HealthMarkets, Inc.
Form 10-Q
August 13, 2009

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

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2009**

**OR**

o **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: 001-14953**

**HEALTHMARKETS, INC.**
(Exact name of registrant as specified in its charter)

| **Delaware** | **75-2044750** |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification Number)** |

**9151 Boulevard 26, North Richland Hills, Texas 76180**
**(Address of principal executive offices, zip code)**
**(817) 255-5200**
**(Registrant s phone 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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

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

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

On July 31, 2009 the registrant had 26,777,074 outstanding shares of Class A-1 Common Stock, $.01 Par Value, and 2,692,138 outstanding shares of Class A-2 Common Stock, $.01 Par Value.

**HEALTHMARKETS, INC.**
**and Subsidiaries**
**Second Quarter 2009 Form 10-Q**
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**HEALTHMARKETS, INC.**
**and Subsidiaries**
**CONSOLIDATED CONDENSED BALANCE SHEETS**
**(In thousands, except per share data)**

| | June 30, 2009 (Unaudited) | December 31, 2008 |
|---|---|---|
| **ASSETS** | | |
| Investments: | | |
| Securities available for sale | | |
| Fixed maturities, at fair value (cost: June 30, 2009 $817,980; December 31, 2008 $855,137) | $ 797,780 | $ 805,026 |
| Equity securities, at fair value (cost: June 30, 2009 $196; December 31, 2008 $178) | 224 | 210 |
| Trading securities, at fair value | 14,259 | 11,937 |
| Short-term and other investments | 309,962 | 210,433 |
| Total investments | 1,122,225 | 1,027,606 |
| Cash and cash equivalents | | 100,339 |
| Student loan receivables | 74,660 | 78,837 |
| Restricted cash | 7,335 | 7,881 |
| Investment income due and accrued | 12,006 | 13,304 |
| Reinsurance recoverable ceded policy liabilities | 372,639 | 384,801 |
| Agent and other receivables | 30,026 | 37,954 |
| Deferred acquisition costs | 72,134 | 72,151 |
| Property and equipment, net | 53,079 | 63,198 |
| Goodwill and other intangible assets | 86,756 | 87,555 |
| Recoverable federal income taxes | 11,989 | 10,177 |
| Other assets | 31,097 | 32,910 |
| | $ 1,873,946 | $ 1,916,713 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Policy liabilities: | | |
| Future policy and contract benefits | $ 469,970 | $ 486,174 |
| Claims | 375,466 | 415,748 |
| Unearned premiums | 55,132 | 61,491 |
| Other policy liabilities | 8,660 | 9,633 |
| Accounts payable and accrued expenses | 42,061 | 58,571 |
| Other liabilities | 89,610 | 94,346 |
| Deferred federal income taxes | 38,798 | 23,495 |
| Debt | 481,070 | 481,070 |
| Student loan credit facility | 81,000 | 86,050 |
| Net liabilities of discontinued operations | 2,078 | 2,210 |
| | 1,643,845 | 1,718,788 |
| Commitments and Contingencies (Note 8) | | |

| | | |
|---|---|---|
| Stockholders Equity: | | |
| Preferred stock, par value $0.01 per share authorized 10,000,000 shares, none issued | | |
| Common Stock, Class A-1, par value $0.01 per share authorized 90,000,000 shares, 27,000,062 issued and 26,777,073 outstanding at June 30, 2009; 27,000,062 issued and 26,887,281 outstanding at December 31, 2008. Class A-2, par value $0.01 per share authorized 20,000,000 shares, 4,026,104 issued and 2,723,516 outstanding at June 30, 2009; 4,026,104 issued and 2,741,240 outstanding at December 31, 2008 | 310 | 310 |
| Additional paid-in capital | 46,064 | 54,004 |
| Accumulated other comprehensive loss | (21,030) | (41,970) |
| Retained earnings | 239,970 | 227,686 |
| Treasury stock, at cost (222,989 Class A-1 common shares and 1,302,588 Class A-2 common shares at June 30, 2009; 112,781 Class A-1 common shares and 1,284,864 Class A-2 common shares at December 31, 2008) | (35,213) | (42,105) |
| | 230,101 | 197,925 |
| | $ 1,873,946 | $ 1,916,713 |

*See Notes to Consolidated Condensed Financial Statements.*

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**HEALTHMARKETS, INC.**
**and Subsidiaries**
**CONSOLIDATED CONDENSED STATEMENTS OF INCOME (LOSS)**
**(In thousands, except per share data)**
**(Unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| **REVENUE** | | | | |
| Health premiums | $ 250,503 | $ 326,038 | $ 513,643 | $ 643,303 |
| Life premiums and other considerations | 624 | 17,761 | 1,342 | 36,516 |
| | 251,127 | 343,799 | 514,985 | 679,819 |
| Investment income | 11,035 | 17,530 | 21,351 | 39,362 |
| Other income | 15,536 | 20,539 | 32,777 | 42,731 |
| Total other-than-temporary impairment losses | (2,683) | (5,581) | (4,078) | (5,581) |
| Portion of loss recognized in other comprehensive income (before taxes) | | | | |
| Net impairment losses recognized in earnings | (2,683) | (5,581) | (4,078) | (5,581) |
| Realized gains | 1,533 | 965 | 1,555 | 2,342 |
| | 276,548 | 377,252 | 566,590 | 758,673 |
| **BENEFITS AND EXPENSES** | | | | |
| Benefits, claims, and settlement expenses | 142,080 | 226,038 | 309,679 | 450,295 |
| Underwriting, acquisition, and insurance expenses | 98,376 | 139,678 | 179,276 | 267,984 |
| Other expenses | 21,908 | 33,840 | 41,914 | 60,791 |
| Interest expense | 8,184 | 10,422 | 17,693 | 21,594 |
| | 270,548 | 409,978 | 548,562 | 800,664 |
| Income (loss) from continuing operations before income taxes | 6,000 | (32,726) | 18,028 | (41,991) |
| Federal income tax expense (benefit) | 2,807 | (13,461) | 6,812 | (16,402) |
| Income (loss) from continuing operations | 3,193 | (19,265) | 11,216 | (25,589) |
| Income from discontinued operations, net | 16 | 36 | 51 | 67 |
| Net income (loss) | $ 3,209 | $ (19,229) | $ 11,267 | $ (25,522) |
| Basic earnings per share: | | | | |
| Income (loss) from continuing operations | $ 0.11 | $ (0.63) | $ 0.38 | $ (0.83) |
| Income (loss) from discontinued operations | 0.00 | 0.00 | 0.00 | 0.00 |
| Net income (loss) per share, basic | $ 0.11 | $ (0.63) | $ 0.38 | $ (0.83) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Diluted earnings per share: | | | | | | | | |
| Income (loss) from continuing operations | $ | 0.11 | $ | (0.63) | $ | 0.37 | $ | (0.83) |
| Income (loss) from discontinued operations | | 0.00 | | 0.00 | | 0.00 | | 0.00 |
| Net income (loss) per share, diluted | $ | 0.11 | $ | (0.63) | $ | 0.37 | $ | (0.83) |

*See Notes to Consolidated Condensed Financial Statements.*

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**HEALTHMARKETS, INC.**
**and Subsidiaries**
**CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**
**(In thousands)**
**(Unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Net income (loss) | $ 3,209 | $ (19,229) | $ 11,267 | $ (25,522) |
| Implementation effect upon adoption of SFAS FSP No. 115-2 | 1,017 | | 1,017 | |
| Other comprehensive income (loss): | | | | |
| Unrealized gains (losses) on securities available for sale arising during the period | 21,670 | (14,547) | 26,771 | (17,998) |
| Reclassification for investment (gains) losses included in net income (loss) | 3,035 | 91 | 3,030 | (414) |
| Other-than-temporary impairment losses recognized in OCI | (1,565) | | (1,565) | |
| Effect on other comprehensive income (loss) from investment securities | 23,140 | (14,456) | 28,236 | (18,412) |
| Unrealized gains (losses) on derivatives used in cash flow hedging during the period | (409) | 5,351 | (899) | (1,980) |
| Reclassification adjustments included in net income (loss) | 2,248 | 1,763 | 4,880 | 2,297 |
| Effect on other comprehensive income from hedging activities | 1,839 | 7,114 | 3,981 | 317 |
| Other comprehensive income (loss) before tax | 24,979 | (7,342) | 32,217 | (18,095) |
| Income tax expense (benefit) related to items of other comprehensive income (loss) | 8,743 | (2,544) | 11,277 | (6,319) |
| Other comprehensive income (loss) net of tax | 16,236 | (4,798) | 20,940 | (11,776) |
| Comprehensive income (loss) | $ 20,462 | $ (24,027) | $ 33,224 | $ (37,298) |

