UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 1999

OR

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

FOR THE TRANSITION PERIOD FROM ______________ TO ______________

COMMISSION FILE NO. 1-6639

MAGELLAN HEALTH SERVICES, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	58-1076937
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6950 COLUMBIA GATEWAY DRIVE SUITE 400 COLUMBIA, MARYLAND	21046
(Address of principal executive offices)	(Zip Code)

(410) 953-1000
(Registrant's telephone number, including area code)

3414 PEACHTREE ROAD, N.E.
SUITE 1400
ATLANTA, GEORGIA 30326

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes /X/ No / /

The number of shares of the registrant's common stock outstanding as of July 31, 1999 was 31,802,888.

FORM 10-Q
MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES
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MAGELLAN HEALTH SERVICES, INC.
QUARTERLY REPORT UNDER SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934
PART I--FINANCIAL INFORMATION

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

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

	SEPTEMBER 30, 1998	JUNE 30, 1999
ASSETS		
Current assets:		
Cash and cash equivalents	$ 92,050	$ 40,307
Accounts receivable, net	174,846	156,349
Restricted cash and investments	89,212	111,882
Refundable income taxes	4,939	--
Other current assets	38,677	24,634
Total current assets	399,724	333,172
Assets restricted for settlement of unpaid claims and other liabilities	37,910	28,751
Property and equipment, net of accumulated depreciation of $60,100 at September 30, 1998, and $68,043 at June 30, 1999	177,169	137,314
Deferred income taxes	97,386	85,767
Investments in unconsolidated subsidiaries	11,066	38,174
Other long-term assets	35,415	21,172
Goodwill, net	992,431	1,066,787
Other intangible assets, net	165,189	152,336
	$ 1,916,290	$1,863,473
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 42,873	$ 22,182
Accrued liabilities	193,530	213,591
Medical claims payable	195,330	218,915
Income taxes payable	--	200
Current maturities of long-term debt and capital lease obligations	23,033	31,260
Total current liabilities	454,766	486,148
Long-term debt and capital lease obligations	1,202,613	1,102,184
Reserve for unpaid claims	30,280	21,366
Deferred credits and other long-term liabilities	14,011	31,435
Minority interest	26,985	1,955
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, without par value		
Authorized--10,000 shares		
Issued and outstanding--none	--	--
Common stock, par value $0.25 per share		
Authorized--80,000 shares		
Issued and outstanding--33,898 shares at September 30, 1998 and 34,067 shares at June 30, 1999	8,476	8,516
Other stockholders' equity:		
Additional paid-in capital	349,651	350,774
Accumulated deficit	(149,238)	(119,601)
Warrants outstanding	25,050	25,050
Common stock in treasury, 2,289 shares at September 30, 1998 and June 30, 1999	(44,309)	(44,309)
Cumulative foreign currency adjustments included in comprehensive income	(1,995)	(45)
Total stockholders' equity	187,635	220,385
	$ 1,916,290	$1,863,473

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

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

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

	FOR THE THREE MONTHS ENDED JUNE 30,		FOR THE NINE MONTHS ENDED JUNE 30,	
	1998	1999	1998	1999
Net revenue	$ 463,929	$ 486,711	$ 1,047,253	$ 1,447,169
Costs and expenses:				
Salaries, cost of care and other operating expenses	406,341	437,197	903,795	1,298,056
Equity in (earnings) losses of unconsolidated subsidiaries	408	(9,116)	16,905	(21,525)
Depreciation and amortization	17,724	20,249	37,649	57,603
Interest, net	24,409	22,640	49,336	70,958
Stock option expense (credit)	12	--	(3,527)	18
Managed care integration costs	1,240	522	12,314	4,391
Gain on sale of European Hospitals	--	(23,912)	--	(23,912)
Special charges (income)	(3,049)	--	(3,000)	2,274
	447,085	447,580	1,013,472	1,387,863
Income before provision for income taxes, minority interest and extraordinary item	16,844	39,131	33,781	59,306
Provision for income taxes	8,339	17,449	15,972	29,113
Income before minority interest and extraordinary item	8,505	21,682	17,809	30,193
Minority interest	1,095	183	5,063	556
Income before extraordinary item	7,410	21,499	12,746	29,637
Extraordinary item--net loss on early extinguishments of debt (net of income tax benefit of $22,010)	--	--	(33,015)	--
Net income (loss)	7,410	21,499	(20,269)	29,637
Unrealized foreign currency translation gain (loss)	125	(88)	(46)	(207)
Provision for (benefit from) income taxes related to unrealized foreign currency translation gain (loss)	50	(35)	(18)	(83)
	75	(53)	(28)	(124)
Comprehensive income (loss)	$ 7,485	$ 21,446	$ (20,297)	$ 29,513
Average number of common shares outstanding--basic	31,523	31,778	30,505	31,710
Average number of common shares outstanding--diluted	32,131	32,041	31,099	31,822
Income (loss) per common share--basic:				
Income before extraordinary item	$ 0.24	$ 0.68	$ 0.42	$ 0.93
Extraordinary loss on early extinguishments of debt	$ --	$ --	$ (1.08)	$ --
Net income (loss)	$ 0.24	$ 0.68	$ (0.66)	$ 0.93
Income (loss) per common share--diluted:				
Income before extraordinary item	$ 0.23	$ 0.67	$ 0.41	$ 0.93
Extraordinary loss on early extinguishments of debt	$ --	$ --	$ (1.06)	$ --
Net income (loss)	$ 0.23	$ 0.67	$ (0.65)	$ 0.93

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

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)
(IN THOUSANDS)

	FOR THE NINE MONTHS ENDED JUNE 30,	
	1998	1999
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (20,269)	$ 29,637
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	37,649	57,603
Equity in (earnings) losses of unconsolidated subsidiaries	16,905	(21,525)
Stock option expense (credit)	(3,527)	18
Non-cash interest expense	1,984	2,882
Gain on sale of assets	(3,000)	(23,623)
Impairment of long-lived assets	2,160	--
Extraordinary loss on early extinguishments of debt	55,025	--
Cash flows from changes in assets and liabilities, net of effects from sales and acquisitions of businesses:		
Accounts receivable, net	(28,360)	4,706
Other assets	(676)	1,624
Restricted cash and investments	(8,268)	(22,670)
Accounts payable and other accrued liabilities	(40,833)	(9,397)
Medical claims payable	22,405	17,282
Reserve for unpaid claims	(16,083)	(8,914)
Income taxes payable and deferred income taxes	(16,544)	28,700
Other liabilities	(7,239)	8,830
Minority interest, net of dividends paid	4,354	1,583
Other	(1,084)	(1,310)
Total adjustments	14,868	35,789
Net cash provided by (used in) operating activities	(5,401)	65,426
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(26,938)	(36,259)
Acquisitions and investments in businesses, net of cash acquired and return of escrowed funds	(1,033,155)	(60,424)
Conversion of joint ventures from consolidation to equity method	--	(21,092)
Distributions received from unconsolidated subsidiaries	--	18,955
Decrease in assets restricted for settlement of unpaid claims	46,943	14,904
Proceeds from sale of assets, net of transaction costs	12,018	58,172
Net cash used in investing activities	(1,001,132)	(25,744)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of debt, net of issuance costs	1,169,887	49,347
Payments on debt and capital lease obligations	(438,563)	(141,917)
Proceeds from exercise of stock options and warrants	4,633	1,145
Purchases of treasury stock	(12,456)	--
Net cash provided by (used in) financing activities	723,501	(91,425)
Net decrease in cash and cash equivalents	(283,032)	(51,743)
Cash and cash equivalents at beginning of period	372,878	92,050
Cash and cash equivalents at end of period	$ 89,846	$ 40,307

The accompanying notes to Condensed Consolidated Financial Statements

are an integral part of these statements.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 1999

(UNAUDITED)

NOTE A--BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. These financial statements should be read in conjunction with the audited consolidated financial statements of Magellan Health Services, Inc. and Subsidiaries ("Magellan" or the "Company") for the fiscal year ended September 30, 1998, included in the Company's Annual Report on Form 10-K, as amended. All references to fiscal years contained herein refer to periods of twelve consecutive months ending on September 30. Certain reclassifications have been made to fiscal 1998 amounts to conform to fiscal 1999 presentation.

NOTE B--SUPPLEMENTAL CASH FLOW INFORMATION

Below is supplemental cash flow information related to the nine months ended June 30, 1998 and 1999 (in thousands):

	NINE MONTHS ENDED JUNE 30,	
	1998	1999
Income taxes paid, net of refunds received	$ 8,572	$ (585)
Interest paid, net of amounts capitalized	$ 53,686	$ 64,116
Non-cash transactions:		
Fair value of common stock in treasury issued in connection with the Green Spring Minority Stockholder Conversion (as defined)	$ 63,496	$ --

NOTE C--LONG-TERM DEBT AND LEASES

Information with regard to the Company's long-term debt and capital lease obligations at September 30, 1998 and June 30, 1999 is as follows (in thousands):

	SEPTEMBER 30, 1998	JUNE 30, 1999
Credit Agreement:		
Revolving Facility due through 2004	$ 40,000	$ --
Term Loan Facility (7.4175% to 7.9175% at June 30, 1999) due through 2006	550,000	499,009
9.0% Senior Subordinated Notes due 2008	625,000	625,000
6.0% to 11.5% notes payable through 2005	4,198	3,035
3.6% capital lease obligations due through 2014	6,448	6,400
	1,225,646	1,133,444
Less amounts due within one year	23,033	31,260
	$ 1,202,613	$ 1,102,184

NOTE D--ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

	SEPTEMBER 30, 1998	JUNE 30, 1999
Salaries, wages and other benefits	$ 23,893	$ 21,373
Interest	9,271	21,692
CHAMPUS adjustments	25,484	34,886
Other	134,882	135,640
	$ 193,530	$ 213,591

NOTE E--INCOME PER COMMON SHARE

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

	THREE MONTHS ENDED JUNE 30,		NINE MONTHS ENDED JUNE 30,	
	1998	1999	1998	1999
Average number of common shares outstanding--basic	31,523	31,778	30,505	31,710
Common stock equivalents--stock options	570	258	578	105
Common stock equivalents--warrants	38	5	16	7
Average number of common shares outstanding--diluted	32,131	32,041	31,099	31,822

NOTE E--INCOME PER COMMON SHARE (CONTINUED)

Options to purchase approximately 3,642,000 shares of common stock at $8.41 to $31.00 per share were outstanding during the nine months ended June 30, 1999, but were excluded from the calculation of average number of common shares outstanding--diluted because the options' exercise prices were greater than the average market price of the common shares underlying such options during the period. Approximately 3,307,000 of these options, which expire between fiscal 2001 and 2009, were outstanding at June 30, 1999.

Warrants to purchase approximately 4,713,000 shares of common stock at $26.15 to $38.70 per share were outstanding during the nine months ended June 30, 1999, but were excluded from the calculation of average number of common shares outstanding--diluted because the warrants' exercise prices were greater than the average market price of the common shares underlying such warrants during the period. All of the warrants, which expire between fiscal 2000 and 2009, were outstanding at June 30, 1999.

