

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

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

For the fiscal year ended December 31, 2008

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 1-6639

**MAGELLAN HEALTH SERVICES, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**58-1076937**  
(I.R.S. Employer  
Identification No.)

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

**06001**  
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act: **None.**

Securities registered pursuant to Section 12(g) of the Act: **Ordinary Common Stock par value (\$0.01 per share).**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2008 (the last business day of the registrant's most recently completed second fiscal quarter) was approximately \$1.5 billion.

The number of shares of Magellan Health Services, Inc.'s Ordinary Common Stock outstanding as of February 25, 2009 was 36,617,025.

**APPLICABLE ONLY TO REGISTRANTS INVOLVED IN BANKRUPTCY  
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13, or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the definitive proxy statement for the 2009 Annual Meeting of Shareholders are incorporated by reference.

---

---

**MAGELLAN HEALTH SERVICES, INC.****REPORT ON FORM 10-K****For the Fiscal Year Ended December 31, 2008****Table of Contents**

	<u>Page</u>
<b><u>PART I</u></b>	
<a href="#">Item 1. Business</a>	<a href="#">3</a>
<a href="#">Item 1A. Risk Factors</a>	<a href="#">19</a>
<a href="#">Item 1B. Unresolved Staff Comments</a>	<a href="#">31</a>
<a href="#">Item 2. Properties</a>	<a href="#">31</a>
<a href="#">Item 3. Legal Proceedings</a>	<a href="#">31</a>
<a href="#">Item 4. Submission of Matters to a Vote of Security Holders</a>	<a href="#">32</a>
<b><u>PART II</u></b>	
<a href="#">Item 5. Market for Registrant's Common Equity and Related Stockholder Matters</a>	<a href="#">33</a>
<a href="#">Item 6. Selected Financial Data</a>	<a href="#">37</a>
<a href="#">Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</a>	<a href="#">38</a>
<a href="#">Item 7A. Quantitative and Qualitative Disclosures about Market Risk</a>	<a href="#">62</a>
<a href="#">Item 8. Financial Statements and Supplementary Data</a>	<a href="#">63</a>
<a href="#">Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</a>	<a href="#">63</a>
<a href="#">Item 9A. Controls and Procedures</a>	<a href="#">63</a>
<a href="#">Item 9B. Other Information</a>	<a href="#">65</a>
<b><u>PART III</u></b>	
<a href="#">Item 10. Directors and Executive Officers of the Registrant</a>	<a href="#">65</a>
<a href="#">Item 11. Executive Compensation</a>	<a href="#">65</a>
<a href="#">Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</a>	<a href="#">65</a>
<a href="#">Item 13. Certain Relationships and Related Transactions</a>	<a href="#">65</a>
<a href="#">Item 14. Principal Accountant Fees and Services</a>	<a href="#">65</a>
<b><u>PART IV</u></b>	
<a href="#">Item 15. Exhibits, Financial Statement Schedule and Additional Information</a>	<a href="#">65</a>

---

## PART I

### Forward-Looking and Cautionary Statements

This Form 10-K 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 (as defined below) 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. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those contemplated by such forward-looking statements. Important factors currently known to management that could cause actual results to differ materially from those in forward-looking statements are set forth under the heading "Risk Factors" in Item 1A and elsewhere in this Form 10-K. When used in this Form 10-K, the words "estimate," "anticipate," "expect," "believe," "should" and similar expressions are intended to be forward-looking statements.

### Item 1. Business

Magellan Health Services, Inc. ("Magellan") was incorporated in 1969 under the laws of the State of Delaware. Magellan's executive offices are located at 55 Nod Road, Avon, Connecticut 06001, and its telephone number at that location is (860) 507-1900. Reference in this report to the "Company" includes Magellan, its majority owned subsidiaries, and all variable interest entities ("VIEs") for which Magellan is the primary beneficiary.

#### *Business Overview*

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

#### Managed Behavioral Healthcare

Two of the Company's segments are in the managed behavioral healthcare business. This line of business generally reflects the Company's coordination and management of the delivery of behavioral healthcare treatment services that are provided through its contracted network of third-party treatment providers, which includes psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities. The treatment services provided through the Company's provider network include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and crisis intervention services. The Company generally does not directly provide, or own any provider of, treatment services except as relates to the Company's contract to provide managed behavioral healthcare services to Medicaid recipients and other beneficiaries of the Maricopa County Regional Behavioral Health Authority (the "Maricopa Contract"). Under the Maricopa Contract, effective August 31, 2007 the Company was required to assume the operations of twenty-four behavioral health direct care facilities for a transitional period and to divest itself of these facilities over a two year period. During August and October 2008, the Company entered into agreements with two separate Provider Network Organizations ("PNOs") which resulted in the transition of thirteen of such behavioral health direct

care facilities to the PNOs over various dates through February 2009. During March 2009, the Company will begin the operation of two additional behavioral health direct care facilities and the Company expects to divest itself of these facilities before August 31, 2009.

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

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

*Commercial.* The Managed Behavioral Healthcare Commercial segment ("Commercial") generally reflects managed behavioral healthcare services and EAP services provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicaid and Medicare members, as well as with employers, including corporations and governmental agencies, and labor unions. Commercial's managed behavioral healthcare contracts encompass risk-based, ASO and EAP arrangements. This segment contains the operating segments previously defined as the Managed Behavioral Healthcare Health Plan Segment ("Health Plan") and the Managed Behavioral Healthcare Employer segment ("Employer"). Prior period balances have been reclassified to reflect this change. The Company now considers Commercial as one segment and it is managed as such. As of December 31, 2008, Commercial's covered lives were 4.2 million, 14.5 million and 20.7 million for risk-based, EAP and ASO products, respectively. For the year ended December 31, 2008, Commercial's revenue was \$416.4 million, \$106.7 million and \$126.5 million for risk-based, EAP and ASO products, respectively.

*Public Sector.* The Managed Behavioral Healthcare Public Sector segment ("Public Sector") generally reflects managed behavioral healthcare services provided to Medicaid recipients under contracts with state and local governmental agencies. Public Sector contracts encompass either risk-based or ASO arrangements. As of December 31, 2008, Public Sector's covered lives were 1.8 million and 0.3 million for risk-based and ASO products, respectively. For the year ended December 31, 2008, Public Sector's revenue was \$1.4 billion and \$5.3 million for risk-based and ASO products, respectively.

#### Radiology Benefits Management

The Radiology Benefits Management segment generally reflects the management of the delivery of diagnostic imaging services to ensure that such services are clinically appropriate and cost effective. The Company's radiology benefits management services currently are provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicaid and Medicare members. The Company has bid on contracts with state and local governmental agencies for the provision of such services to Medicaid recipients. The Company has won one state Medicaid contract, which was implemented in July 2008. The Company offers its radiology benefits management services through ASO contracts, where the Company provides services such as utilization review and claims administration, but does not assume responsibility for the cost of the imaging services, and through risk-based contracts, where the Company assumes all or a substantial portion of the responsibility for the cost of providing diagnostic imaging services. The Company's first two risk-based radiology benefits management contracts became effective June 1, 2007 and July 1, 2007. As of December 31, 2008, covered lives for Radiology Benefits Management were 2.6 million and

13.9 million for risk-based and ASO products, respectively. For the year ended December 31, 2008, revenue for Radiology Benefits Management was \$239.4 million and \$55.9 million for risk-based and ASO products, respectively.

#### Specialty Pharmaceutical Management

The Specialty Pharmaceutical Management segment generally reflects the management of specialty drugs used in the treatment of cancer, multiple sclerosis, hemophilia, infertility, rheumatoid arthritis, chronic forms of hepatitis and other diseases. Specialty pharmaceutical drugs represent high-cost injectible, infused, oral, or inhaled drugs which traditional retail pharmacies often do not supply due to their high cost, sensitive handling, and storage needs. The Company's specialty pharmaceutical management services are provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicare and Medicaid members. The Company's specialty pharmaceutical services include (i) contracting and formulary optimization on behalf of health plans and pharmaceutical manufacturers; (ii) distributing specialty pharmaceutical drugs on behalf of health plans; (iii) providing strategic consulting services to health plans and pharmaceutical manufacturers; and (iv) providing oncology management services to health plans. The Company's Specialty Pharmaceutical Management segment had contracts with 40 health plans as of December 31, 2008.

#### Corporate and Other

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

#### *Acquisition of National Imaging Associates*

On January 31, 2006, the Company acquired all of the outstanding stock of National Imaging Associates, Inc. ("NIA"), a privately held radiology benefits management ("RBM") firm, for approximately \$121 million in cash, after giving effect to cash acquired in the transaction, and NIA became a wholly-owned subsidiary. The Company reports the results of operations of NIA in the Radiology Benefits Management segment. For further discussion, see Note 3—"Acquisitions and Joint Ventures" to the consolidated financial statements set forth elsewhere herein.

#### *Acquisition of ICORE Healthcare, LLC*

On July 31, 2006, the Company acquired all of the outstanding units of membership interest of ICORE Healthcare, LLC ("ICORE"), a specialty pharmaceutical management company, and ICORE became a wholly-owned subsidiary. The Company reports the results of operations of ICORE in the Specialty Pharmaceutical Management segment. For further discussion, see Note 3—"Acquisitions and Joint Ventures" to the consolidated financial statements set forth elsewhere herein.

The Company paid or agreed to pay to the previous unitholders of ICORE, all of whom are members of ICORE's management team, (i) \$161 million of cash at closing; (ii) \$24 million of cash that was used by the unitholders of ICORE to purchase Magellan restricted stock with such restricted stock vesting over three years, provided the unitholders do not earlier terminate their employment with Magellan; (iii) \$25 million plus accrued interest (the "Deferred Payment"), subject to any indemnity claims Magellan may have under the purchase agreement; (iv) the amount of positive working capital that existed at ICORE on the closing date (the "Working Capital Payments"), which was \$18.2 million of which \$17.8 million was paid during 2007 with the remainder paid in January 2008; and (v) a potential earn-out of up to \$75 million (the "Earn-Out"), provided the unitholders do not earlier terminate their employment with the Company prior to the payment of the Earn-Out. The \$161 million of cash paid at closing, the \$25 million Deferred Payment and \$18.2 million of Working Capital

Payments were recorded as purchase price. The \$24 million of restricted stock is being recognized as stock compensation expense over the three year vesting period. The \$24 million in restricted stock paid at the closing was issued in a transaction pursuant to which the unitholders of ICORE at closing applied \$24 million of the purchase price as cash consideration for their purchase of restricted shares of the Company's common stock. The unitholders subscribed to an aggregate of 543,879 restricted shares of the Company's common stock on a basis proportional to each unitholder's economic interest in ICORE at a purchase price of \$44.13 per share, which was the average of the closing prices of the Company's common stock on NASDAQ for the twenty trading days immediately preceding the closing. The Deferred Payment was paid in December 2008. The Earn-Out included (i) up to \$25 million based on earnings for the 18 month period ended December 31, 2007 and (ii) up to \$50 million based on earnings in 2008. Neither Earn-Out provisions were met and as a result, the Company will not pay any additional purchase consideration.

## **Industry**

According to the Centers for Medicare and Medicaid Services ("CMS"), U.S. healthcare spending was projected to increase 6.1 percent to \$2.4 trillion in 2008, representing more than 16 percent of the gross domestic product. With the uncertain economic environment, rising healthcare costs, and the recent shifting of payment responsibilities, healthcare spending will continue to be one of the greatest pressing issues for the American public and the government agencies. The rapidly evolving clinical and technological environment demands the expertise of specialized healthcare management services so to provide both high-quality and affordable care.

The company began its operations in the managed care behavioral health industry. Since 2006, the Company has diversified into the areas of radiology benefits management and specialty pharmaceutical management. The Company has transformed itself into a specialty managed healthcare company by entering various healthcare cost and care management areas that represent a meaningful portion of the healthcare dollar and that are growing at a disproportionately higher rate than other areas of healthcare. The Company defines areas of healthcare that can be carved out for specialty healthcare management to be areas where:

- The management and cost of care are separable from other areas of healthcare management;
- The Company can provide value to its customers resulting from managing care beyond what such customers can achieve on their own;
- The value that the Company provides to its customers is measurable.

## **Business Strategy**

The Company is engaged in the specialty managed healthcare business. It currently provides managed behavioral healthcare services, radiology benefit management services, and specialty pharmaceutical management services. The Company's strategy is to expand its participation in the healthcare management services market through the expansion of its existing businesses and diversification into new specialties and services. The Company believes that its clients would prefer to consolidate outsourced vendors and that as a vendor offering multiple outsourced products, it will have a competitive advantage in the market. The Company seeks to grow its specialty managed healthcare business through the following initiatives:

*Expanding the radiology benefits management services business.* Since the Company's acquisition of NIA in 2006, the Company has continued its focus on delivering innovative and clinically appropriate diagnostic management programs that create value for its clients and improve the consumers' overall healthcare experience. NIA seeks to distinguish itself in the marketplace through a focus on clinical excellence, product and service innovation, and consumerism. Since the acquisition of NIA, the

Company has expanded NIA's original product offerings into risk-based products, and continues to expand its product portfolio with customer-focused solutions in cardiac management and non-advanced imaging. The Company intends to continue marketing both its risk-based products and recently developed products to current ASO customers, as well as new RBM customers, through cross-selling to its managed behavioral healthcare and specialty pharmaceutical management customer base.

*Expanding the specialty pharmaceutical management business.* Since the Company's acquisition of ICORE in 2006, the Company has continued to focus on the expansion of its unique service model of providing contracting and formulary optimization services, specialty pharmaceutical distribution services, and strategic solutions consulting. ICORE's growth strategy is to leverage Magellan's operational platform, software development, and claims processing expertise to develop specialty pharmaceutical management products that drive savings for its customers. The Company recently expanded its product portfolio to include an oncology management product. The Company continues to cross-sell ICORE's product portfolio to its current managed behavioral healthcare and radiology benefits management customer base.

*Expanding product penetration in new or growing markets.* The Company seeks to expand its existing products and services in new and/or growing markets. For example, in recent years, the Medicaid market has increased its use of specialty managed healthcare services. With Medicaid experience in managed behavioral healthcare, radiology benefits management and specialty pharmaceutical management, the Company believes it is positioned to grow its membership and revenues in the Medicaid market over the long term as a result of its proven expertise in managing these services.

*Continued selective diversification of business lines.* The Company actively evaluates opportunities to enter other significant, high trend specialty healthcare businesses that would leverage its expertise and core competencies and/or that could draw on its existing customer relationships.

### **Customer Contracts**

The Company's contracts with customers typically have terms of one to three years, and in certain cases contain renewal provisions (at the customer's option) for successive terms of between one and two years (unless terminated earlier). Substantially all of these contracts may be immediately terminated with cause and many of the Company's contracts are terminable without cause by the customer or the Company either upon the giving of requisite notice and the passage of a specified period of time (typically between 60 and 180 days) or upon the occurrence of other specified events. In addition, the Company's contracts with federal, state and local governmental agencies generally are conditioned on legislative appropriations. These contracts generally can be terminated or modified by the customer if such appropriations are not made. The Company's contracts for managed behavioral healthcare and radiology benefits management services generally provide for payment of a per member per month fee to the Company. See "Risk Factors—Risk-Based Products" and "—Reliance on Customer Contracts."

The Company's contracts with the State of Tennessee's TennCare program ("TennCare") and with subsidiaries of WellPoint, Inc. ("WellPoint") each generated revenues that exceeded, in the aggregate, ten percent of revenues for the consolidated Company for the years ended 2006 and 2007. In addition to TennCare, the Company's Maricopa Contract generated net revenues that exceeded, in the aggregate, ten percent of net revenues for the consolidated Company for the year ended December 31, 2008. The Company also has a significant concentration of business from contracts with various counties in the State of Pennsylvania (the "Pennsylvania Counties") which are part of the Pennsylvania Medicaid program. See further discussion related to these significant customers in "Risk Factors—Reliance on Customer Contracts." In addition, see "Risk Factors—Dependence on Government Spending" for discussion of risks to the Company related to government contracts.

## **Provider Network**

Except for certain services provided under the Maricopa Contract (see "Business—Business Overview"), the Company's managed behavioral healthcare services and EAP treatment services are provided by a contracted network of third-party providers, including psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities. The number and type of providers in a particular area depend upon customer preference, site, geographic concentration and demographic composition of the beneficiary population in that area. The Company's managed behavioral healthcare network consists of approximately 73,000 behavioral healthcare providers, including facility locations, providing various levels of care nationwide. The Company's network providers are almost exclusively independent contractors located throughout the local areas in which the Company's customers' beneficiary populations reside. Outpatient network providers work out of their own offices, although the Company's personnel are available to assist them with consultation and other needs.

Non-facility network providers include both individual practitioners, as well as individuals who are members of group practices or other licensed centers or programs. Non-facility network providers typically execute standard contracts with the Company under which they are generally paid on a fee-for-service basis.

Third-party network facilities include inpatient psychiatric and substance abuse hospitals, intensive outpatient facilities, partial hospitalization facilities, community health centers and other community-based facilities, rehabilitative and support facilities and other intermediate care and alternative care facilities or programs. This variety of facilities enables the Company to offer patients a full continuum of care and to refer patients to the most appropriate facility or program within that continuum. Typically, the Company contracts with facilities on a per diem or fee-for-service basis and, in some limited cases, on a "case rate" or capitated basis. The contracts between the Company and inpatient and other facilities typically are for one-year terms and are terminable by the Company or the facility upon 30 to 120 days' notice.

Historically, the Company's radiology benefits management services were provided by a network of third-party providers that were contracted by the customers of the Company to provide such services to the customers' members or enrollees. To support its offering of risk-based arrangements, the Company has developed and continues to expand a proprietary network of providers directly, through the use of its internal networking resources, and indirectly through a network contracting company. Network providers include diagnostic imaging centers, radiology departments of hospitals that provide advanced imaging services on an outpatient basis, and individual physicians or physician groups that own advanced imaging equipment and specialize in certain specific areas of care. The Company contracts with these providers on a fee-for-service basis.

## **Joint Ventures**

Prior to April 11, 2006, Premier Behavioral Systems of Tennessee, LLC ("Premier") was a joint venture in which the Company owned a 50 percent interest. On April 11, 2006, the Company purchased the other 50 percent interest in Premier for \$1.5 million, so that Premier is now a wholly-owned subsidiary of the Company.

Premier was formed to manage behavioral healthcare benefits for a certain portion of TennCare. In addition, the Company contracted with Premier to provide certain services to the joint venture. Through 2003, the Company accounted for its investment in Premier using the equity method. Effective December 31, 2003, the Company adopted the Financial Accounting Standards Board's ("FASB") Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin ("ARB") No. 51" ("FIN 46"), under which the Company consolidated the balance sheet of Premier in its consolidated balance sheet as of December 31, 2003. Beginning in 2004, the

Company consolidated the results of operations of Premier in its consolidated statement of income. The creditors (or other beneficial interest holders) of Premier have no recourse to the general credit of the Company.

As of December 31, 2005, the Company owned a 37.5 percent interest in Royal Health Care, LLC ("Royal"). Royal was a managed services organization that received management fees for the provision of administrative, marketing, management and support services to seven managed care organizations. Royal did not provide any services to the Company.

The Company accounted for its investment in Royal using the equity method. Effective February 2, 2006, the Company sold its Royal ownership interest back to Royal in exchange for cash proceeds of \$20.5 million. See Note 3—"Acquisitions and Joint Ventures" to the consolidated financial statements set forth elsewhere herein for further information on Royal.

## **Competition**

The Company's business is highly competitive. The Company competes with other healthcare organizations as well as with insurance companies, including health maintenance organizations ("HMOs"), preferred provider organizations ("PPOs"), third-party administrators ("TPAs"), independent practitioner associations ("IPAs"), multi-disciplinary medical groups, pharmacy benefit managers ("PBMs") and other specialty healthcare and managed care companies. Many of the Company's competitors, particularly certain insurance companies, HMOs and PBMs are significantly larger and have greater financial, marketing and other resources than the Company, and some of the Company's competitors provide a broader range of services. The Company may also encounter competition in the future from new market entrants. In addition, some of the Company's customers that are managed care companies may seek to provide specialty managed healthcare services directly to their subscribers, rather than by contracting with the Company for such services. Because of these factors, the Company does not expect to be able to rely to a significant degree on price increases to achieve revenue growth, and expects to continue experiencing pricing pressures.

## **Insurance**

The Company maintains a program of insurance coverage for a broad range of risks in its business. The Company has renewed its general, professional and managed care liability insurance policies with unaffiliated insurers for a one-year period from June 17, 2008 to June 17, 2009. The general liability policies are written on an "occurrence" basis, subject to a \$0.05 million per claim un-aggregated self-insured retention. The professional liability and managed care errors and omissions liability policies are written on a "claims-made" basis, subject to a \$1.0 million per claim (\$10.0 million per class action claim) un-aggregated self-insured retention for managed care liability, and a \$0.05 million per claim un-aggregated self-insured retention for professional liability.

The Company maintains separate general and professional liability insurance policies with an unaffiliated insurer for its Specialty Pharmaceutical Management business. The Specialty Pharmaceutical Management insurance policies have a one-year term for the period June 17, 2008 to June 17, 2009. The general liability policies are written on an "occurrence" basis, subject to a \$0.05 million per claim un-aggregated self-insured retention. The professional liability policy is written on a "claims-made" basis, subject to a \$0.05 million per claim un-aggregated self-insured retention.

The Company maintains separate general and professional liability insurance policies with an unaffiliated insurer for its Maricopa Contract business, which includes coverage for the behavioral health direct care facilities. The Maricopa Contract insurance policies have a one-year term for the period September 1, 2008 to September 1, 2009. The general liability policies are written on an

"occurrence" basis, subject to a \$0.35 million per claim un-aggregated self-insured retention. The professional liability policy is written on a "claims-made" basis, subject to a \$0.35 million per claim un-aggregated self-insured retention.

The Company is responsible for claims within its self-insured retentions, and for portions of claims reported after the expiration date of the policies if they are not renewed, or if policy limits are exceeded. The Company also purchases excess liability coverage in an amount that management believes to be reasonable for the size and profile of the organization. See "Risk Factors—Professional Liability and Other Insurance," for a discussion of the risks associated with the Company's insurance coverage.

## **Regulation**

*General.* The specialty managed healthcare industry is subject to extensive and evolving state and federal regulation. The Company is subject to certain state laws and regulations, including those governing the licensing of insurance companies, HMOs, PPOs, TPAs and companies engaged in utilization review and specialty pharmaceutical management. In addition, the Company is subject to regulations concerning the licensing of healthcare professionals, including restrictions on business corporations from providing, controlling or exercising excessive influence over healthcare services through the direct employment of physicians, psychiatrists or, in certain states, psychologists and other healthcare professionals. These laws and regulations vary considerably among states and the Company may be subject to different types of laws and regulations depending on the specific regulatory approach adopted by each state to regulate the managed care and specialty pharmacy businesses and the provision of healthcare treatment services. In addition, the Company is subject to certain federal laws as a result of the role it assumes in connection with managing its customers' employee benefit plans. The regulatory scheme generally applicable to the Company's operations is described in this section.

The Company believes its operations are structured to comply in all material respects with applicable laws and regulations and that it has received all licenses and approvals that are material to the operation of its business. However, regulation of the specialty managed healthcare industry is constantly evolving, with new legislative enactments and regulatory initiatives at the state and federal levels being implemented on a regular basis. Consequently, it is possible that a court or regulatory agency may take a position under existing or future laws or regulations, or as a result of a change in the interpretation thereof, that such laws or regulations apply to the Company in a different manner than the Company believes such laws or regulations apply. Moreover, any such position may require significant alterations to the Company's business operations in order to comply with such laws or regulations, or interpretations thereof. Expansion of the Company's business to cover additional geographic areas, to serve different types of customers, to provide new services or to commence new operations could also subject the Company to additional licensure requirements and/or regulation. Failure to comply with applicable regulatory requirements could have a material adverse affect on the Company.

*Licenses.* Certain regulatory agencies having jurisdiction over the Company possess discretionary powers when issuing or renewing licenses or granting approval of proposed actions such as mergers, a change in ownership, transfer or assignment of licenses and certain intra-corporate transactions. One or multiple agencies may require as a condition of such license or approval that the Company cease or modify certain of its operations or modify the way it operates in order to comply with applicable regulatory requirements or policies. In addition, the time necessary to obtain a license or approval varies from state to state, and difficulties in obtaining a necessary license or approval may result in delays in the Company's plans to expand operations in a particular state and, in some cases, lost business opportunities. In recent years, in response to governmental agency inquiries or discussions with regulators, the Company has determined to seek licensing for its managed behavioral healthcare and radiology benefits management business as a single service HMO, TPA or utilization review agent in

one or more jurisdictions. Compliance activities, mandated changes in the Company's operations, delays in the expansion of the Company's business or lost business opportunities as a result of regulatory requirements or policies could have a material adverse effect on the Company. As discussed below, the Company is subject to certain state licensure requirements in relation to its specialty pharmaceutical management business.

*Insurance, HMO and PPO Activities.* To the extent that the Company operates or is deemed to operate in some states as an insurance company, HMO, PPO or similar entity, it may be required to comply with certain laws and regulations that, among other things, may require the Company to maintain certain types of assets and minimum levels of deposits, capital, surplus, reserves or net worth. In many states, entities that assume risk under contracts with licensed insurance companies or HMOs have not been considered by state regulators to be conducting an insurance or HMO business. As a result, the Company has not sought licenses as either an insurer or HMO in certain states. The National Association of Insurance Commissioners (the "NAIC") has undertaken a comprehensive review of the regulatory status of entities arranging for the provision of healthcare services through a network of providers that, like the Company, may assume risk for the cost and quality of healthcare services, but that are not currently licensed as an HMO or similar entity. As a result of this review, the NAIC developed a "health organizations risk-based capital" formula, designed specifically for managed care organizations, that establishes a minimum amount of capital necessary for a managed care organization to support its overall operations, allowing consideration for the organization's size and risk profile. The NAIC also adopted a model regulation in the area of health plan standards, which could be adopted by individual states in whole or in part, and could result in the Company being required to meet additional or new standards in connection with its existing operations. Certain states, for example, have adopted regulations based on the NAIC initiative, and as a result, the Company has been subject to certain minimum capital requirements in those states. Certain other states, such as Maryland, Texas, New York and New Jersey, have also adopted their own regulatory initiatives that subject entities such as certain of the Company's subsidiaries to regulation under state insurance laws. This includes, but is not limited to, requiring adherence to specific financial solvency standards. State insurance laws and regulations may limit the Company's ability to pay dividends, make certain investments and repay certain indebtedness. Being licensed as an insurance company, HMO or similar entity could also subject the Company to regulations governing reporting and disclosure, mandated benefits, rate setting and other traditional insurance regulatory requirements. PPO regulations to which the Company may be subject may require the Company to register with a state authority and provide information concerning its operations, particularly relating to provider and payor contracting. The imposition of such requirements could increase the Company's cost of doing business and could delay the Company's conduct or expansion of its business in some areas. The licensing process under state insurance laws can be lengthy and, unless the applicable state regulatory agency allows the Company to continue to operate while the licensing process is ongoing, the Company could experience a material adverse effect on its operating results and financial condition while its license application is pending. In addition, failure to obtain and maintain required licenses typically also constitutes an event of default under the Company's contracts with its customers. The loss of business from one or more of the Company's major customers as a result of such an event of default or otherwise could have a material adverse effect on the Company.

Regulators may impose operational restrictions on entities granted licenses to operate as insurance companies or HMOs. For example, the California Department of Managed Health Care has imposed certain restrictions on the ability of the Company's California subsidiaries to fund the Company's operations in other states, to guarantee or co-sign for the Company's financial obligations, or to pledge or hypothecate the stock of these subsidiaries and on the Company's ability to make certain operational changes with respect to these subsidiaries. In addition, regulators of certain of the Company's subsidiaries may exercise certain discretionary rights under regulations including, without limitation, increasing its supervision of such entities, requiring additional restricted cash or other security.

*Utilization Review and Third-Party Administrator Activities.* Numerous states in which the Company does business have adopted regulations governing entities engaging in utilization review and TPA activities. Utilization review regulations typically impose requirements with respect to the qualifications of personnel reviewing proposed treatment, timeliness and notice of the review of proposed treatment and other matters. TPA regulations typically impose requirements regarding claims processing and payments and the handling of customer funds. Utilization review and TPA regulations may increase the Company's cost of doing business in the event that compliance requires the Company to retain additional personnel to meet the regulatory requirements and to take other required actions and make necessary filings. Although compliance with utilization review regulations has not had a material adverse effect on the Company, there can be no assurance that specific regulations adopted in the future would not have such a result, particularly since the nature, scope and specific requirements of such provisions vary considerably among states that have adopted regulations of this type.

Numerous states require the licensing or certification of entities performing utilization review or TPA activities, however, certain federal courts have held that such licensing requirements are preempted by the Employment Retirement Income Security Act of 1974, as amended ("ERISA"). ERISA preempts state laws that mandate employee benefit structures or their administration, as well as those that provide alternative enforcement mechanisms. The Company believes that its TPA activities performed for its self-insured employee benefit plan customers are exempt from otherwise applicable state licensing or registration requirements based upon federal preemption under ERISA and have relied on this general principle in determining not to seek licenses for certain of the Company's activities in many states. Existing case law is not uniform on the applicability of ERISA preemption with respect to state regulation of utilization review or TPA activities. There can be no assurance that additional licenses will not be required with respect to utilization review or TPA activities in certain states.

*Licensing of Healthcare Professionals/Clinic Facilities.* The provision of healthcare treatment services by physicians, psychiatrists, psychologists and other providers is subject to state regulation with respect to the licensing of healthcare professionals. The Company believes that the healthcare professionals who provide healthcare treatment on behalf of or under contracts with the Company, and the case managers and other personnel of the health services business, are in compliance with the applicable state licensing requirements and current interpretations thereof. However, there can be no assurance that changes in such state licensing requirements or interpretations thereof will not adversely affect the Company's existing operations or limit expansion. With respect to the Company's crisis intervention program, additional licensing of clinicians who provide telephonic assessment or stabilization services to individuals who are calling from out-of-state may be required if such assessment or stabilization services are deemed by regulatory agencies to be treatment provided in the state of such individual's residence. The Company believes that any such additional licenses could be obtained. The Company also maintains licenses in the State of Arizona relating to the direct provision of healthcare services that the Company provides through certain direct care clinics operated under the Maricopa Contract.

*Prohibition on Fee Splitting and Corporate Practice of Professions.* The laws of some states limit the ability of a business corporation to directly provide, control or exercise excessive influence over healthcare services through the direct employment of physicians, psychiatrists, psychologists, or other healthcare professionals, who are providing direct clinical services. In addition, the laws of some states prohibit physicians, psychiatrists, psychologists, or other healthcare professionals from splitting fees with other persons or entities. These laws and their interpretations vary from state to state and enforcement by the courts and regulatory authorities may vary from state to state and may change over time. The Company believes that its operations as currently conducted are in material compliance with the applicable laws. However, there can be no assurance that the Company's existing operations and its contractual arrangements with physicians, psychiatrists, psychologists and other healthcare professionals

will not be successfully challenged under state laws prohibiting fee splitting or the practice of a profession by an unlicensed entity, or that the enforceability of such contractual arrangements will not be limited. The Company believes that it could, if necessary, restructure its operations to comply with changes in the interpretation or enforcement of such laws and regulations, and that such restructuring would not have a material adverse effect on its operations.

*Direct Contracting with Licensed Insurers.* Regulators in several states in which the Company does business have adopted policies that require HMOs or, in some instances, insurance companies, to contract directly with licensed healthcare providers, entities or provider groups, such as IPAs, for the provision of treatment services, rather than with unlicensed intermediary companies. In such states, the Company's customary model of contracting directly is modified so that, for example, the IPAs (rather than the Company) contract directly with the HMO or insurance company, as appropriate, for the provision of treatment services.

*HIPAA.* The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") requires the Secretary of the Department of Health and Human Services ("HHS") to adopt standards relating to the transmission, privacy and security of health information by healthcare providers and healthcare plans. Confidentiality and patient privacy requirements are particularly strict in the Company's behavioral managed care business. In connection with HIPAA, the Company initially commissioned a dedicated HIPAA project management office to achieve compliance within the required timeframes. Oversight responsibilities for HIPAA compliance is now being handled by the Company's Corporate Compliance Department. The Company believes it is currently in compliance with the provisions of HIPAA. The American Recovery and Reinvestment Act of 2009, signed into law on February 17, 2009, represents a significant expansion of the HIPAA privacy and security laws. Regulations interpreting this new law have yet to be promulgated. The Company believes, that it can comply with changes in these laws and regulations, however there can be no assurance that compliance with such laws and regulations would not have a material adverse effect on its operations.

*Other Significant Privacy Regulation.* The privacy regulation under HIPAA generally does not preempt state law except under the following limited circumstances: (i) the privacy rights afforded under state law are contrary to those provided by HIPAA so that compliance with both standards is not possible and (ii) HIPAA's privacy protections are more stringent than the state law in question. Because many states have privacy laws that either provide more stringent privacy protections than those imposed by HIPAA or laws that can be followed in addition to HIPAA, the Company must address privacy issues under HIPAA and state law as well. While the Company has always been required to follow state privacy laws, the Company now has had to review these state laws against HIPAA to determine whether it must comply with standards established by both HIPAA and state law. In addition, HIPAA has created an increased awareness of the issues surrounding privacy, which may generate more state regulatory scrutiny in this area.

*Federal Anti-Remuneration/Fraud and Abuse Laws.* The federal healthcare Anti-Kickback Statute (the "Anti-Kickback Statute") prohibits, among other things, an entity from paying or receiving, subject to certain exceptions and "safe harbors," any remuneration, directly or indirectly, to induce the referral of individuals covered by federally funded health care programs, or the purchase, or the arranging for or recommending of the purchase, of items or services for which payment may be made in whole, or in part, under Medicare, Medicaid, TRICARE or other federally funded health care programs. Sanctions for violating the Anti-Kickback Statute may include imprisonment, criminal and civil fines and exclusion from participation in the federally funded health care programs. The Anti-Kickback Statute has been interpreted broadly by courts, the Office of Inspector General ("OIG") within the U.S. Department of Health & Human Services ("DHHS"), and other administrative bodies. It also is a crime under the Public Contractor Anti-Kickback Statute, for any person to knowingly and willfully offer or provide any remuneration to a prime contractor to the United States, including a contractor servicing federally

funded health programs, in order to obtain favorable treatment in a subcontract. Violators of this law also may be subject to civil monetary penalties. There have been a series of substantial civil and criminal investigations and settlements, at the state and federal level, by pharmacy benefit managers over the last several years in connection with alleged kickback schemes. The Company believes that it is in compliance with the legal requirements imposed by such anti-remuneration laws and regulations, however, there can be no assurance that the Company will not be subject to scrutiny or challenge under such laws or regulations and that any such challenge would not have a material adverse effect on our business, results of operations, financial condition or cash flows.

*Federal Statutes Prohibiting False Claims.* The Federal Civil False Claims Act imposes civil penalties for knowingly making or causing to be made false claims with respect to governmental programs, such as Medicare and Medicaid, for services not rendered, or for misrepresenting actual services rendered, in order to obtain higher reimbursement. Private individuals may bring *qui tam* or whistle blower suits against providers under the Federal Civil False Claims Act, which authorizes the payment of a portion of any recovery to the individual bringing suit. A few federal district courts recently have interpreted the Federal Civil False Claims Act as applying to claims for reimbursement that violate the Anti-Kickback Statute under certain circumstances. The Federal Civil False Claims Act generally provides for the imposition of civil penalties and for treble damages, resulting in the possibility of substantial financial penalties for small billing errors. Criminal provisions that are similar to the Federal Civil False Claims Act provide that a corporation may be fined if it is convicted of presenting to any federal agency a claim or making a statement that it knows to be false, fictitious or fraudulent. Even in situations where the Company does not directly provide services to beneficiaries of federally funded health programs and, accordingly, does not directly submit claims to the federal government, it is possible that the Company could nevertheless become involved in a situation where false claim issues are raised based on allegations that it caused or assisted a government contractor in making a false claim.

The Company is subject to certain provisions of the Deficit Reduction Act of 2005 (the "Act"). The Act requires entities that receive \$5 million or more in annual Medicaid payments establish written policies that provide detailed information about the Federal Civil False Claims Act and the remedies thereunder, as well as any state laws pertaining to civil or criminal penalties for false claims and statements, the "whistleblower" protections afforded under such laws, and the role of such laws in preventing and detecting fraud waste and abuse. The written policies are to be disseminated to all employees, contractors and agents which or who, on behalf of the entity, furnishes, or otherwise authorizes the furnishing of, Medicaid health care items or services; performs billing or coding functions, or is involved in the monitoring of health care provided by the entity. In addition, any such entity that has an employee handbook must include a specific discussion of the federal and state false claims laws, the rights of an employee to be protected as a whistle blower and the entity's policies and procedures for detecting and preventing fraud, waste and abuse. The Company does not believe that it is in violation of the Federal Civil False Claims Act (or its criminal counterparts) and the Company has a corporate compliance and ethics program, policies and procedures and internal controls in place to help maintain an organizational culture of honesty and integrity.

*State Anti-Remuneration/False Claims Law.* Several states have laws and/or regulations similar to the federal anti-remuneration and Federal False Claims Act described above. Sanctions for violating these state anti-remuneration and false claims laws may include injunction, imprisonment, criminal and civil fines and exclusion from participation in the state Medicaid programs. The Company believes that it is in substantial compliance with the legal requirements imposed by such anti-remuneration laws and regulations. However, there can be no assurance that the Company will not be subject to scrutiny or challenge under such laws or regulations and that any such challenge would not have a material adverse effect on our business, results of operations, financial condition or cash flows.

*ERISA.* Certain of the Company's services are subject to the provisions of ERISA. ERISA governs certain aspects of the relationship between employer-sponsored healthcare benefit plans and certain providers of services to such plans through a series of complex laws and regulations that are subject to periodic interpretation by the Internal Revenue Service ("IRS") and the U.S. Department of Labor. In some circumstances, and under certain customer contracts, the Company may be expressly named as a "fiduciary" under ERISA, or be deemed to have assumed duties that make it an ERISA fiduciary, and thus be required to carry out its operations in a manner that complies with ERISA in all material respects. The Company believes that it is in material compliance with ERISA and that such compliance does not currently have a material adverse effect on its operations, there can be no assurance that continuing ERISA compliance efforts or any future changes to ERISA will not have a material adverse effect on the Company.

*Regulation of Customers.* Regulations imposed upon the Company's customers include, among other things, benefits mandated by statute, exclusions from coverage prohibited by statute, procedures governing the payment and processing of claims, record keeping and reporting requirements, requirements for and payment rates applicable to coverage of Medicaid and Medicare beneficiaries, provider contracting and enrollee rights and confidentiality requirements. Although the Company believes that such regulations do not, at present, materially impair its operations, there can be no assurance that such indirect regulation will not have a material adverse effect on the Company in the future. In October 2008, the United States Congress passed legislation establishing parity in financial requirements (e.g. co-pays, deductibles, etc.) and treatment limitations (e.g. limits on the number of visits) between mental health and substance abuse benefits and medical/surgical benefits for health plan members. This new law does not require coverage for mental health or substance abuse disorders but if coverage is provided it must be provided at parity. No specific disorders are mandated for coverage; health plans are able to define mental health and substance abuse to determine what they are going to cover. State mandated benefits laws are not preempted. The law applies to ERISA plans, Medicaid managed care plans and State Children's Health Insurance Program ("SCHIP") plans. There is an exemption for small employers. No assurance can be given that such legislation will not have a material adverse effect on the Company. However, the Company's risk contracts do allow for repricing to occur effective the same date that any legislation becomes effective if that legislation is projected to have a material affect on cost of care.

*Medicare Prescription Drug, Improvement and Modernization Act of 2003.* The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 ("MMA") established a voluntary outpatient prescription drug benefit for Medicare enrollees on an insured basis through Prescription Drug Plans, ("PDPs"), and by Medicare Advantage Plans ("Part D Activities"), in various regions across the United States. Among other things, PDPs and Medicare Advantage Plans are subject to provisions of the MMA and its implementing regulations and guidance intended to deter fraud, waste and abuse and are monitored strictly by the federal Centers for Medicare and Medicaid Services ("CMS") and its contracted Medicare Drug Integrity Contractors ("MEDICs") to ensure that Part D program funds are not spent inappropriately.

The Company is neither a PDP nor a Medicare Advantage Plan; however, the Company contracts with PDPs and Medicare Advantage Plans, collectively "Part D Plans," to provide various services. In our capacity as a subcontractor with certain Part D Plan clients, we are indirectly subject to certain federal rules, regulations, and sub-regulatory guidance pertaining to the operation of Medicare Part D. If CMS or a health plan customer determines that the Company has not performed satisfactorily as a subcontractor, CMS or the health plan customer may require Company to cease its Part D activities or responsibilities under the subcontract. While the Company believes that it provides satisfactory levels of service under its respective subcontracts, the Company can give no assurances that CMS or a Part D Plan will not terminate the Company's business relationships insofar as they pertain to Medicare Part D.

CMS requires PDPs and Medicare Advantage Plans to report 100% of all price concessions received for PBM services. The applicable CMS guidance suggests that best practices would require PDPs and Medicare Advantage Plans to contractually require the right to audit their PBMs as well as require 100% transparency as to manufacturer rebates paid for drugs provided under the sponsor's plan, including the portion of such rebates retained by the PBM as part of the price concession for the PBM's services. Additionally, CMS regulations require Part D Plan sponsors to ensure through their contractual arrangements with first tier, downstream and related entities (which would include PBMs) that CMS has access to such entities' books and records pertaining to services performed in connection with Part D. The CMS regulations also suggests that Part D Plan sponsors should contractually require their first tier, downstream and related entities to comply with certain elements of the sponsor's compliance program. We have not experienced and we do not anticipate that such disclosure and auditing requirements, to the extent required by Medicare plan partners, will have a materially adverse effect on our specialty pharmacy business.

On January 6, 2009, CMS issued a final regulation requiring Part D plan sponsors, beginning in 2010, calculate beneficiary cost sharing based upon the price ultimately received by the pharmacy or other dispensing provider, rather than upon the price paid by the plan. Such calculation could potentially result in lower pharmacy claims reimbursement by Part D plan sponsors. In addition, the regulation requires that any profit realized or loss incurred by a PBM through price negotiations with pharmacies or manufacturers be included as administrative costs to the plan rather than being factored into drug costs for reimbursement purposes.

*FDA Regulation.* The U.S. Food and Drug Administration ("FDA") generally has authority to regulate drug promotional activities that are performed "by or on behalf of" a drug manufacturer. The Company's business includes the provision of educational seminars for prescribers and other of the Company's customers on behalf of manufacturer clients and thus may subject to the federal laws applicable to the promotion of prescription drugs. There can be no assurance that the FDA will not attempt to assert jurisdiction over certain aspects of our specialty pharmacy business in the future and, although we are not controlled directly or indirectly by any drug manufacturer, the impact of future FDA regulation could materially adversely affect our specialty pharmacy business, results of operations, financial condition or cash flows.

*State Comprehensive PBM Regulation.* States continue to introduce broad legislation to regulate pharmacy benefits management activities. Some of this legislation could encompass certain of the activities of the specialty pharmacy business of the Company. In particular, some legislation seeks to impose fiduciary duties or disclosure obligations on entities that provide certain types of pharmacy management services. Both Maine and the District of Columbia have enacted statutes designed to impose certain fiduciary obligations on entities providing PBM services. In 2008, Maryland implemented comprehensive PBM registration legislation. Other states, including Mississippi, Louisiana, Connecticut and Tennessee, have recently enacted laws regulating various pharmacy benefit management activities, and similar legislation is pending in several more states. Such laws generally require certain financial disclosures. Such state laws do not appear to be having a material adverse effect on the Company's specialty pharmacy business. However, the Company can give no assurance that these and other states will not enact legislation with more adverse consequences in the near future; nor can the Company be certain that future regulations or interpretations of existing laws will not adversely affect its specialty pharmacy business.

*State Legislation Affecting Plan or Benefit Design.* Some states have enacted legislation that prohibits certain types of managed care plan sponsors from implementing certain restrictive formulary and network design features, and many states have legislation regulating various aspects of managed care plans, including provisions relating to the pharmacy benefits. Other states mandate coverage of

certain benefits or conditions and require health plan coverage of specific drugs, if deemed medically necessary by the prescribing physician. Such legislation does not generally apply to the Company directly, but may apply to certain clients of the Company, such as HMOs and health insurers.

*Legislation Affecting Drug Prices.* Specialty pharmaceutical manufacturers generally report various price metrics to the federal government, including "average sales price" ("ASP"), "average manufacturer price" ("AMP") and "best price" ("BP"). The Company does not calculate these price metrics, but we note that the ASP, AMP and BP methodologies may create incentives for some drug manufacturers to reduce the levels of discounts or rebates available to purchasers, including the Company, or their clients with respect to specialty drugs. Any changes in the guidance affecting pharmaceutical manufacturer price metric calculations could materially adversely affect the Company's business.

Additionally, most of the Company's distribution contracts with its customers use "average wholesale price" ("AWP") as a benchmark for establishing pricing. As part of a proposed amended and restated settlement in the case of New England Carpenters Health Benefit Fund, et. al. v. First Data Bank, et. al., Civil Action No. 1:05-CV-11148-PBS (D. Mass.), a case brought against First Data Bank, one of several companies that report data on prescription drug prices, First Data Bank has agreed to reduce the wholesale average cost ("WAC") to AWP mark up of certain pharmaceutical products, which will result in a reduction of the AWP. The proposed amended and restated settlement received preliminary but not final approval of the court, and the specific terms of the settlement continue to be litigated. As of the end of January 2009, the amended and restated settlement has not yet been finalized. The Company cannot predict whether or when the amended and restated settlement will be approved or the extent to which, if at all, any final settlement terms will affect the Company's operations.

In the absence of any action on the part of the Company to renegotiate with its customers the pricing of those pharmaceutical distribution contracts that use AWP, a settlement that involves a reduction in First Data Bank's AWP could adversely affect the margins earned on those distribution contracts that use AWP, however it is not expected to have a material adverse affect on the Company's results of operations.

*Regulations Affecting the Company's Pharmacies.* The Company owns two pharmacies that provide services to certain of the Company's health plan customers. The activities undertaken by the Company's pharmacies subject the pharmacies to state and federal statutes and regulations governing, among other things, the licensure and operation of mail order and non-resident pharmacies, repackaging of drug products, stocking of prescription drug products and dispensing of prescription drug products, including controlled substances. The Company's pharmacy facilities are located in Florida and New York and are duly licensed to conduct business in those states. Many states, however, require out-of-state mail order pharmacies to register with or be licensed by the state board of pharmacy or similar governing body when pharmaceuticals are delivered by mail into the state and some states require that an out-of-state pharmacy employ a pharmacist that is licensed in the state into which pharmaceuticals are shipped. The Company holds mail order and non-resident pharmacy licenses where required.

*Regulation of Controlled Substances.* The Company's pharmacies must register with the United States Drug Enforcement Administration (the "DEA"), and individual state controlled substance authorities in order to dispense controlled substances. Federal law requires the Company to comply with the DEA's security, recordkeeping, inventory control, and labeling standards in order to dispense controlled substances. State controlled substance law requires registration and compliance with state pharmacy licensure, registration or permit standards promulgated by the state pharmacy licensing authority.

Some of the state regulatory requirements described above may be preempted in whole or in part by ERISA, which provides for comprehensive federal regulation of employee benefit plans. However, the scope of ERISA preemption is uncertain and is subject to conflicting court rulings. As a result, the Company could be subject to overlapping federal and state regulatory requirements in respect of certain of its operations and may need to implement compliance programs that satisfy multiple regulatory regimes.

*Other Regulation of Healthcare Providers.* The Company's business is affected indirectly by regulations imposed upon healthcare providers. Regulations imposed upon healthcare providers include but are not limited to, provisions relating to the conduct of, and ethical considerations involved in, the practice of psychiatry, psychology, social work and related behavioral healthcare professions, radiology, pharmacy, accreditation, government healthcare program participation requirements, reimbursements for patient services, Medicare and Medicaid fraud and abuse and, in certain cases, the common law duty to warn others of danger or to prevent patient self-injury. Changes in these regulatory requirements applicable to healthcare providers could impact the Company's business methods and practices and there can be no assurances that the impact would not be adverse and material.

*Other Proposed Legislation.* In the last five years, legislation has periodically been introduced at the state and federal levels providing for new healthcare regulatory programs and materially revising existing healthcare regulatory programs (including, without limitation, legislation to carve out certain classes from generic substitution). Recently some states including Massachusetts, Maryland and California have enacted or considered legislation regarding various forms of mandatory or universal health insurance coverage. Such legislation could include both federal and state bills affecting Medicaid programs which may be pending in, or recently passed by, state legislatures and which are not yet available for review and analysis. Such legislation could also include proposals for national health insurance or state-based mandatory universal health insurance coverage and other forms of federal and state regulation of health insurance and healthcare delivery.

There is currently discussion about the potential for health care reform, both at state and national levels. The proposals for reform include the government assuming a larger role in the health care system or a restructuring of Medicare or Medicaid programs. One of the items discussed has been reducing payments to private health plans offering Medicare Advantage. Depending on the outcome of these potential reductions, there is the possibility that membership and earnings derived from these plans may decrease. The Company cannot speculate on the outcome of any such "reform", how it may impact our business, and when it may become effective. Therefore, at this time the Company is unable to predict whether there will be any effect, positive or adverse, on its business as a result of any such healthcare reform.

### **Employees of the Registrant**

At December 31, 2008, the Company had approximately 5,200 full-time and part-time employees. The Company believes it has satisfactory relations with its employees.

### **History**

In late 1997 and early 1998, the Company completed its acquisition of three large managed behavioral healthcare organizations. Due primarily to those debt-financed acquisitions, the Company had amassed over \$1.0 billion in total debt as of September 30, 2002. The Company concluded that it could no longer support the existing capital structure and determined to restructure its debt to levels that were more in line with its operations. On March 11, 2003 (the "Commencement Date"), Magellan and 88 of its subsidiaries filed voluntary petitions for relief under chapter 11 of title 11 of the United States Bankruptcy Code (the "Bankruptcy Code"), in order to accomplish such restructuring.

On January 5, 2004 (the "Effective Date"), Magellan and 88 of its subsidiaries consummated their Third Joint Amended Plan of Reorganization, as modified and confirmed (the "Plan"), which had been confirmed by order of the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") on October 8, 2003, and accordingly the Plan became fully effective and the companies emerged from the protection of their chapter 11 proceedings.

Giving effect to the Plan, Magellan and its subsidiaries continued, in their previous organizational form, to conduct their business as previously conducted, with the same assets in all material respects, but the Company was recapitalized. Under the Plan, the Company's senior secured bank indebtedness under its previous credit agreement (the "Old Credit Agreement"), as existing before the Effective Date, was paid in full, and other then-existing indebtedness (i.e., 9.375% senior notes due 2007 (the "Old Senior Notes"), 9% Senior Subordinated Notes due 2008 in the principal amount of \$625.0 million (the "Old Subordinated Notes") and other general unsecured creditor claims ("Other GUCs")) and the then-existing equity interests in Magellan were cancelled as of the Effective Date in exchange for the distributions provided for by the Plan, all as of the Effective Date.

All distributions were made as of the Effective Date except for distributions related to disputed claims for Other GUCs, for which distributions were made subsequent to the Effective Date periodically as such disputed claims were settled. As of December 31, 2008, the total amount of outstanding, disputed claims for Other GUCs is \$0.7 million ("Disputed Claims"). The Company does not believe that it is probable that any liability for the Disputed Claims will be incurred, and thus no liability has been recorded for the Disputed Claims as of December 31, 2008. Nonetheless, the Company has withheld from distribution 89,798 shares of Ordinary Common Stock (the "Reserved Shares") which will be distributed in accordance with the terms of the Plan upon the final resolution of the Disputed Claims. If the Disputed Claims were to be resolved for the full amount of \$0.7 million, then the amount of additional consideration, in addition to the Reserved Shares, that the Company would be required to issue to the individual claimants that filed the Disputed Claims is cash of \$0.2 million. If the Disputed Claims are resolved for less than \$0.7 million, some or all of the Reserved Shares will be distributed as an incremental distribution to Other GUCs whose claims have been allowed in the bankruptcy.

On January 19, 2005, the Bankruptcy Court entered a final decree closing the chapter 11 case.

#### **Available Information**

The Company makes its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and Section 16 filings available, free of charge, on the Company's website at [www.magellanhealth.com](http://www.magellanhealth.com) as soon as practicable after the Company has electronically filed such material with, or furnished it to, the Securities and Exchange Commission ("SEC"). The information on the Company's website is not part of or incorporated by reference in this report on Form 10-K.

#### **Item 1A. Risk Factors**

##### **Reliance on Customer Contracts—The Company's inability to renew, extend or replace expiring or terminated contracts could adversely affect the Company's liquidity, profitability and financial condition.**

Substantially all of the Company's net revenue is derived from contracts that may be terminated immediately with cause and many, including some of the Company's most significant contracts, are terminable without cause by the customer upon notice and the passage of a specified period of time (typically between 60 and 180 days), or upon the occurrence of certain other specified events. The Company's ten largest customers accounted for 65.9 percent and 73.0 percent of the Company's net

revenue in the years ended December 31, 2007 and 2008, respectively. Loss of all of these contracts or customers would, and loss of any one of these contracts or customers could, materially reduce the Company's net revenue and have a material adverse effect on the Company's liquidity, profitability and financial condition.

### *Significant Customers*

#### Consolidated Company

The Company's contracts with the State of Tennessee's TennCare program ("TennCare") and with subsidiaries of WellPoint each generated net revenues that exceeded, in the aggregate, ten percent of net revenues for the consolidated Company for the year ended December 31, 2007. In addition to TennCare, the Company's Maricopa Contract generated net revenues that exceeded, in the aggregate, ten percent of net revenues for the consolidated Company for the year ended December 31, 2008. The Company also has a significant concentration of business from contracts with various counties in the State of Pennsylvania (the "Pennsylvania Counties") which are part of the Pennsylvania Medicaid program.

The Maricopa Contract, which began September 1, 2007 and which extends through June 30, 2010, generated net revenues of \$196.1 million and \$621.6 million for the years ended December 31, 2007 and 2008, respectively.

The TennCare program is divided into three regions, and through March 31, 2007 the Company's TennCare contracts encompassed all of the TennCare membership for all three regions. As of April 1, 2007 substantially all of the membership in the Middle Grand Region was re-assigned to managed care companies in accordance with contract awards by TennCare pursuant to its request for proposals for the management of the integrated delivery of behavioral and physical medical care to the region. Substantially all of the membership in the West Grand and East Grand Regions was similarly re-assigned to managed care companies in accordance with contract awards by TennCare effective November 1, 2008 and January 1, 2009, respectively. The Company continues to manage behavioral healthcare services for children enrolled in TennCare Select High, statewide, as well as for certain out-of-state TennCare members pursuant to contracts that extend through June 30, 2009. The Company recorded net revenues of \$316.9 million and \$282.4 million for the years ended December 31, 2007 and 2008, respectively, from its TennCare contracts. The portion of the total net revenues associated with the programs for children and out-of-state members referred to above was \$47.0 million for the year ended December 31, 2008.