*See Notes to Consolidated Condensed Financial Statements.*

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**HEALTHMARKETS, INC.**
**and Subsidiaries**
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**
**(In thousands)**
**(Unaudited)**

| | Six Months Ended June 30, 2009 | 2008 |
|---|---|---|
| **Operating Activities:** | | |
| Net income (loss) | $ 11,267 | $ (25,522) |
| Adjustments to reconcile net income (loss) to cash provided by operating activities: | | |
| (Income) loss from discontinued operations | (51) | (67) |
| Realized gains | 3,013 | 3,239 |
| Change in deferred income taxes | 3,479 | (1,354) |
| Depreciation and amortization | 14,614 | 13,750 |
| Amortization of prepaid monitoring fees | 6,250 | 6,250 |
| Equity based compensation expense | 2,285 | (520) |
| Other items, net | 6,867 | 10,626 |
| Changes in assets and liabilities: | | |
| Investment income due and accrued | 1,298 | 2,784 |
| Due premiums | 2,086 | 558 |
| Reinsurance recoverable ceded policy liabilities | 12,162 | 23,152 |
| Agent and other receivables | 6,129 | 33,329 |
| Deferred acquisition costs | 17 | 16,642 |
| Prepaid monitoring fees | (12,500) | (12,500) |
| Current income tax recoverable | (1,812) | (21,231) |
| Policy liabilities | (59,814) | (5,924) |
| Other liabilities and accrued expenses | (13,129) | (16,949) |
| Cash (used in) provided by continuing operations | (17,839) | 26,263 |
| Cash (used in) provided by discontinued operations | (81) | (136) |
| Net cash (used in) provided by operating activities | (17,920) | 26,127 |
| **Investing Activities:** | | |
| Student loan receivables | | |
| Purchases and originations | (1,371) | (2,479) |
| Repayments | 4,576 | 6,492 |
| Securities available for sale | 32,775 | 12,441 |
| Short-term and other investments, net | (99,573) | 862 |
| Purchases of property and equipment | (1,367) | (10,364) |
| Proceeds from subsidiaries sold, net of cash disposed of $437 | (440) | |
| Change in restricted cash | 546 | |
| Decrease (increase) in agent receivables | (1,811) | (815) |
| Cash (used in) provided by continuing operations | (66,665) | 6,137 |
| Cash (used in) provided by discontinued operations | | 129 |

| | | |
|---|---|---|
| Net cash (used in) provided by investing activities | (66,665) | 6,266 |
| | | |
| **Financing Activities:** | | |
| Repayment of student loan credit facility | (5,050) | (7,100) |
| Decrease in investment products | (4,004) | (4,796) |
| Increase in cash overdraft | 4,383 | |
| Proceeds from shares issued to agent plans and other | 4,415 | 7,334 |
| Purchases of treasury stock | (14,390) | (37,878) |
| Excess tax reduction from equity based compensation | (1,108) | (167) |
| | | |
| Cash used in continuing operations | (15,754) | (42,607) |
| Cash used in discontinued operations | | |
| | | |
| Net cash used in financing activities | (15,754) | (42,607) |
| | | |
| Net change in cash and cash equivalents | (100,339) | (10,214) |
| Cash and cash equivalents at beginning of period | 100,339 | 14,309 |
| | | |
| Cash and cash equivalents at end of period in continuing operations | $ | $ 4,095 |
| | | |
| Supplemental disclosures: | | |
| Income taxes paid | $ 6,279 | $ 6,481 |
| | | |
| Interest paid | $ 19,878 | $ 19,621 |

*See Notes to Consolidated Condensed Financial Statements.*

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**HEALTHMARKETS, INC.**
**and Subsidiaries**
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**
**(Unaudited)**

## 1. BASIS OF PRESENTATION

The accompanying consolidated condensed financial statements for HealthMarkets, Inc. (the Company or HealthMarkets ) and its subsidiaries have been prepared in accordance with United States generally accepted accounting principles ( GAAP ) for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, such financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, these financial statements include all adjustments, consisting of normal recurring adjustments and accruals, necessary for the fair presentation of the consolidated condensed balance sheets, statements of income (loss), statements of comprehensive income (loss) and statements of cash flows for the periods presented. The accompanying December 31, 2008 consolidated condensed balance sheet was derived from audited consolidated financial statements, but does not include all disclosures required by GAAP for annual financial statement purposes. Preparing financial statements requires management to make estimates and assumptions that affect the amounts that are reported in the financial statements and the accompanying disclosures. Although these estimates are based on management s knowledge of current events and actions that HealthMarkets may undertake in the future, actual results may differ materially from the estimates. Operating results for the three and six months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2009. Certain amounts in the prior period financial statements have been reclassified to conform to the 2009 financial statement presentation. We have evaluated subsequent events for recognition or disclosure through August 12, 2009, which was the date we filed this Form 10-Q with the SEC. For further information, refer to the consolidated financial statements and notes thereto, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

***Concentrations***

Through the Self-Employed Agency Division ( SEA ) Division, the Company s insurance company subsidiaries provide health insurance products in 42 states and the District of Columbia. As is the case with many of HealthMarkets competitors in this market, a substantial portion of the Company s insurance company subsidiaries products are issued to members of various independent membership associations that act as the master policyholder for such products. The three principal membership associations in the self-employed market that make available to their members our health insurance products are the Alliance for Affordable Services ( AAS ), the National Association for the Self-Employed ( NASE ) and Americans for Financial Security ( AFS ). During the six months ended June 30, 2009, the Company issued approximately 45% of our new policies through AAS, approximately 17% of our new policies through NASE and approximately 22% of our new policies through AFS.

Additionally, during the six months ended June 30, 2009, the Company generated approximately 56% of its health premium revenue from the following 10 states:

| | Percentage |
|---|---|
| California | 13% |
| Texas | 8% |
| Florida | 7% |
| Massachusetts | 6% |
| Illinois | 5% |
| Washington | 4% |
| North Carolina | 4% |
| Maine | 3% |
| Wisconsin | 3% |
| Pennsylvania | 3% |

56%

***Deferred Acquisition Costs ( DAC ) 2009 Change in Estimates***

Prior to January 1, 2009, the basis for the amortization period on deferred lead costs and the portion of DAC associated with commissions paid to agents was the estimated weighted average life of the insurance policy, which approximated 24 months. The monthly amortization factor was calculated to correspond with the historical persistency of policies (i.e. the monthly amortization is variable and is higher in the early months). Beginning January 1, 2009, on newly issued policies, the Company refined its estimated life of the policy to approximate the premium paying period of the policy based on the expected persistency over this period. As such, these costs are now amortized over sixty months, and the

monthly amortization factor is calculated to correspond with the expected persistency experience for the newly issued policies. However, the amounts amortized will continue to be substantially higher in the early months of the policy as both are based on the persistency of the Company s insurance policies. Policies issued before January 1, 2009 will continue to be amortized using the existing assumptions in place at the time of the issuance of the policy.

Additionally, prior to January 1, 2009, certain other underwriting and policy issuance costs, which the Company determined to be more fixed than variable, were expensed as incurred. Effective January 1, 2009, HealthMarkets determined that, due to changes in both the Company s products and underwriting procedures performed, certain of these costs have become more variable than fixed in nature. As such, the Company began deferring such costs over the expected premium paying period of the policy, which approximates five years.

These changes resulted in a decrease in Underwriting, acquisition and insurance expenses of $2.2 million and $7.3 million, respectively, for the three and six months ended June 30, 2009.

**Recent Accounting Pronouncements**

In June 2009, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162* ( SFAS No. 168 ), which recognizes the FASB Accounting Standards Codification (the Codification ) as the source of authoritative U.S. GAAP recognized by the FASB. Additionally, rules and interpretive releases of the Securities and Exchange Commission (the SEC ) under authority of federal securities laws will also continue to be sources of authoritative GAAP for SEC registrants. SFAS No. 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009, at which time, the Codification will supersede all then-existing non-SEC accounting and reporting standards.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* ( SFAS No. 167 ), which modifies financial reporting for variable interest entities ( VIEs ). Under SFAS No. 167, companies are required to perform a periodic analysis to determine whether their variable interest must be consolidated by the Company. Additionally, Companies must disclose significant judgments and assumptions made it determining whether it must consolidate a VIE. Any changes in consolidated entities resulting from a Company s analysis must be applied retrospectively to prior period financial statements. SFAS No. 167 is effective for annual and interim periods beginning after November 15, 2009. The Company has not yet determined the impact that the adoption of SFAS No. 167 will have on its consolidated financial statements.

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of SFAS No. 140,* ( SFAS No. 166 ), which provides greater transparency about transfers of financial assets. SFAS No. 166 requires companies to determine whether the transferor or companies included in the transferor s financial statements have surrendered control over transferred financial assets. In making such determination, companies are required to consider the continuing involvement by the transferor in the transferred financial asset. SFAS No. 166 modifies the financial-components approach used in SFAS No. 140 and limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized. Additionally, this FSP removes the concept of a qualifying special-purpose entity ( QSPE ) from SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and removes the exception from applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* to QSPEs. SFAS No. 166 is effective for annual and interim periods beginning after November 15, 2009. The Company has not yet determined the impact that the adoption of SFAS No. 166 will have on its consolidated financial statements.

In May 2009, the Company adopted SFAS No. 165, *Subsequent Events* ( SFAS No. 165 ), which established general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS No. 165 requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. Additionally, SFAS No. 165 clarifies the circumstances under which an entity should recognize in the financial statements, the effects of events or transactions occurring after the balance sheet date, and required disclosures for such events and transactions. The adoption of SFAS No. 165 did not have a material impact on the Company s consolidated condensed financial statements

In April 2009, the Company adopted FASB Staff Position ( FSP ) SFAS No. 157-4, *Determining The Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying*

*Transactions That Are Not Orderly* ( FSP SFAS No. 157-4 ), which amends SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157"*)*. Under SFAS No. 157, companies were to assume that fair value measurements were determined when an asset was to be exchanged in an orderly transaction between market participants to sell the asset at the measurement date under

current market conditions. FSP SFAS No. 157-4 provides guidance for estimating fair value in accordance with SFAS No. 157 when the market activity for the asset or liability has significantly decreased and guidance for identifying transactions that are not orderly. Furthermore, FSP SFAS No. 157-4 requires disclosure in interim and annual periods for the inputs and valuation techniques used to measure fair value. Additionally, FSP SFAS No. 157-4 requires an entity to disclose a change in valuation technique resulting from the application of FSP SFAS No. 157-4, and to quantify such effects. The adoption of FSP SFAS No. 157-4 did not have a material impact on the Company s consolidated condensed financial statements.

In February 2008, the FASB issued FSP SFAS No. 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). These nonfinancial items would include, for example, reporting units measured at fair value in a goodwill impairment test and nonfinancial assets acquired and liabilities assumed in a business combination. The adoption of the remaining provisions of SFAS No. 157 did not have a material impact on the Company s financial position and results of operations.

In April 2009, the Company adopted FSP SFAS No. 107-1 and APB 28-1, *Disclosures about Fair Value of Financial Instruments* ( FSP SFAS No. 107-1 and APB 28-1 ), which amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments.* FSP SFAS No. 107-1 and APB 28-1 requires companies to provide disclosures about fair value of financial instruments in both interim and annual financial statements. Additionally, under this FSP, companies are required to disclose the methods and significant assumptions used to estimate the fair value of financial instruments in both interim and annual financial statements. The adoption of FSP SFAS No. 107-1 and APB 28-1 did not have a material impact on the Company s consolidated condensed financial statements.