On November 17, 1998, the Company's Board of Directors approved the repricing of stock options outstanding under the Company's existing stock option plans and held by current directors and full-time employees (the "Stock Option Repricing"). Each holder of 10,000 or more stock options who chose to participate in the Stock Option Repricing was required to forfeit a percentage of outstanding stock options depending upon such factors as level of employment and number of options held.

In order to participate in the Stock Option Repricing: (i) members of the Company's Board of Directors, including the Chief Executive Officer ("CEO"), were required to forfeit 40% of their outstanding options; (ii) Named Executive Officers (as defined by Securities and Exchange Commission Regulations) other than the CEO were required to forfeit 30% of their outstanding options; (iii) all other holders of 50,000 or more options were required to forfeit 25% of their outstanding options; and (iv) all other holders of 10,000 to 49,999 options were required to forfeit 15% of their outstanding options.

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

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES

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

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

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

	SEPTEMBER 30, 1998	JUNE 30, 1999
Current assets	$ 22,974	$ 20,022
Property and equipment, net	345	248
Total assets	$ 23,319	$ 20,270
Current liabilities	$ 16,829	$ 13,073
Partners' capital	6,490	7,197
Total liabilities and partners' capital	$ 23,319	$ 20,270
Company investment	$ 3,245	$ 3,599

	THREE MONTHS ENDED JUNE 30, 1998	THREE MONTHS ENDED JUNE 30, 1999	139 DAYS ENDED JUNE 30, 1998	NINE MONTHS ENDED JUNE 30, 1999
Net revenue	$ 13,414	$ 13,281	$ 20,618	$ 41,027
Operating expenses	9,214	7,643	13,611	20,232
Net income	$ 4,200	$ 5,638	$ 7,007	$ 20,795
Company equity income	$ 2,100	$ 2,819	$ 3,504	$ 10,398

The Company acquired its investment in Choice on February 12, 1998, as part of the Merit (as defined) acquisition. Accordingly, statement of operations data related to the nine months ended June 30, 1998, represents only the results of operations of Choice from February 12, 1998 through June 30, 1998.

PREMIER BEHAVIORAL SYSTEMS, LLC. The Company owns a 50% interest in Premier Behavioral Systems, LLC ("Premier"). Premier was formed to manage behavioral healthcare benefits for the State of Tennessee's TennCare program. The Company accounts for its investment in Premier using the equity method. The Company's investment in Premier at September 30, 1998 and June 30, 1999 was $5.8 million and $13.2 million, respectively. The Company's equity in earnings of Premier for the three months ended June 30, 1998 and 1999 was $4.6 million and $4.8 million, respectively, and for the nine months ended June 30, 1998 and 1999 was $4.3 million and $7.4 million, respectively.

CHARTER BEHAVIORAL HEALTH SYSTEMS, LLC. The Company owned a 50% interest in Charter Behavioral Health Systems, LLC ("CBHS") as of September 30, 1998 and June 30, 1999. CBHS was formed on June 17, 1997, as a result of the Company's sale of substantially all of the real estate used in its domestic psychiatric hospital provider business (the "Psychiatric Hospital Facilities") to Crescent Real Estate Equities, L.P. ("Crescent") (the "Crescent Transactions"). CBHS leases the Psychiatric Hospital Facilities from Crescent. The Company accounts for its investment in CBHS using the equity method.

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

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

	SEPTEMBER 30, 1998	JUNE 30, 1999
Current assets	$ 147,119	$ 157,518
Property and equipment, net	21,148	22,792
Other nonconcurrent assets	8,871	9,319
Total assets	$ 177,138	$ 189,629
Current liabilities	$ 141,379	$ 213,198
Long-term debt	67,200	57,194
Other nonconcurrent liabilities	35,437	58,031
Members' deficit	(66,878)	(138,794)
Total liabilities and members' deficit	$ 177,138	$ 189,629

	THREE MONTHS ENDED JUNE 30,		NINE MONTHS ENDED JUNE 30,	
	1998	1999	1998	1999
Net revenue	$ 187,928	$ 180,935	$ 553,370	$ 554,761
Crescent rent expense	14,015	14,075	42,033	42,183
Other operating expenses	191,505	193,815	563,429	576,989
Interest, net	1,300	1,454	3,975	4,468
Net loss before preferred member distribution	$ (18,892)	$ (28,409)	$ (56,067)	$ (68,879)
Company's portion of net loss	$ (9,446)	$ --	$ (28,034)	$ --
Intercompany loss elimination	2,288	--	3,813	--
Company equity loss (2)	$ (7,158)	$ --	$ (24,221)	$ --
Cash provided by (used in) operating activities			$ (4,553)	$ 20,543

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(2) Note appears on page 9.

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

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

	THREE MONTHS ENDED JUNE 30,		NINE MONTHS ENDED JUNE 30,	
	1998	1999	1998	1999
Franchise fee revenue (2)	$ 15,000	$ --	$ 51,100	$ --
Costs:				
Accounts receivable collection fees	$ 248	$ 53	$ 1,862	$ 204
Hospital-based joint venture management fees	$ 1,708	$ 1,897	$ 5,191	$ 4,604

	SEPTEMBER 30, 1998	JUNE 30, 1999
Due to CBHS, net (1)	$ 1,127	$ 3,478
Prepaid CHARTER call center management fees (3)	$ 2,953	$ 3,345
Net book value of leased property (4)	$ 2,850	$ 7,250

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

(2) Franchise fees due from CBHS were approximately $38.0 million and $99.5 million as of September 30, 1998, and June 30, 1999, respectively. CBHS' independent public accountants' report on CBHS' financial statements for the fiscal year ended September 30, 1998, makes reference to uncertainty regarding CBHS' ability to continue as a going concern. The Company recorded equity in loss of its investment in CBHS until all franchise fees due from CBHS were reduced to $0 at September 30, 1998. The Company received no franchise fee payments from CBHS and recorded no franchise fee revenue related to CBHS during the three months and the nine months ended June 30, 1999, due to continuing uncertainties surrounding their collectibility. Cumulative equity in losses of CBHS in excess of the Company's investment in CBHS of $8.7 million ($5.1 million loss during the fiscal year ended September 30, 1998; $3.6 million income during the the nine months ended June 30, 1999) are not reflected in the Company's financial statements at and for the nine months ended June 30, 1999, since the Company has no remaining obligation or commitment to fund CBHS and has no guarantees outstanding for any CBHS obligations.

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

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

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)

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

(4) CBHS leased two psychiatric hospital facilities (collectively, the "CBHS Leaseholds") from the Company as of June 30, 1999. The CBHS Leaseholds were acquired by the Company in connection with CBHS' acquisition of certain businesses from Ramsay Health Care, Inc. on September 28, 1998. The Company paid approximately $7.2 million for the CBHS Leaseholds ($2.8 million during September 1998; $4.4 million during the nine months ended June 30, 1999). The purchase of the CBHS Leaseholds was funded primarily through distributions received from the Provider JV's (as defined). The CBHS Leaseholds are leased to CBHS for a 10-year lease term at an annual rent of $0.7 million. The Company accounted for the purchase of the CBHS Leaseholds as an investment in income producing property. Both the Company and CBHS account for these leases as operating leases.

Under the terms of a letter agreement dated November 10, 1998, between the Company and Crescent Real Estate Funding VII, L.P. ("Crescent Funding"), Crescent Funding has agreed to purchase the CBHS Leaseholds from the Company, at the contract acquisition cost paid by the Company, upon the sale of certain other property owned by Crescent Funding and leased by CBHS at June 30, 1999. Crescent Funding is an affiliate of both Crescent Operating, Inc. ("COI"), the other 50% owner of CBHS, and Crescent, the lessor of the majority of the properties in which CBHS conducts its business.

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

A summary of the Provider JVs is as follows:

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

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

The Provider JVs, along with one consolidated 97.5% owned hospital-based joint venture with approximately $19.8 million of net assets, have been managed by CBHS for a fee equivalent to the

NOTE F--INVESTMENTS IN UNCONSOLIDATED SUBSIDIARIES (CONTINUED)
Company's portion of their earnings since June 17, 1997. Additionally, should the Company liquidate its interests in any or all of these six hospital-based joint ventures, the majority of the net proceeds received by the Company must be redeployed for the benefit of CBHS.

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

	JUNE 30, 1999
Current assets	$ 21,880
Property and equipment, net	23,109
Other noncurrent assets	2,160
Total assets	$ 47,149
Current liabilities	$ 11,028
Owners' capital	36,121
Total liabilities and owners' capital	$ 47,149
Company investment	$ 18,973

	THREE MONTHS ENDED JUNE 30, 1999	NINE MONTHS ENDED JUNE 30, 1999
Net revenue	$ 14,391	$ 43,501
Operating expenses	12,845	37,730
Net income	$ 1,546	$ 5,771
Company equity income	$ 918	$ 3,282

NOTE G--ACQUISITIONS AND DIVESTITURES

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

ACQUIRED COMPANY	SEGMENT	ACQUISITION DATE	CONTRACT PURCHASE PRICE (MILLIONS)
Human Affairs International, Incorporated ("HAI").....	Behavioral	December 4, 1997	$ 122.1(1)
Allied Health Group, Inc. ("Allied").................	Specialty	December 5, 1997	$ 50.0(2)
Merit Behavioral Care Corporation ("Merit")..........	Behavioral	February 12, 1998	$ 750.0

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(1) Excluding potential aggregate contingent consideration of up to $300.0 million (limited to $60.0 million for each of the five years from the acquisition date). On March 26, 1999, the Company paid Aetna, Inc. ("Aetna"), the former owner of HAI, $60.0 million of additional consideration for the purchase of HAI (the "Aetna Payment"). The Aetna Payment was recorded as additional goodwill and identifiable intangible assets.

(2) Excluding $4.5 million of additional consideration paid during the quarter ended December 31, 1998, which was recorded as additional goodwill.

The Company accounted for the Managed Care Acquisitions using the purchase method of accounting.

GREEN SPRING MINORITY STOCKHOLDER CONVERSION. In January 1998, the minority stockholders of Green Spring Health Services, Inc. ("Green Spring") converted their collective 39% interest in Green Spring into an aggregate of 2,831,516 shares of the Company's common stock through exercise of an exchange option (the "Green Spring Minority Stockholder Conversion"). Green Spring became a wholly owned subsidiary of the Company as a result of the Green Spring Minority Stockholder Conversion. The Company issued shares from treasury to effect the Green Spring Minority Stockholder Conversion and accounted for it as a purchase of minority interest at the fair value of consideration paid.

The following unaudited pro forma information for the nine months ended June 30, 1998, has been prepared assuming the Managed Care Acquisitions and the Green Spring Minority Stockholder Conversion occurred on October 1, 1997. The unaudited pro forma information does not purport to be indicative

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

	NINE MONTHS ENDED JUNE 30, 1998
Net revenue	$ 1,346,245
Net income (1)(2)	$ 11,166
Income per common share--basic	$ 0.35
Income per common share--diluted	$ 0.35

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(1) Excludes expected unrealized cost savings related to the Integration Plan (as defined) and managed care integration costs.