Total net revenues from the Company's contracts with WellPoint were \$218.9 million and \$186.7 million during the years ended December 31, 2007 and 2008, respectively, including radiology benefits management revenue of \$77.8 million and \$162.5 million, respectively. One of the Company's managed behavioral healthcare contracts with WellPoint was terminated by WellPoint effective March 31, 2007, and generated net revenues of \$26.0 million during 2007. A second managed behavioral healthcare contract with WellPoint expired December 31, 2007 and generated net revenues of \$85.7 million during the year ended December 31, 2007.

In July 2007, WellPoint acquired a radiology benefits management company, and has expressed its intent to in-source all of its radiology benefits management contracts when such contracts expire. The Company has several radiology benefits management contracts with WellPoint including one that converted from an ASO arrangement to a risk arrangement effective July 1, 2007. Such risk contract originally had a three-year term through June 30, 2010, and cannot be terminated early, except for cause, as defined in the agreement. The term of this risk contract has been extended through December 31, 2010. The Company's other radiology benefits management contracts with WellPoint generated \$11.4 million of net revenues for the year ended December 31, 2008. Substantially all of this revenue relates to contracts that have terminated at various dates in 2008.

Net revenues from the Pennsylvania Counties in the aggregate totaled \$262.2 million and \$288.1 million for the years ended December 31, 2007 and 2008, respectively.

#### By Segment

WellPoint generated greater than ten percent of net revenues for the Commercial segment for the year ended December 31, 2007. Two other customers generated greater than ten percent of Commercial net revenues for the years ended December 31, 2007 and 2008. The first customer has a contract that extends through December 31, 2012 and generated net revenues of \$175.4 million and \$217.0 million for the years ended December 31, 2007 and 2008, respectively. The second customer has a contract that extends through June 30, 2009 and generated net revenues of \$89.3 million and \$90.8 million for the years ended December 31, 2007 and 2008, respectively.

Maricopa and TennCare were the only customers with net revenues greater than ten percent of the net revenues for the Public Sector segment for the year ended December 31, 2008. In addition to Maricopa and TennCare, one customer generated revenues greater than ten percent of the net revenues for the Public Sector segment for the year ended December 31, 2007. This customer has a contract that extends through December 31, 2009 and generated net revenues of \$124.7 and \$140.5 million for the years ended December 31, 2007 and 2008, respectively.

In addition to WellPoint, one other customer generated greater than ten percent of the net revenues for the Radiology Benefits Management segment for the years ended December 31, 2007 and 2008. This customer has a contract that extends through May 31, 2011 and generated net revenues of \$61.3 million and \$96.4 million for the years ended December 31, 2007 and 2008, respectively.

Included in the Company's Specialty Pharmaceutical Management segment are four customers that each exceeded ten percent of the net revenues for this segment for the year ended December 31, 2007. The four customers generated \$60.0 million, \$34.4 million, \$33.6 million and \$24.9 million of net revenues during the year ended December 31, 2007. For the year ended December 31, 2008, five customers each exceeded ten percent of the net revenues for this segment. Four of such customers generated \$71.9 million, \$49.5 million, \$28.0 million, and \$26.8 million of net revenues during the year ended December 31, 2008. The other contract generated net revenues of \$27.1 million for the year ended December 31, 2008, and this contract terminated December 31, 2008.

**Integration of Companies Acquired by Magellan—The Company's profitability could be adversely affected if the integration of companies acquired by Magellan, is not completed in a timely and effective manner.**

As previously discussed, one of the Company's growth strategies is to make strategic acquisitions which are complementary to its existing operations. NIA and ICORE were the first such acquisitions completed by the Company. After Magellan closes on an acquisition, it must integrate the acquired company into Magellan's policies, procedures and systems. Failure to effectively integrate an acquired business could result in excessive costs being incurred, a delay in obtaining targeted synergies, decreased customer performance (which could result in contract penalties and/or terminations), increased employee turnover, and lost sales opportunities.

**Changes in the Medical Managed Care Carve-Out Industry—Certain changes in the business practices of this industry could negatively impact the Company's resources, profitability and results of operations.**

Substantially all of the Company's Commercial, Radiology Benefits Management and Specialty Pharmaceutical Management segments' net revenues are derived from customers in the medical managed care industry, including managed care companies, health insurers and other health plans. Some types of changes in this industry's business practices could negatively impact the Company. For

example, if the Company's managed care customers seek to provide services directly to their subscribers, instead of contracting with the Company for such services, the Company could be adversely affected. In this regard, certain of the Company's major customers in the past have not renewed all or part of their contracts with the Company, and instead provided managed behavioral healthcare services directly to their subscribers. Other of the Company's customers that are managed care companies could also seek to provide services directly to their subscribers, rather than by contracting with the Company for such services. In addition, the Company has a significant number of contracts with Blue Cross Blue Shield plans and other regional health plans. Consolidation of the healthcare industry through acquisitions and mergers could potentially result in the loss of contracts for the Company. Any of these changes could reduce the Company's net revenue, and adversely affect the Company's profitability and financial condition.

**Changes in the Contracting Model for Medicaid Contracts—Certain changes in the contracting model used by states for managed healthcare services contracts relating to Medicaid lives could negatively impact the Company's resources, profitability and results of operations.**

Substantially all of the Company's Public Sector segment net revenue is derived from direct contracts that it has with state or county governments for the provision of services to Medicaid enrollees. In addition to TennCare discussed above, certain other states have recently contracted with managed care companies to manage both the behavioral and physical medical care of its Medicaid enrollees. If other governmental entities change the method for contracting for Medicaid business to a fully integrated model, the Company will attempt to subcontract with the managed care organizations to provide behavioral healthcare management for such Medicaid business; however, there is no assurance that the Company would be able to secure such arrangements. Accordingly, if such a change in the contracting model were to occur, it is possible that the Company could lose current contracted revenues, as well as be unable to bid on potential new business opportunities, thus negatively impacting the Company's profitability and financial condition.

**Risk-Based Products—Because the Company provides services at a fixed fee, if the Company is unable to accurately predict and control healthcare costs, the Company's profitability could decline.**

The Company derives its net revenue primarily from arrangements under which the Company assumes responsibility for costs of treatment in exchange for a fixed fee. The Company refers to such arrangements as "risk-based contracts" or "risk-based products," which includes EAP services. These arrangements provided 82.4 percent and 84.2 percent of the Company's net revenue in the years ended December 31, 2007 and 2008, respectively.

Profitability of the Company's risk contracts could be reduced if the Company is unable to accurately estimate the rate of service utilization by members or the cost of such services when the Company prices its services. The Company's assumptions of utilization and costs when the Company prices its services may not ultimately reflect actual utilization rates and costs, many aspects of which are beyond the Company's control. If the cost of services provided to members under a contract together with the administrative costs exceeds the aggregate fees received by the Company under such contract, the Company will incur a loss on the contract.

The Company's profitability could also be reduced if the Company is required to make adjustments to estimates made in reporting historical financial results regarding cost of care, reflected in the Company's financial statements as medical claims payable. Medical claims payable includes reserves for incurred but not reported ("IBNR") claims, which are claims for covered services rendered by the Company's providers which have not yet been submitted to the Company for payment. The Company estimates and reserves for IBNR claims based on past claims payment experience, including the average interval between the date services are rendered and the date the claims are received and between the date services are rendered and the date claims are paid, enrollment data, utilization

statistics, adjudication decisions, authorized healthcare services and other factors. This data is incorporated into contract-specific reserve models. The estimates for submitted claims and IBNR claims are made on an accrual basis and adjusted in future periods as required. The Company currently possesses a limited amount of experience related to underwriting risk-based RBM products. If such risk-based RBM products are not correctly underwritten, the Company's profitability and financial condition could be adversely affected.

Factors that affect the Company's ability to price the Company's services, or accurately make estimates of IBNR claims and other expenses for which the Company creates reserves may include differences between the Company's assumptions and actual results arising from, among other things:

- changes in the delivery system;
- changes in utilization patterns;
- changes in the number of members seeking treatment;
- unforeseen fluctuations in claims backlogs;
- unforeseen increases in the costs of the services;
- the occurrence of catastrophes;
- regulatory changes; and
- changes in benefit plan design.

Some of these factors could impact the ability of the Company to manage and control the medical costs to the extent assumed in the pricing of its services.

If the Company's membership in risk-based business continues to grow (which is a major focus of the Company's strategy), the Company's exposure to potential losses from risk-based products will also increase.

**Fluctuation in Operating Results—The Company experiences fluctuations in quarterly operating results and, as a consequence, the Company may fail to meet or exceed market expectations, which could cause the Company's stock price to decline.**

The Company's quarterly operating results have varied in the past and may fluctuate significantly in the future due to seasonal and other factors, including:

- changes in utilization levels by enrolled members of the Company's risk-based contracts, including seasonal utilization patterns (for example, members generally tend to seek services less during the third and fourth quarters of the year than in the first and second quarters of the year);
- performance-based contractual adjustments to net revenue, reflecting utilization results or other performance measures;
- changes in estimates for contractual adjustments under commercial contracts;
- retrospective membership adjustments;
- the timing of implementation of new contracts and enrollment changes; and
- changes in estimates regarding medical costs and IBNR claims.

These factors may affect the Company's quarterly and annual net revenue, expenses and profitability in the future and, accordingly, the Company may fail to meet market expectations, which could cause the Company's stock price to decline.

**Dependence on Government Spending—The Company can be adversely affected by changes in federal, state and local healthcare policies, programs, funding, and enrollments.**

All of the Company's Public Sector segment net revenue and a portion of the Company's net revenue in the Company's other three operating segments are derived, directly or indirectly, from governmental agencies, including state Medicaid programs. Contract rates vary from state to state, are subject to periodic negotiation and may limit the Company's ability to maintain or increase rates. The Company is unable to predict the impact on the Company's operations of future regulations or legislation affecting Medicaid programs, or the healthcare industry in general, and future regulations or legislation may have a material adverse effect on the Company. Moreover, any reduction in government spending for such programs could also have a material adverse effect on the Company (See "Reliance on Customer Contracts"). In addition, the Company's contracts with federal, state and local governmental agencies, under both direct contract and subcontract arrangements, generally are conditioned upon financial appropriations by one or more governmental agencies, especially in the case of state Medicaid programs. These contracts generally can be terminated or modified by the customer if such appropriations are not made. The Company faces increased risks in this regard as state budgets have come under increasing pressure due to the recent economic downturn. Finally, some of the Company's contracts with federal, state and local governmental agencies, under both direct contract and subcontract arrangements, require the Company to perform additional services if federal, state or local laws or regulations imposed after the contract is signed so require, in exchange for additional compensation to be negotiated by the parties in good faith. Government and other third-party payors generally seek to impose lower contract rates and to renegotiate reduced contract rates with service providers in a trend toward cost control.

**Restrictive Covenants in the Company's Debt Instruments—Restrictions imposed by the Company's debt agreements limit the Company's operating and financial flexibility. These restrictions may adversely affect the Company's ability to finance the Company's future operations or capital needs or engage in other business activities that may be in the Company's interest.**

On April 30, 2008, the Company entered into a credit facility with Deutsche Bank AG and Citibank, N.A. that provides for a \$100.0 million Revolving Loan Commitment for the issuance of letters of credit for the account of the Company with a sub-limit of up to \$30.0 million for revolving loans (the "New Credit Facility") which contains a number of covenants. These covenants limit Company management's discretion in operating the Company's business by restricting or limiting the Company's ability, among other things, to:

- incur or guarantee additional indebtedness or issue preferred or redeemable stock;
- pay dividends and make other distributions;
- repurchase equity interests;
- make certain advances, investments and loans;
- enter into sale and leaseback transactions;
- create liens;
- sell and otherwise dispose of assets;
- acquire or merge or consolidate with another company; and
- enter into some types of transactions with affiliates.

These restrictions could adversely affect the Company's ability to finance future operations or capital needs or engage in other business activities that may be in the Company's interest. The New Credit Facility also requires the Company to comply with specified financial ratios and tests. Failure to

do so, unless waived by the lenders under the New Credit Facility, pursuant to its terms, would result in an event of default under the New Credit Facility. The New Credit Facility is guaranteed by most of the Company's subsidiaries and is secured by most of the Company's assets and the Company's subsidiaries' assets.

**Required Assurances of Financial Resources—The Company's liquidity, financial condition, prospects and profitability can be adversely affected by present or future state regulations and contractual requirements that the Company provide financial assurance of the Company's ability to meet the Company's obligations.**

Some of the Company's contracts and certain state regulations require the Company or certain of the Company's subsidiaries to maintain specified cash reserves or letters of credit and/or to maintain certain minimum tangible net equity in certain of the Company's subsidiaries as assurance that the Company has financial resources to meet the Company's contractual obligations. Many of these state regulations also restrict the investment activity of certain of the Company's subsidiaries. Some state regulations also restrict the ability of certain of the Company's subsidiaries to pay dividends to Magellan. Additional state regulations could be promulgated that would increase the cash or other security the Company would be required to maintain. In addition, the Company's customers may require additional restricted cash or other security with respect to the Company's obligations under the Company's contracts, including the Company's obligation to pay IBNR claims and other medical claims not yet processed and paid. In addition, certain of the Company's contracts and state regulations limit the profits that the Company may earn on risk-based business. The Company's liquidity, financial condition, prospects and profitability could be adversely affected by the effects of such regulations and contractual provisions. See Note 2—"Summary of Significant Accounting Policies—Restricted Assets" to the consolidated financial statements set forth elsewhere herein for a discussion of the Company's restricted assets.

**Competition—The competitive environment in the specialty managed healthcare industry may limit the Company's ability to maintain or increase the Company's rates, which would limit or adversely affect the Company's profitability, and any failure in the Company's ability to respond adequately may adversely affect the Company's ability to maintain contracts or obtain new contracts.**

The Company's business is highly competitive. The Company competes with other healthcare organizations as well as with insurance companies, including HMOs, PPOs, TPAs, IPAs, multi-disciplinary medical groups, PBMs, specialty pharmacy companies, radiology benefits management companies and other specialty healthcare and managed care companies. Many of the Company's competitors, particularly certain insurance companies, HMOs and PBMs are significantly larger and have greater financial, marketing and other resources than the Company, which can create downward pressure on prices through economies of scale. The entrance or expansion of these larger companies in the specialty managed healthcare industry (including the Company's customers who have in-sourced or who may choose to in-source healthcare services) could increase the competitive pressures the Company faces and could limit the Company's ability to maintain or increase the Company's rates. If this happens, the Company's profitability could be adversely affected. In addition, if the Company does not adequately respond to these competitive pressures, it could cause the Company to not be able to maintain its current contracts or to not be able to obtain new contracts.

**Possible Impact of Healthcare Reform—Potential healthcare reform can significantly reduce the Company's revenues or profitability.**

The U.S. Congress and certain state legislatures are considering legislation that, among other things, would limit healthcare plans and methods of operations, limit employers' and healthcare plans' ability to define medical necessity, permit employers and healthcare plans to be sued in state courts for

coverage determinations, provide universal health insurance at the state level, provide for minimum medical loss ratios, and otherwise affect health care insurance and managed care. It is uncertain whether the Company could recoup, through higher revenues or other measures, the increased costs of federal or state mandated benefits or other increased costs caused by such legislation or similar legislation. Other federal or state changes in law regarding managed care or universal health insurance coverage could also have adverse consequences for the Company's business. The Company cannot predict the effect of this legislation or other legislation that may be adopted by Congress or by the states, and such legislation, if implemented, could have an adverse effect on the Company.

In October 2008, the United States Congress passed legislation establishing parity in financial requirements (e.g. co-pays, deductibles, etc.) and treatment limitations (e.g. limits on the number of visits) between mental health and substance abuse benefits and medical/surgical benefits for members. This new law does not require coverage for mental health or substance abuse disorders but if coverage is provided it must be provided at parity. No specific disorders are mandated for coverage; health plans are able to define mental health and substance abuse to determine what they are going to cover. State mandated benefits laws are not preempted. The law applies to ERISA plans, Medicaid managed care plans and SCHIP plans. There is an exemption for small employers. No assurance can be given that such legislation will not have a material adverse effect on the Company. However, the Company's risk contracts do allow for re-pricing to occur effective the same date that any legislation becomes effective if that legislation is projected to have a material affect on cost of care.

There is currently discussion about the potential for health care reform, both at state and national levels. The proposals for reform include the government assuming a larger role in the health care system or a restructuring of Medicare or Medicaid programs. One of the items discussed has been reducing payments to private health plans offering Medicare Advantage. Depending on the outcome of these potential reductions, there is the possibility that membership and earnings derived from these plans may decrease. The Company cannot speculate on the outcome of any such "reform," how it may impact our business, and when it may become effective. Therefore, at this time the Company is unable to predict whether there will be any effect, positive or adverse, on its business as a result of any such healthcare reform.

**Government Regulation—The Company is subject to substantial government regulation and scrutiny, which increase the Company's costs of doing business and could adversely affect the Company's profitability.**

The specialty managed healthcare industry and the provision of specialty managed healthcare are subject to extensive and evolving federal and state regulation. Such laws and regulations cover, but are not limited to, matters such as licensure, accreditation, government healthcare program participation requirements, information privacy and security, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. The Company's specialty pharmaceutical management business is also the subject of substantial federal and state governmental regulation and scrutiny. Government investigations and allegations have become more frequent concerning possible violations of fraud and abuse and false claims statutes and regulations by healthcare organizations. Violators may be excluded from participating in government healthcare programs, subject to fines or penalties or required to repay amounts received from the government for previously billed services. A violation of such laws and regulations may have a material adverse effect on the Company.

The Company is subject to certain state laws and regulations and federal laws as a result of the Company's role in management of customers' employee benefit plans.

Regulatory issues may also affect the Company's operations including, but not limited to:

- additional state licenses that may be required to conduct the Company's businesses, including utilization review and TPA activities;

- limits imposed by state authorities upon corporations' control or excessive influence over managed healthcare services through the direct employment of physicians, psychiatrists, psychologists or other professionals, and prohibiting fee splitting;
- laws that impose financial terms and requirements on the Company due to the Company's assumption of risk under contracts with licensed insurance companies or HMOs;
- laws in certain states that impose an obligation to contract with any healthcare provider willing to meet the terms of the Company's contracts with similar providers;
- maintaining confidentiality of patient information; and
- complying with HIPAA.

The imposition of additional licensing and other regulatory requirements may, among other things, increase the Company's equity requirements, increase the cost of doing business or force significant changes in the Company's operations to comply with these requirements.

The costs associated with compliance with government regulation as discussed above may adversely affect the Company's financial condition and results of operations.

**The Company faces additional regulatory risks associated with its Specialty Pharmaceutical Management segment which could subject it to additional regulatory scrutiny and liability and which could adversely affect the profitability of the Specialty Pharmaceutical Management segment in the future.**

With the Company's acquisition of ICORE, additional federal and state regulations became applicable to the Company. Various aspects of the Company's Specialty Pharmaceutical Management segment are governed by federal and state laws and regulations not previously applicable to the Company or which may now be applicable in different ways. Significant sanctions may be imposed for violations of these laws and compliance programs are a significant operational requirement of the Company's business. There are significant uncertainties involving the application of many of these legal requirements to the Company. Accordingly, the Company may be required to incur additional administrative and compliance expenses in determining the applicable requirements and in adapting its compliance practices, or modifying its business practices, in order to satisfy changing interpretations and regulatory policies. In addition, there are numerous proposed health care laws and regulations at the federal and state levels, many of which, if adopted, could adversely affect the Company's business. See "Regulation" above.

**Risks Related To Realization of Goodwill and Intangible Assets—The Company's profitability could be adversely affected if the value of intangible assets is not fully realized.**

The Company's total assets at December 31, 2008 reflect goodwill of approximately \$367.4 million, representing approximately 26.0 percent of total assets. The Company completed the Company's annual impairment analysis of goodwill as of October 1, 2008 noting that no impairment was identified.

At December 31, 2008, identifiable intangible assets (customer lists, contracts and provider networks) totaled approximately \$50.6 million. Intangible assets are amortized over their estimated useful lives, which range from approximately three to sixteen years. The amortization periods used may differ from those used by other entities. In addition, the Company may be required to shorten the amortization period for intangible assets in future periods based on changes in the Company's business. There can be no assurance that such goodwill or intangible assets will be realizable.

The Company evaluates, on a regular basis, whether for any reason the carrying value of the Company's intangible assets and other long-lived assets may no longer be completely recoverable, in which case a charge to earnings for impairment losses could become necessary. When events or

changes in circumstances occur that indicate the carrying amount of long-lived assets may not be recoverable, the Company assesses the recoverability of long-lived assets other than goodwill by determining whether the carrying value of such intangible assets will be recovered through the future cash flows expected from the use of the asset and its eventual disposition.

Any event or change in circumstances leading to a future determination requiring additional write-offs of a significant portion of unamortized intangible assets or goodwill would adversely affect the Company's profitability.

**Risk of Potential Limitation of the Company's Net Operating Loss Carryforwards ("NOLs")—Certain future changes in the composition of the Company's stockholder population could, in certain circumstances, limit the Company's ability to use the Company's NOLs.**

The Company estimates that it has reportable federal NOLs as of December 31, 2008 of approximately \$114.8 million available to reduce future federal taxable income. These estimated NOLs expire in 2011 through 2020 and are subject to examination and adjustment by the Internal Revenue Service ("IRS"). In addition, the Company's utilization of such NOLs is subject to limitation under Internal Revenue Code Section 382 ("Section 382"), which affects the timing of the use of these NOLs. At this time, the Company does not believe these limitations will limit the Company's ability to use any federal NOLs before they expire. Although the Company has NOLs that may be available to offset future taxable income, the Company may be subject to Federal Alternative Minimum Tax.

The limitations imposed by Section 382 provide that a corporation that undergoes an "ownership change" may generally thereafter only utilize its pre-change losses (including, in some cases, certain so-called "built-in" losses that have not yet been recognized for federal income tax purposes) to offset a fixed amount of taxable income per year. A corporation generally undergoes an ownership change if the percentage of stock of the corporation owned by one or more 5% shareholders has increased by more than 50 percentage points over, at most, a three-year period (with certain groups of less-than-5% shareholders treated as a single shareholder for this purpose).

In general, the amount of the annual limitation to which a corporation's pre-change losses are subject following an ownership change is equal to the product of (1) the fair market value of the corporation's stock immediately before the ownership change (subject to certain reductions) multiplied by (2) the "long-term tax-exempt rate" in effect for the month in which the ownership change occurs provided, however, that any existing Section 382 limitation cannot be increased due to a subsequent trigger of a Section 382 limitation. In certain circumstances, the annual limitation for a particular year may be increased due to the subsequent recognition of so-called "built-in" gains that existed at the time of the ownership change. Any unused limitation may be carried forward, thereby increasing the annual limitation in the subsequent taxable year. However, if the Company did not continue the Company's historic business or use a significant portion of the Company's assets in a new business for two years after the ownership change, the resulting annual limitation would be reduced, possibly to zero.

The Company underwent such an ownership change upon consummation of its reorganization in January 2004. Subsequent changes in the Company's stock ownership, including sales of the Company's common stock by certain 5% shareholders, certain purchases that result in 5% or greater ownership of the Company's common stock, certain changes in the indirect beneficial ownership of the Company's common stock, and issuances or redemptions of common stock by the Company, could result in another ownership change that would trigger an additional Section 382 limitation. Such additional Section 382 limitation could reduce the amount of NOLs the Company could utilize in a year, and thereby have an adverse effect on the Company's anticipated future cash flow, if, for example, the fair market value of the Company's stock were to decline significantly prior to such ownership change.

**Claims for Professional Liability—Pending or future actions or claims for professional liability (including any associated judgments, settlements, legal fees and other costs) could require the Company to make significant cash expenditures and consume significant management time and resources, which could have a material adverse effect on the Company's profitability and financial condition.**

Management and administration of the delivery of specialty managed healthcare, the operation of specialty pharmacies and specialty pharmacy drug distribution, and the direct provision of healthcare treatment services such as the services that the Company provides through the direct care clinics operated under the Maricopa Contract, entail significant risks of liability. In recent years, participants in the healthcare industry generally, as well as the specialty managed healthcare industry, have become subject to an increasing number of lawsuits. From time to time, the Company is subject to various actions and claims of professional liability alleging negligence in performing utilization review and other specialty managed healthcare activities, as well as for the acts or omissions of the Company's employees, including employed physicians and other clinicians, network providers, pharmacists, or others. In the normal course of business, the Company receives reports relating to deaths and other serious incidents involving patients whose care is being managed by the Company. Such incidents occasionally give rise to malpractice, professional negligence and other related actions and claims against the Company, the Company's employees, or the Company's network providers. The Company is also subject to actions and claims for the costs of services for which payment was denied. Many of these actions and claims seek substantial damages and require the Company to incur significant fees and costs related to the Company's defense and consume significant management time and resources. While the Company maintains professional liability insurance, there can be no assurance that future actions or claims for professional liability (including any judgments, settlements or costs associated therewith) will not have a material adverse effect on the Company's profitability and financial condition.

**Professional Liability and Other Insurance—Claims brought against the Company that exceed the scope of the Company's liability coverage or denial of coverage could materially and adversely affect the Company's profitability and financial condition.**

The Company maintains a program of insurance coverage against a broad range of risks in the Company's business. As part of this program of insurance, the Company carries professional liability insurance, subject to certain deductibles and self-insured retentions. The Company also is sometimes required by customer contracts to post surety bonds with respect to the Company's potential liability on professional responsibility claims that may be asserted in connection with services the Company provides. As of December 31, 2008, the Company had approximately \$55.4 million of such bonds outstanding. The Company's insurance may not be sufficient to cover any judgments, settlements or costs relating to present or future claims, suits or complaints. Upon expiration of the Company's insurance policies, sufficient insurance may not be available on favorable terms, if at all. To the extent the Company's customers are entitled to indemnification under their contracts with the Company relating to liabilities they incur arising from the operation of the Company's programs, such indemnification may not be covered under the Company's insurance policies. To the extent that certain actions and claims seek punitive and compensatory damages arising from the Company's alleged intentional misconduct, such damages, if awarded, may not be covered, in whole or in part, by the Company's insurance policies. If the Company is unable to secure adequate insurance in the future, or if the insurance the Company carries is not sufficient to cover any judgments, settlements or costs relating to any present or future actions or claims, such judgments, settlements or costs may have a material adverse effect on the Company's profitability and financial condition. If the Company is unable to obtain needed surety bonds in adequate amounts or make alternative arrangements to satisfy the requirements for such bonds, the Company may no longer be able to operate in those states, which would have a material adverse effect on the Company.

**Class Action Suits and Other Legal Proceedings—The Company is subject to class action and other lawsuits that could result in material liabilities to the Company or cause the Company to incur material costs, to change the Company's operating procedures in ways that increase costs or to comply with additional regulatory requirements.**

Managed healthcare companies and PBM companies have been targeted as defendants in national class action lawsuits regarding their business practices. The Company has in the past been subject to such national class actions as defendants and is also subject to or a party to other class actions, lawsuits and legal proceedings in conducting the Company's business. In addition, certain of the Company's customers are parties to pending class action lawsuits regarding the customers' business practices for which the customers could seek indemnification from the Company. These lawsuits may take years to resolve and cause the Company to incur substantial litigation expenses and the outcomes could have a material adverse effect on the Company's profitability and financial condition. In addition to potential damage awards, depending upon the outcomes of such cases, these lawsuits may cause or force changes in practices of the Company's industry and may also cause additional regulation of the industry through new federal or state laws or new applications of existing laws or regulations. Such changes could increase the Company's operating costs.

**Government Investigations—The Company may be subjected to additional regulatory requirements and to investigations or regulatory action by governmental agencies, each of which may have a material adverse effect on the Company's business, financial condition and results of operations.**

From time to time, the Company receives notifications from and engages in discussions with various government agencies concerning the Company's businesses and operations. As a result of these contacts with regulators, the Company may, as appropriate, be required to implement changes to the Company's operations, revise the Company's filings with such agencies and/or seek additional licenses to conduct the Company's business. The Company's inability to comply with the various regulatory requirements may have a material adverse effect on the Company's business.

In addition, the Company may become subject to regulatory investigations relating to the Company's business, which may result in litigation or regulatory action. A subsequent legal liability or a significant regulatory action against the Company could have a material adverse effect on the Company's business, financial condition and results of operations. Moreover, even if the Company ultimately prevails in the litigation, regulatory action or investigation, such litigation, regulatory action or investigation could have a material adverse effect on the Company's business, financial condition and results of operations.

**Investment Portfolio—The value of the Company's investments is influenced by varying economic and market conditions, and a decrease in value may result in a loss charged to income.**

The Company's available-for-sale investment securities were \$233.9 million and represented 16.5 percent of the Company's total consolidated assets at December 31, 2008. These assets are carried at fair value, and the unrealized gains or losses are included in accumulated other comprehensive income as a separate component of shareholders' equity, unless the decline in value is deemed to be other-than-temporary. If a decline in value is deemed to be other-than-temporary, the cost basis of the impaired security is written down to fair value and a charge is taken through operations. The Company has concluded that the unrealized losses are temporary and the Company has the intent and ability to hold the securities until they recover or mature. Therefore, the Company has not recorded any other than temporary impairments.

In accordance with applicable accounting standards, the Company reviews its investment securities to determine if declines in fair value below cost are other-than-temporary. This review is subjective and requires a high degree of judgment. The Company conducts this review on a quarterly basis, using both

quantitative and qualitative factors, to determine whether a decline in value is other-than-temporary. Such factors considered include the length of time and the extent to which market value has been less than cost, financial condition and near term prospects of the issuer, trading activity and marketability of the security, recommendations of investment advisors and forecasts of economic, market or industry trends. This review process also entails an evaluation of the Company's ability and intent to hold individual securities until they mature or full cost can be recovered. The current economic environment and recent volatility of securities markets increase the difficulty of assessing investment impairment and the same influences tend to increase the risk of potential impairment of these assets. The Company believes it has adequately reviewed its investment securities for impairment and that its investment securities are carried at fair value. However, over time, the economic and market environment may provide additional insight regarding the fair value of certain securities, which could change the Company's judgment regarding impairment. This could result in realized losses relating to other-than-temporary declines being charged against future income. Given the current market conditions and the significant judgments involved, there is a risk that declines in fair value may occur and material other-than-temporary impairments may be charged to income in future periods, resulting in realized losses.

**Adverse Economic Conditions—The state of the national economy and adverse changes in economic conditions could adversely affect the Company's business and results of operations.**

The state of the economy has negatively affected state budgets and could adversely affect the Company's reimbursement from state Medicaid programs in its Public Sector segment. The state of the economy and adverse economic conditions could also adversely affect our customers in the Commercial, Radiology Benefits Management and Specialty Pharmaceutical Management segments resulting in increased pressures on the Company's operating margins. In addition, the economic conditions may result in decreased membership in the Commercial, Radiology Benefits Management, and Specialty Pharmaceutical Management segments, thereby adversely affecting the revenues to the Company from such customers as well as our operating profitability.

These economic conditions in the debt markets may affect the Company's ability to refinance, or the terms of, a new credit facility, upon the maturity of the Company's existing New Credit Facility on April 29, 2009.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

The Company currently leases approximately 1.2 million square feet of office space comprising 68 offices in 21 states and the District of Columbia, with terms expiring between January 2009 and August 2015. The Company's principal executive offices are located in Avon, Connecticut, which lease expires in September 2012. The Company believes that its current facilities are suitable for and adequate to support the level of its present operations.

**Item 3. Legal Proceedings**

The management and administration of the delivery of specialty managed healthcare entails significant risks of liability. From time to time, the Company is subject to various actions and claims arising from the acts or omissions of its employees, network providers or other parties. In the normal course of business, the Company receives reports relating to deaths and other serious incidents involving patients whose care is being managed by the Company. Such incidents occasionally give rise to malpractice, professional negligence and other related actions and claims against the Company or its

network providers. Many of these actions and claims received by the Company seek substantial damages and therefore require the Company to incur significant fees and costs related to their defense. The Company is also subject to or party to certain class actions, litigation and claims relating to its operations and business practices. In the opinion of management, the Company has recorded reserves that are adequate to cover litigation, claims or assessments that have been or may be asserted against the Company, and for which the outcome is probable and reasonably estimable. Management believes that the resolution of such litigation and claims will not have a material adverse effect on the Company's financial condition or results of operations; however, there can be no assurance in this regard.

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

None.

**PART II****Item 5. Market for Registrant's Common Equity and Related Stockholder Matters**

Since January 6, 2004, shares of the Company's Ordinary Common Stock, \$0.01 par value per share ("Ordinary Common Stock") have traded on the NASDAQ Stock Market under the symbol "MGLN." For further information regarding the Company's Ordinary Common Stock, see Note 7—"Stockholders' Equity" to the consolidated financial statements set forth elsewhere herein. Warrants to purchase shares of the Company's Ordinary Common Stock have traded on the Over-the-Counter Bulletin Board ("OTCBB") under the ticker symbol MGLNW since February 2, 2004. The following tables set forth the high and low closing bid prices of the Company's Ordinary Common Stock as reported by the NASDAQ Stock Market for the years ended December 31, 2007 and 2008, as follows:

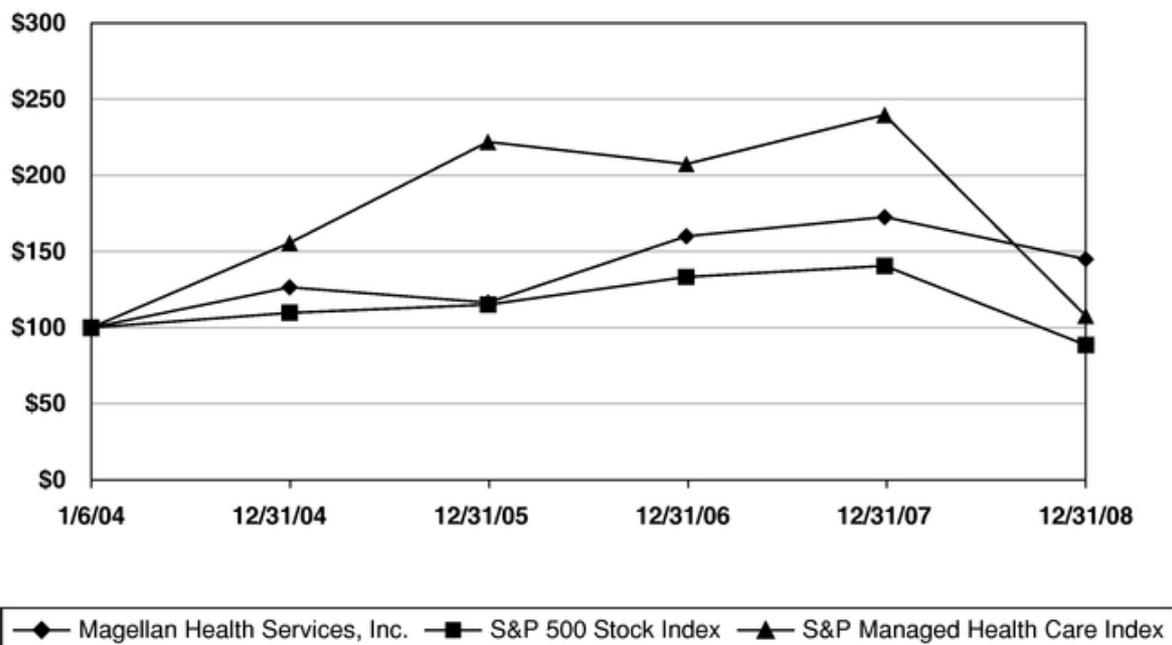
	Ordinary Common Stock Sales Prices	
	High	Low
<b>2007</b>		
First Quarter	\$44.38	\$40.14
Second Quarter	47.79	40.51
Third Quarter	47.11	38.29
Fourth Quarter	48.88	39.79
<b>2008</b>		
First Quarter	47.93	37.80
Second Quarter	41.23	36.10
Third Quarter	44.41	35.18
Fourth Quarter	40.73	30.54

As of December 31, 2008, there were approximately 370 stockholders of record of the Ordinary Common Stock. The stockholders of record data for the Ordinary Common Stock does not reflect persons whose stock was held on that date by the Depository Trust Company or other intermediaries.

**Comparison of Cumulative Total Returns**

The following graph compares the change in the cumulative total return on the Company's common stock to (a) the change in the cumulative total return on the stocks included in the Standard & Poor's 500 Stock Index and (b) the change in the cumulative total return on the stocks included in the S&P Managed Health Care Index, assuming an investment of \$100 made at the close of trading on January 6, 2004, the first full day on which the common stock was registered under Section 12(g) of the Exchange Act and the first full day of trading on NASDAQ, and comparing relative values on December 31, 2004, 2005, 2006, 2007 and 2008. The common stock was first issued under the Company's plan of reorganization in connection with its bankruptcy proceedings on the Effective Date. The Company did not pay any dividends during the period reflected in the graph. Note that the common stock price performance shown below should not be viewed as being indicative of future performance.

**Comparison of Cumulative Total Return**



	January 6, 2004	2004	2005	December 31, 2006	2007	2008
Magellan Health Services, Inc.	\$ 100	\$126.52	\$116.48	\$ 160.07	\$172.70	\$145.04
S&P 500 Stock Index	100	109.72	115.11	133.29	140.62	88.59
S&P Managed Health Care Index(1)	100	155.63	222.08	207.47	239.75	107.79

(1) The S&P Managed Health Care Index consists of Aetna, Inc., CIGNA Corp., Coventry Health Care, Inc., Humana, Inc., UnitedHealth Group, Inc. and WellPoint, Inc.

The information set forth above under the "Comparison of Cumulative Total Returns" does not constitute soliciting material and should not be deemed filed or incorporated by reference into any other of the Company's filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent the filing specifically incorporates such information by reference therein.

**Share Repurchase**

On July 30, 2008 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$200 million of its outstanding common stock through January 31, 2010. Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice. Pursuant to this program, the Company made open market purchases of 3,471,794 shares of the Company's common stock at an aggregate cost of \$119.4 million (excluding broker commissions and transaction fees) during the three months ended December 31, 2008.

Following is a summary of stock repurchases made during the three months ended December 31, 2008:

<u>Period</u>	<u>Total number of Shares Purchased</u>	<u>Average Price Paid per Share(2)</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan(1)(2)</u>
October 1 - 31, 2008	865,214	\$ 37.86	865,214	\$ 150,581
November 1 - 30, 2008	1,202,700	\$ 33.73	1,202,700	110,010
December 1 - 31, 2008	1,403,880	\$ 32.80	1,403,880	63,963
	<u>3,471,794</u>		<u>3,471,794</u>	

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

(2) Excludes broker commissions and transaction fees.

During the period from January 1, 2009 through February 25, 2009, the Company made additional open market purchases of 435,800 shares at an aggregate cost of \$15.6 million, excluding broker commissions and transaction fees.

**Dividends**

The Company did not declare any dividends during either of the years ended December 31, 2007 or 2008. The Company is prohibited from paying dividends on the Ordinary Common Stock under the terms of the New Credit Facility, except in limited circumstances. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Outlook—Liquidity and Capital Resources—Restrictive Covenants in Debt Agreements."

**Securities Authorized for Issuance under Equity Compensation Plans**

The following table sets forth certain information as of December 31, 2008 with respect to the Company's 2008 Management Incentive Plan ("2008 MIP"):

<u>Plan category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u> (a)	<u>Weighted average exercise price of outstanding options, warrants and rights</u>	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(a))</u>
Equity compensation plans approved by security holders	4,441,464(1)	\$ 36.73	3,278,684(2)
Equity compensation plans not approved by security holders	—	—	—
<b>Total</b>	<b>4,441,464(1)</b>	<b>\$ 36.73</b>	<b>3,278,684(2)</b>

(1) Excludes shares of restricted stock and restricted stock units purchased by employees or awarded to employees and the Company's directors pursuant to the 2008 MIP. Additionally excludes 136,735 options issued to certain employees (mainly related to 100,000 options granted to employees that were previously employed by ICORE and 36,735 options granted to employees previously employed by NIA), and 90,291 options issued to certain of the Company's directors.

(2) Consists of shares remaining available for issuance as of December 31, 2008 under the 2008 MIP (under which the Company may issue stock options, restricted stock awards, stock bonuses, stock purchase rights and other equity incentives), after giving effect to the shares issuable upon the exercise of outstanding options, warrants and rights and the shares of restricted stock issued as referred to in footnote (1) above. The 2008 MIP also permits the grant of performance based cash bonus awards to eligible employees and the grant of equity to directors of the Company.

For further discussion, see Note 7—"Stockholders' Equity" to the consolidated financial statements set forth elsewhere herein.

**Item 6. Selected Financial Data**

The following table sets forth selected historical consolidated financial information of the Company as of and for the years ended December 31, 2004, 2005, 2006, 2007 and 2008.

Selected consolidated financial information for the years ended December 31, 2006, 2007 and 2008 and as of December 31, 2007 and 2008 presented below, have been derived from, and should be read in conjunction with, the consolidated financial statements and the notes thereto included elsewhere herein. Selected consolidated financial information for the years ended December 31, 2004 and 2005 has been derived from the Company's audited consolidated financial statements not included in this Form 10-K. The selected financial data set forth below also should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing elsewhere herein.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
(In thousands, except per share amounts)

	Year Ended December 31,				
	2004	2005	2006	2007	2008
<b>Statement of Operations Data:</b>					
Net revenue	\$1,795,402	\$1,808,003	\$1,690,270	\$2,155,953	\$2,625,394
Cost of care	1,190,594	1,204,659	1,081,080	1,409,103	1,830,542
Cost of goods sold	—	—	41,809	149,585	181,356
Direct service costs and other operating expenses(1)	400,023	377,533	385,478	404,003	426,627
Equity in earnings of unconsolidated subsidiaries	(5,277)	(4,350)	(390)	—	—
Depreciation and amortization	42,489	49,088	48,862	57,524	60,810
Interest expense	37,124	44,005	7,292	6,386	2,846
Interest income	(6,127)	(17,464)	(17,628)	(23,836)	(17,030)
Gain on sale of assets	—	(56,367)	(5,148)	—	—
Special charges (benefits)	5,038	(556)	—	—	—
Income from continuing operations before income taxes and minority interest	131,538	211,455	148,915	153,188	140,243
Provision for income taxes	64,835	82,405	62,695	58,669	54,038
Income from continuing operations before minority interest	66,703	129,050	86,220	94,519	86,205
Minority interest, net	347	58	(42)	361	—
Income from continuing operations	66,356	128,992	86,262	94,158	86,205
Income (loss) from discontinued operations(2)	(2,041)	1,597	—	—	—
Net income	<u>\$ 64,315</u>	<u>\$ 130,589</u>	<u>\$ 86,262</u>	<u>\$ 94,158</u>	<u>\$ 86,205</u>
<b>Income (loss) per common share—basic:</b>					
Income from continuing operations	\$ 1.88	\$ 3.59	\$ 2.33	\$ 2.42	\$ 2.18
Income (loss) from discontinued operations	(0.06)	0.04	—	—	—
Net income	\$ 1.82	\$ 3.63	\$ 2.33	\$ 2.42	\$ 2.18
<b>Income (loss) per common share—diluted:</b>					
Income from continuing operations	\$ 1.83	\$ 3.42	\$ 2.23	\$ 2.36	\$ 2.16
Income (loss) from discontinued operations	(0.06)	0.04	—	—	—
Net income	\$ 1.77	\$ 3.46	\$ 2.23	\$ 2.36	\$ 2.16

	December 31,				
	2004	2005	2006	2007	2008
<b>Balance Sheet Data:</b>					
Current assets	\$ 540,945	\$ 540,777	\$ 535,574	\$ 803,092	\$ 822,420
Current liabilities	362,843	311,925	321,073	375,859	373,881
Property and equipment, net	120,604	102,898	100,255	105,735	88,436
Total assets	1,164,281	1,069,486	1,207,520	1,435,123	1,417,564
Total debt and capital lease obligations	379,478	63,084	41,913	13,969	28
Stockholders' equity	\$ 472,996	\$ 633,077	\$ 763,567	\$ 908,232	\$ 908,073

- (1) Includes stock compensation expense of \$23.2 million, \$15.8 million, \$34.0 million, \$30.0 million and \$32.8 million in 2004, 2005, 2006, 2007 and 2008, respectively.
- (2) Net of income taxes.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Form 10-K includes "forward-looking statements" within the meaning of the Securities Act and 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. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those contemplated by such forward-looking statements. Important factors currently known to management that could cause actual results to differ materially from those in forward-looking statements are set forth under the heading "Risk Factors" in Item 1A and elsewhere in this Form 10-K. When used in this Form 10-K, the words "estimate," "anticipate," "expect," "believe," "should" and similar expressions are intended to be forward-looking statements. Also, capitalized or defined terms included in Item 7 have the meanings set forth in Item 1 of this Form 10-K.

### Business Overview

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

#### Managed Behavioral Healthcare

Two of the Company's segments are in the managed behavioral healthcare business. This line of business generally reflects the Company's coordination and management of the delivery of behavioral healthcare treatment services that are provided through its contracted network of third-party treatment providers, which includes psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities. The treatment services provided through the Company's provider network include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and crisis intervention services. The Company generally does not directly provide, or own any provider of, treatment services except as relates to the Company's contract to provide managed behavioral healthcare services to Medicaid recipients and other beneficiaries of the Maricopa County Regional Behavioral Health Authority (the "Maricopa Contract"). Under the Maricopa Contract, effective August 31, 2007 the Company was required to assume the operations of twenty-four behavioral health direct care facilities

for a transitional period and to divest itself of these facilities over a two year period. During August and October 2008, the Company entered into agreements with two separate Provider Network Organizations ("PNOs") which resulted in the transition of thirteen of such behavioral health direct care facilities to the PNOs over various dates through February 2009. During March 2009, the Company will begin the operation of two additional behavioral health direct care facilities and the Company expects to divest itself of these facilities before August 31, 2009.

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

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

*Commercial.* The Managed Behavioral Healthcare Commercial segment ("Commercial") generally reflects managed behavioral healthcare services and EAP services provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicaid and Medicare members, as well as with employers, including corporations and governmental agencies, and labor unions. Commercial's managed behavioral healthcare contracts encompass risk-based, ASO and EAP arrangements. This segment contains the operating segments previously defined as the Managed Behavioral Healthcare Health Plan Segment ("Health Plan") and the Managed Behavioral Healthcare Employer segment ("Employer"). Prior period balances have been reclassified to reflect this change. The Company now considers Commercial as one segment and it is managed as such. As of December 31, 2008, Commercial's covered lives were 4.2 million, 14.5 million and 20.7 million for risk-based, EAP and ASO products, respectively. For the year ended December 31, 2008, Commercial's revenue was \$416.4 million, \$106.7 million and \$126.5 million for risk-based, EAP and ASO products, respectively.

*Public Sector.* The Managed Behavioral Healthcare Public Sector segment ("Public Sector") generally reflects managed behavioral healthcare services provided to Medicaid recipients under contracts with state and local governmental agencies. Public Sector contracts encompass either risk-based or ASO arrangements. As of December 31, 2008, Public Sector's covered lives were 1.8 million and 0.3 million for risk-based and ASO products, respectively. For the year ended December 31, 2008, Public Sector's revenue was \$1.4 billion and \$5.3 million for risk-based and ASO products, respectively.

#### Radiology Benefits Management

The Radiology Benefits Management segment generally reflects the management of the delivery of diagnostic imaging services to ensure that such services are clinically appropriate and cost effective. The Company's radiology benefits management services currently are provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicaid and Medicare members. The Company has bid on contracts with state and local governmental agencies for the provision of such services to Medicaid recipients. The Company has won one state Medicaid contract, which was implemented in July 2008. The Company offers its radiology benefits management services through ASO contracts, where the Company provides services such as utilization review and claims administration, but does not assume responsibility for the cost of the imaging services, and through risk-based contracts, where the Company assumes all or a substantial portion of the responsibility for the cost of providing diagnostic imaging services. The Company's first two risk-based radiology benefits management contracts became effective June 1, 2007 and July 1, 2007.

As of December 31, 2008, covered lives for Radiology Benefits Management were 2.6 million and 13.9 million for risk-based and ASO products, respectively. For the year ended December 31, 2008, revenue for Radiology Benefits Management was \$239.4 million and \$55.9 million for risk-based and ASO products, respectively.

#### Specialty Pharmaceutical Management

The Specialty Pharmaceutical Management segment generally reflects the management of specialty drugs used in the treatment of cancer, multiple sclerosis, hemophilia, infertility, rheumatoid arthritis, chronic forms of hepatitis and other diseases. Specialty pharmaceutical drugs represent high-cost injectible, infused, oral, or inhaled drugs which traditional retail pharmacies often do not supply due to their high cost, sensitive handling, and storage needs. The Company's specialty pharmaceutical management services are provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicare and Medicaid members. The Company's specialty pharmaceutical services include (i) contracting and formulary optimization on behalf of health plans and pharmaceutical manufacturers; (ii) distributing specialty pharmaceutical drugs on behalf of health plans; (iii) providing strategic consulting services to health plans and pharmaceutical manufacturers; and (iv) providing oncology management services to health plans. The Company's Specialty Pharmaceutical Management segment had contracts with 40 health plans as of December 31, 2008.

#### Corporate and Other

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

#### *Acquisition of National Imaging Associates*

On January 31, 2006, the Company acquired all of the outstanding stock of NIA, a privately held radiology benefits management ("RBM") firm, for approximately \$121 million in cash, after giving effect to cash acquired in the transaction, and NIA became a wholly-owned subsidiary. The Company reports the results of operations of NIA in the Radiology Benefits Management segment. For further discussion, see Note 3—"Acquisitions and Joint Ventures" to the consolidated financial statements set forth elsewhere herein.

#### *Acquisition of ICORE Healthcare, LLC*

On July 31, 2006, the Company acquired all of the outstanding units of membership interest of ICORE, a specialty pharmaceutical management company, and ICORE became a wholly-owned subsidiary. The Company reports the results of operations of ICORE in the Specialty Pharmaceutical Management segment. For further discussion, see Note 3—"Acquisitions and Joint Ventures" to the consolidated financial statements set forth elsewhere herein.

The Company paid or agreed to pay to the previous unitholders of ICORE, all of whom are members of ICORE's management team, (i) \$161 million of cash at closing; (ii) \$24 million of cash that was used by the unitholders of ICORE to purchase Magellan restricted stock with such restricted stock vesting over three years, provided the unitholders do not earlier terminate their employment with Magellan; (iii) \$25 million plus accrued interest (the "Deferred Payment"), subject to any indemnity claims Magellan may have under the purchase agreement; (iv) the amount of positive working capital that existed at ICORE on the closing date (the "Working Capital Payments"), which was \$18.2 million of which \$17.8 million was paid during 2007 with the remainder paid in January 2008; and (v) a potential earn-out of up to \$75 million (the "Earn-Out"), provided the unitholders do not earlier terminate their employment with the Company prior to the payment of the Earn-Out. The \$161 million

of cash paid at closing, the \$25 million Deferred Payment and \$18.2 million of Working Capital Payments were recorded as purchase price. The \$24 million of restricted stock is being recognized as stock compensation expense over the three year vesting period. The \$24 million in restricted stock paid at the closing was issued in a transaction pursuant to which the unitholders of ICORE at closing applied \$24 million of the purchase price as cash consideration for their purchase of restricted shares of the Company's common stock. The unitholders subscribed to an aggregate of 543,879 restricted shares of the Company's common stock on a basis proportional to each unitholder's economic interest in ICORE at a purchase price of \$44.13 per share, which was the average of the closing prices of the Company's common stock on NASDAQ for the twenty trading days immediately preceding the closing. The Deferred Payment was paid in December 2008. The Earn-Out included (i) up to \$25 million based on earnings for the 18 month period ended December 31, 2007 and (ii) up to \$50 million based on earnings in 2008. Neither Earn-Out provisions were met and as a result, the Company will not pay any additional purchase consideration.

### **Critical Accounting Policies and Estimates**

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

#### *Stock Compensation*

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004) "Share-Based Payment" ("SFAS 123R"), using the modified prospective transition method. Under this transition method, stock compensation expense for the years ended December 31, 2006, 2007 and 2008 includes compensation expense for all stock compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Stock compensation expense for all stock compensation awards granted after January 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes substantially all of these compensation costs on a straight-line basis over the requisite service period, which is generally the vesting term ranging from three to four years. Prior to the adoption of SFAS 123R, the Company recorded stock compensation under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25").

The Company estimates the fair value of substantially all stock options using the Black-Scholes-Merton option pricing model that employs certain factors including expected volatility of stock price, expected life of the option, risk-free interest rate and expected dividend yield. For the year ended December 31, 2006, management determined that volatility based on actively traded equities of companies that are similar to the Company was a better indicator of expected volatility and future stock price trends than historical Company volatility, due to the lack of sufficient history of the Company subsequent to the Company's emergence from bankruptcy. For the years ended December 31, 2007 and 2008, such volatility was based on the historical volatility of the Company's stock price.

The expected term of the option is based on historical employee stock option exercise behavior and the vesting terms of the respective option. Risk-free interest rates are based on the U.S. Treasury yield in effect at the time of grant.

SFAS 123R also requires the Company to recognize compensation expense for only the portion of options, restricted stock or restricted stock units that are expected to vest. Therefore, estimated forfeiture rates are derived from historical employee termination behavior. The Company's estimated forfeiture rates for the years ended December 31, 2006, 2007 and 2008 are three percent, two percent and eight percent, respectively. If the actual number of forfeitures differs from those estimated, additional adjustments to compensation expense may be required in future periods. If vesting of an award is conditioned upon the achievement of performance goals, compensation expense during the performance period is estimated using the most probable outcome of the performance goals, and adjusted as the expected outcome changes.

#### *Managed Care Revenue*

Managed care revenue, inclusive of revenue from the Company's risk, EAP and ASO contracts, is recognized over the applicable coverage period on a per member basis for covered members. The Company is paid a per member fee for all enrolled members, and this fee is recorded as revenue in the month in which members are entitled to service. The Company adjusts its revenue for retroactive membership terminations, additions and other changes, when such adjustments are identified, with the exception of retroactivity that can be reasonably estimated. Any fees paid prior to the month of service are recorded as deferred revenue. Managed care revenues approximated \$1.6 billion, \$1.9 billion and \$2.2 billion for the years ended December 31, 2006, 2007 and 2008, respectively.

#### *Cost-Plus Contracts*

The Company has certain cost-plus contracts with customers under which the Company recognizes revenue as costs are incurred and as services are performed. Revenues from cost-plus contracts approximated \$32.3 million, \$30.5 million and \$31.5 million for the years ended December 31, 2006, 2007 and 2008, respectively.

#### *Block Grant Revenues*

The Maricopa Contract is partially funded by federal, state and county block grant money, which represents annual appropriations. The Company recognizes revenue from block grant activity ratably over the period to which the block grant funding applies. Block grant revenues were approximately \$40.6 million and \$120.0 million for the years ended December 31, 2007 and 2008, respectively.

#### *Distribution Revenue*

The Company recognizes distribution revenue, which includes the co-payments received from members of the health plans the Company serves, when the specialty pharmaceutical drugs are shipped. At the time of shipment, the earnings process is complete; the obligation of the Company's customer to pay for the specialty pharmaceutical drugs is fixed, and, due to the nature of the product, the member may neither return the specialty pharmaceutical drugs nor receive a refund. Revenues from the distribution of specialty pharmaceutical drugs on behalf of health plans were \$46.3 million, \$160.6 million and \$195.6 million for the years ended December 31, 2006, 2007 and 2008, respectively.