In April 2009, the Company adopted FSP SFAS No. 115-2 and SFAS No. 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments ( FSP SFAS No. 115-2 and SFAS No. 124-2 )*, which amends SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. FSP SFAS No. 115-2 and SFAS No. 124-2 improves the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. Under this FSP, when the fair value is less than the amortized cost basis at the measurement date, a company would be required to assess the impaired security to determine whether the impairment is other-than-temporary. Such assessment may result in the recognition of an other-than-temporary impairment related to a credit loss in the statement of income and the recognition of an other-than-temporary impairment related to a non-credit loss in accumulated other comprehensive income on the balance sheet. To avoid recognizing the entire other-than-temporary impairment in the statement of income, a company would be required to assert (a) it does not have the intent to sell the security and (b) it is more likely than not that it will not have to sell the security before recovery of its cost basis. Additionally, at adoption, a company is permitted to make a one-time cumulative-effect adjustment for securities held at adoption for which an other-than-temporary impairment related to a non-credit loss had been previously recognized. Upon adoption of FSP SFAS No. 115-2 and SFAS No. 124-2, the Company recognized such tax-effected cumulative effect as an increase to the opening balance of retained earnings for $1.0 million with a corresponding decrease to accumulated other comprehensive income, with no overall change to shareholders equity. See Note 4 of Notes to Consolidated Condensed Financial Statements.

On January 1, 2009, the Company adopted SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ( SFAS No. 161 ), which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( SFAS No. 133 ). SFAS No. 161 requires companies with derivative instruments to disclose information that should enable financial statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133, and how derivative instruments and related hedged items affect a company s financial position, financial performance, and cash flows. The required disclosures include the fair value of derivative instruments and their gains or losses in tabular format, information about credit risk related contingent features in derivative agreements, counterparty credit risk, and a company s strategies and objectives for using derivative instruments. The statement expands the current disclosure framework in SFAS No. 133. The adoption of SFAS No. 161 did not have a material impact on the Company s

financial position and results of operations. The expanded disclosures regarding derivative instruments and hedging activities are included in Note 6 of Notes to Consolidated Condensed Financial Statements.

In December 2007, SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*, ( SFAS No. 160 ) was issued. The objective of SFAS No. 160 is to improve the relevance, comparability, and transparency of the financial information related to minority interest that a reporting entity provides in its consolidated financial statements. The adoption of SFAS No. 160 did not have a material impact on the Company s financial position and results of operations.



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## 2. DISPOSITIONS

*Exit from Life Insurance Division Business*

On September 30, 2008 (the Closing Date ), HealthMarkets, LLC completed the transactions contemplated by the Agreement for Reinsurance and Purchase and Sale of Assets dated June 12, 2008 (the Master Agreement ). Pursuant to the Master Agreement, Wilton Reassurance Company or its affiliates ( Wilton ) acquired substantially all of the business of the Company s Life Insurance Division, which operated through The MEGA Life and Health Insurance Company ( MEGA ), Mid-West National Life Insurance Company of Tennessee ( Mid-West ) and The Chesapeake Life Insurance Company ( Chesapeake ) (collectively the Ceding Companies ), and all of the Company s 79% equity interest in each of U.S. Managers Life Insurance Company, Ltd. and Financial Services Reinsurance, Ltd. As part of the transaction, under the terms of the Coinsurance Agreements (the Coinsurance Agreements ) entered into with each of the Ceding Companies on the Closing Date, Wilton has agreed, effective July 1, 2008 (the Coinsurance Effective Date ), to reinsure on a 100% coinsurance basis substantially all of the insurance policies associated with the Company s Life Insurance Division (the Coinsured Policies ). In connection with the reinsurance transaction, the Company recognized an impairment loss to the Life Insurance Division s DAC of approximately $13.0 million and $4.5 million related to legal fees, employee termination costs and other costs for the three months ended June 30, 2008. During the second quarter of 2009, the Company recorded the final settlement on the reinsurance transaction, pursuant to the Coinsurance Agreements, which resulted in a $978,000 gain. Such gain was recorded in Realized gains on the consolidated condensed statement of income (loss).

*Student Loans*

In connection with the execution of the Master Agreement, HealthMarkets, LLC entered into a definitive Stock Purchase Agreement (as amended, the Stock Purchase Agreement ) pursuant to which Wilton agreed to purchase the Company s student loan funding vehicles, CFLD, Inc. and UICI Funding Corp. 2 ( UFC2 ), and the related student association. In connection with the transactions contemplated by the Stock Purchase Agreement, the Company recognized a $5.3 million loss on the condensed consolidated statement of income (loss) at June 30, 2008 related to the reduction in the value of the Company s student loan portfolio. The closing of the Stock Purchase Agreement did not occur due to certain closing conditions that were not satisfied. The Stock Purchase Agreement provides that either party may terminate the agreement if the closing has not occurred by May 31, 2009. Wilton provided written notice of termination of the Stock Purchase Agreement effective August 10, 2009.

Prior to June 30, 2009, the Company had presented the assets and liabilities of CFLD, Inc. and UFC2 as held for sale on its consolidated condensed balance sheet and included the results of operations of CFLD, Inc. and UFC2 in discontinued operations on its consolidated condensed statement of income (loss). As the closing of the Stock Purchase Agreement did not occur, the Company reclassified the assets and liabilities of CFLD and UFC2 out of held for sale and reclassified the results of operations from discontinued operations to continuing operations for all periods presented. Such reclassification in the condensed consolidated statement of income (loss) resulted in an increase in Loss from continuing operations of $3,581 and $5,289 for the three and six months ended June 30, 2008, respectively.

In accordance with the terms of the Coinsured Agreements, Wilton will fund student loans; provided, however, that Wilton will not be required to fund any student loan that would cause the aggregate par value of all such loans funded by Wilton, following the Coinsurance Effective Date, to exceed $10.0 million. As of June 30, 2009, approximately $1.2 million of student loans have been funded under this agreement.

*Sale of ZON-Re*

The Company s Other Insurance Division consisted of ZON-Re USA, LLC ( ZON-Re ), an 82.5%-owned subsidiary, which underwrote, administered and issued accidental death, accidental death and dismemberment ( AD&D ), accident medical, and accident disability insurance products, both on a primary and on a reinsurance basis. The Company distributed these products through professional reinsurance intermediaries and a network of independent commercial insurance agents, brokers and third party administrators.

On June 5, 2009, HealthMarkets, LLC, entered into an Acquisition Agreement (the Acquisition Agreement ) for the sale of its 82.5% membership interest in ZON-Re to Venue Re, LLC ( Venue Re ). The transaction contemplated by the Acquisition Agreement closed effective June 30, 2009. The sale of the Company s membership interest in ZON-Re resulted in a total pre-tax loss of $489,000. The Company will continue to reflect the existing insurance business in its

financial statements to final termination of substantially all liabilities.

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*Exit from the Medicare Market*

In 2007, we initiated efforts to expand into the Medicare market. In the fourth quarter of 2007, we began offering a new portfolio of Medicare Advantage Private-Fee-for-Service Plans called HealthMarkets Care Assured Plans[SM] in selected markets in 29 states with calendar year coverage effective for January 1, 2008. In July 2008, the Company determined it would not continue to participate in the Medicare business after the 2008 plan year. For the three months ended June 30, 2008, the Company recognized a $4.9 million expense associated with a minimum volume guarantee fee related to the Company s contract with a third party administrator. This minimum volume guarantee fee was for member months over the three year term of the contract covering calendar years 2008 through 2010.

**3. FAIR VALUE MEASUREMENTS**

In accordance with SFAS No. 157, the Company categorizes its investments and certain other assets and liabilities recorded at fair value into a three-level fair value hierarchy as follows:

Level 1 Unadjusted quoted market prices for identical assets or liabilities in active markets which are accessible by the Company.

Level 2 Observable prices in active markets for similar assets or liabilities. Prices for identical or similar assets or liabilities in markets that are not active. Directly observable market inputs for substantially the full term of the asset or liability, such as interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, default rates, and credit spreads. Market inputs that are not directly observable but are derived from or corroborated by observable market data.

Level 3 Unobservable inputs based on the Company s own judgment as to assumptions a market participant would use, including inputs derived from extrapolation and interpolation that are not corroborated by observable market data.

The Company evaluates the various types of securities in its investment portfolio to determine the appropriate level in the fair value hierarchy based upon trading activity and the observability of market inputs. The Company employs control processes to validate the reasonableness of the fair value estimates of its assets and liabilities, including those estimates based on prices and quotes obtained from independent third party sources. The Company s procedures generally include, but are not limited to, initial and ongoing evaluation of methodologies used by independent third parties and monthly analytical reviews of the prices against current pricing trends and statistics.

Where possible, the Company utilizes quoted market prices to measure fair value. For investments that have quoted market prices in active markets, the Company uses the quoted market price as fair value and includes these prices in the amounts disclosed in Level 1 of the hierarchy. When quoted market prices in active markets are unavailable, the Company determines fair values using various valuation techniques and models based on a range of observable market inputs including pricing models, quoted market price of publicly traded securities with similar duration and yield, time value, yield curve, prepayment speeds, default rates and discounted cash flow. In most cases, these estimates are determined based on independent third party valuation information, and the amounts are disclosed in Level 2 of the fair value hierarchy. Generally, the Company obtains a single price or quote per instrument from independent third parties to assist in establishing the fair value of these investments.

If quoted market prices and independent third party valuation information are unavailable, the Company produces an estimate of fair value based on internally developed valuation techniques, which, depending on the level of observable market inputs, will render the fair value estimate as Level 2 or Level 3. On occasions when pricing service data is unavailable, the Company may rely on bid/ask spreads from dealers in determining the fair value. When dealer quotations are used to assist in establishing the fair value, the Company generally obtains one quote per instrument. The quotes obtained from dealers or brokers are generally non-binding. When dealer quotations are used, the Company uses the mid-mark as fair value. When broker or dealer quotations are used for valuation or price verification, greater priority is given to executable quotes. As part of the price verification process, valuations based on quotes are corroborated by comparison both to other quotes and to recent trading activity in the same or similar instruments.