(2) Excludes the extraordinary loss on early extinguishments of debt during the nine months ended June 30, 1998, that were directly attributable to the consummation of the Merit acquisition.

EUROPEAN PSYCHIATRIC HOSPITALS. On April 9, 1999, the Company sold its European psychiatric provider operations to Investment AB Bure of Sweden for approximately $57.0 million (before transaction costs of approximately $2.5 million). The sale resulted in a non-recurring gain of approximately $23.9 million before provision for income taxes.

The Company used approximately $38.2 million of the net sale proceeds to make mandatory unscheduled principal payments on indebtedness outstanding under the Term Loan Facility (as defined). The remaining proceeds were used to reduce borrowings outstanding under the Revolving Facility (as defined).

These transactions are more fully described in the Company's current report on Form 8-K which was filed with the Securities and Exchange Commission on April 14, 1999.

NOTE H--CONTINGENCIES

The Company is self-insured for a substantial portion of its general and professional liability risks. The reserves for self-insured general and professional liability losses, including loss adjustment expenses, are included in "Reserve for unpaid claims" in the Company's balance sheet and are based on actuarial estimates that are discounted at an average rate of 6% to their present value based on the Company's historical claims experience adjusted for current industry trends. The undiscounted amount of the reserve for unpaid claims at September 30, 1998 and June 30, 1999, was approximately $34.6 million and $24.5 million, respectively. The carrying amount of accrued medical malpractice claims was $26.2 million and $21.4 million at September 30, 1998 and June 30, 1999, respectively. The reserve for unpaid claims is adjusted periodically, as such claims mature, to reflect changes in actuarial estimates based on experience. During the nine months ended June 30, 1998, the Company recorded reductions in malpractice claim reserves of approximately $4.1 million as a result of updated actuarial estimates. These reductions resulted

NOTE H--CONTINGENCIES (CONTINUED)

primarily from updates to actuarial assumptions regarding the Company's expected losses for more recent policy years. These revisions are based on changes in expected values of ultimate losses resulting from the Company's claim experience, and increased reliance on such claim experience. On July 2, 1999, the Company transferred its remaining medical malpractice claims portfolio (the "Loss Portfolio Transfer") to a third-party insurer. The Loss Portfolio Transfer was funded from assets restricted for settlement of unpaid claims and approximated the carrying amount of accrued medical malpractice claims. The insurance limit obtained through the Loss Portfolio Transfer for future medical malpractice claims is $26.4 million.

The healthcare industry is subject to numerous laws and regulations. The subjects of such laws and regulations include but are not limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, government activity has increased with respect to investigations and/or allegations concerning possible violations of fraud and abuse and false claims statutes and/or regulations by healthcare providers. Entities that are found to have violated these laws and regulations may be excluded from participating in government healthcare programs, subjected to fines and/or penalties or required to repay amounts received from the government for previously billed patient services. The Office of the Inspector General of the Department of Health and Human Services and the United States Department of Justice and certain other governmental agencies are currently conducting inquiries and/or investigations regarding the compliance by the Company and certain of its subsidiaries and the compliance by CBHS and certain of its subsidiaries with such laws and regulations. Certain of the inquiries relate to the operations and business practices of the Company's psychiatric provider operations prior to the consummation of the Crescent Transactions. In addition, the Company is also subject to or party to litigation, claims and civil suits relating to its operations and business practices. In the opinion of management, the Company has recorded reserves that are adequate to cover litigation, claims or assessments that have been or are probable of assertion against the Company arising out of such litigation, civil suits and governmental inquiries. Furthermore, management believes that the resolution of such litigation, civil suits and governmental inquiries will not have a material adverse effect on the Company's financial position or results of operations; however, there can be no assurance in this regard.

On May 26, 1998, a group of eleven plaintiffs purporting to represent an uncertified class of psychiatrists, psychologists and social workers brought an action under the federal antitrust laws in the United States District Court for the District of New Jersey against nine behavioral health managed care organizations, including Merit, CMG, Green Spring and HAI (collectively, the "Defendants"). The complaint alleges that the Defendants violated Section I of the Sherman Act by engaging in a conspiracy to fix the prices at which the Defendants purchase services from mental healthcare providers such as the plaintiffs. The complaint further alleges that the Defendants engaged in a group boycott to exclude mental healthcare providers from the Defendants' networks in order to further the goals of the alleged conspiracy. The complaint also challenges the propriety of the Defendants' capitation arrangements with their respective customers, although it is unclear from the complaint whether the plaintiffs allege that the Defendants unlawfully conspired to enter into capitation arrangements with their respective customers. The complaint seeks treble damages against the Defendants in an unspecified amount and a permanent injunction prohibiting the Defendants from engaging in the alleged conduct which forms the basis of the

NOTE H--CONTINGENCIES (CONTINUED)

complaint, plus costs and attorneys' fees. Upon joint motion by the Defendants, the case was transferred to the United States District Court for the Southern District of New York, the same court where a previous similar case (the "Stephens Case") was dismissed for failure to state a claim upon which relief can be granted. On March 15, 1999, the Defendants filed a joint motion to dismiss the case for substantially the same reasons as in the Stephens Case. On June 16, 1999, the court denied the motion to dismiss. The case currently is in the early stages of discovery. The Company does not believe this matter will have a material adverse effect on its financial position or results of operations.

The Company provides mental health and substance abuse services, as a subcontractor, to beneficiaries of CHAMPUS. The fixed monthly amounts that the Company receives for medical costs under CHAMPUS contracts are subject to retroactive adjustment ("CHAMPUS Adjustments") based upon actual healthcare utilization during the period known as the "data collection period". The Company has recorded reserves of approximately $34.9 million as of June 30, 1999, for CHAMPUS Adjustments.

While management believes that the present reserve for CHAMPUS Adjustments is reasonable, ultimate settlement resulting from the adjustment and available appeal process may vary from the amount provided.

NOTE I--MANAGED CARE INTEGRATION PLAN AND COSTS

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

The Integration Plan will result in the elimination of approximately 1,000 positions during fiscal 1998 and fiscal 1999. Approximately 510 employees had been involuntarily terminated pursuant to the Integration Plan as of June 30, 1999. The Company has substantially completed involuntary terminations related to the Integration Plan, and most of the remaining positions have been or will be eliminated through normal attrition.

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

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

The Company initially recorded approximately $21.3 million of liabilities related to the Integration Plan, of which $12.4 million was recorded as part of the Merit purchase price allocation and $8.9 million was recorded in the statement of operations under "Managed care integration costs" in fiscal 1998. During the nine months ended June 30, 1999, the Company recorded adjustments of approximately $0.1 million, net, to such liabilities, of which $(0.8) million was recorded as part of the Merit purchase price allocation and $0.9 million was recorded in the statement of operations under "Managed care integration costs." The

NOTE I--MANAGED CARE INTEGRATION PLAN AND COSTS (CONTINUED)
Company may record additional adjustments to such liabilities through the remainder of fiscal 1999 depending on its ability to sublease closed offices and upon determination of the final amount of the Company's severance obligations.

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

TYPE OF COST	BALANCE SEPTEMBER 30, 1998	ADJUSTMENTS	PAYMENTS	BALANCE JUNE 30, 1999
Employee termination benefits	$ 6,190	$ 1,103	$ (6,042)	$ 1,251
Facility closing costs	7,475	(826)	(1,130)	5,519
Other	169	(169)	-	-
	$ 13,834	$ 108	$ (7,172)	$ 6,770

OTHER INTEGRATION COSTS. The Integration Plan will result in additional incremental costs that must be expensed as incurred in accordance with Emerging Issues Task Force Consensus 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)" that are not described above and certain other charges. Other integration costs include, but are not limited to, outside consultants, costs to relocate closed office contents and long-lived asset impairments. Other integration costs are reflected in the statement of operations under "Managed care integration costs".

During the quarter and the nine months ended June 30, 1998, the Company incurred approximately $1.2 million and $5.7 million in other integration costs, respectively, including long-lived asset impairments of approximately $2.2 million during the nine months ended June 30, 1998, and outside consulting costs of approximately $0.9 million and $3.1 million for the quarter and the nine months ended June 30, 1998, respectively. During the quarter and the nine months ended June 30, 1999, the Company incurred approximately $0.5 million and $3.5 million in other integration costs, respectively, primarily for outside consulting costs and employee and office relocation costs.

NOTE J--BUSINESS SEGMENT INFORMATION

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

NOTE J--BUSINESS SEGMENT INFORMATION (CONTINUED)

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

	BEHAVIORAL MANAGED HEALTHCARE	HUMAN SERVICES	SPECIALTY MANAGED HEALTHCARE	HEALTHCARE FRANCHISING	HEALTHCARE PROVIDER	CORPORATE OVERHEAD	CONSOLIDATED
THREE MONTHS ENDED JUNE 30, 1998							
Net revenue	$ 332,318	$ 37,385	$ 46,160	$ 15,000	$ 33,066	$ --	$ 463,929
Segment Profit (loss)	$ 45,403	$ 3,898	$ 1,490	$ 6,043	$ 4,438	$ (4,092)	$ 57,180
THREE MONTHS ENDED JUNE 30, 1999							
Net revenue	$ 370,038	$ 48,642	$ 58,611	$ 113	$ 9,307	$ --	$ 486,711
Segment Profit (loss)	$ 55,556	$ 6,036	$ 797	$ (1,559)	$ 910	$ (3,110)	$ 58,630
NINE MONTHS ENDED JUNE 30, 1998							
Net revenue	$ 694,702	$ 96,456	$ 105,593	$ 51,100	$ 99,402	$ --	$1,047,253
Segment Profit (loss)	$ 88,504	$ 9,172	$ 2,026	$ 20,134	$ 18,840	$ (12,123)	$ 126,553
NINE MONTHS ENDED JUNE 30, 1999							
Net revenue	$1,108,949	$ 141,363	$ 150,013	$ 403	$ 46,441	$ --	$1,447,169
Segment Profit (loss)	$ 161,692	$ 16,850	$ 2,180	$ (4,527)	$ 4,079	$ (9,636)	$ 170,638
Total assets:							
September 30, 1998	$1,356,259	$ 119,356	$ 78,062	$ 1,941	$ 178,217	$ 182,455	$1,916,290
June 30, 1999	$1,422,514	$ 123,972	$ 87,470	$ 1,930	$ 90,018	$ 137,569	$1,863,473

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

	THREE MONTHS ENDED JUNE 30, 1998	THREE MONTHS ENDED JUNE 30, 1999	NINE MONTHS ENDED JUNE 30, 1998	NINE MONTHS ENDED JUNE 30, 1999
Segment Profit	$ 57,180	$ 58,630	$ 126,553	$ 170,638
Depreciation and amortization	(17,724)	(20,249)	(37,649)	(57,603)
Interest, net	(24,409)	(22,640)	(49,336)	(70,958)
Stock option (expense) credit	(12)	--	3,527	(18)
Managed care integration costs	(1,240)	(522)	(12,314)	(4,391)
Gain on sale of European hospitals	--	23,912	--	23,912
Special (charges) income	3,049	--	3,000	(2,274)
Income before provision for income taxes, minority interest and extraordinary item	$ 16,844	$ 39,131	$ 33,781	$ 59,306

NOTE K--SUBSEQUENT EVENTS

TPG INVESTMENT. On July 19, 1999, the Company announced that it had entered into a definitive agreement to issue approximately $75.4 million of cumulative convertible preferred stock to TPG Magellan, LLC, an affiliate of the investment firm Texas Pacific Group ("TPG") (the "TPG Investment").

