

HealthMarkets, Inc.
Form 10-Q
November 12, 2010

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

FORM 10-Q

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from _____ to _____.

Commission file number: 001-14953

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

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

**75-2044750
(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 No

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 (§232.405 of this chapter) during the preceding 1 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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.

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

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

On October 25, 2010, the registrant had 28,418,821 outstanding shares of Class A-1 Common Stock, \$.01 Par Value, and 2,738,252 outstanding shares of Class A-2 Common Stock, \$.01 Par Value.

HEALTHMARKETS, INC.
and Subsidiaries
Third Quarter 2010 Form 10-Q
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HEALTHMARKETS, INC.
and Subsidiaries
CONSOLIDATED CONDENSED BALANCE SHEETS
(In thousands, except per share data)

| | September 30, 2010 (Unaudited) | December 31, 2009 |
|-----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------|------------------------------|
| ASSETS | | |
| Investments: | | |
| Securities available for sale | | |
| Fixed maturities, at fair value (cost: 2010 \$706,319; 2009 \$742,630) | \$ 758,595 | \$ 756,180 |
| Equity securities, at fair value (cost: 2009 \$234) | | 234 |
| Trading securities, at fair value | | 9,893 |
| Short-term and other investments, at fair value (cost: 2010 \$315,303; 2009 \$370,676) | 316,921 | 371,534 |
| Total investments | 1,075,516 | 1,137,841 |
| Cash and cash equivalents | 10,066 | 17,406 |
| Student loan receivables | 61,916 | 69,911 |
| Restricted cash | 10,091 | 8,647 |
| Investment income due and accrued | 11,661 | 10,464 |
| Reinsurance recoverable ceded policy liabilities | 361,726 | 361,305 |
| Agent and other receivables | 25,863 | 26,390 |
| Deferred acquisition costs | 39,393 | 64,339 |
| Property and equipment, net of accumulated depreciation of \$145,103 and \$134,155 at September 30, 2010 and December 31, 2009, respectively) | 46,149 | 48,690 |
| Goodwill and other intangible assets | 83,655 | 85,973 |
| Recoverable federal income taxes | | 17,879 |
| Other assets | 21,747 | 22,653 |
| | \$ 1,747,783 | \$ 1,871,498 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Policy liabilities: | | |
| Future policy and contract benefits | \$ 456,011 | \$ 462,217 |
| Claims | 230,329 | 339,755 |
| Unearned premiums | 37,332 | 46,309 |
| Other policy liabilities | 7,711 | 8,247 |
| Accounts payable and accrued expenses | 44,807 | 65,692 |
| Other liabilities | 53,522 | 74,929 |
| Current and deferred federal income taxes | 65,050 | 51,978 |
| Debt | 553,420 | 481,070 |
| Student loan credit facility | 70,400 | 77,350 |
| Net liabilities of discontinued operations | 1,725 | 1,752 |
| | 1,520,307 | 1,609,299 |

Commitments and Contingencies (Note 10)

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, 28,418,821 issued and 28,418,821 outstanding at September 30, 2010; 27,608,371 issued and 27,608,371 outstanding at December 31, 2009.

Class A-2, par value \$0.01 per share authorized 20,000,000 shares, 4,026,104 issued and 2,759,289 outstanding at September 30, 2010; 4,026,104 issued and 2,565,874 outstanding at December 31, 2009

Additional paid-in capital

Accumulated other comprehensive income

Retained earnings

Treasury stock, at cost (-0- Class A-1 common shares and 1,266,815 Class A-2 common shares at September 30, 2010; -0- Class A-1 common shares and 1,460,230 Class A-2 common shares at December 31, 2009)

| | | |
|--|--------------|--------------|
| | 324 | 316 |
| | 54,228 | 42,342 |
| | 32,334 | 3,739 |
| | 161,571 | 246,427 |
| | (20,981) | (30,625) |
| | 227,476 | 262,199 |
| | \$ 1,747,783 | \$ 1,871,498 |

See Notes to Consolidated Condensed Financial Statements.

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

| | Three Months Ended | | Nine Months Ended | |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| REVENUE | | | | |
| Health premiums | \$ 176,736 | \$ 239,560 | \$ 571,423 | \$ 753,203 |
| Life premiums and other considerations | 380 | 487 | 1,529 | 1,829 |
| | 177,116 | 240,047 | 572,952 | 755,032 |
| Investment income | 9,729 | 10,873 | 31,840 | 32,224 |
| Commissions and other income | 18,838 | 15,064 | 49,377 | 47,841 |
| Total other-than-temporary impairment losses | (765) | | (765) | (4,078) |
| Portion of loss recognized in other comprehensive income (before taxes) | | | | |
| Net impairment losses recognized in earnings | (765) | | (765) | (4,078) |
| Realized gains, net | 1,225 | 795 | 3,866 | 2,350 |
| | 206,143 | 266,779 | 657,270 | 833,369 |
| BENEFITS AND EXPENSES | | | | |
| Benefits, claims, and settlement expenses | 57,605 | 126,042 | 279,353 | 435,721 |
| Underwriting, acquisition, and insurance expenses | 39,765 | 80,867 | 138,432 | 260,143 |
| Other expenses | 67,204 | 25,272 | 161,947 | 67,186 |
| Interest expense | 7,375 | 7,559 | 22,835 | 25,252 |
| | 171,949 | 239,740 | 602,567 | 788,302 |
| Income from continuing operations before income taxes | 34,194 | 27,039 | 54,703 | 45,067 |
| Federal income tax expense | 11,951 | 9,644 | 21,288 | 16,456 |
| Income from continuing operations | 22,243 | 17,395 | 33,415 | 28,611 |
| Income from discontinued operations, (net of income tax expense of \$6 and \$21 for the three and nine months ended September 30, 2010, respectively, and \$30 and \$57 for the three and nine months ended September 30, 2009, respectively) | 12 | 55 | 39 | 106 |
| Net income | \$ 22,255 | \$ 17,450 | \$ 33,454 | \$ 28,717 |

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| | | | | | | | | |
|-------------------------------------|----|------|----|------|----|------|----|------|
| Basic earnings per share: | | | | | | | | |
| Income from continuing operations | \$ | 0.75 | \$ | 0.59 | \$ | 1.13 | \$ | 0.97 |
| Income from discontinued operations | | 0.00 | | 0.00 | | 0.00 | | 0.00 |
| Net income per share, basic | \$ | 0.75 | \$ | 0.59 | \$ | 1.13 | \$ | 0.97 |
| Diluted earnings per share: | | | | | | | | |
| Income from continuing operations | \$ | 0.73 | \$ | 0.58 | \$ | 1.09 | \$ | 0.95 |
| Income from discontinued operations | | 0.00 | | 0.00 | | 0.00 | | 0.00 |
| Net income per share, diluted | \$ | 0.73 | \$ | 0.58 | \$ | 1.09 | \$ | 0.95 |

See Notes to Consolidated Condensed Financial Statements.

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

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Net income | \$ 22,255 | \$ 17,450 | \$ 33,454 | \$ 28,717 |
| Implementation effect upon adoption of ASC 320-10 | | | | 1,017 |
| Other comprehensive income: | | | | |
| Unrealized gains on securities available for sale arising during the period | 14,483 | 38,360 | 43,352 | 65,131 |
| Reclassification for investment (gains) losses included in net income | (1,225) | (809) | (3,866) | 2,221 |
| Other-than-temporary impairment losses recognized in OCI | | | | (1,565) |
| Effect on other comprehensive income from investment securities | 13,258 | 37,551 | 39,486 | 65,787 |
| Unrealized gains (losses) on derivatives used in cash flow hedging during the period | (217) | (1,137) | (683) | (2,036) |
| Reclassification adjustments included in net income | 1,217 | 2,380 | 5,190 | 7,260 |
| Effect on other comprehensive income from hedging activities | 1,000 | 1,243 | 4,507 | 5,224 |
| Other comprehensive income before tax | 14,258 | 38,794 | 43,993 | 71,011 |
| Income tax expense related to items of other comprehensive income | 4,990 | 13,579 | 15,398 | 24,856 |
| Other comprehensive income net of tax | 9,268 | 25,215 | 28,595 | 46,155 |
| Comprehensive income | \$ 31,523 | \$ 42,665 | \$ 62,049 | \$ 75,889 |

See Notes to Consolidated Condensed Financial Statements.