#### *Performance-Based Revenue*

The Company has the ability to earn performance-based revenue under certain risk and non-risk contracts. Performance-based revenue generally is based on either the ability of the Company to manage care for its clients below specified targets, or on other operating metrics. For each such contract, the Company estimates and records performance-based revenue after considering the relevant contractual terms and the data available for the performance-based revenue calculation. Pro-rata performance-based revenue is recognized on an interim basis pursuant to the rights and obligations of

each party upon termination of the contracts. Performance-based revenues were \$16.4 million, \$10.4 million and \$13.4 million for the years ended December 31, 2006, 2007 and 2008, respectively.

#### *Cost of Care, Medical Claims Payable and Other Medical Liabilities*

Cost of care is recognized in the period in which members receive managed healthcare services. In addition to actual benefits paid, cost of care in a period also includes the impact of accruals for estimates of medical claims payable. Medical claims payable represents the liability for healthcare claims reported but not yet paid and IBNR related to the Company's managed healthcare businesses.

Such liabilities are determined by employing actuarial methods that are commonly used by health insurance actuaries and that meet actuarial standards of practice.

The IBNR portion of medical claims payable is estimated based on past claims payment experience for member groups, enrollment data, utilization statistics, authorized healthcare services and other factors. This data is incorporated into contract-specific actuarial reserve models and is further analyzed to create "completion factors" that represent the average percentage of total incurred claims that have been paid through a given date after being incurred. Factors that affect estimated completion factors include benefit changes, enrollment changes, shifts in product mix, seasonality influences, provider reimbursement changes, changes in claims inventory levels, the speed of claims processing, and changes in paid claim levels. Completion factors are applied to claims paid through the financial statement date to estimate the ultimate claim expense incurred for the current period. Actuarial estimates of claim liabilities are then determined by subtracting the actual paid claims from the estimate of the ultimate incurred claims. For the most recent incurred months (generally the most recent two months), the percentage of claims paid for claims incurred in those months is generally low. This makes the completion factor methodology less reliable for such months. Therefore, incurred claims for any month with a completion factor that is less than 70 percent are generally not projected from historical completion and payment patterns; rather they are projected by estimating claims expense based on recent monthly estimated cost incurred per member per month times membership, taking into account seasonality influences, benefit changes and health care trend levels, collectively considered to be "trend factors."

Medical claims payable balances are continually monitored and reviewed. If it is determined that the Company's assumptions in estimating such liabilities are significantly different than actual results, the Company's income statement and financial position could be impacted in future periods. Adjustments of prior period estimates may result in additional cost of care or a reduction of cost of care in the period an adjustment is made. Further, due to the considerable variability of health care costs, adjustments to claim liabilities occur each period and are sometimes significant as compared to the net income recorded in that period. Prior period development is recognized immediately upon the actuary's judgment that a portion of the prior period liability is no longer needed or that additional

liability should have been accrued. The following table presents the components of the change in medical claims payable for the years ended December 31, 2006, 2007 and 2008 (in thousands):

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Claims payable and IBNR, beginning of period	\$ 164,013	\$ 156,079	\$ 185,349
Cost of care:			
Current year	1,087,053	1,416,700	1,836,425
Prior years	(5,973)	(7,597)	(5,883)
Total cost of care	<u>1,081,080</u>	<u>1,409,103</u>	<u>1,830,542</u>
Claim payments and transfers to other medical liabilities(1):			
Current year	951,389	1,248,549	1,676,975
Prior years	137,625	131,284	154,494
Total claim payments and transfers to other medical liabilities	<u>1,089,014</u>	<u>1,379,833</u>	<u>1,831,469</u>
Claims payable and IBNR, end of period	156,079	185,349	184,422
Withhold receivables, end of period(2)	(20,319)	(22,683)	(28,562)
Medical claims payable, end of period	<u>\$ 135,760</u>	<u>\$ 162,666</u>	<u>\$ 155,860</u>

- 
- (1) For any given period, a portion of unpaid medical claims payable could be covered by reinvestment liability (discussed below) and may not impact the Company's statement of operations for such periods.
  - (2) Medical claims payable is offset by customer withholds from capitation payments in situations in which the customer has the contractual requirement to pay providers for care incurred.

Actuarial standards of practice require that the claim liabilities be adequate under moderately adverse circumstances. Adverse circumstances are situations in which the actual claims experience could be higher than the otherwise estimated value of such claims. In many situations, the claims paid amount experienced will be less than the estimate that satisfies the actuarial standards of practice.

Care trend factors and completion factors can have a significant impact on the medical claims payable liability. The following example provides the estimated impact to the Company's December 31, 2008 unpaid medical claims payable liability assuming hypothetical changes in care trend factors and completion factors:

<u>Care Trend Factor(1)</u>		<u>Completion Factor(2)</u>	
<u>(Decrease) Increase</u>		<u>(Decrease) Increase</u>	
<u>Trend Factor</u>	<u>Medical Claims Payable</u>	<u>Completion</u>	<u>Medical Claims Payable</u>
	<u>(in thousands)</u>	<u>Factor</u>	<u>(in thousands)</u>
(3)%	\$ (23,000)	(3)%	\$ (31,500)
(2)%	(14,500)	(2)%	(20,500)
(1)%	(7,000)	(1)%	(10,500)
1%	7,000	1%	10,500
2%	14,500	2%	20,500
3%	23,000	3%	31,500

Approximately 70 percent of IBNR dollars is based on care trend factors.

- (1) Assumes a change in the care trend factor for any month that a completion factor is not used to estimate incurred claims (which is generally any month that is less than 70 percent complete).
- (2) Assumes a change in the completion factor for any month for which completion factors are used to estimate IBNR (which is generally any month that is 70 percent or more complete).

Due to the existence of risk sharing provisions in certain customer contracts, a change in the estimate for medical claims payable does not necessarily result in an equivalent impact on cost of care.

The Company believes that the amount of medical claims payable is adequate to cover its ultimate liability for unpaid claims as of December 31, 2008; however, actual claims payments may differ from established estimates.

Other medical liabilities consist primarily of "reinvestment" payables under certain managed behavioral healthcare contracts with Medicaid customers and "profit share" payables under certain risk-based contracts. Under a contract with reinvestment features, if the cost of care is less than certain minimum amounts specified in the contract (usually as a percentage of revenue), the Company is required to "reinvest" such difference in behavioral healthcare programs when and as specified by the customer or to pay the difference to the customer for their use in funding such programs. Under a contract with profit share provisions, if the cost of care is below certain specified levels, the Company will "share" the cost savings with the customer at the percentages set forth in the contract.

#### *Long-lived Assets*

Long-lived assets, including property and equipment and intangible assets to be held and used, are currently reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). Pursuant to this guidance, impairment is determined by comparing the carrying value of these long-lived assets to management's best estimate of the future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. The cash flow projections used to make this assessment are consistent with the cash flow projections that management uses internally in making key decisions. In the event an impairment exists, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the asset, which

is generally determined by using quoted market prices or the discounted present value of expected future cash flows.

### Goodwill

Goodwill is accounted for in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). Pursuant to SFAS 142, the Company is required to test its goodwill for impairment on at least an annual basis. The Company has selected October 1 as the date of its annual impairment test. The goodwill impairment test is a two-step process that requires management to make judgments in determining what assumptions to use in the calculation. The first step of the process consists of estimating the fair value of each reporting unit that has been allocated goodwill based on various valuation techniques, with the primary technique being a discounted cash flow analysis, which requires the input of various assumptions with respect to revenues, operating margins, growth rates and discount rates. The estimated fair value for each reporting unit is compared to the carrying value of the reporting unit, which includes the allocated goodwill. If the estimated fair value is less than the carrying value, a second step is performed to compute the amount of the impairment by determining an "implied fair value" of goodwill. The determination of a reporting unit's "impaired fair value" of goodwill requires the Company to allocate the estimated fair value of the reporting unit to the assets and liabilities of the reporting unit. Any unallocated fair value represents the "implied fair value" of goodwill, which is compared to its corresponding carrying value.

The key assumptions used to determine the fair value of the Company's reporting units included: (a) cash flow projections through 2013; (b) terminal values based on terminal growth rates ranging from 3 percent to 4 percent; and (c) discount rates ranging from 13 percent to 18 percent, which were based on the Company's weighted average cost of capital adjusted for the risks associated with the operations for each of the reporting units. While estimating the fair value of Radiology Benefits Management and the Specialty Pharmaceutical Management, the Company assumed operating income in future years in excess of current year results based primarily on assumed revenue growth.

As a result of the first step of the 2008 annual goodwill impairment analysis, the fair value of each reporting unit with allocated goodwill exceeded its carrying value. Therefore, the second step was not necessary. However, a 53 percent decline in fair value of the Health Plan reporting unit, an 11 percent decline in fair value of Radiology Benefits Management, or a 25 percent decline in fair value of Specialty Pharmaceutical Management would have caused the carrying values for these reporting units to be in excess of fair values, which would require the second step to be performed. The second step could have resulted in an impairment loss for goodwill.

The balance of goodwill has been allocated to the Company's segments as follows (in thousands):

	December 31,	
	2007	2008
Commercial	\$121,032	\$120,485
Radiology Benefits Management	104,549	104,549
Specialty Pharmaceutical Management	142,291	142,291
Total	<u>\$367,872</u>	<u>\$367,325</u>

The changes in the carrying amount of goodwill for the years ended December 31, 2007 and 2008 are reflected in the table below (in thousands):

	2007	2008
Balance as of beginning of period	\$374,381	\$367,872
Adjustment due to changes in valuation allowances(1)	(1,518)	219
Adoption of FIN 48(2)	(518)	—
Adjustment for tax contingency reversals(3)	(4,174)	(766)
Acquisition of NIA	(314)	—
Acquisition of ICORE	15	—
Balance as of end of period	<u>\$367,872</u>	<u>\$367,325</u>

- 
- (1) In accordance with American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7"), reversals of valuation allowances with respect to unrealizable deferred tax assets are recorded as decreases to goodwill to the extent those assets originated in years prior to the Company's reorganization.
  - (2) The Company adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), on January 1, 2007. As a result of the implementation of FIN 48, the Company recorded this decrease to goodwill.
  - (3) During 2007 and 2008, the statute of limitations expired with respect to the assessment of state and local income taxes for certain tax years prior to the Company's reorganization, resulting in the reversal of tax contingencies recorded for these years. The tax benefits of these reversals (net of indirect tax benefits) have been reflected as reductions of goodwill in accordance with SOP 90-7.

#### *Income Taxes*

The Company files a consolidated federal income tax return for the Company and its eighty-percent or more owned subsidiaries, and the Company and its subsidiaries file income tax returns in various state and local jurisdictions.

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"), as it applies to companies that have implemented the fresh start reporting provisions of SOP 90-7 with respect to reversals of valuation allowances on deferred tax assets established with fresh-start accounting. The Company estimates income taxes for each of the jurisdictions in which it operates. This process involves estimating current tax exposures together with assessing temporary differences resulting from differing treatment of items for tax and book purposes. Deferred tax assets and/or liabilities are determined by multiplying the differences between the financial reporting and tax reporting bases for assets and liabilities by the enacted tax rates expected to be in effect when such differences are recovered or settled. The Company then assesses the likelihood that the deferred tax assets will be recovered from the reversal of temporary timing differences and future taxable income, and to the extent the Company cannot conclude that recovery is more likely than not, it establishes a valuation allowance. The effect of a change in tax rates on deferred taxes is recognized in income in the period that includes the enactment date.

The Company estimates that it has reportable federal NOLs as of December 31, 2008 of approximately \$114.8 million available to reduce future federal taxable income. These estimated NOLs expire in 2011 through 2020 and are subject to examination and adjustment by the IRS. In addition, the Company's utilization of such NOLs is subject to limitation under Section 382, which affects the

timing of the use of these NOLs. At this time, the Company does not believe these limitations will limit the Company's ability to use any federal NOLs before they expire. Although the Company has NOLs that may be available to offset future taxable income, the Company may be subject to Federal Alternative Minimum Tax.

The Company's valuation allowances against deferred tax assets were \$10.2 million and \$9.4 million as of December 31, 2007 and 2008, respectively, mostly relating to uncertainties regarding the eventual realization of certain state NOLs and other state deferred tax assets. Determination of the amount of deferred tax assets considered realizable required significant judgment and estimation. Changes in these estimates in the future could materially affect the Company's financial condition and results of operations.

The balance of unrecognized tax benefits as of December 31, 2007 and 2008 was \$118.7 million and \$129.2 million, respectively, most of which was included in deferred credits and other long-term liabilities, and the remainder reducing deferred tax assets. If these unrecognized tax benefits had been realized as of December 31, 2007 and 2008, \$22.7 million and \$22.8 million, respectively, would have impacted the effective tax rate.

Included in the balance of unrecognized tax benefits recorded at December 31, 2007 and 2008 were liabilities of \$5.5 million and \$14.1 million, respectively, for tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the deferral of these deductions to later years would not affect the annual effective tax rate but could result in the acceleration of cash payments and/or reduction to the NOL carryforwards with respect to the earlier period.

With few exceptions, the Company is no longer subject to state or local income tax examinations by tax authorities for years ended prior to December 31, 2005. Further, the statute of limitations regarding the assessment of the federal and most state and local income taxes for the year ended December 31, 2005 will expire during 2009. The Company anticipates that up to \$5.4 million of unrecognized tax benefits (excluding interest costs) recorded as of December 31, 2008 could be reversed during 2009 as a result of statute expirations. All such reversals (net of the related indirect tax benefits) would be reflected as discrete adjustments during the quarter in which the respective statute expiration occurs.

Prior to 2009 and in accordance with SOP 90-7, reversals of both valuation allowances and unrecognized tax benefits with respect to years prior to the Company's reorganization were recorded to goodwill. All other reversals of these balances were recorded as reductions to income tax expense. As a result of implementation of Statement of Financial Accounting Standards ("SFAS") No.141 (R) "Business Combinations" ("SFAS 141(R)"), beginning in 2009 all reversals of valuation allowances and unrecognized tax benefits will be reflected as reductions to income tax expense, even if related to years prior to the Company's reorganization.

## **Results of Operations**

The Company evaluates performance of its segments based on profit or loss from continuing operations before stock compensation expense, depreciation and amortization, interest expense, interest income, gain on sale of assets, special charges or benefits, income taxes and minority interest ("Segment Profit"). Management uses Segment Profit information for internal reporting and control purposes and considers it important in making decisions regarding the allocation of capital and other resources, risk assessment and employee compensation, among other matters. Intersegment sales and transfers are not significant. See Note 12—"Business Segment Information" to the consolidated financial statements set forth elsewhere herein. The Company's segments are defined above.

The table below summarizes, for the periods indicated, operating results by business segment (in thousands):

	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Corporate and Other	Consolidated
<b>Year Ended December 31, 2006</b>						
Net revenue	\$ 784,768	\$ 808,657	\$ 41,617	\$ 55,228	\$ —	\$ 1,690,270
Cost of care	(392,066)	(689,014)	—	—	—	(1,081,080)
Cost of goods sold	—	—	—	(41,809)	—	(41,809)
Direct service costs	(173,704)	(36,321)	(40,136)	(7,437)	—	(257,598)
Other operating expenses	—	—	—	—	(127,880)	(127,880)
Equity in earnings of unconsolidated subsidiaries	390	—	—	—	—	390
Stock compensation expense(1)	1,595	647	3,739	3,577	24,433	33,991
Segment profit (loss)	<u>\$ 220,983</u>	<u>\$ 83,969</u>	<u>\$ 5,220</u>	<u>\$ 9,559</u>	<u>\$(103,447)</u>	<u>\$ 216,284</u>

	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Corporate and Other	Consolidated
<b>Year Ended December 31, 2007</b>						
Net revenue	\$ 784,533	\$ 1,020,839	\$ 170,240	\$ 180,341	\$ —	\$ 2,155,953
Cost of care	(392,325)	(902,594)	(114,184)	—	—	(1,409,103)
Cost of goods sold	—	—	—	(149,585)	—	(149,585)
Direct service costs	(163,800)	(51,922)	(48,841)	(21,529)	—	(286,092)
Other operating expenses	—	—	—	—	(117,911)	(117,911)
Stock compensation expense(1)	2,277	1,172	1,708	8,769	16,068	29,994
Segment profit (loss)	<u>\$ 230,685</u>	<u>\$ 67,495</u>	<u>\$ 8,923</u>	<u>\$ 17,996</u>	<u>\$(101,843)</u>	<u>\$ 223,256</u>

	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Corporate and Other	Consolidated
<b>Year Ended December 31, 2008</b>						
Net revenue	\$ 649,636	\$ 1,451,923	\$ 295,336	\$ 228,499	\$ —	\$ 2,625,394
Cost of care	(344,761)	(1,278,316)	(207,465)	—	—	(1,830,542)
Cost of goods sold	—	—	—	(181,356)	—	(181,356)
Direct service costs	(154,894)	(68,914)	(54,482)	(25,623)	—	(303,913)
Other operating expenses	—	—	—	—	(122,714)	(122,714)
Stock compensation expense(1)	1,368	839	1,472	8,967	20,117	32,763
Segment profit (loss)	<u>\$ 151,349</u>	<u>\$ 105,532</u>	<u>\$ 34,861</u>	<u>\$ 30,487</u>	<u>\$ (102,597)</u>	<u>\$ 219,632</u>

- (1) Stock compensation expense is included in direct service costs and other operating expenses, however this amount is excluded from the computation of segment profit since it is managed on a consolidated basis.

The following table reconciles Segment Profit as calculated in the table above to consolidated income from continuing operations before income taxes and minority interest for the years ended December 31, 2006, 2007 and 2008:

	2006	2007	2008
Segment Profit	\$216,284	\$223,256	\$219,632
Stock compensation expense	(33,991)	(29,994)	(32,763)
Depreciation and amortization	(48,862)	(57,524)	(60,810)
Interest expense	(7,292)	(6,386)	(2,846)
Interest income	17,628	23,836	17,030
Gain on sale of assets	5,148	—	—
Income from continuing operations before income taxes and minority interest	<u>\$148,915</u>	<u>\$153,188</u>	<u>\$140,243</u>

#### Year ended December 31, 2008 ("2008") compared to the year ended December 31, 2007 ("2007")

##### Commercial

##### Net Revenue

Net revenue related to the Commercial segment decreased by 17.2 percent or \$134.9 million from 2007 to 2008. The decrease in revenue is mainly due to terminated contracts of \$193.8 million and net favorable retroactive membership adjustments of \$2.5 million recorded in 2007, which decreases were partially offset by increased membership from existing customers of \$31.5 million, favorable rate changes of \$17.7 million, favorable retroactive membership and rate adjustments of \$5.1 million recorded in 2008, revenue from new contracts implemented after (or during) 2007 of \$5.2 million, and other net favorable variances of \$1.9 million.

##### Cost of Care

Cost of care decreased by 12.1 percent or \$47.6 million from 2007 to 2008. The decrease in cost of care is primarily due to terminated contracts of \$118.9 million, which decrease was partially offset by increased membership from existing customers of \$17.0 million, favorable prior period medical claims

development recorded in 2007 of \$6.7 million, unfavorable prior period medical claims development for 2007 which was recorded in 2008 of \$5.2 million, unfavorable prior period medical claims development recorded in 2008 of \$5.1 million, and care trends and other net unfavorable variances of \$37.3 million. Cost of care as a percentage of risk revenue (excluding EAP revenue) increased from 68.7 percent in 2007 to 76.2 percent in 2008, mainly due to unfavorable care trends and care development, and due to business mix.

#### *Direct Service Costs*

Direct service costs decreased by 5.4 percent or \$8.9 million from 2007 to 2008. The decrease in direct service costs is mainly attributable to terminated contracts, partially offset by a one-time charge in 2008 of \$2.5 million associated with legal matters. Direct service costs increased as a percentage of revenue from 20.9 percent in 2007 to 23.8 percent in 2008, mainly due to business mix.

#### **Public Sector**

##### *Net Revenue*

Net revenue related to Public Sector increased by 42.2 percent or \$431.1 million from 2007 to 2008. This increase is primarily due to revenue from new contracts implemented after (or during) 2007 of \$413.4 million, favorable rate changes of \$42.4 million, and membership increases from existing customers of \$23.0 million, which increases were partially offset by a net loss of membership in connection with the West and Middle Grand Regions of TennCare of \$45.3 million, and other net unfavorable variances of \$2.4 million.

##### *Cost of Care*

Cost of care increased by 41.6 percent or \$375.7 million from 2007 to 2008. This increase is primarily due to care associated with new contracts implemented after (or during) 2007 of \$380.1 million, care associated with rate changes for contracts that have minimum cost of care requirements of \$24.4 million, membership increases from existing customers of \$15.6 million, favorable prior period medical claims development which was recorded in 2007 of \$0.9 million, and care trends and other net variances of \$9.5 million, which increases were partially offset by the net loss of membership in connection with the West and Middle Grand Regions of TennCare of \$37.6 million, favorable prior period medical claims development recorded in 2008 of \$8.6 million, and favorable medical claims development for 2007 which was recorded in 2008 of \$8.6 million. Cost of care decreased as a percentage of risk revenue from 88.8 percent in 2007 to 88.4 percent in 2008, mainly due to favorable medical claims development and business mix.

#### *Direct Service Costs*

Direct service costs increased by 32.7 percent or \$17.0 million from 2007 to 2008. The increase in direct service costs is primarily due to costs associated with new business. As a percentage of revenue, direct service costs decreased from 5.1 percent in 2007 to 4.7 percent in 2008, mainly due to business mix.

#### **Radiology Benefits Management**

##### *Net Revenue*

Net revenue related to the Radiology Benefits Management segment increased by 73.5 percent or \$125.1 million from 2007 to 2008. This increase is primarily due to the conversion of an ASO contract to a risk contract during 2007 of \$75.0 million, revenue from new customers implemented after (or during) 2007 of \$50.7 million, favorable rate adjustments of \$6.9 million, and net increased membership from existing customers of \$1.0 million (inclusive of a net decrease in risk membership of \$4.7 million), which increases were partially offset by terminated contracts of \$7.1 million and other net unfavorable variances of \$1.4 million.

*Cost of Care*

Cost of care increased by 81.7 percent or \$93.3 million from 2007 to 2008. This increase is primarily due to the conversion of an ASO contract to a risk contract during 2007 of \$62.6 million, care associated with new customers implemented after (or during) 2007 of \$39.6 million, and other net increases of \$0.3 million, which increases were partially offset by net decreased membership from existing risk customers of \$5.0 million, favorable prior period claims development recorded in 2008 of \$2.1 million, and favorable claims development for 2007 recorded in 2008 of \$2.1 million. Cost of care decreased as a percentage of risk revenue from 96.6 percent in 2007 to 86.7 percent in 2008 mainly due to favorable rate adjustments, favorable care development and business mix.

*Direct Service Costs*

Direct service costs increased 11.5 percent or \$5.6 million from 2007 to 2008. This increase is primarily attributed to additional costs incurred to support the new risk contract which was implemented in June 2007. As a percentage of revenue, direct service costs decreased from 28.7 percent in 2007 to 18.4 percent in 2008, mainly due to the additional revenue provided by the risk-based contracts in 2008.

***Specialty Pharmaceutical Management***

*Net Revenue*

Net revenue related to the Specialty Pharmaceutical Management segment increased 26.7 percent or \$48.2 million from 2007 to 2008. This increase is primarily due to net increased distribution activity from new and existing customers of \$35.2 million, increased consulting and rebate revenue of \$12.2 million (including \$0.5 million of retrospective rebate revenue recorded in 2008), and other net favorable variances of \$0.8 million.

*Cost of Goods Sold*

Cost of goods sold increased 21.2 percent or \$31.8 million from 2007 to 2008, primarily due to net increased distribution activity from new and existing customers. As a percentage of the portion of net revenue that relates to distribution revenue, cost of goods sold decreased from 92.9 percent in 2007 to 92.7 percent in 2008, mainly due to business mix.

*Direct Service Costs*

Direct service costs increased by 19.0 percent or \$4.1 million from 2007 to 2008. This increase is primarily due to the expenses required to support the aforementioned increases to revenue. As a percentage of revenue, direct service costs decreased from 11.9 percent in 2007 to 11.2 percent in 2008, mainly due to increased distribution revenue.

***Corporate and Other***

*Other Operating Expenses*

Other operating expenses related to the Corporate and Other segment increased by 4.1 percent or \$4.8 million from 2007 to 2008. The increase results primarily from expenses incurred in 2008 pursuant to the provisions of the former Chief Executive Officer's employment agreement of \$10.1 million (includes \$5.4 million of stock compensation expense related to the accelerated vesting for certain equity awards), and net one-time expenses incurred in 2008 of \$1.7 million, which increases were partially offset by expenses incurred in 2007 related to bid proposals of \$2.5 million, and net other favorable variances of \$4.5 million. As a percentage of total net revenue, other operating expenses

decreased from 5.5 percent for 2007 to 4.7 percent for 2008, primarily due to business mix and the increased revenue from radiology risk contracts and the Maricopa Contract.

#### *Depreciation and Amortization*

Depreciation and amortization expense increased by 5.7 percent or \$3.3 million from 2007 to 2008, primarily due to asset additions after (or during) 2007, inclusive of assets related to the Maricopa County contract, partially offset by a decrease in amortization expense due to an intangible asset which became fully amortized in 2007.

#### *Interest Expense*

Interest expense decreased by 55.4 percent or \$3.5 million from 2007 to 2008, mainly due to reductions in outstanding debt balances as a result of repayment of debt in 2008 in connection with the New Credit Facility and lower interest rates.

#### *Interest Income*

Interest income decreased by 28.6 percent or \$6.8 million from 2007 to 2008, mainly due to lower yields.

#### *Income Taxes*

The Company's effective income tax rate was 38.3 percent in 2007 and 38.5 percent in 2008. The 2007 and 2008 effective income tax rates differ from the federal statutory income tax rate primarily due to state income taxes and permanent differences between book and tax income.

### **2007 compared to the year ended December 31, 2006 ("2006")**

#### ***Commercial***

##### *Net Revenue*

Net revenue related to the Commercial segment decreased by \$0.2 million from 2006 to 2007. The decrease in revenue is mainly due to terminated contracts of \$87.0 million and revenue in 2006 of \$6.2 million related to one-time transitional activities associated with a terminated contract, which decreases were partially offset by revenue from new contracts implemented after (or during) 2006 of \$49.8 million, favorable rate changes of \$22.7 million, increased membership from existing customers of \$19.4 million, and other net increases of \$1.1 million.

##### *Cost of Care*

Cost of care increased by 0.1 percent or \$0.3 million from 2006 to 2007. The increase in cost of care is primarily due to care from new contracts implemented after (or during) 2006 of \$32.1 million, favorable contractual settlements affecting cost of care in 2006 of \$5.1 million, increased membership from existing customers of \$8.6 million, favorable prior period medical claims development recorded in 2006 of \$4.5 million, and care trends and other net unfavorable variances of \$5.8 million, which increases were partially offset by terminated contracts of \$44.7 million, favorable prior period medical claims development recorded in 2007 of \$6.7 million, and favorable medical claims development for 2006 which was recorded in 2007 of \$4.4 million. Cost of care as a percentage of risk revenue (excluding EAP business) decreased from 69.1 percent in 2006 to 68.7 percent in 2007, mainly due to the impact of rate changes exceeding care trends partially offset by the favorable contractual settlements in the prior year.

*Direct Service Costs*

Direct service costs decreased by 5.7 percent or \$9.9 million from 2006 to 2007 primarily due to terminated contracts. Direct service costs decreased as a percentage of revenue from 22.1 percent in 2006 to 20.9 percent in 2007, mainly due to favorable rate changes and business mix.

*Equity in Earnings of Unconsolidated Subsidiaries*

The Company recorded \$0.4 million of equity in earnings of unconsolidated subsidiaries in 2006. The Company sold its equity interest in Royal effective February 2, 2006. Accordingly, 2007 does not include any results for Royal.

**Public Sector**

*Net Revenue*

Net revenue related to Public Sector increased by 26.2 percent or \$212.2 million from 2006 to 2007. This increase is primarily due to revenue from new contracts implemented after (or during) 2006 of \$294.8 million, favorable rate changes of \$21.1 million, and membership increases from existing customers of \$10.4 million, which increases were partially offset by a net loss of membership in connection with the Middle Grand Region of TennCare of \$101.0 million, favorable prior period adjustments mainly related to membership recorded in 2006 of \$10.2 million, and other net unfavorable variances of \$2.9 million.

*Cost of Care*

Cost of care increased by 31.0 percent or \$213.6 million from 2006 to 2007. This increase is primarily due to care associated with new contracts implemented after (or during) 2006 of \$268.7 million (including Maricopa Contract implementation costs of \$4.1 million), membership increases from existing customers of \$9.1 million, care associated with rate changes for contracts that have minimum cost of care requirements of \$8.3 million, favorable prior period medical claims development which was recorded in 2006 of \$1.5 million, and care trends and other net variances of \$18.8 million, which increases were partially offset by the net loss of membership in connection with the Middle Grand Region of TennCare of \$83.3 million, prior period membership adjustments recorded in 2006 of \$7.6 million, favorable medical claims development for 2006 which was recorded in 2007 of \$1.0 million and favorable prior period medical claims development recorded in 2007 of \$0.9 million. Cost of care increased as a percentage of risk revenue from 85.8 percent in 2006 to 88.8 percent in 2007, mainly due to business mix.

*Direct Service Costs*

Direct service costs increased by 43.0 percent or \$15.6 million from 2006 to 2007. The increase in direct service costs is primarily due to costs associated with new business, inclusive of one-time implementation costs related to new contracts. As a percentage of revenue, direct service costs increased from 4.5 percent in 2006 to 5.1 percent in 2007, primarily due to one-time implementation costs related to new contracts and business mix.

**Radiology Benefits Management**

*Net Revenue*

Net revenue related to the Radiology Benefits Management segment increased by 309.1 percent or \$128.6 million from 2006 to 2007. This increase is primarily due to revenue from new customers implemented in 2007 of \$62.7 million, increased revenue due to the conversion of an ASO contract to a risk contract of \$61.0 million, increased membership from existing customers of \$1.7 million, and the

inclusion of only eleven months of operating results in 2006 due to the closing of the acquisition of NIA on January 31, 2006, which increases were partially offset by terminated contracts.

#### *Cost of Care*

Cost of care related to Radiology Benefits Management was \$114.2 million for 2007 from the Company's risk-based contracts. In 2006, Radiology Benefits Management did not have any risk-based contracts. Cost of care as a percentage of risk revenue was 96.6 percent in 2007.

#### *Direct Service Costs*

Direct service costs increased 21.7 percent or \$8.7 million from 2006 to 2007. This increase is primarily attributed to the inclusion of only eleven months of operating results in 2006 and to costs associated with new contracts implemented in 2007. As a percentage of revenue, direct service costs decreased from 96.4 percent in 2006 to 28.7 percent in 2007, mainly due to the implementation of two new risk contracts in 2007.

#### ***Specialty Pharmaceutical Management***

##### *Net Revenue*

Net revenue related to the Specialty Pharmaceutical Management segment increased 226.5 percent or \$125.1 million from 2006 to 2007. This increase is primarily attributed to the inclusion of only five months of operating results in 2006 due to the closing of the acquisition of ICORE on July 31, 2006. Other factors resulting in increased net revenue relate to revenue from new customers implemented in 2007 of \$37.7 million and net increased revenue from existing customers of \$10.4 million.

##### *Cost of Goods Sold*

Cost of goods sold increased 257.8 percent or \$107.8 million from 2006 to 2007. This increase is primarily attributed to the inclusion of only five months of operating results in 2006 due to the closing of the acquisition of ICORE on July 31, 2006. Other factors resulting in increased cost of goods sold relate to cost of goods sold from new customers and increased sales from existing customers of \$36.0 million and \$7.9 million, respectively. As a percentage of the portion of net revenue that relates to distribution revenue, cost of goods sold increased from 90.3 percent in 2006 to 92.9 percent in 2007, mainly due to new business having higher cost of goods sold ratios than historic business and the mix of pharmaceuticals distributed in 2007 having higher cost of goods sold ratios than the mix of pharmaceuticals distributed in 2006.

##### *Direct Service Costs*

Direct service costs increased by 189.5 percent or \$14.1 million from 2006 to 2007. The acquisition of ICORE closed on July 31, 2006 and thus 2006 only included five months of operating results from this segment of the Company. As a percentage of revenue, direct service costs decreased from 13.5 percent in 2006 to 11.9 percent in 2007, mainly due to the segment's stock compensation expense not varying due to new business and same store growth.

#### ***Corporate and Other***

##### *Other Operating Expenses*

Other operating expenses related to the Corporate and Other segment decreased by 7.8 percent or \$10.0 million from 2006 to 2007, primarily due to lower stock compensation expense for this segment. As a percentage of total net revenue, other operating expenses decreased from 7.6 percent for 2006 to 5.5 percent for 2007 primarily due to the leveraging of corporate functions in connection with the

acquisitions of NIA and ICORE, lower stock compensation expense for this segment, and the impact of new contracts implemented after (or during) 2006.

#### *Depreciation and Amortization*

Depreciation and amortization expense increased by 17.7 percent or \$8.7 million from 2006 to 2007, primarily due to asset additions, inclusive of assets related to the Maricopa County contract and the full year impact of the acquisitions of NIA and ICORE.

#### *Interest Expense*

Interest expense decreased by 12.4 percent or \$0.9 million from 2006 to 2007, mainly due to reductions in outstanding debt balances as a result of scheduled payments.

#### *Interest Income*

Interest income increased by 35.2 percent or \$6.2 million from 2006 to 2007, mainly due to an increase in average invested balances.

#### *Other Items*

A gain on the disposition of assets of \$5.1 million was recognized in 2006 mainly as a result of the Company's sale of its equity interest in Royal.

#### *Income Taxes*

The Company's effective income tax rate was 42.1 percent in 2006 and 38.3 percent in 2007. The 2006 and 2007 effective income tax rates differ from the federal statutory income tax rate primarily due to state income taxes and permanent differences between book and tax income. The effective income tax rate in 2007 is lower than 2006 mainly due to the inclusion in 2006 of tax provision for certain tax contingencies related to executive compensation expense, as well as the reversal in 2007 of a portion of such tax contingency reserves.

#### **Outlook—Results of Operations**

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

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

In relation to the managed behavioral healthcare business, the Company is a market leader in a mature market with many viable competitors. The Company is continuing its attempts to grow its business in the managed behavioral healthcare industry through aggressive marketing and development of new products; however, due to the maturity of the market, the Company believes that the ability to

grow its current business lines may be limited. In addition, as previously discussed, substantially all of the Company's Commercial segment revenues are derived from Blue Cross Blue Shield health plans and other managed care companies, health insurers and health plans. Certain of the managed care customers of the Company have decided not to renew all or part of their contracts with the Company, and to instead manage the behavioral healthcare services directly for their subscribers.

The Company believes that it will be able to expand its revenues from its Radiology Benefits Management and Specialty Pharmaceutical Management segments. The Company's first two risk-based Radiology Benefits Management contracts became effective June 1, 2007 and July 1, 2007.

*Care Trends.* The Company expects that the Commercial care trend factor for 2009 will be 7 to 9 percent, the Public Sector care trend factor for 2009 will be 3 to 5 percent and the Radiology Benefits Management care trend for 2009 will be 10 to 13 percent.

*Interest Rate Risk.* Changes in interest rates affect interest income earned on the Company's cash equivalents and investments, as well as interest expense on variable interest rate borrowings under the Company's New Credit Facility. Based on the amount of cash equivalents and investments and the borrowing levels under the New Credit Facility as of December 31, 2008, a hypothetical 10 percent increase or decrease in the interest rate associated with these instruments, with all other variables held constant, would not materially affect the Company's future earnings and cash outflows.

## Historical—Liquidity and Capital Resources

### 2008 compared to 2007

*Operating Activities.* The Company's net cash provided by operating activities for 2007 and 2008 totaled \$194.6 million and \$268.3 million, respectively. The \$73.7 million increase in operating cash flows from 2007 to 2008 is primarily attributable to the shift of restricted cash to restricted investments, which results in an operating cash flow source that is directly offset by an investing cash flow use. During 2008, \$108.7 million of restricted cash was shifted to restricted investments as compared to 2007 in which \$15.0 million of restricted investments were shifted to restricted cash. As such, the year over year impact results in a \$123.7 million increase in operating cash flows. In addition, the funding of restricted cash associated with the Company's regulated entities in 2008 was \$36.1 million lower than 2007, mainly due to the initial funding required for the Maricopa Contract in 2007.

Partially offsetting these items is the build-up of receivables and inventory of \$20.5 million associated with the growth experienced in the specialty pharmaceutical management business segment, the reduction from 2007 in the build-up of medical claims payable and other liabilities of \$14.8 million associated with the risk-based radiology contracts and the funding of restricted cash in 2008 of \$13.3 million associated with a risk-based radiology contract. In addition, the Company's operating cash flows were negatively impacted by the decrease in interest income and segment profit of \$6.8 million and \$3.7 million, respectively, from 2007 to 2008, higher current year payments associated with claims run-out for terminated contracts, with 2007 and 2008 run-out payments of \$8.8 million and \$13.9 million, respectively, and other net unfavorable variances of \$21.9 million associated with working capital changes.

During 2008, the Company's restricted cash decreased \$60.4 million, with \$108.7 million of this decrease attributable to the shift of a portion of the Company's restricted cash to restricted investments. Partially offsetting this item is the funding of restricted cash of \$13.3 million associated with a risk-based radiology contract, the increase in restricted cash of \$34.8 million associated with the Company's regulated entities and other net increases of \$0.2 million. Of the increase in restricted cash associated with the Company's regulated entities, \$30.3 million is offset by changes in other assets and liabilities, primarily medical claims payable and other medical liabilities, thus having no impact on operating cash flows.

*Investing Activities.* The Company utilized \$47.6 million and \$36.3 million during 2007 and 2008, respectively, for capital expenditures. During 2007, the Company incurred capital expenditures of \$15.0 million related to the implementation and start-up of the Maricopa County contract, with \$7.0 million of this total attributable to fixed assets related to clinics that were purchased from Value Options. During 2008, capital expenditures associated with the Maricopa County contract totaled \$6.5 million.

During 2007, the Company received net cash of \$0.7 million from the net maturity of "available-for-sale" investments, with the Company using net cash of \$176.0 million during 2008 for the net purchase of "available-for-sale" investments. The net purchase of investments during 2008 is primarily attributable to a shift of restricted cash of \$108.7 million to restricted investments, as noted above. In addition, the Company purchased short-term investments from the cash generated from its operations.

During 2007 and 2008, the Company made working capital payments of \$17.8 million and \$0.4 million, respectively, related to the acquisition of ICORE, with the payment made during 2008 representing the final ICORE working capital payment. In addition, during 2008 the Company settled the \$25.0 million deferred payment associated with the acquisition of ICORE with the previous unitholders of ICORE.

*Financing Activities.* During 2007, the Company received proceeds of \$32.4 million from the exercise of stock options and warrants, obtained a tax benefit of \$14.4 million from the exercise of stock options and had other financing related cash inflows of \$0.3 million. In addition, the Company had \$27.9 million of debt and capital lease payments and had a financing cash flow use of \$0.5 million related to restricted stock units that were surrendered by certain employees in exchange for the payment of taxes associated with restricted stock unit awards that vested.

During 2008, the Company made payments of \$136.2 million, including broker commissions, on the repurchase of Company stock in accordance with its share buy-back program, had \$14.0 million of debt and capital lease payments, and had a financing cash flow use of \$1.8 million related to restricted stock units that were surrendered by certain employees in exchange for the payment of taxes associated with restricted stock unit awards that vested. In addition, the Company received proceeds of \$12.9 million from the exercise of stock options and warrants, obtained a tax benefit of \$7.5 million from the exercise of stock options and had other financing related cash inflows of \$0.4 million.

## **2007 compared to 2006**

*Operating Activities.* The Company's net cash provided by operating activities for 2006 and 2007 totaled \$197.0 million and \$194.6 million, respectively. The \$2.4 million decrease in operating cash flows from 2006 to 2007 is primarily due to the funding of restricted cash associated with the Company's regulated entities of \$54.5 million, with the majority associated with the Maricopa Contract, and other net unfavorable variances of \$1.7 million. Partially offsetting these items is the build-up of medical claims payable and other liabilities of \$22.6 million associated with the new risk-based radiology contracts, lower current year payments associated with claims run-out for terminated contracts, with 2006 and 2007 run-out payments of \$26.8 million and \$8.8 million, respectively, and the increase in segment profit and interest income of \$7.0 million and \$6.2 million, respectively, from 2006 to 2007.

During 2007, the Company's restricted cash increased \$111.7 million, with \$54.5 million of this increase due to the funding associated with regulated entities as previously discussed. In addition, \$42.2 million of the increase in restricted cash is offset by changes in other assets and liabilities, primarily medical claims payable and other medical liabilities, thus having no impact on operating cash flows. The increase in restricted cash was also impacted by the shift of \$15.0 million of the Company's restricted investments to restricted cash, which resulted in an operating cash flow use that is directly

offset by an investing cash flow source. As such, this shift of investments did not impact the Company's total cash and investments.

*Investing Activities.* The Company utilized \$25.5 million and \$47.6 million during 2006 and 2007, respectively, for capital expenditures. During 2007, the Company incurred capital expenditures of \$7.5 million associated with enhancements to the RBM infrastructure largely related to the implementation of systems to support risk-based contracts, which is an increase of \$5.3 million from 2006. In addition, during 2007 the Company incurred capital expenditures of \$15.0 million associated with the start-up and implementation of the Maricopa Contract. The remainder of the capital expenditures for 2007 and the majority of capital expenditures for 2006 related to management information systems and related equipment.

During 2006, the Company received proceeds of \$22.2 million related to the sale of assets, with \$20.5 million in proceeds attributable to the sale of its investment in Royal.

During 2006, the Company received net cash of \$184.6 million from the net maturity of "available-for-sale" investments, a portion of which was utilized to fund the Company's acquisitions of NIA and ICORE on January 31, 2006 and July 31, 2006, respectively. During 2007, the Company received net cash of \$0.7 million from the net maturity of "available-for-sale" investments.

During 2006, the Company used net cash of \$120.8 million and \$162.2 million related to the acquisitions of NIA and ICORE, respectively. During 2007, the Company made Working Capital Payments of \$17.8 million under the ICORE agreement.

During 2006, the Company received proceeds of \$3.0 million related to a previously outstanding note receivable.

*Financing Activities.* During 2006, the Company had \$25.2 million of debt and capital lease payments. In addition, the Company received proceeds of \$9.6 million from the exercise of stock options and warrants.

During 2007, the Company had \$27.9 million of debt and capital lease payments. In addition, the Company received proceeds of \$32.4 million from the exercise of stock options and warrants and obtained a tax benefit of \$14.4 million from the exercise of stock options.

#### **Outlook—Liquidity and Capital Resources**

*Liquidity.* During 2009, the Company expects to fund its estimated capital expenditures of \$25 to \$35 million with cash from operations. The Company does not anticipate that it will need to draw on amounts available under the New Credit Facility for its operations, capital needs or debt service in 2009. The Company also currently expects to have adequate liquidity to satisfy its existing financial commitments over the periods in which they will become due. The Company maintains its current investment strategy of investing in a diversified, high quality, liquid portfolio of investments and continues to closely monitor the situation in the financial and credit markets. The Company estimates that it has no risk of any material permanent loss on its investment portfolio; however, there can be no assurance that the Company will not experience any such losses in the future.

The following table sets forth the future financial commitments of the Company as of the December 31, 2008 (in thousands):

<u>Contractual Obligations</u>	<u>Payments due by period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1 - 3 years</u>	<u>3 - 5 years</u>	<u>More than 5 years</u>
Interest on long-term debt(1)	\$ 288	\$ 287	\$ 1	\$ —	\$ —
Capital lease obligations	28	8	20	—	—
Operating leases(2)	53,546	19,661	31,168	2,717	—
Purchase commitments(3)	2,398	2,398	—	—	—
FIN 48 liabilities(4)	129,156	—	—	—	—
	<u>\$ 185,416</u>	<u>\$ 22,354</u>	<u>\$ 31,189</u>	<u>\$ 2,717</u>	<u>\$ —</u>

- (1) Interest payments have been estimated based upon rates and commitment fees under the New Credit Facility.
- (2) Operating lease obligations include estimated future lease payments for both open and closed offices.
- (3) Purchase commitments includes open purchase orders as of December 31, 2008 relating to ongoing capital expenditure and operational activities.
- (4) The Company is unable to make a reasonably reliable estimate of the period of the cash settlement with the respective taxing authorities for the \$129.2 million balance of its tax contingency reserves. See further discussion in Note 8—"Income Taxes" to the consolidated financial statements set forth elsewhere herein.

In addition to the contractual obligations and commitments discussed above, the Company has a variety of other contractual agreements related to acquiring materials and services used in the Company's operations. However, the Company does not believe these other agreements contain material noncancelable commitments.

**Stock Repurchase.** On July 30, 2008 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$200 million of its outstanding common stock through January 31, 2010. Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice. The Company expects to fund the stock repurchases using cash on hand. From August 1, 2008 through December 31, 2008, the Company repurchased 3,866,505 shares through the stock repurchase plan at an average share price of \$35.18 per share for an aggregate cost of \$136.0 million (excluding broker commissions).

During the period from January 1, 2009 through February 25, 2009, the Company made additional open market purchases of 435,800 shares at an aggregate cost of \$15.6 million, excluding broker commissions and transaction fees.

**Off-Balance Sheet Arrangements.** As of December 31, 2008, the Company has no material off-balance sheet arrangements.

**New Credit Facility.** On April 30, 2008, the Company's credit agreement with Deutsche Bank AG dated January 5, 2004, as amended (the "Credit Agreement") was terminated, and the Company entered into the New Credit Facility which provides for a \$100.0 million Revolving Loan Commitment for the issuance of letters of credit for the account of the Company with a sublimit of up to \$30.0 million for revolving loans. Borrowings under the New Credit Facility will mature on April 29,

2009. The New Credit Facility is guaranteed by substantially all of the subsidiaries of the Company and is secured by substantially all of the assets of the Company and the subsidiary guarantors.

Under the New Credit Facility, the annual interest rate on Revolving Loan borrowings bear interest at a rate equal to the sum of (i) a borrowing margin of 1.00 percent plus (ii) (A) in the case of U.S. dollar denominated loans, the higher of the prime rate or one-half of one percent in excess of the overnight "federal funds" rate, or (B) in the case of Eurodollar denominated loans, an interest rate which is a function of the Eurodollar rate for the selected interest period. The Company has the option to borrow in U.S. dollar denominated loans or Eurodollar denominated loans at its discretion. Letters of Credit issued under the Revolving Loan Commitment bear interest at the rate of 1.125 percent. The commitment commission on the New Credit Facility will be 0.375 percent of the unused Revolving Loan Commitment.

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

- incur or guarantee additional indebtedness or issue preferred or redeemable stock;
- pay dividends and make other distributions;
- repurchase equity interests;
- make certain advances, investments and loans;
- enter into sale and leaseback transactions;
- create liens;
- sell and otherwise dispose of assets;
- acquire or merge or consolidate with another company; and
- enter into some types of transactions with affiliates.

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

The New Credit Facility also requires the Company to comply with specified financial ratios and tests. Failure to do so, unless waived by the lenders under the New Credit Facility pursuant to its terms, would result in an event of default under the New Credit Facility.

*Net Operating Loss Carryforwards.* The Company estimates that it has reportable federal NOLs as of December 31, 2008 of approximately \$114.8 million available to reduce future federal taxable income. These estimated NOLs expire in 2011 through 2020 and are subject to examination and adjustment by the IRS. In addition, the Company's utilization of such NOLs is subject to limitation under Section 382, which affects the timing of the use of these NOLs. At this time, the Company does not believe these limitations will limit the Company's ability to use any federal NOLs before they expire. Although the Company has NOLs that may be available to offset future taxable income, the Company may be subject to Federal Alternative Minimum Tax.

As of December 31, 2008, the Company's valuation allowances against deferred tax assets were \$9.4 million, mostly relating to uncertainties regarding the eventual realization of certain state NOLs and other state deferred tax assets. Determination of the amount of deferred tax assets considered realizable required significant judgment and estimation. Changes in these estimates in the future could materially affect the Company's financial condition and results of operations.

## Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 provides guidance for using fair value to measure assets and liabilities. It also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, and does not expand the use of fair value in any new circumstances. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 ("FSP 157-2"), which delays the effective date of SFAS 157 by one year for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). On January 1, 2008, the Company adopted SFAS 157 for financial assets and liabilities. The adoption did not have a material impact on the consolidated financial statements. The Company has not yet determined the impact on its consolidated financial statements, if any, from the adoption of SFAS 157, as it pertains to non-financial assets and non-financial liabilities.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115" ("SFAS 159"). SFAS 159 permits entities to elect to measure financial instruments and certain other items at fair value. The objective is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. SFAS 159 was effective for the Company on January 1, 2008. The Company did not elect the fair value option for any of the Company's existing financial instruments on January 1, 2008 and has not determined whether or not the Company will elect this option for any eligible financial instruments the Company acquires in the future.

In December 2007, the FASB issued SFAS 141(R) and SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements" ("SFAS 160"). SFAS 141(R) requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values and changes other practices under SFAS 141, some of which could have a material impact on how the Company accounts for business combinations. SFAS 141(R) also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS 160 requires entities to report non-controlling (minority) interests in subsidiaries as equity in the consolidated financial statements. The Company is required to adopt SFAS 141(R) and SFAS 160 simultaneously in the Company's year beginning January 1, 2009. Prior to 2009 and in accordance with SOP 90-7, reversals of both valuation allowances and unrecognized tax benefits with respect to years prior to the Company's reorganization were recorded to goodwill. All other reversals of these balances were recorded as reductions to income tax expense. As a result of the implementation of SFAS 141(R), beginning in 2009 all reversals of valuation allowances and unrecognized tax benefits will be reflected as reductions to income tax expense, even if related to years prior to the Company's reorganization. The Company is currently evaluating the effects, if any, that SFAS 160 may have on the Company's consolidated financial position and results of operations.

## Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Changes in interest rates affect interest income earned on the Company's cash equivalents and restricted cash and investments, as well as interest expense on variable interest rate borrowings under the New Credit Facility. Based on the Company's investment balances, and the borrowing levels under

the New Credit Facility as of December 31, 2008, a hypothetical 10 percent increase or decrease in the interest rate associated with these instruments, with all other variables held constant, would not materially affect the Company's future earnings and cash outflows.

#### **Item 8. Financial Statements and Supplementary Data**

Information with respect to this item is contained in the Company's consolidated financial statements set forth elsewhere herein and financial statement schedule indicated in the Index on Page F-1 of this Report on Form 10-K, and is included herein.

#### **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

#### **Item 9A. Controls and Procedures**

#### **EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

The Company's management evaluated, with the participation of the Company's principal executive and principal financial officers, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), as of December 31, 2008. Based on their evaluation, management has concluded that the Company's disclosure controls and procedures were effective as of December 31, 2008.

#### **CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

In the fourth quarter ended December 31, 2008, there have been no changes in the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

#### **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended). The Company's internal control system was designed to provide reasonable assurance regarding the preparation and fair presentation of published financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company assessed the effectiveness of internal control over financial reporting as of December 31, 2008. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in its statement "Internal Control-Integrated Framework."

Based on this assessment, management has concluded that, as of December 31, 2008, internal control over financial reporting is effective based on these criteria.

The Company's independent registered public accounting firm has issued an audit report on the Company's internal control over financial reporting. This report dated February 25, 2009 appears on page 64 of this Form 10-K.

**Report of Independent Registered Public Accounting Firm on  
Internal Control Over Financial Reporting**

The Board of Directors and Stockholders of Magellan Health Services, Inc.

We have audited Magellan Health Services, Inc.'s ("the Company") internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Magellan Health Services, Inc. as of December 31, 2007 and 2008, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008 of Magellan Health Services, Inc. and our report dated February 25, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Baltimore, Maryland  
February 25, 2009

**Item 9B. Other Information**

At its meeting on February 25, 2009, the board of directors of the Company appointed Eran Brosky as a director to fill the unexpired term of Barry Smith, who resigned from the board on October 29, 2009 as a result of his acceptance of a non-paid position as mission President for the Church of Jesus Christ of Latter Day Saints in North Texas. Mr. Brosky currently serves as the Executive Chairman of the board of directors of inVentiv Health, Inc, a public company providing a broad range of outsourced services to global pharmaceutical and life sciences companies. In connection with his appointment, the board approved a grant of restricted stock of the Company to be made to Mr. Brosky on March 2, 2009, which represents a pro-rated grant of restricted stock for his service on the board from February 25, 2009 until the 2009 Annual Meeting of Shareholders of the Company. The number of shares of restricted stock to be granted to Mr. Brosky shall be determined by dividing \$28,082.54 by the closing price of a share of Common Stock of the Company on NASDAQ on March 2, 2009. Such restricted stock will vest on May 20, 2009, the vesting date for annual restricted stock awards made on May, 20 2008 to other non-management directors of the Company for their service since the 2008 Annual Meeting of Shareholders of the Company. Mr. Brosky was also appointed to the Nominating and Corporate Governance Committee of the board.

On February 24, 2009, Allen Wise resigned from the board of directors of the Company as a result of his appointment as Chief Executive Officer of Coventry Healthcare, Inc. The board decided not to fill the vacancy created by Mr. Wise's resignation and to reduce the size of the board from 10 members to 9 members as authorized by the Company's By-Laws. As a result, there remains one vacancy on the board, and the board is currently conducting a search for a new director to fill the unexpired term of Steven Shulman who, as previously reported, resigned from the board by notice to the Company on February 17, 2009, effective on February 25, 2009.

The board also appointed Rene Lerer as Chairman of the Board.

**PART III**

The information required by Items 10 through 14 is incorporated by reference to the Registrant's definitive proxy statement to be filed pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended, within 120 days after December 31, 2008.

**PART IV**

**Item 15. Exhibits, Financial Statement Schedule and Additional Information**

(a) Documents furnished as part of the Report:

**1. Financial Statements**

Information with respect to this item is contained on Pages F-1 to F-43 of this Report on Form 10-K.

**2. Financial Statement Schedule**

Information with respect to this item is contained on page S-1 of this Report on Form 10-K.

### 3. Exhibits

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
2.1	Agreement and Plan of Merger, dated June 27, 2006, among Magellan Health Services, Inc., Green Spring Health Services Inc., Magellan Sub Co. II, Inc., and Icore Healthcare LLC, which was filed as Exhibit 2.1 to the Company's Quarterly report on Form 10-Q for the quarterly period ended June 30, 2006, which was filed on July 28, 2006, and is incorporated herein by reference.
2.2	Debtors' Third Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code, which was filed as Exhibit 2(a) to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003, which was filed on August 19, 2003, and is incorporated herein by reference.
2.3	Disclosure Statement for the Debtors' Third Amended Joint Plan of Reorganization, which was filed as Exhibit 2(b) to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003, which was filed on August 19, 2003, and is incorporated herein by reference.
2.4	Modifications to Debtors' Third Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code, dated September 25, 2003, which was filed as Exhibit 99.2 to the Company's current report on Form 8-K, which was filed September 30, 2003, and is incorporated herein by reference.
2.5	Modifications to Debtors' Third Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code, dated October 8, 2003, which was filed as Exhibit 2.3 to the Company's current report on Form 8-K, which was filed October 9, 2003, and is incorporated herein by reference.
2.6	Confirmation of Debtors' Third Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code, as Modified, which was filed as Exhibit 2.4 to the Company's current report on Form 8-K, which was filed October 9, 2003, and is incorporated herein by reference.
3.1	Amended and Restated Certificate of Incorporation of the Company, which was filed as Exhibit 3.2 to the Company's Annual Report on Form 10-K for the period ended December 31, 2004, which was filed on March 30, 2004, and is incorporated herein by reference.
3.2	Bylaws of the Company, which were filed as Exhibit 3.1 to the Company's current report on Form 8-K, which was filed on November 5, 2004, and is incorporated herein by reference.
3.3	Amendments to Sections 2 and 3 of Article IV of the Company's Bylaws, adopted February 25, 2008, which were filed as Exhibit 3.2 to the Company's current report on Form 8-K, which was filed on February 25, 2008 and is incorporated herein by reference.
3.4	Bylaws of the company, which were filed as Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2008, which was filed on May 2, 2008, and is incorporated herein by reference.
4.1	Credit Agreement, dated January 5, 2004, among the Company, various lenders listed therein and Deutsche Bank AG, New York Branch, as administrative agent, which was filed as Exhibit 2.2 to the Company's current report on Form 8-K, which was filed January 6, 2004, and is incorporated herein by reference.