TPG will purchase approximately $59.1 million of the Company's Series A Cumulative Convertible Preferred Stock (the "Series A Preferred Stock") at closing. The Series A Preferred Stock carries a dividend of 6.5% per annum, payable in quarterly installments in cash or common stock, subject to certain conditions. Dividends not paid in cash or common stock will accumulate. The Series A Preferred Stock is convertible at any time into approximately 6.3 million shares of the Company's common stock at a conversion price of $9.375 per share and carries "as converted" voting rights. The Company may, under certain circumstances, require the holders of the Series A Preferred Stock to convert such stock into common stock. The Series A Preferred Stock, plus accrued and unpaid dividends thereon, must be redeemed by the Company on the tenth anniversary of the date of its issuance.

TPG will deposit approximately $16.3 million into an interest bearing escrow account (the "Escrow Deposit") at closing for the potential future purchase of the Company's Series B Cumulative Convertible Preferred Stock (the "Series B Preferred Stock"). If the Company obtains stockholder approval for the issuance of common stock upon conversion or exchange of the Series B Preferred Stock and the voting rights in respect of the Series B Preferred Stock (the "Series B Preferred Stock Approval") on or prior to March 5, 2000, the Series B Preferred Stock will be issued to TPG, and the Escrow Deposit, including interest earned thereon, will be disbursed to the Company. If the Company does not obtain the Series B Preferred Stock Approval, TPG may elect not to purchase the Series B Preferred Stock and the Escrow Deposit, including interest earned thereon, will be refunded to TPG.

If the Company's does not obtain the Series B Preferred Stock Approval on or prior to March 5, 2000, and TPG elects to purchase the Series B Preferred Stock, the conversion price will be reduced from $9.625 per share to $9.125 per share and dividends will accrue at 12.0% per annum from March 5, 2000, until the date on which stockholder approval is obtained by the Company.

The Series B Preferred Stock carries a dividend of 6.5% per annum, payable in quarterly installments in cash or common stock, subject to certain conditions. Dividends not paid in cash or common stock will accumulate. The Series B Preferred Stock will be convertible at any time after stockholder approval into approximately 1.7 million shares of the Company's common stock at a conversion price of $9.625 per share. The Company may, under certain circumstances, require the holders of the Series B Preferred Stock to convert their shares into common stock. The Series B Preferred Stock, plus accrued and unpaid dividends thereon, must be redeemed by the Company on the tenth anniversary of the date of issuance of the Series A Preferred Stock.

Upon the closing of the TPG Investment, TPG will be entitled to nominate three directors to the Company's twelve-member Board of Directors.

The TPG Investment is subject to certain regulatory approvals and other customary closing conditions. The Company expects to close the TPG Investment during the fourth quarter of fiscal 1999. Subsequent to closing, certain aspects of the TPG Investment are subject to stockholder approval, including: (i) the issuance of common stock in respect of accrued and unpaid dividend obligations on the Series A and Series B Preferred Stock; (ii) the issuance of common stock upon the conversion or exchange

of the Series B Preferred Stock; and (iii) the vesting of voting rights in respect of the Series B Preferred Stock. The Company intends to seek such approval no later than the next annual meeting of its stockholders, which is expected to be held in March 2000.

The TPG Investment is more fully described in the Company's current report on Form 8-K, which was filed with the Securities and Exchange Commission on July 21, 1999.

RECAPITALIZATION OF CBHS. On August 10, 1999, the Company entered into a binding Letter Agreement with Crescent, COI and CBHS relating to a proposed recapitalization of CBHS and restructuring of relationships among the parties. Under the Letter Agreement, the Company has agreed that it will, at the closing of the contemplated transactions, transfer its remaining hospital-based and franchise assets to CBHS and cancel franchise fees due from CBHS. Thereafter, the Company will no longer be obligated to provide franchise services to CBHS.

The Company will also transfer 80% of its CBHS common interest and all of its preferred interest to CBHS, leaving the Company with a 10% common membership interest in CBHS.

In connection with the execution of the Letter Agreement, the Company, Crescent, COI and CBHS have agreed to provide each other with mutual releases of all claims and disputes against each other, with certain specified exceptions, and Crescent has deferred the August 1999 rent due from CBHS to the last four months of calendar 1999. Additionally, with the execution of the Letter Agreement, the $2.5 million held in escrow in connection with a pending arbitration between the Company and COI was released to COI. The Company and CBHS also have modified and extended their existing arrangement which designates CBHS a preferred provider of inpatient acute behavioral health services.

The closing of the transactions contemplated by the Letter Agreement is anticipated to take place within 30 days, subject to the satisfaction of certain customary closing conditions and consents and other contingencies. If the closing does not occur within 30 days, the Letter Agreement terminates. There can be no assurance that the proposed recapitalization of CBHS will be consummated.

MAGELLAN HEALTH SERVICES, INC. AND SUBSIDIARIES
JUNE 30, 1999
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

This Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Although the Company believes that its plans, intentions and expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such plans, intentions or expectations will be achieved. Important factors that could cause actual results to differ materially from the Company's forward-looking statements are set forth in the Company's Annual Report on Form 10-K, as amended, for the fiscal year ended September 30, 1998. All forward-looking statements attributable to the Company or persons acting on behalf of the Company are expressly qualified in their entirety by the cautionary statements set forth in the Company's Annual Report on Form 10-K, as amended, for the fiscal year ended September 30, 1998.

OVERVIEW

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

- THE BEHAVIORAL MANAGED HEALTHCARE BUSINESS. The Company's MAGELLAN BEHAVIORAL HEALTH division coordinates and manages the delivery of behavioral healthcare treatment services through its network of providers, which includes psychiatrists, psychologists and other medical professionals. The treatment services provided through these networks include outpatient programs (such as counseling or therapy), intermediate care programs (such as intensive outpatient programs and partial hospitalization services), inpatient treatment and alternative care services (such as residential treatment and home or community-based programs). The Company provides these services primarily through: (i) risk-based products, where the Company assumes all or a portion of the responsibility for the cost of providing treatment services in exchange for a fixed per member per month fee, (ii) administrative services only ("ASO") products, where the Company provides services such as utilization review, claims administration or provider network management, (iii) employee assistance programs ("EAPs") and (iv) products which combine features of some or all of the Company's risk-based, ASO, or EAP products.

- THE HUMAN SERVICES BUSINESS. The Company provides various human services through its National MENTOR subsidiary. These human services include specialty home-based healthcare services provided through "mentor" homes as well as residential and day treatment services for individuals with acquired brain injuries and for individuals with mental retardation and developmental disabilities.

- THE SPECIALTY MANAGED HEALTHCARE BUSINESS. The Company's MAGELLAN SPECIALTY HEALTH division provides specialty risk-based and ASO services to its customers, primarily health insurance companies, through its physician networks in the eastern United States. These networks include physicians specializing in cardiology, oncology and diabetes.

- THE HEALTHCARE FRANCHISING BUSINESS. The Company's Charter Advantage, LLC subsidiary franchises the "CHARTER" system of behavioral healthcare primarily to psychiatric hospital facilities operated by CBHS. The Company is currently seeking to divest its healthcare franchising business. See "--Outlook--Results of Operations--Recapitalization of CBHS."

- THE HEALTHCARE PROVIDER BUSINESS. The Company's provider operations included the ownership and operation of three psychiatric hospitals in Europe during the nine months ended June 30, 1999. The Company sold these European psychiatric provider operations on April 9, 1999. See "--Outlook-- Results of Operations--Sale of European Psychiatric Provider Operations." The Company's provider operations currently include: (i) its 50% interest in CBHS, (ii) its interests in six hospital-based joint ventures and (iii) its provider management business in Puerto Rico. The Company is

currently seeking to divest the remainder of its healthcare provider business. See "--Outlook-- Results of Operations--Recapitalization of CBHS."

At June 30, 1999, the Company's MAGELLAN BEHAVIORAL HEALTH division, which was formed primarily through acquisitions completed in fiscal 1996 (Green Spring) and fiscal 1998 (HAI and Merit), managed the behavioral healthcare benefits of approximately 64.9 million individuals; National MENTOR, which acquired eight businesses in fiscal 1998 and fiscal 1999, provided community-based services to approximately 6,400 individuals; and the Company's MAGELLAN SPECIALTY HEALTH division, which was formed primarily through acquisitions completed in fiscal 1997 (Care Management Resources, Inc.) and fiscal 1998 (Allied) managed medical specialty benefits for approximately three million members of health plans.

HISTORICAL RESULTS OF OPERATIONS

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

	BEHAVIORAL MANAGED HEALTHCARE	HUMAN SERVICES	SPECIALTY MANAGED HEALTHCARE	HEALTHCARE FRANCHISING	HEALTHCARE PROVIDER	CORPORATE OVERHEAD	CONSOLIDATED
THREE MONTHS ENDED JUNE 30, 1998							
Net revenue	$ 332,318	$ 37,385	$ 46,160	$ 15,000	$ 33,066	$ --	$ 463,929
Salaries, cost of care and other operating expenses	293,665	33,487	44,670	1,799	28,628	4,092	406,341
Equity in (earnings) losses of unconsolidated subsidiaries	(6,750)	--	--	7,158	--	--	408
	286,915	33,487	44,670	8,957	28,628	4,092	406,749
Segment Profit (loss) (1)	$ 45,403	$ 3,898	$ 1,490	$ 6,043	$ 4,438	$ (4,092)	$ 57,180
THREE MONTHS ENDED JUNE 30, 1999							
Net revenue	$ 370,038	$ 48,642	$ 58,611	$ 113	$ 9,307	$ --	$ 486,711
Salaries, cost of care and other operating expenses	322,678	42,606	57,814	1,672	9,317	3,110	437,197
Equity in earnings of unconsolidated subsidiaries	(8,196)	--	--	--	(920)	--	(9,116)
	314,482	42,606	57,814	1,672	8,397	3,110	428,081
Segment Profit (loss) (1)	$ 55,556	$ 6,036	$ 797	$ (1,559)	$ 910	$ (3,110)	$ 58,630
NINE MONTHS ENDED JUNE 30, 1998							
Net revenue	$ 694,702	$ 96,456	$ 105,593	$ 51,100	$ 99,402	$ --	$1,047,253
Salaries, cost of care and other operating expenses	613,514	87,284	103,567	6,745	80,562	12,123	903,795
Equity in (earnings) losses of unconsolidated subsidiaries	(7,316)	--	--	24,221	--	--	16,905
	606,198	87,284	103,567	30,966	80,562	12,123	920,700
Segment Profit (loss) (1)	$ 88,504	$ 9,172	$ 2,026	$ 20,134	$ 18,840	$ (12,123)	$ 126,553
NINE MONTHS ENDED JUNE 30, 1999							
Net revenue	$ 1,108,949	$ 141,363	$ 150,013	$ 403	$ 46,441	$ --	$1,447,169
Salaries, cost of care and other operating expenses	965,498	124,513	147,833	4,930	45,646	9,636	1,298,056
Equity in earnings of unconsolidated subsidiaries	(18,241)	--	--	--	(3,284)	--	(21,525)
	947,257	124,513	147,833	4,930	42,362	9,636	1,276,531
Segment Profit (loss) (1)	$ 161,692	$ 16,850	$ 2,180	$ (4,527)	$ 4,079	$ (9,636)	$ 170,638