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

| | Nine Months Ended | |
|-----------------------------------------------------------------------------------------|--------------------------|-------------|
| | September 30, | |
| | 2010 | 2009 |
| Operating Activities: | | |
| Net income | \$ 33,454 | \$ 28,717 |
| Adjustments to reconcile net income to cash (used in) provided by operating activities: | | |
| Income from discontinued operations | (39) | (106) |
| Realized (gains) losses, net | (3,101) | 2,217 |
| Change in deferred income taxes | (7,087) | (681) |
| Depreciation and amortization | 17,096 | 22,962 |
| Amortization of prepaid monitoring fees | 11,250 | 9,375 |
| Equity based compensation expense | 10,642 | 5,250 |
| Other items, net | 9,891 | 9,732 |
| Changes in assets and liabilities: | | |
| Investment income due and accrued | (2,212) | 1,010 |
| Due premiums | 928 | 1,845 |
| Reinsurance recoverable ceded policy liabilities | (421) | 8,869 |
| Agent and other receivables | 1,553 | 7,476 |
| Deferred acquisition costs | 24,946 | 3,355 |
| Prepaid monitoring fees | (15,000) | (12,500) |
| Current income tax recoverable | 22,642 | 8,359 |
| Policy liabilities | (121,001) | (90,286) |
| Other liabilities and accrued expenses | (18,327) | (6,514) |
| Cash used in continuing operations | (34,786) | (920) |
| Cash (used in) provided by discontinued operations | 12 | (97) |
| Net cash used in operating activities | (34,774) | (1,017) |
| Investing Activities: | | |
| Student loan receivables | 6,565 | 4,763 |
| Securities available for sale | 120,863 | 59,069 |
| Short-term and other investments, net | 54,715 | (127,140) |
| Purchases of property and equipment | (8,459) | (2,170) |
| Proceeds from subsidiaries sold, net of cash disposed of \$437 in 2009 | | (440) |
| Intangible assets acquired | (297) | |
| Acquisitions net of cash acquired | 252 | |
| Change in restricted cash | 1,742 | 471 |
| Increase in agent receivables | (6,421) | (276) |
| Cash (used in) provided by continuing operations | 168,960 | (65,723) |

| | | |
|---------------------------------------------------------------------|-----------|-----------|
| Cash (used in) provided by discontinued operations | | |
| Net cash (used in) provided by investing activities | 168,960 | (65,723) |
| Financing Activities: | | |
| Repayment of student loan credit facility | (6,950) | (7,200) |
| Decrease in investment products | (4,144) | (4,410) |
| Change in cash overdraft | (7,055) | |
| Proceeds from shares issued to agent plans and other | 6,099 | 6,340 |
| Purchases of treasury stock | (8,675) | (18,279) |
| Dividends paid | (119,514) | |
| Excess tax reduction from equity based compensation | (1,287) | (1,478) |
| Cash used in continuing operations | (141,526) | (25,027) |
| Cash (used in) provided by discontinued operations | | |
| Net cash used in financing activities | (141,526) | (25,027) |
| Net change in cash and cash equivalents | (7,340) | (91,767) |
| Cash and cash equivalents at beginning of period | 17,406 | 100,339 |
| Cash and cash equivalents at end of period in continuing operations | \$ 10,066 | \$ 8,572 |
| Supplemental disclosures: | | |
| Income taxes paid | \$ 9,168 | \$ 13,505 |
| Interest paid | \$ 20,823 | \$ 29,142 |

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, statements of comprehensive income and statements of cash flows for the periods presented. The accompanying December 31, 2009 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 nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2010. We have evaluated subsequent events for recognition or disclosure through the date we filed this Form 10-Q with the Securities and Exchange Commission (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, 2009.

Concentrations

Through its Commercial Health Division (formerly the Self-Employed Agency Division), the Company's insurance subsidiaries provide health insurance products in 41 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 subsidiaries products are issued to members of various independent membership associations that act as the master policyholder for such products. In 2010, the two principal membership associations in the self-employed market through which the Company's health insurance products were made available were the Alliance for Affordable Services (AAS) and Americans for Financial Security (AFS). While the Company believes that its insurance subsidiaries are providing association group coverage in full compliance with applicable law, changes in the relationship with the membership associations and/or changes in the laws and regulations governing association group insurance could have a material adverse impact on the Company's financial condition and results of operations. During the nine months ended September 30, 2010, the Company issued approximately 39% and 12%, of its new policies through AAS and AFS, respectively. The remaining 49% were individual policies not issued through a membership association. In the third quarter the Company discontinued marketing its health insurance products in all but a limited number of states in which Insphere, a subsidiary, does not currently have access to third-party health insurance products. The Company will continue to focus its efforts on selling products underwritten by third-party carriers as well as marketing its own supplemental insurance products.

Additionally, during the nine months ended September 30, 2010, the Company generated approximately 56% of its health premium revenue from new and existing business from the following 10 states:

| | Percentage |
|---------------|------------|
| California | 14% |
| Texas | 7% |
| Florida | 6% |
| Massachusetts | 6% |
| Illinois | 5% |

| | |
|----------------|-----|
| Maine | 5% |
| Washington | 4% |
| North Carolina | 3% |
| Pennsylvania | 3% |
| Georgia | 3% |
| | 56% |

Table of Contents***2010 Change in Estimate Amortization of Intangible Assets***

On January 1, 2010, the Company re-evaluated the amortization period related to an intangible asset recorded in the Commercial Health Division. See Note 6 of Notes to Consolidated Condensed Financial Statements.

Reclassification

Certain amounts in the 2009 financial statements have been reclassified to conform to the 2010 financial statement presentation.

Recent Accounting Pronouncements

In October 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-26, *Financial Services Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)* providing guidance modifying the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal contracts. The guidance specifies that incremental direct costs of contract acquisition attributable to successful efforts should be included as deferred acquisition costs. The guidance also specifies that deferred acquisition costs include advertising costs only when the direct-response advertising accounting criteria are met. The new guidance is effective for reporting periods beginning after December 15, 2011 and should be applied prospectively, with retrospective application permitted. If application of the guidance would result in the capitalization of acquisition costs that had not previously been capitalized prior to adoption, the entity may elect not to capitalize those additional costs. The Company is in process of evaluating the impact of adoption on the Company's results of operations and financial position.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20). ASU 2010-20 provides enhanced disclosures related to the credit quality of financing receivables and the allowance for credit losses, and provides that new and existing disclosures should be disaggregated based on how an entity develops its allowance for credit losses and how it manages credit exposures. Under the provisions of ASU 2010-20, additional disclosures required for financing receivables include information regarding the aging of past due receivables, credit quality indicators, and modifications of financing receivables. The provisions of ASU 2010-20 are effective for periods ending after December 15, 2010, with the exception of the amendments to the rollforward of the allowance for credit losses and the disclosures about modifications which are effective for periods beginning after December 15, 2010. Comparative disclosures are required only for periods ending subsequent to initial adoption. The Company is currently assessing the effects of adopting the provisions of ASU 2010-20.

In April 2010, the FASB issued ASU No. 2010-15, *How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments*, (ASU 2010-15). ASU 2010-15 clarifies that insurance companies should not consider separate account interests held for the benefit of policy holders in an investment to be the insurer's interests and that the Company should not combine those interests with its general account interest in the same investment when assessing the investment for consolidation, unless the separate account interests are held for the benefit of a related party policy holder. Additionally, ASU provides guidance on how an insurer should consolidate an investment fund in situations in which the insurer concludes that consolidation is required. ASU 2010-15 is effective for interim and annual periods beginning after December 15, 2010. The Company does not anticipate that the adoption of ASU 2010-15 will have a material impact on the Company's financial position or results of operations.

During the third quarter of 2010, the Company adopted ASU No. 2010-11, *Derivatives and Hedging (Topic 815) Scope Exception Related to Embedded Credit Derivatives*, (ASU 2010-11). ASU 2010-11 clarifies the scope exception for embedded credit derivative features related to the transfer of credit risk in the form of subordination of one financial instrument to another. This standard also addresses how to determine which embedded credit derivative features, including those in collateralized debt obligations and synthetic collateralized debt obligations, are considered to be embedded derivatives that should not be analyzed for potential bifurcation and separate accounting. Implementation of this standard did not have a material impact on the Company's financial position or results of operations.

On January 1, 2010, the Company adopted ASU No. 2009-17, *Consolidations: Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (ASU 2009-17), which provides amendments to FASB

Accounting Standards Codification (ASC) Topic 810, *Consolidation*. ASU 2009-17 modifies financial reporting for variable interest entities (VIEs). Under this guidance, 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 when determining whether it must consolidate a VIE. Upon adoption, the Company determined that Grapevine Finance, LLC (Grapevine) is a VIE and, as such, the Company began consolidating the activities of Grapevine on January 1, 2010. See Note 5 of Notes to Consolidated Condensed Financial Statements.

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On January 1, 2010, the Company adopted ASU No. 2009-16, *Accounting for Transfers of Financial Assets and Servicing Assets and Liabilities* (ASU 2009-16), which provides amendments to FASB ASC Topic 860, *Transfers and Servicing* (ASC 860). ASU 2009-16 incorporates the amendments to SFAS No. 140 made by SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of SFAS No. 140*, into the FASB ASC. ASU 2009-16 provides greater transparency about transfers of financial assets and requires that all servicing assets and servicing liabilities be initially measured at fair value. Additionally, ASU 2009-16 eliminates the concept of a non-consolidated qualifying special-purpose entity (QSPE) and removes the exception from applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, to QSPEs. Upon adoption, the Company was no longer permitted to account for Grapevine as a QSPE, and instead was required to evaluate its activities under ASU 2009-17. See Note 5 of Notes to Consolidated Condensed Financial Statements.

During the first quarter of 2010, the Company adopted ASC Update 2009-12, *Fair Value Measurements and Disclosures Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)* (ASC 2009-12), which provides amendments to Subtopic 820, *Fair Value Measurements and Disclosures* (ASC 820), for the fair value measurement of investments in certain entities that calculate net asset value per share (or its equivalent). See Note 2 of Notes to Consolidated Condensed Financial Statements for additional disclosures required under ASC 2009-12.

During the first quarter of 2010, the Company adopted ASC Update 2010-06, *Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 amends ASC Subtopic 820-10 to require new disclosures around the transfers in and out of Level 1 and Level 2 and around activity in Level 3 fair value measurements. Such guidance also provides amendments to ASC 820 which clarifies existing disclosures on the level of disaggregation, inputs and valuation techniques. See Note 2 of Notes to Consolidated Condensed Financial Statements for additional fair value measurement disclosures.