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
4.2	Indenture, dated as of January 5, 2004, between the Company and HSBC Bank USA, as trustee, relating to the 9 <sup>3</sup> / <sub>8</sub> % Series A Senior Notes due 2008 and the 9 <sup>3</sup> / <sub>8</sub> % Series B Senior Notes due 2008 of the Company, which was filed as Exhibit 2.3 to the Company's current report on Form 8-K, which was filed January 6, 2004 and is incorporated herein by reference.
4.3	Warrant Agreement, dated as of January 5, 2004, between the Company and Wachovia Bank, National Association, as Warrant Agent, which was filed as Exhibit 2.5 to the Company's current report on Form 8-K, which was filed January 6, 2004, and is incorporated herein by reference.
4.4	Amendment No. 1 to the Warrant Agreement, dated as of January 7, 2004, between the Company and Wachovia Bank, National Association, as Warrant Agent, which was filed as Exhibit 10.1 to the Company's current report on Form 8-K, which was filed January 7, 2004, and is incorporated herein by reference.
4.5	Amended and Restated Warrant Agreement, dated as of January 5, 2004, between the Company and Wachovia Bank, National Association, as Warrant Agent, which was filed as Exhibit 10.2 to the Company's current report on Form 8-K, which was filed January 7, 2004, and is incorporated herein by reference.
4.6	Amendment to Credit Agreement, dated as of October 22, 2004, which was filed as Exhibit 10.1 to the Company's Quarterly report on Form 10-Q for the quarterly period ended September 30, 2004, which was filed on October 29, 2004, and is incorporated herein by reference.
4.7	Credit Agreement, dated April 30, 2008, among the Company, various lenders listed therein and Deutsche Bank AG, as administrative agent, which was filed as Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2008, which was filed on May 2, 2008, and is incorporated herein by reference.
*10.1	Employment Agreement, dated January 5, 2004, between the Company and Steven J. Shulman, Chairman and Chief Executive Officer of the Company, which was filed as Exhibit 2.11 to the Company's current report on Form 8-K/A, which was filed January 7, 2004, and is incorporated herein by reference.
*10.2	Amendment to the January 5, 2004 Employment Agreement between the Company and Steven J. Shulman, Chairman and Chief Executive Officer of the Company, dated as of January 3, 2006, which was filed as Exhibit 10.5 to the Company's current report on Form 8-K, which was filed on January 9, 2006, and is incorporated herein by reference.
*10.3	Employment Agreement, dated January 5, 2004, between the Company and René Lerer, M.D, President and Chief Operating Officer of the Company, which was filed as Exhibit 2.12 to the Company's current report on Form 8-K/A, which was filed January 7, 2004, and is incorporated herein by reference.
*10.4	Amendment to the January 5, 2004 Employment Agreement between the Company and Rene Lerer, M.D., President and Chief Operating Officer of the Company, dated as of January 3, 2006, which was filed as Exhibit 10.6 to the Company's current report on Form 8-K, which was filed on January 9, 2006, and is incorporated herein by reference.
*10.5	Employment Agreement, dated January 5, 2004, between the Company and Mark S. Demilio, Executive Vice President and Chief Financial Officer of the Company, which was filed as Exhibit 2.13 to the Company's current report on Form 8-K/A, which was filed January 7, 2004, and is incorporated herein by reference.

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
*10.6	Amendment to the January 5, 2004 Employment Agreement between the Company and Mark S. Demilio, Executive Vice President and Chief Financial Officer of the Company, dated as of January 3, 2006, which was filed as Exhibit 10.7 to the Company's current report on Form 8-K, which was filed on January 9, 2006, and is incorporated herein by reference.
*10.7	Employment Agreement, dated January 17, 2005, between the Company and Daniel N. Gregoire, Executive Vice President, General Counsel and Secretary of the Company, which was filed as Exhibit 99.1 to the Company's current report on Form 8-K, which was filed on January 18, 2005, and is incorporated herein by reference.
*10.8	Employment Agreement, dated December 17, 2003, between the Company and Eric Reimer, Chief Growth Officer, which was filed as Exhibit 99.1 to the Company's current report on Form 8-K, which was filed on June 30, 2005, and is incorporated herein by reference.
*10.9	Amendment to Employment Agreement, dated December 17, 2003, between the Company and Eric Reimer, Chief Growth Officer, which was filed as Exhibit 99.2 to the Company's current report on Form 8-K, which was filed on June 30, 2005, and is incorporated herein by reference.
*10.10	Letter Agreement, dated June 22, 2005, between the Company and Eric Reimer, Chief Growth Officer, which was filed as Exhibit 99.3 to the Company's current report on Form 8-K, which was filed on June 30, 2005, and is incorporated herein by reference.
*10.11	Magellan Health Services, Inc.—2003 Management Incentive Plan, effective as of January 5, 2004, which was filed as Exhibit 2.14 to the Company's current report on Form 8-K, which was filed January 6, 2004, and is incorporated herein by reference.
*10.12	Magellan Health Services, Inc.—2005 Director Stock Compensation Plan, effective as of March 3, 2005, which was filed as Appendix B to the Company's definitive proxy statement, filed on April 18, 2005, and is incorporated herein by reference.
*10.13	Form of Stock Option Agreement, relating to options granted under the Company's 2003 Management Incentive Plan, which was filed as Exhibit 10.1 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.14	Form of First Amendment to Stock Option Agreement, relating to options granted under the Company's 2003 Management Incentive Plan, which was filed as Exhibit 10.1 to the Company's current report on Form 8-K, which was filed on January 9, 2006, and is incorporated herein by reference.
*10.15	Form of Notice of March 2005 Stock Option Grant, relating to options granted under the Company's 2003 Management Incentive Plan, which was filed as Exhibit 10.2 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.16	Form of Restricted Stock Agreement, relating to restricted shares granted under the Company's 2003 Management Incentive Plan, which was filed as Exhibit 10.3 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.17	Form of Notice of March 2005 Restricted Stock Award, relating to restricted shares granted under the Company's 2003 Management Incentive Plan, which was filed as Exhibit 10.4 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
*10.18	First form of Notice of Stock Option Grant, relating to options granted under the Company's 2003 Management Incentive Plan and dated as of January 5, 2004, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, Rene Lerer, Chief Operating Officer of the Company, and Mark S. Demilio, Chief Financial Officer of the Company, which was filed as Exhibit 10.5 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.19	First form of Notice of Amendment of Stock Option Grant, relating to options granted under the Company's 2003 Management Incentive Plan and dated as of January 3, 2006, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, Rene Lerer, Chief Operating Officer of the Company, and Mark S. Demilio, Chief Financial Officer of the Company, which was filed as Exhibit 10.2 to the Company's current report on Form 8-K, which was filed on January 9, 2006, and is incorporated herein by reference.
*10.20	Second form of Notice of Stock Option Grant, relating to options granted under the Company's 2003 Management Incentive Plan and dated as of January 5, 2004, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, Rene Lerer, Chief Operating Officer of the Company, and Mark S. Demilio, Chief Financial Officer of the Company, which was filed as Exhibit 10.6 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.21	Second form of Notice of Amendment of Stock Option Grant, relating to options granted under the Company's 2003 Management Incentive Plan and dated as of January 3, 2006, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, Rene Lerer, Chief Operating Officer of the Company, and Mark S. Demilio, Chief Financial Officer of the Company, which was filed as Exhibit 10.3 to the Company's current report on Form 8-K, which was filed on January 9, 2006, and is incorporated herein by reference.
*10.22	Third form of Notice of Stock Option Grant, relating to options granted under the Company's 2003 Management Incentive Plan and dated as of January 5, 2004, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, Rene Lerer, Chief Operating Officer of the Company, and Mark S. Demilio, Chief Financial Officer of the Company, which was filed as Exhibit 10.7 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.23	Third form of Notice of Amendment of Stock Option Grant, relating to options granted under the Company's 2003 Management Incentive Plan and dated as of January 3, 2006, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, Rene Lerer, Chief Operating Officer of the Company, and Mark S. Demilio, Chief Financial Officer of the Company, which was filed as Exhibit 10.4 to the Company's current report on Form 8-K, which was filed on January 9, 2006, and is incorporated herein by reference.
*10.24	Form of Notice of Restricted Stock Award, relating to restricted shares granted under the Company's 2003 Management Incentive Plan and dated as of January 5, 2004, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, Rene' Lerer, Chief Operating Officer of the Company and Mark S. Demilio, Chief Financial Officer of the Company, which was filed as Exhibit 10.8 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
*10.25	Notice of Restricted Stock Award, relating to restricted shares granted under the Company's 2003 Management Incentive Plan and dated as of January 5, 2004, between the Company and Steven J. Shulman, Chief Executive Officer of the Company, which was filed as Exhibit 10.9 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.26	Supplemental Accumulation Plan, adopted in 2002, which was filed as Exhibit 10.10 to the Company's current report on Form 8-K, which was filed on March 17, 2005, and is incorporated herein by reference.
*10.27	Form of Stock Option Agreement, relating to the 2006 Management Incentive Plan, which was filed as Exhibit 10.1 to the Company's current report on Form 8-K, which was filed on May 22, 2006, and is incorporated herein by reference.
*10.28	Form of Notice of Stock Option Grant, pursuant to the 2006 Management Incentive Plan, which was filed as Exhibit 10.2 to the Company's current report on Form 8-K, which was filed on May 22, 2006, and is incorporated herein by reference.
*10.29	Form of Restricted Stock Unit Agreement, pursuant to the 2006 Management Incentive Plan, which was filed as Exhibit 10.3 to the Company's current report on Form 8-K, which was filed on May 22, 2006, and is incorporated herein by reference.
*10.30	Form of Notice of Restricted Stock Unit Award, pursuant to the 2006 Management Incentive Plan, which was filed as Exhibit 10.4 to the Company's current report on Form 8-K, which was filed on May 22, 2006, and is incorporated herein by reference.
*10.31	Form of Restricted Stock and Stock Option Award Agreement, pursuant to the 2006 Director Equity Compensation Plan, which was filed as Exhibit 10.5 to the Company's current report on Form 8-K, which was filed on May 22, 2006, and is incorporated herein by reference.
*10.32	Magellan Health Services, Inc.—2006 Management Incentive Plan, effective as of May 16, 2006, which was filed as Exhibit 10.1 to the Company's Quarterly report on Form 10-Q for the quarterly period ended June 30, 2006, which was filed on July 28, 2006, and is incorporated herein by reference.
*10.33	Magellan Health Services, Inc.—2006 Director Equity Compensation Plan, effective as of May 16, 2006, which was filed as Exhibit 10.2 to the Company's Quarterly report on Form 10-Q for the quarterly period ended June 30, 2006, which was filed on July 28, 2006, and is incorporated herein by reference.
*10.34	Magellan Health Services, Inc.—2006 Employee Stock Purchase Plan, effective as of May 16, 2006 which was filed as Exhibit 10.3 to the Company's Quarterly report on Form 10-Q for the quarterly period ended June 30, 2006, which was filed on July 28, 2006, and is incorporated herein by reference.
*10.35	Amended and Restated Supplemental Accumulation Plan, effective as of January 1, 2005, which was filed as Exhibit 10.1 to the Company's Quarterly report on Form 10-Q for the quarter ended September 30, 2006, which was filed on October 26, 2006, and is incorporated herein by reference.
*10.36	Amendment to Employment Agreement, dated July 28, 2006, between the Company and Jeffrey N. West, Senior Vice President and Controller of the Company, which was filed as Exhibit 10.2 to the Company's Quarterly report on Form 10-Q for the quarter ended September 30, 2006, which was filed on October 26, 2006, and is incorporated herein by reference.

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
*10.37	Amendment to Employment Agreement, dated July 28, 2006, between the Company and Eric Reimer, Chief Growth Officer of the Company, which was filed as Exhibit 10.3 to the Company's Quarterly report on Form 10-Q for the quarter ended September 30, 2006, which was filed on October 26, 2006, and is incorporated herein by reference.
*10.38	Amendment to Employment Agreement, dated July 28, 2006, between the Company and Daniel N. Gregoire, Executive Vice President, General Counsel and Secretary of the Company, which was filed as Exhibit 10.4 to the Company's Quarterly report on Form 10-Q for the quarter ended September 30, 2006, which was filed on October 26, 2006, and is incorporated herein by reference.
*10.39	Employment Agreement, dated August 2, 2004, between the Company and R. Caskie Lewis-Clapper, Chief Human Resources Officer, which was filed as Exhibit 10.39 to the Company's Annual Report on Form 10-K, which was filed on February 29, 2008 and is incorporated herein by reference.
*10.40	Amendment to Employment Agreement, dated July 28, 2006, between the Company and R. Caskie Lewis-Clapper, Chief Human Resources Officer, which was filed as Exhibit 10.40 to the Company's Annual Report on Form 10-K, which was filed on February 29, 2008 and is incorporated herein by reference.
*10.41	Employment Agreement dated February 19, 2008 between the Company and Rene Lerer, M.D., which was filed as Exhibit 10.1 to the Company's current report on Form 8-K, which was filed on February 25, 2008 and is incorporated herein by reference.
*10.42	Transition Agreement dated February 19, 2008 between the Company and Steven J. Shulman, which was filed as Exhibit 10.2 to the Company's current report on Form 8-K, which was filed on February 25, 2008 and is incorporated herein by reference.
*10.43	Employment Agreement, dated June 27, 2006 between the Company and Raju Mantena, which was filed as Exhibit 10.43 to the Company's Annual Report on Form 10-K, which was filed on February 29, 2008 and is incorporated herein by reference.
*10.44	Employment Agreement, dated October 2, 2003, between the Company and Russell Petrella, which was filed as Exhibit 10.44 to the Company's Annual Report on Form 10-K, which was filed on February 29, 2008 and is incorporated herein by reference.
*10.45	Amendment to Employment Agreement (Tier II), dated July 28, 2006 between the Company and Russell Petrella, which was filed as Exhibit 10.45 to the Company's Annual Report on Form 10-K, which was filed on February 29, 2008 and is incorporated herein by reference.
*10.46	Employment Agreement, dated February 25, 2008, between the Company and Tina Blasi, which was filed as Exhibit 10.46 to the Company's Annual Report on Form 10-K, which was filed on February 29, 2008 and is incorporated herein by reference.
*10.47	Amendment to Employment Agreement, dated February 25, 2008, between the Company and Tina Blasi, which was filed as Exhibit 10.47 to the Company's Annual Report on Form 10-K, which was filed on February 29, 2008 and is incorporated herein by reference.
*10.48	Form of Stock Option Agreement, relating to options granted under the Company's 2008 Management Incentive Plan, which was filed as Exhibit 10.1 to the Company's current report on Form 8-K, which was filed on May 27, 2008 and is incorporated herein by reference.

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
*10.49	Form of Notice of March 2008 Stock Option Grant, relating to options granted under the Company's 2008 Management Incentive Plan, which was filed as Exhibit 10.2 to the Company's current report on Form 8-K, which was filed on May 27, 2008 and is incorporated herein by reference.
*10.50	Form of Restricted Stock Unit Agreement, relating to restricted stock units granted under the Company's 2008 Management Incentive Plan, which was filed as Exhibit 10.3 to the Company's current report on Form 8-K, which was filed on May 27, 2008 and is incorporated herein by reference.
*10.51	Form of Notice of Restricted Stock Unit Award, relating to restricted stock units granted under the Company's 2008 Management Incentive Plan, which was filed as Exhibit 10.4 to the Company's current report on Form 8-K, which was filed on May 27, 2008 and is incorporated herein by reference.
*10.52	Employment Agreement, dated August 11, 2008 between the Company and Jonathan Rubin, Chief Financial Officer, which was filed as Exhibit 10.1 to the Company's current report on Form 8-K, which was filed on August 13, 2008, and is incorporated herein by reference.
*10.53	Amendment to Employment Agreement, dated August 11, 2008 between the Company and Jonathan Rubin, Chief Financial Officer, which was filed as Exhibit 10.2 to the Company's current report on Form 8-K, which was filed on August 13, 2008, and is incorporated herein by reference.
*10.54	Amendment to Employment Agreement, dated May 1, 2008 between the Company and Mark S. Demilio, Executive Vice President and Chief Financial Officer, which was filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2008, which was filed on May 2, 2008, and is incorporated herein by reference.
*10.55	Magellan Health Services, Inc.—2008 Management Incentive Plan, effective as of February 27, 2008, which was filed as Appendix A to the Company's Definitive Proxy Statement, which was filed on April 11, 2008, and is incorporated herein by reference.
#*10.56	Amendment to Employment Agreement, dated December 1, 2008, between the Company and Jeffrey West, Senior Vice President and Controller.
#*10.57	Amendment to Employment Agreement, dated December 1, 2008, between the Company and Tina Blasi, Chief Executive Officer of NIA.
#*10.58	Amendment to Employment Agreement, dated December 1, 2008, between the Company and Daniel N. Gregoire, Executive Vice President, General Counsel and Secretary.
#*10.59	Amendment to Employment Agreement, dated December 1, 2008, between the Company and R. Caskie Lewis-Clapper, Chief Human Resources Officer.
#*10.60	Amendment to Employment Agreement, dated December 1, 2008, between the Company and Raju Mantena.
#*10.61	Amendment to Agreements and Documents Governing Restricted Stock Units, dated December 1, 2008, between the Company and Caskie Lewis-Clapper, Chief Human Resources Officer.
#*10.62	Amendment to Agreements and Documents Governing Restricted Stock Units, dated December 1, 2008, between the Company and Tina Blasi, Chief Executive Officer of NIA.

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
#*10.63	Amendment to Agreements and Documents Governing Restricted Stock Units, dated December 1, 2008, between the Company and Jeffrey West, Senior Vice President and Controller.
#*10.64	Amendment to Agreements and Documents Governing Restricted Stock Units, dated December 1, 2008, between the Company and Daniel N. Gregoire, Executive Vice President, General Counsel and Secretary.
#*10.65	Amendment to Employment Agreement, as amended and restated December 16, 2008, between the Company and Rene Lerer, M.D, Chief Executive Officer.
#*10.66	Amendment to Agreements and Documents Governing Restricted Stock Units, dated December 1, 2008, between the Company and Rene Lerer, Chief Executive Officer.
#21	List of subsidiaries of the Company.
#23	Consent of Ernst & Young LLP.
#31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
#31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
†32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
†32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Constitutes a management contract, compensatory plan or arrangement.

# Filed herewith.

† Furnished herewith.

(b) Exhibits Required by Item 601 of Regulation S-K:

Exhibits required to be filed by the Company pursuant to Item 601 of Regulation S-K are contained in a separate volume.

(c) Financial statements and schedules required by Regulation S-X Item 14(d):

(1) Not applicable.

(2) Not applicable.

(3) Information with respect to this item is contained on page S-1 of this Report on Form 10-K.

#### 4. Additional Information

The Company will provide to any person without charge, upon request, a copy of its annual Report on Form 10-K (without exhibits) for the year ended December 31, 2008, as filed with the Securities and Exchange Commission. The Company will also provide to any person without charge, upon request, copies of its Code of Ethics for Directors, Code of Ethics for Covered Officers, and Corporate Compliance Handbook for all employees (hereinafter referred to as the "Codes of Ethics"). Any such requests should be made in writing to the Investor Relations Department, Magellan Health Services, Inc., 55 Nod Road, Avon, Connecticut 06001. The documents referred to above and other Securities and Exchange Commission filings of the Company are available on the Company's website at [www.magellanhealth.com](http://www.magellanhealth.com). The Company intends to disclose any future amendments to the provisions of the Codes of Ethics and waivers from such Codes of Ethics, if any, made with respect to any of its directors and executive officers, on its internet site.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

MAGELLAN HEALTH SERVICES, INC.  
(Registrant)

Date: February 27, 2009

/s/ JONATHAN N. RUBIN

---

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

Date: February 27, 2009

/s/ JEFFREY N. WEST

---

Jeffrey N. West  
*Senior Vice President and Controller*  
*(Principal Accounting Officer)*

Pursuant to the requirements of the Securities Exchange Act of 1934, the following persons on behalf of the Registrant and in the capacities and on the dates indicated have signed this Report below.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<hr/> /s/ RENE LERER Rene Lerer	Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)	February 27, 2009
<hr/> /s/ ERAN BROSHY Eran Broshy	Director	February 27, 2009
<hr/> /s/ MICHAEL DIAMENT Michael Diament	Director	February 27, 2009
<hr/> /s/ WILLIAM D. FORREST William D. Forrest	Director	February 27, 2009
<hr/> /s/ NANCY L. JOHNSON Nancy L. Johnson	Director	February 27, 2009
<hr/> /s/ ROBERT M. LE BLANC Robert M. Le Blanc	Director	February 27, 2009

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ WILLIAM J. MCBRIDE</u> William J. McBride	Director	February 27, 2009
<u>/s/ MICHAEL P. RESSNER</u> Michael P. Ressner	Director	February 27, 2009
<u>/s/ JONATHAN N. RUBIN</u> Jonathan N. Rubin	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	February 27, 2009
<u>/s/ JEFFREY N. WEST</u> Jeffrey N. West	Senior Vice President and Controller (Principal Accounting Officer)	February 27, 2009

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**

**INDEX TO FINANCIAL STATEMENTS**

The following consolidated financial statements of the registrant and its subsidiaries are submitted herewith in response to Item 8 and Item 15(a)1:

	<u>Page(s)</u>
<b>Magellan Health Services, Inc.</b>	
Audited Consolidated Financial Statements	
<a href="#">Report of independent registered public accounting firm</a>	<a href="#">F-2</a>
<a href="#">Consolidated balance sheets as of December 31, 2007 and 2008</a>	<a href="#">F-3</a>
<a href="#">Consolidated statements of income for the years ended December 31, 2006, 2007 and 2008</a>	<a href="#">F-4</a>
<a href="#">Consolidated statements of changes in stockholders' equity for the years ended December 31, 2006, 2007 and 2008</a>	<a href="#">F-5</a>
<a href="#">Consolidated statements of cash flows for the years ended December 31, 2006, 2007 and 2008</a>	<a href="#">F-6</a>
<a href="#">Notes to consolidated financial statements</a>	<a href="#">F-7</a>

The following financial statement schedule of the registrant and its subsidiaries is submitted herewith in response to Item 15(a)2:

<a href="#">Schedule II—Valuation and qualifying accounts</a>	<a href="#">S-1</a>
---	---------------------

All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders of Magellan Health Services, Inc.

We have audited the accompanying consolidated balance sheets of Magellan Health Services, Inc. and subsidiaries as of December 31, 2007 and 2008, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. Our audits also included the financial statement schedule of the Company for the years ended December 31, 2006, 2007, and 2008 as listed in the Index at Item 15(a)2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 2007 and 2008, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in 2007 the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 25, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Baltimore, Maryland  
February 25, 2009

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31,****(In thousands, except per share amounts)**

	2007	2008
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 312,372	\$ 211,825
Restricted cash	252,763	192,395
Accounts receivable, less allowance for doubtful accounts of \$1,317 and \$1,915 at December 31, 2007 and 2008, respectively	66,356	82,076
Short-term investments (restricted investments of \$12,962 and \$116,112 at December 31, 2007 and 2008, respectively)	54,145	225,372
Deferred income taxes	75,273	58,092
Other current assets (restricted deposits of \$19,388 and \$17,769 at December 31, 2007 and 2008, respectively)	42,183	52,660
<b>Total Current Assets</b>	<b>803,092</b>	<b>822,420</b>
Property and equipment, net	105,735	88,436
Long-term investments—restricted	2,430	8,527
Deferred income taxes	90,618	76,769
Other long-term assets	6,197	3,472
Goodwill	367,872	367,325
Other intangible assets, net	59,179	50,615
<b>Total Assets</b>	<b>\$ 1,435,123</b>	<b>\$ 1,417,564</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 25,952	\$ 21,527
Accrued liabilities	79,699	96,533
Medical claims payable	162,666	155,860
Other medical liabilities	93,573	99,953
Current maturities of long-term debt and capital lease obligations	13,969	8
<b>Total Current Liabilities</b>	<b>375,859</b>	<b>373,881</b>
Long-term debt and capital lease obligations	—	20
Deferred credits and other long-term liabilities	150,433	135,590
Minority interest	599	—
<b>Total Liabilities</b>	<b>526,891</b>	<b>509,491</b>
Preferred stock, par value \$.01 per share		
Authorized—10,000 shares—Issued and outstanding—none	—	—
Ordinary common stock, par value \$.01 per share		
Authorized—100,000 shares at December 31, 2007 and 2008—		
Issued and outstanding—40,157 shares and 40,873 shares at December 31, 2007 and 2008, respectively	402	409
Multi-Vote common stock, par value \$.01 per share		
Authorized—40,000 shares—Issued and outstanding—none	—	—
Other Stockholders' Equity:		
Additional paid-in capital	539,374	589,011
Retained earnings	363,047	449,252
Warrants outstanding	5,384	5,382
Accumulated other comprehensive income	25	172
Ordinary common stock in treasury, at cost, 0 shares and 3,867 shares at December 31, 2007 and 2008, respectively	—	(136,153)
<b>Total Stockholders' Equity</b>	<b>908,232</b>	<b>908,073</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 1,435,123</b>	<b>\$ 1,417,564</b>

See accompanying notes to consolidated financial statements.

## MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME FOR THE YEARS ENDED DECEMBER 31,

(In thousands, except per share amounts)

	2006	2007	2008
Net revenue	\$ 1,690,270	\$ 2,155,953	\$ 2,625,394
Cost and expenses:			
Cost of care	1,081,080	1,409,103	1,830,542
Cost of goods sold	41,809	149,585	181,356
Direct service costs and other operating expenses(1)	385,478	404,003	426,627
Equity in earnings of unconsolidated subsidiaries	(390)	—	—
Depreciation and amortization	48,862	57,524	60,810
Interest expense	7,292	6,386	2,846
Interest income	(17,628)	(23,836)	(17,030)
Gain on sale of assets	(5,148)	—	—
	<u>1,541,355</u>	<u>2,002,765</u>	<u>2,485,151</u>
Income from continuing operations before income taxes and minority interest	148,915	153,188	140,243
Provision for income taxes	62,695	58,669	54,038
Income from continuing operations before minority interest	86,220	94,519	86,205
Minority interest, net	(42)	361	—
Net income	86,262	94,158	86,205
Other comprehensive income(2)	609	31	147
Comprehensive income	<u>\$ 86,871</u>	<u>\$ 94,189</u>	<u>\$ 86,352</u>
Weighted average number of common shares outstanding—basic (See Note 7)	<u>36,986</u>	<u>38,942</u>	<u>39,607</u>
Weighted average number of common shares outstanding—diluted (See Note 7)	<u>38,621</u>	<u>39,837</u>	<u>39,999</u>
Net income per common share—basic:	<u>\$ 2.33</u>	<u>\$ 2.42</u>	<u>\$ 2.18</u>
Net income per common share—diluted:	<u>\$ 2.23</u>	<u>\$ 2.36</u>	<u>\$ 2.16</u>

(1) Includes stock compensation expense of \$33,991, \$29,994 and \$32,763 for the years ended December 31, 2006, 2007 and 2008, respectively.

(2) Net of income tax provision (benefit) of \$(4), \$21 and \$(94) for the years ended December 31, 2006, 2007 and 2008, respectively.

See accompanying notes to consolidated financial statements.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

(In thousands)

	Common Stock		Common Stock In Treasury		Additional Paid in Capital	Retained Earnings	Warrants Outstanding	Accumulated Other Comprehensive (Loss) Income	Total Stockholders' Equity
	Shares	Amount	Shares	Amount					
<b>Balance at December 31, 2005</b>	36,584	\$ 366	—	\$ —	\$ 429,933	\$ 194,904	\$ 8,489	\$ (615)	\$ 633,077
Stock compensation expense	—	—	—	—	33,991	—	—	—	33,991
Exercise of stock options	515	5	—	—	9,623	—	—	—	9,628
Exercise of stock warrants	151	1	—	—	3,104	—	(3,105)	—	—
Issuance of equity	542	6	—	—	(6)	—	—	—	—
Net income	—	—	—	—	—	86,262	—	—	86,262
Other comprehensive income—other	—	—	—	—	—	—	—	609	609
<b>Balance at December 31, 2006</b>	37,792	378	—	—	476,645	281,166	5,384	(6)	763,567
Stock compensation expense	—	—	—	—	29,994	—	—	—	29,994
Exercise of stock options	2,327	24	—	—	32,379	—	—	—	32,403
Tax benefit from exercise of stock options	—	—	—	—	570	—	—	—	570
Issuance of equity	38	—	—	—	(214)	—	—	—	(214)
Adoption of FIN 48	—	—	—	—	—	(12,277)	—	—	(12,277)
Net income	—	—	—	—	—	94,158	—	—	94,158
Other comprehensive income—other	—	—	—	—	—	—	—	31	31
<b>Balance at December 31, 2007</b>	40,157	402	—	—	539,374	363,047	5,384	25	908,232
Stock compensation expense	—	—	—	—	32,763	—	—	—	32,763
Exercise of stock options	591	7	—	—	12,883	—	—	—	12,890
Tax benefit from exercise of stock options	—	—	—	—	5,378	—	—	—	5,378
Exercise of stock warrants	—	—	—	—	8	—	(2)	—	6
Issuance of equity	125	—	—	—	(1,395)	—	—	—	(1,395)
Repurchase of stock	—	—	(3,867)	(136,153)	—	—	—	—	(136,153)
Net income	—	—	—	—	—	86,205	—	—	86,205
Other comprehensive income—other	—	—	—	—	—	—	—	147	147
<b>Balance at December 31, 2008</b>	40,873	\$ 409	(3,867)	\$ (136,153)	\$ 589,011	\$ 449,252	\$ 5,382	\$ 172	\$ 908,073

See accompanying notes to consolidated financial statements.

## MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31,

(In thousands)

	2006	2007	2008
<b>Cash flows from operating activities:</b>			
Net income	\$ 86,262	\$ 94,158	\$ 86,205
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on sale of assets	(5,148)	—	—
Depreciation and amortization	48,862	57,524	60,810
Equity in earnings of unconsolidated subsidiaries	(390)	—	—
Non-cash interest expense	1,389	2,681	1,423
Non-cash stock compensation expense	33,991	29,994	32,763
Non-cash income tax expense	57,487	38,677	42,241
Cash flows from changes in assets and liabilities, net of effects from acquisitions of businesses:			
Restricted cash	8,941	(111,731)	60,368
Accounts receivable, net	128	2,707	(15,720)
Other assets	(4,365)	(5,233)	(9,290)
Accounts payable and accrued liabilities	(8,062)	15,056	11,519
Medical claims payable and other medical liabilities	(23,155)	69,824	(426)
Other	1,024	906	(1,589)
Net cash provided by operating activities	<u>196,964</u>	<u>194,563</u>	<u>268,304</u>
<b>Cash flows from investing activities:</b>			
Capital expenditures	(25,477)	(47,553)	(36,314)
Acquisitions and investments in businesses, net of cash acquired	(283,005)	(17,790)	(25,425)
Proceeds from sale of assets	22,200	—	—
Purchase of investments	(69,807)	(133,643)	(404,420)
Maturity of investments	254,397	134,367	228,392
Proceeds from note receivable	3,000	—	—
Net cash used in investing activities	<u>(98,692)</u>	<u>(64,619)</u>	<u>(237,767)</u>
<b>Cash flows from financing activities:</b>			
Payments on long-term debt and capital lease obligations	(25,202)	(27,855)	(13,981)
Payments to acquire treasury stock	—	—	(136,153)
Proceeds from exercise of stock options and warrants	9,628	32,403	12,896
Tax benefit from exercise of stock options	—	14,357	7,549
Other	—	(214)	(1,395)
Net cash (used in) provided by financing activities	<u>(15,574)</u>	<u>18,691</u>	<u>(131,084)</u>
Net increase (decrease) in cash and cash equivalents	82,698	148,635	(100,547)
Cash and cash equivalents at beginning of period	81,039	163,737	312,372
Cash and cash equivalents at end of period	<u>\$ 163,737</u>	<u>\$ 312,372</u>	<u>\$ 211,825</u>

See accompanying notes to consolidated financial statements.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2008**

**1. General**

*Basis of Presentation*

The consolidated financial statements of Magellan Health Services, Inc., a Delaware corporation ("Magellan"), include the accounts of Magellan, its majority owned subsidiaries and all variable interest entities ("VIEs") for which Magellan is the primary beneficiary (together with Magellan, the "Company"). All significant intercompany accounts and transactions have been eliminated in consolidation.

*Business Overview*

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

**Managed Behavioral Healthcare**

Two of the Company's segments are in the managed behavioral healthcare business. This line of business generally reflects the Company's coordination and management of the delivery of behavioral healthcare treatment services that are provided through its contracted network of third-party treatment providers, which includes psychiatrists, psychologists, other behavioral health professionals, psychiatric hospitals, general medical facilities with psychiatric beds, residential treatment centers and other treatment facilities. The treatment services provided through the Company's provider network include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and crisis intervention services. The Company generally does not directly provide, or own any provider of, treatment services except as relates to the Company's contract to provide managed behavioral healthcare services to Medicaid recipients and other beneficiaries of the Maricopa County Regional Behavioral Health Authority (the "Maricopa Contract"). Under the Maricopa Contract, effective August 31, 2007 the Company was required to assume the operations of twenty-four behavioral health direct care facilities for a transitional period and to divest itself of these facilities over a two year period. During August and October 2008, the Company entered into agreements with two separate Provider Network Organizations ("PNOs") which resulted in the transition of thirteen of such behavioral health direct care facilities to the PNOs over various dates through February 2009. During March 2009, the Company will begin the operation of two additional behavioral health direct care facilities and the Company expects to divest itself of these facilities before August 31, 2009.

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

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**1. General (Continued)**

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

*Commercial.* The Managed Behavioral Healthcare Commercial segment ("Commercial") generally reflects managed behavioral healthcare services and EAP services provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicaid and Medicare members, as well as with employers, including corporations and governmental agencies, and labor unions. Commercial's managed behavioral healthcare contracts encompass risk-based, ASO and EAP arrangements. This segment contains the operating segments previously defined as the Managed Behavioral Healthcare Health Plan Segment ("Health Plan") and the Managed Behavioral Healthcare Employer segment ("Employer"). Prior period balances have been reclassified to reflect this change. The Company now considers Commercial as one segment and it is managed as such.

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

**Radiology Benefits Management**

The Radiology Benefits Management segment generally reflects the management of the delivery of diagnostic imaging services to ensure that such services are clinically appropriate and cost effective. The Company's radiology benefits management services currently are provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicaid and Medicare members. The Company has bid on contracts with state and local governmental agencies for the provision of such services to Medicaid recipients. The Company has won one state Medicaid contract, which was implemented in July 2008. The Company offers its radiology benefits management services through ASO contracts, where the Company provides services such as utilization review and claims administration, but does not assume responsibility for the cost of the imaging services, and through risk-based contracts, where the Company assumes all or a substantial portion of the responsibility for the cost of providing diagnostic imaging services. The Company's first two risk-based radiology benefits management contracts became effective June 1, 2007 and July 1, 2007.

**Specialty Pharmaceutical Management**

The Specialty Pharmaceutical Management segment generally reflects the management of specialty drugs used in the treatment of cancer, multiple sclerosis, hemophilia, infertility, rheumatoid arthritis, chronic forms of hepatitis and other diseases. Specialty pharmaceutical drugs represent high-cost injectable, infused, oral, or inhaled drugs which traditional retail pharmacies often do not supply due to their high cost, sensitive handling, and storage needs. The Company's specialty pharmaceutical management services are provided under contracts with managed care companies, health insurers and other health plans for some or all of their commercial, Medicare and Medicaid members. The Company's specialty pharmaceutical services include (i) contracting and formulary optimization on behalf of health plans and pharmaceutical manufacturers; (ii) distributing specialty pharmaceutical

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**1. General (Continued)**

drugs on behalf of health plans; (iii) providing strategic consulting services to health plans and pharmaceutical manufacturers; and (iv) providing oncology management services to health plans.

Corporate and Other

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

**2. Summary of Significant Accounting Policies**

*Recent Accounting Pronouncements*

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157 ("SFAS 157"), which provides guidance for using fair value to measure assets and liabilities. It also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, and does not expand the use of fair value in any new circumstances. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 ("FSP 157-2"), which delays the effective date of SFAS 157 by one year for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). On January 1, 2008, the Company adopted SFAS 157 for financial assets and liabilities. The adoption did not have a material impact on the consolidated financial statements. The Company has not yet determined the impact on its consolidated financial statements, if any, from the adoption of SFAS 157, as it pertains to non-financial assets and non-financial liabilities.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115" ("SFAS 159"). SFAS 159 permits entities to elect to measure financial instruments and certain other items at fair value. The objective is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. SFAS 159 was effective for the Company on January 1, 2008. The Company did not elect the fair value option for any of the Company's existing financial instruments on January 1, 2008 and has not determined whether or not the Company will elect this option for any eligible financial instruments the Company acquires in the future.

In December 2007, the FASB issued SFAS No. 141(R) "Business Combinations" ("SFAS 141(R)") and SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements" ("SFAS 160"). SFAS 141(R) requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values and changes other practices under SFAS 141, some of which could have a material impact on how the Company accounts for business combinations. SFAS 141(R) also requires additional disclosure of information surrounding a business

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS 160 requires entities to report non-controlling (minority) interests in subsidiaries as equity in the consolidated financial statements. The Company is required to adopt SFAS 141(R) and SFAS 160 simultaneously in the Company's year beginning January 1, 2009. Prior to 2009 and in accordance with American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7"), reversals of both valuation allowances and unrecognized tax benefits with respect to years prior to the Company's reorganization were recorded to goodwill. All other reversals of these balances were recorded as reductions to income tax expense. As a result of the implementation of SFAS 141(R), beginning in 2009 all reversals of valuation allowances and unrecognized tax benefits will be reflected as reductions to income tax expense, even if related to years prior to the Company's reorganization. The Company is currently evaluating the effects, if any, that SFAS 160 may have on the Company's consolidated financial position and results of operations.

*Use of Estimates*

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

*Managed Care Revenue*

Managed care revenue, inclusive of revenue from the Company's risk, EAP and ASO contracts, is recognized over the applicable coverage period on a per member basis for covered members. The Company is paid a per member fee for all enrolled members, and this fee is recorded as revenue in the month in which members are entitled to service. The Company adjusts its revenue for retroactive membership terminations, additions and other changes, when such adjustments are identified, with the exception of retroactivity that can be reasonably estimated. Any fees paid prior to the month of service are recorded as deferred revenue. Managed care revenues approximated \$1.6 billion, \$1.9 billion and \$2.2 billion for the years ended December 31, 2006, 2007 and 2008, respectively.

*Cost-Plus Contracts*

The Company has certain cost-plus contracts with customers under which the Company recognizes revenue as costs are incurred and as services are performed. Revenues from cost-plus contracts approximated \$32.3 million, \$30.5 million and \$31.5 million for the years ended December 31, 2006, 2007 and 2008, respectively.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

*Block Grant Revenues*

The Maricopa Contract is partially funded by federal, state and county block grant money, which represents annual appropriations. The Company recognizes revenue from block grant activity ratably over the period to which the block grant funding applies. Block grant revenues were approximately \$40.6 million and \$120.0 million for the years ended December 31, 2007 and 2008, respectively.

*Distribution Revenue*

The Company recognizes distribution revenue, which includes the co-payments received from members of the health plans the Company serves, when the specialty pharmaceutical drugs are shipped. At the time of shipment, the earnings process is complete; the obligation of the Company's customer to pay for the specialty pharmaceutical drugs is fixed, and, due to the nature of the product, the member may neither return the specialty pharmaceutical drugs nor receive a refund. Revenues from the distribution of specialty pharmaceutical drugs on behalf of health plans were \$46.3 million, \$160.6 million and \$195.6 million for the years ended December 31, 2006, 2007 and 2008, respectively.

*Performance-Based Revenue*

The Company has the ability to earn performance-based revenue under certain risk and non-risk contracts. Performance-based revenue generally is based on either the ability of the Company to manage care for its clients below specified targets, or on other operating metrics. For each such contract, the Company estimates and records performance-based revenue after considering the relevant contractual terms and the data available for the performance-based revenue calculation. Pro-rata performance-based revenue is recognized on an interim basis pursuant to the rights and obligations of each party upon termination of the contracts. Performance-based revenues were \$16.4 million, \$10.4 million and \$13.4 million for the years ended December 31, 2006, 2007 and 2008, respectively.

*Significant Customers*

Consolidated Company

The Company's contracts with the State of Tennessee's TennCare program ("TennCare") and with subsidiaries of WellPoint, Inc. ("WellPoint") each generated net revenues that exceeded, in the aggregate, ten percent of net revenues for the consolidated Company for the years ended December 31, 2006 and 2007. In addition to TennCare, the Company's Maricopa Contract generated net revenues that exceeded, in the aggregate, ten percent of net revenues for the consolidated Company for the year ended December 31, 2008. The Company also has a significant concentration of business from contracts with various counties in the State of Pennsylvania (the "Pennsylvania Counties") which are part of the Pennsylvania Medicaid program.

The Maricopa Contract, which began September 1, 2007 and which extends through June 30, 2010, generated net revenues of \$196.1 million and \$621.6 million for the years ended December 31, 2007 and 2008, respectively.

The TennCare program is divided into three regions, and through March 31, 2007 the Company's TennCare contracts encompassed all of the TennCare membership for all three regions. As of April 1,

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

2007 substantially all of the membership in the Middle Grand Region was re-assigned to managed care companies in accordance with contract awards by TennCare pursuant to its request for proposals for the management of the integrated delivery of behavioral and physical medical care to the region. Substantially all of the membership in the West Grand and East Grand Regions was similarly re-assigned to managed care companies in accordance with contract awards by TennCare effective November 1, 2008 and January 1, 2009, respectively. The Company continues to manage behavioral healthcare services for children enrolled in TennCare Select High, statewide, as well as for certain out-of-state TennCare members pursuant to contracts that extend through June 30, 2009. The Company recorded net revenues of \$416.4 million, \$316.9 million and \$282.4 million for the years ended December 31, 2006, 2007 and 2008, respectively, from its TennCare contracts. The portion of the total net revenues associated with the programs for children and out-of-state members referred to above was \$47.0 million for the year ended December 31, 2008.

Total net revenues from the Company's contracts with WellPoint were \$200.2 million, \$218.9 million and \$186.7 million during the years ended December 31, 2006, 2007 and 2008, respectively, including radiology benefits management revenue of \$12.6 million, \$77.8 million and \$162.5 million, respectively. One of the Company's managed behavioral healthcare contracts with WellPoint was terminated by WellPoint effective March 31, 2007, and generated net revenues of \$26.0 million during 2007. A second managed behavioral healthcare contract with WellPoint expired December 31, 2007 and generated net revenues of \$85.7 million during the year ended December 31, 2007.

In July 2007, WellPoint acquired a radiology benefits management company, and has expressed its intent to in-source all of its radiology benefits management contracts when such contracts expire. The Company has several radiology benefits management contracts with WellPoint including one that converted from an ASO arrangement to a risk arrangement effective July 1, 2007. Such risk contract originally had a three-year term through June 30, 2010, and cannot be terminated early, except for cause, as defined in the agreement. The term of this risk contract has been extended through December 31, 2010. The Company's other radiology benefits management contracts with WellPoint generated \$11.4 million of net revenues for the year ended December 31, 2008. Substantially all of this revenue relates to contracts that have terminated at various dates in 2008.

Net revenues from the Pennsylvania Counties in the aggregate totaled \$248.2 million, \$262.6 million and \$288.1 million for the years ended December 31, 2006, 2007 and 2008, respectively.

**By Segment**

WellPoint generated greater than ten percent of net revenues for the Commercial segment for the years ended December 31, 2006 and 2007. Two other customers generated greater than ten percent of Commercial net revenues for the years ended December 31, 2006, 2007 and 2008. The first customer has a contract that extends through December 31, 2012 and generated net revenues of \$153.2 million, \$175.4 million and \$217.0 million for the years ended December 31, 2006, 2007 and 2008, respectively. The second customer has a contract that extends through June 30, 2009 and generated net revenues of \$82.9 million, \$89.3 million and \$90.8 million for the years ended December 31, 2006, 2007 and 2008, respectively.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

Maricopa and TennCare were the only customers with net revenues greater than ten percent of the net revenues for the Public Sector segment for the year ended December 31, 2008. In addition to TennCare in 2006, and Maricopa and TennCare in 2007, one customer generated revenues greater than ten percent of the net revenues for the Public Sector segment for such years. This customer has a contract that extends through December 31, 2009 and generated net revenues of \$121.0 million, \$124.7 million and \$140.5 million for the years ended December 31, 2006, 2007 and 2008, respectively.

In addition to WellPoint, two other customers generated greater than ten percent of the net revenues for the Radiology Benefits Management segment for the year ended December 31, 2006. The two customers generated \$5.2 million and \$4.8 million of net revenues during the year ended December 31, 2006. In addition to WellPoint, one other customer generated greater than ten percent of the net revenues for the Radiology Benefits Management segment for the years ended December 31, 2007 and 2008. This customer has a contract that extends through May 31, 2011 and generated net revenues of \$61.3 million and \$96.4 million for the years ended December 31, 2007 and 2008, respectively.

Included in the Company's Specialty Pharmaceutical Management segment are three customers that each exceeded ten percent of the net revenues for this line of business for the year ended December 31, 2006. The three customers generated \$24.8 million, \$11.7 million and \$9.6 million of net revenues in 2006. Included in the Company's Specialty Pharmaceutical Management segment are four customers that each exceeded ten percent of the net revenues for this segment for the year ended December 31, 2007. The four customers generated \$60.0 million, \$34.4 million, \$33.6 million and \$24.9 million of net revenues during the year ended December 31, 2007. For the year ended December 31, 2008, five customers each exceeded ten percent of the net revenues for this segment. Four of such customers generated \$71.9 million, \$49.5 million, \$28.0 million, and \$26.8 million of net revenues during the year ended December 31, 2008. The other contract generated net revenues of \$27.1 million for the year ended December 31, 2008, and this contract terminated December 31, 2008.

*Income Taxes*

The Company files a consolidated federal income tax return for the Company and its eighty-percent or more owned subsidiaries, and the Company and its subsidiaries file income tax returns in various state and local jurisdictions.

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"), as it applies to companies that have implemented the fresh start reporting provisions of SOP 90-7, with respect to reversals of valuation allowances on deferred tax assets established with fresh-start accounting. The Company estimates income taxes for each of the jurisdictions in which it operates. This process involves estimating current tax exposures together with assessing temporary differences resulting from differing treatment of items for tax and book purposes. Deferred tax assets and/or liabilities are determined by multiplying the differences between the financial reporting and tax reporting bases for assets and liabilities by the enacted tax rates expected to be in effect when such differences are recovered or settled. The Company then assesses the likelihood that the deferred tax assets will be recovered from the reversal of temporary timing differences and

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

future taxable income, and to the extent the Company cannot conclude that recovery is more likely than not, it establishes a valuation allowance. The effect of a change in tax rates on deferred taxes is recognized in income in the period that includes the enactment date.

The Company adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized an increase of \$5.8 million in its liability for unrecognized tax benefits and a net decrease of \$6.0 million to its deferred tax assets, which were recorded as a reduction to retained earnings of \$12.3 million and a decrease to goodwill of \$0.5 million.

*Cash and Cash Equivalents*

Cash equivalents are short-term, highly liquid interest-bearing investments with maturity dates of three months or less when purchased, consisting primarily of money market instruments. The Company records as cash and cash equivalents, excess capital and undistributed earnings for its regulated subsidiaries, which as of December 31, 2008 was \$45.8 million.

*Restricted Assets*

The Company has certain assets which are considered restricted for: (i) the payment of claims under the terms of certain managed care contracts; (ii) regulatory purposes related to the payment of claims in certain jurisdictions; and (iii) the maintenance of minimum required tangible net equity levels for certain of the Company's subsidiaries. Significant restricted assets of the Company as of December 31, 2007 and 2008 were as follows (in thousands):

	<u>2007</u>	<u>2008</u>
Restricted cash	\$252,763	\$192,395
Restricted short-term investments	12,962	116,112
Restricted deposits (included in other current assets)	19,388	17,769
Restricted long-term investments	2,430	8,527
Total	<u>\$287,543</u>	<u>\$334,803</u>

*Investments*

Investments consist primarily of U.S. Government and agency securities, obligations of government-sponsored enterprises, corporate debt securities, and certificates of deposit. Investments classified as "available-for-sale" are carried at fair value, based on quoted market prices. The Company's policy is to classify all investments with contractual maturities within one year as current. Investment income is recognized when earned and reported net of investment expenses. Net unrealized holding gains or losses are excluded from earnings and are reported, net of tax, as "accumulated other comprehensive income (loss)" in the accompanying consolidated balance sheets, statements of income and statements of changes in stockholders' equity until realized, unless the losses are deemed to be other-than-temporary. Realized gains or losses, including any provision for other-than-temporary declines in value, are included in the consolidated statements of income.

## MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

## 2. Summary of Significant Accounting Policies (Continued)

The Company periodically evaluates whether any declines in the fair value of investments are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: the length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near-term prospects for recovery of the market value of a security; and the intent and ability of the Company to hold the security until the market value recovers. Declines in value below cost for investments where it is considered probable that all contractual terms of the investment will be satisfied, is due primarily to changes in interest rates (and not because of increased credit risk), and where the Company intends and has the ability to hold the investment for a period of time sufficient to allow a market recovery, are not assumed to be other-than-temporary. The Company periodically reviews those investment securities whose unrealized losses have remained unrealized for more than six months to determine if such unrealized losses are other-than-temporary. Unrealized losses related to investments greater and less than one year are not material.

The Company believes the declines in fair value of its investment securities were caused by changes in market interest rates and overall economic and market uncertainties and expects to receive all amounts due upon the investment maturing. The Company intends to hold these related investment securities to maturity and has the ability to do so. As of December 31, 2007 and 2008, there were no unrealized losses that the Company believed to be other-than-temporary. No realized gains or losses were recorded for the years ended December 31, 2006, 2007 or 2008. The following is a summary of short-term and long-term investments at December 31, 2007 and 2008 (in thousands):

	December 31, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and agency securities	\$ 1,303	\$ 5	\$ —	\$ 1,308
Obligations of government-sponsored enterprises(1)	8,318	31	—	8,349
Corporate debt securities	39,692	6	—	39,698
Certificates of deposit	7,220	—	—	7,220
Total investments at December 31, 2007	<u>\$ 56,533</u>	<u>\$ 42</u>	<u>\$ —</u>	<u>\$ 56,575</u>

	December 31, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and agency securities	\$ 683	\$ 6	\$ —	\$ 689
Obligations of government-sponsored enterprises(1)	52,479	584	—	53,063
Corporate debt securities	173,184	—	(307)	172,877
Certificates of deposit	7,270	—	—	7,270
Total investments at December 31, 2008	<u>\$ 233,616</u>	<u>\$ 590</u>	<u>\$ (307)</u>	<u>\$ 233,899</u>

- (1) Includes investments in notes issued by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Federal Home Loan Bank and the Federal Farm Credit Bank.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

The maturity dates of the Company's investments as of December 31, 2008 are summarized below (in thousands):

	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
2009	\$225,147	\$225,372
2010	8,469	8,527
<b>Total investments at December 31, 2008</b>	<u><u>\$233,616</u></u>	<u><u>\$233,899</u></u>

*Accounts Receivable*

The Company's accounts receivable consists of amounts due from customers throughout the United States. Collateral is generally not required. The Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other information. Management believes the allowance for doubtful accounts is adequate to provide for normal credit losses.

*Concentration of Credit Risk*

Accounts receivable subjects the Company to a concentration of credit risk with third party payors that include health insurance companies, managed healthcare organizations, healthcare providers and governmental entities.

*Long-lived Assets*

Long-lived assets, including property and equipment and intangible assets to be held and used, are currently reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). Pursuant to this guidance, impairment is determined by comparing the carrying value of these long-lived assets to management's best estimate of the future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. The cash flow projections used to make this assessment are consistent with the cash flow projections that management uses internally in making key decisions. In the event an impairment exists, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the asset, which is generally determined by using quoted market prices or the discounted present value of expected future cash flows.

*Property and Equipment*

Property and equipment is stated at cost, except for assets that have been impaired, for which the carrying amount has been reduced to estimated fair value. Expenditures for renewals and improvements are capitalized to the property accounts. Replacements and maintenance and repairs that do not improve or extend the life of the respective assets are expensed as incurred. Internal-use software is capitalized in accordance with SOP 98-1, "Accounting for Cost of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"). Amortization of capital lease assets is included

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2008****2. Summary of Significant Accounting Policies (Continued)**

in depreciation expense and is included in accumulated depreciation as reflected in the table below. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets, which is generally two to ten years for buildings and improvements (or the lease term, if shorter), three to fifteen years for equipment and three to five years for capitalized internal-use software. Depreciation expense was \$36.3 million, \$41.3 million and \$52.2 million for the years ended December 31, 2006, 2007 and 2008, respectively.

Property and equipment, net, consisted of the following at December 31, 2007 and 2008 (in thousands):

	2007	2008
Buildings and improvements	\$ 6,969	\$ 6,733
Equipment	109,043	112,277
Capital leases—equipment	4,905	4,883
Capitalized internal-use software	108,992	133,803
	<u>229,909</u>	<u>257,696</u>
Accumulated depreciation	(124,174)	(169,260)
Property and equipment, net	<u>\$ 105,735</u>	<u>\$ 88,436</u>

*Goodwill*

Goodwill is accounted for in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). Pursuant to SFAS 142, the Company is required to test its goodwill for impairment on at least an annual basis. The Company has selected October 1 as the date of its annual impairment test. The goodwill impairment test is a two-step process that requires management to make judgments in determining what assumptions to use in the calculation. The first step of the process consists of estimating the fair value of each reporting unit that has been allocated goodwill based on various valuation techniques, with the primary technique being a discounted cash flow analysis, which requires the input of various assumptions with respect to revenues, operating margins, growth rates and discount rates. The estimated fair value for each reporting unit is compared to the carrying value of the reporting unit, which includes the allocated goodwill. If the estimated fair value is less than the carrying value, a second step is performed to compute the amount of the impairment by determining an "implied fair value" of goodwill. The determination of a reporting unit's "impaired fair value" of goodwill requires the Company to allocate the estimated fair value of the reporting unit to the assets and liabilities of the reporting unit. Any unallocated fair value represents the "implied fair value" of goodwill, which is compared to its corresponding carrying value.

