
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended: **March 31, 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 number **1-12718**

FOUNDATION HEALTH SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

95-4288333
(I.R.S. Employer Identification No.)

21650 Oxnard Street, Woodland Hills, CA
(Address of principal executive offices)

91367
(Zip Code)

(818) 676-6978
(Registrant's telephone number, including area code)

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

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

The number of shares outstanding of the registrant's Class A Common Stock as of May 12, 1999 was 117,215,876 (excluding 3,194,374 shares held as treasury stock), and 5,047,642 shares of the registrant's Class B Common Stock were outstanding as of such date.

FOUNDATION HEALTH SYSTEMS, INC.
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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

FOUNDATION HEALTH SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Amounts in thousands)

	<u>March 31, 1999</u>	<u>December 31, 1998</u>
	(Unaudited)	
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 615,574	\$ 763,865
Investments—available for sale	564,365	525,082
Premiums receivable, net	222,257	230,157
Amounts receivable under government contracts	292,495	321,411
Deferred taxes	145,184	160,446
Reinsurance and other receivables	153,941	147,827
Other assets	78,268	91,096
Total current assets	<u>2,072,084</u>	<u>2,239,884</u>
Property and equipment, net	334,130	345,269
Goodwill and other intangible assets, net	960,316	977,910
Other assets	344,892	366,478
Total Assets	<u>\$3,711,422</u>	<u>\$3,929,541</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Reserves for claims and other settlements	\$1,016,909	\$ 961,399
Unearned premiums	100,091	288,683
Notes payable and capital leases	1,569	1,760
Amounts payable under government contracts	78,282	69,792
Accounts payable and other liabilities	441,836	503,797
Total current liabilities	<u>1,638,687</u>	<u>1,825,431</u>
Notes payable and capital leases	1,193,679	1,254,278
Other liabilities	94,060	105,790
Total Liabilities	<u>2,926,426</u>	<u>3,185,499</u>
Stockholders' Equity:		
Common Stock and additional paid-in capital	642,355	641,945
Treasury Class A common stock, at cost	(95,831)	(95,831)
Accumulated other comprehensive loss	(8,685)	(7,308)
Retained earnings	247,157	205,236
Total stockholders' equity	<u>784,996</u>	<u>744,042</u>
Total Liabilities and Stockholders' Equity	<u>\$3,711,422</u>	<u>\$3,929,541</u>

See accompanying Notes to Condensed Consolidated Financial Statements.

FOUNDATION HEALTH SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in thousands, except per share data)
(Unaudited)

	First Quarter Ended March 31,	
	1999	1998
Revenues		
Health plan premiums	\$1,855,423	\$1,844,484
Government contracts/Specialty services	348,352	304,740
Investment and other income	18,657	26,150
Gain on sale of pharmacy benefits management operations	53,558	—
Total revenues	2,275,990	2,175,374
Expenses		
Health plan services	1,564,777	1,544,092
Government contracts/Specialty services	238,799	191,468
Selling, general and administrative	321,915	343,850
Depreciation	17,739	17,820
Amortization	10,984	13,021
Interest	21,938	21,861
Restructuring and other costs	21,059	—
Total expenses	2,197,211	2,132,112
Income from operations before income taxes and cumulative effect of change in accounting principle	78,779	43,262
Income tax provision	31,441	17,024
Income before cumulative effect of change in accounting principle	47,338	26,238
Cumulative effect of change in accounting principle	5,417	—
Net income	\$ 41,921	\$ 26,238
Basic and diluted earnings per share:		
Income before cumulative effect of change in accounting principle	\$ 0.39	\$ 0.22
Cumulative effect of change in accounting principle	0.05	—
Net income	\$ 0.34	\$ 0.22
Weighted average shares outstanding:		
Basic	122,233	121,614
Diluted	122,233	121,907

See accompanying Notes to Condensed Consolidated Financial Statements.

FOUNDATION HEALTH SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in thousands)
(Unaudited)

	First Quarter Ended March 31,	
	1999	1998
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 41,921	\$ 26,238
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization and depreciation	28,723	30,841
Gain on sale of pharmacy benefits management operations	(53,558)	—
Cumulative effect of change in accounting principle	5,417	—
Changes in net assets of discontinued operations	—	(30,324)
Other changes	648	939
Changes in assets and liabilities:		
Premiums receivable	7,900	(19,086)
Unearned premiums	(188,592)	(111,640)
Other assets	38,705	29,957
Amounts receivable/payable under government contracts	37,406	20,488
Reserves for claims and other settlements	55,510	(49,991)
Accounts payable and accrued liabilities	(78,702)	(85,520)
Net cash used in operating activities	<u>(104,622)</u>	<u>(188,098)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Sale or maturity of investments	98,232	120,109
Purchase of investments	(142,312)	(166,712)
Purchases of property and equipment	(9,017)	(26,450)
Sales of property and equipment	2,381	—
Net proceeds from the sale of pharmacy benefits management operations	65,000	—
Other	2,427	—
Net cash provided by (used in) investing activities	<u>16,711</u>	<u>(73,053)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options and employee stock purchases	410	1,385
Proceeds from issuance of notes payable and other financing arrangements	20,000	45,000
Repayment of debt and other non-current liabilities	(80,790)	(654)
Net cash provided by (used in) financing activities	<u>(60,380)</u>	<u>45,731</u>
Net decrease in cash and cash equivalents	(148,291)	(215,420)
Cash and cash equivalents, beginning of period	763,865	559,360
CASH AND CASH EQUIVALENTS, END OF PERIOD	<u>\$ 615,574</u>	<u>\$ 343,940</u>

See accompanying Notes to Condensed Consolidated Financial Statements.

FOUNDATION HEALTH SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following notes should be read in conjunction with the notes to the consolidated financial statements and the management's discussion and analysis of financial condition and results of operations for each of the three years in the period ended December 31, 1998 incorporated by reference in the Foundation Health Systems, Inc. (the "Company") Annual Report on Form 10-K for the year ended December 31, 1998.

Note 1—Basis of Presentation

In the opinion of management, the accompanying condensed consolidated financial statements include all normal and recurring adjustments necessary for a fair presentation of the consolidated financial position of the Company and the consolidated results of its operations and its cash flows for the interim periods presented. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the "Commission") applicable to quarterly reports on Form 10-Q. Results of operations for the interim periods are not indicative of results to be expected for the full year.

Certain prior period amounts have been reclassified to conform with the current period presentation. The Company reclassified medical management expenses from health plan services costs to selling, general and administrative ("SG&A") expenses. The Company also reclassified SG&A expenses of its Specialty Services division from Government Contracts/Specialty Services costs to SG&A expenses. In conjunction with its segment reporting, the Company is reporting the revenues and expenses of its Government Contracts/Specialty Services segment on a combined basis in the condensed consolidated statements of operations.

Note 2—Restructuring and Other Costs

During 1998, the Company initiated a formal plan to dispose of certain Central Division health plans included in the Company's Health Plan Services segment in accordance with its anticipated divestitures program. In this connection, the Company adopted a formal plan during the first quarter ended March 31, 1999 to close the Colorado regional support center for these health plans and transfer its operations to the Company's other administrative facilities. The closure is expected to be completed by the end of 1999. The Company recorded a pretax restructuring charge of \$21.1 million including \$18.5 million for severance and \$2.6 million for other expenses associated with the closing of the facility. As of March 31, 1999, no cash payments have been made and \$21.1 million is expected to require future outlays of cash.

During 1997 and 1998, the Company adopted restructuring plans, the principal elements of which included a workforce reduction, the consolidation of employee benefit plans, the consolidation of facilities in certain geographic locations, the consolidation of overlapping provider networks and the consolidation of information systems at all locations. Of the \$146.8 million in restructuring costs recorded as part of the 1997 plans, \$93.2 million represented cash payments and \$42.4 million represented non-cash activities through March 31, 1999. Of the remaining amounts, \$7.5 million is expected to require future outlays of cash and \$3.7 million represents future non-cash activities. Of the \$21.2 million in restructuring costs recorded as part of the 1998 plan, \$15.5 million represented cash payments and \$2.0 million represented non-cash activities through March 31, 1999. Of the remaining amounts, \$3.7 million is expected to require future outlays of cash.

