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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: 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 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 August 11, 1999 was 117,659,410 (excluding 3,194,374 shares held as treasury stock) and 4,567,442 shares of Class B Common Stock were outstanding as of such date.

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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)

	June 30, 1999 (Unaudited)	December 31, 1998
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 475,755	$ 763,865
Investments—available for sale	576,849	525,082
Premiums receivable, net	189,688	230,157
Amounts receivable under government contracts	321,582	321,411
Deferred taxes	245,821	160,446
Reinsurance and other receivables	149,701	147,827
Other assets	76,971	91,096
Total current assets	2,036,367	2,239,884
Property and equipment, net	320,769	345,269
Goodwill and other intangible assets, net	934,399	977,910
Deferred taxes	—	118,759
Other assets	165,083	181,447
Total Assets	$3,456,618	$3,863,269
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Reserves for claims and other settlements	$1,022,953	$1,006,799
Unearned premiums	54,310	288,683
Notes payable and capital leases	2,535	1,760
Amounts payable under government contracts	85,450	69,792
Accounts payable and other liabilities	340,398	458,397
Total current liabilities	1,505,646	1,825,431
Notes payable and capital leases	1,089,190	1,254,278
Deferred taxes	21,121	—
Other liabilities	28,981	39,518
Total Liabilities	2,644,938	3,119,227
Stockholders' Equity:		
Common Stock and additional paid-in capital	642,795	641,945
Treasury Class A common stock, at cost	(95,831)	(95,831)
Accumulated other comprehensive loss	(10,410)	(7,308)
Retained earnings	275,126	205,236
Total stockholders' equity	811,680	744,042
Total Liabilities and Stockholders' Equity	$3,456,618	$3,863,269

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)

	Second Quarter Ended June 30,	
	1999	**1998**
REVENUES		
Health plan premiums	$1,743,698	$1,783,109
Government contracts/Specialty services	365,797	360,827
Investment and other income	21,976	23,444
Loss on sale of businesses	(5,810)	—
Total revenues	2,125,661	2,167,380
EXPENSES		
Health plan services	1,474,360	1,493,723
Government contracts/Specialty services	241,840	233,574
Selling, general and administrative	314,674	334,856
Depreciation	17,037	20,093
Amortization	10,544	11,412
Interest	20,657	22,193
Asset impairments and other costs	—	50,000
Total expenses	2,079,112	2,165,851
Income from operations before income taxes	46,549	1,529
Income taxes	18,580	573
Net income	$ 27,969	$ 956
Basic and diluted earnings per share	$ 0.23	$ 0.01
Weighted average shares outstanding:		
Basic	122,279	121,957
Diluted	123,161	122,335

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)

	Six Months Ended June 30,	
	1999	**1998**
REVENUES		
Health plan premiums	$3,516,078	$3,562,631
Government contracts/Specialty services	733,104	668,863
Investment and other income	40,633	49,594
Net gain on sale of businesses	47,748	—
Total revenues	4,337,563	4,281,088
EXPENSES		
Health plan services	2,974,794	2,976,149
Government contracts/Specialty services	480,894	425,042
Selling, general and administrative	636,589	678,706
Depreciation	34,776	37,913
Amortization	21,528	24,433
Interest	42,595	44,054
Restructuring, asset impairments and other costs	21,059	50,000
Total expenses	4,212,235	4,236,297
Income from operations before income taxes and cumulative effect of change in accounting principle	125,328	44,791
Income taxes	50,021	17,597
Income before cumulative effect of change in accounting principle	75,307	27,194
Cumulative effect of change in accounting principle	5,417	—
Net income	$ 69,890	$ 27,194
Basic and diluted earnings per share:		
Income before cumulative effect of change in accounting principle	$ 0.62	$ 0.22
Cumulative effect of change in accounting principle	0.05	—
Net income	$ 0.57	$ 0.22
Weighted average shares outstanding:		
Basic	122,257	121,786
Diluted	122,296	122,117

See accompanying Notes to Condensed Consolidated Financial Statements.

FOUNDATION HEALTH SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

(Unaudited)

	Six Months Ended June 30,	
	1999	**1998**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 69,890	$ 27,194
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization and depreciation	56,304	62,346
Net gain on sale of businesses	(47,748)	—
Net gain on sale of buildings	(2,482)	—
Cumulative effect of change in accounting principle	5,417	—
Asset impairments	—	35,000
Other changes	2,263	(4,286)
Changes in assets and liabilities, net of effect of dispositions:		
Premiums receivable	34,681	(16,744)
Unearned premiums	(233,570)	(144,432)
Other assets	67,606	(63,156)
Amounts receivable/payable under government contracts	15,487	(33,897)
Reserves for claims and other settlements	22,429	(114,242)
Accounts payable and accrued liabilities	(137,258)	(104,263)
Net cash used in operating activities	(146,981)	(356,480)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Sale or maturity of investments	264,781	428,586
Purchase of investments	(320,612)	(436,577)
Purchases of property and equipment	(13,591)	(77,263)
Net proceeds from the sale of businesses	76,000	—
Net proceeds from the sale of buildings	7,433	—
Other	8,323	5,677
Net cash provided by (used in) investing activities	22,334	(79,577)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options and employee stock purchases	850	12,349
Proceeds from issuance of notes payable and other financing arrangements	20,000	115,560
Repayment of debt and other non-current liabilities	(184,313)	(526)
Net cash provided by (used in) financing activities	(163,463)	127,383
Net decrease in cash and cash equivalents	(288,110)	(308,674)
Cash and cash equivalents, beginning of period	763,865	559,360
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 475,755	$ 250,686

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 as well as the consolidated operating results presented in the management's discussion and analysis contained in this Quarterly Report on Form 10-Q.