The key assumptions used to determine the fair value of the Company's reporting units included: (a) cash flow projections through 2013; (b) terminal values based on terminal growth rates ranging from 3 percent to 4 percent; and (c) discount rates ranging from 13 percent to 18 percent, which were based on the Company's weighted average cost of capital adjusted for the risks associated with the operations for each of the reporting units. While estimating the fair value of Radiology Benefits Management and the Specialty Pharmaceutical Management, the Company assumed operating income in future years in excess of current year results based primarily on assumed revenue growth.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2008****2. Summary of Significant Accounting Policies (Continued)**

As a result of the first step of the 2008 annual goodwill impairment analysis, the fair value of each reporting unit with allocated goodwill exceeded its carrying value. Therefore, the second step was not necessary. However, a 53 percent decline in fair value of the Health Plan reporting unit, an 11 percent decline in fair value of Radiology Benefits Management, or a 25 percent decline in fair value of Specialty Pharmaceutical Management would have caused the carrying values for these reporting units to be in excess of fair values, which would require the second step to be performed. The second step could have resulted in an impairment loss for goodwill.

The balance of goodwill has been allocated to the Company's segments (as defined in Note 1—"General") as follows (in thousands):

	<b>December 31,</b>	
	<b>2007</b>	<b>2008</b>
Commercial	\$121,032	\$120,485
Radiology Benefits Management	104,549	104,549
Specialty Pharmaceutical Management	142,291	142,291
Total	<u>\$367,872</u>	<u>\$367,325</u>

The changes in the carrying amount of goodwill for the years ended December 31, 2007 and 2008 are reflected in the table below (in thousands):

	<b>2007</b>	<b>2008</b>
Balance as of beginning of period	\$374,381	\$367,872
Adjustment due to changes in valuation allowances(1)	(1,518)	219
Adoption of FIN 48(2)	(518)	—
Adjustment for tax contingency reversals(3)	(4,174)	(766)
Acquisition of National Imaging Associates, Inc. ("NIA")	(314)	—
Acquisition of ICORE Healthcare, LLC ("ICORE")	15	—
Balance as of end of period	<u>\$367,872</u>	<u>\$367,325</u>

- 
- (1) In accordance with SOP 90-7, reversals of valuation allowances with respect to unrealizable deferred tax assets are recorded as decreases to goodwill to the extent those assets originated in years prior to the Company's reorganization.
  - (2) The Company adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), on January 1, 2007. As a result of the implementation of FIN 48, the Company recorded this decrease to goodwill.
  - (3) During 2007 and 2008, the statute of limitations expired with respect to the assessment of state and local income taxes for certain tax years prior to the Company's reorganization, resulting in the reversal of tax contingencies recorded for these years. The tax benefits of these reversals (net of indirect tax benefits) have been reflected as reductions of goodwill in accordance with SOP 90-7.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

See further discussion in Note 8—"Income Taxes."

*Intangible Assets*

The following is a summary of intangible assets at December 31, 2007 and 2008, and the estimated useful lives for such assets (in thousands):

<u>Asset</u>	<u>Estimated Useful Life</u>	<u>December 31, 2007</u>		
		<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Amount</u>
Customer agreements and lists	3 to 10 years	\$ 97,790	\$ (44,059)	\$53,731
Provider networks	5 to 16 years	7,430	(1,982)	5,448
		<u>\$ 105,220</u>	<u>\$ (46,041)</u>	<u>\$59,179</u>

<u>Asset</u>	<u>Estimated Useful Life</u>	<u>December 31, 2008</u>		
		<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Amount</u>
Customer agreements and lists	3 to 10 years	\$ 97,790	\$ (52,031)	\$45,759
Provider networks and other	5 to 16 years	7,430	(2,574)	4,856
		<u>\$ 105,220</u>	<u>\$ (54,605)</u>	<u>\$50,615</u>

Amortization expense was \$12.6 million, \$16.2 million and \$8.6 million for the years ended December 31, 2006, 2007 and 2008, respectively. The Company estimates amortization expense will be \$7.8 million, \$6.8 million, \$6.6 million, \$6.6 million and \$6.6 million for the years ending December 31, 2009, 2010, 2011, 2012 and 2013, respectively.

*Cost of Care, Medical Claims Payable and Other Medical Liabilities*

Cost of care is recognized in the period in which members receive managed healthcare services. In addition to actual benefits paid, cost of care in a period also includes the impact of accruals for estimates of medical claims payable. Medical claims payable represents the liability for healthcare claims reported but not yet paid and claims incurred but not yet reported ("IBNR") related to the Company's managed healthcare businesses.

Such liabilities are determined by employing actuarial methods that are commonly used by health insurance actuaries and that meet actuarial standards of practice.

The IBNR portion of medical claims payable is estimated based on past claims payment experience for member groups, enrollment data, utilization statistics, authorized healthcare services and other factors. This data is incorporated into contract-specific actuarial reserve models and is further analyzed to create "completion factors" that represent the average percentage of total incurred claims that have been paid through a given date after being incurred. Factors that affect estimated completion factors include benefit changes, enrollment changes, shifts in product mix, seasonality influences, provider reimbursement changes, changes in claims inventory levels, the speed of claims processing, and

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

changes in paid claim levels. Completion factors are applied to claims paid through the financial statement date to estimate the ultimate claim expense incurred for the current period. Actuarial estimates of claim liabilities are then determined by subtracting the actual paid claims from the estimate of the ultimate incurred claims. For the most recent incurred months (generally the most recent two months), the percentage of claims paid for claims incurred in those months is generally low. This makes the completion factor methodology less reliable for such months. Therefore, incurred claims for any month with a completion factor that is less than 70 percent are generally not projected from historical completion and payment patterns; rather they are projected by estimating claims expense based on recent monthly estimated cost incurred per member per month times membership, taking into account seasonality influences, benefit changes and health care trend levels, collectively considered to be "trend factors."

Medical claims payable balances are continually monitored and reviewed. If it is determined that the Company's assumptions in estimating such liabilities are significantly different than actual results, the Company's results of operations and financial position could be impacted in future periods. Adjustments of prior period estimates may result in additional cost of care or a reduction of cost of care in the period an adjustment is made. Further, due to the considerable variability of health care costs, adjustments to claim liabilities occur each period and are sometimes significant as compared to the net income recorded in that period. Prior period development is recognized immediately upon the

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

actuary's judgment that a portion of the prior period liability is no longer needed or that additional liability should have been accrued. The following table presents the components of the change in medical claims payable for the years ended December 31, 2006, 2007 and 2008 (in thousands):

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Claims payable and IBNR, beginning of period	\$ 164,013	\$ 156,079	\$ 185,349
Cost of care:			
Current year	1,087,053	1,416,700	1,836,425
Prior years	(5,973)	(7,597)	(5,883)
Total cost of care	<u>1,081,080</u>	<u>1,409,103</u>	<u>1,830,542</u>
Claim payments and transfers to other medical liabilities(1):			
Current year	951,389	1,248,549	1,676,975
Prior years	137,625	131,284	154,494
Total claim payments and transfers to other medical liabilities	<u>1,089,014</u>	<u>1,379,833</u>	<u>1,831,469</u>
Claims payable and IBNR, end of period	156,079	185,349	184,422
Withhold receivables, end of period(2)	(20,319)	(22,683)	(28,562)
Medical claims payable, end of period	<u>\$ 135,760</u>	<u>\$ 162,666</u>	<u>\$ 155,860</u>

- 
- (1) For any given period, a portion of unpaid medical claims payable could be covered by reinvestment liability (discussed below) and may not impact the Company's results of operations for such periods.
- (2) Medical claims payable is offset by customer withholds from capitation payments in situations in which the customer has the contractual requirement to pay providers for care incurred.

Actuarial standards of practice require that the claim liabilities be adequate under moderately adverse circumstances. Adverse circumstances are situations in which the actual claims experience could be higher than the otherwise estimated value of such claims. In many situations, the claims paid amount experienced will be less than the estimate that satisfies the actuarial standards of practice.

Due to the existence of risk sharing provisions in certain customer contracts, principally in the Public Sector segment, a change in the estimate for medical claims payable does not necessarily result in an equivalent impact on cost of care.

The Company believes that the amount of medical claims payable is adequate to cover its ultimate liability for unpaid claims as of December 31, 2008; however, actual claims payments may differ from established estimates.

Other medical liabilities consist primarily of "reinvestment" payables under certain managed behavioral healthcare contracts with Medicaid customers and "profit share" payables under certain

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

risk-based contracts. Under a contract with reinvestment features, if the cost of care is less than certain minimum amounts specified in the contract (usually as a percentage of revenue), the Company is required to "reinvest" such difference in behavioral healthcare programs when and as specified by the customer or to pay the difference to the customer for their use in funding such programs. Under a contract with profit share provisions, if the cost of care is below certain specified levels, the Company will "share" the cost savings with the customer at the percentages set forth in the contract.

*Net Income per Common Share*

Net income per common share is computed based on the weighted average number of shares of common stock and common stock equivalents outstanding during the period (see Note 7—"Stockholders' Equity").

*Stock Compensation*

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123 (revised 2004) "Share-Based Payment" ("SFAS 123R"), using the modified prospective transition method. Under this transition method, stock compensation expense for the years ended December 31, 2006, 2007 and 2008 includes compensation expense for all stock compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Stock compensation expense for all stock compensation awards granted after January 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes substantially all of these compensation costs on a straight-line basis over the requisite service period, which is generally the vesting term ranging from three to four years.

The Company uses the Black-Scholes-Merton formula to estimate the fair value of substantially all stock options granted to employees and recorded stock compensation expense of \$34.0 million, \$30.0 million and \$32.8 million for the years ended December 31, 2006, 2007 and 2008, respectively. As stock compensation expense recognized in the consolidated statements of income for the years ended December 31, 2006, 2007 and 2008 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures of two percent, two percent and eight percent, respectively, as required by SFAS 123R. If the actual number of forfeitures differs from those estimated, additional adjustments to compensation expense may be required in future periods. If vesting of an award is conditioned upon the achievement of performance goals, compensation expense during the performance period is estimated using the most probable outcome of the performance goals, and adjusted as the expected outcome changes.

*Fair Value Measurements*

The Company adopted SFAS 157 on January 1, 2008. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The standard outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

fair value measurements and the related disclosures. Under generally accepted accounting practices, certain assets and liabilities must be measured at fair value, and SFAS 157 details the disclosures that are required for items measured at fair value.

The Company has various financial instruments that must be measured under the new fair value standard including investments, which consist primarily of U.S. Government securities, obligations of government-sponsored enterprises, corporate debt securities and certificates of deposit. Pursuant to SFAS 157, financial assets and liabilities are to be measured using inputs from the three levels of the fair value hierarchy, which are as follows:

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

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

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

In accordance with the fair value hierarchy described above, the following table shows the fair value of the Company's financial assets and liabilities that are required to be measured at fair value as of December 31, 2008 (in thousands):

	Fair Value Measurements at December 31, 2008			Total
	Level 1	Level 2	Level 3	
Cash and Cash Equivalents(1)	\$ —	\$150,791	\$ —	\$150,791
Restricted Cash(2)	—	148,745	—	148,745
<b>Investments:</b>				
U.S. Government and agency securities	689	—	—	689
Obligations of government-sponsored enterprises(3)	—	53,063	—	53,063
Corporate debt securities	—	172,877	—	172,877
Certificates of deposit	—	7,270	—	7,270
	<u>\$689</u>	<u>\$532,746</u>	<u>\$ —</u>	<u>\$533,435</u>

(1) Excludes \$61.0 million of cash held in bank accounts by the Company.

(2) Excludes \$43.7 million of restricted cash held in bank accounts by the Company.

(3) Includes investments in notes issued by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Federal Home Loan Bank and the Federal Farm Credit Bank.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**2. Summary of Significant Accounting Policies (Continued)**

*Reclassifications*

Certain prior year amounts have been reclassified to conform to the current year presentation.

**3. Acquisitions and Joint Ventures**

As of December 31, 2005, the Company owned a 37.5 percent interest in Royal Health Care, LLC ("Royal"). Royal was a managed services organization that received management fees for the provision of administrative, marketing, management and support services to seven managed care organizations. Royal did not provide any services to the Company. Effective February 2, 2006, the Company sold its Royal ownership interest back to Royal in exchange for cash proceeds of \$20.5 million.

*Acquisition of National Imaging Associates*

On January 31, 2006, the Company acquired all of the outstanding stock of NIA, a privately held radiology benefits management ("RBM") firm, for approximately \$121 million in cash, after giving effect to cash acquired in the transaction, and NIA became a wholly-owned subsidiary. The Company reports the results of operations of NIA in the Radiology Benefits Management segment.

*Acquisition of ICORE Healthcare, LLC*

On July 31, 2006, the Company acquired all of the outstanding units of membership interest of ICORE, a specialty pharmaceutical management company, and ICORE became a wholly-owned subsidiary. The Company reports the results of operations of ICORE in the Specialty Pharmaceutical Management segment.

The Company paid or agreed to pay to the previous unitholders of ICORE, all of whom are members of ICORE's management team, (i) \$161 million of cash at closing; (ii) \$24 million of cash that was used by the unitholders of ICORE to purchase Magellan restricted stock with such restricted stock vesting over three years, provided the unitholders do not earlier terminate their employment with Magellan; (iii) \$25 million plus accrued interest (the "Deferred Payment"), subject to any indemnity claims Magellan may have under the purchase agreement; (iv) the amount of positive working capital that existed at ICORE on the closing date (the "Working Capital Payments"), which was \$18.2 million of which \$17.8 million was paid during 2007 with the remainder paid in January 2008; and (v) a potential earn-out of up to \$75 million (the "Earn-Out"), provided the unitholders do not earlier terminate their employment with the Company prior to the payment of the Earn-Out. The \$161 million of cash paid at closing, the \$25 million Deferred Payment and \$18.2 million of Working Capital Payments were recorded as purchase price. The \$24 million of restricted stock is being recognized as stock compensation expense over the three year vesting period. The \$24 million in restricted stock paid at the closing was issued in a transaction pursuant to which the unitholders of ICORE at closing applied \$24 million of the purchase price as cash consideration for their purchase of restricted shares of the Company's common stock. The unitholders subscribed to an aggregate of 543,879 restricted shares of the Company's common stock on a basis proportional to each unitholder's economic interest in ICORE at a purchase price of \$44.13 per share, which was the average of the closing prices of the Company's common stock on NASDAQ for the twenty trading days immediately preceding the closing. The Deferred Payment was paid in December 2008. The Earn-Out included (i) up to \$25 million based

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**3. Acquisitions and Joint Ventures (Continued)**

on earnings for the 18 month period ended December 31, 2007 and (ii) up to \$50 million based on earnings in 2008. Neither Earn-Out provisions were met and as a result, the Company will not pay any additional purchase consideration.

**4. Discontinued Operations**

The remaining assets and liabilities of the Company's discontinued operations segments at December 31, 2007 and 2008 included, among other things, (i) cash and cash equivalents of \$0.5 million; (ii) restricted cash of \$0.6 million; (iii) investment in provider joint ventures of \$0.6 million; and (iv) accounts payable and accrued liabilities of \$0.7 million.

**5. Benefit Plans**

The Company has a defined contribution retirement plan (the "401(k) Plan"). Employee participants can elect to contribute up to 75 percent of their compensation, subject to Internal Revenue Service ("IRS") deferral limitations, to the 401(k) Plan. The Company makes contributions to the 401(k) Plan based on employee compensation and contributions. The Company matches 50 percent of each employee's contribution up to 6 percent of their annual compensation. Additionally, the Company can elect to make a discretionary contribution of up to 2 percent of each eligible employee's compensation. The Company recognized \$3.7 million, \$4.2 million and \$5.1 million of expense for the years ended December 31, 2006, 2007 and 2008, respectively, for matching contributions to the 401(k) Plan.

**6. Long-Term Debt and Capital Lease Obligations**

*New Credit Facility*

The Company's credit agreement with Deutsche Bank AG dated January 5, 2004, as amended (the "Credit Agreement") provided for a Term Loan Facility, a Revolving Loan Facility providing for loans of up to \$50.0 million and a Credit-Linked Facility for the issuance of letters of credit for the account of the Company in an aggregate principal amount of \$50.0 million. As of December 31, 2007, the Company had \$12.5 million outstanding under the Term Loan Facility. As of December 31, 2007, the Company had issued letters of credit in the amount of \$47.8 million, resulting in unutilized commitments under the Credit-Linked Facility of \$2.2 million. The Credit Agreement was guaranteed by substantially all of the subsidiaries of the Company and was secured by substantially all of the assets of the Company and the subsidiary guarantors. On April 30, 2008, the Company's Credit Agreement was terminated.

On April 30, 2008, the Company entered into a credit facility with Deutsche Bank AG and Citibank N.A. that provides for a \$100.0 million Revolving Loan Commitment for the issuance of letters of credit for the account of the Company with a sublimit of up to \$30.0 million for revolving loans (the "New Credit Facility"). Borrowings under the New Credit Facility will mature on April 29, 2009. As of December 31, 2008, the Company had issued letters of credit in the amount of \$47.7 million. The New Credit Facility is guaranteed by substantially all of the subsidiaries of the Company and is secured by substantially all of the assets of the Company and the subsidiary guarantors.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**6. Long-Term Debt and Capital Lease Obligations (Continued)**

Under the New Credit Facility, the annual interest rate on Revolving Loan borrowings bear interest at a rate equal to the sum of (i) a borrowing margin of 1.00 percent plus (ii) (A) in the case of U.S. dollar denominated loans, the higher of the prime rate or one-half of one percent in excess of the overnight "federal funds" rate, or (B) in the case of Eurodollar denominated loans, an interest rate which is a function of the Eurodollar rate for the selected interest period. The Company has the option to borrow in U.S. dollar denominated loans or Eurodollar denominated loans at its discretion. Letters of Credit issued under the Revolving Loan Commitment bear interest at the rate of 1.125 percent. The commitment commission on the New Credit Facility is 0.375 percent of the unused Revolving Loan Commitment.

Although the New Credit Facility expires on April 29, 2009, the Company believes it will be able to obtain a new facility or, if not, to use cash on hand to fund letters of credit and other liquidity needs.

*Capital Lease Obligations*

The Company's capital lease obligations represent amounts due under leases for certain software and computer equipment. The recorded gross cost of other capital leased assets was \$4.9 million at December 31, 2007 and 2008.

The Company's long-term debt and capital lease obligations at December 31, 2007 and 2008 consisted of the following (in thousands):

	<u>2007</u>	<u>2008</u>
<b>Credit Agreement:</b>		
Revolving Loan Facility due through 2008	\$ —	\$—
Term Loan Facility (6.74% at December 31, 2007) due through 2008	12,500	—
<b>New Credit Facility:</b>		
Revolving Loan Commitment due through 2009	—	—
Capital Lease Obligations (6.87% at December 31, 2008) due through 2011	1,469	28
	<u>13,969</u>	<u>28</u>
Less current maturities of long-term debt and capital lease obligations	(13,969)	(8)
	<u>\$ —</u>	<u>\$20</u>

**7. Stockholders' Equity**

*Stock Compensation*

At December 31, 2007 and 2008, the Company had equity-based employee incentive plans, which are described below.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**7. Stockholders' Equity (Continued)**

*Stock Option Awards*

On January 5, 2004, the Company established the 2003 Management Incentive Plan ("2003 MIP") which allowed for the issuance of up to 6,373,689 shares of common stock pursuant to stock options or stock grants. Other than the 2004 Options (defined below) and certain options granted under the 2006 MIP (defined below), options granted by the Company have exercise prices equal to the fair market value on the date of grant.

On February 24, 2006, the board of directors of the Company approved three equity plans and recommended they be submitted for approval by the Company's shareholders at the 2006 Annual Meeting of Shareholders. The board approved the 2006 Management Incentive Plan ("2006 MIP"), the 2006 Director Equity Compensation Plan ("Director Plan") and the 2006 Employee Stock Purchase Plan ("ESPP"). All three of these plans were approved by the Company's shareholders at the 2006 Annual Meeting of Shareholders on May 16, 2006.

The 2006 MIP, which is similar to the Company's 2003 MIP, authorized the issuance of equity awards covering a total of 2,750,000 shares of the Company's common stock, no more than 300,000 shares of which may be restricted stock or restricted stock units. A restricted stock unit is a notional account representing the right to receive a share of Ordinary Common Stock (or, at the Company's option, cash in lieu thereof) at some future date. The Director Plan covered 120,000 shares of the Company's common stock, no more than 15,000 of which may be restricted stock or restricted stock units, and provided for the issuance of options and restricted stock or restricted stock units to directors immediately following each annual meeting of shareholders in 2006 and 2007. The ESPP is a noncompensatory plan and covers 100,000 shares of the Company's common stock and permits employees of the Company to purchase Common Stock at a 5 percent discount.

On February 27, 2008 the board of directors of the Company approved the 2008 Management Incentive Plan ("2008 MIP") and recommended it be submitted for approval by the Company's shareholders at the 2008 Annual Meeting of shareholders. The 2008 MIP is similar to the 2006 MIP and the 2003 MIP. The board of directors also authorized a total of up to 4.5 million shares of the Company's Common Stock (which amount will be increased by the amount of any future forfeitures under the 2006 MIP, the 2003 MIP and the Director Plan) to be available for issuance pursuant to the 2008 MIP. Each restricted stock unit or share of restricted stock issued under the 2008 MIP shall be counted as 1.9 option shares for the purpose of calculating shares awarded and shares remaining available for grant pursuant to the 2008 MIP. The 2008 MIP also provides that no further awards are to be made under the 2006 MIP, the 2003 MIP or the Director Plan, and any equity awards remaining available for issuance under such plans are no longer available for issuance except for any forfeitures or other recapture of equity awards previously made under such plans, which will be available for grant under the 2008 MIP. The 2008 MIP, unlike the 2006 MIP and the 2003 MIP, also permits the grant of performance based cash bonus awards to eligible employees and the grant of equity to directors of the Company. Currently, no such cash bonus awards have been issued under the 2008 MIP.

On February 27, 2008, the compensation committee of the board of the Company authorized the grant of stock options and restricted stock units to members of management pursuant to the 2008 MIP with such options and restricted stock units to be issued on March 5, 2008 pursuant to the Company's equity award policy. The options granted to management have a ten year term and an exercise price

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2008****7. Stockholders' Equity (Continued)**

equal to the closing price of a share of Common Stock of the Company on NASDAQ on March 5, 2008, the date of grant of annual equity awards under the Company's equity award policy. The options and restricted stock units granted to management vest ratably on each anniversary date over the three years subsequent to grant, except that the vesting of certain of the restricted stock units are subject to satisfaction of certain performance targets.

The compensation committee also granted to each independent member of the board on May 20, 2008 (the date of the 2008 Annual Meeting of Shareholders), that number of shares of restricted stock of the Company determined by dividing \$125,000 by the closing price of a share of the Company's Common Stock on NASDAQ on May 20, 2008. In addition, the compensation committee granted to the chairman of the board on May 20, 2008, that number of shares of restricted stock of the Company determined by dividing \$500,000 by the closing price of a share of the Company's Common Stock on NASDAQ on May 20, 2008. Such shares of restricted stock granted to directors will vest on May 20, 2009.

The options and restricted stock units awarded to members of management and the directors as described above were subject to and conditioned upon shareholder approval of the 2008 MIP which occurred at the 2008 Annual Meeting of Shareholders of the Company. As such, these awards were not effectively granted nor was any stock compensation expense recorded until May 20, 2008.

The weighted average grant date fair value of substantially all stock options granted during the years ended December 31, 2006, 2007 and 2008 was \$14.27, \$12.24 and \$8.52, respectively, as estimated using the Black- Scholes-Merton option pricing model based on the following weighted average assumptions:

	2006	2007	2008
Risk-free interest rate	4.80%	4.50%	2.76%
Expected life	4 years	4 years	4 years
Expected volatility	29.90%	28.40%	28.40%
Expected dividend yield	0.00%	0.00%	0.00%

For the year ended December 31, 2006, management determined that volatility based on actively traded equities of companies that are similar to the Company was a better indicator of expected volatility and future stock price trends than historical Company volatility. For the years ended December 31, 2007 and 2008, such volatility was based on the historical volatility of the Company's stock price. SFAS 123R also requires the benefits of tax deductions in excess of recognized stock compensation expense to be reported as a financing cash flow, rather than as an operating cash flow. In the year ended December 31, 2006, the tax deductions related to stock compensation expense were not realized because of the availability of Net Operating Loss Carryforwards ("NOLs"), and thus there were no such financing cash flows reported. In the years ended December 31, 2007 and 2008, approximately \$14.4 million and \$7.5 million, respectively, of benefits of such tax deductions related to stock compensation expense were realized and as such were reported as financing cash flows. Of these amounts, \$0.6 million and \$5.4 million, respectively, have been reflected as increases to additional paid in capital for the years ended December 31, 2007 and 2008, respectively. Tax contingencies were recorded for the remaining \$13.8 million and \$2.1 million, respectively, as of December 31, 2007 and 2008.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**7. Stockholders' Equity (Continued)**

Summarized information related to the Company's stock options for the years ended December 31, 2006, 2007 and 2008 is as follows:

	2006		2007	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding, beginning of period	4,014,711	\$ 18.50	4,990,507	\$ 24.64
Granted	1,705,270	37.40	1,594,546	41.38
Cancelled	(214,306)	25.56	(199,019)	38.12
Exercised	(515,168)	18.68	(2,326,938)	13.93
Outstanding, end of period	4,990,507	\$ 24.64	4,059,096	\$ 36.68

	2008			
	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding, beginning of period	4,059,096	\$ 36.68		
Granted	1,643,720	41.19		
Cancelled	(443,310)	40.28		
Exercised	(591,016)	21.81		
Outstanding, end of period	4,668,490	\$ 39.82	6.53	\$ 4,363
Vested and expected to vest at end of period	4,502,148	\$ 39.78	6.46	\$ 4,291
Exercisable, end of period	2,099,273	\$ 38.95	4.50	\$ 2,862

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (based upon the difference between the Company's closing stock price on the last trading day of 2008 of \$39.16 and the exercise price) for all in-the-money options as of December 31, 2008. This amount changes based on the fair market value of the Company's stock.

The total pre-tax intrinsic value of options exercised (based on the difference between the Company's closing stock price on the day the option was exercised and the exercise price) during the years ended December 31, 2006, 2007 and 2008 was \$10.5 million, \$63.4 million and \$12.0 million, respectively.

As of December 31, 2008, there was \$16.6 million of total unrecognized compensation expense related to nonvested stock options that is expected to be recognized over a weighted average remaining recognition period of 1.64 years. The total fair value of options vested during the year ended December 31, 2008 was \$25.7 million.

## MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

## 7. Stockholders' Equity (Continued)

Substantially all of the Company's options granted during the year ended December 31, 2005 vest ratably on each anniversary date over the four years subsequent to grant, and substantially all have a ten year life. Substantially all of the Company's options granted during the years ended December 31, 2006, 2007 and 2008 vest ratably on each anniversary date over the three years subsequent to grant, and substantially all have a ten year life.

At December 31, 2008, 3,278,684 shares of the Company's common stock remain available for future grant under the Company's 2008 MIP. Summarized information relative to the Company's stock options outstanding on December 31, 2008 is as follows:

Range of Exercise Price		Options Outstanding			Options Exercisable		
		Options	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	
\$ 4.44	\$ 34.42	83,825	5.82	\$ 27.98	44,125	\$ 32.09	
\$ 34.57	\$ 34.57	525,781	4.18	\$ 34.57	422,779	\$ 34.57	
\$ 35.79	\$ 38.21	267,410	7.21	\$ 37.23	129,564	\$ 37.33	
\$ 38.52	\$ 38.52	776,766	4.44	\$ 38.52	581,639	\$ 38.52	
\$ 39.07	\$ 40.59	312,069	8.62	\$ 40.15	61,056	\$ 40.12	
\$ 40.63	\$ 40.63	996,901	5.70	\$ 40.63	544,589	\$ 40.63	
\$ 40.64	\$ 41.34	301,717	8.78	\$ 40.92	66,018	\$ 41.02	
\$ 41.47	\$ 41.47	842,888	8.53	\$ 41.47	34,464	\$ 41.47	
\$ 41.55	\$ 46.94	541,032	7.51	\$ 44.71	201,637	\$ 45.34	
\$ 47.22	\$ 48.63	20,101	7.65	\$ 48.18	13,402	\$ 48.18	
		<u>4,668,490</u>	<u>6.53</u>	<u>\$ 39.82</u>	<u>2,099,273</u>	<u>\$ 38.95</u>	

*Option Modification*

On January 3, 2006, the Company amended certain stock options outstanding under the 2003 MIP. The amendments, as further described below, were intended primarily to bring the features of such options into compliance with certain requirements established by Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), which was added to the Code by the American Jobs Creation Act of 2004 and governs as a general matter the federal income tax treatment of deferred compensation. The amended options were originally issued on January 5, 2004 (the "2004 Options"). Because the exercise price of such 2004 Options may be considered to have been less than the fair market value of the shares that may be acquired upon exercise of such options as determined by the market trading in such shares, such options might be subject to the provisions of Section 409A, including certain penalty tax provisions on the option holders.

The amendments in each case reduced the period in which the 2004 Options, once vested, could be exercised from the tenth anniversary of the date of grant to the end of the calendar year in which each option first becomes exercisable. The vesting schedule of the options was not changed and no change was made in the exercise price or other material terms.

## MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

## 7. Stockholders' Equity (Continued)

In addition, the 2004 Options issued to the Company's Chief Executive Officer, Chief Operating Officer and Chief Financial Officer (the "Senior Executives") were also amended to defer until January 5, 2007 the exercisability of all but 137,398 of their options that vested in January 2006. This deferral was agreed upon in connection with the waiver by the Company of the restriction on sale before January 5, 2007 of 413,003 shares held by the Senior Executives, that they had previously acquired upon exercise of a portion of their 2004 Options that vested in January 2005.

In connection with these amendments, the Company agreed to grant new options to option holders, other than the Senior Executives, upon exercise of their 2004 Options. The new options will be in an amount equal to the number of options exercised, will have exercise prices equal to the market price on the date of grant and will vest ratably on each anniversary date over the three years subsequent to grant. In the years ended December 31, 2006, 2007 and 2008, options to purchase 249,455, 233,892 and 345,956 shares, respectively, were granted pursuant to these amendments upon exercise of 2004 Options during these periods.

*Restricted Stock Awards*

During the year ended December 31, 2005, the Company granted shares of restricted stock which vest ratably on each anniversary date over the four years subsequent to grant. During the years ended December 31, 2006, 2007 and 2008, the Company granted shares of restricted stock which generally vest ratably on each anniversary date over the three years subsequent to grant.

Summarized information related to the Company's nonvested restricted stock awards for the years ended December 31, 2006, 2007 and 2008 is as follows:

	2006		2007		2008	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of period	115,257	\$ 34.06	629,234	\$ 42.80	601,384	\$ 43.25
Awarded	550,629	44.06	5,250	44.49	41,190	37.10
Vested	(28,256)	34.05	(31,675)	35.03	(309,494)	43.16
Forfeited	(8,396)	34.57	(1,425)	33.13	(11,145)	32.71
Outstanding, ending of period	<u>629,234</u>	<u>\$ 42.80</u>	<u>601,384</u>	<u>\$ 43.25</u>	<u>321,935</u>	<u>\$ 42.92</u>

On July 31, 2006, pursuant to the Company's purchase of ICORE, the Company granted to the unitholders of ICORE, 543,879 shares of restricted stock of the Company valued at \$24.0 million, which stock will vest over three years, provided that the unitholders do not earlier terminate their employment with the Company. The \$24 million in restricted stock paid at the closing was issued in a transaction pursuant to which the unitholders of ICORE at closing applied \$24 million of the purchase price as cash consideration for their purchase of restricted shares of the Company's common stock. The unitholders subscribed to an aggregate of 543,879 restricted shares of the Company's common stock on a basis proportional to each unitholder's economic interest in ICORE at a purchase price of \$44.13 per share, which was the average of the closing prices of the Company's common stock on NASDAQ for the twenty trading days immediately preceding the closing.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**7. Stockholders' Equity (Continued)**

As of December 31, 2008, there was \$6.1 million of unrecognized stock compensation expense related to nonvested restricted stock awards. This cost is expected to be recognized over a weighted-average period of 0.54 years.

*Restricted Stock Units*

During the years ended December 31, 2006, 2007 and 2008, the Company granted restricted stock units which vest ratably on each anniversary date over the three years subsequent to grant.

Summarized information related to the Company's nonvested restricted stock units for the years ended December 31, 2006, 2007 and 2008 is as follows:

	2006		2007		2008	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Outstanding, beginning of period	—	\$ —	121,032	\$ 40.33	219,736	\$ 40.57
Awarded	121,080	40.33	146,572	40.77	112,874	37.14
Vested	—	—	(38,754)	40.21	(125,371)	40.51
Forfeited	(48)	40.33	(9,114)	42.03	(31,127)	38.85
Outstanding, ending of period	<u>121,032</u>	<u>\$ 40.33</u>	<u>219,736</u>	<u>\$ 40.57</u>	<u>176,112</u>	<u>\$ 38.72</u>

As of December 31, 2008, there was \$2.4 million of unrecognized stock compensation expense related to nonvested restricted stock units. This cost is expected to be recognized over a weighted-average period of 1.61 years.

*Common Stock Warrants*

On January 5, 2004, the Company issued 570,825 warrants to purchase common stock of the Company at a purchase price of \$30.46 per share at anytime until January 5, 2011 ("2004 Warrants"). As of December 31, 2008, 570,183 of these 2004 Warrants remain outstanding. Also on January 5, 2004, the Company entered into a warrant agreement with Aetna whereby Aetna had the option to purchase, between January 1, 2006 and January 5, 2009, 230,000 shares of Ordinary Common Stock at a purchase price of \$10.48 per share. On January 30, 2006, Aetna effected a cashless exercise for all of their warrants, which resulted in 150,815 shares being issued to Aetna.

The following table summarizes the common stock warrants outstanding as of December 31, 2008:

Description	Shares	Exercise Price Per Share	Expiration Date	Approximate Fair Market Value Per Warrant
2004 Warrants	570,183	\$ 30.46	January 5, 2011	\$ 9.44

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**7. Stockholders' Equity (Continued)**

The fair values of the common stock warrants were estimated on the date of their grant/acquisition using the Black-Scholes-Merton option-pricing model based on the following weighted average assumptions:

	<u>2004</u> <u>Warrants</u>
Risk-free interest rate	3.92%
Expected life	7 years
Expected volatility	39.5%
Expected dividend yield	0.0%

*Income per Common Share*

The following table reconciles income (numerator) and shares (denominator) used in the Company's computations of net income per share for the years ended December 31, 2006, 2007 and 2008 (in thousands, except per share amounts):

	<u>2006</u>	<u>2007</u>	<u>2008</u>
<b>Numerator:</b>			
Net income	\$86,262	\$94,158	\$86,205
<b>Denominator:</b>			
Weighted average number of common shares outstanding—basic	36,986	38,942	39,607
Common stock equivalents—stock options	1,446	584	246
Common stock equivalents—warrants	148	168	128
Common stock equivalents—restricted stock	28	104	7
Common stock equivalents—restricted stock units	13	39	11
Weighted average number of common shares outstanding— diluted	<u>38,621</u>	<u>39,837</u>	<u>39,999</u>
Net income per common share—basic	<u>\$ 2.33</u>	<u>\$ 2.42</u>	<u>\$ 2.18</u>
Net income per common share—diluted	<u>\$ 2.23</u>	<u>\$ 2.36</u>	<u>\$ 2.16</u>

The weighted average number of common shares outstanding for the years ended December 31, 2006, 2007 and 2008 was calculated using outstanding shares of the Company's Ordinary Common Stock. Common stock equivalents included in the calculation of diluted weighted average common shares outstanding for the years ended December 31, 2006, 2007 and 2008 represent stock options to purchase shares of the Company's Ordinary Common Stock, restricted stock awards and restricted stock units, stock purchased under the ESPP and shares of Ordinary Common Stock related to certain warrants issued on January 5, 2004.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**7. Stockholders' Equity (Continued)**

*Stock Repurchase*

On July 30, 2008 the Company's board of directors approved a stock repurchase plan which authorizes the Company to purchase up to \$200 million of its outstanding common stock through January 31, 2010. Stock repurchases under the program may be executed through open market repurchases, privately negotiated transactions, accelerated share repurchases or other means. The board of directors authorized management to execute stock repurchase transactions from time to time and in such amounts and via such methods as management deems appropriate. The stock repurchase program may be limited or terminated at any time without prior notice. The Company expects to fund the stock repurchases using cash on hand. From August 1, 2008 through December 31, 2008, the Company repurchased 3,866,505 shares through the stock repurchase plan at an average share price of \$35.18 per share for an aggregate cost of \$136.0 million (excluding broker commissions).

During the period from January 1, 2009 through February 25, 2009, the Company made additional open market purchases of 435,800 shares at an aggregate cost of \$15.6 million, excluding broker commissions and transaction fees.

**8. Income Taxes**

The provision for income taxes related to continuing operations for the years ended December 31, 2006, 2007 and 2008 consisted of the following (in thousands):

	<u>2006</u>	<u>2007</u>	<u>2008</u>
<b>Income taxes currently payable:</b>			
Federal	\$ 5,305	\$ 1,082	\$ 2,365
State	2,420	803	1,853
	<u>7,725</u>	<u>1,885</u>	<u>4,218</u>
<b>Deferred income taxes:</b>			
Federal	50,961	52,614	48,451
State	4,009	4,170	1,369
	<u>54,970</u>	<u>56,784</u>	<u>49,820</u>
	<u>\$62,695</u>	<u>\$58,669</u>	<u>\$54,038</u>

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**8. Income Taxes (Continued)**

A reconciliation of the Company's income tax provision for continuing operations to that computed by applying the statutory federal income tax rate for the years ended December 31, 2006, 2007 and 2008 is as follows (in thousands):

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Income tax provision at federal statutory income tax rate	\$52,120	\$53,616	\$49,085
State income taxes, net of federal income tax benefit	6,429	4,973	3,222
Other—net	4,146	80	1,731
Income tax provision	<u>\$62,695</u>	<u>\$58,669</u>	<u>\$54,038</u>

The Company estimates that it has reportable federal NOLs as of December 31, 2008 of approximately \$114.8 million available to reduce future federal taxable income. These estimated NOLs expire in 2011 through 2020 and are subject to examination and adjustment by the IRS. In addition, the Company's utilization of such NOLs is subject to limitation under Internal Revenue Code Section 382, which affects the timing of the use of these NOLs. At this time, the Company does not believe these limitations will limit the Company's ability to use any federal NOLs before they expire. Although the Company has NOLs that may be available to offset future taxable income, the Company may be subject to Federal Alternative Minimum Tax.

The Company's valuation allowances against deferred tax assets were \$10.2 million and \$9.4 million as of December 31, 2007 and 2008, respectively, mostly relating to uncertainties regarding the eventual realization of certain state NOLs and other state deferred tax assets. Determination of the amount of deferred tax assets considered realizable required significant judgment and estimation. Changes in these estimates in the future could materially affect the Company's financial condition and results of operations.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**8. Income Taxes (Continued)**

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 31, 2007 and 2008 are as follows (in thousands):

	<u>2007</u>	<u>2008</u>
<b>Deferred tax assets:</b>		
Goodwill and intangible assets	\$ 38,922	\$ 29,048
Operating loss carryforwards	85,846	47,891
Stock compensation	11,552	15,533
Risk-share accruals	10,258	18,070
Non-deductible book accruals	23,338	23,939
Refundable tax credits	13,335	15,753
Indirect tax benefits	9,852	11,112
Other	4,848	3,020
Total deferred tax assets	<u>197,951</u>	<u>164,366</u>
Valuation allowance	(10,191)	(9,408)
Deferred tax assets after valuation allowance	<u>187,760</u>	<u>154,958</u>
<b>Deferred tax liabilities:</b>		
Property and depreciation	(21,869)	(20,097)
Total deferred tax liabilities	<u>(21,869)</u>	<u>(20,097)</u>
Net deferred tax assets	<u>\$165,891</u>	<u>\$134,861</u>

The Company periodically performs a comprehensive review of its tax positions and accrues amounts for tax contingencies. Based upon these reviews, the status of ongoing tax audits, and the expiration of applicable statutes of limitations, accruals are adjusted as necessary. The resolution of tax audits is unpredictable and could result in tax liabilities that are significantly different than those which have been estimated and accrued by the Company. Such amounts are included in deferred credits and other long-term liabilities within the accompanying consolidated balance sheets.

A reconciliation of the beginning and ending amount of gross unrecognized tax benefits is as follows:

	<u>2007</u>	<u>2008</u>
Balance as of beginning of period	\$108,323	\$121,040
Additions based on tax positions related to the current year	18,630	10,765
Additions for tax positions of prior years	2,072	3,258
Reductions for tax positions of prior years	(2,126)	(214)
Reductions due to lapses of applicable statutes of limitations	(5,859)	(5,692)
Balance as of end of period	<u>\$121,040</u>	<u>\$129,157</u>

As of December 31, 2007 and 2008, \$118.7 million and \$129.2 million, respectively, of unrecognized tax benefits were included in deferred credits and other long-term liabilities, with the

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**8. Income Taxes (Continued)**

remainder reducing deferred tax assets. If these unrecognized tax benefits had been realized as of December 31, 2007 and 2008, \$22.7 million and \$22.8 million, respectively, would have impacted the effective tax rate.

Included in the balance of unrecognized tax benefits recorded at December 31, 2007 and 2008 were liabilities of \$5.5 million and \$14.1 million, respectively, for tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the deferral of these deductions to later years would not affect the annual effective tax rate but could result in the acceleration of cash payments and/or reduction to the NOL carryforwards with respect to the earlier period.

With few exceptions, the Company is no longer subject to state or local income tax examinations by tax authorities for years ended prior to December 31, 2005. The statute of limitations regarding the assessment of the federal and most state and local income taxes for the year ended December 31, 2005 will expire during 2009. The Company anticipates that up to \$5.4 million of unrecognized tax benefits (excluding interest costs) recorded as of December 31, 2008 could be reversed during 2009 as a result of statute expirations. All such reversals (net of the related indirect tax benefits) would be reflected as discrete adjustments during the quarter in which the respective statute expiration occurs.

Prior to 2009 and in accordance with SOP 90-7, reversals of both valuation allowances and unrecognized tax benefits with respect to years prior to the Company's reorganization were recorded to goodwill. All other reversals of these balances were recorded as reductions to income tax expense. As a result of the implementation of SFAS 141(R), beginning in 2009 all reversals of valuation allowances and unrecognized tax benefits will be reflected as reductions to income tax expense, even if related to years prior to the Company's reorganization.

As of December 31, 2007 and 2008, the Company had accrued approximately \$2.7 million and \$4.2 million, respectively, for the potential payment of interest and penalties (net of indirect benefits). The Company accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. During the years ended December 31, 2006, 2007 and 2008, the Company recognized approximately \$0.6 million, \$1.2 million and \$1.6 million in interest and penalties, excluding \$0.7 million recorded in 2007 as a reduction in retained earnings as a result of implementation of FIN 48.

**9. Supplemental Cash Flow Information**

Supplemental cash flow information for the years ended December 31, 2006, 2007 and 2008 is as follows (in thousands):

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Income taxes paid, net of refunds (received)	<u>\$6,688</u>	<u>\$4,973</u>	<u>\$6,003</u>
Interest paid	<u>\$5,462</u>	<u>\$3,801</u>	<u>\$3,300</u>
Assets acquired through capital leases	<u>\$4,030</u>	<u>\$ 89</u>	<u>\$ 58</u>

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**10. Commitments and Contingencies**

*Insurance*

The Company maintains a program of insurance coverage for a broad range of risks in its business. The Company has renewed its general, professional and managed care liability insurance policies with unaffiliated insurers for a one-year period from June 17, 2008 to June 17, 2009. The general liability policies are written on an "occurrence" basis, subject to a \$0.05 million per claim un-aggregated self-insured retention. The professional liability and managed care errors and omissions liability policies are written on a "claims-made" basis, subject to a \$1.0 million per claim (\$10.0 million per class action claim) un-aggregated self-insured retention for managed care liability, and a \$0.05 million per claim un-aggregated self-insured retention for professional liability.

The Company maintains separate general and professional liability insurance policies with an unaffiliated insurer for its Specialty Pharmaceutical Management business. The Specialty Pharmaceutical Management insurance policies have a one-year term for the period June 17, 2008 to June 17, 2009. The general liability policies are written on an "occurrence" basis, subject to a \$0.05 million per claim un-aggregated self-insured retention. The professional liability policy is written on a "claims-made" basis, subject to a \$0.05 million per claim un-aggregated self-insured retention.

The Company maintains separate general and professional liability insurance policies with an unaffiliated insurer for its Maricopa Contract business, which include coverage for the behavioral health direct care facilities. The Maricopa Contract insurance policies have a one-year term for the period September 1, 2008 to September 1, 2009. The general liability policies are written on an "occurrence" basis, subject to a \$0.35 million per claim un-aggregated self-insured retention. The professional liability policy is written on a "claims-made" basis, subject to a \$0.35 million per claim un-aggregated self-insured retention.

The Company is responsible for claims within its self-insured retentions, and for portions of claims reported after the expiration date of the policies if they are not renewed, or if policy limits are exceeded. The Company also purchases excess liability coverage in an amount that management believes to be reasonable for the size and profile of the organization.

*Regulatory Issues*

The specialty managed healthcare industry is subject to numerous laws and regulations. The subjects of such laws and regulations cover, but are not limited to, matters such as licensure, accreditation, government healthcare program participation requirements, information privacy and security, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Over the past several years, 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 organizations and insurers. 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. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**10. Commitments and Contingencies (Continued)**

In addition, regulators of certain of the Company's subsidiaries may exercise certain discretionary rights under regulations including increasing its supervision of such entities, requiring additional restricted cash or other security or seizing or otherwise taking control of the assets and operations of such subsidiaries.

*Legal*

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

*Operating Leases*

The Company leases certain of its operating facilities and equipment. The leases, which expire at various dates through August 2015, generally require the Company to pay all maintenance, property tax and insurance costs.

At December 31, 2008, aggregate amounts of future minimum payments under operating leases were as follows: 2009—\$19.7 million; 2010—\$15.4 million; 2011—\$9.5 million; 2012—\$6.1 million; 2013—\$1.8 million; 2014 and beyond—\$0.9 million. Operating lease obligations include estimated future lease payments for both open and closed offices.

At December 31, 2008, aggregate amounts of future minimum rentals to be received under operating subleases were as follows: 2009—\$2.3 million; and 2010—\$0.8 million. Operating sublease rentals to be received relate primarily to behavioral health direct care facilities transitioned to PNOs pursuant to the Maricopa Contract.

Rent expense is recognized on a straight-line basis over the terms of the leases. Rent expense was \$15.7 million, \$19.3 million and \$24.3 million for the years ended December 31, 2006, 2007 and 2008, respectively.

**11. Certain Relationships and Related Party Transactions**

Allen Wise, a former Director of the Company, served as the Chairman of Coventry Healthcare, Inc. The Company has a behavioral health services agreement with a subsidiary of

## MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

**11. Certain Relationships and Related Party Transactions (Continued)**

Coventry under which the Company derived revenues of approximately \$2.3 million and \$2.4 million during the years ended December 31, 2007 and 2008, respectively. On February 25, 2009, Allen Wise resigned from the board of directors of the Company as a result of his appointment as Chief Executive Officer of Coventry Healthcare, Inc. William McBride, a Director of the Company serves as a member of the board of directors of AmeriGroup Corporation. The Company has a radiology benefits management agreement with a subsidiary of AmeriGroup under which the Company derived revenues of approximately \$0.4 million in 2008.

**12. Business Segment Information**

The accounting policies of the Company's segments are the same as those described in Note 1—"General." The Company evaluates performance of its segments based on profit or loss from continuing operations before stock compensation expense, depreciation and amortization, interest expense, interest income, gain on sale of assets, special charges or benefits, income taxes and minority interest ("Segment Profit"). Management uses Segment Profit information for internal reporting and control purposes and considers it important in making decisions regarding the allocation of capital and other resources, risk assessment and employee compensation, among other matters. Intersegment sales and transfers are not significant. The following tables summarize, for the periods indicated, operating results by business segment (in thousands):

	Commercial	Public Sector	Radiology Benefits Management	Specialty Pharmaceutical Management	Corporate and Other	Consolidated
<b>Year Ended December 31, 2006</b>						
Net revenue	\$ 784,768	\$ 808,657	\$ 41,617	\$ 55,228	\$ —	\$ 1,690,270
Cost of care	(392,066)	(689,014)	—	—	—	(1,081,080)
Cost of goods sold	—	—	—	(41,809)	—	(41,809)
Direct service costs	(173,704)	(36,321)	(40,136)	(7,437)	—	(257,598)
Other operating expenses	—	—	—	—	(127,880)	(127,880)
Equity in earnings of unconsolidated subsidiaries	390	—	—	—	—	390
Stock compensation expense(1)	1,595	647	3,739	3,577	24,433	33,991
Segment profit (loss)	<u>\$ 220,983</u>	<u>\$ 83,969</u>	<u>\$ 5,220</u>	<u>\$ 9,559</u>	<u>\$(103,447)</u>	<u>\$ 216,284</u>
Identifiable assets by business segment(2)						
Restricted cash	\$ 29,721	\$ 108,555	\$ —	\$ —	\$ 2,756	\$ 141,032
Net accounts receivable	28,040	16,396	494	25,348	162	70,440
Investments	5,218	21,757	—	—	28,550	55,525
Goodwill	127,242	—	104,863	142,276	—	374,381

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

(2) Identifiable assets by business segment are those assets that are used in the operations of each segment. The remainder of the Company's assets cannot be specifically identified by segment.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**12. Business Segment Information (Continued)**

	<u>Commercial</u>	<u>Public Sector</u>	<u>Radiology Benefits Management</u>	<u>Specialty Pharmaceutical Management</u>	<u>Corporate and Other</u>	<u>Consolidated</u>
<b>Year Ended December 31, 2007</b>						
Net revenue	\$ 784,533	\$ 1,020,839	\$ 170,240	\$ 180,341	\$ —	\$ 2,155,953
Cost of care	(392,325)	(902,594)	(114,184)	—	—	(1,409,103)
Cost of goods sold	—	—	—	(149,585)	—	(149,585)
Direct service costs	(163,800)	(51,922)	(48,841)	(21,529)	—	(286,092)
Other operating expenses	—	—	—	—	(117,911)	(117,911)
Stock compensation expense(1)	2,277	1,172	1,708	8,769	16,068	29,994
Segment profit (loss)	<u>\$ 230,685</u>	<u>\$ 67,495</u>	<u>\$ 8,923</u>	<u>\$ 17,996</u>	<u>\$(101,843)</u>	<u>\$ 223,256</u>
Identifiable assets by business segment(2)						
Restricted cash	\$ 35,838	\$ 213,400	\$ —	\$ —	\$ 3,525	\$ 252,763
Net accounts receivable	19,579	19,384	3,927	22,888	578	66,356
Investments	5,309	7,506	—	—	43,760	56,575
Goodwill	121,032	—	104,459	142,291	—	367,782
	<u>Commercial</u>	<u>Public Sector</u>	<u>Radiology Benefits Management</u>	<u>Specialty Pharmaceutical Management</u>	<u>Corporate and Other</u>	<u>Consolidated</u>
<b>Year Ended December 31, 2008</b>						
Net revenue	\$ 649,636	\$ 1,451,923	\$ 295,336	\$ 228,499	\$ —	\$ 2,625,394
Cost of care	(344,761)	(1,278,316)	(207,465)	—	—	(1,830,542)
Cost of goods sold	—	—	—	(181,356)	—	(181,356)
Direct service costs	(154,894)	(68,914)	(54,482)	(25,623)	—	(303,913)
Other operating expenses	—	—	—	—	(122,714)	(122,714)
Stock compensation expense(1)	1,368	839	1,472	8,967	20,117	32,763
Segment profit (loss)	<u>\$ 151,349</u>	<u>\$ 105,532</u>	<u>\$ 34,861</u>	<u>\$ 30,487</u>	<u>\$(102,597)</u>	<u>\$ 219,632</u>
Identifiable assets by business segment(2)						
Restricted cash	\$ 13,649	\$ 171,513	\$ 3,268	\$ —	\$ 3,965	\$ 192,395
Net accounts receivable	22,544	19,764	7,226	31,108	1,434	82,076
Investments	28,990	88,347	10,413	—	106,149	233,899
Goodwill	120,485	—	104,549	142,291	—	367,325

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

(2) Identifiable assets by business segment are those assets that are used in the operations of each segment. The remainder of the Company's assets cannot be specifically identified by segment.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**12. Business Segment Information (Continued)**

The following table reconciles Segment Profit to consolidated income from continuing operations before income taxes and minority interest for the years ended December 31, 2006, 2007 and 2008 (in thousands):

	<u>2006</u>	<u>2007</u>	<u>2008</u>
Segment Profit	\$216,284	\$223,256	\$219,632
Stock compensation expense	(33,991)	(29,994)	(32,763)
Depreciation and amortization	(48,862)	(57,524)	(60,810)
Interest expense	(7,292)	(6,386)	(2,846)
Interest income	17,628	23,836	17,030
Gain on sale of assets	5,148	—	—
Income from continuing operations before income taxes and minority interest	<u>\$148,915</u>	<u>\$153,188</u>	<u>\$140,243</u>

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**13. Selected Quarterly Financial Data (Unaudited)**

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2007 and 2008 (in thousands, except per share amounts):

	For the Quarter Ended			
	March 31, 2007	June 30, 2007	September 30, 2007	December 31, 2007
<b>Fiscal Year Ended December 31, 2007</b>				
Net revenue	\$ 487,004	\$ 452,868	\$ 558,076	\$ 658,005
Cost and expenses:				
Cost of care	308,819	279,218	369,008	452,058
Cost of goods sold	34,117	36,594	37,341	41,533
Direct service costs and other operating expenses(1)	97,875	98,139	102,468	105,521
Depreciation and amortization	13,652	13,505	14,393	15,974
Interest expense	1,852	1,604	1,571	1,359
Interest income	(5,187)	(5,519)	(6,434)	(6,696)
	<u>451,128</u>	<u>423,541</u>	<u>518,347</u>	<u>609,749</u>
Income from continuing operations before income taxes and minority interest	35,876	29,327	39,729	48,256
Provision for income taxes	14,907	12,311	14,712	16,739
Income from continuing operations before minority interest	20,969	17,016	25,017	31,517
Minority interest, net	—	192	(47)	216
Net income	<u>\$ 20,969</u>	<u>\$ 16,824</u>	<u>\$ 25,064</u>	<u>\$ 31,301</u>
Weighted average number of common shares outstanding—basic	<u>38,231</u>	<u>38,842</u>	<u>39,193</u>	<u>39,485</u>
Weighted average number of common shares outstanding—diluted	<u>39,264</u>	<u>39,838</u>	<u>39,849</u>	<u>40,380</u>
Net income per common share—basic:	<u>\$ 0.55</u>	<u>\$ 0.43</u>	<u>\$ 0.64</u>	<u>\$ 0.79</u>
Net income per common share—diluted:	<u>\$ 0.53</u>	<u>\$ 0.42</u>	<u>\$ 0.63</u>	<u>\$ 0.78</u>

(1) Includes stock compensation expense of \$6,787, \$7,703, \$8,172 and \$7,332 for the quarters ended March 31, June 30, September 30, and December 31, 2007, respectively.

**MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2008**

**13. Selected Quarterly Financial Data (Unaudited) (Continued)**

	For the Quarter Ended			
	March 31, 2008	June 30, 2008	September 30, 2008	December 31, 2008
<b>Fiscal Year Ended December 31, 2008</b>				
Net revenue	\$ 650,290	\$ 656,858	\$ 656,462	\$ 661,784
Cost and expenses:				
Cost of care	454,074	458,090	456,584	461,794
Cost of goods sold	46,824	43,413	44,281	46,838
Direct service costs and other operating expenses(2)	109,748	106,483	105,879	104,517
Depreciation and amortization	14,374	14,523	16,086	15,827
Interest expense	1,215	1,017	592	22
Interest income	(5,493)	(3,716)	(4,127)	(3,694)
	<u>620,742</u>	<u>619,810</u>	<u>619,295</u>	<u>625,304</u>
Income from continuing operations before income taxes and minority interest	29,548	37,048	37,167	36,480
Provision for income taxes	12,303	15,101	13,738	12,896
Income from continuing operations before minority interest	17,245	21,947	23,429	23,584
Minority interest, net	1	59	(60)	—
Net income	<u>\$ 17,244</u>	<u>\$ 21,888</u>	<u>\$ 23,489</u>	<u>\$ 23,584</u>
Weighted average number of common shares outstanding—basic	<u>39,736</u>	<u>39,961</u>	<u>40,272</u>	<u>38,464</u>
Weighted average number of common shares outstanding—diluted	<u>40,340</u>	<u>40,307</u>	<u>40,722</u>	<u>38,631</u>
Income per common share—basic:				
Net income per common share—basic:	<u>\$ 0.43</u>	<u>\$ 0.55</u>	<u>\$ 0.58</u>	<u>\$ 0.61</u>
Net income per common share—diluted:	<u>\$ 0.43</u>	<u>\$ 0.54</u>	<u>\$ 0.58</u>	<u>\$ 0.61</u>

(1) Includes stock compensation expense of \$6,787, \$7,703, \$8,172 and \$7,332 for the quarters ended March 31, June 30, September 30, and December 31, 2007, respectively.

(2) Includes stock compensation expense of \$12,018, \$6,499, \$7,832 and \$6,414 for the quarters ended March 31, June 30, September 30, and December 31, 2008, respectively.

## MAGELLAN HEALTH SERVICES, INC.

## SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS

(In thousands)

<u>Classification</u>	<u>Balance at Beginning of Period</u>	<u>Charged to Costs and Expenses</u>	<u>Charged to Other Accounts</u>	<u>Addition</u>	<u>Deduction</u>	<u>Balance at End of Period</u>
<b>Year ended December 31, 2006:</b>						
Allowance for doubtful accounts	\$ 2,442	\$ 296(3)	\$(1,043)(1)	\$ —	\$ (193)	\$ 1,502 (2)
<b>Year Ended December 31, 2007</b>						
Allowance for doubtful accounts	1,502	217(3)	(588)(1)	261(4)	(75)	1,317 (2)
<b>Year Ended December 31, 2008</b>						
Allowance for doubtful accounts	1,317	891(3)	(273)(1)	—	(20)	1,915 (2)

- 
- (1) Recoveries of accounts receivable previously written off.
- (2) Accounts written off.
- (3) Bad debt expense.
- (4) To establish a reserve on pre-acquisition balances of ICORE Healthcare, LLC.



**AMENDMENT TO EMPLOYMENT AGREEMENT  
(For Compliance with Requirements of Code Section 409A)**

This **Amendment to Employment Agreement** between Magellan Health Services, Inc. (“Employer”) and Jeffrey West (“Employee”) entered into as of this 1st day of December, 2008.

**WHEREAS**, Employer and Employee desire to amend the terms of the Employment Agreement, as amended, currently in effect between Employer and Employee (the “Employment Agreement”).

**NOW THEREFORE**, Employer or Employee agree that the Employment Agreement is hereby amended as follows:

1. **Reorganization of Sections of Employment Agreement.** Section 10 of the Employment Agreement (“Governing Law”) is moved to become the fifth to last Section of the Employment Agreement, and renumbered accordingly, with the four final Sections renumbered appropriately.

2. **New Section of Employment Agreement.** The following new text is inserted as Section 10 of the Employment Agreement:

10 **Special Rules for Compliance with Code Section 409A.** This Section 10 serves to ensure compliance with applicable requirements of Section 409A of the Internal Revenue Code (the “Code”). Certain provisions of this Section 10 modify other provisions of this Employment Agreement. If the terms of this Section 10 conflict with other terms of the Employment Agreement, the terms of this Section 10 control.

(a) **Timing of Certain Payments.** Payments and benefits specified under this Employment Agreement shall be paid at the times specified as follows:

- (i) **Accrued Payments at Termination.** Sections 6(a) — (d) of this Employment Agreement and Section I.1(ii) of the Amendment to the Employment Agreement relating to Change in Control ( the “CiC Amendment”) require payment of amounts earned but unpaid, or accrued, at the date of Employee’s termination. Unless the amount is payable under an applicable plan, program or arrangement on explicit terms providing for a delay in payment compliant with Code Section 409A, these amounts shall be payable at the date the amounts otherwise would have been payable under the applicable plans, programs and arrangements in the absence of termination but in no event more than thirty (30) days after Employee’s termination of employment, subject to 10(d).
- (ii) **Gross-Up.** Gross-up payments payable under the CiC Amendment will be paid as promptly as practicable after the excise tax is payable by Employee,

---

and in any event must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee remits the excise tax or related taxes to the taxing authorities; provided, however, that any gross-up payment will be subject to Section 10(d) if applicable under Section 409A.

- (iii) **Expense Reimbursements.** Any payment under Section 5 or otherwise as an expense reimbursement hereunder must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee incurred the reimbursable expense.
  - (iv) **Other Payments.** Any other payment or benefit required under this Employment Agreement to be paid in a lump sum or otherwise to be paid promptly at or following a date or event shall be paid within five (5) days after the due date, subject to Section 10(b), (c) and (d) below.
  - (v) **No Influence on Year of Payment.** In the case of any payment under the Employment Agreement payable during a specified period of time following a termination or other event (including any payment for which the permitted payment period begins in one calendar year and ends in a subsequent calendar year), Employee shall have no right to elect in which year the payment will be made, and the Company’s determination of when to make the payment shall not be influenced in any way by Employee.
- (b) **Special Rules for Severance Payments.** In the case of payments in the nature of continuation of payments under Section 4(a) required under Section 6(c) (“Pre-CiC Severance Payments”) and severance payable under Section I.1(iii) of the CiC Amendment (the “CiC Severance Payments” and, with the Pre-CiC Severance Payment, the “Severance Payments”), the following rules will apply:
- (i) **Separate Payments.** Each monthly installment of the Pre-CiC Severance Payments shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A. The portion of the CiC Severance Payments that exceeds the Pre-CiC Severance Payments (or the present value thereof, if such present valuing is required to comply with Section 409A), and the portion attributable to inclusion of Target Bonus in the calculation of CiC Severance Payments (or, if so required, the present value thereof) as compared to Pre-CiC Severance Payments, shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A (the “Separate Lump Sum”).
  - (ii) **Severance Payment Timing Rules.** Each installment of Pre-CiC Severance Payments shall be treated as follows for purposes of Section 409A:
    - (A) Installments payable during the year of termination and by March 15 of the year following termination shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation §

- (B) Installments payable during the period within six (6) months after termination, to the extent not covered by Section 10(b)(ii)(A), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii);
- (C) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B), installments payable as Pre-CiC Severance Payments shall be excluded, to the maximum extent possible, by such “two-years/two-times” exclusion (applied in the reverse order of payment of the installments — that is, to the latest installments first); and
- (D) All installments of the Pre-CiC Severance Payment not covered by Section 10(b)(ii)(A), (B) and (C) shall be paid at the applicable installment payment date in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule of Section 10(d).

The portions of the CiC Severance Payments that correspond to the Pre-CiC Severance Payments (that is, deemed to be the same payment for purposes of Section 409A) shall be governed by Section 10(b)(ii)(A) — (D) above, provided that amounts of the CiC Severance Payments corresponding to Pre-CiC Severance Payments covered by Section 10(b)(ii)(A), (B), and (C) above shall be payable as a lump sum within five (5) days after termination of employment. The Separate Lump Sum shall be treated as follows for purposes of Section 409A:

- (E) The Separate Lump Sum shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation § 1.409A-1(b)(4);
- (F) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B) and (C), the Separate Lump Sum, to the extent not covered by Section 10(b)(ii)(E), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion; and
- (G) Any portion of the Separate Lump Sum not covered by Section 10(b)(ii)(E) and (F) shall be paid within five (5) days after the qualifying termination of employment in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule and other provisions of Section 10(d) and except to the extent that the Separate Lump Sum is not deemed to be a valid separate payment from amounts governed by Section 10(b)(ii)(D).

Any portions of the CiC Severance Payments corresponding to Pre-CiC Severance Payments governed by Section 10(b)(ii)(D) shall be payable,

3

---

subject to Section 10(d), in a lump sum within five (5) days after the qualifying termination of employment if such termination has occurred within two years following a a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(10) (a “409A Change in Control”), and in any other case shall be payable at the applicable time under Section 10(b)(ii)(D).

- (c) Special Rules for Other Payments. With respect to amounts payable under Section I.1(ii) of the CiC Amendment (relating to incentive awards), the following rules will apply:
  - (i) Separate Payments. The amounts payable thereunder shall each be deemed to be a separate payment for all purposes, including for purposes of Section 409A (subject to any further designation of separate payments explicitly made in any separately identifiable plan or arrangement for purposes of Section 409A).
  - (ii) Payment Timing Rules. A payment referenced in Section 10(c)(i) shall be payable as a lump-sum payment within five (5) days after termination of employment if and to the extent that (A) the separate payment constitutes short-term deferral under Treasury Regulation § 1.409A-1(b)(4), (B) the amount of the separate payment not covered by Section 10(c)(ii)(A) can be paid under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii), after first applying such exclusion under Section 10(b)(ii), (C) the separate payment is covered by any other applicable exclusion or exemption under Treasury Regulation § 1.409A-1(b)(9) (provided that the exclusion under subsection (b)(9)(v)(D) shall be used only to the extent not relied upon for other payments or benefits) and (D), the six-month delay rule in Section 10(d) does not apply to the separate payment (except as otherwise provided in Section 10(c)(iii)). Any other such separate payment (i.e., amounts subject to the six-month delay rule) shall be subject to the six-month delay rule of Section 10(d), subject to Section 10(c)(iii). Any delay in payment under the six-month delay rule shall not limit Employee’s rights under this Employment Agreement to not forfeit a specified item of compensation as a result of Employee’s termination.
  - (iii) Payments of 409A Deferrals For a Termination Not Within Two Years After a 409A Change in Control. If a payment referenced in Section 10(c)(ii) is a direct payment or a substitute or replacement for a right to payment (the “Original Payment Right”) that constitutes a deferral of compensation under Section 409A, and if either (A) the Change in Control does not involve a 409A Change in Control, or (B) Employee’s termination triggering payments hereunder did not occur within the two-year period following a 409A Change in Control, then such payments (i.e., payments that constitute deferrals under

4

---

Section 409A) must be paid at the times and in the form applicable to a separation from service under the terms of the Original Payment Right, subject to Section 10(d). If in no circumstances was such payment payable upon a separation from service under the Original Payment Right, then this Section 10(c)(iii) shall not apply.

- (d) Six-Month Delay Rule.

- (i) **General Rule.** The six-month delay rule will apply to payments and benefits under the Employment Agreement if all of the following conditions are met:
- (A) Employee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (10) thereof) for the year in which the termination occurs. The Company will determine status of “key employees” annually, under administrative procedures applicable to all Section 409A plans and arrangements and applied in accordance with Treasury Regulation § 1.409A-1(i).
  - (B) The Company’s stock is publicly traded on an established securities market or otherwise.
  - (C) The payment or benefit in question is a deferral of compensation and not excepted, exempted or excluded from being such by the short-term deferral rule, or the “two-years/two-times” rule in Treasury Regulation § 1.409A-1(b)(9)(iii), or any other exception, exemption or exclusion; provided, however, that the exclusion under Treasury Regulation § 1.409A-1(b)(9)(v)(D) shall apply only if and to the extent that it is not necessary to apply to any other payment or benefit payable within six (6) months after Employee’s termination.
- (ii) **Effect of Rule.** If it applies, the six-month delay rule will delay a payment or benefit which otherwise would be payable under this Employment Agreement within six (6) months after Employee’s separation from service.
- (A) Any delayed payment or benefit shall be paid on the date six (6) months after Employee’s separation from service.
  - (B) During the six-month delay period, accelerated payment will occur in the event of the Employee’s death but not for any other reason (including no acceleration upon a Change in Control), except for accelerations expressly permitted under Treasury Regulation § 1.409A-1 — A-6.
  - (C) Any payment that is not triggered by a termination, or is triggered by a termination but would be made more than six (6) months after the termination (without applying this six-month delay rule), or would be payable at a fixed date not tied to termination that is earlier than the

5

---

expiration of the six-month delay period, shall be unaffected by the six-month delay rule.

- (iii) **Limit to Application of Six-Month Delay Rule.** If the terms of this Employment Agreement or other plan or arrangement or document relating to this Employment Agreement or payments hereunder impose this six-month delay rule in circumstances in which it is not required for compliance with Section 409A, those terms shall not be given effect.
- (e) **Other Provisions.**
- (i) **Good Reason.** The definition of “Good Reason” under the Employment Agreement, and related rules governing constructive termination not for cause, is intended to qualify as an “involuntary separation” within the meaning of Treasury Regulation § 1.409A-1(n)(2)(i), and shall be so construed and interpreted.
  - (ii) **Non-transferability.** No right to any payment or benefit under this Employment Agreement shall be subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by Employee’s creditors or of any of Employee’s beneficiaries.
  - (iii) **No Acceleration.** The timing of payments and benefits under the Employment Agreement which constitute a deferral of compensation under Code Section 409A may not be accelerated to occur before the time specified for payment hereunder, except to the extent permitted under Treasury Regulation § 1.409A-3(j)(4) or as otherwise permitted under Code Section 409A without Employee incurring a tax penalty.
  - (iv) **Timing Relating to Release.** Other provisions of this Employment Agreement (including this Section 10) notwithstanding, if Employee is obligated to execute a release, non-competition, or other agreement as a condition to receipt of a payment hereunder, the Company will supply to Employee a form of such release or other document not later than the date of Employee’s termination, which must be returned within the time period required by law and must not be revoked by Employee within the applicable time period in order for Employee to satisfy any such condition, such that it becomes legally effective. If any amount payable during a fixed period following Employee’s termination is subject to a requirement or condition requiring Employee’s execution of a release (including any case in which such fixed period would begin in one year and end in the next), the Company, in determining the time of payment of any such amount, will not be influenced by Employee or the timing of any action by Employee including execution of such a release or other document and expiration of any revocation period. In particular, the Company will be entitled in its discretion to deposit any payment hereunder in escrow at any time during such fixed period, so that such deposited amount is

6

---

constructively received and taxable income to Employee upon deposit (it may be constructively received even in the absence of such deposit) but with distribution from such escrow remaining subject to Employee’s execution and non-revocation of such release or other document.

- (v) **Definition of Termination of Employment.** For purposes of this Employment Agreement, the term “termination of employment” shall mean a separation from service as defined in Treasury Regulation § 1.409A-1(h); provided, however, that if a date for termination of employment is designated by the Company but Employee has a separation from service prior to such designated date, the designated termination date shall be deemed the date of termination for any compensation payable under this Agreement that would fully qualify for the short-term deferral exception under Treasury Regulation § 1.409A-1(b)(4) and/or the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) under both circumstances (i.e., assuming the separation from service date was the termination date hereunder or that the designated termination of employment date was the termination date hereunder), then for that purpose the termination of employment date shall be the designated termination date.

(vi) References to Other Plans. References in the Employment Agreement to the obligation of the Company to pay amounts under other plans, including Employee's vested portion of any Magellan deferred compensation or other benefit plan, shall not be construed to modify the timing of payment, which shall be governed by such other plans.

3. **Modification to Section 6.** The provisions of Section 6(c) are hereby amended as follows:

After the initial instance of clause (ii) in Section 6(c), before the period, insert the following:

provided that, in such case, Employee shall have given notice to the Company that the event or condition referred to in clause (i) or (ii) has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company, and Employee has terminated employment for that reason within eighteen (18) months after such uncured event or condition has arisen.

The provisions of Section I.2(C) of the CiC Amendment setting forth the definition of "Good Reason" are hereby amended as follows:

In clause (i), the term "reduction in Employee's salary" is replaced by the term "material reduction in Employee's salary", and the term "reduction in Employee's target bonus opportunity" is replaced by the term "material reduction in Employee's target

7

bonus opportunity", and at the end of clause (i) before the semicolon the following text is inserted:

provided, however, that a reduction in salary and/or target bonus opportunity with an annualized value of one and one half percent (1.5%) of Employee's then current annual base pay or more in the aggregate, taking into account any related effect a salary reduction has on target bonus and other components of compensation, shall be deemed material;

The final proviso of Section I.2(C) of the CiC Amendment is deleted and in its stead is inserted the following:

provided that, in each such case, Employee shall have given notice to the Company that such event or condition has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company, and Employee has terminated employment for Good Reason within eighteen (18) months after such uncured event or condition has arisen.

4. **Other Amendments.** Other provisions of the Employment Agreement are amended as follows:

A new sentence is added as the second to last sentence of Section 1, stating:

Non-renewal of this Agreement by either party will in all cases result in termination of employment at the non-renewal date.

A new sentence is added at the end of Section 4(a), stating:

Annual bonus, if any, will be determined and paid (unless validly deferred if then permitted by the Company) between January 1 and March 15 of the year following the performance year.

A clause is inserted before the period at the end of Section 5, stating:

subject to Section 10(a)(iii).

In the preamble to Section I.1 of the CiC Amendment, before the colon insert ", in each case subject to Section 10".

A new sentence is added at the end of Section 4(b), as follows:

Any continued medical coverage following termination of employment, to the extent provided under Section 6 or any other provision of this Agreement, if and to the extent such medical coverage (or the Company's contributions or

8

reimbursement of such coverage) represents taxable income to Employee, is intended to qualify as excluded from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(v)(B), and the rights to such coverage shall be limited to the extent necessary to qualify thereunder.

5. Nothing in this Amendment shall be construed to increase or enhance the compensation or benefits payable under the Agreement. The sole purpose of this Amendment is to add limitations required under Code Section 409A so that payments and benefits otherwise provided under the Agreement are not subject to tax penalties and other adverse consequences under Section 409A.

This amendment to Employment Agreement is entered into by the parties as of the date first above written.

Magellan Health Services, Inc.

Employee:

By:

/s/ Jeffrey West



---

Duly Authorized

---

Jeffrey West

**AMENDMENT TO EMPLOYMENT AGREEMENT  
(For Compliance with Requirements of Code Section 409A)**

This **Amendment to Employment Agreement** between Magellan Health Services, Inc. (“Employer”) and Tina Blasi (“Employee”) entered into as of this 1st day of December, 2008.

**WHEREAS**, Employer and Employee desire to amend the terms of the Employment Agreement, as amended, currently in effect between Employer and Employee (the “Employment Agreement”).

**NOW THEREFORE**, Employer or Employee agree that the Employment Agreement is hereby amended as follows:

1. **Reorganization of Sections of Employment Agreement.** Section 10 of the Employment Agreement (“Governing Law”) is moved to become the fifth to last Section of the Employment Agreement, and renumbered accordingly, with the four final Sections renumbered appropriately.

2. **New Section of Employment Agreement.** The following new text is inserted as Section 10 of the Employment Agreement:

10 **Special Rules for Compliance with Code Section 409A.** This Section 10 serves to ensure compliance with applicable requirements of Section 409A of the Internal Revenue Code (the “Code”). Certain provisions of this Section 10 modify other provisions of this Employment Agreement. If the terms of this Section 10 conflict with other terms of the Employment Agreement, the terms of this Section 10 control.

(a) **Timing of Certain Payments.** Payments and benefits specified under this Employment Agreement shall be paid at the times specified as follows:

- (i) **Accrued Payments at Termination.** Sections 6(a) — (d) of this Employment Agreement and Section I.1(ii) of the Amendment to the Employment Agreement relating to Change in Control ( the “CiC Amendment”) require payment of amounts earned but unpaid, or accrued, at the date of Employee’s termination. Unless the amount is payable under an applicable plan, program or arrangement on explicit terms providing for a delay in payment compliant with Code Section 409A, these amounts shall be payable at the date the amounts otherwise would have been payable under the applicable plans, programs and arrangements in the absence of termination but in no event more than thirty (30) days after Employee’s termination of employment, subject to 10(d).
- (ii) **Gross-Up.** Gross-up payments payable under the CiC Amendment will be paid as promptly as practicable after the excise tax is payable by Employee,

---

and in any event must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee remits the excise tax or related taxes to the taxing authorities; provided, however, that any gross-up payment will be subject to Section 10(d) if applicable under Section 409A.

- (iii) **Expense Reimbursements.** Any payment under Section 5 or otherwise as an expense reimbursement hereunder must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee incurred the reimbursable expense.
  - (iv) **Other Payments.** Any other payment or benefit required under this Employment Agreement to be paid in a lump sum or otherwise to be paid promptly at or following a date or event shall be paid within five (5) days after the due date, subject to Section 10(b), (c) and (d) below.
  - (v) **No Influence on Year of Payment.** In the case of any payment under the Employment Agreement payable during a specified period of time following a termination or other event (including any payment for which the permitted payment period begins in one calendar year and ends in a subsequent calendar year), Employee shall have no right to elect in which year the payment will be made, and the Company’s determination of when to make the payment shall not be influenced in any way by Employee.
- (b) **Special Rules for Severance Payments.** In the case of payments in the nature of continuation of payments under Section 4(a) required under Section 6(c) (“Pre-CiC Severance Payments”) and severance payable under Section I.1(iii) of the CiC Amendment (the “CiC Severance Payments” and, with the Pre-CiC Severance Payment, the “Severance Payments”), the following rules will apply:
- (i) **Separate Payments.** Each monthly installment of the Pre-CiC Severance Payments shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A. The portion of the CiC Severance Payments that exceeds the Pre-CiC Severance Payments (or the present value thereof, if such present valuing is required to comply with Section 409A), and the portion attributable to inclusion of Target Bonus in the calculation of CiC Severance Payments (or, if so required, the present value thereof) as compared to Pre-CiC Severance Payments, shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A (the “Separate Lump Sum”).
  - (ii) **Severance Payment Timing Rules.** Each installment of Pre-CiC Severance Payments shall be treated as follows for purposes of Section 409A:
    - (A) Installments payable during the year of termination and by March 15 of the year following termination shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation §

- (B) Installments payable during the period within six (6) months after termination, to the extent not covered by Section 10(b)(ii)(A), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii);
- (C) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B), installments payable as Pre-CiC Severance Payments shall be excluded, to the maximum extent possible, by such “two-years/two-times” exclusion (applied in the reverse order of payment of the installments — that is, to the latest installments first); and
- (D) All installments of the Pre-CiC Severance Payment not covered by Section 10(b)(ii)(A), (B) and (C) shall be paid at the applicable installment payment date in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule of Section 10(d).

The portions of the CiC Severance Payments that correspond to the Pre-CiC Severance Payments (that is, deemed to be the same payment for purposes of Section 409A) shall be governed by Section 10(b)(ii)(A) — (D) above, provided that amounts of the CiC Severance Payments corresponding to Pre-CiC Severance Payments covered by Section 10(b)(ii)(A), (B), and (C) above shall be payable as a lump sum within five (5) days after termination of employment. The Separate Lump Sum shall be treated as follows for purposes of Section 409A:

- (E) The Separate Lump Sum shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation § 1.409A-1(b)(4);
- (F) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B) and (C), the Separate Lump Sum, to the extent not covered by Section 10(b)(ii)(E), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion; and
- (G) Any portion of the Separate Lump Sum not covered by Section 10(b)(ii)(E) and (F) shall be paid within five (5) days after the qualifying termination of employment in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule and other provisions of Section 10(d) and except to the extent that the Separate Lump Sum is not deemed to be a valid separate payment from amounts governed by Section 10(b)(ii)(D).

Any portions of the CiC Severance Payments corresponding to Pre-CiC Severance Payments governed by Section 10(b)(ii)(D) shall be payable,

3

---

subject to Section 10(d), in a lump sum within five (5) days after the qualifying termination of employment if such termination has occurred within two years following a a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(10) (a “409A Change in Control”), and in any other case shall be payable at the applicable time under Section 10(b)(ii)(D).

- (c) Special Rules for Other Payments. With respect to amounts payable under Section I.1(ii) of the CiC Amendment (relating to incentive awards), the following rules will apply:
  - (i) Separate Payments. The amounts payable thereunder shall each be deemed to be a separate payment for all purposes, including for purposes of Section 409A (subject to any further designation of separate payments explicitly made in any separately identifiable plan or arrangement for purposes of Section 409A).
  - (ii) Payment Timing Rules. A payment referenced in Section 10(c)(i) shall be payable as a lump-sum payment within five (5) days after termination of employment if and to the extent that (A) the separate payment constitutes short-term deferral under Treasury Regulation § 1.409A-1(b)(4), (B) the amount of the separate payment not covered by Section 10(c)(ii)(A) can be paid under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii), after first applying such exclusion under Section 10(b)(ii), (C) the separate payment is covered by any other applicable exclusion or exemption under Treasury Regulation § 1.409A-1(b)(9) (provided that the exclusion under subsection (b)(9)(v)(D) shall be used only to the extent not relied upon for other payments or benefits) and (D), the six-month delay rule in Section 10(d) does not apply to the separate payment (except as otherwise provided in Section 10(c)(iii)). Any other such separate payment (i.e., amounts subject to the six-month delay rule) shall be subject to the six-month delay rule of Section 10(d), subject to Section 10(c)(iii). Any delay in payment under the six-month delay rule shall not limit Employee’s rights under this Employment Agreement to not forfeit a specified item of compensation as a result of Employee’s termination.
  - (iii) Payments of 409A Deferrals For a Termination Not Within Two Years After a 409A Change in Control. If a payment referenced in Section 10(c)(ii) is a direct payment or a substitute or replacement for a right to payment (the “Original Payment Right”) that constitutes a deferral of compensation under Section 409A, and if either (A) the Change in Control does not involve a 409A Change in Control, or (B) Employee’s termination triggering payments hereunder did not occur within the two-year period following a 409A Change in Control, then such payments (i.e., payments that constitute deferrals under

4

---

Section 409A) must be paid at the times and in the form applicable to a separation from service under the terms of the Original Payment Right, subject to Section 10(d). If in no circumstances was such payment payable upon a separation from service under the Original Payment Right, then this Section 10(c)(iii) shall not apply.

- (d) Six-Month Delay Rule.

- (i) **General Rule.** The six-month delay rule will apply to payments and benefits under the Employment Agreement if all of the following conditions are met:
- (A) Employee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (10) thereof) for the year in which the termination occurs. The Company will determine status of “key employees” annually, under administrative procedures applicable to all Section 409A plans and arrangements and applied in accordance with Treasury Regulation § 1.409A-1(i).
  - (B) The Company’s stock is publicly traded on an established securities market or otherwise.
  - (C) The payment or benefit in question is a deferral of compensation and not excepted, exempted or excluded from being such by the short-term deferral rule, or the “two-years/two-times” rule in Treasury Regulation § 1.409A-1(b)(9)(iii), or any other exception, exemption or exclusion; provided, however, that the exclusion under Treasury Regulation § 1.409A-1(b)(9)(v)(D) shall apply only if and to the extent that it is not necessary to apply to any other payment or benefit payable within six (6) months after Employee’s termination.
- (ii) **Effect of Rule.** If it applies, the six-month delay rule will delay a payment or benefit which otherwise would be payable under this Employment Agreement within six (6) months after Employee’s separation from service.
- (A) Any delayed payment or benefit shall be paid on the date six (6) months after Employee’s separation from service.
  - (B) During the six-month delay period, accelerated payment will occur in the event of the Employee’s death but not for any other reason (including no acceleration upon a Change in Control), except for accelerations expressly permitted under Treasury Regulation § 1.409A-1 — A-6.
  - (C) Any payment that is not triggered by a termination, or is triggered by a termination but would be made more than six (6) months after the termination (without applying this six-month delay rule), or would be payable at a fixed date not tied to termination that is earlier than the

5

---

expiration of the six-month delay period, shall be unaffected by the six-month delay rule.

- (iii) **Limit to Application of Six-Month Delay Rule.** If the terms of this Employment Agreement or other plan or arrangement or document relating to this Employment Agreement or payments hereunder impose this six-month delay rule in circumstances in which it is not required for compliance with Section 409A, those terms shall not be given effect.
- (e) **Other Provisions.**
- (i) **Good Reason.** The definition of “Good Reason” termination under the Employment Agreement, and related rules governing constructive termination not for cause, is intended to qualify as an “involuntary separation” within the meaning of Treasury Regulation § 1.409A-1(n)(2)(i), and shall be so construed and interpreted.
  - (ii) **Non-transferability.** No right to any payment or benefit under this Employment Agreement shall be subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by Employee’s creditors or of any of Employee’s beneficiaries.
  - (iii) **No Acceleration.** The timing of payments and benefits under the Employment Agreement which constitute a deferral of compensation under Code Section 409A may not be accelerated to occur before the time specified for payment hereunder, except to the extent permitted under Treasury Regulation § 1.409A-3(j)(4) or as otherwise permitted under Code Section 409A without Employee incurring a tax penalty.
  - (iv) **Timing Relating to Release.** Other provisions of this Employment Agreement (including this Section 10) notwithstanding, if Employee is obligated to execute a release, non-competition, or other agreement as a condition to receipt of a payment hereunder, the Company will supply to Employee a form of such release or other document not later than the date of Employee’s termination, which must be returned within the time period required by law and must not be revoked by Employee within the applicable time period in order for Employee to satisfy any such condition, such that it becomes legally effective. If any amount payable during a fixed period following Employee’s termination is subject to a requirement or condition requiring Employee’s execution of a release (including any case in which such fixed period would begin in one year and end in the next), the Company, in determining the time of payment of any such amount, will not be influenced by Employee or the timing of any action by Employee including execution of such a release or other document and expiration of any revocation period. In particular, the Company will be entitled in its discretion to deposit any payment hereunder in escrow at any time during such fixed period, so that such deposited amount is

6

---

constructively received and taxable income to Employee upon deposit (it may be constructively received even in the absence of such deposit) but with distribution from such escrow remaining subject to Employee’s execution and non-revocation of such release or other document.

- (v) **Definition of Termination of Employment.** For purposes of this Employment Agreement, the term “termination of employment” shall mean a separation from service as defined in Treasury Regulation § 1.409A-1(h); provided, however, that if a date for termination of employment is designated by the Company but Employee has a separation from service prior to such designated date, the designated termination date shall be deemed the date of termination for any compensation payable under this Agreement that would fully qualify for the short-term deferral exception under Treasury Regulation § 1.409A-1(b)(4) and/or the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) under both circumstances (i.e., assuming the separation from service date was the termination date hereunder or that the designated termination of employment date was the termination date hereunder), then for that purpose the termination of employment date shall be the designated termination date.

(vi) References to Other Plans. References in the Employment Agreement to the obligation of the Company to pay amounts under other plans, including Employee's vested portion of any Magellan deferred compensation or other benefit plan, shall not be construed to modify the timing of payment, which shall be governed by such other plans.

3. **Modification to Section 6.** The provisions of Section 6(c) are hereby amended as follows:

In the initial instance of clause (iii), at the end of clause (iii) before the semicolon the following text is inserted:

provided that such reduction is otherwise material (for this purpose, a reduction in base salary with an annualized value of one and one half percent (1.5%) of Employee's the current annual base pay or more shall be deemed material); and provided further that, in each such case, Employee shall have given notice to the Company that the event or condition referred to in clause (i), (ii) or (iii) has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company (in addition to any other right of the Company to cure), and Employee has terminated employment for that reason within eighteen (18) months after such uncured event or condition has arisen.

The provisions of Section I.2(C) of the CiC Amendment setting forth the definition of "Good Reason" are hereby amended as follows:

7

In clause (i), the term "reduction in Employee's salary" is replaced by the term "material reduction in Employee's salary", and the term "reduction in Employee's target bonus opportunity" is replaced by the term "material reduction in Employee's target bonus opportunity", and at the end of clause (i) before the semicolon the following text is inserted:

provided, however, that a reduction in salary and/or target bonus opportunity with an annualized value of one and one half percent (1.5%) of Employee's the current annual base pay or more in the aggregate, taking into account any related effect a salary reduction has on target bonus and other components of compensation, shall be deemed material;

The final proviso of Section I.2(C) of the CiC Amendment is deleted and in its stead is inserted the following:

provided that, in each such case, Employee shall have given notice to the Company that such event or condition has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company, and Employee has terminated employment for Good Reason within eighteen (18) months after such uncured event or condition has arisen.

4. **Other Amendments.** Other provisions of the Employment Agreement are amended as follows:

A new sentence is added as the second to last sentence of Section 1, stating:

Non-renewal of this Agreement by either party will in all cases result in termination of employment at the non-renewal date.

A new sentence is added at the end of Section 4(e), stating:

Annual bonus, if any, will be determined and paid (unless validly deferred if then permitted by the Company) between January 1 and March 15 of the year following the performance year.

A clause is inserted before the period at the end of Section 5, stating:

subject to Section 10(a)(iii).

In the preamble to Section I.1 of the CiC Amendment, before the colon insert " , in each case subject to Section 10".

A new sentence is added at the end of Section 4(b), as follows:

8

Any continued medical coverage following termination of employment, to the extent provided under Section 6 or any other provision of this Agreement, if and to the extent such medical coverage (or the Company's contributions or reimbursement of such coverage) represents taxable income to Employee, is intended to qualify as excluded from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(v)(B), and the rights to such coverage shall be limited to the extent necessary to qualify thereunder.

5. Nothing in this Amendment shall be construed to increase or enhance the compensation or benefits payable under the Agreement. The sole purpose of this Amendment is to add limitations required under Code Section 409A so that payments and benefits otherwise provided under the Agreement are not subject to tax penalties and other adverse consequences under Section 409A.

This amendment to Employment Agreement is entered into by the parties as of the date first above written.

Magellan Health Services, Inc.

Employee:

By:

/s/ Tina M. Blasi



---

Duly Authorized

---

Tina Blasi

**AMENDMENT TO EMPLOYMENT AGREEMENT  
(For Compliance with Requirements of Code Section 409A)**

This **Amendment to Employment Agreement** between Magellan Health Services, Inc. (“Employer”) and Daniel Gregoire (“Employee”) entered into as of this 1st day of December, 2008.

**WHEREAS**, Employer and Employee desire to amend the terms of the Employment Agreement, as amended, currently in effect between Employer and Employee (the “Employment Agreement”).

**NOW THEREFORE**, Employer or Employee agree that the Employment Agreement is hereby amended as follows:

1. **Reorganization of Sections of Employment Agreement.** Section 10 of the Employment Agreement (“Governing Law”) is moved to become the fifth to last Section of the Employment Agreement, and renumbered accordingly, with the four final Sections renumbered appropriately.

2. **New Section of Employment Agreement.** The following new text is inserted as Section 10 of the Employment Agreement:

10 **Special Rules for Compliance with Code Section 409A.** This Section 10 serves to ensure compliance with applicable requirements of Section 409A of the Internal Revenue Code (the “Code”). Certain provisions of this Section 10 modify other provisions of this Employment Agreement. If the terms of this Section 10 conflict with other terms of the Employment Agreement, the terms of this Section 10 control.

(a) **Timing of Certain Payments.** Payments and benefits specified under this Employment Agreement shall be paid at the times specified as follows:

(i) **Accrued Payments at Termination.** Sections 6(a) — (d) of this Employment Agreement and Section I.1(ii) of the Amendment to the Employment Agreement relating to Change in Control ( the “CiC Amendment”) require payment of amounts earned but unpaid, or accrued, at the date of Employee’s termination. Unless the amount is payable under an applicable plan, program or arrangement on explicit terms providing for a delay in payment compliant with Code Section 409A, these amounts shall be payable at the date the amounts otherwise would have been payable under the applicable plans, programs and arrangements in the absence of termination but in no event more than thirty (30) days after Employee’s termination of employment, subject to 10(d).

(ii) **Gross-Up.** Gross-up payments payable under the CiC Amendment will be paid as promptly as practicable after the excise tax is payable by Employee, and in any event must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee remits the excise tax or related taxes to the taxing authorities; provided, however, that any gross-up payment will be subject to Section 10(d) if applicable under Section 409A.

(iii) **Expense Reimbursements.** Any payment under Section 5 or otherwise as an expense reimbursement hereunder must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee incurred the reimbursable expense.

(iv) **Other Payments.** Any other payment or benefit required under this Employment Agreement to be paid in a lump sum or otherwise to be paid promptly at or following a date or event shall be paid within five (5) days after the due date, subject to Section 10(b), (c) and (d) below.

(v) **No Influence on Year of Payment.** In the case of any payment under the Employment Agreement payable during a specified period of time following a termination or other event (including any payment for which the permitted payment period begins in one calendar year and ends in a subsequent calendar year), Employee shall have no right to elect in which year the payment will be made, and the Company’s determination of when to make the payment shall not be influenced in any way by Employee.

(b) **Special Rules for Severance Payments.** In the case of payments of severance required under Section 6(c)(iii) (“Pre-CiC Severance Payment”) and severance payable under Section I.1(iii) of the CiC Amendment (the “CiC Severance Payments” and, with the Pre-CiC Severance Payment, the “Severance Payments”), the following rules will apply:

(i) **Separate Payments.** The Pre-CiC Severance Payment shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A. The portion of the CiC Severance Payments that exceeds the Pre-CiC Severance Payment (or the present value thereof, if such present valuing is required to comply with Section 409A), and the portion attributable to inclusion of Target Bonus in the calculation of CiC Severance Payments (or, if so required, the present value thereof) as compared to Pre-CiC Severance Payment, shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A (the “Separate Lump Sum”).

(ii) **Severance Payment Timing Rules.** The Pre-CiC Severance Payment shall be treated as follows for purposes of Section 409A:

(A) The Pre CiC Severance Payment shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation §

(C) [Reserved]; and

(D) To the extent that the Pre-CiC Severance Payment is not covered by Section 10(b)(ii)(A) an (B), it shall be paid at the applicable payment date in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule of Section 10(d).

The portions of the CiC Severance Payments that correspond to the Pre-CiC Severance Payment (that is, deemed to be the same payment for purposes of Section 409A) shall be governed by Section 10(b)(ii)(A) — (D) above, provided that amounts of the CiC Severance Payments corresponding to Pre-CiC Severance Payment covered by Section 10(b)(ii)(A) and (B) above shall be payable as a lump sum within five (5) days after termination of employment. The Separate Lump Sum shall be treated as follows for purposes of Section 409A:

(E) The Separate Lump Sum shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation § 1.409A-1(b)(4);

(F) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B), the Separate Lump Sum, to the extent not covered by Section 10(b)(ii)(E), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion; and

(G) Any portion of the Separate Lump Sum not covered by Section 10(b)(ii)(E) and (F) shall be paid within five (5) days after the qualifying termination of employment in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule and other provisions of Section 10(d).

Any portions of the CiC Severance Payments corresponding to Pre-CiC Severance Payment governed by Section 10(b)(ii)(D) shall be payable, subject to Section 10(d), in a lump sum within five (5) days after the qualifying termination of employment if such termination has occurred within two years following a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(10) (a “409A Change in Control”), and in any other case shall be payable at the applicable time under Section 10(b)(ii)(D).

(c) Special Rules for Other Payments. With respect to amounts payable under Section 6(c)(ii) and/or under Section I.1(ii) of the CiC Amendment (relating to incentive awards), the following rules will apply:

(i) Separate Payments. The amounts payable thereunder shall each be deemed to be a separate payment for all purposes, including for purposes of Section 409A (subject to any further designation of separate payments explicitly made in any separately identifiable plan or arrangement for purposes of Section 409A).

(ii) Payment Timing Rules. A payment referenced in Section 10(c)(i) shall be payable as a lump-sum payment within five (5) days after termination of employment if and to the extent that (A) the separate payment constitutes short-term deferral under Treasury Regulation § 1.409A-1(b)(4), (B) the amount of the separate payment not covered by Section 10(c)(ii)(A) can be paid under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii), after first applying such exclusion under Section 10(b)(ii), (C) the separate payment is covered by any other applicable exclusion or exemption under Treasury Regulation § 1.409A-1(b)(9) (provided that the exclusion under subsection (b)(9)(v)(D) shall be used only to the extent not relied upon for other payments or benefits) and (D), the six-month delay rule in Section 10(d) does not apply to the separate payment (except as otherwise provided in Section 10(c)(iii)). Any other such separate payment (i.e., amounts subject to the six-month delay rule) shall be subject to the six-month delay rule of Section 10(d), subject to Section 10(c)(iii). Any delay in payment under the six-month delay rule shall not limit Employee’s rights under this Employment Agreement to not forfeit a specified item of compensation as a result of Employee’s termination.

(iii) Payments of 409A Deferrals For a Termination Not Within Two Years After a 409A Change in Control. If a payment referenced in Section 10(c)(ii) is a direct payment or a substitute or replacement for a right to payment (the “Original Payment Right”) that constitutes a deferral of compensation under Section 409A, and if either (A) the Change in Control does not involve a 409A Change in Control, or (B) Employee’s termination triggering payments hereunder did not occur within the two-year period following a 409A Change in Control, then such payments (i.e., payments that constitute deferrals under Section 409A) must be paid at the times and in the form applicable to a separation from service under the terms of the Original Payment Right, subject to Section 10(d). If in no circumstances was such payment payable upon a separation from service under the Original Payment Right, then this Section 10(c)(iii) shall not apply.

(d) Six-Month Delay Rule.

(i) General Rule. The six-month delay rule will apply to payments and benefits under the Employment Agreement if all of the following conditions are met:

(A) Employee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (10) thereof) for the year in which the termination occurs. The Company will determine status of “key employees” annually, under administrative procedures applicable to all Section 409A plans and arrangements and applied in accordance with Treasury Regulation § 1.409A-1(i).

(B) The Company’s stock is publicly traded on an established securities market or otherwise.

(C) The payment or benefit in question is a deferral of compensation and not excepted, exempted or excluded from being such by the short-term deferral rule, or the “two-years/two-times” rule in Treasury Regulation § 1.409A-1(b)(9)(iii), or any other exception, exemption or

exclusion; provided, however, that the exclusion under Treasury Regulation § 1.409A-1(b)(9)(v)(D) shall apply only if and to the extent that it is not necessary to apply to any other payment or benefit payable within six (6) months after Employee's termination.

- (ii) Effect of Rule. If it applies, the six-month delay rule will delay a payment or benefit which otherwise would be payable under this Employment Agreement within six (6) months after Employee's separation from service.
  - (A) Any delayed payment or benefit shall be paid on the date six (6) months after Employee's separation from service.
  - (B) During the six-month delay period, accelerated payment will occur in the event of the Employee's death but not for any other reason (including no acceleration upon a Change in Control), except for accelerations expressly permitted under Treasury Regulation § 1.409A-1 — A-6.
  - (C) Any payment that is not triggered by a termination, or is triggered by a termination but would be made more than six (6) months after the termination (without applying this six-month delay rule), or would be payable at a fixed date not tied to termination that is earlier than the expiration of the six-month delay period, shall be unaffected by the six-month delay rule.
- (iii) Limit to Application of Six-Month Delay Rule. If the terms of this Employment Agreement or other plan or arrangement or document relating to this Employment Agreement or payments hereunder impose this six-month

5

---

delay rule in circumstances in which it is not required for compliance with Section 409A, those terms shall not be given effect.

- (e) Other Provisions.
- (i) Good Reason. The definition of "Good Reason" under the Employment Agreement, and related rules governing constructive termination not for cause, is intended to qualify as an "involuntary separation" within the meaning of Treasury Regulation § 1.409A-1(n)(2)(i), and shall be so construed and interpreted.
- (ii) Non-transferability. No right to any payment or benefit under this Employment Agreement shall be subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by Employee's creditors or of any of Employee's beneficiaries.
- (iii) No Acceleration. The timing of payments and benefits under the Employment Agreement which constitute a deferral of compensation under Code Section 409A may not be accelerated to occur before the time specified for payment hereunder, except to the extent permitted under Treasury Regulation § 1.409A-3(j)(4) or as otherwise permitted under Code Section 409A without Employee incurring a tax penalty.
- (iv) Timing Relating to Release. Other provisions of this Employment Agreement (including this Section 10) notwithstanding, if Employee is obligated to execute a release, non-competition, or other agreement as a condition to receipt of a payment hereunder, the Company will supply to Employee a form of such release or other document not later than the date of Employee's termination, which must be returned within the time period required by law and must not be revoked by Employee within the applicable time period in order for Employee to satisfy any such condition, such that it becomes legally effective. If any amount payable during a fixed period following Employee's termination is subject to a requirement or condition requiring Employee's execution of a release (including any case in which such fixed period would begin in one year and end in the next), the Company, in determining the time of payment of any such amount, will not be influenced by Employee or the timing of any action by Employee including execution of such a release or other document and expiration of any revocation period. In particular, the Company will be entitled in its discretion to deposit any payment hereunder in escrow at any time during such fixed period, so that such deposited amount is constructively received and taxable income to Employee upon deposit (it may be constructively received even in the absence of such deposit) but with distribution from such escrow remaining subject to Employee's execution and non-revocation of such release or other document.

6

- 
- (v) Definition of Termination of Employment. For purposes of this Employment Agreement, the term "termination of employment" shall mean a separation from service as defined in Treasury Regulation § 1.409A-1(h); provided, however, that if a date for termination of employment is designated by the Company but Employee has a separation from service prior to such designated date, the designated termination date shall be deemed the date of termination for any compensation payable under this Agreement that would fully qualify for the short-term deferral exception under Treasury Regulation § 1.409A-1(b)(4) and/or the "two-year/two-times" exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) under both circumstances (i.e., assuming the separation from service date was the termination date hereunder or that the designated termination of employment date was the termination date hereunder), then for that purpose the termination of employment date shall be the designated termination date.
  - (vi) References to Other Plans. References in the Employment Agreement to the obligation of the Company to pay amounts under other plans, including Employee's vested portion of any Magellan deferred compensation or other benefit plan, shall not be construed to modify the timing of payment, which shall be governed by such other plans.

3. **Modification to "Good Reason" Definitions.** The provisions of Section 6(c) setting forth the definition of "Good Reason" are hereby amended as follows:

In clause (i), the term "reduction" is replaced by the term "material reduction", and at the end of clause (i) before the semicolon the following text is inserted:

provided, however, that a reduction in Base Salary and/or Target Bonus with an annualized value of one and one half percent (1.5%) of Employee's then current annual base pay or more in the aggregate, taking into account any related effect a salary reduction has on target bonus and other

components of compensation, shall be deemed material;

The final proviso of Section 6(c) is deleted and in its stead is inserted the following:

provided that, in each such case, Employee shall have given notice to the Company that such event or condition has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company, and Employee has terminated employment for Good Reason within eighteen (18) months after such uncured event or condition has arisen.

7

The provisions of Section I.2(C) of the CiC Amendment setting forth the definition of "Good Reason" are hereby amended as follows:

In clause (i), the term "reduction in Employee's salary" is replaced by the term "material reduction in Employee's salary", and the term "reduction in Employee's target bonus opportunity" is replaced by the term "material reduction in Employee's target bonus opportunity", and at the end of clause (i) before the semicolon the following text is inserted:

provided, however, that a reduction in salary and/or target bonus opportunity with an annualized value of one and one half percent (1.5%) of Employee's then current annual base pay or more in the aggregate, taking into account any related effect a salary reduction has on target bonus and other components of compensation, shall be deemed material;

The final proviso of Section I.2(C) of the CiC Amendment is deleted and in its stead is inserted the following:

provided that, in each such case, Employee shall have given notice to the Company that such event or condition has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company, and Employee has terminated employment for Good Reason within eighteen (18) months after such uncured event or condition has arisen.

4. **Other Amendments.** Other provisions of the Employment Agreement are amended as follows:

A new sentence is added as the second to last sentence of Section 1, stating:

Non-renewal of this Agreement by either party will in all cases result in termination of employment at the non-renewal date.

A new sentence is added at the end of Section 4(b), stating:

Annual bonus, if any, will be determined and paid (unless validly deferred if then permitted by the Company) between January 1 and March 15 of the year following the performance year.

A clause is inserted before the period at the end of Section 5, stating:

subject to Section 10(a)(iii).

In the preamble to Section I.1 of the CiC Amendment, before the colon insert ", in each case subject to Section 10".

8

A new sentence is added at the end of Section 4(c), as follows:

Any continued medical coverage following termination of employment, to the extent provided under Section 6 or any other provision of this Agreement, if and to the extent such medical coverage (or the Company's contributions or reimbursement of such coverage) represents taxable income to Employee, is intended to qualify as excluded from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(v)(B), and the rights to such coverage shall be limited to the extent necessary to qualify thereunder.

5. Nothing in this Amendment shall be construed to increase or enhance the compensation or benefits payable under the Agreement. The sole purpose of this Amendment is to add limitations required under Code Section 409A so that payments and benefits otherwise provided under the Agreement are not subject to tax penalties and other adverse consequences under Section 409A.

This amendment to Employment Agreement is entered into by the parties as of the date first above written.

Magellan Health Services, Inc.

Employee:

By:   
Duly Authorized

/s/ Daniel Gregoire  
Daniel Gregoire

9

**AMENDMENT TO EMPLOYMENT AGREEMENT**  
**(For Compliance with Requirements of Code Section 409A)**

This **Amendment to Employment Agreement** between Magellan Health Services, Inc. (“Employer”) and R. Caskie Lewis-Clapper (“Employee”) entered into as of this 1st day of December, 2008.

**WHEREAS**, Employer and Employee desire to amend the terms of the Employment Agreement, as amended, currently in effect between Employer and Employee (the “Employment Agreement”).

**NOW THEREFORE**, Employer or Employee agree that the Employment Agreement is hereby amended as follows:

1. **Reorganization of Sections of Employment Agreement.** Section 10 of the Employment Agreement (“Governing Law”) is moved to become the fifth to last Section of the Employment Agreement, and renumbered accordingly, with the four final Sections renumbered appropriately.

2. **New Section of Employment Agreement.** The following new text is inserted as Section 10 of the Employment Agreement:

10 **Special Rules for Compliance with Code Section 409A.** This Section 10 serves to ensure compliance with applicable requirements of Section 409A of the Internal Revenue Code (the “Code”). Certain provisions of this Section 10 modify other provisions of this Employment Agreement. If the terms of this Section 10 conflict with other terms of the Employment Agreement, the terms of this Section 10 control.

(a) **Timing of Certain Payments.** Payments and benefits specified under this Employment Agreement shall be paid at the times specified as follows:

- (i) **Accrued Payments at Termination.** Sections 6(a) — (d) of this Employment Agreement and Section I.1(ii) of the Amendment to the Employment Agreement relating to Change in Control ( the “CiC Amendment”) require payment of amounts earned but unpaid, or accrued, at the date of Employee’s termination. Unless the amount is payable under an applicable plan, program or arrangement on explicit terms providing for a delay in payment compliant with Code Section 409A, these amounts shall be payable at the date the amounts otherwise would have been payable under the applicable plans, programs and arrangements in the absence of termination but in no event more than thirty (30) days after Employee’s termination of employment, subject to 10(d).
- (ii) **Gross-Up.** Gross-up payments payable under the CiC Amendment will be paid as promptly as practicable after the excise tax is payable by Employee,

---

and in any event must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee remits the excise tax or related taxes to the taxing authorities; provided, however, that any gross-up payment will be subject to Section 10(d) if applicable under Section 409A.

- (iii) **Expense Reimbursements.** Any payment under Section 5 or otherwise as an expense reimbursement hereunder must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee incurred the reimbursable expense.
- (iv) **Other Payments.** Any other payment or benefit required under this Employment Agreement to be paid in a lump sum or otherwise to be paid promptly at or following a date or event shall be paid within five (5) days after the due date, subject to Section 10(b), (c) and (d) below.
- (v) **No Influence on Year of Payment.** In the case of any payment under the Employment Agreement payable during a specified period of time following a termination or other event (including any payment for which the permitted payment period begins in one calendar year and ends in a subsequent calendar year), Employee shall have no right to elect in which year the payment will be made, and the Company’s determination of when to make the payment shall not be influenced in any way by Employee.

(b) **Special Rules for Severance Payments.** In the case of payments in the nature of continuation of payments under Section 4(a) required under Section 6(c) (“Pre-CiC Severance Payments”) and severance payable under Section I.1(iii) of the CiC Amendment (the “CiC Severance Payments” and, with the Pre-CiC Severance Payment, the “Severance Payments”), the following rules will apply:

- (i) **Separate Payments.** Each monthly installment of the Pre-CiC Severance Payments shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A. The portion of the CiC Severance Payments that exceeds the Pre-CiC Severance Payments (or the present value thereof, if such present valuing is required to comply with Section 409A), and the portion attributable to inclusion of Target Bonus in the calculation of CiC Severance Payments (or, if so required, the present value thereof) as compared to Pre-CiC Severance Payments, shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A (the “Separate Lump Sum”).
- (ii) **Severance Payment Timing Rules.** Each installment of Pre-CiC Severance Payments shall be treated as follows for purposes of Section 409A:

(A) Installments payable during the year of termination and by March 15 of the year following termination shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation §

- (B) Installments payable during the period within six (6) months after termination, to the extent not covered by Section 10(b)(ii)(A), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii);
- (C) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B), installments payable as Pre-CiC Severance Payments shall be excluded, to the maximum extent possible, by such “two-years/two-times” exclusion (applied in the reverse order of payment of the installments — that is, to the latest installments first); and
- (D) All installments of the Pre-CiC Severance Payment not covered by Section 10(b)(ii)(A), (B) and (C) shall be paid at the applicable installment payment date in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule of Section 10(d).

The portions of the CiC Severance Payments that correspond to the Pre-CiC Severance Payments (that is, deemed to be the same payment for purposes of Section 409A) shall be governed by Section 10(b)(ii)(A) — (D) above, provided that amounts of the CiC Severance Payments corresponding to Pre-CiC Severance Payments covered by Section 10(b)(ii)(A), (B), and (C) above shall be payable as a lump sum within five (5) days after termination of employment. The Separate Lump Sum shall be treated as follows for purposes of Section 409A:

- (E) The Separate Lump Sum shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation § 1.409A-1(b)(4);
- (F) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B) and (C), the Separate Lump Sum, to the extent not covered by Section 10(b)(ii)(E), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion; and
- (G) Any portion of the Separate Lump Sum not covered by Section 10(b)(ii)(E) and (F) shall be paid within five (5) days after the qualifying termination of employment in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule and other provisions of Section 10(d) and except to the extent that the Separate Lump Sum is not deemed to be a valid separate payment from amounts governed by Section 10(b)(ii)(D).