Note 3—Comprehensive Income

The Company's comprehensive income for the first quarters ended March 31 is as follows (amounts in thousands):

	<u>1999</u>	<u>1998</u>
Net Income	\$41,921	\$26,238
Other comprehensive income (loss), net of tax:		
Change in unrealized appreciation (depreciation) on investments	<u>(1,377)</u>	<u>3,805</u>
Comprehensive Income	<u>\$40,544</u>	<u>\$30,043</u>

Note 4—Earnings Per Share

Basic earnings per share excludes dilution and reflects income divided by the weighted average shares of common stock outstanding during the periods presented. Diluted earnings per share is based upon the weighted average shares of common stock and dilutive common stock equivalents (all of which are comprised of stock options) outstanding during the periods presented; no adjustment to income is required. Common stock equivalents arising from dilutive stock options are computed using the treasury stock method. There were no such shares of common stock equivalents for the three months ended March 31, 1999 and 293,000 shares for the three months ended March 31, 1998.

Note 5—Segment Information

Presented below are segment data for the first quarter ended March 31, 1999 and 1998 (amounts in thousands):

	<u>Health Plan Services</u>	<u>Government Contracts/ Specialty Services</u>	<u>Corporate/ Other</u>	<u>Total</u>
March 31, 1999				
Revenues from external sources	\$1,855,423	\$348,352	\$ 72,215	\$2,275,990
Intersegment revenues	1,681	40,485	7,946	50,112
Income before income taxes and cumulative effect of change in accounting principle	8,497	32,597	37,685	78,779
March 31, 1998				
Revenues from external sources	\$1,844,484	\$304,740	\$ 26,150	\$2,175,374
Intersegment revenues	6,230	31,035	8,246	45,511
Income before income taxes	35,621	26,333	(18,692)	43,262

Note 6—Change in Accounting Principle

Effective January 1, 1999, the Company adopted Statement of Position 98-5 "Reporting on the Costs of Start-Up Activities" and changed its method of accounting for start-up and organization costs. The change involved expensing these costs as incurred, rather than the Company's previous accounting principle of capitalizing and subsequently amortizing such costs.

The change in accounting principle resulted in the write-off of the costs capitalized as of January 1, 1999. The cumulative effect of the write-off was \$5.4 million (net of tax benefit of \$3.7 million) and has been expensed and reflected in the condensed consolidated statement of operations for the three months ended March 31, 1999.

Note 7—Disposition of Assets

On March 31, 1999, the Company completed the sale of certain of its pharmacy benefits management operations for net cash proceeds of \$65.0 million and recognized a net gain of \$53.6 million.

On November 4, 1998, the Company entered into a definitive agreement for the sale of its HMO operations in the states of Texas, Louisiana and Oklahoma to AmCareco, Inc. The sale was consummated effective April 30, 1999. As part of the transaction, the Company received convertible preferred stock of the buyer and cash in excess of certain statutory surplus and minimum working capital requirements of the plans sold.

In December 1997, the Company adopted a formal plan to sell its workers' compensation segment which was accounted for as discontinued operations for the first quarter ended March 31, 1998. The loss on disposition of \$99 million recorded at December 31, 1997 included the anticipated results of discontinued operations through the disposal date; accordingly, net losses of \$4.2 million related to the operations of the workers' compensation segment are not reflected on the Company's condensed consolidated statement of operations for the quarter ended March 31, 1998. On December 10, 1998, the Company completed the sale of the workers' compensation segment.

Note 8—Legal Proceedings

Complaints have been filed in federal and state courts seeking an unspecified amount of damages on behalf of an alleged class of persons who purchased shares of common stock, convertible subordinated debentures and options to purchase common stock of FPA Medical Management, Inc. ("FPA") at various times between February 3, 1997 and May 15, 1998. The complaints allege that the Company and certain former officers violated federal and state securities laws by misrepresenting and failing to disclose certain information about a 1996 agreement between the Company and FPA, about FPA's business and about the Company's 1997 sale of FPA common stock held by the Company. Management believes these suits are without merit and intends to vigorously defend the actions.

The Company is involved in various other legal proceedings, which are routine in its business. In the opinion of management, based upon current facts and circumstances known by the Company, the resolution of these matters should not have a material adverse effect on the financial position or results of operations of the Company.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Foundation Health Systems, Inc. (together with its subsidiaries, the "Company") is an integrated managed care organization which administers the delivery of managed health care services. The Company's operations consist of two operating segments: Health Plan Services and Government Contracts/Specialty Services. Through its subsidiaries, the Company offers group, individual, Medicaid and Medicare health maintenance organization ("HMO") and preferred provider organization ("PPO") plans; government sponsored managed care plans; and managed care products related to administration and cost containment, behavioral health, dental, vision and pharmaceutical products and other services.

The Health Plan Services segment consists of HMOs organized into four operational divisions located in the following geographic regions: the California Division, the Northeast Division, the Central Division and the Arizona Division. During the first quarter ended March 31, 1999, these health plans were located in Arizona, California, Colorado, Connecticut, Florida, Idaho, Louisiana, New Jersey, New Mexico, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Texas, Utah, Washington and West Virginia. As discussed above, the Company sold its HMO operations in the States of Louisiana, Oklahoma and Texas effective April 30, 1999. The Company's health plans provide a wide range of managed health care services throughout the United States with approximately 4.1 million at risk and administrative services only members. The Company's HMO subsidiaries contract to provide medical care services to a defined,

enrolled population for a predetermined, prepaid monthly fee for group, Medicaid, individual and Medicare plans throughout their respective service areas. All of the HMOs are state licensed and some are also federally qualified. The Company also operates PPO networks which provide access to health care services and owns six health and life insurance companies licensed to sell insurance throughout most of the United States. The financial results include the results of two hospitals owned by the Company operating in California.

The Government Contracts/Specialty Services segment administers large, multi-year managed health care government contracts. This segment subcontracts to affiliated and unrelated third parties the administration and health care risk of parts of these contracts and currently administers health care programs covering approximately 1.5 million eligible individuals under the Civilian Health and Medical Program of the Uniformed Services (“CHAMPUS”) through the TRICARE program. Currently, the Company provides these services under three TRICARE contracts that cover Alaska, Arkansas, California, Hawaii, Oklahoma, Oregon, Texas, Washington and parts of Arizona, Idaho and Louisiana. This segment also offers behavioral health, pharmacy management, dental and vision services and sub-acute hospital unit management as well as managed care and workers’ compensation products related to bill review, administration and cost containment for hospitals, health plans and other entities.

This discussion and analysis contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve risks and uncertainties which may cause actual results to differ materially from those projected or implied in these statements. The risks and uncertainties faced by the Company include, but are not limited to, those set forth under “Additional Information Concerning the Company’s Business,” “Cautionary Statements” and other sections within the Company’s filings with the Commission.

Consolidated Results of Operations

The Company’s net income for the first quarter ended March 31, 1999 was \$41.9 million, or \$0.34 per diluted share, compared to net income for the comparable period in 1998 of \$26.2 million, or \$0.22 per diluted share. Excluding the cumulative effect of the change in accounting principle for organization and start up costs, net income was \$47.3 million or \$0.39 per diluted share for the first quarter ended March 31, 1999.

The table below and the paragraphs which follow provide selected financial information related to the Company's performance in the first quarter ended March 31, 1999 and 1998 (amounts in thousands except PMPM data):

	First Quarter Ended March 31,	
	1999	1998
Total revenues	\$2,275,990	\$2,175,374
Expenses:		
Health plan services	1,564,777	1,544,092
Government contracts/Specialty services	238,799	191,468
Selling, general and administrative	321,915	343,850
Depreciation	17,739	17,820
Amortization	10,984	13,021
Interest	21,938	21,861
Restructuring and other costs	21,059	—
Total expenses	<u>2,197,211</u>	<u>2,132,112</u>
Overall MCR	81.8%	80.8%
Administrative (SG&A+depreciation) ratio	15.4%	16.8%
HEALTH PLAN SERVICES SEGMENT:		
Health plan premiums	\$1,855,423	\$1,844,484
Health plan MCR	84.3%	83.7%
Health plan premiums per member per month	\$ 143.95	\$ 136.33
Health plan services per member per month	\$ 121.40	\$ 114.13
GOVERNMENT CONTRACTS/SPECIALTY SERVICES SEGMENT:		
Government contracts/Specialty services revenues	\$ 348,352	\$ 304,740
Government contracts/Specialty services MCR	68.6%	62.8%

Enrollment Information
First Quarter Ended March 31,
(Amounts in Thousands)

	1999	1998	Percent Change
Health Plan Services:			
Commercial	3,141	3,523	(10.8%)
Medicare Risk	283	310	(8.7%)
Medicaid	642	488	31.6%
	<u>4,066</u>	<u>4,321</u>	(5.9%)
Government Contracts:			
CHAMPUS PPO and Indemnity	713	882	(19.2%)
CHAMPUS HMO	803	720	11.5%
	<u>1,516</u>	<u>1,602</u>	(5.4%)

Revenues and Health Care Costs

The Company's revenues grew by \$100.6 million or 4.6% for the first quarter ended March 31, 1999 as compared to the comparable period in 1998. Growth in Health Plan revenues of \$10.9 million was due primarily to increases in premium rates in virtually all markets partially offset by decreases in commercial enrollment. Growth in Government contracts/Specialty services revenues totaled \$43.6 million due to growth in mental health services and certain revenue adjustments under government contracts. See "Segment Information" for further discussion of Health Plan and Government Contract/Specialty Services.