In January 2010, the FASB issued ASC Update 2010-09, *Subsequent Events: Amendments to Certain Recognition and Disclosure Requirements* (ASU 2010-09), which amends ASC Topic 855, Subsequent Events. Such guidance requires an entity to evaluate subsequent events through the date that the financial statements are issued. ASU 2010-09 is effective for interim and annual periods ending after June 15, 2010. The Company had previously evaluated subsequent events through the date the financial statements are issued and will continue to do so under this guidance.

Impact on Medical Loss Ratio from Update of Completion Factors

The majority of the Company's claim liabilities are estimated using the developmental method, which involves the use of completion factors for most incurral months, supplemented with additional estimation techniques, such as loss ratio estimates, in the most recent incurral months. This method applies completion factors to claim payments in order to estimate the ultimate amount of the claim. These completion factors are derived from historical experience and are dependent on the incurred dates of the claim, as well as the dates a payment is made against the claim.

The loss ratio for the quarter reflects an update to the completion factors used at the end of the third quarter of 2010 to reflect more recent patterns of claim payments. Through September 2010, the Company has seen an ongoing decrease in the time period from incurral to payment of a claim, resulting in higher completion factors and lower reserves. In response to these trends, in the third quarter, the Company used more recent experience to develop the completion factors, resulting in a decrease in claim liabilities of \$30.6 million recognized during the three months ended September 30, 2010. The Company will continue to evaluate and update completion factors on an ongoing basis, as appropriate, and will evaluate the impact, if any, that Health Care Reform Legislation may have on the completion factors.

The decrease in loss ratio for the quarter also reflects the Company's refinement of a previously estimated claim liability, established in the fourth quarter of 2009, arising from a review of claim processing for state mandated benefits. As a result of this refinement, during the three months ended September 30, 2010, the Company recognized a decrease in claim liabilities of \$15.9 million.

2. FAIR VALUE MEASUREMENTS

In accordance with ASC 820, the Company categorizes its investments and certain other assets and liabilities recorded at fair value into a three-level fair value hierarchy as follows:

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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 which 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.

In accordance with ASC 820, 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 September 30, 2010, 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 \$202.4 million of

Corporate debt and other classified as Level 2, and \$1.0 million of Commercial-backed investments classified as Level 3. The Corporate debt and other investments classified as Level 2 noted above includes \$103.4 million of an investment grade corporate bond issued by UnitedHealth Group Inc. that was received as consideration for the sale of the Company's former Student Insurance Division in December 2006 and \$90.2 million of an investment grade corporate bond received from a unit of the CIGNA Corporation as consideration for the receipt of the former Star HRG assets (see Note 5 of Notes to Consolidated Condensed Financial Statements).

Table of Contents*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 at September 30, 2010 | | | | |
|---------------------------------------------------|-----------------------|----------------|----------------|--------------|
| | Level 1 | Level 2 | Level 3 | Total |
| | (In thousands) | | | |
| U.S. and U.S. Government agencies | \$ 4,650 | \$ 52,131 | \$ | \$ 56,781 |
| Corporate debt and other | | 407,775 | | 407,775 |
| Collateralized debt obligations | | | | |
| Residential-backed issued by agencies | | 79,548 | | 79,548 |
| Commercial-backed issued by agencies | | 8,718 | | 8,718 |
| Residential-backed | | 2,847 | | 2,847 |
| Commercial-backed | | 45,445 | 1,023 | 46,468 |
| Asset-backed | | 8,813 | | 8,813 |
| Municipals | | 147,645 | | 147,645 |
| Other invested assets ⁽¹⁾ | | | 1,645 | 1,645 |
| Short-term investments ⁽²⁾ | 292,641 | | | 292,641 |
| | \$ 297,291 | \$ 752,922 | \$ 2,668 | \$ 1,052,881 |

(1) Investments in entities that calculate net asset value per share

(2) Amount excludes \$22.6 million of short-term other investments which are not subject to fair value measurement.

| Liabilities at Fair Value at September 30, 2010 | | | | |
|--------------------------------------------------------|-----------------------|----------------|----------------|--------------|
| | Level 1 | Level 2 | Level 3 | Total |
| | (In thousands) | | | |
| Interest rate swaps | \$ | \$ 3,493 | \$ | \$ 3,493 |
| Agent and employee plans | | | 5,867 | 5,867 |
| | \$ | \$ 3,493 | \$ 5,867 | \$ 9,360 |

| Assets at Fair Value at December 31, 2009 | | | | |
|--------------------------------------------------|-----------------------|----------------|----------------|--------------|
| | Level 1 | Level 2 | Level 3 | Total |
| | (In thousands) | | | |
| U.S. and U.S. Government agencies | \$ 8,943 | \$ 40,847 | \$ | \$ 49,790 |
| Corporate debt and other | | 344,509 | | 344,509 |
| Collateralized debt obligations | | | 2,905 | 2,905 |
| Residential-backed issued by agencies | | 105,898 | | 105,898 |
| Commercial-backed issued by agencies | | 8,710 | | 8,710 |
| Residential-backed | | 3,882 | | 3,882 |
| Commercial-backed | | 44,715 | 1,297 | 46,012 |
| Asset-backed | | 15,337 | 465 | 15,802 |
| Municipals | | 171,434 | 7,238 | 178,672 |
| Trading securities | | | 9,893 | 9,893 |
| Put options ⁽¹⁾ | | | 657 | 657 |

| | | | | |
|-------------------------------------------------|------------|------------|-----------|--------------|
| Short-term and other investments ⁽²⁾ | 344,011 | 6,164 | 937 | 351,112 |
| | \$ 352,954 | \$ 741,496 | \$ 23,392 | \$ 1,117,842 |

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

(2) Amount excludes \$20.7 million of short-term other investments and equity securities which are not subject to fair value measurement.

| | Liabilities at Fair Value at December 31, 2009 | | | |
|--------------------------|-------------------------------------------------------|----------------|----------------|--------------|
| | Level 1 | Level 2 | Level 3 | Total |
| | (In thousands) | | | |
| Interest rate swaps | \$ | \$ 8,766 | \$ | \$ 8,766 |
| Agent and employee plans | | | 16,651 | 16,651 |
| | \$ | \$ 8,766 | \$ 16,651 | \$ 25,417 |

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 agency bonds, corporate bonds, mortgage-backed and asset-backed securities, and municipal securities and bonds.

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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. The fair values of the majority of non-U.S. treasury securities 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-backed and asset-backed securities, and municipal bonds.

The Company also holds a fixed income commercial asset-backed investment for which it estimates the fair value using an internal pricing matrix with some unobservable inputs that are significant to the valuation. Consequently, the lack of transparency in the inputs and availability of independent third party pricing information for this investment resulted in its fair value being classified within the Level 3 of the hierarchy. As of September 30, 2010, the fair value of such commercial asset-backed security which represents approximately 0.1% of the Company's total fixed income investments is reflected within the Level 3 of the fair value hierarchy.

Trading securities & Put Options

Prior to June 30, 2010, the Company held fixed income trading securities which consisted of auction rate securities, for which the fair value was determined based on unobservable inputs. Accordingly, the fair value of this asset was reflected within Level 3 of the fair value hierarchy.

The put options that the Company owned were directly related to agreements the Company entered into with UBS during 2008 to facilitate the repurchase of certain auction rate municipal securities. The options were carried at fair value, which was related to the fair value of the auction rate securities, and were recorded in *Other assets* on the consolidated condensed balance sheets. The Company accounted for such put options in accordance with ASC 320, *Investments - Debt and Equity Securities*, which provided 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 on an instrument by instrument basis.

During 2009, the Company redeemed \$4.6 million of its auction rate securities with UBS at par. At December 31, 2009, the Company held auction rate securities with a face value of \$10.6 million. These remaining auction rate securities were redeemed by UBS at par on June 30, 2010.

Other invested assets

The Company's other invested assets consist of one alternative investment that owns a portfolio of collateralized debt obligation equity investments managed by a third party management group. The Company calculates the fair market value of such investment using the net asset value per share, which is determined based on unobservable inputs. Accordingly, the fair value of this asset is reflected within Level 3 of the fair value hierarchy.

The Company has committed to fund \$5.0 million to such equity investment, of which the entire amount has been funded to date. There are no redemption opportunities, and the fund will terminate when the underlying collateralized debt obligation deals mature.

Short-term investments

The Company's short-term investments primarily consist of highly liquid money market funds, which are reflected within Level 1 of the fair value hierarchy.

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.

Table of Contents*Agent and Employee Stock Plans*

The Company accounts for its agent and certain 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 (see Note 11 of Notes to Consolidated Condensed Financial Statements). 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 nine months ended September 30, 2010.

