAD, N.E. SUITE 1400 ATLANTA, GEORGIA	30326
(Address of principal executive offices)	(Zip Code)

(404) 841-9200
(Registrant's telephone number, including area code)

NOT APPLICABLE
(Former name, former address and former fiscal year, if changed since last report)

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 January 29, 1999 was 31,777,788.

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MAGELLAN HEALTH SERVICES, INC.
QUARTERLY REPORT UNDER SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934
PART I--FINANCIAL INFORMATION

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	SEPTEMBER 30, 1998	DECEMBER 31, 1998
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 92,050	$ 49,358
Accounts receivable, net	174,846	172,990
Restricted cash and investments	89,212	132,099
Refundable income taxes	4,939	--
Other current assets	38,677	33,916
Total Current Assets	399,724	388,363
Assets restricted for settlement of unpaid claims and other liabilities	37,910	33,978
Property and equipment, net of accumulated depreciation of $60,100 at September 30, 1998 and $60,231 at December 31, 1998	177,169	156,436
Deferred income taxes	97,386	94,069
Investments in unconsolidated subsidiaries	11,066	31,814
Other long-term assets	35,415	18,751
Goodwill, net	992,431	1,067,085
Other intangible assets, net	165,189	160,447
	$ 1,916,290	$1,950,943
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 42,873	$ 33,593
Accrued liabilities	193,530	242,199
Medical claims payable	195,330	191,384
Income taxes payable	--	681
Current maturities of long-term debt and capital lease obligations	23,033	29,428
Total Current Liabilities	454,766	497,285
Long-term debt and capital lease obligations	1,202,613	1,156,020
Reserve for unpaid claims	30,280	27,149
Deferred credits and other long-term liabilities	14,011	74,633
Minority interest	26,985	4,683
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock, without par value		
Authorized--10,000 shares		
Issued and outstanding--none	--	--
Common Stock, par value $0.25 per share		
Authorized--80,000 shares		
Issued and outstanding--33,898 shares at September 30, 1998 and December 31, 1998	8,476	8,476
Other Stockholders' Equity:		
Additional paid-in capital	349,651	349,663
Accumulated deficit	(149,238)	(145,057)
Warrants outstanding	25,050	25,050
Common stock in treasury, 2,289 shares at September 30, 1998 and December 31, 1998	(44,309)	(44,309)
Cumulative foreign currency adjustments included in comprehensive income	(1,995)	(2,650)
Total Stockholders' Equity	187,635	191,173
	$ 1,916,290	$1,950,943

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 DECEMBER 31,	
	1997	1998
Net revenue	$ 212,371	$ 463,143
Costs and expenses:		
Salaries, cost of care and other operating expenses	172,331	413,216
Equity in (earnings) losses of unconsolidated subsidiaries	12,122	(4,982)
Depreciation and amortization	6,969	18,391
Interest, net	7,401	24,109
Stock option expense (credit)	(3,959)	12
Managed care integration costs	--	1,750
Unusual items	--	22
	194,864	452,518
Income before provision for income taxes and minority interest	17,507	10,625
Provision for income taxes	7,003	6,037
Income before minority interest	10,504	4,588
Minority interest	2,876	407
Net income	7,628	4,181
Unrealized foreign currency adjustment, net of income tax (benefit) provision of $39 in 1997 and $(436) in 1998	59	(655)
Comprehensive income	$ 7,687	$ 3,526
Average number of common shares outstanding--basic	28,969	31,613
Average number of common shares outstanding--diluted	29,784	31,660
Net income per common share--basic	$ 0.26	$ 0.13
Net income per common share--diluted	$ 0.26	$ 0.13

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 THREE MONTHS

	ENDED DECEMBER 31,	
	1997	1998
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 7,628	$ 4,181
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	6,969	18,391
Equity in (earnings) losses of unconsolidated subsidiaries	12,122	(4,982)
Stock option expense (credit)	(3,959)	12
Non-cash interest expense	422	954
Gain on sale of assets	--	(1,062)
Cash flows from changes in assets and liabilities, net of effects from sales and acquisitions of businesses:		
Accounts receivable, net	(16,304)	(6,267)
Restricted cash and investments	--	(42,887)
Other assets	(10,633)	3,289
Accounts payable and other accrued liabilities	(27,776)	34,142
Medical claims payable	6,592	(3,946)
Reserve for unpaid claims	(9,256)	(3,131)
Income taxes payable and deferred income taxes	2,056	9,363
Other liabilities	(1,623)	(223)
Minority interest, net of dividends paid	3,199	924
Other	(1,162)	(1,099)
Total adjustments	(39,353)	3,478
Net cash provided by (used in) operating activities	(31,725)	7,659
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(4,578)	(14,357)
Acquisitions and investments in businesses, net of cash acquired and return of escrowed funds	(165,548)	6,444
Conversion of joint ventures from consolidation to equity method	--	(21,092)
Distributions received from unconsolidated subsidiaries	--	9,303
Decrease in assets restricted for settlement of unpaid claims and other liabilities	14,364	5,808
Proceeds from sale of assets	--	3,619
Cresent Transaction costs	(4,253)	(7)
Net cash used in investing activities	(160,015)	(10,282)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of debt, net of issuance costs	--	(69)
Payments on debt and capital lease obligations	(140)	(40,000)
Proceeds from exercise of stock options and warrants	1,917	--
Purchases of treasury stock	(12,456)	--
Net cash used in financing activities	(10,679)	(40,069)
Net decrease in cash and cash equivalents	(202,419)	(42,692)
Cash and cash equivalents at beginning of period	372,878	92,050
Cash and cash equivalents at end of period	$ 170,459	$ 49,358

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

DECEMBER 31, 1998

(UNAUDITED)

NOTE A--BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements 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. These financial statements should be read in conjunction with the audited consolidated financial statements of Magellan Health Services, Inc. and Subsidiaries ("Magellan" or the "Company") for the fiscal year ended September 30, 1998, included in the Company's Annual Report on Form 10-K. Certain reclassifications have been made to fiscal 1998 amounts to conform to fiscal 1999 presentation.

NOTE B--SUPPLEMENTAL CASH FLOW INFORMATION

Below is supplemental cash flow information related to the three months ended December 31, 1997 and 1998 (in thousands):

	FOR THE THREE MONTHS ENDED DECEMBER 31, 1997	1998
Income taxes paid, net of refunds received	$ 4,752	$ (3,570)
Interest paid, net of amounts capitalized	21,550	12,601

NOTE C--LONG-TERM DEBT AND LEASES

Information with regard to the Company's long-term debt and capital lease obligations at September 30, 1998 and December 31, 1998 is as follows (in thousands):

	SEPTEMBER 30, 1998	DECEMBER 31, 1998
Credit Agreement:		
Revolving Facility due through 2004	$ 40,000	$ --
Term Loan Facility (7.3725% to 7.8725% at December 31, 1998) due through 2006	550,000	550,000
9.0% Senior Subordinated Notes due 2008	625,000	625,000
6.07% to 11.5% Mortgage and other notes payable through 2005	4,198	4,010
4.05% Capital lease obligations due through 2014	6,448	6,438
	1,225,646	1,185,448
Less amounts due within one year	23,033	29,428
	$ 1,202,613	$1,156,020

NOTE D--ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

	SEPTEMBER 30, 1998	DECEMBER 31, 1998
Salaries, wages and other benefits	$ 23,893	$ 12,504
Interest	9,271	23,200
CHAMPUS adjustments	25,484	29,330
Other	134,882	177,165
	$ 193,530	$ 242,199

NOTE E--INCOME PER COMMON SHARE

The following table presents the components of average number of common shares outstanding-diluted (in thousands):

	THREE MONTHS ENDED DECEMBER 31, 1997	THREE MONTHS ENDED DECEMBER 31, 1998
Average number of common shares outstanding--basic...	28,969	31,613
Common stock equivalents--stock options.............	762	39
Common stock equivalents--warrants..................	53	8
Average number of common shares outstanding--diluted.............................	29,784	31,660

Options to purchase approximately 1,649,000 shares of common stock at $14.56 to $31.00 per share were outstanding during the quarter ended December 31, 1998, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common shares. Approximately 1,315,000 of these options, which expire between fiscal 2001 and 2009, were outstanding at December 31, 1998.

Warrants to purchase approximately 4,713,000 shares of common stock at $26.15 to $38.70 per share were outstanding during the quarter ended December 31, 1998, but were not included in the computation of diluted EPS because the warrants' exercise prices were greater than the average market price of the common shares. The warrants, which expire between fiscal 2000 and 2009, were outstanding at December 31, 1998.

On November 17, 1998, the Company's Board of Directors approved the repricing of stock options outstanding under the Company's existing stock option plans which were held by current directors and full-time employees (the "Stock Option Repricing"). Each holder of 10,000 or more stock options that was

NOTE E--INCOME PER COMMON SHARE (CONTINUED)
eligible to participate in the Stock Option Repricing was required to forfeit a percentage of outstanding stock options as follows:

- - Current Directors, including the Chief Executive Officer............	40%
- - Named Executive Officers...	30%
- - Holders of 50,000 or more stock options............................	25%
- - Holders of 10,000-49,999 stock options.............................	15%

The Stock Option Repricing was consummated on December 8, 1998, based on the fair market value of the Company's common stock on such date. Approximately 1.7 million outstanding stock options were repriced to $8.41 and approximately 0.5 million outstanding stock options were forfeited as a result of the Stock Option Repricing. Each participant in the Stock Option Repricing is precluded from exercising repriced stock options until June 8, 1999.

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES

CHARTER BEHAVIORAL HEALTH SYSTEMS, LLC. The Company owned a 50% interest in Charter Behavioral Health Systems, LLC ("CBHS") as of September 30, 1998 and December 31, 1998. The Company accounts for its investment in CBHS using the equity method.

A summary of financial information for CBHS is as follows (in thousands):

	SEPTEMBER 30, 1998	DECEMBER 31, 1998
Current assets	$ 147,119	$ 143,545
Property and equipment, net	21,148	21,460
Other nonconcurrent assets	8,871	9,211
Total Assets	$ 177,138	$ 174,216
Current liabilities	$ 141,379	$ 152,888
Long-term debt	67,200	67,200
Other nonconcurrent liabilities	35,437	47,661
Members' deficit	(66,878)	(93,533)
Total Liabilities and Members' Deficit	$ 177,138	$ 174,216

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

	THREE MONTHS ENDED DECEMBER 31,	
	1997	1998
Net Revenue	$ 178,058	$ 182,221
Operating expenses	199,664	206,290
Interest, net	1,370	1,588
Net loss before preferred member distribution	$ (22,976)	$ (25,657)
Cash provided by (used in) operating activities	$ (2,176)	$ 4,904
Magellan equity loss (2)	$ (11,488)	$ --

The Company's transactions with CBHS and related balances are as follows (in thousands):

THREE MONTHS ENDED
DECEMBER 31,

	1997	1998
Franchise fee revenue (2)..................	$ 19,575	$ --
Costs:		
Accounts receivable collection fees.......	$ 1,054	$ 93
Hospital-based joint venture management fees..................................	1,630	1,319

	SEPTEMBER 30, 1998	DECEMBER 31, 1998
Due to CBHS, net (1)......................	$ 1,127	$ 4,244
Prepaid CHARTER call center management fees (3)...............................	$ 2,953	$ 5,314
Net book value of leased property (4).....	$ 2,850	$ 7,250

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(1) The nature of hospital accounts receivable billing and collection processes have resulted in the Company and CBHS receiving remittances which belong to the other party. Additionally, the Company and CBHS have established a settlement and allocation process for the accounts receivable related to those patients who were not yet discharged from their treatment on June 16, 1997. These and other events result in the amount presented as due to CBHS.