The overall medical care ratio ("MCR") (medical costs as a percentage of Health Plan premiums and Government contracts/Specialty services revenues) for the first quarter ended March 31, 1999 was 81.8% as compared to 80.8% for the comparable period in 1998. The increase was primarily due to higher pharmacy costs in all divisions, benefit cost increases which exceeded premium rate increases, and increased utilization of pharmaceuticals and provider services throughout the Company's health plans.

On March 31, 1999, the Company completed the sale of certain of its pharmacy benefits management operations. As a result, the Company recorded \$65 million in net cash proceeds and a net gain of \$53.6 million.

Selling, General and Administrative Costs

The Company's selling, general and administrative ("SG&A") expenses decreased by \$21.9 million or 6.4% for the first quarter ended March 31, 1999 as compared to the comparable period in 1998. The decrease in SG&A expenses during 1999 is primarily attributable to the Company's ongoing efforts to control its SG&A expenses and savings associated with the integration of its 1997 acquisitions.

Amortization and Depreciation

Amortization and depreciation expense decreased by \$2.1 million for the first quarter ended March 31, 1999 as compared to the comparable period in 1998. The decrease is due to write-downs of goodwill and other long-lived assets to their estimated fair value during the year ended December 31, 1998.

Interest Expense

Interest expense was \$21.9 million for the first quarters ended March 31, 1999 and 1998. Decreased interest expense from the reduction in the revolving credit facility balance was offset by a higher borrowing rate in 1999 as compared to the comparable period in 1998.

Income Tax Provision

The effective tax provision rate was 39.9% on income from operations for the first quarter ended March 31, 1999 compared to the effective tax provision rate on continuing operations of 39.4% for the comparable period in 1998.

Restructuring and Other Costs

During 1998, the Company initiated a formal plan to dispose of certain Central Division health plans included in the Company's Health Plan Services segment in accordance with its anticipated divestitures program. In this connection, the Company adopted a formal plan during the first quarter ended March 31, 1999 to close the Colorado regional support center for these health plans and transfer its operations to the Company's other administrative facilities. The closure is expected to be completed by the end of 1999. The Company recorded a pretax restructuring charge of \$21.1 million including \$18.5 million for severance and \$2.6 million for other expenses associated with the closing of the facility.

Segment Information

Health Plan Services

Health Plan Services revenues increased by \$10.9 million or 0.6% in the first quarter ended March 31, 1999 as compared to the comparable period in 1998 primarily due to average premium rate increases of 8.0% in the commercial market which were offset by a 5.9% decrease in enrollment. Health plan health care costs increased by \$20.7 million, or 1.3%, for the first quarter ended March 31, 1999 as compared to the comparable period in 1998. The health plans MCR increased from 83.7% in the first quarter ended March 31, 1998 to 84.3% in the comparable period in 1999 due to higher medical costs particularly in physician and hospital fee for service costs, an increase in pharmacy costs and increased utilization of pharmaceuticals and provider services.

The Company's commercial business is experiencing lower margins than in 1998 due to health care cost increases outpacing health plan revenue increases in 1999. Premium rate increases in the commercial line of products contributed to revenue increases for the first quarter ended March 31, 1999 as compared to the comparable period in 1998 in virtually all of the Company's health plans, but were partially offset by enrollment decreases in commercial HMO markets. Commercial health plan revenues and health care costs on a per member per month basis have increased approximately 8% and 11%, respectively, during the first quarter ended March 31, 1999 as compared to the comparable period in 1998.

The Company's Medicare business is experiencing higher margins than in 1998, particularly in the Northeast division. Medicare premium rates have increased in all markets averaging about 6% due to new premiums charged to members and a favorable mix shift from exiting unfavorable markets. Medicare health care costs on a per member per month basis have increased approximately 5% during the first quarter ended March 31, 1999 as compared to the comparable period in 1998.

The Company's Medicaid business is experiencing lower margins than in 1998. Medicaid revenues and health care costs on a per member per month basis have increased approximately 1% and 8%, respectively, during the first quarter ended March 31, 1999 as compared to the comparable period in 1998. Medicaid enrollment in the California division has increased significantly resulting in a 42.9% increase in member months during the first quarter ended March 31, 1999, compared to the comparable period in 1998. Medicaid premium rates have increased slightly in all markets except for the Northeast where they have decreased by 1.3%. Medicaid health care costs have increased on a per member per month basis in all of the Company's markets.

Government Contracts/Specialty Services

Government contracts/Specialty services revenue increased by \$43.6 million or 14.3% during the first quarter ended March 31, 1999 as compared to the comparable period in 1998 primarily due to certain revenue adjustments under government contracts and growth in the Company's managed behavioral health network and bill review cost containment businesses.

The Government contracts/Specialty services MCR increased to 68.6% for the first quarter ended March 31, 1999 compared to 62.8% for the comparable period in 1998. This increase for the first quarter ended March 31, 1999 is primarily due to increased pharmacy costs and increased utilization of provider services.

Impact of Inflation and Other Elements

The managed health care industry is labor intensive and its profit margin is low; hence, it is especially sensitive to inflation. Increases in medical expenses or contracted medical rates without corresponding increases in premiums could have a material adverse effect on the Company.

Various federal and state legislative initiatives regarding the health care industry have been proposed during recent legislative sessions, and health care reform and similar issues continue to be in the forefront of social and political discussion. If health care reform or similar legislation is enacted, such legislation could impact the Company. Management cannot at this time predict whether any such initiative will be enacted and, if enacted, the impact on the financial condition or results of operations of the Company.

The Company's ability to expand its business is dependent, in part, on competitive premium pricing and its ability to secure cost-effective contracts with providers. Achieving these objectives is becoming increasingly difficult due to the competitive environment. In addition, the Company's profitability is dependent, in part, on its ability to maintain effective control over health care costs while providing members with quality care. Factors such as health care reform, integration of acquired companies, regulatory changes, utilization, new technologies, hospital costs, major epidemics and numerous other external influences may affect the Company's operating results. Accordingly, past financial performance is not a reliable indicator of future performance, and investors should not use historical records to anticipate results or future period trends.

The Company's HMO and insurance subsidiaries are required to maintain reserves to cover their estimated ultimate liability for expenses with respect to reported and unreported claims incurred. These reserves are estimates of future payments based on various assumptions. Establishment of appropriate reserves is an inherently uncertain process, and there can be no certainty that currently established reserves will prove adequate in light of subsequent actual experience, which in the past has resulted and in the future could result in loss reserves being too high or too low. The accuracy of these estimates may be affected by external forces such as changes in the rate of inflation, the regulatory environment, the judicial administration of claims, medical costs and other factors. Future loss development or governmental regulators could require reserves for prior periods to be increased, which would adversely impact earnings in future periods. In light of present facts and current legal interpretations, management believes that adequate provisions have been made for claims and loss reserves.

The Company's HMO subsidiaries contract with providers in California, and to a lesser degree in other areas, primarily through capitation fee arrangements. Under a capitation fee arrangement, the Company's subsidiary pays the provider a fixed amount per member on a regular basis and the provider accepts the risk of the frequency and cost of member utilization of services. The inability of providers to properly manage costs under capitation arrangements can result in financial instability of such providers. Any financial instability of capitated providers could lead to claims for unpaid health care against the Company's HMO subsidiaries, even though such subsidiaries have made their regular payments to the capitated providers. Depending on state law, the Company's HMO subsidiaries may be liable for such claims.

Year 2000

The Company recognizes that the arrival of the year 2000 requires computer systems to be able to recognize the date change from 1999 to 2000 and, like other companies, is assessing and modifying its computer applications and business processes to provide for their continued functionality.

The "Year 2000" issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's computer programs that have time sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, prepare invoices or engage in normal business activities. In addition, the Year 2000 problems of the Company's providers and customers, including governmental entities, can affect the Company's operations, which are highly dependent upon information technology for processing claims, determining eligibility and exchanging information.