Changes in Level 3 Assets and Liabilities Measured at Fair Value For The Three Months Ended September 30, 2010

| | Beginning Balance | Unrealized Gains or (Losses) | Purchases, Sales, Payments and Issuances, Net (In thousands) | Realized Gains or (Losses)(1) | Transfer in/(out) of Level 3, Net | Ending Balance |
|-------------------------------------------|------------------------------|---------------------------------------------|---------------------------------------------------------------------------------------------|----------------------------------------------|------------------------------------------------------|---------------------------|
| Assets | | | | | | |
| Collateralized debt obligations | \$ 2,202 | \$ (116) | \$ (1,541) | \$ (545) | \$ | \$ |
| Commercial-backed Asset-backed Municipals | 1,117 | (2) | (92) | | | 1,023 |
| Trading securities | | | | | | |
| Put options | | | | | | |
| Other invested assets | 1,522 | 123 | | | | 1,645 |
| | \$ 4,841 | \$ 5 | \$ (1,633) | \$ (545) | \$ | \$ 2,668 |
| Liabilities | | | | | | |
| Agent and employee stock plans | \$ 5,772 | \$ 25 | \$ 70 | \$ | \$ | \$ 5,867 |

Changes in Level 3 Assets and Liabilities Measured at Fair Value For The Nine Months Ended September 30, 2010

| | Beginning Balance | Unrealized Gains or (Losses) | Purchases, Sales, Payments and Issuances, Net (In thousands) | Realized Gains or (Losses)(1) | Transfer in/(out) of Level 3, Net | Ending Balance |
|---------------------------------|------------------------------|---------------------------------------------|---------------------------------------------------------------------------------------------|----------------------------------------------|------------------------------------------------------|---------------------------|
| Assets | | | | | | |
| Collateralized debt obligations | \$ 2,905 | \$ (835) | \$ (1,525) | \$ (545) | \$ | \$ |

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| | | | | | | | |
|-----------------------|-----------|--------|-------------|----------|----------|----|----------|
| Commercial-backed | 1,297 | (5) | (269) | | | | 1,023 |
| Asset-backed | 465 | | | (465) | | | |
| Municipals | 7,238 | 762 | (8,000) | | | | |
| Trading securities | 9,893 | 657 | (10,550) | | | | |
| Put options | 657 | (657) | | | | | |
| Other invested assets | 937 | 755 | (47) | | | | 1,645 |
| | \$ 23,392 | \$ 677 | \$ (20,391) | \$ (545) | \$ (465) | \$ | \$ 2,668 |

Liabilities

| | | | | | | | |
|--------------------------------|-----------|------------|------------|----|----|----|----------|
| Agent and employee stock plans | \$ 16,651 | \$ (3,441) | \$ (7,343) | \$ | \$ | \$ | \$ 5,867 |
|--------------------------------|-----------|------------|------------|----|----|----|----------|

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

During the three months ended September 30, 2010, there were sales and redemptions of Level 3 financial instruments in the amount of \$1.6 million, of which \$95,000 is classified as Commercial-backed, and \$1.5 million is classified as Collateralized Debt Obligations, in the table above. The Company had a net settlement gain of \$3,000 during the three months ended September 30, 2010, all of which is classified as Commercial-backed in the table above. The Company had no purchases and no issuances of Level 3 financial instruments during the third quarter of 2010.

During the nine months ended September 30, 2010, there were sales and redemptions of Level 3 financial instruments in the amount of \$20.4 million, of which \$1.5 million is classified as Collateralized Debt Obligations, \$280,000 is classified as Commercial-backed, \$8.0 million is classified as Municipals, and \$10.6 million is classified as Trading securities in the table above. The Company had a net settlement loss of \$(20,000) during the nine months ended September 30, 2010, of which \$(47,000) is classified as Other invested assets, \$16,000 is classified as Collateralized debt obligations and \$11,000 is classified as Commercial-backed in the table above. The Company had no purchases and no issuances of Level 3 financial instruments during the first nine months of 2010.

During the three months ended September 30, 2010, the Company did not transfer securities between Level 1, Level 2 and Level 3. During the nine months ended September 30, 2010, the Company transferred one security out of Level 3 to Level 2. Prior to 2010, the Company valued this security internally; however, during the first quarter of 2010, the security began being priced by a pricing service. Furthermore, the Company determined there were adequate observable inputs that were sufficient for pricing the security.

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

| | Beginning Balance | Unrealized Gains or (Losses) | Purchases, Sales, Payments and Issuances, Net In Thousands | Realized Losses(1) | Transfer in/(out) of Level 3, Net | Ending Balance |
|---------------------------------|------------------------------|---------------------------------------------|-------------------------------------------------------------------------------------------|-------------------------------|------------------------------------------------------|---------------------------|
| Assets | | | | | | |
| Collateralized debt obligations | \$ 2,563 | \$ 533 | \$ | \$ | \$ | \$ 3,096 |
| Commercial backed Asset backed | 1,424 | 52 | (88) | | | 1,388 |
| Municipals | 360 | 85 | | | | 445 |
| Trading securities | 7,301 | (31) | | | | 7,270 |
| Put options | 14,259 | (53) | (250) | | | 13,956 |
| Other invested assets | 741 | 53 | (66) | | | 794 |
| | 141 | 365 | | | | 440 |
| | \$ 26,789 | \$ 1,004 | \$ (404) | \$ | \$ | \$ 27,389 |
| Liabilities | | | | | | |
| Agent and employee stock plans | \$ 13,184 | \$ | \$ 1,798 | \$ | \$ | \$ 14,982 |

Changes in Level 3 Assets and Liabilities Measured at Fair Value for the Nine Months Ended September 30, 2009

| | Beginning Balance | Unrealized Gains or (Losses) | Purchases, Sales, Payments and Issuances, Net In Thousands | Realized Losses(1) | Transfer in/(out) of Level 3, Net | Ending Balance |
|---------------------------------|------------------------------|---------------------------------------------|-------------------------------------------------------------------------------------------|-------------------------------|------------------------------------------------------|---------------------------|
| Assets | | | | | | |
| Collateralized debt obligations | \$ 2,585 | \$ 1,906 | \$ | \$ (1,395) | \$ | \$ 3,096 |
| Commercial backed Asset backed | 1,494 | 149 | (255) | | | 1,388 |
| Municipals | 252 | 193 | | | | 445 |
| Trading securities | 6,539 | 731 | | | | 7,270 |
| Put options | 11,937 | 2,369 | (350) | | | 13,956 |
| Other invested assets | 3,163 | (2,369) | (294) | | | 794 |
| | 476 | 258 | | | | 440 |
| | \$ 26,446 | \$ 3,237 | \$ (899) | \$ (1,395) | \$ | \$ 27,389 |

Liabilities

| | | | | | |
|--------------------------------|-----------|----|------------|----|-----------|
| Agent and employee stock plans | \$ 18,158 | \$ | \$ (3,176) | \$ | \$ 14,982 |
|--------------------------------|-----------|----|------------|----|-----------|

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

During the three and nine months ended September 30, 2009, the Company had no purchases and no issuances of Level 3 financial instruments. Additionally, the Company did not transfer securities between Level 1, Level 2 and Level 3.

Investments not reported at fair value

Other investments 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.

3. INVESTMENTS

The Company's investments consist of the following at September 30, 2010 and December 31, 2009:

| | September 30, 2010 | December 31, 2009 |
|----------------------------------|-----------------------------------|------------------------------|
| | (In thousands) | |
| Securities available for sale | | |
| Fixed maturities | \$ 758,595 | \$ 756,180 |
| Equity securities | | 234 |
| Trading securities | | 9,893 |
| Short-term and other investments | 316,921 | 371,534 |
| Total investments | \$ 1,075,516 | \$ 1,137,841 |

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

| | September 30, 2010 | | | | |
|-----------------------------------------------------------------------|---------------------------|---------------------------------------|-----------------------------------------------------------|------------------------------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses (In thousands) | Non-credit Loss Recognized in OCI | Fair Value |
| U.S. and U.S. Government agencies | \$ 55,384 | \$ 1,403 | \$ (6) | \$ | \$ 56,781 |
| Collateralized debt obligations Residential-backed issued by agencies | 75,248 | 4,307 | (7) | | 79,548 |
| Commercial-backed issued by agencies | 8,150 | 568 | | | 8,718 |
| Residential-backed | 2,758 | 95 | (6) | | 2,847 |
| Commercial-backed | 43,918 | 2,550 | | | 46,468 |
| Asset-backed | 8,648 | 451 | (5) | (281) | 8,813 |
| Corporate bonds and municipals | 433,817 | 32,588 | (1,219) | | 465,186 |
| Other | 78,396 | 11,838 | | | 90,234 |
| Total fixed maturities | \$ 706,319 | \$ 53,800 | \$ (1,243) | \$ (281) | \$ 758,595 |

| | December 31, 2009 | | | | |
|-----------------------------------------------------------------------|---------------------------|---------------------------------------|-----------------------------------------------------------|------------------------------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses (In thousands) | Non-credit Loss Recognized in OCI | Fair Value |
| U.S. and U.S. Government agencies | \$ 48,600 | \$ 1,229 | \$ (39) | \$ | \$ 49,790 |
| Collateralized debt obligations Residential-backed issued by agencies | 2,070 | 990 | (155) | | 2,905 |
| Commercial-backed issued by agencies | 102,497 | 3,580 | (179) | | 105,898 |
| Commercial-backed issued by agencies | 8,337 | 373 | | | 8,710 |
| Residential-backed | 3,934 | 2 | (54) | | 3,882 |
| Commercial-backed | 45,054 | 998 | (40) | | 46,012 |
| Asset-backed | 16,176 | 306 | (399) | (281) | 15,802 |
| Corporate bonds and municipals | 509,862 | 14,626 | (6,474) | | 518,014 |
| Other | 6,100 | | (933) | | 5,167 |
| Total fixed maturities | \$ 742,630 | \$ 22,104 | \$ (8,273) | \$ (281) | \$ 756,180 |

The amortized cost and fair value of available for sale fixed maturities at September 30, 2010, 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.

| | September 30, 2010 | |
|---------------------------------------------|---------------------------|-------------------|
| | Amortized | |
| | Cost | Fair Value |
| | (In thousands) | |
| <i>Maturity:</i> | | |
| One year or less | \$ 36,460 | \$ 37,218 |
| Over 1 year through 5 years | 174,571 | 184,640 |
| Over 5 years through 10 years | 218,229 | 236,569 |
| Over 10 years | 138,337 | 153,774 |
| | 567,597 | 612,201 |
| Mortgage-backed and asset-backed securities | 138,722 | 146,394 |
| Total fixed maturities | \$ 706,319 | \$ 758,595 |

See Note 2 of Notes to Consolidated Condensed Financial Statements for additional disclosures on fair value measurements.