(2) Franchise fees due from CBHS were approximately $38.0 million and $58.5 million as of September 30, 1998 and December 31, 1998, respectively. CBHS' independent public accountants' report on CBHS' financial statements for the year ended September 30, 1998, makes reference to uncertainty regarding CBHS' ability to continue as a going concern. The Company recorded equity in loss of its investment in CBHS until all franchise fees due from CBHS were reduced to $0 at September 30, 1998. The Company received no franchise fee payments from CBHS and recorded no franchise fee revenue related to CBHS during the three months ended December 31, 1998, due to continuing uncertainties surrounding their collectibility. Cumulative equity in losses of CBHS in excess of the

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

Company's investment in CBHS of $7.7 million ($5.1 million during the fiscal year ended September 30, 1998; $2.6 million during the three months ended December 31, 1998) are not reflected in the Company's financial statements at and for the three months ended December 31, 1998, since the Company has no remaining obligation or commitment to fund CBHS and has no guarantees outstanding for any CBHS obligations.

(3) CBHS is responsible for funding substantially all of the operations of the 1-800-CHARTER call center under a management agreement (the "Call Center Management Agreement") which was entered into on December 22, 1997.

Under the Call Center Management Agreement, CBHS agreed to fund the operations of the call center with the exceptions of capital expenditures and lease payments for an initial term of eighteen months in exchange for

payment of approximately $5.9 million, which approximated the budgeted costs for the call center over the term of the agreement. In December 1998, the Call Center Management Agreement was extended for an additional twelve months at a cost to the Company of approximately $3.3 million.

(4) CBHS leased two psychiatric hospital facilities (collectively, the "CBHS Leaseholds") from the Company as of December 31, 1998, that were acquired by the Company in connection with CBHS' acquisition of certain businesses from Ramsay Health Care, Inc. on September 28, 1998. The Company paid approximately $7.2 million for the CBHS Leaseholds ($2.8 million during September 1998; $4.4 million during the quarter ended December 31, 1998). The purchase of the CBHS Leaseholds was funded primarily through distributions received from the Provider JV's (as defined). The CBHS Leaseholds are leased to CBHS for a 10-year lease term at an annual rent of $0.7 million. The Company accounted for the purchase of the CBHS Leaseholds as an investment in income producing property. Both the Company and CBHS account for these leases as operating leases.

Under the terms of a letter agreement dated November 10, 1998, between the Company and Crescent Real Estate Funding VII, L.P. ("Crescent Funding"), Crescent Funding has agreed to purchase the CBHS Leaseholds from the Company, at the contract acquisition cost paid by the Company, upon the sale of certain other property owned by Crescent Funding and leased by CBHS at December 31, 1998. Crescent Funding is an affiliate of both Crescent Operating, Inc. ("COI"), the other 50% owner of CBHS, and Crescent Real Estate Equities, L.P. ("Crescent"), the lessor of the majority of the properties in which CBHS conducts its business.

CHOICE BEHAVIORAL HEALTH PARTNERSHIP. The Company is a 50% partner with Value Options, Inc. in Choice Behavioral Health Partnership ("Choice"), a managed behavioral healthcare company. Choice 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.

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

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

	SEPTEMBER 30, 1998	DECEMBER 31, 1998
Current assets	$ 22,974	$ 20,957
Property and equipment, net	345	310
Total Assets	$ 23,319	$ 21,267
Current liabilities	$ 16,829	$ 16,514
Partners' capital	6,490	4,753
Total Liabilities and Partners' Capital	$ 23,319	$ 21,267
Magellan Investment	$ 3,245	$ 2,207

THREE MONTHS ENDED

	DECEMBER 31, 1998
Net revenue	$ 14,580
Operating expenses	8,348
Net income	$ 6,232
Magellan equity income	$ 3,116

The Company acquired its investment in Choice on February 12, 1998, as part of the Merit (as defined) acquisition. Accordingly, statement of operations data for the three months ended December 31, 1997, is not presented.

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, 1998 and December 31, 1998 was $5.8 million and $6.5 million, respectively. The Company's equity in earnings (losses) of Premier for the three months ended December 31, 1997 and 1998 was $(0.6) million and $0.7 million, respectively.

HOSPITAL-BASED JOINT VENTURES. The Company owns non-controlling interests in five hospital-based joint ventures ("Provider JV's"). Generally, each member of the joint venture leased and/or contributed certain assets in each respective market to the joint venture with the Company becoming the managing member.

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

A summary of the Provider JV's is as follows:

MARKET	DATE	OWNERSHIP PERCENTAGE	MINORITY OWNER/S
Chicago, IL	June, 1994	75%	Naperville Health Ventures
Albuquerque, NM	May, 1995	67%	Columbia/HCA Healthcare Corporation
Raleigh, NC	June,1995	50%	Columbia/HCA Healthcare Corporation
Lafayette, LA	October, 1995	50%	Columbia/HCA Healthcare Corporation
Anchorage, AK	August, 1996	57%	Columbia/HCA Healthcare Corporation

The Provider JV's results of operations were included in the Company's consolidated financial statements from inception, less minority interest, through September 30, 1998. On October 1, 1998, the Provider JV's were converted from consolidation to the equity method of accounting. See "Management's Discussion and Analysis--Recent Accounting Pronouncements--EITF 96-16".

The Company's ownership interests in the Provider JV's have been managed by CBHS for a fee equivalent to Magellan's portion of the joint ventures' earnings since June 17, 1997.

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

	DECEMBER 31, 1998
Current assets	$ 21,026
Property and equipment, net	23,761
Other noncurrent assets	2,196

Total Assets	$ 46,983
Current liabilities	$ 10,413
Partners' capital	36,570
Total Liabilities and Partners' Capital	$ 46,983
Magellan Investment	$ 20,455

	THREE MONTHS ENDED DECEMBER 31, 1998
Net revenue	$ 14,845
Operating expenses	12,604
Net income	$ 2,241
Magellan equity income	$ 1,199

NOTE G--ACQUISITIONS

MANAGED CARE ACQUISITIONS. During fiscal 1998, the Company acquired the following businesses in its Behavioral Managed Healthcare ("Behavioral") and Specialty Managed Healthcare ("Specialty") business segments (collectively, the "Managed Care Acquisitions"):

ACQUIRED COMPANY	SEGMENT	ACQUISITION DATE	CONTRACT PURCHASE PRICE (IN MILLIONS)
Human Affairs International, Incorporated ("HAI")	Behavioral	12/4/97	$ 122.1(1)
Allied Health Group, Inc. ("Allied")	Specialty	12/5/97	$ 50.0(2)
Merit Behavioral Care Corporation ("Merit")	Behavioral	2/12/98	$ 750.0

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(1) Excluding potential contingent consideration of up to $300.0 million.

(2) Excluding contingent consideration of $4.5 million paid during the quarter ended December 31,1998.

The Company accounted for the Managed Care Acquisitions using the purchase method of accounting. The purchase price allocation for the Merit acquisition is tentative and subject to final valuation allowances on deferred tax assets, integration plan matters (see Note I), CHAMPUS Adjustments (as defined) and certain other matters. The Company expects the Merit purchase price allocation to be finalized during the quarter ended March 31, 1999.

GREEN SPRING MINORITY STOCKHOLDER CONVERSION. In January 1998, the minority stockholders of Green Spring converted their collective 39% interest in Green Spring into an aggregate of 2,831,516 shares of the Company's common stock through exercise of an exchange option (the "Green Spring Minority Stockholder

Conversion"). As a result of the Green Spring Minority Stockholder Conversion, the Company owns 100% of Green Spring. The Company issued shares from treasury to effect the Green Spring Minority Stockholder Conversion and accounted for it as a purchase of minority interest at the fair value of consideration paid.

The following unaudited pro forma information for the quarter ended December 31, 1997, has been prepared assuming the Managed Care Acquisitions and the Green Spring Minority Stockholder Conversion were consummated on October 1, 1997. The unaudited pro forma information does not purport to be

NOTE G--ACQUISITIONS (Continued)
indicative of the results that would have actually been obtained had such transactions been consummated on October 1, 1997, or which may be attained in future periods (in thousands, except per share amounts):

	PRO FORMA FOR THE THREE MONTHS ENDED DECEMBER 31, 1997
Net revenue	$ 428,272
Net income (1)	$ 3,515
Net income per common share -- basic	$ 0.11
Net income per common share -- diluted	$ 0.11

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(1) Excludes expected unrealized cost savings related to the Integration Plan (as defined).

NOTE H--CONTINGENCIES

The Company is self-insured for a substantial portion of its general and professional liability risks. The reserves for self-insured general and professional liability losses, including loss adjustment expenses, are included in "Reserve for unpaid claims" in the Company's balance sheet and are based on actuarial estimates that are discounted at an average rate of 6% to their present value based on the Company's historical claims experience adjusted for current industry trends. The undiscounted amount of the reserve for unpaid claims at September 30, 1998 and December 31, 1998, was approximately $34.6 million and $30.3 million, respectively. The carrying amount of accrued medical malpractice claims was $26.2 million and $23.8 million at September 30, 1998 and December 31, 1998, respectively. The reserve for unpaid claims is adjusted periodically as such claims mature, to reflect changes in actuarial estimates based on actual experience. During the quarter ended December 31, 1997, the Company recorded reductions in malpractice claim reserves of approximately $4.1 million, as a result of updated actuarial estimates. These reductions resulted primarily from updates to actuarial assumptions regarding the Company's expected losses for more recent policy years. These revisions are based on changes in expected values of ultimate losses resulting from the Company's claim experience, and increased reliance on such claim experience. While management and its actuaries believe that the present reserve is reasonable, ultimate settlement of losses may vary from the amount recorded.

The healthcare industry is subject to numerous laws and regulations. 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 excluded from participating in government healthcare programs, subjected to fines or penalties or required to repay amounts received from the government for previously billed patient services. The Office of the Inspector General of the Department of Health and Human Services and the United States Department of Justice

NOTE H--CONTINGENCIES (CONTINUED)

and certain other governmental agencies are currently conducting inquiries and/or investigations regarding the compliance by the Company and certain of its subsidiaries and the compliance by CBHS and certain of its subsidiaries with such laws and regulations. Certain of the inquiries relate to the operations and business practices of the Company's psychiatric provider operations prior to the consummation of the Crescent Transactions (as defined). In addition, the Company is also subject to or party to litigation, claims and civil suits relating to its operations and business practices. In the opinion of management, the Company has recorded reserves that are adequate to cover litigation, claims or assessments that have been or may be asserted against the Company arising out of such litigation, civil suits and governmental inquiries. Furthermore, management believes that the resolution of such litigation, civil suits and governmental inquiries will not have a material adverse effect on the Company's financial position or results of operations; however, there can be no assurance in this regard.

In October 1996, a group of eight plaintiffs purporting to represent an uncertified class of psychiatrists, psychologists and social workers brought an action under the federal antitrust laws in the United States District Court for the Southern District of New York against nine behavioral health managed care organizations, including Merit, CMG, Green Spring and HAI (collectively, the "Defendants"). The complaint (the "Stephens Case") alleges that the Defendants violated Section I of the Sherman Act by engaging in a conspiracy to fix the prices at which the defendants purchase services from mental healthcare providers such as the plaintiffs. The complaint further alleges that the Defendants engaged in a group boycott to exclude mental healthcare providers from the Defendants' networks in order to further the goals of the alleged conspiracy. The complaint also challenges the propriety of the Defendants' capitation arrangements with their respective customers, although it is unclear from the complaint whether the plaintiffs allege that the Defendants unlawfully conspired to enter into capitation arrangements with their respective customers. The complaint seeks treble damages against the Defendants in an unspecified amount and a permanent injunction prohibiting the Defendants from engaging in the alleged conduct which forms the basis of the complaint, plus costs and attorneys' fees. On May 12, 1998, the District Court granted the Defendants' motion to dismiss the complaint with prejudice. On May 27, 1998, the plaintiffs filed a notice of appeal of the District Court's dismissal of their complaint with the United States Second Circuit Court of Appeals. On November 16, 1998, the Second Circuit court issued a Summary Order affirming the District Court's decision. The plaintiffs have not filed a petition for rehearing, and the time allotted for doing so has expired. The plaintiffs have 90 days from the date of judgment to file a petition for certiorari with the United States Supreme Court. The plaintiffs have not indicated whether they will file such a petition. If no petition is filed, or if a filed petition is denied, this matter will have been concluded. The Company does not believe this matter will have a material adverse effect on its financial position or results of operations.