Project Status—The Year 2000 effort for the Company has the highest priority of technology projects and has the full support of the Company’s management. The project has dedicated resources with multiple teams to address its unique systems environment. Uniform project management techniques have been adopted with overall oversight responsibility residing with the Company’s Chief Technology Officer, assisted by a special project manager hired by the Company. An executive management committee is also actively and directly involved in an oversight capacity in the Company’s Year 2000 project and receives monthly reports from the project manager. In addition, the project manager regularly meets with the Company’s audit committee to further discuss the Company’s Year 2000 issues.

The Company is addressing its Year 2000 issues in several ways. Selected systems are being retired with the business functions being converted to Year 2000 compliant systems. A number of the Company’s systems include packaged software from large vendors that the Company is closely monitoring to ensure that these systems are Year 2000 compliant. The Company believes that vendors will make timely updates available to ensure that all remaining purchased software is Year 2000 compliant. The remaining systems’ compliance with Year 2000 will be addressed by internal technical staff. The Company has engaged IBM Global Services to assist in the program management of the project. In addition, the Company has assessed its third party relationships with respect to non-information technology assets and services, has retained IBM’s The Wilkerson Group, and is developing contingency plans to provide continuity of material relationships. Legal consultants have been retained to assist with insurance review and assessment of the Company’s obligations and rights.

The Company has divided its Year 2000 effort into five phases: (1) Assessment and Strategy, (2) Detailed Analysis and Planning, (3) Remediation, (4) Testing and Implementation, and (5) Certification. During the first quarter of 1999, the Company made substantial progress in its efforts to address Year 2000 issues. The Company has established the third quarter of 1999 to complete all phases and is endeavoring to accelerate completion ahead of that time. The following table sets forth the estimated percentage completion of each of the Company’s Year 2000 phases with respect to its Year 2000 project overall.

	<u>Phase 1</u>	<u>Phase 2</u>	<u>Phase 3</u>	<u>Phase 4</u>	<u>Phase 5</u>
Overall—May 1999	100%	100%	93%	55%	3%
Overall—February 1999 (as reported in the Company’s Annual Report on Form 10-K)	100%	83%	54%	11%	0%

Third Parties—The Company’s inventory of third party relationships has identified general purpose utility vendors, care delivery organizations (such as providers), customer service vendors and certain other entities as strategically important to the Company. The assessment continues and is expected to be completed within the second quarter of 1999. The Company is also in the process of following up with the important third parties identified in the assessment to help ensure that the relationships will not be materially interrupted or affected by the Year 2000 problem. There can be no assurance that the systems of other companies on which the Company relies will be compliant on a timely basis, or that the failure by a third party to be compliant would not have a material adverse effect on the Company.

Costs—The Company is evaluating on an on-going basis the related costs to resolve its potential Year 2000 problems. The Company has reduced its estimate of the total cost for the project from approximately \$42.7 million to \$36-40 million, excluding the costs to accelerate the replacement of hardware or software otherwise required to be purchased by the Company. The decrease is a result principally of a reduction in the anticipated duration of the employment of outside consultants and contractors and a shift of certain responsibilities to internal labor. Through the first quarter of 1999, the Company expended approximately \$20.2 million relating to, among other things, the cost to repair or replace software and related hardware problems, the cost of assessment, analysis and planning, and internal and external communications. The Company currently estimates that the percentages of its total expenditures for Year 2000 issues will be approximately as follows: 35% for internal costs, 30% for outside consultants and contractors and 35% for

software-related and hardware-related costs. The Company has established a line-item in its overall operating budget specifically for Year 2000 costs. The operating subsidiaries for each line of business of the Company, however, are paying for the costs of assessment, planning, remediation and testing of Year 2000 issues for their respective operations.

Notwithstanding the foregoing, the costs of the project and the timetable in which the Company plans to complete the Year 2000 compliance requirements are based on estimates derived from utilizing numerous assumptions of future events including the continued availability of certain resources, third party modification plans and other factors. There can be no assurances that these estimates will be achieved and actual results and costs could differ materially from these estimates.

Certain insurance coverages for defense costs associated with Year 2000 litigation have already been secured under the Company's Directors and Officers Liability Insurance policy and will be re-evaluated upon renewal of that policy. At this time, it is unclear as to the extent of existing insurance coverage, if any, the Company may have to cover potential Year 2000 costs and liabilities under its other insurance policies. The Company is currently analyzing the availability of such coverage under other existing and future insurance policies and products.

Contingency Planning—An important part of the Company's Year 2000 project involves identifying worst case scenarios and seeking to develop contingency plans. The Company has completed the assessment of its mission critical business functions and has sought to prioritize them in order to address the most critical issues first in remediation efforts and to develop alternatives to these critical processes as part of contingency planning. A mission critical business activity or system is one that cannot be without an automated or functional system for a period of 21 days without causing significant business impact to the particular line of business. Among other things, the Company's divisions have assessed potential negative impacts on a valid member's ability to receive services, the ability to generate revenue, the need for additional expenditures, compliance with legal, regulatory or accreditation requirements, meeting contractual obligations and reimbursing providers, vendors and agents. The Company is in the process of documenting and validating its contingency plans and expects to complete such process by the end of the second quarter of 1999. The Company currently anticipates that its contingency plans will include the use of manual as well as on-line files of its members to avoid disruption in the verification of membership and eligibility for the provision of health care services to its members.

Risks—The Company is highly dependent upon its own information technology systems and that of its providers and customers. Failure by the Company or a third party to correct a material Year 2000 problem could result in a failure of or an interruption in the Company's business activities and operations. Such interruptions and failures could materially and adversely affect the Company's results of operations, liquidity and financial condition. Due to the general uncertainty inherent in the Year 2000 problem, resulting in part from the uncertainty of the readiness of third party providers and customers, the Company is not able at this time to determine whether the Year 2000 problems will have a material adverse effect on the Company's results of operations, liquidity or financial condition. The Company's Year 2000 project is expected to reduce significantly the Company's level of uncertainty and the possibility of significant or long-lasting interruptions of the Company's business operations; however, the Company believes that it is impossible to predict all of the areas in which material problems may arise.

The Company has been formally communicating with others with whom it does significant business to determine their Year 2000 issues. The Company is currently projecting to complete its assessment of third party risks by the end of the second quarter of 1999. There can be no assurances that the systems of other companies on which the Company's systems rely will be Year 2000 ready, that any Year 2000 problems of such companies will be timely remedied, or that the failure by another company to be Year 2000 ready would not have a material adverse effect on the Company.

Forward-looking statements contained in this Year 2000 section should be read in connection with the Company's cautionary statements identifying important risk factors that could cause the Company's actual

results to differ materially from those projected in these forward-looking statements, which cautionary statements are contained in the Company's Annual Report on Form 10-K for the year ended December 31, 1998. The information contained herein is intended to be a "Year 2000 Readiness Disclosure" as defined in the Year 2000 Information and Readiness Disclosure Act of 1998 enacted on October 19, 1998.

Liquidity and Capital Resources

Certain of the Company's subsidiaries must comply with minimum capital and surplus requirements under applicable state laws and regulations, and must have adequate reserves for claims. Certain subsidiaries must maintain ratios of current assets to current liabilities pursuant to certain government contracts. The Company believes it is in compliance with these contractual and regulatory requirements in all material respects.

The Company believes that cash from operations, existing working capital, lines of credit, and funds from planned divestitures of business are adequate to fund existing obligations, introduce new products and services, and continue to develop health care-related businesses. The Company regularly evaluates cash requirements for current operations and commitments, and for capital acquisitions and other strategic transactions. The Company may elect to raise additional funds for these purposes, either through additional debt or equity, the sale of investment securities or otherwise, as appropriate.

Government health care receivables are best estimates of payments that are ultimately collectible or payable. Since these amounts are subject to government audit and negotiation, amounts ultimately collected may vary from current estimates. Additionally, the timely collection of such receivables is also impacted by government audit and negotiation.

For the first quarter ended March 31, 1999, cash used in operating activities was \$104.6 million compared to \$188.1 million in the first quarter of 1998. This change was due primarily to increases in reserves for claims and other settlements and collection of premiums receivable, which were offset by decreases in unearned premiums, accounts payable and other liabilities. Net cash provided by investing activities was \$16.7 million during the first quarter of 1999 as compared to cash used in investing activities of \$73.1 million during 1998. This increase was primarily due to the proceeds from the sale of pharmacy benefits management operations. Net cash used in financing activities was \$60.4 million during the first quarter of 1999 as compared to cash provided by financing activities of \$45.7 million during the comparable period in 1998. The decrease in 1999 was due to the repayment of funds drawn under the Company's Credit Facility (as defined below), which were partially offset by additional drawings under the Credit Facility.