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

| | Three Months Ended | | Nine Months Ended | |
|----------------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| | (In thousands) | | | |
| Fixed maturities | \$ 8,559 | \$ 9,290 | \$ 27,160 | \$ 28,980 |
| Equity securities | | 19 | | 36 |
| Short-term and other investments | 390 | 273 | 1,866 | (937) |
| Agent receivables | 163 | 613 | 857 | 1,959 |
| Student loan interest income | 1,030 | 1,149 | 3,153 | 3,625 |
| | 10,142 | 11,344 | 33,036 | 33,663 |
| Less investment expenses | 413 | 471 | 1,196 | 1,439 |
| | \$ 9,729 | \$ 10,873 | \$ 31,840 | \$ 32,224 |

Table of Contents*Realized Gains and Losses*

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

Fixed maturities

Proceeds from the sale and call of investments in fixed maturities were \$32.0 million and \$109.7 million for the three and nine months ended September 30, 2010, respectively, and \$38.2 million and \$52.6 million for the three and nine months ended September 30, 2009, respectively. Proceeds from maturities, sinking and principal reductions amounted to \$8.8 million and \$38.5 million for the three and nine months ended September 30, 2010, respectively, and \$27.5 million and \$62.9 million for the three and nine months ended September 30, 2009, respectively. During the three and nine months ended September 30, 2010, the Company realized gross gains of \$1.2 million and \$3.9, respectively, on the sale and call of fixed maturity investments. During the three and nine months ended September 30, 2009, the Company realized gross gains of \$809,000 and \$1.9 million, respectively, on the sale and call of fixed maturity investments. The company realized no gross losses during the three and nine months ended September 30, 2010 and 2009 on the sale or call of fixed maturity investments.

Equity securities

The Company realized no gross gains on equity securities during the three and nine months ended September 30, 2010. The Company realized no gross losses for 3 months ended September 30, 2010 and a gross loss of \$4,000 for nine months ended September 30, 2010 on equity securities. The Company realized no gross gains and no gross losses on equity securities during the three and nine months ended September 30, 2009.

Trading securities and Put options

The Company accounted for certain municipal auction rate securities as trading securities. In 2008, the Company entered into an agreement with UBS to facilitate the repurchase of certain auction rate municipal securities. At such time, the Company received put options. Any gain or loss recognized on the trading securities was offset by the same gain or loss on the put options. During 2009, the Company redeemed \$4.6 million of its auction rate securities with UBS at par. At December 31, 2009, the Company held auction rate securities with a face value of \$10.6 million. The remaining auction rate securities were redeemed by UBS at par on June 30, 2010.

Other than temporary impairment (OTTI)

During the three and nine months ended September 30, 2010, the Company recognized an OTTI loss on one security in the amount of \$765,000. The Company recognized no OTTI losses during the three months ended September 30, 2009 and recognized \$4.1 million of OTTI losses during the nine months ended September 30, 2009 which were deemed to be other-than-temporary reductions. All of the 2010 and 2009 OTTI losses were attributable to credit losses and, as such, were recorded in *Net impairment losses recognized in earnings* on the consolidated condensed statement of income.

Set forth below is a summary of cumulative OTTI losses on debt securities held by the Company at September 30, 2010, a portion of which have been recognized in *Net impairment losses recognized in earnings* on the consolidated condensed statement of income and a portion of which have been recognized in *Accumulated other comprehensive income* on the consolidated condensed balance sheet:

| Cumulative OTTI | Additions for | Reductions | Cumulative |
|------------------------|----------------------|---------------------|-------------------------|
| credit losses | OTTI | for | OTTI |
| recognized for | securities | increases in | credit losses |
| securities | where | cash | recognized for |
| | credit losses | flows | securities still |
| | where no | expected to | recognized for |
| | credit losses | be collected | securities still |
| | were | that | recognized for |
| | recognized | are | securities still |
| | OTTI | recognized | securities still |
| | where | for | securities still |
| | credit losses | securities | securities still |
| | recognized | sold | securities still |

| still held at January 1, 2010 | recognized prior to January 1, 2010 | prior to January 1, 2010 (In thousands) | during the period (Realized) | over the remaining life of the security | held at September 30, 2010 |
|------------------------------------------|--------------------------------------------------------|------------------------------------------------------------|---------------------------------------------|--------------------------------------------------------------------|-------------------------------------------|
| \$ 12,670 | \$ 0 | \$ 765 | \$ (9,315) | \$ (16) | \$ 4,104 |

Table of Contents*Unrealized Gains and Losses**Fixed maturities*

Set forth below is a summary of gross unrealized losses in its fixed maturities as of September 30, 2010 and December 31, 2009:

| Description of Securities | Unrealized Loss | | September 30, 2010 | | Total | |
|-----------------------------------------------------------------------|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Less Than 12 Months | | 12 Months or Longer | | Fair Value | Unrealized Losses |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | |
| | | | | | | |
| U.S. and U.S. Government agencies | \$ 2,495 | \$ 6 | \$ | \$ | \$ 2,495 | \$ 6 |
| Collateralized debt obligations Residential-backed issued by agencies | 5,164 | 5 | 2,204 | 2 | 7,368 | 7 |
| Commercial-backed issued by agencies | | | 326 | 6 | 326 | 6 |
| Residential-backed Commercial-backed | | | 1,974 | 5 | 1,974 | 5 |
| Asset-backed | | | | | | |
| Corporate bonds and municipals | 2,177 | 18 | 27,698 | 1,201 | 29,875 | 1,219 |
| Other | | | | | | |
| Total | \$ 9,836 | \$ 29 | \$ 32,202 | \$ 1,214 | \$ 42,038 | \$ 1,243 |

| Description of Securities | Unrealized Loss | | December 31, 2009 | | Total | |
|-----------------------------------------------------------------------|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Less Than 12 Months | | 12 Months or Longer | | Fair Value | Unrealized Losses |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | |
| | | | | | | |
| U.S. and U.S. Government agencies | \$ 3,917 | \$ 39 | \$ | \$ | \$ 3,917 | \$ 39 |
| Collateralized debt obligations Residential-backed issued by agencies | | | 685 | 155 | 685 | 155 |
| Commercial-backed issued by agencies | 23,585 | 179 | | | 23,585 | 179 |
| Residential-backed | | | 3,128 | 54 | 3,128 | 54 |
| Commercial-backed | | | 7,887 | 40 | 7,887 | 40 |
| Asset-backed | 1,406 | 19 | 10,540 | 380 | 11,946 | 399 |
| Corporate bonds and municipals | 9,203 | 34 | 174,331 | 6,440 | 183,534 | 6,474 |
| Other | | | 5,167 | 933 | 5,167 | 933 |
| Total | \$ 38,111 | \$ 271 | \$ 201,738 | \$ 8,002 | \$ 239,849 | \$ 8,273 |

Unrealized Losses Less Than 12 Months

Of the \$29,000 in unrealized losses that had existed for less than twelve months at September 30, 2010, no security had an unrealized loss in excess of 10% of the security's cost.

Of the \$271,000 in unrealized losses that had existed for less than twelve months at December 31, 2009, no security had an unrealized loss in excess of 10% of the security's cost.

Unrealized Losses 12 Months or Longer

Of the \$1.2 million in unrealized losses that had existed for twelve months or longer at September 30, 2010, one security classified as Corporate bonds and municipals in the table above had an unrealized loss in excess of 10% of the security's cost. The amount of unrealized loss with respect to that security was \$540,000 at September 30, 2010.

Of the \$8.0 million in unrealized losses that had existed for twelve months or longer at December 31, 2009, eight securities had unrealized losses in excess of 10% of the security's cost, of which two were classified as Asset-backed securities, one was classified as Other, four were classified as Corporate bonds and municipals, and one was classified as Collateralized debt obligations in the table above. The amount of unrealized loss with respect to those securities was \$3.9 million at December 31, 2009, of which \$307,000 relates to Asset-backed securities, \$933,000 relates to

Other, \$2.5 million relates to Corporate bonds and municipals and \$155,000 relates to Collateralized debt obligations in the table above.

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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. was volatile during 2008; however, the Company has seen improved market conditions during 2009 and 2010, which are reflected in the decrease in unrealized losses, as well as a decrease in the number of securities with unrealized losses. 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, the Company 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 its cost basis, which may be at maturity of the security. Based on such review, the Company believes that, as of September 30, 2010, the unrealized loss in these investments is temporary.

It is at least reasonably probable that 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 and 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

The Company had no unrealized investment gains and no unrealized losses on equity securities during the three and nine months ended September 30, 2010. The Company had gross unrealized investment gains on equity securities of \$4,000 and \$1,000 during the three and nine months ended September 30, 2009, respectively.