On May 26, 1998, the counsel representing the plaintiffs in the Stephens Case filed an action in the United States District Court for the District of New

Jersey on behalf of a group of thirteen plaintiffs who also purport to represent an uncertified class of psychiatrists, psychologists and clinical social workers. This complaint alleges substantially the same violations of federal antitrust laws by the Defendants. The Defendants believe the factual and legal issues involved in this case are substantially similar to those involved in the Stephens Case and intend to vigorously defend themselves in this litigation. On August 28, 1998, the Defendants filed a joint motion requesting that the case be: i) transferred to the Southern District of New York; ii) alternatively, that all proceedings be stayed pending the Second

NOTE H--CONTINGENCIES (CONTINUED)

Circuit's determination of the Stephens Case appeal, given the RES JUDICATA effect of the Stephens Case dismissal; and iii) if the Court proceeds with the case, that the complaint be dismissed for failure to state a claim for substantially the same reasons as in the Stephens Case. The plaintiffs have opposed this motion, which was argued on November 23, 1998. At the conclusion of the November 23 hearing, the Court ruled that the case should be transferred to the Southern District of New York. The Defendants' motion to dismiss was deemed withdrawn without prejudice to its resubmission in the Southern District. The plaintiffs have stated that they intend to appeal the Court's transfer order to the United States District Court for the District of New Jersey. The Company does not believe this matter will have a material adverse effect on its financial position or results of operations.

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 $29.3 million as of December 31, 1998, for CHAMPUS Adjustments.

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. Management approved and committed the Company to a plan to combine and integrate the operations of its Behavioral and Specialty segments (the "Integration Plan") during fiscal 1998. The Integration Plan will result in the elimination of duplicative functions and will standardize business practices and information technology platforms.

The Integration Plan will result in the elimination of approximately 1,000 positions during fiscal 1998 and fiscal 1999. Approximately 425 employees had been involuntarily terminated pursuant to the Integration Plan as of December 31, 1998. The Company estimates that approximately 100 additional employees will be involuntarily terminated as a result of the Integration Plan. The remaining positions have been or will be eliminated through normal attrition.

The employee groups of the Behavioral segment that are primarily affected include executive management, finance, human resources, information systems and legal personnel at the various corporate headquarters and regional offices and credentialing, claims processing, contracting and marketing personnel at various operating locations. The Company expects to complete the specific identification of all personnel who will be involuntarily terminated during the quarter ended March 31, 1999, and will complete its involuntary terminations by the end of fiscal 1999.

The Integration Plan has resulted in the closure and identified closure of approximately 20 leased facilities during fiscal 1998 and 1999. The Company expects the remaining office closures, if any, to be insignificant.

The Company recorded approximately $21.3 million of liabilities related to

the Integration Plan, of which $12.4 million was recorded as part of the Merit purchase price allocation and $8.9 million was

NOTE I--MANAGED CARE INTEGRATION PLAN AND COSTS (CONTINUED)
recorded in the statement of operations under "Managed Care integration costs" in fiscal 1998. The Company may record adjustments to such liabilities in fiscal 1999 depending on the Company's ability to sublease closed offices and upon determination of the final amount of the Company's severance obligations.

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

TYPE OF COST	BALANCE SEPTEMBER 30, 1998	ADDITIONS	PAYMENTS	BALANCE DECEMBER 31, 1998
Employee termination benefits............	$ 6,190	$ --	$ 2,824	$ 3,366
Facility closing costs...................	7,475	--	140	7,335
Other....................................	169	--	--	169
	$ 13,834	$ --	$ 2,964	$ 10,870

OTHER INTEGRATION COSTS. The Integration Plan will result in additional incremental costs that must be 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 ended December 31, 1998, the Company incurred approximately $1.8 million in other integration costs, including outside consulting costs of approximately $0.8 million and employee and office relocation costs of approximately $0.4 million.

NOTE J--BUSINESS SEGMENT INFORMATION

The Company operates through five reportable segments which are engaged in various aspects of the healthcare industry. Intersegment sales and transfers among these segments are not significant.

NOTE J--BUSINESS SEGMENT INFORMATION (CONTINUED)
The following tables summarize, for the periods indicated, net revenue, Segment Profit (as defined) and total assets by business segment (in thousands):

BEHAVIORAL SPECIALTY

THREE MONTHS ENDED DECEMBER 31, 1997	MANAGED HEALTHCARE	HUMAN SERVICES	MANAGED HEALTHCARE	HEALTHCARE FRANCHISING	HEALTHCARE PROVIDER	CORPORATE OVERHEAD	CONSOLIDATED
Net revenue..........................	$ 119,211	$ 26,314	$ 14,107	$ 19,575	$ 33,164	$ --	$ 212,371
Segment Profit (loss)................	14,659	2,297	(676)	5,845	9,202	(3,409)	27,918

THREE MONTHS ENDED DECEMBER 31, 1998	BEHAVIORAL MANAGED HEALTHCARE	HUMAN SERVICES	SPECIALTY MANAGED HEALTHCARE	HEALTHCARE FRANCHISING	HEALTHCARE PROVIDER	CORPORATE OVERHEAD	CONSOLIDATED
Net revenue..........................	$ 356,551	$ 45,739	$ 41,041	$ 175	$ 19,637	$ --	$ 463,143
Segment Profit (loss)................	52,620	5,287	416	(1,320)	1,199	(3,293)	54,909

	BEHAVIORAL MANAGED HEALTHCARE	HUMAN SERVICES	SPECIALTY MANAGED HEALTHCARE	HEALTHCARE FRANCHISING	HEALTHCARE PROVIDER	CORPORATE OVERHEAD	CONSOLIDATED
Total assets, September 30, 1998......	$1,356,259	$ 119,356	$ 78,062	$ 1,941	$ 178,217	$ 182,455	$1,916,290
Total assets, December 31, 1998.......	$1,463,516	$ 122,310	$ 75,129	$ 1,854	$ 136,757	$ 151,377	$1,950,943

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

THREE MONTHS ENDED DECEMBER 31, 1997	
Segment Profit..	$ 27,918
Depreciation and amortization...	(6,969)
Interest, net...	(7,401)
Stock option credit...	3,959
Income before provision for income taxes and minority interest..............	$ 17,507

THREE MONTHS ENDED DECEMBER 31, 1998	
Segment Profit..	$ 54,909
Depreciation and amortization...	(18,391)
Interest, net...	(24,109)
Stock option expense..	(12)
Managed care integration costs..	(1,750)
Unusual items...	(22)
Income before provision for income taxes and minority interest..............	$ 10,625

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

This Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). 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 for the fiscal year ended September 30, 1998. 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 for the fiscal year ended September 30, 1998.

OVERVIEW

The Company historically derived the majority of its revenue from providing behavioral healthcare services in an inpatient setting prior to the consummation of the Crescent Transactions on June 17, 1997. Payments from third-party payors are the principal source of revenue for most behavioral healthcare providers. In the early 1990's, many third party payors sought to control the cost of providing care to their patients by instituting managed care programs or seeking the assistance of managed care companies. Providers participating in managed care programs agree to provide services to patients for a discount from established rates, which generally results in pricing concessions by the providers and lower margins. Additionally, managed care programs generally encourage alternatives to inpatient treatment settings and reduce utilization of inpatient services. As a result, third-party payors established managed care programs or engaged managed care companies in many areas of healthcare, including behavioral healthcare. The Company, which until the consummation of the Crescent Transactions was the largest operator of psychiatric hospitals in the United States, was adversely affected by the adoption of managed care programs by the third-party payors.

Prior to the first quarter of fiscal 1996, the Company was not a provider of behavioral managed healthcare services. During the first quarter of fiscal 1996, the Company acquired a 61% ownership interest in Green Spring Health Services, Inc. ("Green Spring"). At that time, the Company intended to become a fully integrated behavioral healthcare provider by combining the behavioral managed healthcare products offered by Green Spring with the direct treatment services offered by the Company's psychiatric hospitals. The Company believed that an entity that participated in both the managed care and the provider segments of the behavioral healthcare industry could more efficiently provide and manage behavioral healthcare for insured populations than an entity that was solely a managed care company. The Company also believed that earnings from its behavioral managed healthcare business would offset, in part, the negative impact on the financial performance of its psychiatric hospitals caused by managed care. Green Spring was the Company's first significant involvement in behavioral managed healthcare. During the first quarter of fiscal 1998, pursuant to the Green Spring Minority Stockholder Conversion, the minority stockholders of Green Spring converted their interests in Green Spring into an aggregate of 2,831,516 shares of the Company's Common Stock.

Subsequent to the Company's acquisition of Green Spring, the growth of the behavioral managed healthcare industry accelerated. Under the Company's majority ownership, Green Spring increased its base of covered lives from 12.0 million as of the end of calendar year 1995 to 21.1 million as of the end of calendar year 1997, a compound annual growth rate of over 32%. While growth in the industry was

accelerating, the behavioral managed healthcare industry also began to consolidate. The Company concluded that this consolidation presented an opportunity for the Company to increase its participation in the behavioral managed healthcare industry, which the Company believed offered growth and earnings prospects superior to those of the psychiatric hospital industry. Therefore, the Company decided to sell its domestic psychiatric facilities to obtain capital for expansion in the behavioral managed healthcare business.

On June 17, 1997, the Company sold substantially all of its domestic acute care psychiatric hospitals and residential treatment facilities (the "Psychiatric Hospital Facilities"), to Crescent Real Estate Equities, L.P. ("Crescent") for $417.2 million in cash (before costs of approximately $16.0 million) and certain other consideration (the "Crescent Transactions"). The sale of the Psychiatric Hospital Facilities provided the Company with approximately $200 million of net cash proceeds, after debt repayment, for use in implementing its business strategy to increase its participation in the managed healthcare industry. The Company used the net cash proceeds of approximately $200 million to finance the acquisitions of HAI and Allied in December 1997.

The Company further implemented its business strategy through the Merit acquisition.