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. In the second quarter ended June 30, 1999, the Company reclassified and adjusted certain intercompany revenues and expenses which did not impact net income or earnings per share. In addition, in the first quarter ended March 31, 1999, the Company reclassified medical management expenses from health plan medical expenses to selling, general and administrative expenses ("SG&A") and also recorded SG&A expenses of its Specialty services businesses in SG&A, rather than in Specialty services costs as had been the case in prior periods.

Note 2—Restructuring, Asset Impairments 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 strategic plan to focus on core operations. In this connection, the Company implemented a formal plan during the first quarter ended March 31, 1999 to close the Colorado regional processing center for these health plans and transfer its operations to the Company's other administrative facilities. In August 1999, the Company sold certain of the processing center facilities and accompanying real estate. See "Item 5. Recent Developments—Colorado Operations." The closure of the remaining processing center facilities is expected to be completed for all but the Colorado operations by the end of the third quarter of 1999. The Company recorded a pretax restructuring charge of $21.1 million during the first quarter of 1999. Of the $21.1 million of restructuring costs, $1.4 million represented cash payments and $16.5 million is expected to require future outlays of cash as of June 30, 1999.

During 1998, FPA Medical Management, Inc. ("FPA") filed for bankruptcy protection. FPA, through its affiliated medical groups, provided services to the Company's affiliated members. The Company leased healthcare facilities to FPA prior to the bankruptcy. As a result, the Company recorded $50.0 million of charges primarily comprised of real estate asset impairments, notes receivable impairments, and other items in the second quarter ended June 30, 1998.

Note 2—Restructuring, Asset Impairments and Other Costs (Continued)

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 $167.9 million in net restructuring costs recorded as part of the 1997 and 1998 plans, $9.7 million is expected to require future outlays of cash and $3.5 million represents future non-cash activities as of June 30, 1999.

Note 3—Comprehensive Income

The Company's comprehensive income for the three and six months ended June 30 is as follows (amounts in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	1999	1998	1999	1998
Net income	$27,969	$ 956	$69,890	$27,194
Other comprehensive income (loss), net of tax:				
Change in unrealized appreciation (depreciation) on investments	(1,725)	(2,629)	(3,102)	1,176
Comprehensive income (loss)	$26,244	$(1,673)	$66,788	$28,370

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 881,000 and 39,000 shares of common stock equivalents for the three and six months ended June 30, 1999, respectively, and 378,000 and 331,000 shares of common stock equivalents for the three and six months ended June 30, 1998, respectively.

Note 5—Segment Information

Presented below are segment data for the three and six months ended June 30, 1999 and 1998 (amounts in thousands):

	Health Plan Services	Government Contracts/Specialty Services	Corporate/ Other	Total
Three Months Ended June 30, 1999				
Revenues from external sources	$1,743,698	$365,797	$ 16,166	$2,125,661
Intersegment revenues	89,206	—	5,902	95,108
Income (loss) before income taxes	30,140	23,572	(7,163)	46,549
Three Months Ended June 30, 1998				
Revenues from external sources	$1,783,109	$360,827	$ 23,444	$2,167,380
Intersegment revenues	92,609	—	9,331	101,940
Income (loss) before income taxes	36,392	37,361	(72,224)	1,529
Six Months Ended June 30, 1999				
Revenues from external sources	$3,516,078	$733,104	$ 88,381	$4,337,563
Intersegment revenues	173,930	—	13,848	187,778
Income before income taxes and cumulative effect of change in accounting principle	38,637	56,169	30,522	125,328
Six Months Ended June 30, 1998				
Revenues from external sources	$3,562,631	$668,863	$ 49,594	$4,281,088
Intersegment revenues	163,801	—	17,578	181,379
Income (loss) before income taxes	72,013	63,694	(90,916)	44,791

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 six months ended June 30, 1999.

Note 7—Disposition of Assets

On March 8, 1999, the Company entered into a definitive agreement for the sale of its HMO operations in the state of New Mexico. Completion of the transaction is subject to various conditions and certain regulatory approvals.

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

FOUNDATION HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 7—Disposition of Assets (Continued)

During the second quarter ended June 30, 1999, the Company completed the sale of its HMO operations in the states of Texas, Louisiana and Oklahoma and its preferred provider organization network subsidiary, Preferred Health Network, Inc. As part of the transactions, the Company received certain cash proceeds and convertible preferred stock. The Company recognized total losses on the sales of $5.8 million, before taxes, in the second quarter ended June 30, 1999.

On July 2, 1999, the Company entered into a definitive agreement for the sale of its HMO operations in the state of Utah. Completion of the transaction is subject to various conditions and certain regulatory approvals.

On July 16, 1999, the Company entered into a definitive agreement for the sale of its two California hospitals. Completion of the transaction is subject to various conditions and certain regulatory approvals.