The Company has a \$1.5 billion credit facility (the "Credit Facility"), with Bank of America as Administrative Agent for the Lenders thereto, which was amended by a Letter Agreement dated as of March 27, 1998 and Amendments in April, July and November 1998 and in March 1999 with the Lenders (the "Amendments"). All previous revolving credit facilities were terminated and rolled into the Credit Facility on July 8, 1997. At the election of the Company, and subject to customary covenants, loans are initiated on a bid or committed basis and carry interest at offshore or domestic rates, at the applicable LIBOR rate plus margin or the bank reference rate. Actual rates on borrowings under the Credit Facility vary, based on competitive bids and the Company's unsecured credit rating at the time of the borrowing. As of March 31, 1999, the Company was in compliance with the financial covenants of the Credit Facility, as amended by the Amendments. The Credit Facility expires in July 2002, but it may be extended under certain circumstances for two additional years.

In February 1999, the Company entered into an agreement to sell certain of its pharmacy benefits management operations to an unrelated third party. On March 31, 1999, the Company completed the sale. The net proceeds of \$65 million from the sale was used in April 1999 to reduce corporate debt.

The Company has initiated a formal plan to dispose of certain non-core health plans included in the Company's Health Plan Services segment. It is anticipated that the sales of these health plans will be completed during 1999. In this regard, the Company adopted a formal plan to close the regional support center connected to the health plans in the Central Division. The phase-down of the support center is expected to be completed by the end of 1999. During the first quarter ended March 31, 1999, the Company recorded restructuring and other costs of \$21.1 million associated with this facility closure.

The Company's subsidiaries must comply with certain minimum capital requirements under applicable state laws and regulations. The long-term portion of principal and interest payments under the promissory notes issued to The California Wellness Foundation in connection with the Health Net conversion to for-profit status is subordinated to Health Net meeting tangible equity requirements under applicable California statutes and regulations. During the first quarter of 1999, the Company contributed \$21.7 million to its subsidiaries to meet risk-based or other capital requirements of the regulated entities. As of March 31, 1999, the Company's subsidiaries were in compliance with minimum capital requirements.

Legislation has been or may be enacted in certain states in which the Company's subsidiaries operate imposing substantially increased minimum capital and/or statutory deposit requirements for HMOs in such states. Such statutory deposits may only be drawn upon under limited circumstances relating to the protection of policyholders.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to interest rate and market risk primarily due to its investing and borrowing activities. Market risk generally represents the risk of loss that may result from the potential change in the value of a financial instrument as a result of fluctuations in interest rates and in equity prices. Interest rate risk is a consequence of maintaining fixed income investments. The Company is exposed to interest rate risks arising from changes in the level or volatility of interest rates, prepayment speeds and/or the shape and slope of the yield curve. In addition, the Company is exposed to the risk of loss related to changes in credit spreads. Credit spread risk arises from the potential that changes in an issuer's credit rating or credit perception may affect the value of financial instruments.

The Company has several bond portfolios to fund reserves. The Company attempts to manage the interest rate risks related to its investment portfolios by actively managing the asset/liability duration of its investment portfolios. The overall goal of the investment portfolios is to support the ongoing operations of the Company's business units. The Company's philosophy is to actively manage assets to maximize total return over a multiple-year time horizon, subject to appropriate levels of risk. Each business unit will have additional requirements with respect to liquidity, current income and contribution to surplus. The Company manages these risks by setting risk tolerances, targeting asset-class allocations, diversifying among assets and asset characteristics, and using performance measurement and reporting.

The Company uses a value-at-risk model to assess the market risk of its investments. The estimation of potential losses that could arise from changes in market conditions is typically accomplished through the use of statistical models which seek to predict risk of loss based on historical price and volatility patterns. The Company's measured value at risk for its investments from continuing operations, using a 95% confidence level, was approximately \$4.0 million at March 31, 1999.

The Company's calculated value-at-risk exposure represents an estimate of reasonably possible net losses that could be recognized on its investment portfolios assuming hypothetical movements in future market rates and are not necessarily indicative of actual results which may occur. It does not represent the maximum possible loss nor any expected loss that may occur, since actual future gains and losses will differ from those estimated, based upon actual fluctuations in market rates, operating exposures, and the timing thereof, and changes in the Company's investment portfolios during the year.

The Company, however, believes that any loss incurred would be offset by the effects of interest rate movements on the respective liabilities, since these liabilities are affected by many of the same factors that affect asset performance; that is, economic activity, inflation and interest rates, as well as regional and industry factors.

In addition, the Company has some interest rate market risk due to its borrowings. Notes payable, capital leases and other financing arrangements totaled \$1.195 million at March 31, 1999 and the related average interest rate was 6.8% (which interest rate is subject to change pursuant to the terms of the Credit Facility). See a description of the Credit Facility under "Liquidity and Capital Resources." The table below presents the expected cash flows of market risk sensitive instruments at March 31, 1999. These cash flows include both expected principal and interest payments consistent with the terms of the outstanding debt as of March 31, 1999 (amounts in thousands).

	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>Beyond</u>	<u>Total</u>
Long-term Borrowings							
Floating Rate	\$217,090	\$77,340	\$77,340	\$1,139,940	\$2,540	\$13,866	\$1,528,116

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

Medaphis Corporation

On November 7, 1996, the Company's predecessor, HSI, filed a lawsuit against Medaphis Corporation ("Medaphis") and its former Chairman and Chief Executive Officer Randolph G. Brown, entitled *Health Systems International, Inc. v. Medaphis Corporation, Randolph G. Brown and Does 1-50*, case number BC 160414, Superior Court of California, County of Los Angeles. The lawsuit arises out of the acquisition of Health Data Sciences Corporation ("HDS") by Medaphis. In July 1996, HSI, the owner of 1,234,544 shares of Series F Preferred Stock of HDS, representing over sixteen percent of the total outstanding equity of HDS, voted its shares in favor of the acquisition of HDS by Medaphis. HSI received as the result of the acquisition 976,771 shares of Medaphis Common Stock in exchange for its Series F Preferred Stock. Pursuant to the Merger Agreement, the Company succeeded to the interests of HSI in the Medaphis lawsuit, and the Company has been substituted for HSI as plaintiff in the suit.

In its complaint, the Company alleges that Medaphis was actually a poorly run company with sagging earnings in its core business, and had artificially maintained its stock prices through a series of acquisitions

Management believes these suits against the Company and its former officers are without merit and intends to defend the actions vigorously.

Miscellaneous Proceedings

The Company and certain of its subsidiaries are also parties to various legal proceedings, many of which involve claims for coverage encountered in the ordinary course of its business. Based in part on advice from litigation counsel to the Company and upon information presently available, management of the Company is of the opinion that the final outcome of all such proceedings should not have a material adverse effect upon the Company's results of operations or financial condition.

Item 2. Changes in Securities

Revolving Credit Facility

The Company has an unsecured, five-year \$1.5 billion revolving credit facility pursuant to a Credit Agreement dated July 8, 1997 (the "Credit Agreement") with the banks identified in the Credit Agreement (the "Banks") and Bank of America National Trust and Savings Association ("Bank of America") as Administrative Agent. All previous revolving credit facilities of the Company were terminated and rolled into the Credit Agreement. The Credit Agreement contains customary representations and warranties, affirmative and negative covenants, and events of default. Specifically, Section 7.11 of the Credit Agreement provides that the Company and its subsidiaries may, so long as no event of default exists: (i) declare and distribute stock as a dividend; (ii) purchase, redeem, or acquire its stock, options and warrants with the proceeds of concurrent public offerings; and (iii) declare and pay dividends or purchase, redeem, or otherwise acquire its capital stock, warrants, options or similar rights with cash subject to certain specified limitations.

Under the Credit Agreement, as amended pursuant to a Letter Agreement dated as of March 27, 1998, the First Amendment and Waiver to Credit Agreement dated as of April 6, 1998, the Second Amendment to Credit Agreement dated as of July 31, 1998, the Third Amendment to Credit Agreement dated as of November 6, 1998 and the Fourth Amendment to Credit Agreement dated as of March 26, 1999 (collectively, the "Amendments") with the Banks, the Company is: (i) obligated to maintain certain covenants keyed to the Company's financial condition and performance (including a Total Leverage Ratio and Fixed Charge Ratio); (ii) obligated to limit liens; (iii) subject to customary covenants, including (A) disposition of assets only in the ordinary course and generally at fair value and (B) restrictions on acquisitions, mergers, consolidations, loans, leases, joint ventures, contingent obligations and certain transactions with affiliates; (iv) permitted to sell the Company's workers' compensation insurance business, provided that the net proceeds shall be applied towards repayment of the outstanding loans under the Credit Agreement (which sale the Company completed on December 10, 1998); and (v) permitted to incur additional indebtedness in an aggregate amount not to exceed \$1,000,000,000 upon certain terms and conditions, including mandatory prepayment of the outstanding loans under the Credit Agreement with a certain portion of the proceeds from the issuance of such indebtedness, resulting in a permanent reduction of the aggregate amount of commitments under the Credit Agreement by the amount so prepaid. The Amendments also provided for an increase in the interest and facility fees under the Credit Agreement.