RESULTS OF OPERATIONS

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

THREE MONTHS ENDED DECEMBER 31, 1997	BEHAVIORAL MANAGED HEALTHCARE	HUMAN SERVICES	SPECIALTY MANAGED HEALTHCARE	HEALTHCARE FRANCHISING	HEALTHCARE PROVIDER	CORPORATE OVERHEAD	CONSOLIDATED
Net revenue	$ 119,211	$ 26,314	$ 14,107	$ 19,575	$ 33,164	$ --	$ 212,371
Salaries, cost of care and other operating expenses	103,918	24,017	14,783	2,242	23,962	3,409	172,331
Equity in losses of unconsolidated subsidiaries	634	--	--	11,488	--	--	12,122
	104,552	24,017	14,783	13,730	23,962	3,409	184,453
Segment Profit (loss)(1)	$ 14,659	$ 2,297	$ (676)	$ 5,845	$ 9,202	$ (3,409)	$ 27,918

THREE MONTHS ENDED DECEMBER 31, 1998	BEHAVIORAL MANAGED HEALTHCARE	HUMAN SERVICES	SPECIALTY MANAGED HEALTHCARE	HEALTHCARE FRANCHISING	HEALTHCARE PROVIDER	CORPORATE OVERHEAD	CONSOLIDATED
Net revenue	$ 356,551	$ 45,739	$ 41,041	$ 175	$ 19,637	$ --	$ 463,143
Salaries, cost of care and other operating expenses	307,714	40,452	40,625	1,495	19,637	3,293	413,216
Equity in earnings of unconsolidated subsidiaries	(3,783)	--	--	--	(1,199)	--	(4,982)
	303,931	40,452	40,625	1,495	18,438	3,293	408,234
Segment Profit (loss)(1)	$ 52,620	$ 5,287	$ 416	$ (1,320)	$ 1,199	$ (3,293)	$ 54,909

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(1) The Company evaluates performance of its segments based on profit or loss from operations before depreciation, amortization, interest, stock option expense (credit), managed care integration costs, gain or loss on asset sales, other unusual items, income taxes and minority interest ("Segment Profit"). See the reconciliation of Segment Profit to consolidated income before provision for income taxes and minority interest included in Note J--"Business Segment Information" to the Company's condensed consolidated financial statements set forth elsewhere herein.

BEHAVIORAL MANAGED CARE. Revenue increased 199.2% or $237.4 million, to $356.6 million for the quarter ended December 31, 1998, from $119.2 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 196.1%, or $203.8 million, to $307.7 million for the quarter

ended December 31, 1998, from $103.9 million in the same period in fiscal 1998. Equity in earnings of unconsolidated subsidiaries increased $4.4 million to $3.8 million for the quarter ended December 31, 1998, from a loss of $0.6 million for the same period in fiscal 1998. The increases resulted primarily from the acquisitions of HAI and Merit in fiscal 1998 and internal growth at Green Spring. Behavioral managed care revenues and equity in earnings of unconsolidated subsidiaries also increased as a result of the award of several new contracts in fiscal 1998 and significant improvements in negotiated rates and terms of the TennCare contract in fiscal 1998. The increase in Segment Profit was also attributable to reductions in administrative costs at Green Spring and HAI as a result of the Integration Plan.

HUMAN SERVICES. Revenue increased 73.8%, or $19.4 million, to $45.7 million for the quarter ended December 31, 1998, from $26.3 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 68.4%, or $16.5 million, to $40.5 million for the quarter ended December 31, 1998 from $24.0 million in the same period in fiscal 1998. The increases were attributable to the eight acquisitions consummated in fiscal 1998 and fiscal 1999 and internal growth. Placements in Mentor homes increased 23.8% to 3,640 at December 31, 1998, compared to 2,940 at December 31, 1997.

SPECIALTY MANAGED CARE. Revenue increased 190.9%, or $26.9 million, to

$41.0 million for the quarter ended December 31, 1998, compared to $14.1 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 174.8%, or $25.8 million, to $40.6 million for the quarter ended December 31, 1998, compared to $14.8 million in the same period in fiscal 1998. The increase in revenue and salaries, cost of care and other operating expenses was primarily related to the Allied acquisition. Allied's revenues and salaries, cost of care and other operating expenses were $40.8 million and $39.9 million, respectively, for the quarter ended December 31, 1998, compared to $14.1 million and $13.3 million for the quarter ended December 31, 1997.

HEALTHCARE FRANCHISING. Revenue decreased to $0.2 million for the quarter ended December 31, 1998, from $19.6 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses decreased 33.3%, or $0.7 million, to $1.5 million for the quarter ended December 31, 1998, from $2.2 million in the same period in fiscal 1998. Equity in loss of CBHS decreased to $0 for the quarter ended December 31, 1998, from $11.5 million in the same period in fiscal 1998. The decrease in revenue resulted from uncertainties surrounding the collectibility of franchise fees due from CBHS, for which no franchise fee revenue was recognized during the quarter ended December 31, 1998, while $19.6 million of CBHS franchise revenue was recognized and collected in the same period in fiscal 1998. The decrease in equity in loss of CBHS is attributable to the fact that the Company had reduced its investment in CBHS to $0 at September 30, 1998, and was no longer required to record its pro rata share of CBHS' loss for the quarter ended December 31, 1998. See Note F--"Investments in Unconsolidated Subsidiaries--Charter Behavioral Health Systems, LLC" to the Company's condensed consolidated financial statements set forth elsewhere herein.

HEALTHCARE PROVIDER. Revenue decreased 41.0%, or $13.6 million, to $19.6 million for the quarter ended December 31, 1998, from $33.2 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses decreased 18.3%, or $4.4 million, to $19.6 million for the quarter ended December 31, 1998 from $24.0 million in fiscal 1998. Equity in earnings of unconsolidated subsidiaries increased to $1.2 million for the quarter ended December 31, 1998, from $0 in the same period in fiscal 1998. These changes resulted primarily from the conversion of five provider joint ventures from consolidation to the equity method. See "--Recent Accounting Pronouncements--EITF 96-16". During the quarter ended December 31, 1997, the Company recorded reductions of expenses of $4.1 million as a result of updated actuarial estimates related to malpractice claim reserves. These reductions resulted primarily from updates to actuarial assumptions regarding the Company's expected losses for more recent policy years. These revisions are based on changes in expected values of ultimate losses resulting from the Company's claim experience, and increased reliance on such claim experience. While management and its actuaries

believe that the present reserve is reasonable, ultimate settlement of losses may vary from the amount recorded and result in additional fluctuations in income in future periods.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization increased 162.9%, or $11.4 million, to $18.4 million for the quarter ended December 31, 1998, from $7.0 million in the same period in fiscal 1998. The increase was primarily attributable to depreciation and amortization resulting from the HAI, Allied and Merit acquisitions of $10.9 million, in the aggregate, for the quarter ended December 31, 1998 compared to $0.5 million for the same period in fiscal 1998.

INTEREST, NET. Interest expense, net, increased 225.7%, or $16.7 million, to $24.1 million for the quarter ended December 31, 1998, from $7.4 million in the same period in fiscal 1998. The increase was primarily the result of interest expense incurred on borrowings used to fund the Merit acquisition and related transactions.

OTHER ITEMS. Stock option expense for the quarter ended December 31, 1998, was not material compared to a credit of $4.0 million in fiscal 1998 primarily due to the exercise of stock options by a certain optionee in fiscal 1998.

The Company recorded Managed Care integration costs of $1.8 million for the quarter ended December 31, 1998. See Note I--"Managed Care Integration Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein.

The Company's effective income tax rate increased to 56.8% for the quarter ended December 31, 1998, compared to 40% in the same period in fiscal 1998. The increase was primarily attributable to non-deductible goodwill amortization of $4.5 million for the quarter ended December 31, 1998, resulting from the Merit acquisition.

Minority interest decreased 86.2%, or $2.5 million, to $0.4 million, compared to $2.9 million in the same period in fiscal 1998. This decrease resulted primarily from the conversion of five provider joint ventures from consolidation to the equity method (See "--Recent Accounting Pronouncements--EITF 96-16") and from the Green Spring Minority Stockholder Conversion in January 1998.

IMPACT OF THE MERIT ACQUISITION ON RESULTS OF OPERATIONS. As of December 31, 1998, the Company had approximately 62.8 million covered lives under behavioral managed healthcare contracts. The Company believes it has the leading market position in each of the major product markets in which it competes, according to enrollment data reported in the industry trade publication entitled "Managed Behavioral Health Market Share in the United States 1997-1998" published by Open Minds, Gettysburg, Pennsylania ("Open Minds"). The Company believes that the Merit acquisition created opportunities for the Company to achieve significant cost savings in its behavioral managed healthcare business. Management believes that cost saving opportunities will result from leveraging fixed overhead over a larger revenue base and an increased number of covered lives and from reducing duplicative corporate and regional selling, general and administrative expenses. As a result, the Company expects to achieve approximately $60.0 million of cost savings in its behavioral managed healthcare business on an annual basis by September 30, 1999. Such cost savings are measured relative to the combined operating expenses of Green Spring, HAI and Merit prior to the Merit acquisition. The Company spent approximately $4.7 million during the quarter ended December 31, 1998 and, expects to spend an additional $5.0 million to $10.0 million during fiscal 1999 in connection with achieving such cost savings.

The Company expects to record additional managed care integration costs during future periods to the extent the integration of Green Spring, HAI and Merit results in additional facility closures at HAI and Green Spring and for integration costs incurred that benefit future periods. The full implementation of the integration plan is expected to be completed by fiscal 2000.

BEHAVIORAL MANAGED HEALTHCARE RESULTS OF OPERATIONS. The Company's behavioral managed healthcare segment results of operations are subject to significant fluctuations on a quarterly basis. These

potential earnings fluctuations may result from: (i) changes in utilization levels by enrolled members of the Company's risk-based contracts; (ii) performance-based contractual adjustments to revenue, reflecting utilization results or other performance measures; (iii) retroactive contractual adjustments under commercial contracts and CHAMPUS contracts; (iv) retrospective membership adjustments and (v) timing of implementation of new contracts and enrollment changes.

HISTORICAL LIQUIDITY AND CAPITAL RESOURCES

OPERATING ACTIVITIES. The Company's net cash provided by (used in) operating activities was $(31.7) million and $7.7 million for the three months ended December 31, 1997 and 1998, respectively. The increase in cash provided by operating activities in fiscal 1999 compared to fiscal 1998 was primarily the result of (i) reduction in interest paid of $8.9 million, (ii) reduction in income taxes paid, net of refunds received, of $8.3 million, (iii) reduction in payments of previously reserved claims of $6.1 million and (iv) increases in cash flows from operations as a result of the HAI and Merit acquistions, offset by reductions in franchise fees collected from CBHS of $19.6 million.

INVESTING ACTIVITIES. Capital expenditures increased 213.0%, or $9.8 million, to $14.4 million for the quarter ended December 31, 1998, compared to $4.6 million in the same period in fiscal 1998. This increase was due primarily to: i) capital expenditures at businesses acquired in fiscal 1998 and ii) increased capital expenditures in the Company's Behavioral segment related to: a) the Integration Plan (See Note I--"Managed Care Integration Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein), and b) acceleration of capital expenditures related to year 2000 computer issues (See "--Potential Impact of Year 2000 Computer Issues").

The Company acquired businesses in its managed behavioral healthcare and human services segments and acquired the assets of a psychiatric hospital (See Note F--"Investment in Unconsolidated Subsidiaries--Charter Behavioral Health Systems, LLC" to the Company's condensed consolidated financial statements set forth elsewhere herein) for an aggregate cost of $7.7 million. Additionally, the $20.0 million placed in escrow upon consummation of the Allied acquisition was returned to the Company during the quarter, with $4.5 million then being paid by the Company to the former owners of Allied as additional consideration for the Allied acquisition.

The Company's condensed consolidated balance sheet at December 31, 1998, reflects a reduction in cash and cash equivalents of $21.1 million from the September 30, 1998 balance which is related to the conversion of several subsidiaries from consolidation to the equity method. See "--Recent Accounting Pronouncements--EITF 96-16". This reduction in cash and cash equivalents appears as net cash used in investing activities in the Company's condensed consolidated statement of cash flows for the quarter ended December 31, 1998, but does not represent an actual reduction of cash and cash equivalents at the affected subsidiaries. Additionally, the Company received $9.3 million in distributions from unconsolidated subsidiaries, including those referred to above, during the quarter ended December 31, 1998.

The Company utilized $165.5 million in funds, net of cash acquired, for acquisitions and investments in businesses, including Allied and HAI, during the quarter ended December 31, 1997. In addition, the Company paid approximately $4.3 million for Crescent Transaction costs during the quarter ended December 31, 1997.