4. STUDENT LOANS

Through its student loan funding vehicles, CFLD-I and UFC2, the Company holds alternative (i.e., non-federally guaranteed) student loans extended to students at selected colleges and universities. The Company's insurance subsidiaries previously offered an interest-sensitive whole life insurance product with a child term rider. The child term rider included a special provision under which private student loans to help fund the insured child's higher education could be made available, subject to the terms, conditions and qualifications of the policy and the child term rider. Pursuant to the terms of the child term rider, the making of any student loan is expressly conditioned on the availability of a guarantee for the loan at the time the loan is made. During 2003, the Company discontinued offering the child term rider; however, for policies previously issued, outstanding potential commitments to fund student loans extend through 2026.

In connection with the Company's exit from the Life Insurance Division business, HealthMarkets, LLC entered into Coinsurance Agreements with Wilton Reassurance Company or its affiliates (Wilton). In accordance with the terms of the Coinsurance 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 September 30, 2010, approximately \$1.9 million of student loans have been funded by Wilton.

Pursuant to a Private Loan Program Loan Origination and Sale Agreement (the Loan Origination Agreement), dated July 28, 2005, among Richland State Bank, Richland Loan Processing Center, LLC (collectively, Richland), UICI and UFC2, the student loans were originated by Richland. Once issued, UFC2 would purchase the loans from Richland and provide for the administration of the loans. On April 28, 2010, Richland gave written notice of its intent to terminate the Loan Origination Agreement and the agreement terminated effective July 28, 2010. The Company is attempting to find a replacement for Richland; however, there can be no assurance whether and when a new lender will be located. In addition, as discussed above, the making of any student loan is expressly conditioned on the availability of a guarantee for the loan, and there is no longer a guarantor for the student loan program. As a result, loans under the child term rider are not available at this time.

5. GRAPEVINE

On August 3, 2006, Grapevine Finance, LLC (Grapevine) was incorporated in the State of Delaware as a wholly owned subsidiary of HealthMarkets, LLC. On August 16, 2006, MEGA distributed and assigned to HealthMarkets, LLC, as a dividend in kind, a \$150.8 million note receivable from a unit of the CIGNA Corporation as consideration for the receipt of the former Star HRG assets (the CIGNA Note) and a related guaranty agreement pursuant to which

the CIGNA Corporation unconditionally guaranteed the payment when due of the CIGNA Note (the Guaranty Agreement). After receiving the assigned CIGNA Note and Guaranty Agreement from MEGA, HealthMarkets, LLC, assigned the CIGNA Note and Guaranty Agreement to Grapevine. On August 16, 2006, Grapevine issued \$72.4 million of its senior secured notes (the Grapevine Notes) to an institutional purchaser (see Note 7 of Notes to Consolidated Condensed Financial Statements). The net proceeds from the Grapevine Notes of \$71.9 million were distributed to HealthMarkets, LLC. On November 1, 2006, the Company s investment in Grapevine was reduced by the receipt of cash from Grapevine of \$72.4 million.

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Prior to January 1, 2010, the Company accounted for its investment in Grapevine under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS No. 140), which was codified into ASC 860. Under SFAS No. 140, the Company's investment in Grapevine was classified as a non-consolidated qualifying special-purpose entity (QSPE). As a QSPE, the Company did not consolidate the financial results of Grapevine and, instead, accounted for its residual interest in Grapevine as an investment in fixed maturity securities pursuant to EITF No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, which was codified into FASB ASC Topic 325 40, *Investments Other Beneficial Interests in Securitized Financial Assets* (ASC 325-40). The Company recorded its investment in Grapevine, at fair value, in Fixed maturities on the consolidated balance sheets.

On January 1, 2010, the Company adopted ASU 2009-16 (see Note 1 of Notes to Consolidated Condensed Financial Statements *Recent Accounting Pronouncements*). The Company performed an analysis to determine if Grapevine is a variable interest entity (VIE) and if so, whether or not the activities of Grapevine should be included in consolidation. During such analysis, the Company determined that HealthMarkets, LLC has the power to direct matters that most significantly impact the activities of the Grapevine, LLC and HealthMarkets, LLC has the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to Grapevine, LLC. After such analysis, the Company concluded that Grapevine is a VIE, and its activities should be included in consolidation. As such, the note receivable from CIGNA is recorded at fair value in Fixed maturities on the consolidated condensed balance sheet (see Note 3 of Notes to Consolidated Condensed Financial Statements) and the Grapevine notes are recorded in Debt on the consolidated condensed balance sheet (see Note 7 of Notes to Consolidated Condensed Financial Statements).

6. GOODWILL AND INTANGIBLES

Goodwill and other intangible assets by segment as of September 30, 2010 and December 31, 2009 are as follows:

| | September 30, 2010 | | | |
|----------------------------|---------------------------|----------------------------------------|-------------------------------------|------------|
| | Goodwill | Other Intangible Assets | Accumulated Amortization | Net |
| | (In thousands) | | | |
| Commercial Health Division | \$ 40,025 | \$ 16,620 | \$ (10,950) | \$ 45,695 |
| Inspire | | 38,663 | (1,062) | 37,601 |
| Disposed Operations | 359 | | | 359 |
| | \$ 40,384 | \$ 55,283 | \$ (12,012) | \$ 83,655 |

| | December 31, 2009 | | | |
|----------------------------|--------------------------|----------------------------------------|-------------------------------------|------------|
| | Goodwill | Other Intangible Assets | Accumulated Amortization | Net |
| | (In thousands) | | | |
| Commercial Health Division | \$ 40,025 | \$ 55,283 | \$ (9,694) | \$ 85,614 |
| Disposed Operations | 359 | | | 359 |
| | \$ 40,384 | \$ 55,283 | \$ (9,694) | \$ 85,973 |

Other intangible assets include the acquisition of the right to certain renewal commissions from Special Investment Risks, Ltd (SIR). Previously, SIR sold health insurance policies that were either issued by a third-party insurance company and coinsured by the Company, or policies that were issued directly by the Company. Effective January 1, 1997, the Company acquired the agency force of SIR, and in accordance with the terms of the asset sale agreement,

SIR retained the right to receive certain commissions and renewal commissions. On May 19, 2006, the Company and SIR entered into a termination agreement, pursuant to which SIR received an aggregate of \$47.5 million from the Company and all future commission payments owed to SIR under the asset sale agreement were discharged in full.

Intangible Asset Amortization 2010 Change in Estimate

On January 1, 2010, the Company transferred a portion of the intangible asset related to SIR from the Commercial Health Division to Insphere as a result of the reorganization of the Company's agent sales force and the launch of Insphere, with which these agents are now associated. At the time of such transfer, the Company re-evaluated the amortization periods recorded in both the Commercial Health Division and Insphere. Based on such evaluation, the Company determined that the portion related to Insphere should continue to be amortized through 2029. The Company also determined that due to the decrease in the number of health policies issued through the Commercial Health Division, the portion of the intangible asset that remains with the Commercial Health Division will be amortized over a remaining period of 60 months. These changes resulted in an increase in Underwriting, acquisition and insurance expenses on the consolidated condensed statement of income of \$315,000 and \$1.2 million for the three and nine months ended September 30, 2010, respectively.

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The Company recorded amortization expense associated with other intangible assets of \$696,000 and \$2.3 million for the three and nine months ended September 30, 2010, respectively.

Estimated amortization expense for the next five years and thereafter related to intangible assets is as follows:

| | Amortization Expense (In thousands) |
|------------|----------------------------------------------------|
| 2010 | \$ 640 |
| 2011 | 2,075 |
| 2012 | 1,690 |
| 2013 | 1,629 |
| 2014 | 1,794 |
| Thereafter | 31,399 |
| | \$ 39,227 |

7. DEBT

On April 5, 2006, 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 September 30, 2010, 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 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.

On August 16, 2006, Grapevine issued \$72.4 million of its senior secured notes (the Grapevine Notes) to an institutional purchaser. The net proceeds from the Grapevine Notes of \$71.9 million were distributed to HealthMarkets, LLC. The Grapevine Notes bear interest at an annual rate of 6.712%. The interest is to be paid semi-annually on January 15th and July 15th of each year beginning on January 15, 2007. The principal payment is due at maturity on July 15, 2021. The Grapevine Notes are collateralized by Grapevine's assets including the CIGNA Note. Grapevine services its debt primarily from cash receipts from the CIGNA Note. All cash receipts from the CIGNA Note are paid into a debt service coverage account maintained and held by an institutional trustee (the Grapevine Trustee) for the benefit of the holder of the Grapevine Notes. Pursuant to an indenture and direction notices from Grapevine, the Grapevine Trustee uses the proceeds in the debt service coverage account to (i) make interest payments on the Grapevine Notes, (ii) pay for certain Grapevine expenses and (iii) distribute cash to HealthMarkets, subject to

satisfaction of certain restricted payment tests.