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

QUARTER ENDED JUNE 30, 1999, COMPARED TO THE SAME PERIOD IN FISCAL 1998

BEHAVIORAL MANAGED HEALTHCARE. Revenue increased 11.3% or $37.7 million, to $370.0 million for the quarter ended June 30, 1999, from $332.3 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 9.9%, or $29.0 million, to $322.7 million for the quarter ended June 30, 1999, from $293.7 million in the same period in fiscal 1998. Equity in earnings of unconsolidated subsidiaries increased $1.4 million to $8.2 million for the quarter ended June 30, 1999, from $6.8 million for the same period in fiscal 1998. The increases in revenue and salaries, cost of care and other operating expenses resulted primarily from (i) increased enrollment related to existing health plan customers, (ii) expanded services and lives under management with certain public sector customers, (iii) new business development and (iv) increases in retroactive customer settlements, offset by reductions in general and administrative costs as a result of the Integration Plan and the termination of one public sector contract in fiscal 1999. Total covered lives increased 5.9%, or 3.6 million to 64.9 million at June 30, 1999 from 61.3 million at June 30, 1998. The Company frequently records retroactive customer settlements, which may be favorable or unfavorable, under its commercial behavioral managed healthcare contracts. Revenue and Segment Profit for the quarter ended June 30, 1999, reflect approximately $5.3 million of such favorable settlements compared to favorable settlements of $0.4 million during the same period in fiscal 1998. Equity in earnings of unconsolidated subsidiaries increased primarily as a result of improved performance at Choice and Premier. Premier's results for the quarters ended June 30, 1999 and 1998, included approximately $4.0 million of income related to adjustments to medical claims payable as a result of favorable developments in payment trends.

HUMAN SERVICES. Revenue increased 30.0%, or $11.2 million, to $48.6 million for the quarter ended June 30, 1999, from $37.4 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 27.2%, or $9.1 million, to $42.6 million for the quarter ended June 30, 1999 from $33.5 million in the same period in fiscal 1998. The increases were attributable to acquisitions consummated in fiscal 1998 and fiscal 1999 and internal growth. Placements in residential programs increased 17.1% to 3,830 at June 30, 1999, compared to 3,270 at June 30, 1998. Total placements were 6,400 at June 30, 1999.

SPECIALTY MANAGED HEALTHCARE. Revenue increased 26.8%, or $12.4 million, to $58.6 million for the quarter ended June 30, 1999, compared to $46.2 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 29.3%, or $13.1 million, to $57.8 million for the quarter ended June 30, 1999, compared to $44.7 million in the same period in fiscal 1998. The increase in revenue and salaries, cost of care and other operating expenses was primarily related to a shift toward more risk-based business.

HEALTHCARE FRANCHISING. Revenue decreased to $0.1 million for the quarter ended June 30, 1999, from $15.0 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses decreased to $1.7 million for the quarter ended June 30, 1999, from $1.8 million in the same period in fiscal 1998. Equity in loss of CBHS decreased to $0 for the quarter ended June 30, 1999, from $7.2 million in the same period in fiscal 1998. The decrease in revenue resulted from uncertainties surrounding the collectibility of franchise fees due from CBHS, for which no franchise fee revenue was recognized during the quarter ended June 30, 1999, while $15.0 million of CBHS franchise revenue was recognized in the

same period in fiscal 1998. The decrease in equity in loss of CBHS is attributable to the fact that the Company had reduced its investment in CBHS to $0 at September 30, 1998, and was no longer required to record its pro rata share of CBHS' loss for the quarter ended June 30, 1999. See Note F--"Investments in Unconsolidated Subsidiaries--Charter Behavioral Health Systems, LLC" to the Company's condensed consolidated financial statements set forth elsewhere herein.

HEALTHCARE PROVIDER. Revenue decreased 71.9%, or $23.8 million, to $9.3 million for the quarter ended June 30, 1999, from $33.1 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses decreased 67.5%, or $19.3 million, to $9.3 million for the quarter ended June 30, 1999, from $28.6 million in fiscal 1998. Equity in earnings of unconsolidated subsidiaries increased to $0.9 million for the quarter ended June 30, 1999, from $0 in the same period in fiscal 1998. These changes resulted primarily from the sale of the European hospitals on April 9, 1999 and from the conversion of the Provider JVs from consolidation to the equity method on October 1, 1998. See "--Recent Accounting Pronouncements--EITF 96-16" and "Outlook--Results of Operations--Sale of European Psychiatric Provider Operations."

DEPRECIATION AND AMORTIZATION. Depreciation and amortization increased 14.1%, or $2.5 million, to $20.2 million for the quarter ended June 30, 1999, from $17.7 million in the same period in fiscal 1998. The increase was primarily attributable to depreciation related to recent capital expenditures and amortization related to the Aetna Payment.

INTEREST, NET. Interest expense, net, decreased 7.4%, or $1.8 million, to $22.6 million for the quarter ended June 30, 1999, from $24.4 million in the same period in fiscal 1998. The decrease was primarily the result of reduced interest expense related to lower average borrowings outstanding under the Credit Agreement (as defined).

OTHER ITEMS. The Company recorded managed care integration costs of $0.5 million for the quarter ended June 30, 1999, compared to $1.2 million in the same period in fiscal 1998. For a more complete discussion of managed care integration costs, see Note I--"Managed Care Integration Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein.

The Company recorded special income, net, of $3.0 million during the quarter and the nine months ended June 30, 1998, for the net gain on the sale of assets formerly used in its healthcare provider business.

The Company recorded a gain on the sale of its European psychiatric hospitals of approximately $23.9 million for the quarter ended June 30, 1999. See Note G--"Acquisitions and Divestitures--European Psychiatric Hospitals" to the Company's condensed consolidated financial statements set forth elsewhere herein.

Minority interest was immaterial for the quarter ended June 30, 1999, compared to $1.1 million in the same period in fiscal 1998. This decrease resulted primarily from the conversion of five provider joint ventures from consolidation to the equity method (See "--Recent Accounting Pronouncements--EITF 96-16").

NINE MONTHS ENDED JUNE 30, 1999, COMPARED TO THE SAME PERIOD IN FISCAL 1998

BEHAVIORAL MANAGED HEALTHCARE. Revenue increased 59.6% or $414.2 million, to $1.11 billion for the nine months ended June 30, 1999, from $694.7 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 57.4%, or $352.0 million, to $965.5 million for the nine months ended June 30, 1999, from $613.5 million in the same period in fiscal 1998. Equity in earnings of unconsolidated subsidiaries increased $10.9 million, to $18.2 million for the nine months ended June 30, 1999, from $7.3 million for the same period in fiscal 1998. The increases resulted primarily from the HAI and Merit acquisitions and the factors mentioned above in the comparison of the quarter ended June 30, 1999 to the same period in fiscal 1998. Revenue and Segment Profit for the nine months ended June 30, 1999 reflect approximately $8.4 million of favorable retroactive customer settlements compared to favorable settlements of $1.8 million during the same period of fiscal 1998.

HUMAN SERVICES. Revenue increased 46.5%, or $44.9 million, to $141.4 million for the nine months ended June 30, 1999, from $96.5 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 42.6%, or $37.2 million, to $124.5 million for the nine months ended June 30, 1999 from $87.3 million in the same period in fiscal 1998. The increases resulted primarily from the aforementioned factors for the quarter ended June 30, 1999 compared to the same period in fiscal 1998.

SPECIALTY MANAGED HEALTHCARE. Revenue increased 42.0%, or $44.4 million, to $150.0 million for the nine months ended June 30, 1999, compared to $105.6 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses increased 42.7%, or $44.2 million, to $147.8 million for the nine months ended June 30, 1999, compared to $103.6 million in the same period in fiscal 1998. The increase in revenue and salaries, cost of care and other operating expenses was primarily related to the Allied acquisition and the factors mentioned in the comparison of the quarter ended June 30, 1999 to the same period in fiscal 1998.

HEALTHCARE FRANCHISING. Revenue decreased to $0.4 million for the nine months ended June 30, 1999, from $51.1 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses decreased 26.9%, or $1.8 million, to $4.9 million for the nine months ended June 30, 1999, from $6.7 million in the same period in fiscal 1998. Equity in loss of CBHS decreased to $0 for the nine months ended June 30, 1999, from $24.2 million in the same period in fiscal 1998. The changes resulted primarily from the aforementioned factors for the quarter ended June 30, 1999 compared to the quarter ended June 30, 1998. See Note F--"Investments in Unconsolidated Subsidiaries--Charter Behavioral Health Systems, LLC" to the Company's condensed consolidated financial statements set forth elsewhere herein.

HEALTHCARE PROVIDER. Revenue decreased 53.3%, or $53.0 million, to $46.4 million for the nine months ended June 30, 1999, from $99.4 million in the same period in fiscal 1998. Salaries, cost of care and other operating expenses decreased 43.4%, or $35.0 million, to $45.6 million for the nine months ended June 30, 1999 from $80.6 million in fiscal 1998. Equity in earnings of unconsolidated subsidiaries increased to $3.3 million for the nine months ended June 30, 1999, from $0 in the same period in fiscal 1998. These changes resulted primarily from the aforementioned factors for the quarter ended June 30, 1999 compared to the same period in fiscal 1998. See "--Recent Accounting Pronouncements--EITF 96-16". During the nine months ended June 30, 1998, the Company recorded reductions of expenses of $4.1 million as a result of updated actuarial estimates related to malpractice claim reserves. These reductions resulted primarily from updates to actuarial assumptions regarding the Company's expected losses for more recent policy years. These revisions were based on changes in expected values of ultimate losses resulting from the Company's claim experience, and increased reliance on such claim experience.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization increased 53.2%, or $20.0 million, to $57.6 million for the nine months ended June 30, 1999, from $37.6 million in the same period in fiscal 1998. The increase was primarily attributable the Managed Care Acquisitions and the aforementioned factors for the quarter ended June 30, 1999 compared to the same period in fiscal 1998.