FINANCING ACTIVITIES. The Company repaid $40.0 million of debt obligations outstanding under the Revolving Facility (as defined) during the quarter ended December 31, 1998. As of December 31, 1998, the Company had $132.5 million of availability under the Revolving Facility (as defined), excluding $17.5 million of availability reserved for certain letters of credit. The Company was in compliance with all debt covenants as of December 31, 1998.

The Company repurchased approximately 545,000 shares of its common stock for approximately $12.5 million during the quarter ended December 31, 1997.

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 New Credit Agreement include $550.0 million under a term loan facility (the "Term Loan Facility") and up to $150.0 million under a revolving facility (the "Revolving Facility"). Commencing in the second quarter of fiscal 1999, the Company is required to make principal payments with respect to the Term Loan 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 thousands):

FISCAL YEAR	PRINCIPAL AMOUNT
1999	$ 19.8
2000	32.4
2001	38.9
2002	49.4
2003	92.0
2004	156.5
2005	131.8
2006	29.2
2007	--
2008	625.0

$ 1,175.0

In addition, any amounts outstanding under the Revolving Facility mature in February 2004.

POTENTIAL PURCHASE PRICE ADJUSTMENTS. In December 1997, the Company purchased HAI from Aetna US Healthcare, Inc. ("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 believes it will be required to make both the full Tranche 1 Payment and the full Tranche 2 Payment for the Contract Year ended December 31, 1998, subject to further discussion with Aetna. Accordingly, the Company recorded $60.0 million of goodwill and other intangible assets and a corresponding liability (which is included in "Deferred credits and other long term liabilities" in the Company's condensed consolidated balance sheet set forth elsewhere herein) as of December 31, 1998. The Company intends to borrow under the Revolving Facility to meet this obligation, which is expected to be paid during the second quarter of fiscal 1999.

In December, 1997 the Company purchased Allied for $70.0 million, excluding transaction costs. The purchase price the Company originally paid for Allied consisted of a $50.0 million payment to the former owners of Allied and a $20.0 million deposit into an interest-bearing escrow account and was subject to increase or decrease based on the operating performance of Allied during the three years following the closing. The Company was required to pay up to $60.0 million, of which $20.0 million would have been distributed from the escrow account, during the three years following the closing of the Allied acquisition if Allied's performance exceeded certain earnings targets.

During the quarter ended December 31, 1998, the Company and the former owners of Allied amended the Allied purchase agreement (the "Allied Amendments"). The Allied Amendments resulted in the following changes to the original terms of the Allied purchase agreement:

- The original $20.0 million placed in escrow by the Company at the consummation of the Allied acquisition, plus accrued interest, was repaid to the Company. This $20.0 million was included in the $70.0 million originally paid for Allied.

- The Company paid the former owners of Allied $4.5 million additional consideration which was recorded as goodwill.

- The Company capped future obligations with respect to additional contingent payments for the purchase of Allied at $3 million. The earnings targets which must be met by Allied for this amount to be paid were revised upwards as well.

By virtue of acquiring Merit, the Company may be required to make certain contingent payments in fiscal 1999 to the former shareholders of CMG Health, Inc. ("CMG"), which was acquired by Merit in September, 1997, based upon the performance of three CMG customer contracts. No contingent consideration will be payable to the former shareholders of CMG based on the performance of two of the three CMG customer contracts at December 31, 1998. The Company may still be required to pay contingent consideration to the former shareholders of CMG depending on the financial performance of Choice. The payment of contingent consideration to the former shareholders of CMG depends on the financial performance of Choice from October 1, 1996 to June 30, 1997, which is subject to a CHAMPUS Adjustment the Company expects to receive in fiscal 1999. Such contingent payments are subject to an aggregate maximum of $23.5 million.

CREDIT FACILITIES. The Revolving Facility will provide the Company with

revolving loans and letters of credit in an aggregate principal amount at any time not to exceed $150.0 million. At December 31, 1998, the Company had approximately $132.5 million of availability under the Revolving Facility. The Company estimates that it will spend approximately $50.0 million for capital expenditures in fiscal 1999. The majority of the Company's anticipated capital expenditures relate to management information systems and related equipment. The Company believes that the cash flows generated from its operations, together with amounts available for borrowing under the Credit Agreement, should be sufficient to fund its debt service requirements, anticipated capital expenditures, contingent payments with respect to HAI and CMG, and other investing and financing activities. 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 and other factors, many of which are beyond the Company's control.

RESTRICTIVE FINANCING COVENANTS. The Credit Agreement imposes 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. 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.

RECENT ACCOUNTING PRONOUNCEMENTS

In April 1998, the AICPA issued Statement of Position 98-5, "Reporting on the Costs of Start-up Activities" ("SOP 98-5"). SOP 98-5 requires all nongovernmental entities to expense costs of start-up activities as those costs are incurred. Start-up costs, as defined by SOP 98-5, include pre-operating costs, pre-opening costs and organization costs.

SOP 98-5 becomes effective for financial statements for fiscal years beginning after December 15, 1998. At adoption, a company must record a cumulative effect of a change in accounting principle to write off any unamortized start-up costs remaining on the balance sheet when SOP 98-5 is adopted. Prior year financial statements cannot be restated. The Company adopted SOP 98-5 effective October 1, 1998. The Company's adoption of SOP 98-5 had no impact on its financial position or results of operations.

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 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)

POTENTIAL IMPACT OF YEAR 2000 COMPUTER ISSUES

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 date information.

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

STATE OF READINESS

The Company's IT systems are largely decentralized, with each major operating unit having its own standards for systems which include both purchased and internally-developed software. The Company's IT hardware infrastructure is built mainly around mid-range computers and IBM PC-compatible servers and desktop systems.

The Company's principal means of ensuring year 2000 compliance for purchased software has been the replacement of non-compliant systems. This replacement process would have been undertaken for business reasons irrespective of the year 2000 problem; however, it would, more than likely, have been implemented over a longer period of time. The Company's internally-developed software was either designed to be year 2000 compliant from inception or is in the process of being modified to be compliant. Approximately 70% of the Company's mid-range IT hardware has been certified as year 2000 compliant, with the remainder scheduled to be certified by the end of the third quarter of fiscal 1999. Most of the Company's non-compliant IBM PC-compatible servers and desktops have been

replaced, with the remainder expected to be replaced by the end of fiscal 1999.

Additionally, the Company is in the process of integrating recently acquired businesses and their associated IT systems. A primary focus of the integration is on standardization of systems where possible, including ensuring the year 2000 compliance of the surviving systems.

Each of the Company's major operating units has a Chief Information Officer who is responsible for ensuring that all year 2000 issues are addressed and mitigated before any computational problems related to dates after December 31, 1999, occur.

The Company's plan for IT systems consists of several phases, primarily:

(i) Inventory--identifying all IT systems and the magnitude of year 2000 compliance risk of each according to its potential business impact;

(ii) Date assessment--identifying IT systems that use date functions and assessing them for year 2000 functionality;

(iii) Remediation--reprogramming, or replacing where necessary, inventoried items to ensure they are year 2000 ready; and

(iv) Testing and certification--testing the code modifications and new inventory with other associated systems, including extensive date testing and performing quality assurance testing to ensure successful operation in the post-1999 environment. The Company has substantially completed the inventory and assessment phases for substantially all of its IT systems. The Company's IT systems are currently in the remediation and testing and certification phases. The Company plans to complete the remediation of substantially all of its critical IT systems by the end of the second quarter of fiscal 1999, the remediation of its other IT systems by the end of the third quarter of fiscal 1999 and the testing and certification of all of its IT systems by the end of fiscal 1999.

The Company leases most of the office space in which its reliance on Embedded Systems presents a potential problem and is currently working with the respective lessors to identify and correct any potential year 2000 problems related to these Embedded Systems.

The Company believes that its year 2000 projects generally are on schedule.

EXTERNAL RELATIONSHIPS

The Company also faces the risk that one or more of its critical suppliers or customers ("External Relationships") will not be able to interact with the Company due to the third party's inability to resolve its own year 2000 issues, including those associated with its own External Relationships. The Company has completed its inventory of External Relationships and risk rated each External Relationship based upon the potential business impact, available alternatives and cost of substitution. The Company is attempting to determine the overall year 2000 readiness of its External Relationships. In the case of significant customers and mission critical suppliers such as banks, telecommunications providers and other utilities and IT vendors, the Company is engaged in discussions with the third parties and is attempting to obtain detailed information as to those parties' year 2000 plans and state of readiness. The Company, however, does not have sufficient information at the current time to predict whether its External Relationships will be year 2000 ready.

YEAR 2000 COSTS

Total costs incurred solely for remediation of potential year 2000 problems are currently estimated to be approximately $1.0 million in fiscal 1999. A large majority of these costs are expected to be incremental expenses that will not recur in the year 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 will accelerate approximately $5.0 million of capital expenditures that would have been budgeted for future periods into fiscal 1999 to ensure year 2000 compliance for outdated systems.

Year 2000 compliance is critical to the Company. The Company has redeployed some resources from non-critical system enhancements to address year 2000

issues. Due to the importance of IT systems to the Company's business, management has deferred non-critical systems enhancements to become year 2000

ready. The Company does not expect these redeployments and deferrals to have a material impact on the Company's financial condition or results of operations.

RISKS AND CONTINGENCY/RECOVERY PLANNING

If the Company's year 2000 issues were unresolved, the most reasonably likely worst case scenario would include, among other possibilities, the inability to accurately and timely authorize and process benefits and claims, accurately bill customers, assess claims exposure, determine liquidity requirements, report accurate data to management, stockholders, customers, regulators and others, business interruptions or shutdowns, financial losses, reputational harm, loss of significant customers, increased scrutiny by regulators and litigation related to year 2000 issues. The Company is attempting to limit the potential impact of the year 2000 by monitoring the progress of its own year 2000 project and those of its critical External Relationships and by developing contingency/recovery plans. The Company cannot guarantee that it will be able to resolve all of its year 2000 issues. Any critical unresolved year 2000 issues at the Company or its External Relationships, however, could have a material adverse effect on the Company's results of operations, liquidity or financial condition.

The Company has developed contingency/recovery plans aimed at ensuring the continuity of critical business functions before and after December 31, 1999. As part of that process, the Company has substantially completed the development of manual work alternatives to automated processes which will both ensure business continuity and provide a ready source of input to affected systems when they are returned to an operational status. These manual alternatives presume, however, that basic infrastructure such as electrical power and telephone service, as well as purchased systems which are advertised to be year 2000 compliant by their manufacturers (primarily personal computers and productivity software) will remain unaffected by the year 2000 problem.

PART II--OTHER INFORMATION

ITEM 6.--EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

EXHIBIT NO.	DESCRIPTION OF EXHIBIT
2(a)	Second Amendment to Asset Purchase Agreement, dated November 18, 1998, among the Company; Allied Health Group, Inc.; Gut Management, Inc.; Sky Management Co.; Florida Specialty Network, LTD; Surgical Associates of South Florida, Inc.; Surginet, Inc.; Jacob Nudel, M.D.; David Russin, M.D.; and Lawrence Schimmel, M.D., which was filed as Exhibit 2(m) to the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 1998, and is incorporated herein by reference.
2(b)	Third Amendment to Asset Purchase agreement, dated December 31, 1998, among the Company; Allied Health Group, Inc.; Gut Management, Inc.; Sky Management Co.; Florida Specialty Network, LTD; Surgical Associates of South Florida, Inc.; Surginet, Inc.; Jacob Nudel, M.D.; David Russin, M.D.; and Lawrence Schimmel, M.D.
*10	Employment Agreement, dated December 9, 1998, between Magellan Behavioral Health, Inc. and John Wider, President and Chief Operating Officer of Magellan Behavioral Health, Inc.
27	Financial Data Schedule

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* Constitutes a management contract or compensatory plan arrangement.