On December 10, 1998, the Company completed the sale of the workers' compensation segment which was accounted for as discontinued operations for the three and six months ended June 30, 1998. The loss on disposition of $99 million recorded at December 31, 1997 included the anticipated results of discontinued operations through the date of disposition; accordingly, net losses of $4.2 million and $7.9 million related to the operations of the workers' compensation segment are not reflected on the Company's condensed consolidated statements of operations for the three and six months ended June 30, 1998, respectively.

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. Subsequent to the Company's filing of a motion to dismiss all claims asserted against it in the consolidated federal class actions, all claims against the Company's former officers were voluntarily dismissed from the consolidated class actions in both federal and state court. Thereafter, all proceedings in the consolidated federal class actions were stayed and the motion to dismiss was denied without prejudice to renewal after the expiration of the stay. Management believes these suits are without merit and intends to vigorously defend the actions.

The Company and certain of its subsidiaries are also parties to various other legal proceedings, many of which involve claims for coverage encountered in the ordinary course of 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 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 six months ended June 30, 1999, these health plans were located in Arizona, California, Colorado, Connecticut, Florida, Idaho, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Utah, Washington and West Virginia. 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 4.0 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, individual Medicare and Medicaid 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 Securities and Exchange Commission.

CONSOLIDATED OPERATING RESULTS

The Company's net income for the second quarter ended June 30, 1999 was $28.0 million, or $0.23 per basic and diluted share, compared to net income for the comparable period in 1998 of $1.0 million, or $0.01 per basic and diluted share. The Company's net income for the six months ended June 30, 1999 was $69.9 million, or $0.57 per basic and diluted share, compared to net income for the comparable period in 1998 of $27.2 million or $0.22 per basic and diluted share. Excluding the cumulative effect of the change in accounting principle for organization and start up costs recorded during the first quarter of 1999, net income was $75.3 million or $0.62 per basic and diluted share for the six months ended June 30, 1999.

The table immediately below and the paragraphs that follow provide selected financial information related to the Company's performance for the 1999 and 1998 periods. The second table below, relating to the three months ended March 31, June 30, September 30 and December 31, 1998 and March 31, 1999, contains certain prior period amounts that have been reclassified to conform with the current period presentation. In the second quarter ended June 30, 1999, the Company reclassified and adjusted certain intercompany revenues and expenses which did not impact net income or earnings per share. The reclassifications did result in higher reported revenues in its Government Contracts/Specialty Services unit and lower reported revenues and costs in its Health Plan services unit compared with amounts previously disclosed. FHS believes this more accurately reflects the performance of its specialty companies as if they were independent entities. In addition, in the first quarter ended March 31, 1999, the Company reclassified medical management expenses from health plan medical expenses to selling, general and administrative expenses ("SG&A") and also recorded SG&A expenses of its Specialty services businesses in SG&A, rather than in Specialty services costs as had been the case in prior periods.

	Second Quarter Ended		Six Months Ended	
	June 30, 1999	June 30, 1998	June 30, 1999	June 30, 1998
	(Amounts in thousands, except per member per month amounts)			
Revenues:				
Health plan premiums	$1,743,698	$1,783,109	$3,516,078	$3,562,631
Government contracts/Specialty services	365,797	360,827	733,104	668,863
Investment and other income	21,976	23,444	40,633	49,594
Net gain (loss) on sale of businesses	(5,810)	—	47,748	—
Total revenues	2,125,661	2,167,380	4,337,563	4,281,088
Expenses:				
Health plan services	1,474,360	1,493,723	2,974,794	2,976,149
Government contracts/Specialty services	241,840	233,574	480,894	425,042
Selling, general and administrative	314,674	334,856	636,589	678,706
Depreciation	17,037	20,093	34,776	37,913
Amortization	10,544	11,412	21,528	24,433
Interest	20,657	22,193	42,595	44,054
Restructuring, asset impairment and other costs	—	50,000	21,059	50,000
Total expenses	2,079,112	2,165,851	4,212,235	4,236,297
Income from operations before income taxes and cumulative effect of change in accounting principle	46,549	1,529	125,328	44,791
Income tax provision	18,580	573	50,021	17,597
Income before cumulative effect of change in accounting principle	27,969	956	75,307	27,194
Cumulative effect of change in accounting principle	—	—	5,417	—
Net income	$ 27,969	$ 956	$ 69,890	$ 27,194
Administrative (SG&A + Depreciation) Ratio	15.72%	16.56%	15.80%	16.94%
Health plan MCR	84.55%	83.77%	84.61%	83.54%
Government contracts/Specialty services MCR	66.11%	64.73%	65.60%	63.55%
Overall MCR	81.36%	80.57%	81.33%	80.38%
Health plan premiums per member per month	$ 137.18	$ 126.30	$ 137.34	$ 126.49
Health plan services per member per month	$ 115.99	$ 105.80	$ 116.20	$ 105.66