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

| | Principal Amount at September 30, 2010 | Maturity Date | Interest Rate(a) | Interest Expense | | | |
|----------------------------------------|----------------------------------------------------|------------------|---------------------|----------------------------------------|----------|---------------------------------------|-----------|
| | | | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | | | | 2010 | 2009 | 2010 | 2009 |
| <i>2006 credit agreement:</i> | | | | | | | |
| Term loan | \$ 362,500 | 2012 | 1.528% | \$ 2,540 | \$ 3,737 | \$ 8,571 | \$ 12,757 |
| \$75 Million revolver (non-use fee) | | 2011 | | 70 | 92 | 210 | 235 |
| Grapevine Note | 72,350 | 2021 | 6.712% | 1,220 | | 3,632 | |
| <i>Trust preferred securities:</i> | | | | | | | |
| UICI Capital Trust I HealthMarkets | 15,470 | 2034 | 3.876% | 154 | 165 | 450 | 544 |
| Capital Trust I HealthMarkets | 51,550 | 2036 | 3.342% | 467 | 478 | 1,330 | 1,668 |
| Capital Trust II | 51,550 | 2036 | 8.367% | 1,102 | 1,102 | 3,271 | 3,271 |
| <i>Other:</i> | | | | | | | |
| Interest on Deferred Tax Gain | | | 4.000% | 536 | 790 | 1,591 | 2,357 |
| Amortization of financing fees | | | | 1,286 | 1,195 | 3,780 | 3,554 |
| Total | \$ 553,420 | (b) | 0.000%(c) | \$ 7,375 | \$ 7,559 | \$ 22,835 | \$ 24,386 |
| Student Loan Credit Facility | 70,400 | | | | | | 866 |
| Total | \$ 623,820 | | | \$ 7,375 | \$ 7,559 | \$ 22,835 | \$ 25,252 |

(a) Represents the interest rate September 30, 2010.

(b) 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 (see *Student Loan Credit Facility* discussion below).

(c) The interest rate on each series of SPE Notes resets monthly in a Dutch auction process.

The fair value of the Company's debt, exclusive of indebtedness outstanding under the secured student loan credit facility, was \$491.7 million and \$394.8 million at September 30, 2010 and December 31, 2009, respectively. The fair value of such debt is estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements. At September 30, 2010 and December 31, 2009, the carrying amount of outstanding indebtedness secured by student loans approximated the fair value, as interest rates on such indebtedness reset monthly.

Student Loan Credit Facility

At September 30, 2010 and December 31, 2009, the Company had an aggregate of \$70.4 million and \$77.4 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 September 30, 2010 and December 31, 2009, indebtedness outstanding under the Student Loan Credit Facility was secured by student loans and accrued interest in the carrying amount of \$63.1 million and \$70.8 million, respectively, and by a pledge of cash, cash equivalents and other qualified investments of \$7.4 million and \$6.6 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), both 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 nine months ended September 30, 2010, the Company made principal payments of approximately \$2.1 million and \$7.0 million, respectively, on the SPE notes. During the three and nine months ended September 30, 2009, the Company made principal payments of approximately \$2.2 million and \$7.2 million, respectively, on the SPE notes.

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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 ASC Topic 815 *Derivatives and Hedging*. 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. In accordance with ASC 820, the fair values of the Company's interest rate swaps are also contained in Note 2 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 September 30, 2010, the Company owned one interest rate swap agreement with an aggregate notional amount of \$100 million. The terms of the swap agreement is 5 years beginning on April 11, 2006. The Company had a 4 year swap with an aggregate notional amount of \$100 million that matured on April 11, 2010.

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 September 30, 2010 and December 31, 2009:

| | Asset Derivatives | | | Liability Derivatives | | |
|--------------------------------------------------------------------|------------------------|-------------------------------|------------------------------|------------------------|-------------------------------|------------------------------|
| | Balance Sheet Location | September 30, 2010 Fair Value | December 31, 2009 Fair Value | Balance Sheet Location | September 30, 2010 Fair Value | December 31, 2009 Fair Value |
| Derivatives designated as hedging instruments under ASC Topic 815: | | | | | | |
| Interest rate swaps | | \$ | \$ | Other liabilities | \$ 3,493 | \$ 8,766 |
| Total derivatives | | \$ | \$ | | \$ 3,493 | \$ 8,766 |

The table below represents the effect of derivative instruments in hedging relationships under ASC Topic 815 on the Company's consolidated condensed statements of income for the three and nine months ended September 30, 2010 and 2009:

Derivative Instruments in Hedging Relationships for the Three Months Ended September 30, 2010 and 2009

| Location of Gain (Loss) from Accumulated | Amount of Interest Expense (Income) Reclassified from | Location of (Gain) Loss Recognized in |
|------------------------------------------|-------------------------------------------------------|---------------------------------------|
|------------------------------------------|-------------------------------------------------------|---------------------------------------|

| | Amount of Gain (Loss) | | OCI into Income (Effective Portion) | Accumulated OCI into Income (Expense) (Effective Portion) | | Income on Derivative (Ineffective Portion) | Amount of (Gain) Loss | |
|------------------------|----------------------------------------------------------------------|----------|-------------------------------------------------|--------------------------------------------------------------------|----------|--------------------------------------------------------|------------------------------------------------------------------------------|--------|
| | Recognized in OCI on Derivative (Effective Portion) 2010 | 2009 | | 2010 | 2009 | | Recognized in Income on Derivative (Ineffective Portion) 2010 | 2009 |
| Interest rate swaps | \$ 1,000 | \$ 1,243 | Interest Expense | \$ 1,153 | \$ 2,255 | Investment income | \$ 64 | \$ 125 |

**Derivative Instruments in Hedging Relationships for the Nine Months Ended September 30,
2010 and 2009**

| | Amount of Gain (Loss) | | 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) | Amount of (Gain) Loss | |
|------------------------|----------------------------------------------------------------------|----------|------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------|----------|----------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------|--------|
| | Recognized in OCI on Derivative (Effective Portion) 2010 | 2009 | | 2010 | 2009 | | Recognized in Income on Derivative (Ineffective Portion) 2010 | 2009 |
| Interest rate swaps | \$ 4,507 | \$ 5,224 | Interest Expense | \$ 4,868 | \$ 6,741 | Investment income | \$ 322 | \$ 519 |

During 2010 and 2009, the Company did not have any derivative instruments not designated as hedging instruments. 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.

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At September 30, 2010, accumulated other comprehensive income included a deferred after-tax net loss of \$1.7 million related to the interest rate swaps of which \$197,000 (\$129,000 net of tax) is the remaining amount of loss associated with the previous terminated hedging relationship. This amount is expected to be reclassified into Investment income on the Company's consolidated statement of income (loss) in conjunction with the interest payments on the variable rate debt through April 2011.

9. NET INCOME PER SHARE

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------------------|------------------------------------------|-----------|------------------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| | (In thousands, except per share amounts) | | | |
| Income from continuing operations | \$ 22,243 | \$ 17,395 | \$ 33,415 | \$ 28,611 |
| Income from discontinued operations | 12 | 55 | 39 | 106 |
| Net income available to common shareholders | \$ 22,255 | \$ 17,450 | \$ 33,454 | \$ 28,717 |
| Weighted average shares outstanding, basic | 29,815 | 29,424 | 29,702 | 29,582 |
| Dilutive effect of stock options and other shares | 808 | 648 | 889 | 601 |
| Weighted average shares outstanding, dilutive | 30,623 | 30,072 | 30,591 | 30,183 |
| <i>Basic earnings per share:</i> | | | | |
| From continuing operations | \$ 0.75 | \$ 0.59 | \$ 1.13 | \$ 0.97 |
| From discontinued operations | 0.00 | 0.00 | 0.00 | 0.00 |
| Net income per share, basic | \$ 0.75 | \$ 0.59 | \$ 1.13 | \$ 0.97 |
| <i>Diluted earnings per share:</i> | | | | |
| From continuing operations | \$ 0.73 | \$ 0.58 | \$ 1.09 | \$ 0.95 |
| From discontinued operations | 0.00 | 0.00 | 0.00 | 0.00 |
| Net income per share, basic | \$ 0.73 | \$ 0.58 | \$ 1.09 | \$ 0.95 |

10. COMMITMENTS AND CONTINGENCIES***Litigation and Regulatory Matters***

The Company is a party to various material proceedings, which are described in the Company's Annual Report on Form 10-K filed for the year ended December 31, 2009 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, Mid-West was named as a defendant in an action filed on January 9, 2009 (*Matthew Austen v. Mid-West National Life Insurance Company of Tennessee; Elizabeth Solomon*) in the Superior Court of Orange County, California, Case No. 30-2009 00117080. Plaintiff alleged bad faith, breach of contract, negligent misrepresentation, and intentional misrepresentation and sought unspecified economic, punitive, exemplary, and mental damages, costs, interest, and attorneys' fees. On June 1, 2009, the case was transferred on Mid-West's motion

for change of venue to Los Angeles County Superior Court (*Matthew Austen v. Mid-West National Life Insurance Company of Tennessee; Elizabeth Solomon*), Case No. LC086172. The parties settled this matter in connection with a mediation held on October 12, 2010 and this action has been dismissed.

As previously disclosed, on December 18, 2008, HealthMarkets and MEGA were named as defendants in a putative class action (*Jerry T. Hopkins, individually and on behalf all those others similarly situated v. HealthMarkets, Inc. et al.*) pending in the Superior Court of Los Angeles County, California, Case No. BC404133. Plaintiff alleges invasion of privacy in violation of California Penal Code § 630, et seq., negligence and the violation of common law privacy arising from allegations that the defendants monitored and/or recorded the telephone conversations of California residents without providing them with notice or obtaining their consent. Plaintiff seeks an order certifying the suit as a California class action and seeks compensatory and punitive damages. On December 3, 2009, plaintiff Jerry Hopkins was dismissed as the class plaintiff and Jerry Buszek was substituted in his place. On March 10, 2010, defendants motion for summary judgment was denied. On August 16, 2010, plaintiff filed a motion for class certification. Discovery is ongoing and no trial date has been set.