(b) Reports on Form 8-K

The following current reports on Form 8-K were filed by the Registrant with the Securities and Exchange Commission during the quarter ended December 31, 1998.

DATE OF REPORT	ITEM REPORTED AND DESCRIPTION	FINANCIAL STATEMENTS FILED
October 28, 1998(1)	Acquisition--Merit acquisition	Yes(2)
October 28, 1998	Other--Pro forma financial information	Yes(3)

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(1) The date of the earliest event reported is February 12, 1998. This current report on Form 8-K amends the Company's previous current reports on Form 8-K related to the Merit acquisition which were filed on April 3, 1998 and February 27, 1998.

(2) Audited Consolidated Balance Sheets for each of the two fiscal years in the period ended September 30, 1997; Audited Consolidated Statements of Operations, Audited Consolidated Statements of Stockholder's Equity, and Audited Consolidated Statements of Cash Flows for each of the three fiscal years in the period ended September 30, 1997; Unaudited Consolidated Balance Sheet as of December 31, 1997; Unaudited Consolidated Statements of Operations and Unaudited Consolidated Statements of Cash Flows for the quarters ended December and 1996 for Merit Behavioral Care Corporation. Unaudited Pro Forma Consolidated Balance Sheet as of December 31, 1997 and Unaudited Pro Forma Consolidated Statements of Operations for the fiscal year ended September 30, 1997, and for the quarter ended December 31, 1997, for the Company.

(3) Unaudited Pro Forma Consolidated Statements of Operations for the fiscal year ended September 30, 1997, and for the nine months ended June 30, 1998, for the Company.

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)

/s/ CRAIG L. MCKNIGHT

Date: February 12, 1999 — Craig L. McKnight
EXECUTIVE VICE PRESIDENT AND
CHIEF FINANCIAL OFFICER

/s/ JEFFREY T. HUDKINS

Date: February 12, 1999 — Jeffrey T. Hudkins
VICE PRESIDENT AND CONTROLLER
(PRINCIPAL ACCOUNTING OFFICER)

Exhibit 2(b)

THIRD AMENDMENT
TO
ASSET PURCHASE AGREEMENT

THIS THIRD AMENDMENT TO ASSET PURCHASE AGREEMENT (this "Amendment") is made and entered into as of this __ day of December, 1998, by and among Allied Specialty Care Services, Inc., a Florida corporation formerly known as CMSF, Inc. (the "Buyer"), Allied Health Group, Inc., a Florida corporation ("AHG"), Gut Management, Inc., a Florida corporation ("Gut"), Sky Management Co., a Florida corporation ("Sky"), Florida Specialty Network, Ltd., a Florida limited partnership ("FSN"), Surgical Associates of South Florida, Inc., a Florida corporation ("SASF"), Surginet, Inc., a Florida corporation ("Surginet" and, together with AHG, Gut, Sky, FSN and SASF, the "Sellers" and individually, a "Seller"), Jacob Nudel, M.D. ("Nudel"), David Russin, M.D. ("Russin"), Lawrence Schimmel, M.D. ("Schimmel" and, together with Nudel and Russin, the "Executive Shareholders") and Magellan Health Services, Inc., a Delaware corporation and the ultimate corporate Parent of the Buyer (the "Parent").

RECITALS

A. The parties entered into that certain Asset Purchase Agreement dated as of October 16, 1997 (the "Original Agreement"), as amended by that certain First Amendment to Asset Purchase Agreement dated as of December 5, 1997 (the "First Amendment"), as further amended by that certain Second Amendment to Asset Purchase Agreement dated as of November 18, 1998 (the "Second Amendment", the Original Agreement, as amended by the First Amendment and as further amended by the Second Agreement referred to herein as the "Asset Purchase Agreement"). Capitalized terms used herein and not otherwise defined shall have the meanings ascribed to them in the Asset Purchase Agreement.

B. The parties desire to further amend the Asset Purchase Agreement, on the terms and subject to the conditions set forth hereinbelow.

NOW, THEREFORE, in consideration of the foregoing and the mutual promises of the parties, and in consideration of the representations, warranties and covenants herein contained, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto, intending to be legally bound, hereby agree as follows:

1. AMENDMENTS.

1.1 BUY-OUT OF REMAINING EARNOUT. In exchange for the payment by the Buyer to AHG of the aggregate sum of $500,000 (the "Remaining Buyout Price"), payable in cash upon the execution of this Amendment by wire transfer of immediately available funds, (a) the Buyer shall be entitled to receive, and AHG shall release all claims to, the Remaining Clawback (as said term is defined in the Second Amendment) and any interest or earnings thereon, and (b) the

Buyer shall purchase, and AHG shall sell, the Remaining Earnout (as said term is defined in the Second Amendment). The parties to this Amendment acknowledge and agree that the Remaining Buyout Price is payable in consideration for the purchase of the Remaining Earn-Out, and that there is no perceived value of future claims to the purchase of the Remaining Clawback. The parties to this Amendment further acknowledge and agree that the Remaining Buyout Price, after deduction of attorneys fees and expenses of Sellers and of the Executive Shareholders incurred in connection with the transactions contemplated by this Amendment, will be paid to GHS, Inc. pursuant to the terms and conditions of the Letter Agreement (as said term is defined in the Second Amendment).

1.2 AMENDMENT TO AND TERMINATION OF REMAINING EARNOUT PROVISIONS. The Asset Purchase Agreement is hereby amended by deleting Sections 3.3A and 3.4A (which are set forth in Section 1.2(b) of the Second Amendment) in their entirety.

2. DISBURSEMENTS OF ESCROW FUND. Buyer and AHG hereby agree to issue joint instructions to the Escrow Agent (i) to deliver from the Escrow Funds $500,000.00 by federal funds wire transfer to the Broad and Cassel Trust Account, in accordance with wire transfer instructions furnished in writing by AHG, for further credit to AHG (said payment constituting payment of the Remaining Buyout Price), and (ii) to deliver the balance of the Escrow Funds by federal funds wire transfer to Buyer, in accordance with wire transfer instructions furnished in writing by Buyer. Buyer and AHG shall then cause the Escrow Agreement to be terminated.

3. REPRESENTATIONS AND WARRANTIES.

3.1 REPRESENTATIONS AND WARRANTIES OF BUYER AND PARENT. In order to induce the Seller and the Executive Shareholders to enter into this Amendment, and to consummate the transactions contemplated hereby, the Buyer and the Parent, on a joint and several basis, represent and warrant as follows:

(a) POWER AND AUTHORITY; BINDING AGREEMENT. The Buyer and the Parent have the full right, power and authority to enter into, and to perform their respective obligations under, this Amendment. The execution and delivery by the Buyer and the Parent of this Amendment and the performance of their respective obligations hereunder have been duly authorized by all necessary corporate action and no other proceedings on the part of the Buyer or the Parent are necessary to authorize the execution of this Amendment and the performance of transactions contemplated hereby. This Amendment has been duly and validly executed and delivered by the Buyer and the Parent and constitutes the legal, valid and binding obligation of the Buyer and of the Parent enforceable against the Buyer and the Parent in accordance with its terms, except as enforcement may be limited by bankruptcy, insolvency, moratorium or other laws affecting creditors= rights generally, or equitable principles, whether applied in a proceeding in equity or law.

3.2 REPRESENTATIONS AND WARRANTIES OF SELLERS AND EXECUTIVE SHAREHOLDERS. In order to induce the Buyer and the Parent to enter into this Amendment, and to consummate the transactions contemplated hereby, the Seller and the Executive Shareholders, on

a joint and several basis, represent and warrant as follows; provided, however, that the representations and the warranties of each Executive Shareholder are made only as to himself and to each Seller in which such Executive Shareholder owns any shares or partnership interests, as the case may be:

(a) POWER AND AUTHORITY; BINDING AGREEMENT. Each Seller has the full right, power and authority to enter into, and to perform its obligations under, this Amendment and the consent of no other party is necessary or required in order to permit or allow each such Seller to enter into and perform its obligations hereunder. The execution and delivery by each Seller of this Amendment and the performance of its obligations hereunder have been duly authorized by all necessary corporate or partnership action, as applicable, and no other proceedings on the part of such Seller is necessary to authorize the execution of this Amendment and the performance of transactions contemplated hereby. This Amendment has been duly and validly executed and delivered by each Seller and constitutes the legal, valid and binding obligation of such Seller enforceable against such Seller in accordance with its terms, except as enforcement may be limited by bankruptcy, insolvency, moratorium or other laws affecting creditors= rights generally, or equitable principles, whether applied in a proceeding in equity or law. This Amendment has been duly and validly executed and delivered by each Executive Shareholder and constitutes the legal, valid and binding obligation of such Executive Shareholder enforceable against such Executive Shareholder in accordance with its terms, except as enforcement may be limited by bankruptcy, insolvency, moratorium or other laws affecting creditors= rights generally, or equitable principles, whether applied in a proceeding in equity or law.

4. RATIFICATION. Except as modified by this Amendment, the Asset Purchase Amendment is and shall continue to be in full force and effect and is hereby in all respects confirmed, approved and ratified.

5. MISCELLANEOUS.

5.1 FURTHER ASSURANCES. At any time, and from time to time, each party will execute such additional instruments and take such action as may be reasonably requested by the other party to confirm or perfect title to any property transferred hereunder or otherwise to carry out the intent and purposes of this Amendment.

5.2 COSTS AND EXPENSES. Each party hereto agrees to pay its own costs and expenses incurred in negotiating this Amendment and consummating the transactions described herein.

5.3 TIME. Time is of the essence.

5.4 ENTIRE AMENDMENT. This Amendment and the transactions contemplated hereby constitute the entire Amendment among the parties hereto with respect to the

subject matter hereof, and supersede all prior negotiations, letters and understandings relating to the subject matter hereof.

5.5 AMENDMENT. This Amendment may not be amended, supplemented or modified in whole or in part except by an instrument in writing signed by the party or parties against whom enforcement of any such amendment, supplement or modification is sought.

5.6 ASSIGNMENT. Except as otherwise provided in Section 12.1 of the Asset Purchase Agreement, this Amendment may not be assigned by any party hereto without the prior written consent of the other parties.

5.7 CHOICE OF LAW. This Amendment will be interpreted, construed and enforced in accordance with the laws of the State of Florida.

5.8 HEADINGS. The section and subsection headings in this Amendment are inserted for convenience only and shall not affect in any way the meaning or interpretation of this Amendment.

5.9 PRONOUNS. All pronouns and any variations thereof shall be deemed to refer to the masculine, feminine, neuter, singular or plural as the context may require.

5.10 NUMBER AND GENDER. Words used in this Amendment, regardless of the number and gender specifically used, shall be deemed and construed to include any other number, singular or plural, and any other gender, masculine, feminine or neuter, as the context indicates is appropriate.

5.11 CONSTRUCTION. The parties hereto and their respective legal counsel participated in the preparation of this Amendment; therefore, this Amendment shall be construed neither against nor in favor of any of the parties hereto, but rather in accordance with the fair meaning thereof.

5.12 EFFECT OF WAIVER. The failure of any party at any time or times to require performance of any provision of this Amendment will in no manner affect the right to enforce the same. The waiver by any party of any breach of any provision of this Amendment will not be construed to be a waiver by any such party of any succeeding breach of that provision or a waiver by such party of any breach of any other provision.