To the extent the Company determines that a price or quote is inconsistent with actual trading activity observed in that investment or similar investments, or if the Company does not think the quote is reflective of the market value for the investment, the Company will internally develop a fair value using this observable market information and disclose the occurrence of this circumstance.

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In accordance with SFAS No. 157, the Company has categorized its available for sale securities into a three level fair value hierarchy based on the priority of inputs to the valuation techniques. The fair values of investments disclosed in Level 1 of the fair value hierarchy include money market funds and certain U.S. government securities, while the investments disclosed in Level 2 include the majority of the Company s fixed income investments. In cases where there is limited activity or less transparency around inputs to the valuation, the Company classifies the fair value estimates within Level 3 of the fair value hierarchy.

As of June 30, 2009, all of the Company s investments classified within Level 2 and Level 3 of the fair value hierarchy are valued based on quotes or prices obtained from independent third parties, except for $101.0 million of Corporate debt and other classified as Level 2, $1.7 million of Corporate debt and other classified as Level 3 and $1.4 million of Mortgage and asset-backed investments classified as Level 3. The $101.0 million of Corporate debt and other investments classified as Level 2 noted above includes $86.3 million of an investment grade corporate bond issued by UnitedHealth Group that was received as consideration for the sale of the Company s former Student Insurance Division in December 2006.

*Fair Value Hierarchy on a Recurring Basis*

Assets and liabilities measured at fair value on a recurring basis are categorized in the tables below based upon the lowest level of significant input to the valuations.

**Assets at Fair Value as of June 30, 2009**

| **In thousands** | **Level 1** | **Level 2** | **Level 3** | **Total** |
|---|---|---|---|---|
| U.S. and U.S. Government agencies | $ 5,135 | $ 35,013 | $ | $ 40,148 |
| Corporate debt and other | 2,833 | 383,561 | | 386,394 |
| Collateralized debt obligations | | | 2,563 | 2,563 |
| Residential backed issued by agencies | | 91,889 | | 91,889 |
| Commercial backed issued by agencies | | 8,711 | | 8,711 |
| Residential backed | | 4,718 | | 4,718 |
| Commercial backed | | 70,874 | 1,424 | 72,298 |
| Asset backed | | 19,568 | 360 | 19,928 |
| Municipals | | 163,831 | 7,301 | 171,132 |
| Corporate equities | 29 | | | 29 |
| Trading securities | | | 14,259 | 14,259 |
| Put options (1) | | | 741 | 741 |
| Short-term and other investments (2) | 284,224 | 6,304 | 140 | 290,668 |
| | $ 292,221 | $ 784,469 | $ 26,788 | $ 1,103,478 |

(1) Included in Other assets on the consolidated condensed balance sheet.

(2) Amount excludes $19.3 million of short term other investments which are not subject to fair

value
measurement.

**Liabilities at Fair Value as of June 30, 2009**

| **In thousands** | **Level 1** | **Level 2** | **Level 3** | **Total** |
|---|---|---|---|---|
| Interest rate swaps | $ | $ 11,511 | $ | $ 11,511 |
| Agent and employee plans | | | 13,184 | 13,184 |
| | $ | $ 11,511 | $ 13,184 | $ 24,695 |

The following is a description of the valuation methodologies used for certain assets and liabilities of the Company measured at fair value on a recurring basis, including the general classification of such assets pursuant to the valuation hierarchy.

*Fixed Income Investments*

*Available for sale investments*

The Company s fixed income investments include investments in U.S. treasury securities, U.S. government agencies bonds, corporate bonds, mortgage and asset backed securities, and municipal auction rate securities and bonds.

The Company estimates the fair value of its U.S. treasury securities using unadjusted quoted market prices, and accordingly, discloses these investments in Level 1 of the fair value hierarchy. In general, the fair values of the majority of the fixed income investments held by the Company are determined based on observable market inputs provided by independent third party valuation information. The market inputs utilized in the pricing evaluation include but are not limited to, benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and industry and economic events. The Company classifies the fair value estimates

based on these observable market inputs within Level 2 of the fair value hierarchy. Investments classified within Level 2 consist of U.S. government agencies bonds, corporate bonds, mortgage and asset backed securities, and municipal bonds.

The Company also holds a small number of fixed income investments, including certain mortgage and asset backed securities, and collateralized debt obligations, for which it estimates the fair value using internal pricing matrices with some unobservable inputs that are significant to the valuation. The Company estimates the fair value of its entire portfolio of municipal auction rate securities based on non-binding quotes received from independent third parties due to limited activity and market data for auction rate securities, resulting from liquidity issues in the global credit and capital markets. Consequently, the lack of transparency in the inputs and the availability of independent third party pricing information for these investments resulted in their fair values being classified within the Level 3 of the hierarchy. As of June 30, 2009, the fair values of certain municipal auction rate securities, collateralized debt obligations and mortgage and asset-backed securities which represent approximately 1.5% of the Company s total fixed income investments are reflected within the Level 3 of the fair value hierarchy.

Beginning in 2008, the Company determined that the non-binding quoted price received from an independent third party broker for a particular collateralized debt obligation investment did not reflect a value based on an active market. During discussions with the independent third party broker, the Company learned that the price quote was established by applying a discount to the most recent price that the broker had offered the investment. However, there were no responding bids to purchase the investment at that price. As this price was not set based on an active market, the Company developed a fair value for the investment. The Company continues to fair value the debt obligation as such during 2009.

The Company established a fair value for the investment based on information about the underlying pool of assets supplied by the investment s asset manager. The Company developed a discounted cash flow valuation for the investment by applying assumptions for a variety of factors including among other things, default rates, recovery rates and a discount rate. The Company believes the assumptions for these factors were developed in a manner consistent with those that a market participant would use in valuation and were based on the information provided regarding the underlying pool of assets, various current market benchmarks, industry data for similar assets types, and particular market observations about similar assets.

*Trading securities*

The Company s fixed income trading securities consist of auction rate securities, for which the fair value is determined based on unobservable inputs. Accordingly, the fair value of this asset is reflected within Level 3 of the fair value hierarchy.

*Equities*

The Company maintains one investment in equity securities for which the Company uses a quoted market price based on observable market transactions. The Company includes the fair value estimate for this stock in Level 1 of the hierarchy. The remaining amount in equity securities represents one security accounted for using the equity method of accounting and, therefore, does not require fair value disclosure under the provisions of SFAS No. 157.

*Short-term and other investments*

The Company s short-term and other investments primarily consist of highly liquid money market funds, which are reflected within Level 1 of the fair value hierarchy. Additionally, the fair value of one of the Company s investment assets included in short-term and other investments is determined based on unobservable inputs. Accordingly, the fair value of this asset is reflected within Level 3 of the fair value hierarchy.

*Put Options*

The put options that the Company owned as of June 30, 2009 are directly related to the agreements the Company entered into with UBS during 2008 to facilitate the repurchase of certain auction rate municipal securities. The options are carried at fair value which is related to the fair value of the auction rate securities (see *Trading securities* above).

*Derivatives*

The Company s derivative instruments are valued utilizing valuation models that primarily use market observable inputs and are traded in the markets where quoted market prices are not readily available, and accordingly,

these instruments are reflected within the Level 2 of the fair value hierarchy.

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*Agent and Employee Stock Plans*

The Company accounts for its agent and employee stock plan liabilities based on the Company s share price at the end of each reporting period. The Company s share price at the end of each reporting period is based on the prevailing fair value as determined by the Company s Board of Directors. The Company largely uses unobservable inputs in deriving the fair value of its share price and the value is, therefore, reflected in Level 3 of the hierarchy.

*Changes in Level 3 Assets and Liabilities*

The tables below summarize the change in balance sheet carrying values associated with Level 3 financial instruments and agent and employee stock plans for the three and six months ended June 30, 2009.

**Changes in Level 3 Assets and Liabilities Measured at Fair Value for the Three Months Ended June 30, 2009**

| | Beginning Balance | Unrealized Gains or (Losses) | Purchases, Sales, Payments and Issuances, Net | Realized Losses(1) | Transfer in/(out) of Level 3, Net | Ending Balance |
|---|---|---|---|---|---|---|
| | | | In Thousands | | | |
| **Assets** | | | | | | |
| Collateralized debt obligations | $ 1,780 | $ 783 | $ | $ | $ | $ 2,563 |
| Commercial backed | 1,450 | 62 | (88) | | | 1,424 |
| Asset backed | 350 | 10 | | | | 360 |
| Municipals | 7,378 | (77) | | | | 7,301 |
| Trading securities | 14,475 | (216) | | | | 14,259 |
| Put options | 525 | 216 | | | | 741 |
| Other invested assets | 251 | (7) | (103) | | | 141 |
| **Liabilities** | | | | | | |
| Agent and employee stock plans | $11,459 | $ | $ 1,725 | $ | $ | $13,184 |

**Changes in Level 3 Assets and Liabilities Measured at Fair Value for the Six Months Ended June 30, 2009**

| | Beginning Balance | Unrealized Gains or (Losses) | Purchases, Sales, Payments and Issuances, Net | Realized Losses(1) | Transfer in/(out) of Level 3, Net | Ending Balance |
|---|---|---|---|---|---|---|
| | | | In Thousands | | | |
| **Assets** | | | | | | |
| Collateralized debt obligations | $ 2,585 | $ 1,373 | $ | $(1,395) | $ | $ 2,563 |
| Commercial backed | 1,494 | 98 | (168) | | | 1,424 |
| Asset backed | 252 | 108 | | | | 360 |
| Municipals | 6,539 | 762 | | | | 7,301 |
| Trading securities | 11,937 | 2,422 | (100) | | | 14,259 |
| Put options | 3,163 | (2,422) | | | | 741 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Other invested assets | 476 | (107) | (228) | | | 141 |
| **Liabilities** | | | | | | |
| Agent and employee stock plans | $18,158 | $ | $ (4,974) | $ | $ | $13,184 |

(1) Realized losses for the period are included in Realized gains on the Company s consolidated condensed statement of income (loss).