Shareholder Rights Plan

On May 20, 1996, the Board of Directors of the Company declared a dividend distribution of one right (a "Right") for each outstanding share of the Company's Class A Common Stock and Class B Common Stock (collectively, the "Common Stock"), to stockholders of record at the close of business on July 31, 1996 (the "Record Date"). The Board of Directors of the Company also authorized the issuance of one Right for each share of Common Stock issued after the Record Date and prior to the earliest of the Distribution Date (as defined below), the redemption of the Rights, and the expiration of the Rights, and

in certain other circumstances. Rights will attach to all Common Stock certificates representing shares then outstanding and no separate Rights certificates will be distributed. Subject to certain exceptions contained in the Rights Agreement dated as of June 1, 1996 by and between the Company and Harris Trust and Savings Bank, as Rights Agent (the "Rights Agreement"), the Rights will separate from the Common Stock in the event any person acquires 15% or more of the outstanding Class A Common Stock, the Board of Directors of the Company declares a holder of 10% or more to the outstanding Class A Common Stock to be an "Adverse Person," or any person commences a tender offer for 15% or more of the Class A Common Stock (each event causing a "Distribution Date").

Except as set forth below and subject to adjustment as provided in the Rights Agreement, each Right entitles its registered holder, upon the occurrence of a Distribution Date, to purchase from the Company one one-thousandth of a share of Series A Junior Participating Preferred Stock, at a price of \$170.00 per one-thousandth share. However, in the event any person acquires 15% or more of the outstanding Class A Common Stock, or the Board of Directors of the Company declares a holder of 10% or more of the outstanding Class A Common Stock to be an "Adverse Person," the Rights (subject to certain exceptions contained in the Rights Agreement) will instead become exercisable for Class A Common Stock having a market value at such time equal to \$340.00. The Rights are redeemable under certain circumstances at \$.01 per Right and will expire, unless earlier redeemed, on July 31, 2006.

A copy of the Rights Agreement has been filed with the Securities and Exchange Commission as Exhibit 99.1 to the Company's Registration Statement on Form 8-A (File No. 001-12718). In connection with its execution of the Merger Agreement for the merger transaction involving Foundation Health Corporation and Health Systems International, Inc., the Company's predecessors, the Company entered into Amendment No. 1 (the "Rights Amendment") to the Rights Agreement to exempt the Merger Agreement and related transactions from triggering the Rights. In addition, the Rights Amendment modifies certain terms of the Rights Agreement applicable to the determination of certain "Adverse Persons," which modifications became effective upon consummation of the transactions provided for under the Merger Agreement. This summary description of the Rights does not purport to be complete and is qualified in its entirety by reference to the Rights Agreement.

Item 3. Defaults Upon Senior Securities

Not applicable.

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

No matters were submitted to a vote of the Company's security holders during the quarter ended March 31, 1999.

Item 5. Other Information

Cautionary Statements

In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Company has previously filed with its Annual Report on Form 10-K for the year ended December 31, 1998 certain cautionary statements identifying important risk factors that could cause the Company's actual results to differ materially from those projected in forward-looking statements of the Company made by or on behalf of the Company.

The Company wishes to caution readers that these factors, among others, could cause the Company's actual financial or enrollment results to differ materially from those expressed in any projected, estimated or forward-looking statements relating to the Company. The factors should be considered in conjunction with any discussion of operations or results by the Company or its representatives, including any forward-

looking discussion, as well as comments contained in press releases, presentations to securities analysts or investors, or other communications by the Company.

In making these statements, the Company was not and is not undertaking to address or update each factor in future filings or communications regarding the Company's business or results, and is not undertaking to address how any of these factors may have caused changes to discussions or information contained in previous filings or communications. In addition, certain of these matters may have affected the Company's past results and may affect future results.

Recent Developments

FOHP. In 1997, the Company purchased convertible debentures (the "FOHP Debentures") of FOHP, Inc., a New Jersey corporation ("FOHP"), in the aggregate principal amount of approximately \$80.7 million and converted approximately \$70.6 million principal amount of the FOHP Debentures into shares of Common Stock of FOHP. As a result, the Company owned approximately 98% of the outstanding shares of FOHP common stock.

Effective December 31, 1997, the Company purchased nonconvertible debentures in the amount of \$24 million from FOHP. The debentures mature on December 31, 2002. The debentures were issued to the Company in consideration for additional capital contributions made by the Company pursuant to the Amended and Restated Securities Purchase Agreement, dated February 10, 1997, and as amended March 13, 1997, among the Company, FOHP, and First Option Health Plan of New Jersey, Inc. ("FOHP-NJ"), a wholly-owned subsidiary of FOHP (collectively, the "Definitive Agreements"). Pursuant to the Definitive Agreements, at any time during the 1999 calendar year, the Company may acquire any remaining shares of FOHP not owned by the Company pursuant to a tender offer, merger, combination or other business combination transaction for consideration (to be paid in cash or stock of the Company) equal to the value of such FOHP stock based on appraisal determinations.

Pursuant to an Agreement and Plan of Merger dated as of October 26, 1998, Physicians Health Services of New Jersey, Inc., a New Jersey HMO wholly-owned by the Company, merged with and into FOHP-NJ on January 1, 1999 and FOHP-NJ changed its name to Physicians Health Services of New Jersey, Inc. ("PHS-NJ"). On December 31, 1998, the Company converted \$1,197,183 principal amount of its remaining convertible debentures of FOHP into common stock of FOHP. As a result, the Company now owns approximately 99.6% of the outstanding equity of FOHP. The minority shareholders of FOHP are physicians, hospitals and other health care providers.

Pursuant to an Agreement and Plan of Merger dated as of November 16, 1998, a wholly-owned subsidiary of the Company will merge with and into FOHP and FOHP will become a wholly-owned subsidiary of the Company. The merger is anticipated to occur in the second quarter of 1999. In connection with the merger, the current minority shareholders of FOHP will be entitled to either the value of their shares as of December 31, 1998 as determined by an appraiser or payment rights which entitle the holders to receive not less than \$15.00 per payment right on or about July 1, 2001, provided that, with respect to the payment rights (i) for a provider shareholder, such shareholder agrees to remain a provider to PHS-NJ until December 31, 2001 and a specified number of hospital providers in the provider network does not leave the network prior to December 31, 2001, (ii) for a hospital provider shareholder, such payment rights will be subject to additional conditions to payment relating to reimbursement rates, enrollment of hospital employees in PHS-NJ health plans, and payments of premiums to PHS-NJ and (iii) for a non-provider shareholder, such shareholder will be entitled to receive additional consideration of \$2.25 per payment right and a pro rata portion of a bonus to be funded by monies forfeited by provider shareholders, provided that PHS-NJ achieves certain annual returns on common equity.

QualMed Plans for Health of Pennsylvania, Inc. Effective December 31, 1998, the Company purchased the minority interests in QualMed Plans for Health of Pennsylvania, Inc. ("QualMed-PA"), a then majority-owned subsidiary of the Company, for approximately \$2 million. Previously, the Company owned

approximately 83% of the common stock of QualMed-PA. In January 1999, the Company transferred the assets of QualMed-PA, including the assets relating to its preferred provider organization (“MaxNet(R)”) and managed workers’ compensation (“CompTek(R)”) business and operations, to Preferred Health Network, Inc., another wholly-owned subsidiary of the Company.

MedPartners Provider Network, Inc. On March 11, 1999, MedPartners Provider Network, Inc. (“MPN”), a Knox-Keene licensed entity and a subsidiary of MedPartners, Inc., a publicly-held physician practice and pharmacy benefit management company, was placed into conservatorship by the State of California under Section 1393(C) of the California Health and Safety Code. The conservator immediately filed a petition under Chapter 11 of the Bankruptcy Code on behalf of MPN. MPN and various provider groups and clinics affiliated with MedPartners, Inc. provide health care services to approximately 215,000 enrollees of the Company’s Health Net HMO subsidiary.