5.13 SEVERABILITY. The invalidity, illegality or unenforceability of any provision or provisions of this Amendment will not affect any other provision of this Amendment, which will remain in full force and effect, nor will the invalidity, illegality or unenforceability of a portion of any provision of this Amendment affect the balance of such provision. In the event that any one or more of the provisions contained in this Amendment or any portion thereof shall for any reason be held to be invalid, illegal or unenforceable in any respect, this Amendment shall be

reformed, construed and enforced as if such invalid, illegal or unenforceable provision had never been contained herein.

5.14 BINDING NATURE. This Amendment will be binding upon and will inure to the benefit of any successor or successors of the parties hereto.

5.15 NO THIRD-PARTY BENEFICIARIES. Notwithstanding anything in this Amendment to the contrary, no person (including, without limitation, GHS, Inc.) shall be deemed to possess any third-party beneficiary right pursuant to this Amendment. It is the intent of the parties hereto that no direct benefit to any third party is intended or implied by the execution of this Amendment.

5.16 COUNTERPARTS. This Amendment may be executed in one or more counterparts, each of which will be deemed an original and all of which together will constitute one and the same instrument.

[SIGNATURES BEGIN ON THE FOLLOWING PAGE]

IN WITNESS WHEREOF, the parties hereto have duly executed this Amendment as of the day and year first above written.

ALLIED SPECIALTY CARE SERVICES, INC.

By: --------------------------------

Title: ------------------------------

ALLIED HEALTH GROUP, INC.

By: --------------------------------

Title: ------------------------------

GUT MANAGEMENT, INC.

By: --------------------------------

Title: ------------------------------

SKY MANAGEMENT CO.

By: --------------------------------

Title: ------------------------------

FLORIDA SPECIALTY NETWORK, LTD., BY ITS GENERAL PARTNER, FLORIDA SPECIALTY NETWORK, INC.

By: --------------------------------

Title: ------------------------------

SURGICAL ASSOCIATES OF SOUTH FLORIDA, INC.

By: --------------------------------

Title: ------------------------------

SURGINET, INC.

By: --------------------------------

Title: ------------------------------

Lawrence Schimmel, M.D., Individually

Jacob Nudel, M.D., Individually

David Russin, M.D., Individually

MAGELLAN HEALTH SERVICES, INC.

By: --------------------------------

Title: ------------------------------

Exhibit 10

EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT ("Agreement") is made and entered into by and between John Wider, an individual ("Officer"), and MAGELLAN BEHAVIORAL HEALTH, INC., a Delaware corporation ("Employer").

WHEREAS, Employer desires to obtain the services of Officer and Officer desires to render services to Employer; and

WHEREAS, Employer and Officer desire to set forth the terms and conditions of Officer's employment with Employer under this Agreement;

NOW, THEREFORE, in consideration of the foregoing recitals and of the mutual covenants and agreements contained in this Agreement, the parties agree as follows:

STATEMENT OF AGREEMENT

1. EMPLOYMENT. Employer agrees to employ Officer, and Officer accepts such employment in accordance with the terms of this Agreement, for an initial term of three years commencing on November 17, 1998 and, unless terminated earlier in accordance with the terms of this Agreement, ending on November 16, 2001. After the initial three-year term has expired, this Agreement will renew automatically on the anniversary date of each year for a one-year term. If either party desires not to renew the Agreement, they must provide the other party with written notice of their intent not to renew the Agreement at least one hundred twenty days prior to the next anniversary date.

2. POSITION AND DUTIES OF OFFICER. Officer will serve as President and Chief Operating Officer of Employer. Officer agrees to serve in such position, or in such other positions of a similar status or level with substantially similar duties, and to perform the duties commensurate with such position that Employer may assign from time to time to Officer until the expiration of the term or such time as Officer's employment with Employer is terminated pursuant to this Agreement. The parties acknowledge and agree that shifts in reporting relationships from "straight line" to "dotted line" or vice versa for certain corporate functions will not be deemed a violation of this Section or Section 6(c)(iv).

3. TIME DEVOTED AND LOCATION OF OFFICER.

(a) Officer will devote his or his full business time and energy to the business affairs and interests of Employer, and will use his best efforts and abilities to promote Employer's interests. Officer agrees that he or she will diligently endeavor to perform services contemplated by this Agreement in a manner consistent with his position and in accordance with the policies established by the Employer.

(b) Officer's primary business office will be located in Columbia, Maryland.

4. COMPENSATION.

(a) BASE SALARY. Employer will pay Officer a base salary in the amount of three hundred eighty thousand dollars per year, which amount will be paid in bi-weekly intervals less appropriate withholdings for federal and state taxes and other deductions authorized by Officer. Such salary will be subject to review and potential increase by Employer from time to time. Any reduction in Officer's base salary will be consistent with and the result of reductions made regarding other officers or employees at his level including the President and Chief Executive Officer of Magellan Health Services.

(b) BENEFITS. Officer will be eligible to participate in benefit plans commensurate with his position. Officer will receive separate information detailing the terms of such benefits and the terms of such plans will control. Officer also will be eligible to participate in any annual incentive plan and

stock option plan applicable to Officer by its terms. Officer will be entitled during the term of this Agreement to such other benefits of employment with Employer as are now or may later be in effect for salaried officers or employees of Employer, and also will be eligible to participate in other executive level benefits adopted for officers or employees at his level. This Agreement shall not be construed to modify or limit Officer's right to applicable COBRA benefits in the event of termination of this Agreement.

5. EXPENSES. During the term of this Agreement, Employer will reimburse Officer promptly for all reasonable travel, entertainment, parking, business meetings and similar expenditures in pursuance and furtherance of Employer's business upon receipt of reasonably supporting documentation as required by Employer's policies applicable to its officers and employees generally.

6. TERMINATION.

(a) TERMINATION DUE TO RESIGNATION AND TERMINATION WITH CAUSE. Except as otherwise set forth in this Agreement, this Agreement, Officer's employment, and Officer's rights to receive compensation and benefits from Employer, will terminate upon the occurrence of any of the following events: (i) the effective date of Officer's resignation, or (ii) termination for cause at the discretion of Employer under the following circumstances: (w) Officer's commission of an act of fraud or dishonesty involving his duties on behalf of Employer; (x) Officer's willful failure or refusal to faithfully and diligently perform duties assigned to Officer or other breach of any material term under this Agreement; (y) Officer's willful failure or refusal to abide by Employer's policies, rules, procedures or directives; or (z) Officer's conviction of a felony or a misdemeanor involving moral turpitude. If Officer resigns or is terminated pursuant to this Section 6(a), Employer's only remaining financial obligation to Officer under this Agreement will be to pay any earned but unpaid base salary through the date of Officer's termination.

For the events described in Sections 6(a)(ii)(x) and (y), Employer will give Officer written notice of such event and a reasonable opportunity to cure such situation, but in no event less than thirty days.

(b) TERMINATION WITHOUT CAUSE AND EXPIRATION. Employer may terminate this Agreement without cause at any time by giving thirty days prior written notice to Officer. If Employer terminates this Agreement without cause, Employer shall continue to pay Officer severance as hereinafter defined for a period of time equal to the greater of (i) the remaining term of this Agreement or (ii) two years. For purposes of this Section 6(b), "severance" shall mean the compensation provided for in Section 4(a) of this Agreement plus a prorated bonus calculated with reference to any existing bonus plan and the date of termination of this Agreement. Officer's entitlement to a pro-rated bonus will be subject to established terms of such bonus plan and the performance of Officer's relevant business unit. In addition, Employer will continue to pay, during the severance period, the portion of premiums for life, health and disability insurance maintained by Employer in which Officer participated at the date of termination. No other severance benefits or compensation will be paid to Officer if he is terminated pursuant to this Section 6(b), unless otherwise provided for in the terms of the applicable benefit plan. In the event of non-renewal of this Agreement by Employer, Employer shall pay Officer severance for a period of two years from the date of expiration of this Agreement. As a precondition to the right to receive any severance, Officer shall be in strict compliance with Officer's obligations as set forth in Section 7 of this Agreement.

(c) TERMINATION BY OFFICER FOR GOOD CAUSE. Officer may terminate this Agreement, and his employment with Employer, for "good cause" upon the occurrence of any of the following:

(i) a requirement by Employer that Officer relocate his personal residence in order to fulfill Officer's duties under this Agreement;

(ii) the failure of Employer to comply with Section 4;

(iii) any material breach of this Agreement by Employer; or

(iv) the assignment to Officer of any duties inconsistent with Officer's status as President and Chief Operating Officer of Employer or a

substantial alteration in the nature or status of his responsibilities.

Prior to terminating this Agreement pursuant to this Section, Officer shall give to Employer written notice of his "good cause" for terminating this Agreement and provide Employer with a reasonable period in which to contest or correct the "good cause", but in no event less than thirty days. In the event of a termination for "good cause" pursuant to this Section, Officer will be entitled to receive all compensation and benefits provided for in this Agreement for a termination by Employer without cause.

(d) AUTOMATIC TERMINATION. This Agreement will terminate automatically upon the death or permanent disability of Officer. Officer will be deemed to be "Disabled" or to suffer from a "Disability" within the meaning of this Agreement if, because of a physical or mental impairment, Officer has been unable to perform the essential functions of his position for a period of 180 consecutive days, or if Officer can reasonably be expected to be unable to perform the essential functions of his position for such period. The term "essential duties" is defined as the ability to consistently perform his assigned duties, including travel requirements. Subject to continuing coverage under applicable benefit plans, if Officer is terminated pursuant to this Section 6(d), Employer's only remaining financial obligation to Officer under this Agreement will be to pay any earned but unpaid base salary through the date of Officer's termination.

(e) EFFECT OF TERMINATION. Except as otherwise provided for in this Section 6, upon termination of this Agreement, all rights and obligations under this Agreement will cease except for the rights and obligations under Sections 4 and 5 to the extent Officer has not been compensated or reimbursed for services performed prior to termination (the amount of compensation to be prorated for the portion of the pay period prior to termination); the rights and obligations under Sections 7, 8 and 9; and all procedural and remedial provisions of this Agreement. A termination of this Agreement will constitute a termination of Officer's employment with Employer.

(f) TERMINATION UPON A CHANGE OF CONTROL. Officer will be entitled to terminate this Agreement upon a change of control and will be entitled to the salary, benefits and other rights provided in this Agreement as though the termination had been initiated by Employer without cause. For purposes of this Agreement, a change of control will take place upon the occurrence of any of the following events: (a) the acquisition after the beginning of the term in one or more transactions of beneficial ownership (within the meaning of Rule 13d-3(a)(1) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) by any person or entity (other than Officer or Henry Harbin) or any group of persons or entities (other than Henry Harbin) who constitute a group (within the meaning of Rule 13d-5 of the Exchange Act) of any securities of Employer such that as a result of such acquisition such person or entity or group beneficially owns (within the meaning of Rule 13d-3(a)(1) under the Exchange Act) more than 50% of Employer's then outstanding voting securities entitled to vote on a regular basis for a majority of the Board of Directors of Employer; or (b) the sale of all or substantially all of the assets of Employer (including, without limitation, by way of merger, consolidation, lease or transfer) in a transaction (except for a sale-leaseback transaction) where Employer or the holders of common stock of Employer do not receive (i) voting securities representing a majority of the voting power entitled to vote on a regular basis for the Board of Directors of the acquiring entity or of an affiliate which controls the acquiring entity, or (ii) securities representing a majority of the equity interest in the acquiring entity or of an affiliate that controls the acquiring entity, if other than a corporation; PROVIDED, that if Officer becomes entitled to any payments (whether hereunder or otherwise) by reason of an event described in Internal Revenue Code

Section 280G (a "Parachute Event") that would constitute "excess parachute payments" (as defined in Internal Revenue Code Section 280G) if paid, then Officer's entitlement to such payments will be reduced by such amount as will cause none of such payments to constitute excess parachute payments, if, and only if, the net amount received by Officer by reason of the Parachute Event, after imposition of all applicable taxes (including taxes under Internal Revenue

Code Section 4099), would be greater after such reduction than if such reduction were not made.