***Fair Value Option***

SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS No. 159 ), provides a fair value option election that permits an entity to elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities. Changes in fair value for assets and liabilities for which the election is made will be recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The Company adopted SFAS No. 159 in the fourth quarter of 2008 for certain put options that were acquired during 2008. Such put options are recorded in Other assets on the consolidated condensed balance sheet.

***Investments not reported at fair value***

Other investments primarily consists of investments in equity investees, which are accounted for under the equity method of accounting on the Company s consolidated condensed balance sheet at cost.

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**4. INVESTMENTS**

The Company s investments consist of the following at June 30, 2009 and December 31, 2008:

| | June 30, 2009 | December 31, 2008 |
|---|---|---|
| | (In thousands) | |
| Securities available for sale | | |
| Fixed maturities | $ 797,780 | $ 805,026 |
| Equity securities | 224 | 210 |
| Trading securities | 14,259 | 11,937 |
| Short-term and other investments | 309,962 | 210,433 |
| Total investments | $ 1,122,225 | $ 1,027,606 |

Available for sale fixed maturities are reported at fair value which was derived as follows:

| | June 30, 2009 | | | | |
|---|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Non-credit Loss Recognized in OCI | Fair Value |
| | (In thousands) | | | | |
| U.S. and U.S. Government agencies | $ 38,791 | $ 1,357 | $ | $ | $ 40,148 |
| Collateralized debt obligations | 2,335 | 443 | (216) | | 2,562 |
| Residential backed issued by agencies | 88,578 | 3,316 | (6) | | 91,888 |
| Commercial backed issued by agencies | 8,392 | 318 | | | 8,710 |
| Residential backed | 5,003 | 8 | (292) | | 4,719 |
| Commercial backed | 76,360 | 34 | (4,097) | | 72,297 |
| Asset backed | 22,627 | 247 | (2,946) | | 19,928 |
| Corporate bonds and municipals | 569,692 | 7,884 | (25,368) | | 552,208 |
| Other | 6,202 | | (882) | | 5,320 |
| Total fixed maturities | $ 817,980 | $ 13,607 | $ (33,807) | $ | $ 797,780 |

| | December 31, 2008 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In thousands) | | | |
| U.S. and U.S. Government agencies | $ 36,014 | $ 1,794 | $ | $ 37,808 |
| Collateralized debt obligations | 3,700 | | (1,115) | 2,585 |
| Residential backed issued by agencies | 72,468 | 1,910 | (6) | 74,372 |
| Commercial backed issued by agencies | 37,406 | 781 | (53) | 38,134 |
| Residential backed | 6,340 | | (878) | 5,462 |
| Commercial backed | 76,959 | | (8,427) | 68,532 |

| | | | | |
|---|---|---|---|---|
| Asset backed | 25,011 | 70 | (6,148) | 18,933 |
| Corporate bonds and municipals | 590,996 | 4,229 | (41,985) | 553,240 |
| Other | 6,243 | | (283) | 5,960 |
| Total fixed maturities | $ 855,137 | $ 8,784 | $ (58,895) | $ 805,026 |

The amortized cost and fair value of available for sale fixed maturities at June 30, 2009, by contractual maturity, are set forth in the table below. Fixed maturities subject to early or unscheduled prepayments have been included based upon their contractual maturity dates. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | **June 30, 2009** | |
|---|---|---|
| | **Amortized Cost** | **Fair Value** |
| | **(In thousands)** | |
| *Maturity:* | | |
| One year or less | $ 36,698 | $ 36,812 |
| Over 1 year through 5 years | 198,505 | 197,364 |
| Over 5 years through 10 years | 241,756 | 229,469 |
| Over 10 years | 140,059 | 136,591 |
| | 617,018 | 600,236 |
| Mortgage and asset backed securities | 200,962 | 197,544 |
| Total fixed maturities | $ 817,980 | $ 797,780 |

See Note 3 of Notes to Consolidated Condensed Financial Statements for additional disclosures on fair value measurements.

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A summary of net investment income sources is set forth below:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | (In thousands) | | | |
| Fixed maturities | $ 9,984 | $ 14,457 | $ 19,690 | $ 29,163 |
| Equity securities | 45 | 20 | 17 | (9) |
| Short-term and other investments | 810 | 2,731 | 1,266 | 9,553 |
| Agent receivables | 685 | 812 | 1,346 | 1,651 |
| | 11,524 | 18,020 | 22,319 | 40,358 |
| Less investment expenses | 489 | 490 | 968 | 996 |
| | $ 11,035 | $ 17,530 | $ 21,351 | $ 39,362 |

*Realized Gains*

Realized gains and losses on sales of investments are recognized in net income (loss) on the specific identification basis and include write downs on those investments deemed to have an other than temporary decline in fair values. Gains and losses on trading securities are reported in Realized gains on the consolidated condensed statements of income (loss).

*Fixed maturities*

Proceeds from the sale and call of investments in fixed maturities were $13.4 million and $15.1 million for the three and six months ended June 30, 2009, respectively, and $76.1 million and $127.1 million for the three and six months ended June 30, 2008, respectively. Gross gains of $1.0 million and $1.0 million were realized on the sale and call of fixed maturity investments for the three and six months ended June 30, 2009, respectively. Gross gains of $468,000 and $973,000 and gross losses of $559,000 and $559,000 were realized on the sale and call of fixed maturity investments for the three and six months ended June 30, 2008, respectively.

*Equity securities*

The Company realized no gains or losses on equity securities during the three and six months ended June 30, 2009 and the three and six months ended June 30, 2008.

*Trading securities*

The Company accounts for certain put options that were acquired during 2008 as trading securities. The Company recognized gross realized gains of $216,000 and $0 for the three and six months ended June 30, 2009, respectively, and gross realized losses of $0 and $2.4 million for the three and six months ended June 30, 2009, respectively, in the consolidated condensed statement of income (loss).

*Unrealized Gains (Losses)*

Unrealized investment gains and losses on available for sale securities, net of applicable deferred income tax, are reported in Accumulated other comprehensive income (loss) as a separate component of stockholders equity and accordingly have no effect on net income (loss).

Set forth below is a summary of gross unrealized losses in its fixed maturities as of June 30, 2009 and December 31, 2008:

| | June 30, 2009 | | | | | |
|---|---|---|---|---|---|---|
| | Unrealized Loss Less Than 12 Months | | Unrealized Loss 12 Months or longer | | Total | |
| Description of Securities | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |

| | | | | **(In thousands)** | | |
|---|---|---|---|---|---|---|
| U.S. and U.S. Government agencies | $ | $ | $ | $ | $ | $ |
| Collateralized debt obligations | 688 | 136 | 195 | 80 | 883 | 216 |
| Residential backed issued by agencies | 501 | 5 | 1,981 | 1 | 2,482 | 6 |
| Residential backed | | | 3,964 | 292 | 3,964 | 292 |
| Commercial backed | | | 69,854 | 4,097 | 69,854 | 4,097 |
| Asset backed | | | 16,130 | 2,946 | 16,130 | 2,946 |
| Corporate bonds and municipals | 12,329 | 607 | 283,473 | 24,761 | 295,802 | 25,368 |
| Other | | | 5,318 | 882 | 5,318 | 882 |
| Total | $ 13,518 | $ 748 | $ 380,915 | $ 33,059 | $ 394,433 | $ 33,807 |

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| | December 31, 2008 | | | | | |
|---|---|---|---|---|---|---|
| | Unrealized Loss Less Than 12 Months | | Unrealized Loss 12 Months or longer | | Total | |
| **Description of Securities** | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** |
| | (In thousands) | | | | | |
| U.S. and U.S. Government agencies | $ | $ | $ | $ | $ | $ |
| Collateralized debt obligations | | | 2,310 | 1,115 | 2,310 | 1,115 |
| Residential backed issued by agencies | 49 | | 2,361 | 59 | 2,410 | 59 |
| Residential backed | | | 5,461 | 878 | 5,461 | 878 |
| Commercial backed | 28,432 | 2,960 | 40,100 | 5,468 | 68,532 | 8,428 |
| Asset backed | | | 13,072 | 6,148 | 13,072 | 6,148 |
| Corporate bonds and municipals | 117,143 | 6,877 | 289,731 | 35,107 | 406,874 | 41,984 |
| Other | | | 5,960 | 283 | 5,960 | 283 |
| Total | $ 145,624 | $ 9,837 | $ 358,995 | $ 49,058 | $ 504,619 | $ 58,895 |

Of the $748,000 in unrealized losses that had existed for less than twelve months, three securities had an unrealized loss in excess of 10% of the security s cost, which was attributable to the one collateralized debt obligation and two corporate bonds. The amount of unrealized loss with respect to these three securities was $570,000 at June 30, 2009.

Of the $33.1 million in unrealized losses that have existed for twelve months or longer, twenty-seven securities had unrealized losses in excess of 10% of the security s cost, of which one was a Collateralized debt obligation, one was Residential backed security, one was Commercial backed security, seven were Asset backed securities, sixteen were Corporate bonds and municipals and one was in Other in the table above. The amount of unrealized loss with respect to those securities was $15.0 million at June 30, 2009 of which $80,000 relates to a Collateralized debt obligation, $520,000 relates to one was Commercial backed security, $2.3 million relates to Asset backed securities, $11.1 million relates to Corporate bonds and municipals and $882,000 relates to the one Other security.

As a Company that holds investments in the financial services industry, HealthMarkets has been affected by conditions in U.S. financial markets and economic conditions throughout the world. The financial environment in the U.S. has been volatile during 2008 and 2009, and challenging market conditions have persisted throughout the first six months of 2009. The Company continually monitors investments with unrealized losses that have existed for twelve months or longer and considers such factors as the current financial condition of the issuer, the performance of underlying collateral and effective yields. Additionally, HealthMarkets considers whether it has the intent to sell the security and whether it is more likely than not that the Company will be required to sell the debt security before the fair value reverts to our cost basis, which may be at maturity of the security. Based on such review, the Company believes that, as of June 30, 2009, the unrealized loss in these investments is temporary.