INTEREST, NET. Interest expense, net, increased 44.0%, or $21.7 million, to $71.0 million for the nine months ended June 30, 1999, from $49.3 million in the same period in fiscal 1998. The increase was primarily the result of interest expense incurred on borrowings used to fund the Merit acquisition and related transactions.

OTHER ITEMS. Stock option expense for the nine months ended June 30, 1999, was not material compared to a credit of $3.5 million in fiscal 1998 primarily due to fluctuations in the market price of the Company's stock in fiscal 1998.

The Company recorded managed care integration costs of $4.4 million for the nine months ended June 30, 1999, compared to $12.3 million in the same period in fiscal 1998. For a more complete discussion of managed care integration costs, see Note I--"Managed Care Integration Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein.

The Company's effective income tax rate increased to 49.1% for the nine months ended June 30, 1999, compared to 47.3% in the same period in fiscal 1998. The increase was primarily attributable to the increase in non-deductible goodwill amortization resulting from the Merit acquisition of $13.5 million for the nine months ended June 30, 1999, compared to $6.2 million for the same period in fiscal 1998.

Minority interest decreased 88.2%, or $4.5 million, to $0.6 million, compared to $5.1 million in the same period in fiscal 1998. This decrease resulted primarily from the conversion of the Provider JVs from consolidation to the equity method on October 1, 1998 (See "--Recent Accounting Pronouncements--EITF 96-16") and from the Green Spring Minority Stockholder Conversion in January 1998.

The Company recorded an extraordinary loss on early extinguishment of debt of approximately $33.0 million, net of tax benefit, during the nine months ended June 30, 1998, related primarily to refinancing the Company's long-term debt in connection with the Merit acquisition.

OUTLOOK--RESULTS OF OPERATIONS

SALE OF EUROPEAN PSYCHIATRIC PROVIDER OPERATIONS. On April 9, 1999, the Company sold its European psychiatric provider operations. See Note G -- "Acquisitions and Divestitures--European Psychiatric Hospitals" to the Company's condensed consolidated financial statements set forth elsewhere herein. The sale of the European psychiatric provider operations would have reduced the Company's net income by approximately $1.6 million, or $.05 per diluted share, on a pro forma basis (assuming the sale was consummated on October 1, 1997) for the fiscal year ended September 30, 1998.

BEHAVIORAL MANAGED HEALTHCARE RESULTS OF OPERATIONS. The Company's behavioral managed healthcare Segment Profits are subject to significant fluctuations on a quarterly basis. These potential earnings fluctuations may result from: (i) changes in utilization levels by enrolled members of the Company's risk-based contracts; (ii) performance-based contractual adjustments to revenue, reflecting utilization results or other performance measures; (iii) retroactive contractual adjustments under commercial contracts and CHAMPUS contracts; (iv) retrospective membership adjustments; (v) timing of implementation of new contracts and enrollment changes and (vi) pricing adjustments upon long-term contract renewals.

The Company's contract with the State of Tennessee to manage the behavioral healthcare benefits for the State's TennCare program ("TennCare Contract") represented approximately 15% of the Company's behavioral managed care revenue and approximately 10% of the Company's consolidated revenue in fiscal 1998. The TennCare Contract contains provisions that limit the Company's profit, subject to the carryforward of losses incurred in prior periods. The Company's profit under the TennCare Contract benefitted from the carryforward of losses incurred in prior periods during the quarter and the nine months ended June 30, 1999. The Company's profit under the TennCare Contract may be lower in future quarters as a result of these contract provisions.

TPG INVESTMENT. On July 19, 1999, the Company announced that it had entered into the TPG Investment. See Note K--"Subsequent Events--TPG Investment". The TPG Investment is expected to close during the fourth quarter of fiscal 1999. The Company expects the TPG Investment to reduce fiscal 2000 diluted income per common share by up to 15%.

RECAPITALIZATION OF CBHS. On August 10, 1999, the Company entered into a binding Letter Agreement with Crescent, COI and CBHS relating to a proposed recapitalization of CBHS and restructuring of relationships among the parties. See Note K--"Subsequent Events--Recapitalization of CBHS".

The Company expects the proposed recapitalization of CBHS, as contemplated by the Letter Agreement, to qualify as the disposal of its healthcare provider and healthcare franchising segments under Accounting Priciples Board Opinion No. 30 ("APB 30"), "Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", if consummated. APB 30 requires that the results of continuing operations be reported separately from those of discontinued operations for all periods presented and that any gain or loss from disposal of a segment of a business be reported in conjunction with the related results

of discontinued operations. The Company expects to record a loss on disposal (primarily non-cash) of its healthcare provider and healthcare franchising segments of $42.0 million to $48.0 million, net of tax, as a result of the proposed recapitalization of CBHS, if consummated. There can be no assurance that the proposed recapitalization of CBHS will be consummated.

HISTORICAL LIQUIDITY AND CAPITAL RESOURCES

OPERATING ACTIVITIES. The Company's net cash provided by (used in) operating activities was $(5.4) million and $65.4 million for the nine months ended June 30, 1998 and 1999, respectively. The increase in cash provided by operating activities in fiscal 1999 compared to fiscal 1998 was primarily the result of reduction in income taxes paid, net of refunds received, of $9.2 million, and increases in cash flows from operations as a result of the Managed Care Acquisitions, offset by reductions in franchise fees collected from CBHS of $30.6 million and (iv) increases in interest paid of $10.4 million.

INVESTING ACTIVITIES. Capital expenditures increased 34.9%, or $9.3 million, to $36.3 million for the nine months ended June 30, 1999, compared to $26.9 million in the same period in fiscal 1998. This increase was due primarily to: (i) capital expenditures of businesses acquired in fiscal 1998 and (ii) increased capital expenditures in the Company's Behavioral Managed Healthcare segment related to: (a) the Integration Plan (See Note I--"Managed Care Integration Plan and Costs" to the Company's condensed consolidated financial statements set forth elsewhere herein), and (b) acceleration of capital expenditures related to year 2000 computer issues (See "--Potential Impact of Year 2000 Computer Issues").

The Company used $60.4 million of funds, net of cash acquired, during the nine months ended June 30, 1999 for acquisitions and investments in businesses, which included (i) the Aetna Payment of $60.0 million, (ii) contingent consideration paid to the former owners of Allied of $4.5 million and (iii) other acquisitions and payments of contingent consideration and transaction costs of $15.9 million offset by the refund of the $20.0 million placed in escrow upon consummation of the Allied Acquisition.

The Company utilized $1.03 billion in funds, net of cash acquired, for acquisitions and investments in businesses, including the Managed Care Acquisitions, during the nine months ended June 30, 1998.

The Company's condensed consolidated balance sheet at June 30, 1999, reflects a reduction in cash and cash equivalents of $21.1 million from the September 30, 1998 balance which is related to the conversion of the Provider JVs from consolidation to the equity method. See "--Recent Accounting Pronouncements--EITF 96-16". This reduction in cash and cash equivalents appears as net cash used in investing activities in the Company's condensed consolidated statement of cash flows for the nine months ended June 30, 1999, but does not represent an actual reduction of cash and cash equivalents at the affected subsidiaries. Additionally, the Company received $19.0 million in distributions from unconsolidated subsidiaries, including the Provider JVs, during the nine months ended June 30, 1999. See Note F-- "Investments in Unconsolidated Subsidiaries" to the Company's condensed consolidated financial statements set forth elsewhere herein.

The Company received proceeds of approximately $12.0 million and $58.2 million, net of transaction costs, from the sale of assets formerly used in its healthcare provider business during the nine months ended June 30, 1998 and 1999, respectively.

FINANCING ACTIVITIES. The Company repaid $51.0 million of debt obligations outstanding under the Term Loan Facility (as defined) during the nine months ended June 30, 1999. Borrowings outstanding under the Revolving Facility (as defined) decreased $40.0 million during the nine months ended June 30, 1999 to $0 as of June 30, 1999. As of June 30, 1999, the Company had $132.4 million of availability under the Revolving Facility (as defined), excluding $17.6 million of availability reserved for certain letters of credit. The Company was in compliance with all debt covenants as of June 30, 1999.

The Company repurchased approximately 545,000 shares of its common stock for approximately $12.5 million during the nine months ended June 30, 1998.

OUTLOOK-LIQUIDITY AND CAPITAL RESOURCES

DEBT SERVICE OBLIGATIONS. The interest payments on the Company's $625.0 million 9% Series A Senior Subordinated Notes due 2008 (the "Notes") and interest and principal payments on indebtedness outstanding pursuant to the Company's $700.0 million senior secured bank credit agreement (the "Credit Agreement") represent significant liquidity requirements for the Company. Borrowings under the Credit Agreement bear interest at floating rates and require interest payments on varying dates depending on the interest rate option selected by the Company. Borrowings pursuant to the Credit Agreement include $499.0 million under a term loan facility (the "Term Loan Facility") and up to $150.0 million under a revolving facility (the "Revolving Facility"). The Company is required to repay the principal amount of borrowings outstanding under the Term Loan Facility and the principal amount of the Notes in the years and amounts set forth in the following table (in millions):

FISCAL YEAR	REMAINING PRINCIPAL AMOUNT
1999.......	$ 6.1
2000.......	30.1
2001.......	36.2
2002.......	45.9
2003.......	85.5
2004.......	145.6
2005.......	122.5
2006.......	27.1
2007.......	--
2008.......	$ 625.0

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

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

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

"Tranche 1 Cumulative Incremental Members" means, with respect to any Contract Year, (i) the number of Equivalent Members (as defined) serviced by the Company during such Contract Year for Tranche 1 Members, minus (ii) (A) for each Contract Year other than the initial Contract Year, the number of Equivalent Members serviced by the Company for Tranche 1 Members during the immediately preceding Contract Year or (B) for the initial Contract Year, the number of Tranche 1 Members as of

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

For each Contract Year, the Company is obligated to pay to Aetna the lesser of (i) the vested portion of the Tranche 1 Payment for such Contract Year and the vested and unpaid amount relating to prior Contract Years as of the end of the immediately preceding Contract Year and (ii) $25.0 million. To the extent that the vested and unpaid portion of the Tranche 1 Payment exceeds $25.0 million, the Tranche 1 Payment remitted to Aetna shall be deemed to have been paid first from any vested but unpaid amounts from previous Contract Years in order from the earliest Contract Year for which vested amounts remain unpaid to the most recent Contract Year at the time of such calculation. Except with respect to the Contract Year ending in 2002, any vested but unpaid portion of the Tranche 1 Payment shall be available for payment to Aetna in future Contract Years, subject to certain exceptions. All vested but unpaid amounts of Tranche 1 Payments shall expire following the payment of the Tranche 1 Payment in respect to the Contract Year ending in 2002, subject to certain exceptions. In no event shall the aggregate Tranche 1 Payments to Aetna exceed $125.0 million.

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

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

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

The Company paid $60.0 million to Aetna for both the full Tranche 1 Payment and the full Tranche 2 Payment for the Contract Year ended December 31, 1998, on March 26, 1999. Accordingly, the Company recorded $60.0 million of goodwill and other intangible assets related to the purchase of HAI during the nine months ended June 30, 1999.