7. PROTECTION OF CONFIDENTIAL INFORMATION/NON-COMPETITION/NON-SOLICITATION.

Officer covenants and agrees as follows:

(a) During Employer's employment of Officer and for a period of two years following the termination of Officer's employment for any reason, Officer will not use or disclose, directly or indirectly, for any reason whatsoever or in any way, other than at the direction of Employer during the course of Officer's employment or after receipt of the prior written consent of Employer, any confidential information or trade secrets of Employer or its controlled subsidiaries or affiliates, including, but not limited to, the following: lists of past, current or potential customers of Employer and its controlled subsidiaries and affiliates; all systems, manuals, materials, processes and other intellectual property of any type used by Employer or its controlled subsidiaries and affiliates in connection with their respective business operations; financial statements, cost reports and other financial information; contract proposals and bidding information; rate and fee structures; policies and procedures developed as part of a confidential business plan; and management systems and procedures, including manuals and supplements (collectively, the "Confidential Information"). The obligation not to use or disclose any Confidential Information will not apply to: (i) any Confidential Information known by Officer before commencing employment with Employer, (ii) Confidential Information which Officer obtains from a third party, provided Officer has no actual or constructive knowledge that the third party obtained the Confidential Information by wrongful or inappropriate means, (iii) following the termination of the employment of Officer with Employer, to any information that is or becomes public knowledge through no fault of Officer, and that may be utilized by the public without any direct or indirect obligation to Employer, but the termination of the obligation for non-use or nondisclosure by reason of such information becoming public will extend only from the date such information becomes public knowledge, or (iv) disclosure compelled by legal process. The above will be without prejudice to any rights or remedies of Employer under any state or federal law protecting trade secrets or other information.

(b) During Employer's employment of Officer and for a period of two years following the term or termination of Officer's employment with Employer for any reason, Officer will not, within a radius of fifty miles of any existing operation of Employer or its controlled subsidiaries or affiliates engaged in the delivery of behavioral managed care services, engage, directly or indirectly, in any commercial capacity, whether in an executive, operational, consulting or sales capacity, in the development or delivery of behavioral managed care services, or have any material ownership interest in any business owning, operating, developing, contracting or providing such behavioral managed care services. Employer acknowledges and agrees that this provision shall not be construed to prohibit the provision by Officer of consulting services not in the field of behavioral managed care.

(c) During Employer's employment of Officer and for a period of two years following the term or termination of Officer's employment for any reason, Officer will not solicit or call upon any current client of Employer or its controlled subsidiaries or affiliates for the purpose of the delivery of behavioral managed care services by an entity or person(s) other than Employer or its controlled subsidiaries or affiliates. For purposes of this Section 7(c), the term "current client" is defined as any entity or person(s) with whom Employer, or its controlled subsidiaries or affiliates, has provided, or has contracted to provide, behavioral managed care services during the year preceding the final date of Officer's employment with Employer.

(d) During Employer's employment of Officer and for a period of one year following the termination of Officer's employment with Employer for any reason, Officer will not solicit for employment, directly or indirectly, any employee of Employer or any of its controlled subsidiaries or affiliates who was employed with Employer or its controlled subsidiaries or affiliates within the one year period immediately prior to Officer's termination.

(e) The foregoing terms of this Section 7 shall be modified as follows:

(i) GENERAL LIMITATIONS. The provisions of Section 7(b) shall not

apply with respect to any employment approved in writing by an authorized officer of Employer, or employment with a health maintenance organization or insurance company provided Officer's duties do not come within the scope of the prohibitions set forth in Section 7(b);

(ii) RESIGNATION. In the event of termination due to resignation pursuant to Section 6(a) of this Agreement, the prohibitions set forth in Section 7(b) and Section 7(c) shall apply for one year.

(iii) TERMINATION WITHOUT CAUSE. In the event of termination without cause pursuant to Section 6(b) or termination for good reason by Officer pursuant to Section 6(c); after a period of one year from the date of termination of this Agreement and written notice to Employer, Officer may undertake employment or provide services in contravention of Sections 7(b) and (c), provided, however, that Officer shall be entitled to no further severance subsequent to the commencement of such employment or undertakings.

(iv) TERMINATION FOR CAUSE. In the event of a termination for cause pursuant to Section 6(a) of this Agreement, the prohibitions set forth in Sections 7(b) and (c) shall apply for six months following the termination of Officer's employment with Employer.

(v) EXPIRATION. In the event this Agreement should expire after its original term or any extension, after a period of one year from the date of termination of this Agreement and written notice to Employer, Officer may undertake employment or provide services in contravention of Sections 7(b) and (c), provided, however, that Officer shall be entitled to no further severance subsequent to the commencement of such employment or undertakings.

(vi) CHANGE IN CONTROL. In the event of termination by Officer due to a change in control pursuant to Section 6(f), after a period of one year from the date of termination of this Agreement and written notice to Employer, Officer may undertake employment or provide services in contravention of Sections 7(b) and (c), provided, however, that Officer shall be entitled to no further severance subsequent to the commencement of such employment or undertakings.

8. WORK MADE FOR HIRE. Officer agrees that any written program materials, protocols, research papers and all other writings (the "Work"), which Officer develops for Employer's use, or for use by Employer's controlled subsidiaries or affiliates, during the term of this Agreement, will be considered "work made for hire" within the meaning of the United States Copyright Act, Title 17, United States Code, which vests all copyright interest in and to the Work in the Employer. In the event, however, that any court of competent jurisdiction finally declares that the Work is not or was not a work made for hire as agreed, Officer agrees to assign, convey, and transfer to the Employer all right, title and interest Officer may presently have or may have or be deemed to have in and to any such Work and in the copyright of such work, including but not limited to, all rights of reproduction, distribution, publication, public performance, public display and preparation of derivative works, and all rights of ownership and possession of the original fixation of the Work and any and all copies. Additionally, Officer agrees to execute any documents necessary for Employer to record and/or perfect its ownership of the Work and the applicable copyright. The foregoing will not apply to any writings Officer develops which are not for Employer's use or are in each instance specifically excluded in advance of publication from the coverage of the foregoing by Employer's Board of Directors.

9. PROPERTY OF EMPLOYER. Officer agrees that, upon the termination of Officer's employment with Employer, Officer will immediately surrender to Employer all property, equipment, funds, lists, books, records and other materials of Employer or its controlled subsidiaries or affiliates in the possession of or provided to Officer.

10. GOVERNING LAW. This Agreement and all issues relating to the validity, interpretation and performance will be governed by and interpreted under the laws of the State of Maryland.

11. REMEDIES. Employer and Officer agree that an actual or threatened violation by Officer of the covenants and obligations set forth in Sections 7, 8 and 9 will cause irreparable harm to Employer or its controlled subsidiaries or affiliates and that the remedy at law for any such violation will be inadequate. Officer agrees, therefore, that Employer or its controlled subsidiaries or affiliates will be entitled to appropriate equitable relief, including, but not limited to, a temporary restraining order and a preliminary injunction, without the necessity of posting a bond. The provisions of Sections 7, 8 and 9 will survive the termination of this Agreement in accordance with the terms set forth in each Section.

12. ARBITRATION. Except for an action for injunctive relief as described in Section 11, any disputes or controversies arising under this Agreement will be settled by arbitration in Columbia, Maryland in accordance with the rules of the American Arbitration Association relating to the arbitration of employment disputes. The determination and findings of such arbitrators will be final and binding on all parties and may be enforced, if necessary, in any court of competent jurisdiction.

- ---------
Officer's
Initials

13. ATTORNEYS' FEES. In the event of litigation or arbitration between Officer and Employer arising out of or as a result of this Agreement or the acts of the parties pursuant to this Agreement, or seeking an interpretation of this Agreement, the prevailing party in such litigation or arbitration, in addition to any other judgment or award, shall be entitled to receive such sums as the court or panel hearing the matter shall find to be reasonable as and for attorneys' fees.

14. NOTICES. Any notice or request required or permitted to be given to any party will be given in writing and, excepting personal delivery, will be given at the address set forth below or at such other address as such party may designate by written notice to the other party to this Agreement:

To Officer: John Wider
3705 Running Springs
Ellicott City, MD 21042

To Employer: Magellan Health Services, Inc.
3414 Peachtree Road, N.E.
Suite 1400
Atlanta, Georgia 30326
Attention: Chief Executive Officer

With a copy to: Magellan Health Services, Inc.
3414 Peachtree Road, N.E.
Suite 1400
Atlanta, Georgia 30326
Attention: General Counsel

Each notice given in accordance with this Section will be deemed to have been given, if personally delivered, on the date personally delivered; if delivered by facsimile transmission, when sent and confirmation of receipt is received; or, if mailed, on the third day following the day on which it is deposited in the United States mail, certified or registered mail, return receipt requested, with postage prepaid, to the address last given in accordance with this Section.

15. HEADINGS. The headings of the sections of this Agreement have been inserted for convenience of reference only and should not be construed or interpreted to restrict or modify any of the terms or provisions of this Agreement.

16. SEVERABILITY. If any provision of this Agreement is held to be illegal, invalid, or unenforceable under present or future laws effective during the term of this Agreement, such provision will be fully severable and this Agreement and each separate provision will be construed and enforced as if such illegal,

invalid or unenforceable provision had never comprised a part of this Agreement, and the remaining provisions of this Agreement will remain in full force and effect and will not be affected by the illegal, invalid or unenforceable provision or by its severance from this Agreement. In addition, in lieu of such illegal, invalid or unenforceable provision, there will be added automatically, as a part of this Agreement, a provision as similar in terms to such illegal, invalid or unenforceable provision as may be possible and be legal, valid and enforceable, if such reformation is allowable under applicable law.

17. BINDING EFFECT. This Agreement will be binding upon and shall inure to the benefit of each party and each party's respective successors, heirs and legal representatives. This Agreement may not be assigned by Officer to any other person or entity but may be assigned by Employer to any subsidiary or affiliate of Employer or to any successor to or transferee of all, or any part, of the stock or assets of Employer.

18. EMPLOYER POLICIES, REGULATIONS AND GUIDELINES FOR OFFICERS. Employer may issue policies, rules, regulations, guidelines, procedures or other material, whether in the form of handbooks, memoranda, or otherwise, relating to its officers. These materials are general guidelines for Officer's information and will not be construed to alter, modify or amend this Agreement for any purpose whatsoever.

19. ENTIRE AGREEMENT. This Agreement embodies the entire agreement and understanding between the parties with respect to its subject matter and supersedes all prior agreements and understandings, whether written or oral, relating to its subject matter, unless expressly provided otherwise within this Agreement. No amendment or modification of this Agreement, will be valid unless made in writing and signed by each of the parties. No representations, inducements or agreements have been made to induce either Officer or Employer to enter into this Agreement which are not expressly set forth within this Agreement. Officer and Employer acknowledge and agree that Employer's controlled subsidiaries and affiliates are express third party beneficiaries of this Agreement.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the _____ day of _______________, 1998.

	MAGELLAN BEHAVIORAL HEALTH, INC.
"Officer"	"Employer"
	By:
- -------------------------------	-------------------------------
	Name: -------------------------------
	Title: -------------------------------

<ARTICLE> 5
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THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE CONDENSED CONSOLIDATED BALANCE SHEETS AND CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS FOUND ON PAGES 1 AND 2 OF THE COMPANY'S FORM 10-Q FOR THE YEAR-TO-DATE, AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.
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