It is at least reasonably probable the Company s assessment of whether the unrealized losses are other than temporary may change over time, given, among other things, the dynamic nature of markets or changes in the Company s assessment of its ability or intent to hold impaired investment securities, which could result in the Company recognizing other-than-temporary impairment charges or realized losses on the sale of such investments in the future.

*Equity securities*

Gross unrealized investment gains (losses) on equity securities were $1,000 and $(3,000) for the three and six months ended June 30, 2009, respectively, and $(5,000) and $(7,000) for the three and six months ended June 30, 2008, respectively.

*Other-than-temporary impairments*

Investments are reviewed at least quarterly, using both quantitative and qualitative factors, to determine if they have experienced an impairment of value that is considered other-than-temporary. In its review, management considers the following indicators of impairment: fair value significantly below cost; decline in fair value attributable to specific adverse conditions affecting a particular investment; decline in fair value attributable to specific conditions, such as conditions in an industry or in a geographic area; decline in fair value for an extended period of time; downgrades by rating agencies from investment grade to non-investment grade; financial condition deterioration of the issuer and situations where dividends have been reduced or eliminated or scheduled interest payments have not been made. Additionally, the Company assesses whether the amortized cost basis will be recovered by comparing the present value of cash flows expected to be collected with the amortized cost basis of the investment. When the determination is made that an impairment exists but the Company does not intend to sell the security and it is not more likely than not that the entity will be required to sell the

security before the recovery of its remaining amortized cost basis, the Company will determine the amount of the impairment related to a credit loss and the amount related to other factors.

During the three months and six months ended June 30, 2009, the Company recognized other-than-temporary impairments of $2.7 million and $4.1 million, respectively. Impairments recognized in the second quarter of 2009 resulted from two debt obligation securities, which were subsequently sold in July 2009. These impairments, which the Company deemed to be other-than-temporary reductions, were attributable to credit losses and, as such, these impairments were recorded in the consolidated condensed statement of income (loss). During the three and six months ended June 30, 2008, the Company recognized impairment charges of $5.6 million primarily related to certain investments in collateralized debt obligations. These impairment charges resulted from other than temporary reductions in the fair value of the investments compared to the Company s cost basis.

Upon adoption of FSP SFAS No. 115-2 and 124-2, the Company recorded a cumulative-effect adjustment for debt securities held at adoption for which an other-than-temporary impairment had been previously recognized. The Company recognized such tax-effected cumulative effect of initially applying FSP SFAS No. 115-2 and 124-2 as an adjustment to Retained earnings for $1.0 million, net of tax with a corresponding adjustment to Accumulated other comprehensive income.

| Cumulative OTTI credit losses recognized for securities still held at April 1, 2009 | Additions to OTTI securities where no credit losses were recognized prior to April 1, 2009 | Additions for OTTI securities where credit losses have been recognized prior to April 1, 2009 | Reductions for securities sold during the period (realized) | Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security | Credit losses on debt securities for which a portion of an OTTI was recognized in OCI at June 30, 2009 |
|---|---|---|---|---|---|
| (In thousands) | | | | | |
| $28,012 | $ 2,683 | $ | $ (1,521) | $ (224) | $ 28,950 |

**5. DEBT**

On April 5, 2006, the HealthMarkets, LLC entered into a credit agreement, providing for a $500.0 million term loan facility and a $75.0 million revolving credit facility, which includes a $35.0 million letter of credit sub-facility. The full amount of the term loan was drawn at closing. At June 30, 2009, the Company had an aggregate of $362.5 million of indebtedness outstanding under the term loan facility, which indebtedness bore interest at the London inter-bank offered rate ( LIBOR ) plus a borrowing margin of 1.00%. The Company has not drawn on the $75.0 million revolving credit facility.

In addition, on April 5, 2006, HealthMarkets Capital Trust I and HealthMarkets Capital Trust II (two newly formed Delaware statutory business trusts, collectively the Trusts ) issued $100.0 million of floating rate trust preferred securities (the Trust Securities ) and $3.1 million of floating rate common securities. The Trusts invested the proceeds from the sale of the Trust Securities, together with the proceeds from the issuance to HealthMarkets, LLC by the Trusts of the common securities, in $100.0 million principal amount of HealthMarkets, LLC s Floating Rate Junior Subordinated Notes due June 15, 2036 (the Notes ), of which $50.0 million principal amount accrue interest at a floating rate equal to three-month LIBOR plus 3.05% and $50.0 million principal amount accrue interest at a fixed rate of 8.367%.

On April 29, 2004, UICI Capital Trust I (a Delaware statutory business trust, the 2004 Trust ) completed the private placement of $15.0 million aggregate issuance amount of floating rate trust preferred securities with an aggregate liquidation value of $15.0 million (the 2004 Trust Preferred Securities ). The 2004 Trust invested the $15.0 million proceeds from the sale of the 2004 Trust Preferred Securities, together with the proceeds from the issuance to the Company by the 2004 Trust of its floating rate common securities in the amount of $470,000 (the Common Securities and, collectively with the 2004 Trust Preferred Securities, the 2004 Trust Securities ), in an equivalent face amount of the Company s Floating Rate Junior Subordinated Notes due 2034 (the 2004 Notes ). The 2004 Notes will mature on April 29, 2034. The 2004 Notes accrue interest at a floating rate equal to three-month LIBOR plus 3.50%, payable quarterly.

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The following table sets forth detail of the Company s debt and interest expense:

| | Principal Amount at June 30, 2009 | Interest Expense Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|---|
| | | 2009 | 2008 | 2009 | 2008 |
| | | (In thousands) | | | |
| *2006 credit agreement*: | | | | | |
| Term loan | $ 362,500 | $ 4,060 | $ 5,168 | $ 9,020 | $ 10,593 |
| $75 Million revolver (non-use fee) | | 115 | 35 | 143 | 72 |
| *Trust preferred securities*: | | | | | |
| UICI Capital Trust I | 15,470 | 178 | 249 | 379 | 541 |
| HealthMarkets Capital Trust I | 51,550 | 555 | 762 | 1,191 | 1,766 |
| HealthMarkets Capital Trust II | 51,550 | 1,091 | 1,091 | 2,169 | 2,181 |
| *Other:* | | | | | |
| Other interest | | 788 | 1,054 | 1,566 | 2,096 |
| Amortization of financing fees | | 1,183 | 1,121 | 2,359 | 2,222 |
| Total | $ 481,070 | $ 7,970 | $ 9,480 | $ 16,827 | $ 19,471 |
| Student Loan Credit Facility | 81,000 | 214 | 942 | 866 | 2,123 |
| Total | $ 562,070 | $ 8,184 | $ 10,422 | $ 17,693 | $ 21,594 |

The fair value of the Company s long-term debt was $388.8 million and $317.4 million at June 30, 2009 and December 31, 2008, respectively. The fair value of such long-term debt is estimated using discounted cash flow analyses, based on the Company s current incremental borrowing rates for similar types of borrowing arrangements.

*Student Loan Credit Facility*

At June 30, 2009 and December 31, 2008, the Company had an aggregate of $81.0 million and $86.1 million, respectively, of indebtedness outstanding under a secured student loan credit facility (the Student Loan Credit Facility ), which indebtedness is represented by Student Loan Asset-Backed Notes issued by a bankruptcy-remote special purpose entity (the SPE Notes ). At June 30, 2009 and December 31, 2008, indebtedness outstanding under the Student Loan Credit Facility was secured by alternative (*i.e.,* non-federally guaranteed) student loans and accrued interest in the carrying amount of $75.8 million and $80.5 million, respectively, and by a pledge of cash, cash equivalents and other qualified investments of $5.3 million and $5.9 million, respectively.

The SPE Notes represent obligations solely of the SPE, and not of the Company or any other subsidiary of the Company. For financial reporting and accounting purposes, the Student Loan Credit Facility has been classified as a financing as opposed to a sale. Accordingly, in connection with the financing, the Company recorded no gain on sale of the assets transferred to the SPE.

The SPE Notes were issued by the SPE in three tranches ($50.0 million of Series 2001A-1 Notes (the Series 2001A -1 Notes ) and $50.0 million of Series 2001A-2 Notes (the Series 2001A-2 Notes ) issued on April 27, 2001, and $50.0 million of Series 2002A Notes (the Series 2002A Notes ) issued on April 10, 2002). The interest rate on each series of SPE Notes resets monthly in a Dutch auction process. The Series 2001A-1 Notes and Series 2001A-2 Notes have a final stated maturity of July 1, 2036; the Series 2002A Notes have a final stated maturity of July 1, 2037. Beginning July 1, 2005, the SPE Notes were also subject to mandatory redemption in whole or in part on each interest payment date from any monies received as a recovery of the principal amount of any student loan securing payment of the SPE Notes, including scheduled, delinquent and advance payments, payouts or prepayments. During the three and six months ended June 30, 2009, the Company made principal payments of approximately $2.8 million and

$5.1 million, respectively, and during the three and six months ended June 30, 2008, the Company made principal payments of approximately $4.3 million and $7.1 million, respectively, on the SPE notes.

**6. DERIVATIVES**

HealthMarkets uses derivative instruments, specifically interest rate swaps, as part of its risk management activities to protect against the risk of changes in prevailing interest rates adversely affecting future cash flows associated with certain debt. The Company accounts for such interest rate swaps in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. These swap agreements are designed as hedging instruments and the Company formally documents qualifying hedged transactions and hedging instruments, and assesses, both at inception of the contract and on an ongoing basis, whether the hedging instruments are effective in offsetting changes in cash flows of the hedged transaction. The Company uses regression analysis to assess the hedge effectiveness in achieving the offsetting cash flows attributable to the risk being hedged. In addition, the Company utilizes the hypothetical derivative methodology for the measurement of ineffectiveness. Derivative gains and losses not effective in hedging the expected cash flows will be recognized immediately in earnings. The fair values of the interest rate swaps are contained in Note 3 of Notes to

Consolidated Condensed Financial Statements. In assessing the fair value, the Company takes into consideration the current interest rates and the current creditworthiness of the counterparties, as well as the current creditworthiness of the Company, as applicable.