Any portions of the CiC Severance Payments corresponding to Pre-CiC Severance Payments governed by Section 10(b)(ii)(D) shall be payable,

3

---

subject to Section 10(d), in a lump sum within five (5) days after the qualifying termination of employment if such termination has occurred within two years following a a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(10) (a “409A Change in Control”), and in any other case shall be payable at the applicable time under Section 10(b)(ii)(D).

- (c) Special Rules for Other Payments. With respect to amounts payable under Section I.1(ii) of the CiC Amendment (relating to incentive awards), the following rules will apply:
  - (i) Separate Payments. The amounts payable thereunder shall each be deemed to be a separate payment for all purposes, including for purposes of Section 409A (subject to any further designation of separate payments explicitly made in any separately identifiable plan or arrangement for purposes of Section 409A).
  - (ii) Payment Timing Rules. A payment referenced in Section 10(c)(i) shall be payable as a lump-sum payment within five (5) days after termination of employment if and to the extent that (A) the separate payment constitutes short-term deferral under Treasury Regulation § 1.409A-1(b)(4), (B) the amount of the separate payment not covered by Section 10(c)(ii)(A) can be paid under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii), after first applying such exclusion under Section 10(b)(ii), (C) the separate payment is covered by any other applicable exclusion or exemption under Treasury Regulation § 1.409A-1(b)(9) (provided that the exclusion under subsection (b)(9)(v)(D) shall be used only to the extent not relied upon for other payments or benefits) and (D), the six-month delay rule in Section 10(d) does not apply to the separate payment (except as otherwise provided in Section 10(c)(iii)). Any other such separate payment (i.e., amounts subject to the six-month delay rule) shall be subject to the six-month delay rule of Section 10(d), subject to Section 10(c)(iii). Any delay in payment under the six-month delay rule shall not limit Employee’s rights under this Employment Agreement to not forfeit a specified item of compensation as a result of Employee’s termination.
  - (iii) Payments of 409A Deferrals For a Termination Not Within Two Years After a 409A Change in Control. If a payment referenced in Section 10(c)(ii) is a direct payment or a substitute or replacement for a right to payment (the “Original Payment Right”) that constitutes a deferral of compensation under Section 409A, and if either (A) the Change in Control does not involve a 409A Change in Control, or (B) Employee’s termination triggering payments hereunder did not occur within the two-year period following a 409A Change in Control, then such payments (i.e., payments that constitute deferrals under

4

---

Section 409A) must be paid at the times and in the form applicable to a separation from service under the terms of the Original Payment Right, subject to Section 10(d). If in no circumstances was such payment payable upon a separation from service under the Original Payment Right, then this Section 10(c)(iii) shall not apply.

- (d) Six-Month Delay Rule.

- (i) General Rule. The six-month delay rule will apply to payments and benefits under the Employment Agreement if all of the following conditions are met:
- (A) Employee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (10) thereof) for the year in which the termination occurs. The Company will determine status of “key employees” annually, under administrative procedures applicable to all Section 409A plans and arrangements and applied in accordance with Treasury Regulation § 1.409A-1(i).
  - (B) The Company’s stock is publicly traded on an established securities market or otherwise.
  - (C) The payment or benefit in question is a deferral of compensation and not excepted, exempted or excluded from being such by the short-term deferral rule, or the “two-years/two-times” rule in Treasury Regulation § 1.409A-1(b)(9)(iii), or any other exception, exemption or exclusion; provided, however, that the exclusion under Treasury Regulation § 1.409A-1(b)(9)(v)(D) shall apply only if and to the extent that it is not necessary to apply to any other payment or benefit payable within six (6) months after Employee’s termination.
- (ii) Effect of Rule. If it applies, the six-month delay rule will delay a payment or benefit which otherwise would be payable under this Employment Agreement within six (6) months after Employee’s separation from service.
- (A) Any delayed payment or benefit shall be paid on the date six (6) months after Employee’s separation from service.
  - (B) During the six-month delay period, accelerated payment will occur in the event of the Employee’s death but not for any other reason (including no acceleration upon a Change in Control), except for accelerations expressly permitted under Treasury Regulation § 1.409A-1 — A-6.
  - (C) Any payment that is not triggered by a termination, or is triggered by a termination but would be made more than six (6) months after the termination (without applying this six-month delay rule), or would be payable at a fixed date not tied to termination that is earlier than the

5

---

expiration of the six-month delay period, shall be unaffected by the six-month delay rule.

- (iii) Limit to Application of Six-Month Delay Rule. If the terms of this Employment Agreement or other plan or arrangement or document relating to this Employment Agreement or payments hereunder impose this six-month delay rule in circumstances in which it is not required for compliance with Section 409A, those terms shall not be given effect.
- (e) Other Provisions.
- (i) Good Reason. The definition of “Good Reason” under the Employment Agreement, and related rules governing constructive termination not for cause, is intended to qualify as an “involuntary separation” within the meaning of Treasury Regulation § 1.409A-1(n)(2)(i), and shall be so construed and interpreted.
  - (ii) Non-transferability. No right to any payment or benefit under this Employment Agreement shall be subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by Employee’s creditors or of any of Employee’s beneficiaries.
  - (iii) No Acceleration. The timing of payments and benefits under the Employment Agreement which constitute a deferral of compensation under Code Section 409A may not be accelerated to occur before the time specified for payment hereunder, except to the extent permitted under Treasury Regulation § 1.409A-3(j)(4) or as otherwise permitted under Code Section 409A without Employee incurring a tax penalty.
  - (iv) Timing Relating to Release. Other provisions of this Employment Agreement (including this Section 10) notwithstanding, if Employee is obligated to execute a release, non-competition, or other agreement as a condition to receipt of a payment hereunder, the Company will supply to Employee a form of such release or other document not later than the date of Employee’s termination, which must be returned within the time period required by law and must not be revoked by Employee within the applicable time period in order for Employee to satisfy any such condition, such that it becomes legally effective. If any amount payable during a fixed period following Employee’s termination is subject to a requirement or condition requiring Employee’s execution of a release (including any case in which such fixed period would begin in one year and end in the next), the Company, in determining the time of payment of any such amount, will not be influenced by Employee or the timing of any action by Employee including execution of such a release or other document and expiration of any revocation period. In particular, the Company will be entitled in its discretion to deposit any payment hereunder in escrow at any time during such fixed period, so that such deposited amount is

6

---

constructively received and taxable income to Employee upon deposit (it may be constructively received even in the absence of such deposit) but with distribution from such escrow remaining subject to Employee’s execution and non-revocation of such release or other document.

- (v) Definition of Termination of Employment. For purposes of this Employment Agreement, the term “termination of employment” shall mean a separation from service as defined in Treasury Regulation § 1.409A-1(h); provided, however, that if a date for termination of employment is designated by the Company but Employee has a separation from service prior to such designated date, the designated termination date shall be deemed the date of termination for any compensation payable under this Agreement that would fully qualify for the short-term deferral exception under Treasury Regulation § 1.409A-1(b)(4) and/or the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) under both circumstances (i.e., assuming the separation from service date was the termination date hereunder or that the designated termination of employment date was the termination date hereunder), then for that purpose the termination of employment date shall be the designated termination date.

(vi) References to Other Plans. References in the Employment Agreement to the obligation of the Company to pay amounts under other plans, including Employee's vested portion of any Magellan deferred compensation or other benefit plan, shall not be construed to modify the timing of payment, which shall be governed by such other plans.

3. **Modification to Section 6.** The provisions of Section 6(c) are hereby amended as follows:

In the initial instance of clause (iii), at the end of clause (iii) before the semicolon the following text is inserted:

provided that such reduction is otherwise material (for this purpose, a reduction in base salary with an annualized value of one and one half percent (1.5%) of Employee's then current annual base pay or more shall be deemed material); and provided further that, in each such case, Employee shall have given notice to the Company that the event or condition referred to in clause (i), (ii) or (iii) has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company (in addition to any other right of the Company to cure), and Employee has terminated employment for that reason within eighteen (18) months after such uncured event or condition has arisen.

The provisions of Section I.2(C) of the CiC Amendment setting forth the definition of "Good Reason" are hereby amended as follows:

7

---

In clause (i), the term "reduction in Employee's salary" is replaced by the term "material reduction in Employee's salary", and the term "reduction in Employee's target bonus opportunity" is replaced by the term "material reduction in Employee's target bonus opportunity", and at the end of clause (i) before the semicolon the following text is inserted:

provided, however, that a reduction in salary and/or target bonus opportunity with an annualized value of one and one half percent (1.5%) of Employee's then current annual base pay or more in the aggregate, taking into account any related effect a salary reduction has on target bonus and other components of compensation, shall be deemed material;

The final proviso of Section I.2(C) of the CiC Amendment is deleted and in its stead is inserted the following:

provided that, in each such case, Employee shall have given notice to the Company that such event or condition has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company, and Employee has terminated employment for Good Reason within eighteen (18) months after such uncured event or condition has arisen.

4. **Other Amendments.** Other provisions of the Employment Agreement are amended as follows:

A new sentence is added as the second to last sentence of Section 1, stating:

Non-renewal of this Agreement by either party will in all cases result in termination of employment at the non-renewal date.

A new sentence is added at the end of Section 4(a), stating:

Annual bonus, if any, will be determined and paid (unless validly deferred if then permitted by the Company) between January 1 and March 15 of the year following the performance year.

A clause is inserted before the period at the end of Section 5, stating:

subject to Section 10(a)(iii).

In the preamble to Section I.1 of the CiC Amendment, before the colon insert " , in each case subject to Section 10".

A new sentence is added at the end of Section 4(b), as follows:

8

---

Any continued medical coverage following termination of employment, to the extent provided under Section 6 or any other provision of this Agreement, if and to the extent such medical coverage (or the Company's contributions or reimbursement of such coverage) represents taxable income to Employee, is intended to qualify as excluded from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(v)(B), and the rights to such coverage shall be limited to the extent necessary to qualify thereunder.

5. Nothing in this Amendment shall be construed to increase or enhance the compensation or benefits payable under the Agreement. The sole purpose of this Amendment is to add limitations required under Code Section 409A so that payments and benefits otherwise provided under the Agreement are not subject to tax penalties and other adverse consequences under Section 409A.

This amendment to Employment Agreement is entered into by the parties as of the date first above written.

Magellan Health Services, Inc.

Employee:

By:

/s/ R. Caskie Lewis-Clapper



---

Duly Authorized

R. Caskie Lewis-Clapper

**AMENDMENT TO EMPLOYMENT AGREEMENT**  
**(For Compliance with Requirements of Code Section 409A)**

This **Amendment to Employment Agreement** between Magellan Health Services, Inc. (“Employer”) and Raju Mantena (“Employee”) entered into as of this 1st day of December, 2008.

**WHEREAS**, Employer and Employee desire to amend the terms of the Employment Agreement, as amended, currently in effect between Employer and Employee (the “Employment Agreement”).

**NOW THEREFORE**, Employer or Employee agree that the Employment Agreement is hereby amended as follows:

1. **Reorganization of Sections of Employment Agreement.** Section 10 of the Employment Agreement (“Governing Law”) is moved to become the fifth to last Section of the Employment Agreement, and renumbered accordingly, with the four final Sections renumbered appropriately.

2. **New Section of Employment Agreement.** The following new text is inserted as Section 10 of the Employment Agreement:

10 **Special Rules for Compliance with Code Section 409A.** This Section 10 serves to ensure compliance with applicable requirements of Section 409A of the Internal Revenue Code (the “Code”). Certain provisions of this Section 10 modify other provisions of this Employment Agreement. If the terms of this Section 10 conflict with other terms of the Employment Agreement, the terms of this Section 10 control.

(a) **Timing of Certain Payments.** Payments and benefits specified under this Employment Agreement shall be paid at the times specified as follows:

(i) **Accrued Payments at Termination.** Sections 6(a) — (d) of this Employment Agreement require payment of amounts earned but unpaid, or accrued, at the date of Employee’s termination. Unless the amount is payable under an applicable plan, program or arrangement on explicit terms providing for a delay in payment compliant with Code Section 409A, these amounts shall be payable at the date the amounts otherwise would have been payable under the applicable plans, programs and arrangements in the absence of termination but in no event more than thirty (30) days after Employee’s termination of employment, subject to 10(d).

(ii) **Expense Reimbursements.** Any payment under Section 5 or otherwise as an expense reimbursement hereunder must be paid no later than the end of Employee’s taxable year next following the taxable year in which Employee incurred the reimbursable expense.

(iii) **Other Payments.** Any other payment or benefit required under this Employment Agreement to be paid in a lump sum or otherwise to be paid promptly at or following a date or event shall be paid within five (5) days after the due date, subject to Section 10(b), (c) and (d) below.

(v) **No Influence on Year of Payment.** In the case of any payment under the Employment Agreement payable during a specified period of time following a termination or other event (including any payment for which the permitted payment period begins in one calendar year and ends in a subsequent calendar year), Employee shall have no right to elect in which year the payment will be made, and the Company’s determination of when to make the payment shall not be influenced in any way by Employee.

(b) **Special Rules for Severance Payments.** In the case of payments in the nature of continuation of payments under Section 4(a) required under Section 6(c) (“Severance Payments”), the following rules will apply:

(i) **Separate Payments.** Each monthly installment of the Severance Payments shall be deemed to be a separate payment for all purposes, including for purposes of Section 409A.

(ii) **Severance Payment Timing Rules.** Each installment of Severance Payments shall be treated as follows for purposes of Section 409A:

(A) Installments payable during the year of termination and by March 15 of the year following termination shall, to the maximum extent possible, be deemed to constitute a short-term deferral under Treasury Regulation § 1.409A-1(b)(4);

(B) Installments payable during the period within six (6) months after termination, to the extent not covered by Section 10(b)(ii)(A), shall, to the maximum extent possible, be deemed to constitute amounts payable under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii);

(C) To the extent that the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) has not been fully applied by virtue of Section 10(b)(ii)(B), installments payable as Severance Payments shall be excluded, to the maximum extent possible, by such “two-years/two-times” exclusion (applied in the reverse order of payment of the installments — that is, to the latest installments first); and

(D) All installments of the Severance Payment not covered by Section 10(b)(ii)(A), (B) and (C) shall be paid at the applicable installment payment date in compliance with Section 409A, except that any such payment shall be subject to the six-month delay rule of Section 10(d).

(c) **Special Rules for Other Payments.** With respect to any bonus amount that might be payable following termination of employment under any plan or arrangement covering Employee as may then be in effect, the following rules will apply:

(i) **Separate Payments.** The amounts payable thereunder shall each be deemed to be a separate payment for all purposes, including for purposes of Section 409A (subject to any further designation of separate payments explicitly made in any separately identifiable plan or arrangement for

purposes of Section 409A).

- (ii) Payment Timing Rules. A payment referenced in Section 10(c)(i) shall be payable as a lump-sum payment within thirty (30) days after termination of employment if and to the extent that (A) the separate payment constitutes short-term deferral under Treasury Regulation § 1.409A-1(b)(4), (B) the amount of the separate payment not covered by Section 10(c)(ii)(A) can be paid under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii), after first applying such exclusion under Section 10(b)(ii), (C) the separate payment is covered by any other applicable exclusion or exemption under Treasury Regulation § 1.409A-1(b)(9) (provided that the exclusion under subsection (b)(9)(v)(D) shall be used only to the extent not relied upon for other payments or benefits) and (D), the six-month delay rule in Section 10(d) does not apply to the separate payment (except as otherwise provided in Section 10(c)(iii)). Any other such separate payment (i.e., amounts subject to the six-month delay rule) shall be subject to the six-month delay rule of Section 10(d), subject to Section 10(c)(iii). Any delay in payment under the six-month delay rule shall not limit Employee’s rights under this Employment Agreement to not forfeit a specified item of compensation as a result of Employee’s termination.
- (iii) Payments of 409A Deferrals For a Termination Not Within Two Years After a 409A Change in Control. If a payment referenced in Section 10(c)(ii) is a direct payment or a substitute or replacement for a right to payment (the “Original Payment Right”) that constitutes a deferral of compensation under Section 409A, and if either (A) the Change in Control does not involve a 409A Change in Control, or (B) Employee’s termination triggering payments hereunder did not occur within the two-year period following a 409A Change in Control, then such payments (i.e., payments that constitute deferrals under Section 409A) must be paid at the times and in the form applicable to a separation from service under the terms of the Original Payment Right, subject to Section 10(d). If in no circumstances was such payment payable upon a separation from service under the Original Payment Right, then this Section 10(c)(iii) shall not apply.

3

(d) Six-Month Delay Rule.

- (i) General Rule. The six-month delay rule will apply to payments and benefits under the Employment Agreement if all of the following conditions are met:
  - (A) Employee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (10) thereof) for the year in which the termination occurs. The Company will determine status of “key employees” annually, under administrative procedures applicable to all Section 409A plans and arrangements and applied in accordance with Treasury Regulation § 1.409A-1(i).
  - (B) The Company’s stock is publicly traded on an established securities market or otherwise.
  - (C) The payment or benefit in question is a deferral of compensation and not excepted, exempted or excluded from being such by the short-term deferral rule, or the “two-years/two-times” rule in Treasury Regulation § 1.409A-1(b)(9)(iii), or any other exception, exemption or exclusion; provided, however, that the exclusion under Treasury Regulation § 1.409A-1(b)(9)(v)(D) shall apply only if and to the extent that it is not necessary to apply to any other payment or benefit payable within six (6) months after Employee’s termination.
- (ii) Effect of Rule. If it applies, the six-month delay rule will delay a payment or benefit which otherwise would be payable under this Employment Agreement within six (6) months after Employee’s separation from service.
  - (A) Any delayed payment or benefit shall be paid on the date six (6) months after Employee’s separation from service.
  - (B) During the six-month delay period, accelerated payment will occur in the event of the Employee’s death but not for any other reason (including no acceleration upon a Change in Control), except for accelerations expressly permitted under Treasury Regulation § 1.409A-1—A-6.
  - (C) Any payment that is not triggered by a termination, or is triggered by a termination but would be made more than six (6) months after the termination (without applying this six-month delay rule), or would be payable at a fixed date not tied to termination that is earlier than the expiration of the six-month delay period, shall be unaffected by the six-month delay rule.
- (iii) Limit to Application of Six-Month Delay Rule. If the terms of this Employment Agreement or other plan or arrangement or document relating to this Employment Agreement or payments hereunder impose this six-month

4

delay rule in circumstances in which it is not required for compliance with Section 409A, those terms shall not be given effect.

(e) Other Provisions.

- (i) Good Reason. The definition of “Good Reason” under the Employment Agreement, and related rules governing constructive termination not for cause, is intended to qualify as an “involuntary separation” within the meaning of Treasury Regulation § 1.409A-1(n)(2)(i), and shall be so construed and interpreted.
- (ii) Non-transferability. No right to any payment or benefit under this Employment Agreement shall be subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by Employee’s creditors or of any of Employee’s beneficiaries.
- (iii) No Acceleration. The timing of payments and benefits under the Employment Agreement which constitute a deferral of compensation under Code Section 409A may not be accelerated to occur before the time specified for payment hereunder, except to the extent permitted under Treasury Regulation § 1.409A-3(j)(4) or as otherwise permitted under Code Section 409A without Employee incurring a tax penalty.

(iv) Timing Relating to Release. Other provisions of this Employment Agreement (including this Section 10) notwithstanding, if Employee is obligated to execute a release, non-competition, or other agreement as a condition to receipt of a payment hereunder, the Company will supply to Employee a form of such release or other document not later than the date of Employee's termination, which must be returned within the time period required by law and must not be revoked by Employee within the applicable time period in order for Employee to satisfy any such condition, such that it becomes legally effective. If any amount payable during a fixed period following Employee's termination is subject to a requirement or condition requiring Employee's execution of a release (including any case in which such fixed period would begin in one year and end in the next), the Company, in determining the time of payment of any such amount, will not be influenced by Employee or the timing of any action by Employee including execution of such a release or other document and expiration of any revocation period. In particular, the Company will be entitled in its discretion to deposit any payment hereunder in escrow at any time during such fixed period, so that such deposited amount is constructively received and taxable income to Employee upon deposit (it may be constructively received even in the absence of such deposit) but with distribution from such escrow remaining subject to Employee's execution and non-revocation of such release or other document.

5

---

(v) Definition of Termination of Employment. For purposes of this Employment Agreement, the term "termination of employment" shall mean a separation from service as defined in Treasury Regulation § 1.409A-1(h); provided, however, that if a date for termination of employment is designated by the Company but Employee has a separation from service prior to such designated date, the designated termination date shall be deemed the date of termination for any compensation payable under this Agreement that would fully qualify for the short-term deferral exception under Treasury Regulation § 1.409A-1(b)(4) and/or the "two-year/two-times" exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) under both circumstances (i.e., assuming the separation from service date was the termination date hereunder or that the designated termination of employment date was the termination date hereunder), then for that purpose the termination of employment date shall be the designated termination date.

(vi) References to Other Plans. References in the Employment Agreement to the obligation of the Company to pay amounts under other plans, including Employee's vested portion of any Magellan deferred compensation or other benefit plan, shall not be construed to modify the timing of payment, which shall be governed by such other plans.

3. **Modification to "Good Reason" Definitions.** The provisions of Section 6(a) are hereby amended as follows:

After clause (z) in Section 6(a)(ii), before the period, insert the following:

provided that, in such case, Employee shall have given notice to the Company that the event or condition referred to in clause (x), (y) or (z) has arisen within ninety (90) days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than thirty (30) days after Employee has given such notice thereof to the Company (in addition to any right of the Company to cure as provided above), and Employee has terminated employment for that reason within eighteen (18) months after such uncured event or condition has arisen.

In clause (z) of Section 6(a)(ii), the term "adverse effect" is replaced by the term "material adverse effect"

4. **Other Amendments.** Other provisions of the Employment Agreement are amended as follows:

A new sentence is added as the last sentence of Section 1, stating:

Non-renewal of this Agreement by either party will in all cases result in termination of employment at the non-renewal date.

6

---

A new sentence is added at the end of Section 4(c), stating:

Annual bonus, if any, will be determined and paid (unless validly deferred if then permitted by the Company) between January 1 and March 15 of the year following the performance year.

A clause is inserted before the period at the end of Section 5, stating:

subject to Section 10(a)(iii).

A new sentence is added at the end of Section 4(b), as follows:

Any continued medical coverage following termination of employment, to the extent provided under Section 6 or any other provision of this Agreement, if and to the extent such medical coverage (or the Company's contributions or reimbursement of such coverage) represents taxable income to Employee, is intended to qualify as excluded from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(v)(B), and the rights to such coverage shall be limited to the extent necessary to qualify thereunder.

5. Nothing in this Amendment shall be construed to increase or enhance the compensation or benefits payable under the Agreement. The sole purpose of this Amendment is to add limitations required under Code Section 409A so that payments and benefits otherwise provided under the Agreement are not subject to tax penalties and other adverse consequences under Section 409A.

This amendment to Employment Agreement is entered into by the parties as of the date first above written.



By: \_\_\_\_\_  
Duly Authorized

/s/ Raju Mantena  
Raju Mantena

**Magellan Health Services, Inc.**

***Amendment to Agreements and Documents Governing Restricted Stock Units***

This document shall be deemed a global amendment to Restricted Stock Unit (“RSU”) Agreements, Notices of Restricted Stock Grant and other documents relating to RSUs under the 2006 Plan and 2008 Plan, granted by **Magellan Health Services, Inc. (“Magellan”)** on or before December 31, 2008 to the **employee named below (hereinafter “Grantee”)** and which remain outstanding after December 31, 2008. For purposes of Internal Revenue Code Section 409A (hereinafter “409A”), each tranche of RSUs that vests at a separate stated vesting date or is earned by performance over a separate measuring period is deemed to be a separate payment, and any pro rata portion of a tranche that may become vested or would not become vested upon a termination or other event in a given calendar year will be deemed to be a separate payment. The amendments herein are meant to confirm that the RSUs granted to Grantee will qualify under the IRS Section 409A “short-term deferral” rules to the maximum extent possible; RSUs not so qualifying under such “short term” deferral rules are referred to herein as “409A RSUs” .

**A. “Good Reason” Amendments**

(1.) All agreements relating to such RSUs are hereby amended as follows (to the extent such agreements do not already incorporate these terms):

With respect to the definition of “Good Reason,” the triggering event based on reduction in salary or reduction in bonus opportunity shall be triggered only for a material reduction, and references to “reduction” in such definition (relating to salary or bonus) shall be changed to refer instead to “material reduction.” At the end of the provision relating to this triggering event for Good Reason, the following provision shall be added:

For purposes of this provision, an action or actions of the Company will be deemed “material” if, individually or in the aggregate, the action or actions result(s) or potentially result(s) in a reduction in compensation in the current year or a future year having a present value to Grantee of at least one and one half percent (1.5%) of Grantee’s then current base salary, provided that actions may be material in a given case at levels less than the specified level.

The proviso at the end of the definition of “Good Reason,” dealing with the required notice from Grantee to the Company, is modified to read as follows:

provided that, in each such case, Grantee provides notice to the Company within 90 days that such event or condition constituting Good Reason has arisen, and such event or condition continues uncured for a period of more than 30 days after Grantee gives notice thereof to the Company, and Grantee terminates Service within 18 months after such event or condition has arisen.

(2.) Settlement of RSUs triggered by an event, such as vesting, shall occur on the first business day that occurs on or after the date of such event, unless a different 409A compliant settlement date is specified for such RSU.

(3.) The foregoing notwithstanding, this Part A will not apply to any RSU agreement that, due to an elective deferral or controlling language in a separate employment agreement, would constitute a 409A RSU despite the application of this Part A.

**B. Effects of RSUs Being 409A RSUs.**

If RSUs fail to qualify for exceptions from Section 409A and become 409A RSUs as defined above, the following restrictions will apply:

(1) The “six-month delay rule”

- The six-month delay rule will apply to 409A RSUs if these four conditions are met:
  - The grantee has a separation from service (within the meaning of Treasury Regulation § 1.409A-1(h))
  - A distribution of shares is triggered by the separation from service (but not due to death)
  - The Grantee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (5) thereof). The Company will determine status of “key employees” annually, under administrative procedures applicable to all 409A plans and arrangements
  - The Company’s stock is publicly traded on an established securities market or otherwise.
- If it applies, the six-month delay rule will delay a distribution in settlement of 409A RSUs triggered by separation from service where the distribution otherwise would be within six months after the separation
  - Any delayed payment shall be made on the date six months after separation from service
  - During the six-month delay period, accelerated distribution will be permitted in the event of the grantee’s death and for no other reason (including no acceleration upon a Change in Control), except for the limited exceptions permitted under the 409A regulations
  - Any payment that is not triggered by a separation from service, or triggered by a separation from service but which would be made more than six months after separation (without applying this six-month delay rule), shall be unaffected by the six-month delay rule. Each payment in a series of installments would be treated as a separate payment for this purpose.
- If the terms of a 409A RSUs agreement impose this six-month delay rule in circumstances in which it is not required for compliance with 409A, those terms shall not be given effect.

(2) Change in Control Rule:

- If any distribution of 409A RSUs would be triggered by a Change in Control, such distribution will be made only if, in connection with the Change in Control, there occurs a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(5) (a “409A Change in Control”).
- In this case, distribution of the 409A RSUs shall occur not later than five business days after (i) the occurrence of a 409A Change in Control occurring at the time of or following the Change in Control or (ii) upon occurrence of the Change in Control occurring within 90 days after the 409A Change in Control, but only if the occurrence

of the Change in Control is non-discretionary and objectively determinable at the time of the 409A Change in Control (in this case, the Grantee shall have no influence on when during such 90-day period the settlement shall occur).

- Upon a Change in Control during the six-month delay period, no accelerated distribution applies (even if the events involve a 409A Change in Control) to a distribution delayed by application of the six-month delay rule.

**(3) Separation from Service**

- Any distribution in settlement of 409A RSUs that is triggered by a termination of employment will occur only at such time as the participant has had a “separation from service” within the meaning of Treasury Regulation § 1.409A-1(h), regardless of whether any other event might be viewed as a termination of employment by the Company for any other purpose.
- In particular, if a grantee switches to part-time employment or becomes a consultant in connection with a termination of employment, whether the event will be deemed a termination of employment for purposes of 409A RSUs will be determined in accordance with Treasury Regulation § 1.409A-1(h).

**(4) Other Restrictions.**

- The settlement of 409A RSUs may not be accelerated by the Company except to the extent permitted under 409A.
- Any restriction imposed on RSUs under these 409A Compliance Rules or imposed on RSUs under the terms of other documents solely to ensure compliance with 409A shall not be applied to RSUs that are not 409A RSUs except to the extent necessary to preserve the status of such RSUs as not 409A RSUs. If any mandatory term required for 409A RSUs or non-409A RSUs to avoid tax penalties under Section 409A is not otherwise explicitly provided under this document or other applicable documents, such term is hereby incorporated by reference and fully applicable as though set forth at length herein.

**C. Other Revisions**

Any reference in an RSU agreement to the RSU continuing to be “exercisable” for a period after termination of Grantee’s service shall be stricken as inapplicable, because RSUs are not subject to “exercise.”

[Signatures Appear on Next Page]

IN WITNESS WHEREOF, the Amendment has been executed on behalf of Magellan and by Grantee whose name appears below as of the date referred to above.

Date: December 1, 2008

Magellan Health Services, Inc.

Employee / Grantee:

By:   
 Rene Lerer, President and Chief  
 Executive Officer

/s/ R. Caskie L.-Clapper  
 R C. Lewis-Clapper

**Magellan Health Services, Inc.**

***Amendment to Agreements and Documents Governing Restricted Stock Units***

This document shall be deemed a global amendment to Restricted Stock Unit (“RSU”) Agreements, Notices of Restricted Stock Grant and other documents relating to RSUs under the 2006 Plan and 2008 Plan, granted by **Magellan Health Services, Inc. (“Magellan”)** on or before December 31, 2008 to the **employee named below (hereinafter “Grantee”)** and which remain outstanding after December 31, 2008. For purposes of Internal Revenue Code Section 409A (hereinafter “409A”), each tranche of RSUs that vests at a separate stated vesting date or is earned by performance over a separate measuring period is deemed to be a separate payment, and any pro rata portion of a tranche that may become vested or would not become vested upon a termination or other event in a given calendar year will be deemed to be a separate payment. The amendments herein are meant to confirm that the RSUs granted to Grantee will qualify under the IRS Section 409A “short-term deferral” rules to the maximum extent possible; RSUs not so qualifying under such “short term” deferral rules are referred to herein as “409A RSUs” .

**A. “Good Reason” Amendments**

- (1.) All agreements relating to such RSUs are hereby amended as follows (to the extent such agreements do not already incorporate these terms):

With respect to the definition of “Good Reason,” the triggering event based on reduction in salary or reduction in bonus opportunity shall be triggered only for a material reduction, and references to “reduction” in such definition (relating to salary or bonus) shall be changed to refer instead to “material reduction.” At the end of the provision relating to this triggering event for Good Reason, the following provision shall be added:

For purposes of this provision, an action or actions of the Company will be deemed “material” if, individually or in the aggregate, the action or actions result(s) or potentially result(s) in a reduction in compensation in the current year or a future year having a present value to Grantee of at least one and one half percent (1.5%) of Grantee’s then current base salary, provided that actions may be material in a given case at levels less than the specified level.

The proviso at the end of the definition of “Good Reason,” dealing with the required notice from Grantee to the Company, is modified to read as follows:

provided that, in each such case, Grantee provides notice to the Company within 90 days that such event or condition constituting Good Reason has arisen, and such event or condition continues uncured for a period of more than 30 days after Grantee gives notice thereof to the Company, and Grantee terminates Service within 18 months after such event or condition has arisen.

- (2.) Settlement of RSUs triggered by an event, such as vesting, shall occur on the first business day that occurs on or after the date of such event, unless a different 409A compliant settlement date is specified for such RSU.
- (3.) The foregoing notwithstanding, this Part A will not apply to any RSU agreement that, due to an elective deferral or controlling language in a separate employment agreement, would constitute a 409A RSU despite the application of this Part A.

**B. Effects of RSUs Being 409A RSUs.**

If RSUs fail to qualify for exceptions from Section 409A and become 409A RSUs as defined above, the following restrictions will apply:

(1) The “six-month delay rule”

- The six-month delay rule will apply to 409A RSUs if these four conditions are met:
  - The grantee has a separation from service (within the meaning of Treasury Regulation § 1.409A-1(h))
  - A distribution of shares is triggered by the separation from service (but not due to death)
  - The Grantee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (5) thereof). The Company will determine status of “key employees” annually, under administrative procedures applicable to all 409A plans and arrangements
  - The Company’s stock is publicly traded on an established securities market or otherwise.
- If it applies, the six-month delay rule will delay a distribution in settlement of 409A RSUs triggered by separation from service where the distribution otherwise would be within six months after the separation
  - Any delayed payment shall be made on the date six months after separation from service
  - During the six-month delay period, accelerated distribution will be permitted in the event of the grantee’s death and for no other reason (including no acceleration upon a Change in Control), except for the limited exceptions permitted under the 409A regulations
  - Any payment that is not triggered by a separation from service, or triggered by a separation from service but which would be made more than six months after separation (without applying this six-month delay rule), shall be unaffected by the six-month delay rule. Each payment in a series of installments would be treated as a separate payment for this purpose.
- If the terms of a 409A RSUs agreement impose this six-month delay rule in circumstances in which it is not required for compliance with 409A, those terms shall not be given effect.

(2) Change in Control Rule:

- If any distribution of 409A RSUs would be triggered by a Change in Control, such distribution will be made only if, in connection with the Change in Control, there occurs a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(5) (a “409A Change in Control”).
- In this case, distribution of the 409A RSUs shall occur not later than five business days after (i) the occurrence of a 409A Change in Control occurring at the time of or following the Change in Control or (ii) upon occurrence of the Change in Control occurring within 90 days after the 409A Change in Control, but only if the occurrence of the Change in Control is non-discretionary and objectively determinable at the time

---

of the 409A Change in Control (in this case, the Grantee shall have no influence on when during such 90-day period the settlement shall occur).

- Upon a Change in Control during the six-month delay period, no accelerated distribution applies (even if the events involve a 409A Change in Control) to a distribution delayed by application of the six-month delay rule.

**(3) Separation from Service**

- Any distribution in settlement of 409A RSUs that is triggered by a termination of employment will occur only at such time as the participant has had a “separation from service” within the meaning of Treasury Regulation § 1.409A-1(h), regardless of whether any other event might be viewed as a termination of employment by the Company for any other purpose.
- In particular, if a grantee switches to part-time employment or becomes a consultant in connection with a termination of employment, whether the event will be deemed a termination of employment for purposes of 409A RSUs will be determined in accordance with Treasury Regulation § 1.409A-1(h).

**(4) Other Restrictions.**

- The settlement of 409A RSUs may not be accelerated by the Company except to the extent permitted under 409A.
- Any restriction imposed on RSUs under these 409A Compliance Rules or imposed on RSUs under the terms of other documents solely to ensure compliance with 409A shall not be applied to RSUs that are not 409A RSUs except to the extent necessary to preserve the status of such RSUs as not 409A RSUs. If any mandatory term required for 409A RSUs or non-409A RSUs to avoid tax penalties under Section 409A is not otherwise explicitly provided under this document or other applicable documents, such term is hereby incorporated by reference and fully applicable as though set forth at length herein.

**C. Other Revisions**

Any reference in an RSU agreement to the RSU continuing to be “exercisable” for a period after termination of Grantee’s service shall be stricken as inapplicable, because RSUs are not subject to “exercise.”

[Signatures Appear on Next Page]

---

IN WITNESS WHEREOF, the Amendment has been executed on behalf of Magellan and by Grantee whose name appears below as of the date referred to above.

Date: December 1, 2008

Magellan Health Services, Inc.

Employee / Grantee:

By:   
\_\_\_\_\_  
Rene Lerer, President and Chief  
Executive Officer

/s/ Tina M. Blasi  
\_\_\_\_\_  
Tina M. Blasi

**Magellan Health Services, Inc.**

***Amendment to Agreements and Documents Governing Restricted Stock Units***

This document shall be deemed a global amendment to Restricted Stock Unit (“RSU”) Agreements, Notices of Restricted Stock Grant and other documents relating to RSUs under the 2006 Plan and 2008 Plan, granted by **Magellan Health Services, Inc. (“Magellan”)** on or before December 31, 2008 to the **employee named below (hereinafter “Grantee”)** and which remain outstanding after December 31, 2008. For purposes of Internal Revenue Code Section 409A (hereinafter “409A”), each tranche of RSUs that vests at a separate stated vesting date or is earned by performance over a separate measuring period is deemed to be a separate payment, and any pro rata portion of a tranche that may become vested or would not become vested upon a termination or other event in a given calendar year will be deemed to be a separate payment. The amendments herein are meant to confirm that the RSUs granted to Grantee will qualify under the IRS Section 409A “short-term deferral” rules to the maximum extent possible; RSUs not so qualifying under such “short term” deferral rules are referred to herein as “409A RSUs” .

**A. “Good Reason” Amendments**

(1.) All agreements relating to such RSUs are hereby amended as follows (to the extent such agreements do not already incorporate these terms):

With respect to the definition of “Good Reason,” the triggering event based on reduction in salary or reduction in bonus opportunity shall be triggered only for a material reduction, and references to “reduction” in such definition (relating to salary or bonus) shall be changed to refer instead to “material reduction.” At the end of the provision relating to this triggering event for Good Reason, the following provision shall be added:

For purposes of this provision, an action or actions of the Company will be deemed “material” if, individually or in the aggregate, the action or actions result(s) or potentially result(s) in a reduction in compensation in the current year or a future year having a present value to Grantee of at least one and one half percent (1.5%) of Grantee’s then current base salary, provided that actions may be material in a given case at levels less than the specified level.

The proviso at the end of the definition of “Good Reason,” dealing with the required notice from Grantee to the Company, is modified to read as follows:

provided that, in each such case, Grantee provides notice to the Company within 90 days that such event or condition constituting Good Reason has arisen, and such event or condition continues uncured for a period of more than 30 days after Grantee gives notice thereof to the Company, and Grantee terminates Service within 18 months after such event or condition has arisen.

(2.) Settlement of RSUs triggered by an event, such as vesting, shall occur on the first business day that occurs on or after the date of such event, unless a different 409A compliant settlement date is specified for such RSU.

(3.) The foregoing notwithstanding, this Part A will not apply to any RSU agreement that, due to an elective deferral or controlling language in a separate employment agreement, would constitute a 409A RSU despite the application of this Part A.

**B. Effects of RSUs Being 409A RSUs.**

If RSUs fail to qualify for exceptions from Section 409A and become 409A RSUs as defined above, the following restrictions will apply:

(1) The “six-month delay rule”

- The six-month delay rule will apply to 409A RSUs if these four conditions are met:
  - The grantee has a separation from service (within the meaning of Treasury Regulation § 1.409A-1(h))
  - A distribution of shares is triggered by the separation from service (but not due to death)
  - The Grantee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (5) thereof). The Company will determine status of “key employees” annually, under administrative procedures applicable to all 409A plans and arrangements
  - The Company’s stock is publicly traded on an established securities market or otherwise.
- If it applies, the six-month delay rule will delay a distribution in settlement of 409A RSUs triggered by separation from service where the distribution otherwise would be within six months after the separation
  - Any delayed payment shall be made on the date six months after separation from service
  - During the six-month delay period, accelerated distribution will be permitted in the event of the grantee’s death and for no other reason (including no acceleration upon a Change in Control), except for the limited exceptions permitted under the 409A regulations
  - Any payment that is not triggered by a separation from service, or triggered by a separation from service but which would be made more than six months after separation (without applying this six-month delay rule), shall be unaffected by the six-month delay rule. Each payment in a series of installments would be treated as a separate payment for this purpose.
- If the terms of a 409A RSUs agreement impose this six-month delay rule in circumstances in which it is not required for compliance with 409A, those terms shall not be given effect.

(2) Change in Control Rule:

- If any distribution of 409A RSUs would be triggered by a Change in Control, such distribution will be made only if, in connection with the Change in Control, there occurs a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(5) (a “409A Change in Control”).
- In this case, distribution of the 409A RSUs shall occur not later than five business days after (i) the occurrence of a 409A Change in Control occurring at the time of or following the Change in Control or (ii) upon occurrence of the Change in Control occurring within 90 days after the 409A Change in Control, but only if the occurrence

of the Change in Control is non-discretionary and objectively determinable at the time of the 409A Change in Control (in this case, the Grantee shall have no influence on when during such 90-day period the settlement shall occur).

- Upon a Change in Control during the six-month delay period, no accelerated distribution applies (even if the events involve a 409A Change in Control) to a distribution delayed by application of the six-month delay rule.

**(3) Separation from Service**

- Any distribution in settlement of 409A RSUs that is triggered by a termination of employment will occur only at such time as the participant has had a “separation from service” within the meaning of Treasury Regulation § 1.409A-1(h), regardless of whether any other event might be viewed as a termination of employment by the Company for any other purpose.
- In particular, if a grantee switches to part-time employment or becomes a consultant in connection with a termination of employment, whether the event will be deemed a termination of employment for purposes of 409A RSUs will be determined in accordance with Treasury Regulation § 1.409A-1(h).

**(4) Other Restrictions.**

- The settlement of 409A RSUs may not be accelerated by the Company except to the extent permitted under 409A.
- Any restriction imposed on RSUs under these 409A Compliance Rules or imposed on RSUs under the terms of other documents solely to ensure compliance with 409A shall not be applied to RSUs that are not 409A RSUs except to the extent necessary to preserve the status of such RSUs as not 409A RSUs. If any mandatory term required for 409A RSUs or non-409A RSUs to avoid tax penalties under Section 409A is not otherwise explicitly provided under this document or other applicable documents, such term is hereby incorporated by reference and fully applicable as though set forth at length herein.

**C. Other Revisions**

Any reference in an RSU agreement to the RSU continuing to be “exercisable” for a period after termination of Grantee’s service shall be stricken as inapplicable, because RSUs are not subject to “exercise.”

[Signatures Appear on Next Page]

IN WITNESS WHEREOF, the Amendment has been executed on behalf of Magellan and by Grantee whose name appears below as of the date referred to above.

Date: December 1, 2008

Magellan Health Services, Inc.

Employee / Grantee:

By:   
 Rene Lerer, President and Chief  
 Executive Officer

/s/ Jeff West  
 Jeffrey N. West

**Magellan Health Services, Inc.**

***Amendment to Agreements and Documents Governing Restricted Stock Units***

This document shall be deemed a global amendment to Restricted Stock Unit (“RSU”) Agreements, Notices of Restricted Stock Grant and other documents relating to RSUs under the 2006 Plan and 2008 Plan, granted by **Magellan Health Services, Inc. (“Magellan”)** on or before December 31, 2008 to the **employee named below (hereinafter “Grantee”)** and which remain outstanding after December 31, 2008. For purposes of Internal Revenue Code Section 409A (hereinafter “409A”), each tranche of RSUs that vests at a separate stated vesting date or is earned by performance over a separate measuring period is deemed to be a separate payment, and any pro rata portion of a tranche that may become vested or would not become vested upon a termination or other event in a given calendar year will be deemed to be a separate payment. The amendments herein are meant to confirm that the RSUs granted to Grantee will qualify under the IRS Section 409A “short-term deferral” rules to the maximum extent possible; RSUs not so qualifying under such “short term” deferral rules are referred to herein as “409A RSUs” .

**A. “Good Reason” Amendments**

- (1.) All agreements relating to such RSUs are hereby amended as follows (to the extent such agreements do not already incorporate these terms):

With respect to the definition of “Good Reason,” the triggering event based on reduction in salary or reduction in bonus opportunity shall be triggered only for a material reduction, and references to “reduction” in such definition (relating to salary or bonus) shall be changed to refer instead to “material reduction.” At the end of the provision relating to this triggering event for Good Reason, the following provision shall be added:

For purposes of this provision, an action or actions of the Company will be deemed “material” if, individually or in the aggregate, the action or actions result(s) or potentially result(s) in a reduction in compensation in the current year or a future year having a present value to Grantee of at least one and one half percent (1.5%) of Grantee’s then current base salary, provided that actions may be material in a given case at levels less than the specified level.

The proviso at the end of the definition of “Good Reason,” dealing with the required notice from Grantee to the Company, is modified to read as follows:

provided that, in each such case, Grantee provides notice to the Company within 90 days that such event or condition constituting Good Reason has arisen, and such event or condition continues uncured for a period of more than 30 days after Grantee gives notice thereof to the Company, and Grantee terminates Service within 18 months after such event or condition has arisen.

- (2.) Settlement of RSUs triggered by an event, such as vesting, shall occur on the first business day that occurs on or after the date of such event, unless a different 409A compliant settlement date is specified for such RSU.
- (3.) The foregoing notwithstanding, this Part A will not apply to any RSU agreement that, due to an elective deferral or controlling language in a separate employment agreement, would constitute a 409A RSU despite the application of this Part A.

**B. Effects of RSUs Being 409A RSUs.**

If RSUs fail to qualify for exceptions from Section 409A and become 409A RSUs as defined above, the following restrictions will apply:

(1) The “six-month delay rule”

- The six-month delay rule will apply to 409A RSUs if these four conditions are met:
  - The grantee has a separation from service (within the meaning of Treasury Regulation § 1.409A-1(h))
  - A distribution of shares is triggered by the separation from service (but not due to death)
  - The Grantee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (5) thereof). The Company will determine status of “key employees” annually, under administrative procedures applicable to all 409A plans and arrangements
  - The Company’s stock is publicly traded on an established securities market or otherwise.
- If it applies, the six-month delay rule will delay a distribution in settlement of 409A RSUs triggered by separation from service where the distribution otherwise would be within six months after the separation
  - Any delayed payment shall be made on the date six months after separation from service
  - During the six-month delay period, accelerated distribution will be permitted in the event of the grantee’s death and for no other reason (including no acceleration upon a Change in Control), except for the limited exceptions permitted under the 409A regulations
  - Any payment that is not triggered by a separation from service, or triggered by a separation from service but which would be made more than six months after separation (without applying this six-month delay rule), shall be unaffected by the six-month delay rule. Each payment in a series of installments would be treated as a separate payment for this purpose.
- If the terms of a 409A RSUs agreement impose this six-month delay rule in circumstances in which it is not required for compliance with 409A, those terms shall not be given effect.

(2) Change in Control Rule:

- If any distribution of 409A RSUs would be triggered by a Change in Control, such distribution will be made only if, in connection with the Change in Control, there occurs a change in the ownership of the Company, a change in effective control of the Company, or a change in the ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(5) (a “409A Change in Control”).
- In this case, distribution of the 409A RSUs shall occur not later than five business days after (i) the occurrence of a 409A Change in Control occurring at the time of or following the Change in Control or (ii) upon occurrence of the Change in Control occurring within 90 days after the 409A Change in Control, but only if the occurrence

of the Change in Control is non-discretionary and objectively determinable at the time of the 409A Change in Control (in this case, the Grantee shall have no influence on when during such 90-day period the settlement shall occur).

- Upon a Change in Control during the six-month delay period, no accelerated distribution applies (even if the events involve a 409A Change in Control) to a distribution delayed by application of the six-month delay rule.

**(3) Separation from Service**

- Any distribution in settlement of 409A RSUs that is triggered by a termination of employment will occur only at such time as the participant has had a “separation from service” within the meaning of Treasury Regulation § 1.409A-1(h), regardless of whether any other event might be viewed as a termination of employment by the Company for any other purpose.
- In particular, if a grantee switches to part-time employment or becomes a consultant in connection with a termination of employment, whether the event will be deemed a termination of employment for purposes of 409A RSUs will be determined in accordance with Treasury Regulation § 1.409A-1(h).

**(4) Other Restrictions.**

- The settlement of 409A RSUs may not be accelerated by the Company except to the extent permitted under 409A.
- Any restriction imposed on RSUs under these 409A Compliance Rules or imposed on RSUs under the terms of other documents solely to ensure compliance with 409A shall not be applied to RSUs that are not 409A RSUs except to the extent necessary to preserve the status of such RSUs as not 409A RSUs. If any mandatory term required for 409A RSUs or non-409A RSUs to avoid tax penalties under Section 409A is not otherwise explicitly provided under this document or other applicable documents, such term is hereby incorporated by reference and fully applicable as though set forth at length herein.

**C. Other Revisions**

Any reference in an RSU agreement to the RSU continuing to be “exercisable” for a period after termination of Grantee’s service shall be stricken as inapplicable, because RSUs are not subject to “exercise.”

[Signatures Appear on Next Page]

IN WITNESS WHEREOF, the Amendment has been executed on behalf of Magellan and by Grantee whose name appears below as of the date referred to above.

Date: December 1, 2008

Magellan Health Services, Inc.

Employee / Grantee:

By:   
 Rene Lerer, President and Chief  
 Executive Officer

/s/ Daniel Gregoire  
 Daniel N. Gregoire

**EMPLOYMENT AGREEMENT**

(As amended and restated December 16, 2008)

THIS EMPLOYMENT AGREEMENT (“Agreement”) is made and entered into by and between Rene Lerer (“Executive”) and Magellan Health Services, Inc. on behalf of itself and its subsidiaries and affiliates (collectively referred to herein as the “Company” or “Employer”).

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

WHEREAS, Employer and Executive desire to set forth the terms and conditions of Executive’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 Executive, and Executive accepts such employment in accordance with the terms of this Agreement (provided, however, that the payments to be made under Section 4(b) and 4(c)(iii) intended to be exempt from Section 162(m) of the Internal Revenue Code of 1986, as amended (the “Code”), are subject to approval by the Company’s shareholders), for a term of three years from the date of the execution of this Agreement (the “Operative Date”). Thereafter, this Agreement shall automatically renew for twelve (12) month periods, unless sooner terminated as provided herein. 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 six (6) months prior to the next renewal date. Employer’s notice of intent not to renew the Agreement shall be deemed to be a termination without Cause (as defined below) occurring immediately prior to the expiration of the term of this Agreement and the provisions of Section 6(d) or 6(e), as applicable, shall apply. Non-renewal of this Agreement by either party will in all cases result in termination of employment at the non-renewal date.

2. Position And Duties Of Executive; Location Of Employment.

(a) Executive will serve as President and Chief Executive Officer and member of the board of directors of the Company (as constituted following the Operative Date) (the “Board”). Executive shall (i) report, as President and Chief Executive Officer, directly to the Board and (ii) have such duties and responsibilities typical of, and consistent with, the position of President and Chief Executive Officer in a public company the size and nature of the Company. Executive agrees to serve in such position, until the expiration of the term or such time as Executive’s employment with Employer is terminated pursuant to this Agreement.

(b) Executive shall perform his duties at the Company’s principal executive offices located in Avon, Connecticut (the “Offices”).

3. Time Devoted. Executive will devote 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. Executive 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. Notwithstanding the foregoing, Executive shall be entitled to (i) serve on the boards of directors of companies on which Executive serves as of the Operative Date, (ii) with the prior approval of the Board, serve on the boards of directors of a reasonable number of other

companies, (iii) serve on civic or charitable boards and (iv) manage his personal and family investments, to the extent such activities do not materially interfere with the performance of his duties for the Company.

4. Compensation.

(a) Base Salary. Employer will pay Executive a base salary in the amount of \$900,000 per year (“Base Salary”), with annual review for increase by the Board or a duly authorized committee thereof, it being understood that any such increase shall be at the discretion of the Board or a duly authorized committee thereof, which amount will be paid in semi-monthly intervals, less appropriate withholdings for federal and state taxes and other deductions authorized by Executive.

(b) Bonus. Executive shall be entitled to an annual target bonus opportunity of 100% of Base Salary (“Target Bonus”) with the ability to earn up to 200% of Base Salary at the sole discretion of the Board or a duly authorized committee thereof. The applicable performance targets for each year shall be fixed by the Board or a duly authorized committee thereof during the first quarter of the year after consultation with Executive (the “Performance Targets”); provided that the Performance Targets established with respect to the Target Bonus shall not be less favorable than the corporate performance targets applicable to other bonus eligible executives of the Company. The performance criteria upon which such Performance Targets are based shall be one or more of the performance criteria set forth in the Company’s Management Incentive Plan. Executive shall earn the applicable portion of the Target Bonus based on the achievement of the Performance Targets, as follows:

% Achievement of Performance Targets	% of Target Bonus Earned
100%	100%

The Board or a duly authorized committee thereof may, in its sole discretion, authorize the Company to pay Executive additional bonus amounts. Payments of any annual bonus shall be made no later than the March 15 of the year following the year in which such bonus is earned (e.g., by March 15, 2009 for the bonus earned for 2008). The Target Bonus or applicable percentage thereof, if any, for a given year shall be earned on December 31 of such year and, except

as specifically set forth in Sections 6(c)(ii) and (iii), 6(d)(ii) and (iii) and 6(e)(ii) and (iii), Executive shall not be entitled to any payment of Target Bonus, or a percentage thereof, for a given year if he is not employed on December 31 of such year.

(c) Equity Award. The Company shall make an annual equity grant to Executive ("Long Term Compensation"). The amount of Long Term Compensation will be determined annually by the Board or a duly authorized committee thereof based on performance and compensation trends in the industry. The initial Long Term Compensation to be issued in the first quarter of 2008 in accordance with the Company's Policy Regarding Awards of Equity-Based Incentive Arrangements to Executive Officers and Other Employees, which deals with the terms, timing and pricing of equity awards will be in the amount of \$3.7 million. The mix of stock options, restricted stock units ("RSUs"), and other equity-linked securities, which in 2008 will aggregate to \$3.7 million, and the performance based vesting schedule will be determined by the Board or a duly authorized committee thereof.

(d) Benefits. Executive shall be entitled to participate in the employee welfare benefit programs of the Company on a basis at least as favorable as other similarly-situated, senior-level executives of the Company; provided that (i) subject to the obligations set forth in clause (ii) below, the Board may modify or terminate any employee welfare benefit program established by the Company; provided that no such amendment or termination may adversely affect any benefits accrued by Executive prior to the date of such amendment or termination and (iii) in any event, the Company

2

---

shall provide at its cost life insurance benefits to Executive of no less than three times Executive's Base Salary, Executive shall be permitted to purchase at his own expense additional life insurance coverage in an amount no less than three times his Base Salary, and the Company shall provide long-term disability coverage equal to no less than 60% of Executive's Base Salary; provided, in all cases Executive is insurable by an insurance company with respect to such coverage.

(e) Other Long Term Incentives. Executive shall be entitled to participate in the long-term incentive programs of the Company including those contained in the Management Incentive Plan, on a basis that are at least as favorable as awards to other similarly-situated, senior-level executives of the Company, it being understood that the Board may modify or terminate any long-term incentive plan established by the Company; provided that no such amendment or termination may adversely affect any outstanding long-term incentive awards of Executive.

(f) Deferred Compensation Plan. For so long as the Company sponsors a deferred compensation plan approved by the Board on or after the Operative Date, Executive shall be entitled to participate in any such qualified or non-qualified deferred compensation plan with the Company contributing an amount equal to 11% of Executive's Base Salary or, if greater, such amount as is provided to other senior executives, on terms no less favorable a basis than is made available to other senior executives of the Company, it being understood that the Board may modify or terminate any deferred compensation plan established by the Company; provided that no such amendment or termination may adversely affect any benefits accrued by Executive prior to the date of such amendment or termination and the power to modify or terminate such a plan is subject to limitations under Code Section 409A.

(g) Perquisite. Executive shall be entitled to use of a car of his choosing leased by the Company at an expense to the Company of no more than \$25,000 per annum.