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

distributed from the escrow account, during the three years following the closing of the Allied acquisition if Allied's performance exceeded certain earnings targets.

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

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

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

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

By virtue of acquiring Merit, the Company may be required to make certain contingent payments in fiscal 1999 to the former shareholders of CMG Health, Inc. ("CMG"), which was acquired by Merit in September, 1997, based upon the performance of three CMG customer contracts. No contingent consideration will be payable to the former shareholders of CMG based on the performance of two of the three CMG customer contracts at December 31, 1998. The Company may still be required to pay contingent consideration to the former shareholders of CMG depending on the financial performance of Choice. The payment of contingent consideration to the former shareholders of CMG depends on the financial performance of Choice from October 1, 1996 to June 30, 1997, which is subject to a CHAMPUS Adjustment the Company expects to receive in fiscal 1999. Such contingent payments are subject to an aggregate maximum of $23.5 million. The Company has initiated legal proceedings against certain former owners of CMG with respect to representations made by such former owners in conjunction with Merit's acquisition of CMG. The amount and timing of contingent payments to CMG, if any, are subject to the outcome of these proceedings.

REVOLVING FACILITY. The Revolving Facility will provide the Company with revolving loans and letters of credit in an aggregate principal amount at any time not to exceed $150.0 million. At June 30, 1999, the Company had approximately $132.4 million of availability under the Revolving Facility. The Company estimates that it will spend approximately $50.0 million for capital expenditures in fiscal 1999. The majority of the Company's anticipated capital expenditures relate to management information systems and related equipment. The Company believes that the cash flows generated from its operations, together with amounts available for borrowing under the Revolving Facility, should be sufficient to fund its debt service requirements, anticipated capital expenditures, contingent payments with respect to HAI and CMG, and other investing and financing activities. The Company's future operating performance and ability to service or refinance the Notes or to extend or refinance the indebtedness outstanding pursuant to the Credit Agreement will be subject to future economic conditions and to financial, business and other factors, many of which are beyond the Company's control.

RESTRICTIVE FINANCING COVENANTS. The Credit Agreement imposes restrictions on the Company's ability to make capital expenditures, and both the Credit Agreement and the indenture governing the Notes (the "Indenture") limit the Company's ability to incur additional indebtedness. Such restrictions, together with the highly leveraged financial condition of the Company, may limit the Company's ability to respond to market opportunities. The covenants contained in the Credit Agreement also, among other things, restrict the ability of the Company to dispose of assets; repay other indebtedness; amend other debt instruments (including the Indenture); pay dividends; create liens on assets; enter into sale and leaseback transactions; make investments, loans or advances; redeem or repurchase common stock and make acquisitions.

STRATEGIC ALTERNATIVES TO REDUCE LONG-TERM DEBT AND IMPROVE LIQUIDITY. The Company's sale of its European psychiatric provider operations in April 1999 represents another step in the Company's strategy of exiting its healthcare provider and healthcare franchising business segments in order to reduce long-term debt and improve liquidity. The Company is currently involved in discussions with various parties to divest certain non-core businesses. There can be no assurance that the Company will be able to divest any businesses or that the divestiture of such businesses would result in significant reductions of long-term debt or improvements in liquidity.

The Company expects to receive approximately $70 million of net proceeds upon issuance of the Series A and Series B Preferred Stock. Approximately 50% of the proceeds received from the issuance of the Series A Preferred Stock will be used to reduce debt outstanding under the Term Loan Facility. Approximately 50% of the proceeds received from the issuance of the Series B Preferred Stock will be used to reduce debt outstanding under the Term Loan Facility if the Company obtains the Series B Preferred Stock Approval on or before March 5, 2000. The remaining proceeds will be available for general corporate purposes. If the Company does not receive the Series B Preferred Stock Approval on or before March 5, 2000 and TPG elects to purchase the Series B Preferred Stock, 100% of the proceeds will be used to reduce debt outstanding under the Term Loan Facility. The Company is also reviewing additional strategic alternatives to improve its capital structure and liquidity. There can be no assurance that the Company will be able to consummate any transaction that will improve its capital structure and/or liquidity.

On August 10, 1999, the Company entered into a binding Letter Agreement with Crescent, COI and CBHS relating to a proposed recapitalization of CBHS and restructuring of relationships among the parties. See Note K--"Subsequent Events--Recapitalization of CBHS". The Company does not believe the proposed recapitalization of CBHS, if consummated, will have a significant impact on liquidity.

NET OPERATING LOSS CARRYFORWARDS. During June 1999, the Company received an assessment from the Internal Revenue Service (the "IRS Assessment") related to its federal income tax returns for the fiscal years ended September 30, 1992 and 1993. The IRS Assessment disallows approximately $162 million of deductions that relate primarily to interest expense in fiscal 1992. The Company plans to appeal the IRS Assessment during the fourth quarter of fiscal 1999.

The Company had previously recorded a valuation allowance for the full amount of the $162 million of deductions disallowed in the IRS Assessment. The IRS Assessment is not expected to result in a material cash payment for income taxes related to prior years; however, the Company's federal income tax net operating loss carryforwards would be reduced if the Company's appeal is unsuccessful.

RECENT ACCOUNTING PRONOUNCEMENTS

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

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

Emerging Issues Task Force Issue 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but a Minority Shareholder or Shareholders Have Certain Approval or Veto Rights" ("EITF 96-16") supplements the guidance contained in AICPA Accounting Research Bulletin 51, "Consolidated Financial Statements", and in Statement of Financial Accounting Standards

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

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

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

In addition, the transition provisions of EITF 96-16 must be applied to majority-owned subsidiaries previously consolidated under ARB 51/FAS 94 for which the underlying agreements have not been modified in financial statements issued for years ending after December 15, 1998 (fiscal 1999 for the Company). The adoption of the transition provisions of EITF 96-16 on October 1, 1998 had the following effect on the Company's consolidated financial position (in thousands):

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

POTENTIAL IMPACT OF YEAR 2000 COMPUTER ISSUES

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

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

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

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

The Company's principal means of ensuring year 2000 readiness for purchased software has been the replacement, upgrade or repair of non-compliant systems. This replacement process would have been undertaken for business reasons irrespective of the year 2000 problem; however, it would, more than likely, have been implemented over a longer period of time. The Company's internally-developed software was either designed to be year 2000 ready from inception or is in the process of being modified to be year 2000 ready. Approximately 87% of the Company's mission critical systems have been remediated to a state of year 2000 readiness, with the remainder scheduled to be remediated by the end of fiscal 1999. Most of the Company's non-compliant IBM PC-compatible servers and desktops have been replaced, with the remainder expected to be replaced by the end of fiscal 1999.

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

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

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

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

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

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

(iv) Testing and certification--testing the code modifications and new inventory with other associated systems, including extensive date testing and performing quality assurance testing to ensure successful operation in the post-1999 environment.

The Company has substantially completed the inventory and assessment phases for substantially all of its IT systems. The Company's IT systems are currently in the remediation and testing and certification phases. The Company plans to complete the remediation, testing and certification of all of its IT systems by the end of fiscal 1999.

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

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

EXTERNAL RELATIONSHIPS. The Company also faces the risk that one or more of its critical suppliers or customers ("External Relationships") will not be able to interact with the Company due to the third party's inability to resolve its own year 2000 issues, including those associated with its own External Relationships. The Company has completed its inventory of External Relationships and risk rated each External Relationship based upon the potential business impact, available alternatives and cost of substitution. The

Company is in the process of determining the overall year 2000 readiness of its External Relationships. In the case of significant customers and mission critical suppliers such as banks, telecommunications providers and other utilities and IT vendors, the Company is engaged in discussions with the third parties and is in the process of obtaining detailed information as to those parties' year 2000 plans and state of readiness. The Company, however, does not have sufficient information at the current time to predict whether its External Relationships will be year 2000 ready.

YEAR 2000 COSTS. Total costs incurred solely for remediation of potential year 2000 problems are currently estimated to be approximately $4.2 million in fiscal 1999. A large majority of these costs are expected to be incremental expenses that will not recur in the year 2000 or thereafter. The Company expenses these costs as incurred and funds these costs through operating cash flows. In addition, the Company estimates that it will accelerate approximately $6.3 million of capital expenditures that would have been budgeted for future periods into fiscal 1999 to ensure year 2000 readiness for outdated systems.

Year 2000 readiness is critical to the Company. The Company has redeployed some resources from non-critical system enhancements to address year 2000 issues. Due to the importance of IT systems to the Company's business, management has deferred non-critical systems enhancements to become year 2000 ready. The Company does not expect these redeployments and deferrals to have a material impact on the Company's financial condition or results of operations.

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

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

PART II--OTHER INFORMATION

ITEM 5.--OTHER INFORMATION

On May 31, 1999, the Company announced that it was relocating its headquarters from Atlanta, Georgia to Columbia, Maryland. The address of the Company's principal executive offices is now 6950 Columbia Gateway Drive; Suite 400; Columbia, Maryland 21046.

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

(a) Exhibits

EXHIBIT NO.	DESCRIPTION OF EXHIBIT
2(a)	Share Purchase Agreement, dated April 2, 1999, by and among the Company, Charter Medical International, S.A., Inc. (a wholly owned subsidiary of the Company), Investment AB Bure, and CMEL Holding Limited (a wholly owned subsidiary of Investment AB Bure), filed with the Company's current report on Form 8-K, which was filed on April 14, 1999, and is incorporated herein by reference.
2(b)	Stock Purchase Agreement, dated April 2, 1999, by and among the Company, Charter Medical International, S.A., Inc. (a wholly owned subsidiary of the Company), Investment AB Bure, and Grogrunden 515 AB (a wholly owned subsidiary of Investment AB Bure), filed with the Company's current report on Form 8-K, which was filed on April 14, 1999, and is incorporated herein by reference.
2(c)	First Amendment to Share Purchase Agreement, dated April 2, 1999, by and among the Company, Charter Medical International, S.A., Inc. (a wholly owned subsidiary of the Company), Investment AB Bure, and CMEL Holding Limited (a wholly owned subsidiary of Investment AB Bure), filed with the Company's current report on Form 8-K, which was filed on April 14, 1999, and is incorporated herein by reference.
2(d)	First Amendment to Stock Purchase Agreement, dated April 8, 1999, by and among the Company, Charter Medical International, S.A., Inc. (a wholly owned subsidiary of the Company), Investment AB Bure, and CMEL Holding Limited (a wholly owned subsidiary of Investment AB Bure), filed with the Company's current report on Form 8-K, which was filed on April 14, 1999, and is incorporated herein by reference.
4(a)	Amendment No. 2, dated as of April 30, 1999, to the Credit Agreement dated as of February 12, 1998, among the Company, certain of the Company's subsidiaries listed therein and the Chase Manhattan Bank, as administrative agent.
4(b)	Investment Agreement, dated as of July 19, 1999, between the Company and TPG Magellan LLC together with the following exhibits: (i) form of Certificate of Designations of Series A Cumulative Convertible Preferred Stock; (ii) form of Certificate of Designations of Series B Cumulative Convertible Preferred Stock; (iii) form of Certificate of Designations of Series C Junior Participating Preferred Stock; and (iv) form of Escrow Agreement by and among The Company, TPG Magellan LLC and SunTrust Bank, Atlanta, as escrow agent, filed as exhibit 4.1 to the Company's current report on Form 8-K, which was filed on July 21, 1999, and is incorporated herein by reference.