	First Quarter Ended March 31, 1998	Second Quarter Ended June 30, 1998	Third Quarter Ended September 30, 1998	Fourth Quarter Ended December 31, 1998	First Quarter Ended March 31, 1999
	(Amounts in thousands, except per member per month amounts)				
Revenues:					
Health plan premiums	$1,779,522	$1,783,109	$1,769,291	$1,792,239	$1,772,380
Government contracts/Specialty services	308,036	360,827	348,732	393,672	367,307
Investment and other income	26,150	23,444	20,441	29,006	72,215
Total revenues	2,113,708	2,167,380	2,138,464	2,214,917	2,211,902
Expenses:					
Health plan services	1,482,426	1,493,723	1,539,072	1,563,251	1,500,434
Government contracts/Specialty services	191,468	233,574	232,346	266,687	239,054
Selling, general and administrative	343,850	334,856	350,406	361,759	321,915
Depreciation	17,820	20,093	20,276	20,762	17,739
Amortization	13,021	11,412	12,323	12,386	10,984
Interest	21,861	22,193	23,626	24,479	21,938
Asset impairment and other costs	—	50,000	87,987	136,966	21,059
Total expenses	2,070,446	2,165,851	2,266,036	2,386,290	2,133,123
Income (loss) from operations before income taxes and cumulative effect of change in accounting principle	43,262	1,529	(127,572)	(171,373)	78,779
Income tax provision (benefit)	17,024	573	(38,953)	(67,640)	31,441
Income (loss) before cumulative effect of change in accounting principle	26,238	956	(88,619)	(103,733)	47,338
Cumulative effect of change in accounting principle	—	—	—	—	5,417
Net income (loss)	$ 26,238	$ 956	$ (88,619)	$ (103,733)	$ 41,921
Administrative (SG&A + Depreciation) Ratio	17.33%	16.56%	17.50%	17.50%	15.87%
Health plan MCR	83.30%	83.77%	86.99%	87.22%	84.66%
Government contracts/Specialty services MCR	62.16%	64.73%	66.63%	67.74%	65.08%
Overall MCR	80.18%	80.57%	83.64%	83.72%	81.30%
Health plan premiums per member per month	$ 126.67	$ 126.30	$ 128.38	$ 133.89	$ 137.50
Health plan services per member per month	$ 105.52	$ 105.80	$ 111.68	$ 116.78	$ 116.40

Enrollment Information
(Amounts in thousands)

	June 30, 1999	June 30, 1998	Percent Change
Health Plan Services			
Commercial	3,073	3,516	(12.6%)
Medicare Risk	269	318	(15.4%)
Medicaid	673	550	22.4%
	4,015	4,384	(8.4%)
Government Contracts:			
CHAMPUS PPO and Indemnity	684	782	(12.5%)
CHAMPUS HMO	817	662	23.4%
	1,501	1,444	(3.9%)

Revenues and Health Care Costs

The Company's revenues decreased by $41.7 million or 1.9% for the second quarter ended June 30, 1999 and $56.5 million or 1.3% for the six months ended June 30, 1999 as compared to the comparable periods in 1998. Decreases in Health Plan revenues of $39.4 million and $46.6 million for the second quarter and six months ended June 30, 1999, respectively, as compared to the comparable periods in 1998 were due primarily to decreases in enrollment partially offset by increases in premium rates. The sale of the HMO operations in the states of Texas, Louisiana and Oklahoma that eliminated approximately $7.0 million in health plan revenues for the second quarter ended June 30, 1999 also contributed to the decreases. Growth in Government contracts/Specialty services revenues totaled $5.0 million and $64.2 million for the second quarter and six months ended June 30, 1999, respectively, as compared to the comparable periods in 1998. This growth is primarily due to increases in government contracts and mental health revenues which were partially offset by decreases in pharmacy revenue. See "Segment Information" for further discussion of Health Plan Services and Government contract/Specialty services.

Included in total revenues for the six months ended June 30, 1999 is a $53.6 million gain on the sale of certain pharmacy benefits processing services of the Company during the first quarter of 1999 which was partially offset by losses totaling $5.8 million related to the sale of certain businesses during the second quarter of 1999.

The overall medical care ratio ("MCR") (medical costs as a percentage of Health Plan premiums and Government contracts/Specialty services revenues) for the second quarter and six months ended June 30, 1999 was 81.36% and 81.33%, respectively, as compared to 80.57% and 80.38%, respectively, for the comparable periods in 1998. The increases were primarily due to higher pharmacy costs in most of the Company's health plans and increased costs from higher physician and hospital costs.

Selling, General and Administrative Costs

The Company's selling, general and administrative ("SG&A") expenses decreased by $20.2 million or 6.0% for the second quarter ended June 30, 1999 as compared to the comparable period in 1998. The Company's selling, general and administrative ("SG&A") expenses decreased by $42.1 million or 6.2% for the six months ended June 30, 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, savings associated with the integration of its 1997 mergers and acquisitions, and reductions in costs resulting from the sales of certain operations.

Amortization and Depreciation

Amortization and depreciation expense decreased by $3.9 million and $6.0 million for the second quarter and six months ended June 30, 1999, respectively, as compared to the comparable periods in 1998. The decrease is due to the write-down of goodwill and other long-lived assets to their estimated fair value during the year ended December 31, 1998 and the write-off of organization and pre-operating costs during the first quarter ended March 31, 1999.

Interest Expense

Interest expense decreased by $1.5 million for the second quarter and six months ended June 30, 1999 and 1998 as compared to the comparable periods in 1998. A decrease in interest expense from the reduction in the revolving credit facility balance was partially offset by a higher borrowing rate in 1999 as compared to the comparable period in 1998.