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Gem Insurance Company. Since October of 1997, Gem Insurance Company (“Gem”), a subsidiary of the Company, has implemented a restructuring plan to reduce operating losses and its in-force insurance risk. In 1997, Gem initiated a withdrawal from the Nevada insurance markets, and began restructuring its insurance products in Utah and then in certain other markets. Gem also reduced commissions to market-level rates and terminated certain general agents. Gem continued to implement such restructuring plan in 1998. As a result, the number of Gem’s insureds dropped from over 100,000 at the start of 1998 to approximately 1,300 at April 30, 1999. Gem has filed notices of intention to withdraw from Nebraska and the small group market in Colorado. Currently, Foundation Health Systems Life and Health Insurance Company, a subsidiary of the Company, services Gem’s insureds through an administrative services agreement between the companies. The Company is reviewing the possibility of winding up the operations of Gem or merging such operations into another insurance subsidiary of the Company. Upon completion of its current withdrawals, Gem will be licensed in only five states.

Colorado Operations. In March 1999, the Company entered into a letter of intent to sell the capital stock of QualMed Plans for Health of Colorado, Inc., the Company’s HMO subsidiary in the state of Colorado, to Wellpoint Health Networks Inc. The Company anticipates closing the sale by the end of 1999. Although the Company has entered into a letter of intent for the foregoing sale, consummation of the sale is subject to executing a definitive agreement mutually satisfactory to the parties and satisfaction of all conditions to be set forth therein, including obtaining regulatory approvals. In addition, the Company has decided to close its regional support center in Pueblo, Colorado and expects to complete such closing by the end of 1999.

New Mexico Operations. In March 1999, the Company also entered into a definitive agreement to sell the capital stock of QualMed Plans for Health, Inc., the Company’s HMO subsidiary in the state of New Mexico, to Health Care Horizons, Inc. Although the Company has entered into a definitive agreement for the foregoing sale, consummation of the sale is subject to various conditions and certain regulatory approvals. The Company anticipates closing the sale by the end of 1999.

Other Potential Divestitures

Southern California Hospitals. The Company is reviewing the possibility of divesting its ownership of two Southern California hospitals, a 128-bed hospital located in Los Angeles, California, the East Los Angeles Doctors Hospital, and a 200-bed hospital located in Gardena, California, the Memorial Hospital of Gardena. The Company is presently responding to inquiries of parties which have expressed an interest in the purchase of such businesses.

Certain Other Operations. The Company continues to evaluate the profitability realized or likely to be realized by its existing businesses and operations, and is reviewing from a strategic standpoint which of such businesses or operations should be divested.

Director and Executive Officer Changes

In February 1999, the Board of Directors of the Company elected Jay M. Gellert, the Company’s President and Chief Executive Officer, to fill a vacancy on the Board of Directors. Effective March 1, 1999, Malik M. Hasan, M.D. resigned from the Company’s Board of Directors. Accordingly, there currently exists a vacancy on the Board of Directors. The Board of Directors is currently in the process of recruiting an appropriate replacement director to fill the vacancy pursuant to and in accordance with the Company’s Fifth Amended and Restated By-Laws. In May 1999, the Board of Directors elected Richard W. Hanselman as Chairman of the Board of Directors.

In April 1999, Karin D. Mayhew became Senior Vice President Human Resources of the Company. In May 1999, Ross D. Henderson, M.D. became Senior Vice President and Chief Medical Officer of the Company. Dr. Henderson succeeded Dale T. Berkbiger, M.D. in such position.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

The following exhibits are filed as part of this Quarterly Report on Form 10-Q or are incorporated herein by reference:

- 2.1 Agreement and Plan of Merger, dated October 1, 1996, by and among Health Systems International, Inc., FH Acquisition Corp. and Foundation Health Corporation (filed as Exhibit 2.5 to the Company's Annual Report on Form 10-K for the year ended December 31, 1996, which is incorporated by reference herein).
- 2.2 Agreement and Plan of Merger, dated May 8, 1997, by and among the Company, PHS Acquisition Corp. and Physicians Health Services, Inc. (filed as Exhibit 2.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1997, which is incorporated by reference herein).
- 2.3 Amendment No. 1 to Agreement and Plan of Merger, dated October 20, 1997, by and among the Company, PHS Acquisition Corp. and Physicians Health Services, Inc. (filed as Exhibit 2.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1997, which is incorporated by reference herein).
- 3.1 Fourth Amended and Restated Certificate of Incorporation of the Registrant (filed as Exhibit 4.1 to the Company's Registration Statement on Form S-8 (File No. 333-24621), which is incorporated by reference herein).
- 3.2 Fifth Amended and Restated Bylaws of the Registrant (filed as Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, which is incorporated by reference herein).
- 4.1 Form of Class A Common Stock Certificate (included as Exhibit 4.2 to the Company's Registration Statements on Forms S-1 and S-4 (File nos. 33-72892 and 33-72892-01, respectively), which is incorporated by reference herein).
- 4.2 Form of Class B Common Stock Certificate (included as Exhibit 4.3 to the Company's Registration Statements on Forms S-1 and S-4 (File nos. 33-72892 and 33-72892-01, respectively), which is incorporated by reference herein).
- 4.3 Rights Agreement dated as of June 1, 1996 by and between the Company and Harris Trust and Savings Bank, as Rights Agent (filed as Exhibit 99.1 to the Company's Registration Statement on Form 8-A (File No. 001-12718), which is incorporated by reference herein).
- 4.4 First Amendment to the Rights Agreement dated as of October 1, 1996, by and between the Company and Harris Trust and Savings Bank, as Rights Agent (filed as Exhibit 10.40 to the Company's Annual Report on Form 10-K for the year ended December 31, 1996, which is incorporated by reference herein).
- 10.1 Letter Agreement dated June 1, 1998 between The California Wellness Foundation and the Company (filed as Exhibit 10.75 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998, which is incorporated by reference herein).
- *10.2 Employment Letter Agreement between the Company and Karin D. Mayhew dated January 22, 1999, a copy of which is filed herewith.
- *10.3 Employment Letter Agreement between the Company and Ross D. Henderson dated April 29, 1999, a copy of which is filed herewith.

- 10.4 Letter Agreement dated June 25, 1998 between B. Curtis Westen and the Company (filed as Exhibit 10.73 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998, which is incorporated by reference herein).
- 10.5 Employment Letter Agreement dated July 3, 1996 between Jay M. Gellert and the Company (filed as Exhibit 10.37 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996, which is incorporated by reference herein).
- 10.6 Amended Letter Agreement between the Company and Jay M. Gellert dated as of August 22, 1997 (filed as Exhibit 10.69 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997, which is incorporated by reference herein).
- 10.7 Employment Letter Agreement between the Company and Dale Terrell dated December 31, 1997 (filed as Exhibit 10.71 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997, which is incorporated by reference herein).
- 10.8 Employment Letter Agreement between the Company and Steven P. Erwin dated March 11, 1998 (filed as Exhibit 10.72 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997, which is incorporated by reference herein).
- 10.9 Employment Agreement between the Company and Maurice Costa dated December 31, 1997 (filed as Exhibit 10.71 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997, which is incorporated by reference herein).
- 10.10 Employment Letter Agreement between the Company and Gary S. Velasquez dated May 1, 1996 (filed as Exhibit 10.13 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.11 Employment Agreement between Foundation Health Corporation and Edward J. Munno dated November 8, 1993 (filed as Exhibit 10.14 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.12 Amendment Number One to Employment Agreement between Foundation Health Corporation and Edward J. Munno dated May 1, 1996 (filed as Exhibit 10.15 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.13 Employment Letter Agreement between the Company and Cora Tellez dated November 16, 1998 (filed as Exhibit 10.16 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.14 Employment Letter Agreement between the Company and Karen Coughlin dated March 12, 1999 (filed as Exhibit 10.17 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.15 Employment Letter Agreement between the Company and J. Robert Bruce dated September 22, 1998 (filed as Exhibit 10.18 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.16 Waiver and Release of Claims between the Company and Robert Natt (filed as Exhibit 10.20 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.17 Form of Severance Payment Agreement dated December 4, 1998 by and between the Company and various of its executive officers (filed as Exhibit 10.21 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).