EXHIBIT NO.	DESCRIPTION OF EXHIBIT
4(c)	Registration Rights Agreement, dated as of July 19, 1999, between the Company and TPG Magellan LLC, filed as exhibit 4.2 to the Company's current report on Form 8-K, which was filed on July 21, 1999, and is incorporated herein by reference.
27	Financial Data Schedule

(b) Reports on Form 8-K

The Company filed the following current report on Form 8-K with the Securities and Exchange Commission during the quarter ended June 30, 1999.

DATE OF REPORT	ITEM REPORTED AND DESCRIPTION	FINANCIAL STATEMENTS FILED
April 14, 1999	Item 2. Disposition of Assets--Europe Sale	Yes (1)

(1) Unaudited Pro Forma Consolidated Balance Sheet at December 31, 1998; Unaudited Pro Forma Consolidated Statements of Operations for the fiscal year and for the three months ended September 30, 1998 and December 31, 1998, respectively.

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

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

MAGELLAN HEALTH SERVICES, INC.
(Registrant)

Date: August 13, 1999 /s/ CLIFFORD W. DONNELLY

Clifford W. Donnelly
EXECUTIVE VICE PRESIDENT AND
CHIEF FINANCIAL OFFICER

Date: August 13, 1999 /s/ JEFFREY T. HUDKINS

Jeffrey T. Hudkins
VICE PRESIDENT AND CONTROLLER
(PRINCIPAL ACCOUNTING OFFICER)

Exhibit 4(a)

AMENDMENT NO. 2 entered into as of April 30, 1999 (this "AMENDMENT"), to the Credit Agreement dated as of February 12, 1998 (as amended, supplemented or otherwise modified from time to time, the "CREDIT AGREEMENT"), among Magellan Health Services, Inc., a Delaware corporation (the "PARENT BORROWER"); Charter Behavioral Health System of New Mexico, Inc., a New Mexico corporation; Merit Behavioral Care Corporation, a Delaware corporation; each other wholly owned domestic subsidiary of the Parent Borrower that becomes a "Subsidiary Borrower" pursuant to Section 2.23 of the Credit Agreement (each, a "SUBSIDIARY BORROWER" and, collectively, the "SUBSIDIARY BORROWERS" (such term is used herein as modified in Article I of the Credit Agreement); the Parent Borrower and the Subsidiary Borrowers are collectively referred to herein as the "BORROWERS"); the Lenders (as defined in Article I of the Credit Agreement); The Chase Manhattan Bank, a New York banking corporation, as administrative agent (in such capacity, the "ADMINISTRATIVE AGENT") for the Lenders, as collateral agent (in such capacity the "COLLATERAL AGENT") for the Lenders and as an issuing bank (in such capacity, an "ISSUING BANK"); First Union National Bank, a national banking corporation, as syndication agent (in such capacity, the "SYNDICATION AGENT") for the Lenders and as an issuing bank (in such capacity, an "ISSUING BANK"); and Credit Lyonnais New York Branch, a licensed branch of a bank organized and existing under the laws of the Republic of France, as documentation agent (in such capacity, the "DOCUMENTATION AGENT") for the Lenders and as an issuing bank (in such capacity, an "ISSUING BANK" and, together with The Chase Manhattan Bank and First Union National Bank, each in its capacity as an issuing bank, the "ISSUING BANKS").

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

B. The Parent Borrower has requested that the Required Lenders amend certain provisions of the Credit Agreement as set forth herein.

C. The Required Lenders are willing so to amend such provisions of the Credit Agreement pursuant to the terms and subject to the conditions set forth herein.

D. Capitalized terms used but not defined herein have the meanings assigned to them in the Credit Agreement.

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

SECTION 1. AMENDMENT TO SECTION 2.13. Section 2.13 of the Credit Agreement is hereby amended by replacing the figure "100%" in paragraph (d) thereof with the figure "75%".

SECTION 2. AMENDMENT TO SECTION 2.23. Section 2.23 of the Credit Agreement is hereby amended and restated in its entirety to read as follows:

SECTION 2.23. ADDITIONAL BORROWERS. The parties hereto agree that any wholly owned Domestic Subsidiary Guarantor that is not a Borrower as of the Closing Date, or that ceases to be a Borrower after the Closing Date, may enter into and become a party to this Agreement by executing a New Borrower Agreement. Upon execution and delivery after the date hereof by the Administrative Agent, the Collateral Agent and such a Domestic Subsidiary Guarantor of a New Borrower Agreement, such Domestic Subsidiary Guarantor shall become a Borrower hereunder to the extent provided in the New Borrower Agreement. The Parent Borrower may terminate any Subsidiary Borrower's interests, rights and obligations under this Agreement in respect of (a)(i) all outstanding Term Loans and (ii) all Revolving Loans made to, or Letters of Credit issued for the account of, any Borrowers other than such Subsidiary Borrower or (b) all Term Loans, Revolving Loans and Letters of Credit, in each case to the extent provided in a Subsidiary Borrower Termination executed and delivered by the Parent Borrower to the Administrative Agent with respect to such Subsidiary Borrower, PROVIDED that (x) no such Subsidiary Borrower subject to any such termination shall cease to be a Guarantor for so long as it shall remain a Subsidiary, except as otherwise provided in the Guarantee Agreement, and (y) in the case of any such termination pursuant to clause (b) above, such Subsidiary shall cease to be a Subsidiary Borrower and a party to this Agreement. Notwithstanding the preceding sentence, no Subsidiary Borrower Termination pursuant to clause (b) above will become effective as to any Subsidiary Borrower at a time when any principal of or interest on any Revolving Loan to such Subsidiary Borrower, or any letter of credit issued for the account of such Subsidiary Borrower, shall be outstanding hereunder. The execution and delivery of a New Borrower Agreement or a Subsidiary Borrower Termination shall not require the consent of any other Borrower hereunder. The rights and obligations of each Borrower hereunder shall remain in full force and effect notwithstanding the addition of any new Borrower or termination of any Borrower as a party to this Agreement.

SECTION 3. AMENDMENTS TO SECTION 5.04. Section 5.04 of the Credit Agreement is hereby amended by replacing the words "Green Spring, Merit, Human Affairs International, Incorporated, National Mentor, Inc. and such other material Subsidiaries" in paragraphs (a) and (b) thereof with the words "the Behavioral Managed Care, Specialty Managed Care and Human Services business segments of the Parent Borrower and such other material business segments of the Parent Borrower".

SECTION 4. AMENDMENT TO SECTION 9.17. Section 9.17 of the Credit Agreement is hereby amended by deleting the first sentence of paragraph (a) thereof and substituting the following sentence therefor:

"Each Borrower agrees that it shall, jointly with the other Borrowers and severally, be liable for (a) all the Obligations or (b) in the case of any Subsidiary Borrower that is the subject of a New Borrower Agreement or Subsidiary Borrower Termination, the Obligations specified in Section 1 of the New Borrower Agreement or Subsidiary Borrower Termination, as the case may be, most recently delivered in respect of such Subsidiary Borrower."

SECTION 5. AMENDMENTS TO FORMS OF NEW BORROWER AGREEMENT AND SUBSIDIARY BORROWER TERMINATION. The Form of New Borrower Agreement set forth as

Exhibit C-2 to the Credit Agreement and the Form of Subsidiary Borrower Termination set forth as Exhibit C-3 to the Credit Agreement are hereby amended by deleting such Forms in their entirety and substituting therefor the Form of New Borrower Agreement and Form of Subsidiary Borrower Termination set forth as Schedule 1 and Schedule 2 hereto, respectively.

SECTION 6. AMENDMENT TO SCHEDULE 1.01(d). Schedule 1.01(d) to the Credit Agreement is hereby amended by deleting such Schedule in its entirety and substituting therefor the Schedule 1.01(d) set forth as Schedule 3 hereto.

SECTION 7. REPRESENTATIONS AND WARRANTIES. Each Borrower represents and warrants to the Administrative Agent and to each of the Lenders that:

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

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

(c) On the date hereof and immediately after giving effect to this Amendment, no Event of Default or Default has occurred and is continuing.

SECTION 8. AMENDMENT FEE. In consideration of the agreements of the Required Lenders contained in this Amendment, the Parent Borrower agrees to pay to the Administrative Agent, for the account of each Lender that delivers an executed counterpart of this Amendment prior to 12:00 p.m., New York City time, on the date first above written, an amendment fee (the "AMENDMENT FEE") in an amount equal to 0.05% of the sum of such Lender's outstanding Term Loans and Revolving Credit Commitment as of such date.

SECTION 9. CONDITIONS TO EFFECTIVENESS. This Amendment shall become effective as of the date first above written (PROVIDED that Sections 2, 4 and 5 hereof shall become effective as of September 30, 1998) when the Administrative Agent shall have received (a) counterparts of this Amendment that, when taken together, bear the signatures of the Borrowers and the Required Lenders and (b) the Amendment Fees.

SECTION 10. CREDIT AGREEMENT. Except as specifically amended hereby, the Credit Agreement shall continue in full force and effect in accordance with the provisions thereof as in existence on the date hereof. After the date hereof, any reference to the Credit Agreement shall mean the Credit Agreement as amended hereby. This Amendment shall be a Loan Document for all purposes.

SECTION 11. APPLICABLE LAW. THIS AMENDMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF NEW YORK.

SECTION 12. COUNTERPARTS. This Amendment may be executed in two or more counterparts, each of which shall constitute an original but all of which when taken together shall constitute but one agreement. Delivery of an executed signature page to this Amendment by

facsimile transmission shall be effective as delivery of a manually signed counterpart of this Amendment.

SECTION 13. EXPENSES. The Parent Borrower agrees to reimburse the Administrative Agent for its out-of-pocket expenses in connection with this Amendment, including the reasonable fees, charges and disbursements of Cravath, Swaine & Moore, counsel for the Administrative Agent.

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

MAGELLAN HEALTH SERVICES, INC.,

by

Name:
Title:

CHARTER BEHAVIORAL HEALTH SYSTEM OF NEW MEXICO, INC.,

by

Name:
Title:

MERIT BEHAVIORAL CARE CORPORATION,

by

Name:
Title:

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

by

Name:
Title:

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

by

Name:
Title:

CREDIT LYONNAIS NEW YORK BRANCH,
individually and as Documentation Agent and an
Issuing Bank,

by

Name:
Title:

To Approve the Amendment:

Name of Institution
----

by

Name:

Title:

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

9-MOS
SEP-30-1999
JUN-30-1999
40,307,000
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156,349,000
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333,172,000
205,357,000
68,043,000
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