Income Tax Provision

The effective tax rate was 39.9% on income from operations for the second quarter and six months ended June 30, 1999, respectively, compared to the effective tax rate on continuing operations of 37.5% and 39.3%, respectively, for the comparable periods 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 strategic plan to focus on core operations. In this connection, the Company implemented a formal plan during the first quarter ended March 31, 1999 to close the Colorado regional processing center for these health plans and transfer its operations to the Company's other administrative facilities. In August 1999, the Company sold certain of the processing center facilities and accompanying real estate. See "Item 5. Recent Developments—Colorado Operations." The closure of the remaining processing center facilities is expected to be completed for all but the Colorado operations by the end of the third quarter of 1999. The Company recorded a pretax restructuring charge of $21.1 million including $18.7 million for severance and $2.4 million for other expenses associated with the closing of the facility during the first quarter ended March 31, 1999. Of the $18.9 million remaining as of June 30, 1999, approximately $16.5 million is expected to require future cash outlays.

SEGMENT INFORMATION

Health Plan Services

Health Plan revenues decreased by $39.4 million or 2.2% in the second quarter ended June 30, 1999 as compared to the comparable period in 1998 and decreased by $46.6 million or 1.3% for the six months ended June 30, 1999 as compared to the comparable period in 1998. These decreases were primarily due to an 8.4% decrease in enrollment in the Company's health plans. The sale of the HMO operations in the states of Texas, Louisiana, and Oklahoma eliminated approximately $7.0 million in health plan revenues for the second quarter ended June 30, 1999. Of the total membership decline, 65,000 members were enrolled in plans that have been sold. These decreases were partially offset by an average increase in premium rates as a result of instituting pricing discipline which yielded a revenue per member per month ("PMPM") increase of 8.6% for the second quarter and six months ended June 30, 1999.

Health Plan costs decreased by $19.4 million, or 1.3% for the second quarter ended June 30, 1999 as compared to the comparable period in 1998 and decreased by $1.4 million or 0.1% for the six months ended June 30, 1999 as compared to the comparable period in 1998. The health plans MCR increased from 83.77% for the second quarter ended June 30, 1998 to 84.55% for the comparable period in 1999 and from 83.54% for the six months ended June 30, 1998 to 84.61% for the comparable period in 1999. These increases were primarily due to higher pharmacy costs in most of the Company's health plans and increased costs from higher physician and hospital costs.

Government Contracts/Specialty Services

Government contracts/Specialty services revenue increased by $5.0 million or 1.4% during the second quarter ended June 30, 1999 as compared to the same period in 1998, and by $64.2 million or 9.6% for the six months ended June 30, 1999 as compared to the same period in 1998. Favorable revenue adjustments under government contracts, coupled with growth in the managed behavioral health network and bill review cost containment businesses, were partially offset by loss of revenues previously generated by certain pharmacy benefits processing services which were sold during the first quarter ended March 31, 1999.

Government contracts/Specialty services MCR increased to 66.11% in the second quarter ended June 30, 1999 from 64.73% for the comparable 1998 period and to 65.60% in the six months ended June 30, 1999 from 63.55% for the comparable 1998 period. The increase was primarily a result of higher 1998 administrative government contract revenue having no associated health care costs, only administrative costs.

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, and has determined that there are no significant applications for which the Company does not have adequate ability to work around in the event of failure. 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, retained IBM's The Wilkerson Group, and has developed 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 internal 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 second 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. 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.

	Phase 1	Phase 2	Phase 3	Phase 4	Phase 5
Overall—July 1999	100%	100%	100%	88%	54%
Overall—May 1999 (as reported in the Company's Quarterly Report on Form 10-Q for the first quarter of 1999)	100%	100%	93%	55%	3%

Third Parties—The Company has substantially completed its assessment of third party relationships and 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. During the second quarter, the assessment was focused on delegated authorities and certain other providers and the Company is endeavoring to obtain assurances from those entities as to their Year 2000 readiness. 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 estimates that the total cost for the project will be approximately $34-38 million, excluding the costs to accelerate the replacement of hardware or software otherwise required to be purchased by the Company. This represents a decrease in the expected overall cost from $36-40 million, due in part to actual and expected cost-savings from the shutdown or transfer of certain hardware and software associated with certain completed divestitures. Through the second quarter of 1999, the Company expended approximately $28.4 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: 36% for internal costs, 30% for outside consultants and contractors and 34% 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, testing and certification 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. 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 engaged in ongoing efforts to analyze 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 prioritized 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 has documented and tested its contingency plans. Such contingency plans include, among other things, 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. There can be no assurance that the contingency plans of the Company, if implemented, will adequately address Year 2000 problems that may arise or prevent such problems from having a material adverse effect on the Company's operations.

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 has substantially completed its assessment of third party risks and is in the process of confirming that third parties with whom the Company does significant business have taken substantial steps to address potential Year 2000 problems and that such parties will undertake additional remediation efforts to significantly reduce the possibility of material disruptions to the Company. There can be no assurances, however, 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 six months ended June 30, 1999, cash used by operating activities was $147.0 million compared to $356.5 million in the comparable period 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. The timing differences in Medicare and Medicaid payments also affected cash flow from operations. Excluding these timing differences would have resulted in a positive cash flow from operations of $32.6 million for the six months ended June 30, 1999. Net cash provided by investing activities was $22.3 million during the six months ended June 30, 1999 as compared to cash used in investing activities of $79.6 million during the comparable period in 1998. This increase was primarily due to the proceeds from the sale of certain pharmacy benefits processing services of the Company and the Company's preferred provider organization network subsidiary operations. Net cash used in financing activities was $163.5 million during the six months ended June 30, 1999 as compared to cash provided by financing activities of $127.4 million during the comparable period in 1998. The change was primarily due to the repayment of funds drawn under the Company's Credit Facility (as defined below).