At June 30, 2009, the Company owned two interest rate swap agreements with an aggregate notional amount of $200 million. The terms of the swaps are 4 and 5 years beginning on April 11, 2006. Additionally, the Company owned a 3 year swap, which matured on April 11, 2009.

The Company employs control procedures to validate the reasonableness of valuation estimates obtained from a third party. The table below represents the fair values of the Company s derivative assets and liabilities as of June 30, 2009 and December 31, 2008:

| | Asset Derivatives | | | Liability Derivatives | | |
|---|---|---|---|---|---|---|
| | | June 30, 2009 | December 31, 2008 | | June 30, 2009 | December 31, 2008 |
| | | | (In thousands) | | | |
| | Balance Sheet Location | Fair Value | Fair Value | Balance Sheet Location | Fair Value | Fair Value |
| Derivatives designated as hedging instruments under SFAS No. 133 | | | | | | |
| Interest rate swaps | | $ | $ | Other liabilities | $ 11,511 | $ 13,538 |
| Total derivatives | | $ | $ | | $ 11,511 | $ 13,538 |

The tables below represent the effect of derivative instruments in hedging relationships under SFAS No. 133 on the Company s consolidated condensed statements of income (loss) for the three and six months ended June 30, 2009 and 2008:

**Derivative Instruments in Hedging Relationships Under SFAS No. 133 for the Three Months Ended June 30, 2009**

| | Amount of Gain (Loss) Recognized in OCI on | Location of Gain (Loss) from Accumulated OCI into Income (Effective | Amount of Interest Expense (Income) Reclassified from Accumulated OCI into Income | Location of (Gain) Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness | Amount of (Gain) Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from |
|---|---|---|---|---|---|

| | Derivative (Effective Portion) | | Portion) | (Expense) (Effective Portion) | | Testing) | Effectiveness Testing) | |
|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | | **2009** | **2008** | | **2009** | **2008** |
| | | | | **(In thousands)** | | | | |
| Interest rate swaps | $ (409) | $ 5,351 | Interest expense | $ 2,070 | $ 1,573 | Investment income | $ 178 | $ 190 |

**<u>Derivative Instruments in Hedging Relationships Under SFAS No. 133 for the Six Months Ended June 30, 2009</u>**

| | Amount of Gain (Loss) Recognized in OCI on Derivative(Effective Portion) | | Location of Gain (Loss) from Accumulated OCI into Income (Effective Portion) | Amount of Interest Expense (Income) Reclassified from Accumulated OCI into Income (Expense) (Effective Portion) | | Location of (Gain) Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of (Gain) Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | |
|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | | **2009** | **2008** | | **2009** | **2008** |
| | | | | **(In thousands)** | | | | |
| Interest rate swaps | $ (899) | $ (1,980) | Interest expense | $ 4,486 | $ 1,921 | Investment income | $ 394 | $ 376 |

HealthMarkets does not expect the ineffectiveness related to its hedging activity to be material to the Company s financial results in the future. There were no components of the derivative instruments that were excluded from the assessment of hedge effectiveness.

At June 30, 2009, accumulated other comprehensive income (loss) included a deferred after-tax net loss of $6.8 million related to the interest rate swaps of which $771,000 ($501,000 net of tax) is the remaining amount of loss associated with the previous terminated hedging relationship. This amount is expected to be reclassified into earnings in conjunction with the interest payments on the variable rate debt through April 2011, of which $509,000 is expected to be reclassified into earnings within the next twelve months.

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## 7. NET INCOME (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | (In thousands, except per share amounts) | | | |
| Income (loss) from continuing operations | $ 3,193 | $ (19,265) | $ 11,216 | $ (25,589) |
| Income (loss) from discontinued operations | 16 | 36 | 51 | 67 |
| Net income (loss) available to common shareholders | $ 3,209 | $ (19,229) | $ 11,267 | $ (25,522) |
| Weighted average shares outstanding, basic | 29,558 | 30,447 | 29,657 | 30,587 |
| Dilutive effect of stock options and other shares | 558 | | 584 | |
| Weighted average shares outstanding, dilutive | 30,116 | 30,447 | 30,241 | 30,587 |
| *Basic earnings (losses) per share*: | | | | |
| From continuing operations | $ 0.11 | $ (0.63) | $ 0.38 | $ (0.83) |
| From discontinued operations | 0.00 | 0.00 | 0.00 | 0.00 |
| Net income (loss) per share, basic | $ 0.11 | $ (0.63) | $ 0.38 | $ (0.83) |
| *Diluted earnings (losses) per share*: | | | | |
| From continuing operations | $ 0.11 | $ (0.63) | $ 0.37 | $ (0.83) |
| From discontinued operations | 0.00 | 0.00 | 0.00 | 0.00 |
| Net income (loss) per share, basic | $ 0.11 | $ (0.63) | $ 0.37 | $ (0.83) |

The common stock equivalents for the three and six months ended June 30, 2008 are excluded from the weighted average shares used to compute diluted net loss per share as they would be anti-dilutive to the per share calculation. The Company s diluted weighted average shares outstanding for the three and six months ended June 30, 2008 were 676,513 and 689,988, respectively.

## 8. COMMITMENTS AND CONTINGENCIES

*Leases*

During the second quarter of 2009, the Company recorded an impairment expense of approximately $1.7 million, which is included in Underwriting, acquisition and insurance expense on the consolidated condensed statement of income (loss) for the three and six months ended June 30, 2009, related to leased facilities which the Company no longer utilizes. These costs represent impairments of leasehold improvements as well as a provision for future remaining lease obligations. In accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, the provision recorded for lease obligations on the cease-use date was determined based on the fair value of the liability for costs that will continue to be incurred over the remaining term of the lease without economic benefit to the Company.

With respect to the facilities discussed above, at June 30, 2009 the Company had a liability of $992,000, which is included in Other liabilities on the consolidated condensed balance sheet. Payments toward the liability will continue through February 2013, which is the remaining term of the lease. Such liability is based on the future commitment, net of expected sublease income.

*Litigation Matters*

The Company is a party to various material legal proceedings, which are described in the Company s Annual Report on Form 10-K filed for the year ended December 31, 2008 under the caption "*Item 3. Legal Proceedings*. Except as discussed below, during the three month period covered by this Quarterly Report on Form 10-Q, the Company has not been named in any new material legal proceeding, and there have been no material developments in the previously reported legal proceedings.

***Litigation Matters***

As previously disclosed, HealthMarkets and Mid-West were named as defendants in an action filed on December 30, 2003 (*Montgomery v. UICI et al.*) in the Superior Court of the State of California, County of Los Angeles, Case No. BC308471. Plaintiff asserted statutory and common law causes of action for both monetary and injunctive relief based on a series of allegations concerning marketing and claims handling practices. On March 1, 2004, HealthMarkets and Mid-West removed the matter to the United States District Court for the Central District of California, Western Division. On May 11, 2004, the Judicial Panel on Multidistrict Litigation issued a transfer order transferring the *Montgomery* matter to the United States District Court for the Northern District of Texas for coordinated pretrial proceedings (*In re UICI*

*Association-Group Insurance Litigation,* MDL Docket No. 1578). On July 10, 2009, the parties settled this matter on terms that do not have a material adverse effect on the Company s consolidated financial condition and results of operations.

As previously disclosed, HealthMarkets and MEGA were named as defendants in an action filed on July 25, 2006 (*Christopher Closson, individually, and as Successor in interest to Kathy Closson, deceased v. HealthMarkets, MEGA, HealthMarkets Lead Marketing Group, National Association for the Self-Employed, et al.*) pending in the Superior Court for the County of Riverside, California, Case No. RIC453741. Plaintiff has alleged several causes of action, both individually and in his capacity as successor in interest to Kathy Closson, including intentional misrepresentation, fraud by concealment and promissory fraud. Plaintiff seeks injunctive relief, and general and punitive monetary damages in an unspecified amount. On April 14, 2009, the California Court of Appeals granted summary judgment in favor of MEGA and HealthMarkets Lead Marketing Group dismissing Mr. Closson s remaining individual claims. The California Supreme Court affirmed this holding on June 24, 2009. Mr. Closson s claims against MEGA and HealthMarkets Lead Marketing Group, in his capacity as successor in interest to Kathy Closson, remain pending.

As previously disclosed, MEGA was named as a defendant in an action filed on August 31, 2006 *(Tracy L. Dobbelaere and Robert Dobbelaere v. The MEGA Life and Health Insurance Company, et al.)* pending in the Circuit Court of Clinton County, Missouri, Cause No. 06CN-CV00618. Plaintiffs alleged several causes of action including negligence, negligent misrepresentation, intentional misrepresentation and loss of consortium and sought unspecified general and punitive damages, interest and attorney s fees. On July 7, 2009, the parties settled this matter on terms that do not have a material adverse effect on the Company s consolidated financial condition and results of operations.

As previously disclosed, Mid-West was named as a defendant in a putative class action filed on November 7, 2008 (*Cynthia Hrnyak, on behalf of herself and all others similarly situated v. Mid-West National Life Insurance Company of Tennessee*) pending in the United States District Court for the Northern District of Ohio, Case No. 1:08CV2642. Plaintiff alleged several causes of action, including breach of contract, unjust enrichment, violation of the Ohio Revised Code Annotated Section 3918.08 and bad faith, arising from the alleged failure to refund unearned premium on credit insurance policies issued by Mid-West in connection with automobile loans upon early termination of coverage. Plaintiff seeks an order certifying the suit as a nationwide class action, compensatory and punitive damages and injunctive relief. The parties have agreed on the terms of a proposed settlement. On June 24, 2009, the Court signed a preliminary order approving such terms; however, any final settlement of this matter is subject to a fairness hearing scheduled for November 23, 2009. The Company believes that any final settlement of this matter will be on terms that do not have a material adverse effect on the Company s consolidated financial condition and results of operations.