- 10.18 Early Retirement Agreement dated August 6, 1998 between the Company and Malik M. Hasan, M.D. (filed as Exhibit 10.77 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998, which is incorporated by reference herein).
- 10.19 Severance Payment Agreement, dated as of April 25, 1994, among the Company, QualMed, Inc. and B. Curtis Westen (filed as Exhibit 10.10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1994, which is incorporated by reference herein).
- 10.20 Severance Payment Agreement between the Company and J. Robert Bruce dated September 15, 1998 (filed as Exhibit 10.23 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.21 Severance Payment Agreement between the Company and Maurice Costa dated April 6, 1998 (filed as Exhibit 10.24 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.22 The Company's Second Amended and Restated 1991 Stock Option Plan (filed as Exhibit 10.30 to Registration Statement on Form S-4 (File No. 33-86524), which is incorporated by reference herein).
- 10.23 The Company's Second Amended and Restated Non-Employee Director Stock Option Plan (filed as Exhibit 10.31 to Registration Statement on Form S-4 (File No. 33-86524), which is incorporated by reference herein).
- 10.24 The Company's Employee Stock Purchase Plan (filed as Exhibit 10.33 to the Company's Registration Statements on Forms S-1 and S-4 (File nos. 33-72892 and 33-72892-01, respectively), which is incorporated by reference herein).
- 10.25 The Company's Performance-Based Annual Bonus Plan (filed as Exhibit 10.35 to Registration Statement on Form S-4 (File No. 33-86524), which is incorporated by reference herein).
- 10.26 Deferred Compensation Agreement dated as of March 3, 1995, by and among Malik M. Hasan, M.D., the Company and the Compensation and Stock Option Committee of the Board of Directors of the Company (filed as Exhibit 10.31 to the Company's Annual Report on Form 10-K for the year ended December 31, 1994, which is incorporated by reference herein).
- 10.27 Trust Agreement for Deferred Compensation Arrangement for Malik M. Hasan, M.D., dated as of March 3, 1995, by and between the Company and Norwest Bank Colorado N.A. (filed as Exhibit 10.32 to the Company's Annual Report on Form 10-K for the year ended December 31, 1994, which is incorporated by reference herein).
- 10.28 The Company's Deferred Compensation Plan Trust Agreement dated as of September 1, 1998 between the Company and Union Bank of California (filed as Exhibit 10.31 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.29 The Company's 401(k) Associate Savings Plan (filed as Exhibit 4.5 to the Company's Registration Statement on Form S-8 filed on March 31, 1998, which is incorporated by reference herein).
- 10.30 The Company's 1997 Stock Option Plan (filed as Exhibit 10.45 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, which is incorporated by reference herein).
- 10.31 The Company's 1998 Stock Option Plan (filed as Exhibit 4.5 to the Company's Registration Statement on Form S-8 filed on December 4, 1998, which is incorporated by reference herein).

- 10.32 The Company's Employee Stock Purchase Plan (filed as Exhibit 10.47 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, which is incorporated by reference herein).
- 10.33 The Company's Performance-Based Annual Bonus Plan (filed as Exhibit 10.48 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, which is incorporated by reference herein).
- 10.34 The Company's Third Amended and Restated Non-Employee Director Stock Option Plan (filed as Exhibit 10.46 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, which is incorporated by reference herein).
- 10.35 Managed Health Network, Inc. Incentive Stock Option Plan (filed as Exhibit 4.8 to the Company's Registration Statement on Form S-8 (File No. 333-24621), which is incorporated by reference herein).
- 10.36 Managed Health Network, Inc. Amended and Restated 1991 Stock Option Plan (filed as Exhibit 4.9 to the Company's Registration Statement on Form S-8 (File No. 333-24621), which is incorporated by reference herein).
- 10.37 1990 Stock Option Plan of Foundation Health Corporation (filed as Exhibit 4.5 to the Company's Registration Statement on Form S-8 (File No. 333-24621), which is incorporated by reference herein).
- 10.38 FHC Directors Retirement Plan (filed as an exhibit to FHC's Form 10-K for the year ended June 30, 1994, which is incorporated by reference herein).
- 10.39 Participation Agreement dated as of May 25, 1995 among Foundation Health Medical Services, as Construction Agent and Lessee, FHC, as Guarantor, First Security Bank of Utah, N.A., as Owner Trustee, Sumitomo Bank Leasing and Finance, Inc., The Bank of Nova Scotia and NationsBank of Texas, N.A., as Holders and NationsBank of Texas, N.A., as Administrative Agent for the Lenders; and Guaranty Agreement dated as of May 25, 1995 by FHC for the benefit of First Security Bank of Utah, N.A. (filed as an exhibit to FHC's Form 10-K for the year ended June 30, 1995, filed with the Commission on September 27, 1995, which is incorporated by reference herein).
- 10.40 FHC's Deferred Compensation Plan, as amended and restated (filed as an exhibit to FHC's Form 10-K for the year ended June 30, 1995, which is incorporated by reference herein).
- 10.41 FHC's Supplemental Executive Retirement Plan, as amended and restated (filed as an exhibit to FHC's Form 10-K for the year ended June 30, 1995, which is incorporated by reference herein).
- 10.42 FHC's Executive Retiree Medical Plan, as amended and restated (filed as an exhibit to FHC's Form 10-K for the year ended June 30, 1995, which is incorporated by reference herein).
- 10.43 Stock and Note Purchase Agreement by and between FHC, Jonathan H., Schoff, M.D., FPA Medical Management, Inc., FPA Medical Management of California, Inc. and FPA Independent Practice Association dated as of June 28, 1996 (filed as Exhibit 10.109 to FHC's Annual Report on Form 10-K for the year ended June 30, 1996, which is incorporated by reference herein).
- 10.44 Credit Agreement dated July 8, 1997 among the Company, the banks identified therein and Bank of America National Trust and Savings Association in its capacity as Administrative Agent (providing for an unsecured \$1.5 billion revolving credit facility) (filed as Exhibit 10.23 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, which is incorporated by reference herein).

- 10.45 Guarantee Agreement dated July 8, 1997 between the Company and First Security Bank, National Association (filed as Exhibit 10.24 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1997, which is incorporated by reference herein).
- 10.46 First Amendment and Waiver to Credit Agreement dated April 6, 1998 among the Company, Bank of America National Trust and Savings Association and the Banks (as defined therein) (filed as Exhibit 10.64 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1998, which is incorporated by reference herein).
- 10.47 Second Amendment to Credit Agreement dated July 31, 1998 among the Company, Bank of America National Trust and Savings Association and the Banks (as defined therein) (filed as Exhibit 10.65 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998, which is incorporated by reference herein).
- 10.48 Third Amendment to Credit Agreement, dated November 6, 1998, among the Company, Bank of America National Trust and Savings Association and the Banks (as defined therein) (filed as Exhibit 10.65 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1998, which is incorporated by reference herein).
- 10.49 Fourth Amendment to Credit Agreement, dated as of March 26, 1999, among the Company, Bank of America National Trust and Savings Association and the Banks, as defined therein (filed as Exhibit 10.64 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.50 Form of Credit Facility Commitment Letter, dated March 27, 1998, between the Company and the Majority Banks (as defined therein) (filed as Exhibit 10.70 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997, which is incorporated by reference herein).
- 10.51 Registration Rights Agreement dated as of March 2, 1995 between the Company and the California Wellness Foundation (filed as Exhibit No. 28.2 to the Company's Current Report on Form 8-K dated March 2, 1995, which is incorporated by reference herein).
- 10.52 Office Lease, dated as of January 1, 1992, by and between Warner Properties III and Health Net (filed as Exhibit 10.23 to the Company's Registration Statements on Forms S-1 and S-4 (File Nos. 33-72892 and 33-72892-01, respectively), which is incorporated by reference herein).
- 10.53 Lease Agreement between HAS-First Associates and FHC dated August 1, 1998 and form of amendment thereto (filed as an exhibit to FHC's Registration Statement on Form S-1 (File No. 33-34963), which is incorporated by reference herein).
- 10.54 Asset Purchase Agreement dated December 31, 1998 by and between the Company and Access Health, Inc. (filed as Exhibit 10.62 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.55 Purchase Agreement dated February 26, 1999 by and among the Company, Foundation Health Pharmaceutical Services, Inc., Integrated Pharmaceutical Services, Inc., and Advance Paradigm, Inc. (filed as Exhibit 10.63 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.56 The Company's Supplemental Executive Retirement Plan effective as of January 1, 1996 (filed as Exhibit 10.65 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).
- 10.57 The Company's Deferred Compensation Plan effective as of May 1, 1998 (filed as Exhibit 10.66 to the Company's Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).

- 10.58 The Company's 1995 Stock Appreciation Rights Plan (filed as Exhibit 10.12 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1995, which is incorporated by reference herein).
- 11.1 Statement relative to computation of per share earnings of the Company (included in the Notes to the Condensed Consolidated Financial Statements contained in this Quarterly Report on Form 10-Q).
- 27.1 Financial Data Schedule for the first quarter ended March 31, 1999, a copy of which has been filed with the EDGAR version of this filing.

* A copy of the Exhibit is filed herewith.

(b) Reports on Form 8-K

No Current Reports on Form 8-K were filed by the Company during the quarterly period ended March 31, 1999.