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 June 30, 1999, the Company was in compliance with the financial covenants of the Credit Facility, as amended by the Amendments. As of June 30, 1999, the maximum commitment level under the Credit Agreement was approximately $1.4 billion, of which approximately $340 million remained available. The Credit Facility expires in July 2002, but it may be extended under certain circumstances for two additional years.

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 implemented a formal plan to close the regional processing center connected to the health plans in the Central Division. In August 1999, the Company sold certain of the processing center facilities and accompanying real estate. See "Item 5. Recent Development—Colorado Operations." The closure of the remaining processing center facilities is expected to be completed for all but the Colorado operations by the end of the third quarter of 1999. During the first quarter ended March 31, 1999, the Company recorded restructuring and other costs of $21.1 million associated with the processing center 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 second quarter of 1999, the Company was not required to make any contributions to its subsidiaries to meet risk-based capital requirements of the regulated entities. The Company will, however, make contributions to its subsidiaries, as necessary, to meet risk-based capital requirements under state laws and regulations during the second half of 1999. The Company contributed $3.0 million to one of its subsidiaries to meet other capital requirements during the second quarter ended June 30, 1999. As of June 30, 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 $4.5 million at June 30, 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 $1,091.7 million at June 30, 1999 and the related average interest rate was 6.6% (which interest rate is subject to change pursuant to the terms of the Credit Facility). For a description of the Credit Facility see "Liquidity and Capital Resources." The table below presents the expected cash flows of market risk sensitive instruments at June 30, 1999. These cash flows include both expected principal and interest payments consistent with the terms of the outstanding debt as of June 30, 1999 (amounts in thousands).

	1999	2000	2001	2002	2003	Beyond	Total
Long-term Borrowings Floating Rate	291,826	69,378	69,378	1,048,658	2,540	17,343	1,499,123

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Medaphis Corporation

On November 7, 1996 the Company (then named Health Systems International, Inc. (“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 “Medaphis Action”). 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. The Company alleges that Medaphis, Brown and other insiders deceived the Company by presenting materially false financial statements and by failing to disclose that Medaphis would shortly reveal a “write off” of up to $40 million in reorganization costs and would lower its earnings estimate for the following year, thereby more than halving the value of the Medaphis shares received by the Company.

The Company and Medaphis have reached a tentative agreement in principle to settle their legal disputes related to the Medaphis Action. The broad parameters of the settlement provide for the Company to receive net proceeds of approximately $25.0 million consisting of: (i) $4.5 in cash to be funded by Medaphis’ insurers, (ii) proceeds from the sale of the 976,771 shares of Medaphis common stock currently owned by the Company and (iii) proceeds from the sale of Medaphis common stock to be issued to the Company as part of the settlement. In exchange, the Company and Medaphis will terminate ongoing litigation and each will grant the other a general release. The settlement agreement is contingent upon numerous events, including funding of insurance proceeds, final documentation and execution of the settlement agreement, and issuance, registration and sale of the common stock. Accordingly, there can be no assurance that the Company and Medaphis will reach a final binding settlement agreement. The Company and Medaphis have agreed to stay pending litigation while they attempt to negotiate a binding settlement.

FPA Medical Management, Inc.

Since May 1998, several complaints (the “FPA 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 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 FPA Complaints name as defendants FPA, certain of FPA’s auditors, the Company and certain of the Company’s former officers. The FPA Complaints allege that the Company and such former officers violated federal and state securities laws by misrepresenting and failing to disclose certain information about a 1996 transaction between the Company and FPA, about FPA’s business and about the Company’s 1997 sale of FPA common stock held by the Company. The Company has filed a motion to dismiss all claims asserted against it in the consolidated federal class actions but has not formally responded to the other complaints. Subsequent to the Company’s filing of a motion to dismiss all claims asserted against it in the consolidated federal class action, all claims against the Company’s former officers were voluntarily dismissed from the consolidated class actions in both federal and state court. Thereafter, all proceedings in the consolidated federal class actions were stayed and the motion to dismiss was denied without prejudice to renewal after the expiration of the stay. 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 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 of 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. The Credit Agreement also provides for mandatory prepayment of the outstanding loans under the Credit Agreement with a certain portion of the proceeds from the issuance of such indebtedness and from sales of assets, resulting in a permanent reduction of the aggregate amount of commitments under the Credit Agreement by the amount so prepaid. As of June 30, 1999, the maximum commitment level permitted under the Credit Agreement was approximately $1.4 billion, of which approximately $340 million remained available. 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 or commences a tender offer for 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 entirely 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

On May 6, 1999, the Company held its 1999 Annual Meeting of Stockholders (the "Annual Meeting"). At the Annual Meeting, the Company's stockholders voted upon proposals to (i) elect four directors for a term of three years ("Proposal 1") and (ii) ratify the selection of Deloitte & Touche LLP as the Company's independent public accountants for the year ending December 31, 1999 ("Proposal 2"). The following provides voting information for all matters voted upon at the Annual Meeting, and includes a separate tabulation with respect to each nominee for director:

Proposal 1

Election of Directors	Votes For	Votes Against	Votes Withheld
J. Thomas Bouchard	105,451,415	0	939,635
Thomas T. Farley	105,414,635	0	976,415
Patrick Foley	105,411,109	0	979,941
Richard J. Stegemeier	105,454,244	0	936,806

Each of Messrs. Bouchard, Farley, Foley and Stegemeier was elected as a Class III director for a three-year term at the Annual Meeting. Other directors whose term of office as directors continued after the Annual Meeting were: Gov. George Deukmejian, Adm. Earl B. Fowler, Jay M. Gellert, Roger Greaves, Richard W. Hanselman, and Raymond S. Troubh.

Proposal 2

With respect to the ratification of the selection of Deloitte & Touche LLP as the Company's independent public accountants for the year ending December 31, 1999, 106,320,573 votes were cast in favor, 44,080 votes were cast against and 26,397 votes were withheld for such proposal.

In total, 117,200,785 shares of Class A Common Stock were eligible to vote at the Annual Meeting, 106,391,050 shares were voted at the Annual Meeting and 10,809,735 shares were unvoted at the Annual Meeting.

No other matters were submitted to a vote of the Company's security holders during the quarter ended June 30, 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.

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 owned approximately 99.6% of the outstanding equity of FOHP. The minority shareholders of FOHP were physicians, hospitals and other health care providers.

Pursuant to an Agreement and Plan of Merger dated as of November 16, 1998, which was approved by the stockholders of FOHP at a special meeting held July 29, 1999, a wholly-owned subsidiary of the Company merged into FOHP on July 30, 1999 and FOHP became a wholly-owned subsidiary of the Company. In connection with the merger, the former minority shareholders of FOHP are entitled to either $0.25 per share (the value per FOHP share as of December 31, 1998 as determined by an outside 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 provider shareholders, other than hospitals, such shareholder must remain a provider of PHS-NJ until July 1, 2001 and agree to remain a provider to PHS-NJ from July 1, 2001 until December 31, 2001, and a specified number of hospital shareholders must not leave the provider network prior to December 31, 2001 for such provider shareholder to be eligible to receive such payment, (ii) for hospital shareholders, such payment rights are subject to the same foregoing conditions and additional conditions relating to reimbursement rates, enrollment of hospital employees in PHS-NJ health plans, and payments of premiums to PHS-NJ for such hospital shareholder to be eligible to receive such payment and (iii) for provider shareholders, other than hospitals, 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 hospital shareholders, provided that PHS-NJ achieves certain annual returns on common equity and certain of the foregoing conditions are met.

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 certain of the assets of QualMed-PA, including the assets relating to its preferred provider organization ("MaxNet®") and managed workers' compensation ("CompTek®") business and operations, to Preferred Health Network, Inc., a wholly-owned subsidiary of the Company that was recently sold as described below.

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.

The Company continues to monitor the situation closely and has been involved in discussions with various parties to attempt to maintain continuity of care and to minimize the impact that MPN's conservatorship and bankruptcy could have on affected Health Net members. The Company understands from various public statements made by MedPartners, Inc. that it intends to divest its California clinic operations.

MedPartners, Inc., MPN and the State of California executed an Amended and Restated Operations and Settlement Agreement dated as of June 16, 1999 (the "O&S Agreement"), containing the basic principles for an orderly transition of the California operations of MedPartners, Inc., and the resolution of unpaid provider claims. A Bankruptcy Court Order approving the O&S Agreement was obtained by MPN

on July 19, 1999. Although court approval of the O&S Agreement has been obtained, a number of conditions subsequent and third party consents required by such agreement are yet to occur or be obtained before the transactions reflected therein will become effective. MedPartners, Inc. is also pursuing the sale of all of its physician management operations in California. As of August 1, 1999, sales have been consummated on operations covering approximately 32% of the total number of members of the Company associated with MedPartners, Inc.'s physician groups. Sales for the remainder of the physician groups are pending.

At this time, no assurances can be given that a final settlement agreement on the terms reflected in the O&S Agreement will become effective or be implemented or that sales for the remainder of MedPartners, Inc.'s physician groups will be consummated. In the event of a final implementation of a settlement on the terms reflected in the O&S Agreement, the Company believes that the bankruptcy of MPN will not have a material adverse effect on the Company's California operations. If the settlement reflected in the O&S Agreement is not fully implemented, such failure could have a material adverse effect on the Company's California operations in the event the Company is ultimately held liable to pay unpaid provider claims and/or the Company is unable to quickly transition its remaining members covered by MPN to alternate providers. However, the Company has developed and is implementing various transitional strategies that it believes will reduce any such adverse impact in the event a settlement on the terms reflected in the O&S Agreement is not fully implemented on a timely basis or at all.

Insurance Subsidiaries. The Company is in the process of restructuring its insurance subsidiaries to merge Foundation Health National Life Insurance Company ("FHNL") and Foundation Health Systems Life and Health Insurance Company ("FHS Life") under a holding company subsidiary of the Company, FHS Life Holdings Company, Inc. The merger has received regulatory approval from each merging entity's state of incorporation.