As previously disclosed, HealthMarkets is a party to three separate collective actions filed under the Federal Fair Labor Standards Act ( FLSA ) *(Sherrie Blair et al., v. Cornerstone America et al.*, filed on May 26, 2005 in the United States District Court for the Northern District of Texas, Fort Worth Division, Civil Action No. 4:04-CV-333-Y; *Norm Campbell et al., v. Cornerstone America et al.,* filed on May 26, 2005 in the United States District Court for the Northern District of Texas, Fort Worth Division, Civil Action No. 4:05-CV-334-Y; and *Joseph Hopkins et al., v. Cornerstone America et al.*, filed on May 26, 2005 in the United States District Court for the Northern District of Texas, Fort Worth Division, Civil Action No. 4:05-CV-332-Y). On December 9, 2005, the Court consolidated all of the actions and made the *Hopkins* suit the lead case. In each of the cases, plaintiffs, for themselves and on behalf of others similarly situated, seek to recover unpaid overtime wages alleged to be due under section 16(b) of the FLSA. The complaints allege that the named plaintiffs (consisting of former district sales leaders and regional sales leaders in the Cornerstone America independent agent hierarchy) were employees within the meaning of the FLSA and are therefore entitled, among other relief, to recover unpaid overtime wages under the terms of the FLSA. The parties filed motions for summary judgment on August 1, 2006. On March 30, 2007, the Court denied HealthMarkets and Mid-West s motion and granted the plaintiffs motion. On August 2, 2007, the District Court granted HealthMarkets and Mid-West s motion for interlocutory appeal but denied requests to stay the litigation. In September 2007, the United States Fifth Circuit Court of Appeals granted HealthMarkets and Mid-West s petition to hear the interlocutory appeal and, in October 2008, affirmed the trial court s ruling in favor of plaintiffs on the issue of their status as

employees under the FLSA and remanded the case to the trial court for further proceedings. On March 23, 2009, the United States Supreme Court denied HealthMarkets and Mid-West s petition for writ of certiorari. A court-approved notice to prospective participants in the collective action was mailed in April 2008, providing prospective participants with the ability to file opt-in elections. Discovery in this matter is ongoing. The Company is in the process of evaluating the impact that these matters may have on its relationships with agents. At present, it is unclear what effect these matters may have on the Company s consolidated financial condition and results of operations.

As previously disclosed, on October 23, 2006, MEGA was named as a defendant in an action filed by the Massachusetts Attorney General on behalf of the Commonwealth of Massachusetts (*Commonwealth of Massachusetts v. The MEGA Life and Health Insurance Company*),

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pending in the Superior Court of Suffolk County, Massachusetts, Case Number 06-4411. The Complaint was served on MEGA on or around January 19, 2007. Plaintiff has alleged that MEGA engaged in unfair and deceptive practices by issuing policies that contained exclusions of, or otherwise failed to cover, certain benefits mandated under Massachusetts law. In addition, plaintiff has alleged that MEGA violated Massachusetts laws that (i) require health insurance policies to provide coverage for outpatient contraceptive services to the extent the policies provide coverage for other outpatient services and (ii) limit exclusions of coverage for pre-existing conditions. On August 22, 2007, the Attorney General filed an amended complaint which added HealthMarkets and Mid-West as defendants in this action and broadened plaintiff s original allegations. The amended complaint includes allegations that the defendants engaged in unfair and deceptive trade practices and illegal association membership practices, imposed illegal waiting periods and restrictions on coverage of pre-existing conditions and failed to comply with Massachusetts law regarding mandatory benefits. Civil discovery has commenced and motions on various points of law and procedure have been filed by the parties. Defendants motion to dismiss the action on grounds of limits on the Attorney General s authority was denied on March 10, 2008 and defendants request for appeal was denied on May 9, 2008. The parties are actively engaged in discussions regarding a settlement of this matter and settlement discussions are expected to conclude shortly. The terms of any settlement are expected to include a material payment and a change in business practices expected to have a material adverse effect on the Company s ability to operate in the Commonwealth of Massachusetts.

The Company and its subsidiaries are parties to various other pending and threatened legal proceedings, claims, demands, disputes and other matters arising in the ordinary course of business, including some asserting significant liabilities arising from claims, demands, disputes and other matters with respect to insurance policies, relationships with agents, relationships with former or current employees and other matters. From time to time, some such matters, where appropriate, may be the subject of internal investigation by management, the Board of Directors, or a committee of the Board of Directors.

Given the expense and inherent risks and uncertainties of litigation, we regularly evaluate litigation matters pending against us, including those described in Note 16 of Notes to the Company s Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008, to determine if settlement of such matters would be in the best interests of the Company and its stockholders. The costs associated with any such settlement could be substantial and, in certain cases, could result in an earnings charge in any particular quarter in which we enter into a settlement agreement. Although we have recorded litigation reserves which represent our best estimate on probable losses, both known and incurred but not reported, our recorded reserves might prove to be inadequate to cover an adverse result or settlement for extraordinary matters. Therefore, costs associated with the various litigation matters to which we are subject and any earnings charge recorded in connection with a settlement agreement could have a material adverse effect on our consolidated results of operations in a period, depending on the results of our operations for the particular period.

*Regulatory Matters*

As previously disclosed, in December 2006, MEGA, Mid-West and Chesapeake (the Insurance Companies ) entered into a regulatory settlement agreement ( RSA ) with the Massachusetts Division of Insurance (the Division ) following two prior limited scope market conduct examinations, the first pertaining to operations, complaint handling, marketing and sales, certificate holder services, underwriting and rating, and the second pertaining to claims handling practices in small group health insurance. The Division has monitored the Insurance Companies activities and implementation of the RSA requirements and, in January 2009, commenced a re-examination of certain key provisions of the RSA. The Insurance Companies and the Division are actively engaged in discussions regarding a settlement that would resolve all outstanding matters stemming from the RSA, as well as all issues identified in subsequent reviews and/or re-examinations conducted through February 2009 and settlement discussions are expected to conclude shortly. The terms of any settlement are expected to include a material payment and a change in business practices expected to have a material adverse effect on the Company s ability to operate in the Commonwealth of Massachusetts.

The Company s insurance subsidiaries are subject to various other pending market conduct or other regulatory examinations, inquiries or proceedings arising in the ordinary course of business. As previously disclosed, these

matters include the multi-state market conduct examination of HealthMarkets principal insurance subsidiaries for the examination period January 1, 2000 through December 31, 2005. Reference is made to the discussion of these and other matters contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2008 under the caption Item 3 Legal Proceedings and in Note 16 of Notes to Consolidated Condensed Financial Statements included in such report. State insurance regulatory agencies have authority to levy significant fines and penalties and require remedial action resulting from findings made during the course of such matters. Market conduct or other regulatory examinations, inquiries or proceedings could result in, among other things, changes in business practices that require the Company to incur substantial costs. Such results, individually or in combination, could injure our reputation, cause negative publicity, adversely affect our debt and financial strength ratings, place us at a competitive disadvantage in marketing or administering our products or impair our ability to sell insurance policies or retain customers, thereby adversely affecting

our business, and potentially materially adversely affecting the results of operations in a period, depending on the results of operations for the particular period. Determination by regulatory authorities that we have engaged in improper conduct could also adversely affect our defense of various lawsuits.

**9. SEGMENT INFORMATION**

The Company operates three business segments, the Insurance segment, Corporate and Disposed Operations. The Insurance segment includes the Company s SEA Division, Medicare and Other Insurance. Corporate includes investment income not allocated to the Insurance segment, realized gains or losses, interest expense on corporate debt, the Company s Student Loans business, general expenses relating to corporate operations, variable non-cash stock-based compensation and operations that do not constitute reportable operating segments. Disposed Operations includes the former Life Insurance Division, former Star HRG Division and former Student Insurance Division.

Allocations of investment income and certain general expenses are based on a number of assumptions and estimates, and the business segments reported operating results would change if different allocation methods were applied. Certain assets are not individually identifiable by segment and, accordingly, have been allocated by formulas. Segment revenues include premiums and other policy charges and considerations, net investment income, fees and other income. Management does not allocate income taxes to segments. Transactions between reportable segments are accounted for under respective agreements, which provide for such transactions generally at cost.

Revenue from continuing operations, income (loss) from continuing operations before income taxes, and assets by operating segment are set forth in the tables below:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | (Dollars in thousands) | | | |
| ***Revenue from continuing operations:*** | | | | |
| Insurance: | | | | |
| Self-Employed Agency Division | $ 271,753 | $ 315,535 | $ 556,588 | $ 638,424 |
| Medicare Division | (13) | 29,916 | 1 | 46,018 |
| Other Insurance Division | 2,247 | 8,219 | 5,954 | 15,911 |
| Total Insurance | 273,987 | 353,670 | 562,543 | 700,353 |
| Corporate | 2,504 | 146 | 3,996 | 10,844 |
| Intersegment Eliminations | 36 | (44) | | (91) |
| Total revenue excluding disposed operations | 276,527 | 353,772 | 566,539 | 711,106 |
| Disposed Operations | 21 | 23,480 | 51 | 47,567 |
| Total revenue from continuing operations | $ 276,548 | $ 377,252 | $ 566,590 | $ 758,673 |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | (In thousands) | | (In thousands) | |
| ***Income (loss) from continuing operations before federal income taxes:*** | | | | |
| Insurance: | | | | |
| Self-Employed Agency Division | $ 31,162 | $ 18,450 | $ 64,450 | $ 30,745 |
| Medicare Division | (6,976) | (7,327) | (10,327) | (12,304) |
| Other Insurance Division | 1,718 | 3,169 | 2,414 | 4,241 |

| | | | | |
|---|---|---|---|---|
| Total Insurance | 25,904 | 14,292 | 56,537 | 22,682 |
| Corporate | (18,861) | (29,801) | (36,419) | (45,145) |
| Total operating income (loss) excluding disposed operations | 7,043 | (15,509 | | |