5. Expenses. During the term of this Agreement, Employer will reimburse Executive promptly for all reasonable and appropriate travel, entertainment, parking, business meetings and similar expenditures in pursuance and furtherance of Employer's business and all licensing and professional organization dues and fees and all other expenses reimbursable to employees generally pursuant to the Company's policies upon receipt of reasonably supporting documentation as required by Employer's policies applicable to its employees generally. Any reimbursement payment under Section 5, Section 4(d) or (g) or otherwise as an expense reimbursement hereunder must be paid no later than the end of Employee's taxable year next following the taxable year in which Employee incurred the reimbursable expense (but the obligation to pay promptly generally will require payment in a much shorter period).

## 6. Termination.

(a) Termination Due to Resignation. Executive may resign his employment at any time by giving 90 days written notice of resignation to Employer. Except as otherwise set forth in this Agreement, Executive's employment, and Executive's right to receive compensation and benefits from Employer, will terminate upon the effective date of Executive's termination. If Executive resigns pursuant to this Section 6(a), Employer's only remaining financial obligation to Executive under this Agreement will be to pay (subject to Section 11): (i) any earned but unpaid Base Salary through the date of termination, (ii) all vested stock options shall remain exercisable for six months following the date of termination of Executive's employment, (iii) any other amounts earned, accrued or owing to Executive but not yet paid, and (iv) other payments, entitlements or benefits, if any, that are payable in accordance with applicable plans, programs, arrangements or other agreements of the Company or any affiliate.

3

---

(b) Termination with Cause. Except as otherwise set forth in this Section 6(b), Executive's employment, and Executive's right to receive compensation and benefits from Employer, may be terminated for Cause at the discretion of Employer under the following circumstances:

(i) Executive is convicted of (or pleads guilty or nolo contendere to) a felony;

(i i) intentional fraud by Executive in the performance of his duties for the Company or intentional misappropriation of Company funds by Executive;

(iii) (A) material breach of Section 8(b), (c) or (d) of this Agreement or (B) a willful and material breach of Section 8(a) of this Agreement;

(iv) a willful and material violation by Executive of the Company's written policies and procedures that are legal and ethical and have been made available to Executive and relate to the performance of his duties for the Company (provided that the Company has not failed to terminate other employees for comparable violations) or willful gross misconduct by Executive relating to the performance of his duties for the Company; or

(v) willful failure to comply with direction of the Board or any duly authorized committee thereof (including any written policies or procedures promulgated by those bodies), provided that (A) such directions (or policies or procedures) are action of the Board or a duly authorized committee thereof within the meaning of Section 141 of the General Corporation Law of the State of Delaware (or any comparable provision of applicable law), (B) the existence of such directions (or policies or procedures) is known by Executive or such directions (or policies or procedures) have been communicated to Executive, (C) such directions (or policies or procedures) are consistent with the duties and role of a Chief Executive Officer or a director of a company the nature and size of the Company and (D) such directions (or policies or procedures) do not require actions that are illegal or unethical.

Each of clauses (i) through (v) are independent of others and the fact that Executive may not be terminated for Cause under any one of such clauses shall have no bearing on whether he may be terminated for Cause under any other such clauses. For purposes of clauses (iii) and (iv)(but not clause (v)), no act or failure to act shall be deemed to be "willful" if Executive reasonably believed in good faith that such act or failure to act was in, or not opposed to, the best interests of the Company. Anything to the contrary notwithstanding, Executive's employment shall not be terminated for "Cause," within the meaning of clauses (ii) through (v) above, unless Executive has been given written notice by the Board stating the basis for such termination and, in the case of clauses (iii) through (v) above, he is also given fifteen (15) days to cure the neglect or conduct that is the basis of any such claim and, if he fails to cure such conduct, or such conduct cannot be cured (and also for any purported termination for Cause under clause (ii) above), Executive has an opportunity to be heard before the Board and after such hearing, the Board gives Executive written notice confirming that in the judgment of a majority of the members of the Board that, for so long as the Company has or is required by law to have two such directors, includes at least two directors who are independent for purposes of the listing requirements of the principal securities exchange (including, for this purpose, the Nasdaq Stock Market) on which the Company's securities are listed (or, in the event the Company's securities are no longer listed on any such securities exchange, the listing requirements of the last such exchange on which the Company's securities were listed) "Cause" for terminating Executive's employment on the basis set forth in the original notice exists. Executive's communication to the Board of his disagreement with decisions made by the Board and the reasons for that disagreement shall not constitute "Cause" provided that he does not engage in conduct constituting Cause as set forth in clause (v) above. Any termination for Cause shall be subject to de novo review in accordance with the arbitration provisions of this Agreement. If an arbitrator or arbitrators determine

4

---

that the basis of Cause did not exist, then Executive's termination of employment shall be treated as a termination without Cause.

If Executive's employment is terminated pursuant to this Section 6(b), (A) Employer's only remaining financial obligation to Executive under this Agreement will be to pay (subject to Section 11): (i) any earned but unpaid Base Salary through the date of termination, (ii) any other amounts earned, accrued or owing to Executive but not yet paid, and (iii) other payments, entitlements or benefits, if any, that are payable in accordance with applicable plans, programs, arrangements or other agreements of the Company or any affiliate and (B) all stock options shall terminate immediately upon the date of termination.

(c) Automatic Termination. This Agreement and Executive's employment hereunder will terminate automatically upon the death or Disability of Executive. "Disability" shall mean Executive's inability, due to physical or mental incapacity, to substantially perform his duties and responsibilities for a period of 180 consecutive days as determined by a medical doctor selected by the Company and Executive. If the parties cannot agree on a medical doctor, each party shall select a medical doctor and the two doctors shall select a third doctor who shall be the approved medical doctor for this purpose. If Executive's employment is terminated pursuant to this Section 6(c), Executive (or in the event of his death, his estate or other legal representative) will receive (subject to Section 11):

(i) Base Salary through the end of the month in which termination occurs (Section 11(a) may apply, however);

(ii) An amount equal to the product of the Target Bonus for the year in which termination occurs and a fraction, the numerator of which is the number of elapsed days in such year of termination up to and including the date of termination and the denominator of which is 365 (366 in the case of a leap year)("pro rata Target Bonus"), payable in a single installment immediately after termination (the six-month delay rule of Section 11(d) may apply, however);

(iii) in the case of a termination due to Executive's Disability, a lump-sum cash payment equal to two times the sum of (a) Base Salary plus (b) Target Bonus; provided that this payment shall be made only if Executive's circumstances constituting Disability are not covered by the Company's long-term disability program so that Executive will not receive long-term disability benefits under such program as in effect on December 31, 2008. The Company will not reduce the long-term disability coverage (in scope or amount) of Executive after December 31, 2008, and any broadening of the scope of disability coverage under such program will not apply to Executive unless payments under such broadened coverage would be in the same form and at the same times as under the Section 6(c)(iii). Amounts due to Executive under this Section 6(c)(iii) will be payable in a single installment immediately after termination (the six-month delay rule of Section 11(d) may apply, however);

(iv) accelerated vesting of all outstanding equity awards not yet vested, with all vested options remaining exercisable for two years following termination (but not beyond the original term of such options); options that are not exercisable as of the date of termination because the applicable performance hurdle has not been satisfied as of such date shall not become exercisable until and unless the applicable conditions for exercisability are satisfied during this two-year post-termination exercise period (Section 11 may apply to equity awards constituting deferrals of compensation under Code Section 409A, however);

(v) continued health benefits for Executive and his spouse in the event of Executive's disability, and for Executive's spouse in the event of his death, as described in Section 6 (d) (v) below;

(vi) any other amounts earned, accrued or owing to Executive but not yet paid (Section 11(b)(i) may apply, however); and

5

---

(vi) other payments, entitlements or benefits, if any, that are payable in accordance with applicable plans, programs, arrangements or other agreements of the Company or any affiliate.

(d) Termination Without Cause By The Company or With Good Reason By Executive. Employer may terminate this Agreement and Executive's employment without Cause at any time. If Employer terminates this Agreement without Cause or if Executive terminates this Agreement and Executive's employment with Good Reason, Executive shall (unless Section 6(e) is applicable) receive (subject to Section 11):

(i) Base Salary through the date of termination;

(ii) pro-rata Target Bonus for the year in which termination occurs, payable in a single installment immediately after termination (the six-month delay rule of Section 11(d) may apply, however);

(iii) 2 times the sum of (a) Base Salary plus (b) Target Bonus, payable in a single cash installment immediately after termination (the six-month delay rule of Section 11(d) may apply, however);

(iv) accelerated vesting of all outstanding equity awards not yet vested, with all vested options remaining exercisable for two years after termination (but not beyond the original term of such options); options that are not exercisable as of the date of termination because the applicable performance hurdle has not been satisfied as of such date shall not become exercisable until and unless the applicable conditions for exercisability are satisfied during this two-year post-termination exercise period (Section 11 may apply to equity awards constituting deferrals of compensation under Code Section 409A, however);

(v) health benefits as follows: If and for so long as Executive is eligible following termination of employment for continued coverage under the Company's medical, dental and hospitalization plans (the "Health Plan"), the Company shall continue to provide such coverage to Executive and his spouse until Executive shall attain age 65 and for his spouse until she shall attain age 65. If such continued insurance coverage under the Health Plan is not available, and if Executive is eligible upon termination of employment for COBRA continuation coverage under the Health Plan and elects such coverage, Executive shall receive cash payments equal on an after-tax basis to the full monthly premium cost to Executive to purchase such COBRA continuation coverage for Executive and his spouse, with such payments to be made by the Company to Executive on a monthly basis for the duration of Executive's COBRA continuation period and in accordance with Section 11, which payments shall be made in lieu of any payments provided hereinabove that would otherwise be made during the COBRA continuation period so that there is no duplication of payments during the COBRA continuation period. (Such right to reimbursement of the cost of COBRA participation shall be deemed a separate payment right from other rights under this Section 6(d)(v). If or when Executive is not eligible for such continued coverage under the Health Plan, Executive shall instead receive cash payments equal on an after-tax basis to the cost of an individual insurance policy which the Company shall obtain to provide health coverage equivalent to that which Executive would have received under the Health Plan had Executive and his spouse qualified for such coverage under the Health Plan, with such payments to be made by the Company to Executive on a monthly basis until Executive shall attain age 65 and for Executive's spouse until she shall attain age 65 and in accordance with Section 11 (it being understood that the Company payments to Executive attributable to this coverage will be equal on an after-tax basis to the full monthly premium cost to Executive to purchase such coverage independently). If no such insurance coverage can be purchased independently, the Company shall pay for medical, dental and hospitalization expenses incurred by Executive and his spouse (each until

6

---

age 65) to the full extent such expenses would have been paid under such coverage, with an additional payment of a gross-up for taxes on the benefits received by Executive and his spouse (including the gross-up). If Executive enrolls in group health insurance coverage with another employer following termination of his employment with the Company, the Company's obligations under this section shall be suspended for the period during which such other health insurance is in effect. Executive shall not be required to enroll in any such coverage with a new employer, and if any such coverage procured by Executive ceases for any reason before Executive and his wife reach age 65, the obligations of the Company under this section shall arise again for the remaining period until Executive and his wife each reach age 65. If any benefit under this Section 6(d)(v) constitutes a deferral of compensation not compliant with Code Section 409A, the Company will pay to executive a gross-up so that the after tax cost of the benefit, taking into account penalties and interest incurred under Section 409A, to Executive and his spouse will be the same as if this benefit were compliant with Section 409A;

(vi) at his election, continuation of his life insurance and/or long-term disability coverage by the Company for up to two years following termination (provided Executive reimburses the Company for such premiums);

(vii) any other amounts earned, accrued or owing to Executive but not yet paid (Section 11(b)(i) may apply, however);

(viii) other payments, entitlements or benefits, if any, that are payable in accordance with applicable plans, programs, arrangements or other agreements of the Company or any affiliate.

For purposes of this Agreement "Good Reason" shall mean termination by Executive of his employment after written notice to the Company following the occurrence of any of the following events without his consent:

(i) a reduction in Executive's then current Base Salary, the then Target Bonus opportunity (i.e., 100% of Base Salary) or, to the extent as would constitute a breach of this Agreement, any other compensation to which Executive is entitled under this Agreement, other than a reduction in the right to participate in a deferred compensation plan if such reduction is applicable to all senior executives;

(ii) a material diminution in Executive's positions, duties or authorities (including any removal of Executive from any position set forth in Section 2 above, or any failure to elect or re-elect the Executive as a member of the Board) or interference with Executive's carrying out his duties or exercising his authority so that he is unable to carry out his duties or exercise his authority as Chief Executive Officer or director (including any action by the Board or one or more members thereof to give direction to other employees of the Company with the intent of undermining, or in a manner that, by itself or in combination with other actions described in this parenthetical in clause (ii), could reasonably be expected to materially undermine Executive's authority, provided that no action taken by (A) the Board or one or more members thereof in accordance with any requirement of law or regulation or the listing standards of NASDAQ or other securities exchange on which the Company's securities are listed or (B) the Board as a whole or a duly authorized committee of the Board as a whole, in accordance with generally accepted principles of sound corporate governance for public companies of the size and nature of the Company, shall constitute "Good Reason");

(iii) the assignment to Executive of duties which are materially inconsistent with his duties or which materially impair Executive's ability to function as President and Chief Executive Officer of the Company or as director;

(iv) a change in the reporting structure so that Executive reports to someone other than the Board;

7

(v) requiring Executive to relocate, or the relocation of the Offices, to a location that is more than 30 miles from Avon, Connecticut;

(vi) a breach by the Company of any material provision of this Agreement;

(vii) the failure of the Company to obtain the assumption in writing of its obligation to perform this Agreement by any successor to all or substantially all of the assets of the Company within 15 days after a merger, consolidation, sale or similar transaction; or

(viii) for any reason by Executive during the 30-day period immediately following the six-month anniversary of a Change in Control (whether or not Executive consented to such Change in Control);

provided that in the case of clauses (i) through (vii) (but not clause (viii)) such event continues uncured for fifteen (15) days after Executive gives the Company notice thereof.

The foregoing notwithstanding, solely with respect to RSUs or other equity award that would qualify as a short-term deferral but for Executive's right to terminate for Good Reason under the foregoing definition, for any such award granted before a Change in Control (as defined below) the applicable definition of Good Reason shall be that set forth above but modified such that (A) the reduction in compensation referenced in clause (i) must be material (for this purpose, a reduction in Base Salary, Target Bonus or other compensation with an annualized value, separately or in the aggregate, of at least 1.5% of pre-reduction Base Salary shall be deemed material, but other reductions may be material in the circumstances); (B), for avoidance of doubt, the assignment of materially inconsistent duties under clause (iii) must be materially adverse to Executive; (C) clause (viii) shall not apply (because Section 7 would apply earlier, upon the Change in Control, in any event); and (D), in all cases, Executive shall have given notice to the Company that the event or condition referred to any of the applicable clauses has arisen within 90 days after such event or condition has arisen, and the event or condition has continued uncured for a period of more than 30 days after Executive has given such notice thereof to the Company (in addition to any other right of the Company to cure), and Executive has terminated employment for that reason within 18 months after such uncured event or condition has arisen.

(e) Termination Without Cause By the Company or With Good Reason By Executive In Connection With, Or Within Three Years After, A Change in Control. If Employer terminates this Agreement and Executive's employment without Cause, or if Executive terminates this Agreement and his employment with Good Reason, in connection with a Change in Control (as defined below)(whether before or at the time of such Change in Control) or within three years after a Change in Control, Executive shall receive, in lieu of the amounts and benefits described in Section 6(d):

(i) Base Salary through the date of termination;

(ii) pro-rata Target Bonus for the year in which termination occurs, payable in a single installment immediately after termination (the six-month delay rule of Section 11(d) may apply, however);;

(iii) 3 times the sum of (a) Base Salary plus (b) Target Bonus, payable in a single cash installment immediately after termination (the six-month delay rule of Section 11(d) may apply, however);;

(iv) accelerated vesting of all outstanding equity awards not yet vested, with all vested options remaining exercisable for two years after termination (but not beyond the original term of such options); options that are not exercisable as of the date of termination because the applicable

performance hurdle has not been satisfied as of such date shall not become exercisable until and unless the applicable conditions for exercisability are satisfied during this two-year post-termination exercise period; provided that this clause (iv) shall apply to stock options that vested upon the Change in Control as provided in Section 7 below only if such options will receive more favorable treatment under this clause (Section 11 may apply to equity awards constituting deferrals of compensation under Code Section 409A, however);

(v) health benefits as provided in Section 6(d)(v) above;

(vi) at his election, continuation of his life insurance and/or long-term disability coverage by the Company for up to three years following termination (provided Executive reimburses the Company for such premiums);

(vii) any other amounts earned, accrued or owing to Executive but not yet paid (Section 11(b)(i) may apply, however);

(viii) other payments, entitlements or benefits, if any, that are payable in accordance with applicable plans, programs, arrangements or other agreements of the Company or any affiliate.

For purposes of this Agreement "Change in Control" shall mean the occurrence of any one of the following events:

(i) any "person," as such term is used in Sections 3(a)(9) and 13(d) of the Securities Exchange Act of 1934, becomes after the Operative Date a "beneficial owner," as such term is used in Rule 13d-3 promulgated under that act, of 30% or more of the Voting Stock of the Company;

(ii) the majority of the Board consists of individuals other than Incumbent Directors, which term means the members of the Board on the Operative Date; provided that any person becoming a director subsequent to the Operative Date whose election or nomination for election was supported by two-thirds of the directors who then comprised the Incumbent Directors, shall be considered to be an Incumbent Director;

(iii) the Company adopts any plan of liquidation providing for the distribution of all or substantially all of the Company's assets;

(iv) all or substantially all of the assets of the Company are disposed of pursuant to a merger, consolidation, share exchange, reorganization or other transaction unless the shareholders of the Company immediately prior to such merger, consolidation, share exchange, reorganization or other transaction

beneficially own, directly or indirectly, in substantially the same proportion as they owned the Voting Stock or other ownership interests of the Company, a majority of the Voting Stock or other ownership interests of the entity or entities, if any, that succeed to the business of the Company; or

(v) the Company combines with another company and is the surviving corporation but, immediately after the combination, the shareholders of the Company immediately prior to the combination hold, directly or indirectly, 50% or less of the Voting Stock of the combined company (there being excluded from the number of shares held by such shareholders, but not from the Voting Stock of the combined company, any shares received by Affiliates of such other company who were not Affiliates of the Company prior to the relevant transaction in exchange for stock of such other company).

For purposes of the Change in Control definition, (A) "the Company" shall include any entity that succeeds to all or substantially all of the business of the Company, (B) "Affiliate" of a person or other

---

entity shall mean a person or other entity that directly or indirectly controls, is controlled by, or is under common control with the person or other entity specified, and (C) "Voting Stock" shall mean any capital stock of any class or classes having general voting power under ordinary circumstances, in the absence of contingencies, to elect the directors of a corporation and reference to a percentage of Voting Stock shall refer to such percentage of the votes of such Voting Stock.

(f) 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 the last sentence of Section 1, this Section 6 and Sections 7, 8, 9 and 10; and all procedural and remedial provisions of this Agreement.

(g) No Mitigation; No Offset. In the event of termination of employment, Executive shall be under no obligation to seek other employment, and there shall be no offset against any amounts due him under the Agreement on account of any remuneration attributable to any subsequent employer or claims asserted by the Company or any affiliate.

#### 7. Change In Control Protection.

(a) Treatment of Equity. There shall be full vesting immediately prior to a Change in Control that occurs prior to the termination of Executive's employment for any reason of all outstanding equity awards (including, but not limited to, stock options), with all vested stock options to remain exercisable for the remainder of their terms; provided that options held by Executive shall be cashed out in connection with a Change in Control if (i) required by the terms of the Management Incentive Plan and (ii) all other options issued by the Company are cashed out in connection with such Change in Control (the amount payable shall not exceed the difference between the fair market value at the settlement date and the aggregate exercise price of such stock options, such limit to be applied in conformity with Code Section 409A). Options that are not exercisable because the applicable performance hurdle has not been satisfied shall become exercisable immediately prior to a Change in Control that occurs prior to the termination of Executive's employment for any reason.

(b) Tax Gross-Up. The following provisions shall apply with respect to any excise tax imposed under Section 4999 of the Internal Revenue Code as amended (the "Code"), (the "Excise Tax"):

(i) If any of the payments or benefits received or to be received by Executive in connection with a Change in Control or Executive's termination of employment (whether pursuant to the terms of this Agreement or any other plan, arrangement or agreement with the Company, any person whose actions result in a Change in Control of the Company or any person affiliated with the Company or such person (the "Total Payments")) will be subject to the Excise Tax, the Company shall pay to Executive an additional amount (the "Gross-Up Payment") such that the net amount retained by Executive after payment of (a) the Excise Tax, if any, on the Total Payments and (b) any Excise Tax and income tax due in respect of the Gross-Up Payment, shall equal the Total Payments. Such payment shall be made in a single lump sum within 10 days following the date a determination that only such payment is required (subject to Section 11).

(ii) For purposes of determining whether any of the Total Payments will be subject to Excise Tax and the amount of such Excise Tax, (i) any Total Payments shall be treated as "parachute payments" (within the meaning of Section 280G(b)(2) of the Code) unless, in the opinion of tax counsel selected by the Company and reasonably acceptable to Executive, such payments or benefits (in whole or in part) should not constitute parachute payments, including by reason of Section 280G(b)(4)(A) of the Code, and all "excess parachute payments" (within the meaning of Section 280G(b)(1) of the Code) shall be treated as subject to the Excise Tax unless, in the opinion of such tax counsel, such excess parachute payments (in whole or in part) represent reasonable compensation for

---

services actually rendered (within the meaning of Section 280G(b)(4)(B) of the Code), or are otherwise not subject to the Excise Tax, and (ii) the value of any non-cash benefits or any deferred payment or benefit shall be determined by the Company's independent auditors in accordance with the principles of Section 280G(d)(3) of the Code. For purposes of determining the amount of the Gross-Up Payment, Executive shall be deemed to pay federal income and employment taxes at the highest marginal rate of federal income and employment taxation in the calendar year in which the Gross-Up Payment is to be made and state and local income and employment taxes at the highest marginal rate of taxation in the state and locality of Executive's residence on the date of termination of employment (or such other time as hereinafter described), net of the maximum reduction in federal income or employment taxes which could be obtained from deduction of such state and local taxes.

In the event that the Excise Tax is subsequently determined to be less than the amount taken into account hereunder at the time of termination of Executive's employment (or such other time as is hereinafter described), Executive shall repay to the Company, at the time that the amount of such reduction in Excise Tax is finally determined, the portion of the Gross-Up Payment attributable to such reduction plus interest on the amount of such repayment at the applicable federal rate, as defined in Section 1274(b)(2)(B) of the Code. In the event that the Excise Tax is determined to exceed the amount taken into account hereunder at the time of the termination of Executive's employment (or such other time as is hereinafter described) (including by reason of any payment the existence or amount of which cannot be determined at the time of the Gross-Up Payment), the Company shall make an additional Gross-Up Payment in respect of such excess (plus any interest at the applicable federal rate, penalties or additions payable by Executive with respect to such excess) at

the time that the amount of such excess is finally determined. Executive and the Company shall each reasonably cooperate with the other in connection with any administrative or judicial proceedings concerning the existence or amount of liability for Excise Tax with respect to the Total Payments.

#### 8. Protection Of Confidential Information/Non-Competition/Non-Solicitation.

Executive covenants and agrees as follows:

(a) (i) Confidential Information: During Employer's employment of Executive and following the termination of Executive's employment for any reason, Executive 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 Executive's employment or after receipt of the prior written consent of Employer, any Confidential Information (as herein after defined) of Employer or its controlled subsidiaries or affiliates, that comes into his knowledge during his employment by Employer (the "Confidential Information"). The obligation not to use or disclose any Confidential Information will not apply to any Confidential Information that (i) is or becomes public knowledge through no fault of Executive, 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 (ii) is obligated to be produced under order of a court of competent jurisdiction or a valid administrative, congressional, or other subpoena, civil investigative demand or similar process; provided, however, that upon issuance of any such order, subpoena, demand or other process, Executive shall promptly notify the Employer and shall provide the Employer with a n opportunity (if then available) to contest and cooperate with the Employer to contest, in each case, at the Employer's expense, the propriety of such order or subpoena (or to arrange for appropriate safeguards against any further disclosure by the court or administrative or congressional body seeking to compel disclosure of such Confidential Information). The above will be without prejudice to any additional rights or remedies of Employer under any state or federal law protecting trade secrets or other information.

(ii) Trade Secrets. Executive shall hold in confidence all Trade Secrets of Employer, its direct and indirect subsidiaries, and/or its customers that came into his knowledge during his

11

---

employment by Employer and shall not disclose, publish or make use of at any time after the date hereof such Trade Secrets, other than at the direction of Employer, for as long as the information remains a Trade Secret.

(iii) For purposes of this Agreement, the following definitions apply:

"Confidential Information" means any data or information, other than Trade Secrets, that is valuable to Employer and not generally known to the public or to competitors of Employer.

"Trade Secret" means information including, but not limited to, any technical or non-technical data, know-how, software, formula, pattern, compilation, program, device, method, technique, plan, blueprint, drawing, process, financial data, financial plan, product plan, list of actual or potential customers or suppliers or other information similar to any of the foregoing, which (i) derives economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can derive economic value from its disclosure or use; and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

(iv) Interpretation. The restrictions stated in paragraphs 8(a)(i) and 8(a)(ii) are in addition to and not in lieu of protections afforded to trade secrets and confidential information under applicable state law. Nothing in this Agreement is intended to or shall be interpreted as diminishing or otherwise limiting Employer's right under applicable state law to protect its trade secrets and confidential information.

(b) Non-Competition.

(i) Executive covenants and agrees that for any period during which Base Salary is continued (or in respect of which it is paid in a lump sum), or for one year after Executive's voluntary termination of employment without Good Reason or his termination of employment for Cause ("Non-Compete Period"), he will not directly or indirectly engage in or invest in, own, manage, operate, finance, control or participate in the ownership, management, operation, financing or control of, be employed by, associated with or in any manner connected with, lend Executive's name or any similar name to, lend Executive's credit to, or render services or advice to any business similar to or competitive with any business engaged in, or which provides goods or services similar to or competitive with any goods and services provided by Employer or its subsidiaries or affiliates at the time of termination, in the United States or any other geographic location in which Employer or a controlled subsidiary or affiliate of Employer operates, other than Internet Healthcare Group, Digital Insurance, and Navimedix, unless waived in writing by Employer in its sole discretion. Executive recognizes that the above restriction is reasonable and necessary to protect the interest of the Employer and its controlled subsidiaries and affiliates.

The foregoing shall not be deemed to prohibit Executive's association with a company if an immaterial portion of such company's revenues is attributable to operations directly competitive with the Company (provided Executive is not employed within those directly competitive operations). Further, nothing contained in this Section 8(b)(i) shall restrict Executive from making any investments in any corporation or other business enterprise whose outstanding capital stock or other equity interests are listed or admitted to unlisted trading privileges on a national securities exchange or included for quotation through an inter-dealer quotation system of a registered national securities association, provided that such investment (i) represents less than five percent (5%) of the aggregate outstanding capital stock or other equity interests of such corporation, partnership or business enterprise and (ii) does not otherwise provide Executive or any affiliate of Executive with the right or power (whether or not exercised) to influence, direct or cause the direction of the management,

12

---

policies and/or affairs of any business or enterprise which is or might directly or indirectly compete with any business operations or activities of Company or any of its subsidiaries.

(ii) During the period following Executive's termination from his employment with Employer for which Executive is subject to the restrictions set forth in Section 8(b)(i), Executive may submit a written request to Employer outlining a proposed employment or other employment opportunity that

Executive is considering. Employer will review such request and make a determination, in its sole discretion, as to whether the opportunity would constitute a breach of the non-competition covenant.

(c) **Non-Solicitation.** To protect the goodwill of Employer and its controlled subsidiaries and affiliates, or the customers of Employer and its controlled subsidiaries and affiliates, Executive agrees that, during his employment and for any period during which Base Salary is continued (or in respect of which it is paid in a lump sum), or for one year after Executive's voluntary termination of employment without Good Reason or his termination of employment for Cause, he or she will not, without the prior written permission of Employer, directly or indirectly, for himself or on behalf of any other person or entity, solicit, divert away, take away or attempt to solicit or take away any Customer of Employer for purposes of providing or selling services that are offered by Employer or a controlled subsidiary or affiliate of Employer. For purposes of this Section 8(c), "Customer" means any individual or entity to whom Employer or its controlled subsidiaries or affiliates has provided, or contracted to provide, services during the twelve months prior to the termination of his employment.

(d) **Solicitation of Employees.** During Employer's employment of Executive and for any period during which Base Salary is continued (or in respect of which it is paid in a lump sum), or for one year after Executive's voluntary termination of employment without Good Reason or his termination of employment for Cause, Executive will not, and will not assist any other person or entity to, directly or indirectly, solicit for employment or consultation 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 Executive's termination, or in any manner knowingly induce or attempt to induce any such employee to terminate his or her employment with Employer.

9. **Work Made For Hire.** Executive agrees that any written program materials, protocols, research papers, other writings (including those in electronic format), as well as improvements, inventions, new techniques, programs or products (the "Work") made or developed by Executive within or after normal working hours relating to the business or activities of Employer or any of its subsidiaries, shall be deemed to have been made or developed by Executive solely for the benefit of Employer and 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, Executive agrees to assign, convey, and transfer to the Employer all right, title and interest Executive 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, without payment of any consideration by Employer, except as set forth in this Agreement. Additionally, Executive agrees to execute any documents necessary for Employer to record and/or perfect its ownership of the Work and the applicable copyright.

10. **Property Of Employer.** Executive agrees that, upon the termination of Executive's employment with Employer, Executive 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 Executive.

13

---

11 **Special Rules for Compliance with Code Section 409A.** This Section 11 serves to ensure compliance with applicable requirements of Code Section 409A. Certain provisions of this Section 11 modify other provisions of this Agreement. If the terms of this Section 11 conflict with other terms of the Agreement, the terms of this Section 11 control.

(a) **Definition of Termination of Employment; Timing Rule Where Separation from Service Precedes Designated Termination Date.** For purposes of this Agreement, the term "termination of employment" shall mean a separation from service as defined in Treasury Regulation § 1.409A-1(h); provided, however, that if a date for termination of employment is designated by the Company but Executive has a separation from service prior to such designated date, the designated termination date shall be deemed the date of termination for any compensation payable under this Agreement that would fully qualify for the short-term deferral exception under Treasury Regulation § 1.409A-1(b)(4) and/or the "two-year/two-times" exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii) under both circumstances (i.e., assuming the separation from service date was the termination date hereunder or that the designated termination of employment date was the termination date hereunder); in such case, the termination date may not be designated so as to cause such compensation to be a deferral of compensation under Section 409A. If Executive has a separation from service in connection with a non-renewal of the Agreement under Section 1, resignation under Section 6(a) or other circumstance but remains entitled to payments of salary or other amounts under this Agreement through the designated termination date or until the end of the month in which the designated termination date occurs, if such payments constitute a deferral of compensation they shall be subject to Section 11(d).

(b) **Timing of Certain Payments.** Payments and benefits specified under this Agreement shall be paid at the times specified as follows:

(i) **Accrued Payments at Termination.** In the case of any amount that is earned but unpaid at the time of Executive's termination of employment, unless the amount is payable under an applicable plan, program or arrangement on explicit terms providing for a delay in payment compliant with Code Section 409A, these amounts shall be payable at the date the amounts otherwise would have been payable under the applicable plans, programs and arrangements in the absence of termination but in no event more than 30 days after Executive's termination of employment, subject to Section 11(d).

(ii) **Gross-Up.** Gross-up payments payable under Section 7(b) will be paid at the time specified in Section 7(b)(i), and in any event must be paid no later than the end of Executive's taxable year next following the taxable year in which Executive remits the excise tax or related taxes to the taxing authorities; provided, however, that any gross-up payment will be subject to Section 11(d) if applicable under Section 409A.

(iii) **Other Payments.** Any other payment or benefit required under this Agreement to be paid in a lump sum or otherwise to be paid promptly at or following a date or event shall be paid within five days after the due date, subject to Section 11(c) and (d) below.

(iv) **No Influence on Year of Payment.** In the case of any payment under the Agreement payable during a specified period of time following a termination or other event (including any payment for which the permitted payment period begins in one calendar year and ends in a subsequent calendar year), Executive shall have no right to elect in which year the payment will be made, and the Company's determination of when to make the payment shall not be influenced in any way by Executive.

14

---

(c) Special Rules for Termination Payments. With respect to severance amounts and bonus payments for the year of termination payable under this Agreement, the following rules will apply:

(i) Separate Payments. Amounts payable under this Agreement shall be deemed separate payments for purposes of Code Section 409A as follows (each clause constituting a separate payment to the extent permitted under Section 409A):

(A) The amount specified Section 6(d)(iii) and the equal amount under Section 6(e)(iii);

(B) The amount by which the amount payable under Section 6(e)(iii) exceeds that payable under Section 6(d)(iii);

(C) The amount specified in Section 6(c)(iii); and

(D) The amount specified in Sections 4(b), 6(c)(ii), 6(d)(ii) and 6(e)(ii).

Amounts may be further designated as separate payments in any separately identifiable plan or arrangement for purposes of Section 409A.

(ii) Payment Timing Rules. A payment referenced in Section 11(c)(i) shall be payable as a lump-sum payment at the date of termination of employment if and to the extent that (A) the separate payment constitutes short-term deferral under Treasury Regulation § 1.409A-1(b)(4), (B) the amount of the separate payment not covered by Section 11(c)(ii)(A) can be paid under the “two-year/two-times” exclusion from being a deferral of compensation under Treasury Regulation § 1.409A-1(b)(9)(iii), after first applying such exclusion under Section 11(b)(ii), (C) the separate payment is covered by any other applicable exclusion or exemption under Treasury Regulation § 1.409A-1(b)(9) (provided that the exclusion under subsection (b)(9)(v)(D) shall be not be used for this purpose) and (D), the six-month delay rule in Section 11(d) does not apply to the separate payment. Any other such separate payment (i.e., amounts subject to the six-month delay rule) shall be subject to the six-month delay rule of Section 11(d). Any delay in payment under the six-month delay rule shall not limit Executive’s rights under this Agreement to not forfeit a specified item of compensation as a result of Executive’s termination.

(d) Six-Month Delay Rule.

(i) General Rule. The six-month delay rule will apply to payments and benefits under the Agreement payable upon a termination of employment if all of the following conditions are met:

(A) Executive is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (10) thereof) for the year in which the termination occurs. The Company will determine status of “key employees” annually, under administrative procedures applicable to all Section 409A plans and arrangements and applied in accordance with Treasury Regulation § 1.409A-1(i).

(B) The Company’s stock is publicly traded on an established securities market or otherwise.

(C) The payment or benefit in question is a deferral of compensation and not excepted, exempted or excluded from being such by the short-term deferral rule under Treasury Regulation § 1.409A-1(b)(4), or the “two-years/two-times” rule in Treasury Regulation § 1.409A-1(b)(9)(iii), or any other exception, exemption or exclusion;

15

---

provided, however, that the exclusion under Treasury Regulation § 1.409A-1(b)(9)(v)(D) shall not be applied to severance payments or pro-rata bonus payments.

(ii) Effect of Rule. If it applies, the six-month delay rule will delay a payment or benefit which otherwise would be payable under this Agreement within six months after Executive’s termination of employment.

(A) Any delayed payment or benefit shall be paid on the date six months after Executive’s separation from service.

(B) During the six-month delay period, accelerated payment will occur in the event of the Executive’s death but not for any other reason (including no acceleration upon a Change in Control), except for accelerations expressly permitted under Treasury Regulation § 1.409A-1 — A-6.

(C) Any payment that is not triggered by a termination, or is triggered by a termination but would be made more than six months after the termination (without applying this six-month delay rule), or would be payable at a fixed date not tied to termination that is earlier than the expiration of the six-month delay period, shall be unaffected by the six-month delay rule.

(iii) Limit to Application of Six-Month Delay Rule. If the terms of this Agreement or other plan or arrangement or document relating to this Agreement or payments hereunder impose this six-month delay rule in circumstances in which it is not required for compliance with Section 409A, those terms shall not be given effect.

(e) Other Provisions.

(i) Reimbursements and In-Kind Benefits. Any reimbursements made or in-kind benefits provided under this Agreement shall be subject to the following conditions:

(A) The amount of expenses eligible for reimbursement or in-kind benefits provided in any one taxable year of Executive shall not affect the amount of expenses eligible for reimbursement or in-kind benefits provided in any other taxable year of Executive;

(B) The reimbursement of any expense shall be made each calendar quarter and not later than the last day of Executive's taxable year following Executive's taxable year in which the expense was incurred (unless this Agreement specifically provides for reimbursement by an earlier date);

(C) The right to reimbursement of an expense or payment of an in-kind benefit shall not be subject to liquidation or exchange for another benefit (this provision does not override express terms of Sections 4(d)(v) and 5(d)(v), however).. .

In addition, with respect to any reimbursement made under Sections 4(d)(v) or 5(d)(v) for expenses for medical coverage paid for by Executive, any such reimbursements made during the period of time Executive would be entitled (or would, but for such reimbursement, be entitled) to continuation coverage under the Company Health Plan pursuant to COBRA if Executive had elected such coverage and paid the applicable premiums shall be exempt from Section 409A of the Code and the six-month delay in payment described in this Section 11 pursuant to Section 1.409A-1(b)(9)(v)(B) of the Regulations.

16

---

Executive's right to reimbursements and in-kind benefits under this Agreement shall be treated as a right to a series of separate payments under Section 1.409A-2(b)(2)(iii) of the Regulations.

- (ii) Non-transferability. No right to any payment or benefit under this Agreement shall be subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by Executive's creditors or of any of Executive's beneficiaries.
- (iii) No Acceleration. The timing of payments and benefits under the Agreement which constitute a deferral of compensation under Code Section 409A may not be accelerated to occur before the time specified for payment hereunder, except to the extent permitted under Treasury Regulation § 1.409A-3(j)(4) or as otherwise permitted under Code Section 409A without Executive incurring a tax penalty.
- (iv) References to Other Plans. References in the Agreement to the obligation of the Company to pay amounts under other plans, including Executive's vested portion of any Company deferred compensation or other benefit plan, shall not be construed to modify the timing of payment, which shall be governed by such other plans.

12. Remedies. An actual or threatened violation by Executive of the covenants and obligations set forth in Sections 8, 9 and 10 will cause irreparable harm to Employer or its controlled subsidiaries or affiliates and the remedy at law for any such violation will be inadequate. Executive 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.

13. Arbitration. Except for an action for injunctive relief as described in Section 12, any disputes or controversies arising under this Agreement will be settled by arbitration in Hartford, Connecticut, in accordance with the Commercial Arbitration Rules of the American Arbitration Association. 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. The costs and expenses of the arbitration shall be paid for by Employer, but each party shall pay its own attorney's fees and other litigation costs.

Executive's Initials

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 Executive: Address on file with Employer.

To Employer: Magellan Health Services, Inc. 55 Nod Road Avon, CT 06001 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.

17

---

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, to the extent 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 Executive 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 Employees. Employer may issue policies, rules, regulations, guidelines, procedures or other material, whether in the form of handbooks, memoranda, or otherwise, relating to its Executives. These materials are general guidelines for Executive's information and will not be construed to alter, modify, or amend this Agreement for any purpose whatsoever.

19. Indemnification. The Company shall indemnify Executive to the fullest extent permitted by the laws of State of Delaware and the Company shall obtain and maintain directors and officers liability insurance in an amount not less than \$50 million.

20. Governing Law. This Agreement and all issues relating to the validity, interpretation, and performance will be governed by, interpreted, and enforced under the laws of the State of Connecticut.

21. 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 Executive or Employer to enter into this Agreement, which are not expressly set forth within this Agreement. Executive and Employer acknowledge and agree that Employer's controlled subsidiaries and affiliates are express third party beneficiaries of this Agreement.

[signatures follow]

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the 16 day of December, 2008.

“Executive”

“Employer”

Magellan Health Services, Inc.

/s/ Rene Lerer

/s/ Michael Diament

Rene Lerer

By:

Name: Michael Diament

Title: Chairman, Compensation Committee

**Magellan Health Services, Inc.**

***Amendment to Agreements and Documents Governing Restricted Stock Units***

This document shall be deemed a global amendment to Restricted Stock Unit (“RSU”) Agreements, Notices of Restricted Stock Grant and other documents relating to RSUs under the 2006 Plan and 2008 Plan, granted by **Magellan Health Services, Inc. (“Magellan”)** on or before December 31, 2008 to the **employee named below (hereinafter “Grantee”)** and which remain outstanding after December 31, 2008. For purposes of Internal Revenue Code Section 409A (hereinafter “409A”), each tranche of RSUs that vests at a separate stated vesting date or is earned by performance over a separate measuring period is deemed to be a separate payment, and any pro rata portion of a tranche that may become vested or would not become vested upon a termination or other event in a given calendar year will be deemed to be a separate payment. The amendments herein are meant to confirm that the RSUs granted to Grantee will qualify under the IRS Section 409A “short-term deferral” rules to the maximum extent possible; RSUs not so qualifying under such “short term” deferral rules are referred to herein as “409A RSUs” .

**A. “Good Reason” Amendments**

- (1.) All agreements relating to such RSUs are hereby amended as follows (to the extent such agreements do not already incorporate these terms):

With respect to the definition of “Good Reason,” the triggering event based on reduction in salary or reduction in bonus opportunity shall be triggered only for a material reduction, and references to “reduction” in such definition (relating to salary or bonus) shall be changed to refer instead to “material reduction.” At the end of the provision relating to this triggering event for Good Reason, the following provision shall be added:

For purposes of this provision, an action or actions of the Company will be deemed “material” if, individually or in the aggregate, the action or actions result(s) or potentially result(s) in a reduction in compensation in the current year or a future year having a present value to Grantee of at least one and one half percent (1.5%) of Grantee’s then current base salary, provided that actions may be material in a given case at levels less than the specified level.

The proviso at the end of the definition of “Good Reason,” dealing with the required notice from Grantee to the Company, is modified to read as follows:

provided that, in each such case, Grantee provides notice to the Company within 90 days that such event or condition constituting Good Reason has arisen, and such event or condition continues uncured for a period of more than 30 days after Grantee gives notice thereof to the Company, and Grantee terminates Service within 18 months after such event or condition has arisen.

- (2.) Settlement of RSUs triggered by an event, such as vesting, shall occur on the first business day that occurs on or after the date of such event, unless a different 409A compliant settlement date is specified for such RSU.
- (3.) The foregoing notwithstanding, this Part A will not apply to any RSU agreement that, due to an elective deferral or controlling language in a separate employment agreement, would constitute a 409A RSU despite the application of this Part A.

**B. Effects of RSUs Being 409A RSUs.**

If RSUs fail to qualify for exceptions from Section 409A and become 409A RSUs as defined above, the following restrictions will apply:

(1) The “six-month delay rule”

- The six-month delay rule will apply to 409A RSUs if these four conditions are met:
  - The grantee has a separation from service (within the meaning of Treasury Regulation § 1.409A-1(h))
  - A distribution of shares is triggered by the separation from service (but not due to death)
  - The Grantee is a “key employee” (as defined in Code Section 416(i) without regard to paragraph (5) thereof). The Company will determine status of “key employees” annually, under administrative procedures applicable to all 409A plans and arrangements
  - The Company’s stock is publicly traded on an established securities market or otherwise.
- If it applies, the six-month delay rule will delay a distribution in settlement of 409A RSUs triggered by separation from service where the distribution otherwise would be within six months after the separation
  - Any delayed payment shall be made on the date six months after separation from service
  - During the six-month delay period, accelerated distribution will be permitted in the event of the grantee’s death and for no other reason (including no acceleration upon a Change in Control), except for the limited exceptions permitted under the 409A regulations
  - Any payment that is not triggered by a separation from service, or triggered by a separation from service but which would be made more than six months after separation (without applying this six-month delay rule), shall be unaffected by the six-month delay rule. Each payment in a series of installments would be treated as a separate payment for this purpose.
- If the terms of a 409A RSUs agreement impose this six-month delay rule in circumstances in which it is not required for compliance with 409A, those terms shall not be given effect.

(2) Change in Control Rule:

- If any distribution of 409A RSUs would be triggered by a Change in Control, such distribution will be made only if, in connection with the Change in Control, there occurs a change in the ownership of the Company, a change in effective control of the Company, or a change in the

ownership of a substantial portion of the assets of the Company as defined in Treasury Regulation § 1.409A-3(i)(5) (a “409A Change in Control”).

- In this case, distribution of the 409A RSUs shall occur not later than five business days after (i) the occurrence of a 409A Change in Control occurring at the time of or following the Change in Control or (ii) upon occurrence of the Change in Control occurring within 90 days after the 409A Change in Control, but only if the occurrence

of the Change in Control is non-discretionary and objectively determinable at the time of the 409A Change in Control (in this case, the Grantee shall have no influence on when during such 90-day period the settlement shall occur).

- Upon a Change in Control during the six-month delay period, no accelerated distribution applies (even if the events involve a 409A Change in Control) to a distribution delayed by application of the six-month delay rule.

**(3) Separation from Service**

- Any distribution in settlement of 409A RSUs that is triggered by a termination of employment will occur only at such time as the participant has had a “separation from service” within the meaning of Treasury Regulation § 1.409A-1(h), regardless of whether any other event might be viewed as a termination of employment by the Company for any other purpose.
- In particular, if a grantee switches to part-time employment or becomes a consultant in connection with a termination of employment, whether the event will be deemed a termination of employment for purposes of 409A RSUs will be determined in accordance with Treasury Regulation § 1.409A-1(h).

**(4) Other Restrictions.**

- The settlement of 409A RSUs may not be accelerated by the Company except to the extent permitted under 409A.
- Any restriction imposed on RSUs under these 409A Compliance Rules or imposed on RSUs under the terms of other documents solely to ensure compliance with 409A shall not be applied to RSUs that are not 409A RSUs except to the extent necessary to preserve the status of such RSUs as not 409A RSUs. If any mandatory term required for 409A RSUs or non-409A RSUs to avoid tax penalties under Section 409A is not otherwise explicitly provided under this document or other applicable documents, such term is hereby incorporated by reference and fully applicable as though set forth at length herein.

**C. Other Revisions**

Any reference in an RSU agreement to the RSU continuing to be “exercisable” for a period after termination of Grantee’s service shall be stricken as inapplicable, because RSUs are not subject to “exercise.”

[Signatures Appear on Next Page]

IN WITNESS WHEREOF, the Amendment has been executed on behalf of Magellan and by Grantee whose name appears below as of the date referred to above.

Date: December 1, 2008

Magellan Health Services, Inc.

Employee / Grantee:

By : /s/ Daniel Gregoire  
Daniel Gregoire, General Counsel

/s/ Rene Lerer  
Rene Lerer

C=corporation; CLS=company limited by shares; GP=general partnership; LLC=limited liability company; LP=limited partnership; MC=medical corporation; NP=non-profit corporation; PC=professional corporation; ULLC=unlimited liability company

**MAGELLAN HEALTH SERVICES, INC.**

**LIST OF SUBSIDIARIES**

<b>Entity Name:</b>	<b>Jurisdiction of Domicile:</b>	<b>Entity Type:</b>
Green Spring Health Services, Inc.	Delaware	C
<i>Subsidiaries:</i>		
Advantage Behavioral Systems, Inc.	Pennsylvania	C
AdvoCare of Tennessee, Inc.	Tennessee	C
<i>Subsidiary:</i>		
Premier Holdings, LLC	Tennessee	LLC
<i>Subsidiary:</i>		
Premier Behavioral Systems of Tennessee, LLC	Tennessee	LLC
ICORE Healthcare, LLC	Delaware	
<i>Subsidiary:</i>		
ONCORE Healthcare, LLC		
Magellan Behavioral of Michigan, Inc.	Michigan	C
Magellan Behavioral Health of New Jersey, LLC	New Jersey	LLC
Managed Care Services Mainstay of Central Pennsylvania, Inc.	Pennsylvania	C
Magellan Health Services of California, Inc. — Employer Services	California	C
Magellan Behavioral Health, Inc.	Delaware	C
<i>Subsidiaries:</i>		
Human Affairs International of California, Inc.	California	C
Magellan Behavioral Health of Colorado, Inc.	Colorado	C
Magellan Behavioral Health of Florida, Inc.	Florida	C
<i>Subsidiary:</i>		
The Community Based Care Partnership, Ltd.	Florida	
Magellan Behavioral Health Systems, LLC	Utah	LLC
<i>Subsidiary:</i>		
<hr/>		
Human Affairs International of Pennsylvania, Inc.	Pennsylvania	C
Magellan Behavioral Health of Nebraska, LLC	Nebraska	LLC
Magellan Health Services of Arizona, Inc.	Arizona	C
Magellan CBHS Holdings, LLC	Delaware	LLC
<i>Subsidiaries:</i>		
Charter Behavioral Health System of Dallas, Inc.	Texas	C
Charter Behavioral Health System of Lafayette, Inc.	Louisiana	C

<i>Subsidiary:</i>		
The Charter Cypress Behavioral Health System, L.L.C.	Tennessee	LLC
Charter Behavioral Health System of Lake Charles, Inc.	Louisiana	C
Charter Behavioral Health System of Massachusetts, Inc.	Massachusetts	C
Charter Behavioral Health System of New Mexico, Inc.	New Mexico	C
<i>Subsidiary:</i>		
The Charter Heights Behavioral Health System Limited Partnership	Delaware	LP
Charter Fairmount Behavioral Health System, Inc.	Pennsylvania	C
Charter Hospital of Santa Teresa, Inc.	New Mexico	C
Charter Lakeside Behavioral Health Systems, Inc.	Tennessee	C
Charter Medical of Puerto Rico, Inc.	Puerto Rico	C
Charter MOB of Charlottesville, Inc.	Virginia	C
<i>Subsidiary:</i>		
Mental Healthsource, L.L.C.	Virginia	LLC
Charter North Star Behavioral Health System, L.L.C.	Tennessee	LLC
Charter Northridge Behavioral Health System, Inc.	North Carolina	C
<i>Subsidiary:</i>		
Holly Hill/Charter Behavioral Health System, L.L.C.	Tennessee	LLC
Plymouth Insurance Company, Ltd.	Bermuda	C
MBH of Puerto Rico, Inc.	Puerto Rico	C
Merit Behavioral Care Corporation	Delaware	C
<i>Subsidiaries:</i>		
AGCA, Inc.	Pennsylvania	C
<i>Subsidiary:</i>		
AGCA New York, Inc.	New York	C

---

<i>Subsidiary:</i>		
U.S. IPA Providers, Inc.	New York	C
Arizona Biodyne, Inc.	Arizona	C
Magellan HRSC, Inc.	Ohio	C
Magellan Health Services of New Mexico, Inc.	New Mexico	C
Merit Behavioral Care of Massachusetts, Inc.	Massachusetts	C
<i>Subsidiary:</i>		
Magellan Behavioral Health of Connecticut, LLC	Connecticut	LLC
Magellan Behavioral Health of Pennsylvania, Inc.	Pennsylvania	C
CMG Health, Inc.	Maryland	C
Montana Community Partners, Inc.	Montana	C

Continuum Behavioral Care, LLC	Rhode Island	LLC
Continuum Behavioral Healthcare Corporation	Delaware	C
Magellan Behavioral Health Providers of Texas, Inc.	Texas	C
MBC of America, Inc.	Delaware	C
<i>Subsidiary:</i>		
Empire Community Delivery Systems, LLC	New York	LLC
MBC of North Carolina, LLC	North Carolina	LLC
Magellan Behavioral Care of Iowa, Inc.	Iowa	C
Merit Health Insurance Company	Illinois	C
<i>Subsidiary:</i>		
Magellan Life Insurance Company	Delaware	C
PPC Group, Inc.	Delaware	C
P.P.C., Inc.	Missouri	C
<i>Subsidiary:</i>		
Personal Performance Consultants of New York, Inc.	New York	C
National Imaging Associates, Inc.	Delaware	
<i>Subsidiary:</i>		
NIA IPA of New York, Inc.	New York	
National Imaging Associates of Pennsylvania, LLC	Pennsylvania	LLC
Tennessee Behavioral Health, Inc.	Tennessee	C
Magellan Capital, Inc.	Delaware	LLC
<hr/>		
Magellan Financial Capital, Inc.	Nevada	C
Magellan Sub Co III, Inc.	Florida	C
<hr/>		

**Consent of Independent Registered Public Accounting Firm**

We consent to the incorporation by reference in this Annual Report (Form 10-K) of Magellan Health Services, Inc. of our report dated February 25, 2009, with respect to the consolidated financial statements of Magellan Health Services, Inc., included in the 2008 Annual Report to Shareholders of Magellan Health Services, Inc..

Our audits also included the financial statement schedule of Magellan Health Services, Inc. listed in Item 15(a). This schedule is the responsibility of Magellan Health Services, Inc.'s management. Our responsibility is to express an opinion based on our audits. In our opinion, as to which the date is February 25, 2009, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We consent to the incorporation by reference in the following Registration Statements of Magellan Health Services, Inc.:

<b>Form</b>	<b>Registration Number</b>	<b>Date Filed</b>
S-8	333-151509	5/20/2008
S-8	333-141056	3/05/2007
S-8	333-134202	5/17/2006
S-8	333-134201	5/17/2006
S-8	333-134199	5/17/2006
S-8	333-123222	3/09/2005

of our report dated February 25, 2009, with respect to the consolidated financial statements of Magellan Health Services, Inc. incorporated herein by reference, our report dated February 25, 2009, with respect to the effectiveness of internal control over financial reporting of Magellan Health Services, Inc., included herein, and our report included in the preceding paragraph with respect to the financial statement schedule of Magellan Health Services, Inc. included in this Annual Report

(Form 10-K) of Magellan Health Services, Inc. for the year ended December 31, 2008.

/s/ Ernst & Young LLP

Baltimore, Maryland  
February 25, 2009

---

## CERTIFICATIONS

I, René Lerer, certify that:

1. I have reviewed this report on Form 10-K of Magellan Health Services, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 27, 2009

/s/ RENÉ LERER

Name: René Lerer

Title: Chief Executive Officer

---

## CERTIFICATIONS

I, Jonathan N. Rubin, certify that:

1. I have reviewed this report on Form 10-K of Magellan Health Services, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 27, 2009

/s/ JONATHAN N. RUBIN

Name: Jonathan N. Rubin

Title: Chief Financial Officer

---

**CERTIFICATION**  
**PURSUANT TO 18 U.S.C. SECTION 1350,**  
**AS ADOPTED BY SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, René Lerer, as Chief Executive Officer of Magellan Health Services, Inc. (the "Company") certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) the accompanying Form 10-K report for the period ending December 31, 2008 as filed with the U.S. Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 27, 2009

/s/ RENÉ LERER

\_\_\_\_\_  
Name: René Lerer

Title: Chief Executive Officer

---

**CERTIFICATION**  
**PURSUANT TO 18 U.S.C. SECTION 1350,**  
**AS ADOPTED BY SECTION 906 OF THE SARBANES—OXLEY ACT OF 2002**

I, Jonathan N. Rubin, as Chief Financial Officer of Magellan Health Services, Inc. (the “Company”) certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) the accompanying Form 10-K report for the period ending December 31, 2008 as filed with the U.S. Securities and Exchange Commission (the “Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 27, 2009

/s/ JONATHAN N. RUBIN

\_\_\_\_\_  
Name: Jonathan N. Rubin

Title: Chief Financial Officer

---