Louisiana, Oklahoma and Texas HMO Operations. On April 30, 1999, the Company completed the sale of its HMO operations in the states of Texas, Louisiana and Oklahoma to AmCareco, Inc. 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. The transaction is subject to certain post-closing adjustments and affiliates of the Company will continue to provide certain administrative, behavioral health and other services to such HMO operations for a transitionary period pursuant to separate agreements.

Pharmacy Benefits Processing Services. On March 31, 1999, the Company completed the sale to Advance Paradigm of the capital stock of Foundation Health Pharmaceutical Services, Inc., and certain pharmacy benefit processing services of Integrated Pharmaceutical Services, Inc. for approximately $65.0 million in cash. In addition, as part of the transaction, Advance Paradigm will provide to the Company at competitive rates claims processing, retail network management and payment of claims pharmacy benefits services under a services agreement. Advance Paradigm will also provide pharmacy mail service to the Company's Health Plan Divisions. For a period of five years, the Company may not compete with respect to such services in any market in which Advance Paradigm conducts business, subject to certain exceptions.

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 1,100 at June 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 announced it had 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. As previously disclosed, consummation of the sale was 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. No such definitive agreement has yet been executed, and the Company continues to consider various alternatives to wind-down its business in Colorado. In this connection, in August 1999, the Company sold certain of its regional processing facilities and accompanying real estate in Pueblo, Colorado, including certain equipment and other assets located at the facilities, to the Pueblo Economic Development Company and The TPA, Inc. The closure of the remaining processing facilities is expected to occur for all but the Colorado operations by the end of the third quarter of 1999.

New Mexico Operations. In March 1999, the Company 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. A public hearing on the transaction has been set for August 30 and 31, 1999, and the Company anticipates closing the sale by the end of the third quarter of 1999.

Preferred Health Network, Inc. In May 1999, the Company sold the capital stock of Preferred Health Network, Inc., its PPO network subsidiary ("PHN"), to Beyond Benefits, Inc. PHN and the Company, or certain affiliates thereof, entered into agreements at closing to provide each other with certain continued access to each other's networks.

Utah Operations. In July 1999, the Company entered into a definitive agreement to sell the outstanding capital stock of Intergroup of Utah, Inc., the Company's HMO subsidiary in the state of Utah, to Altius Health Plans 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.

Southern California Hospitals. In July 1999, the Company entered into a definitive agreement to sell East Los Angeles Doctors Hospital and Memorial Hospital of Gardena, two Southern California hospitals, to HealthPlus+ Corp. 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. Certain subsidiaries of the Company will maintain contractual arrangements with the hospitals following the sale.

Other Potential Divestitures. 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. Berkbigler, 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).

*3.3 Certain Amendments to the Fifth Amended and Restated Bylaws of the Registrant, a copy of which is filed herewith.

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 (filed as Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1999, which is incorporated by reference herein).

10.3 Employment Letter Agreement between the Company and Ross D. Henderson dated April 29, 1999 (filed as Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1999, which is incorporated by reference herein).

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 Foundation Health Corporation 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, 1998 (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 Annual Report on 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 Annual Report on 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 Waiver and Release of Claims between the Company and Dale T. Berkbigler, M.D. dated as of June 30, 1999, a copy of which is filed herewith.

10.23 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).

10.24 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).

10.25 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).

10.26 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).

10.27 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).

10.28 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).

10.29 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).

10.30 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).

10.31 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).

10.32 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).

10.33 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).

10.34 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).

10.35 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).

10.36 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).

10.37 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).

10.38 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).

10.39 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).

10.40 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).

10.41 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).

10.42 FHC Directors Retirement Plan (filed as an exhibit to FHC's Form 10-K for the year ended June 30, 1994 filed with the Commission on September 24, 1994, which is incorporated by reference herein).

10.43 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).

10.44 FHC's Deferred Compensation Plan, as amended and restated (filed as Exhibit 10.99 to FHC's Form 10-K for the year ended June 30, 1995, which is incorporated by reference herein).

10.45 FHC's Supplemental Executive Retirement Plan, as amended and restated (filed as Exhibit 10.100 to FHC's Form 10-K for the year ended June 30, 1995, which is incorporated by reference herein).

10.46 FHC's Executive Retiree Medical Plan, as amended and restated (filed as Exhibit 10.101 to FHC's Form 10-K for the year ended June 30, 1995, which is incorporated by reference herein).

10.47 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).

10.48 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).

10.49 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).

10.50 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).

10.51 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).

10.52 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).

10.53 Fourth Amendment to Credit Agreement, dated as of March 26, 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 Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).

10.55 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).

10.56 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).

10.57 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).

10.58 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).

10.59 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 Annual Report on Form 10-K for the year ended December 31, 1998, which is incorporated by reference herein).

10.60 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 Annual Report on Form 10-K for the year ended December 31, 1998, 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 second quarter ended June 30, 1999, a copy of which has been filed with the EDGAR version of this filing.

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* 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 June 30, 1999.

SIGNATURES

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

FOUNDATION HEALTH SYSTEMS, INC.
(REGISTRANT)

By: /s/ JAY M. GELLERT

Jay M. Gellert
President and Chief Executive Officer

Date: August 16, 1999

By: /s/ STEVEN P. ERWIN

Steven P. Erwin
Executive Vice President and Chief Financial Officer

Date: August 16, 1999