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As previously disclosed, MEGA was named as defendant in an action filed on April 13, 2009 (*Richard Doble and Rochelle Doble v. MEGA*) pending in the United States District Court, Northern District of California, Case No. CV 09-1611-CRB. Plaintiffs have alleged several causes of action, including breach of contract and breach of the implied covenant of good faith and fair dealing. Plaintiffs seek unspecified general and compensatory damages, punitive damages, damages for emotional distress and attorneys' fees. Discovery in this matter is ongoing and a jury trial is scheduled to begin in November of 2010.

MEGA was named as a defendant in an action filed on August 5, 2008 (*Robert Perry v. The MEGA Life and Health Insurance Company, et al.*) pending in the Superior Court of Maricopa County, Arizona, Case No. CV2008-018505. Plaintiff alleged several causes of action arising from a dispute regarding medical claims, including breach of contract, bad faith, false advertising, consumer fraud, professional negligence and negligent misrepresentation and sought unspecified actual, general, and punitive damages and attorneys' fees and costs. In connection with a mediation held on November 3, 2010, the parties reached an agreement in principle to settle this matter.

The Company believes that resolution of the above proceedings, after consideration of applicable reserves and/or potentially available insurance coverage benefits, did not (to the extent resolved) or will not (to the extent not already resolved) have a material adverse effect on the Company's consolidated financial condition and results of operations. 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 18 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, 2009, 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

Since October 2004, the Company has been engaged in discussions with the Office of the Insurance Commissioner of Washington State (the Washington DOI) in an effort to resolve issues with respect to the use of a policy form that was initially approved by the Office in 1997. As previously disclosed, on March 8, 2005, the Washington DOI issued a cease and desist order prohibiting MEGA from selling a previously approved health insurance product to consumers in the State of Washington. The Company voluntarily terminated the sale of similar products by Mid-West pending resolution of this matter with the Washington DOI. The Company's association group business in Washington that is individually underwritten is considered to be large group business for purposes of the state minimum loss ratio standard. The minimum loss ratio standard is currently 80%. As a result of these matters, the Company has determined that it might not be in a position to operate on a profitable basis in Washington State. In March 2010, the Company and the Washington DOI reached a preliminary agreement in principle that the Company would non-renew its health benefit plan policies and withdraw from the health benefit plan market place in the next several months, subject to further discussions between the parties regarding the implications of national health care reform. MEGA and Mid-West currently have over 9,000 certificate holders in the State of Washington. Following such further discussions between the parties, in May 2010, the Company proposed to maintain the status quo for the Company's in force block of business pending finalization of applicable regulations necessary to assess the impact of national health care reform. Discussion with the Washington DOI regarding the Company's proposal is ongoing.

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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 the Company's principal insurance subsidiaries for the examination period January 1, 2000 through December 31, 2005, which was resolved on May 29, 2008 through execution of a regulatory settlement agreement with the states of Washington and Alaska and four other monitoring states. The settlement agreement provides, among other things, for a re-examination by the monitoring states. If the re-examination is unfavorable, the Company's principal insurance subsidiaries are subject to additional penalties of up to \$10 million. 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, 2009 under the caption "Item 3 Legal Proceedings" and in Note 18 of Notes to Consolidated 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.

In March 2010, the Patient Protection and Affordable Care Act and a reconciliation measure, the Health Care and Education Reconciliation Act of 2010 (collectively, the "Health Care Reform Legislation") were signed into law. The Health Care Reform Legislation will result in broad-based material changes to the United States health care system. The Health Care Reform Legislation is expected to significantly impact the Company's financial conditions and results of operations, including but not limited to the minimum medical loss ratio requirements applicable to its insurance subsidiaries as well to third-party insurance carriers doing business with Insphere. Provisions of the Health Care Reform Legislation become effective at various dates over the next several years and a number of additional steps are required to implement these requirements, including, without limitation, further guidance and clarification in the form of implementing regulations. Due to the complexity of the Health Care Reform Legislation, the pending status of implementing regulations and lack of interpretive guidance, and gradual implementation, the full impact of Health Care Reform Legislation on the Company's business is not yet fully known. However, the Company has started to dedicate material resources and, in the future, expects to dedicate additional material resources and to incur material expenses to implement Health Care Reform Legislation and expects that certain elements of the Health Care Reform Legislation will have a material adverse effect on its financial condition and results of operations. For additional information, see Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations," National Health Care Reform discussion on beginning on page 29.

11. STOCKHOLDERS' EQUITY

The Company's Board of Directors determines the prevailing "fair market value" of the HealthMarkets' Class A-1 and A-2 common stock in good faith, considering factors it deems appropriate. Since the de-listing of the Company's stock in 2006, the Company has generally retained several independent investment firms to value its common stock on an annual basis, or more frequently if circumstances warrant. When setting the "fair market value" of the Company's common stock, the Board considers among other factors it deems appropriate, each independent investment firm's valuation for reasonableness in light of known and expected circumstances.

As of September 30, 2010, the "fair market value" of the Company's Class A-1 and Class A-2 common stock, as determined by the Board of Directors, was \$9.03.

12. SEGMENT INFORMATION

The Company operates four business segments: the Insurance segment, Insphere, Corporate, and Disposed Operations. The Insurance segment includes the Company's Commercial Health Division. Insphere includes net commission revenue, agent incentives, marketing costs and costs associated with the creation and development of Insphere. Corporate includes investment income not allocated to the Insurance segment, realized gains or losses, interest

expense on corporate debt, the Company's student loan business, general expenses relating to corporate operations and operations that do not constitute reportable operating segments. Disposed Operations includes the remaining run out of the Medicare Division and the Other Insurance Division as well as the residual operations from the disposition of other businesses prior to 2009.

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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, commission revenue, 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 from continuing operations before income taxes, and assets by operating segment are set forth in the tables below:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (In thousands) | | | |
| Revenue from continuing operations: | | | | |
| Insurance Commercial Health Division: | \$ 192,151 | \$ 259,625 | \$ 620,755 | \$ 816,213 |
| Insphere: | 11,511 | | 24,524 | |
| Corporate: | 4,762 | 5,001 | 17,173 | 8,997 |
| Intersegment Eliminations: | (3,027) | (516) | (7,116) | (516) |
| Total revenues excluding disposed operations | 205,397 | 264,110 | 655,336 | 824,694 |
| Disposed Operations: | 746 | 2,669 | 1,934 | 8,675 |
| Total revenue from continuing operations | \$ 206,143 | \$ 266,779 | \$ 657,270 | \$ 833,369 |

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (In thousands) | | | |
| Income (loss) from continuing operations before federal income taxes: | | | | |
| Insurance Commercial Health Division: | \$ 89,474 | \$ 44,494 | \$ 187,883 | \$ 108,944 |
| Insphere: | (23,341) | (3,842) | (69,862) | (3,842) |
| Corporate: | (33,088) | (16,744) | (65,326) | (53,163) |
| Total operating income excluding disposed operations | 33,045 | 23,908 | 52,695 | 51,939 |
| Disposed Operations | 1,149 | 3,131 | 2,008 | (6,872) |
| Total income from continuing operations before federal income taxes | \$ 34,194 | \$ 27,039 | \$ 54,703 | \$ 45,067 |

Assets by operating segment at September 30, 2010 and December 31, 2009 are set forth in the table below:

| | September 30, 2010 | December 31, 2009 |
|--|-----------------------------------|------------------------------|
| | (In thousands) | |

| | | |
|------------------------------------------------------|--------------|--------------|
| <i>Assets:</i> | | |
| Insurance Commercial Health Division: | \$ 527,577 | \$ 731,594 |
| Insphere: | 71,014 | 14,507 |
| Corporate: | 770,991 | 734,040 |
| Total assets excluding assets of Disposed Operations | 1,369,582 | 1,480,141 |
| Disposed Operations | 378,201 | 391,357 |
| Total assets | \$ 1,747,783 | \$ 1,871,498 |

Disposed Operations assets at September 30, 2010 and December 31, 2009 primarily represent reinsurance recoverable for the former Life Insurance Division of \$355.4 million and \$353.7 million, respectively, associated with the Coinsurance Agreements entered into with Wilton.

13. AGENT AND EMPLOYEE STOCK-BASED COMPENSATION PLANS

Stock Plan Awards

In September 2010, the Company granted 485,000 non-qualified stock option awards and 200,000 restricted stock awards under the Second Amended and Restated HealthMarkets 2006 Management Options Plan. Each of the awards vests in 20% increments over five years. The stock options have an exercise price equal to the fair market value per share at the date of grant. In connection with the granting of the stock option awards, certain individuals were required to forfeit all stock options previously granted to such individuals. In total, 20,400 previously granted stock options were forfeited, of which 3,055 stock options consisted of performance options with no established performance goals.

InVest Stock Ownership Plan

In connection with the reorganization of the Company's agent sales force into an independent career-agent distribution company, and the launch of Insphere, effective January 1, 2010, the series of stock accumulation plans established for the benefit of the independent contractor insurance agents and contractor sales representatives (the Predecessor Plans) were superseded and replaced by the HealthMarkets, Inc. InVest Stock Ownership Plan (ISOP). Eligible insurance agents and designated eligible employees may participate in the ISOP. Accounts under the Predecessor Plans were transferred to the ISOP. Several features of the ISOP differ in certain material respects from the Predecessor Plans, including, but not limited to, plan participation by designated eligible employees and the elimination of the reallocation of forfeited matching account credits after June 30, 2010.

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For financial reporting purposes, the Company accounts for the Company-match feature of the ISOP for nonemployee agents by recognizing compensation expense over the vesting period in an amount equal to the fair market value of vested shares at the date of their vesting and distribution to the agent-participant. The Company accounts for the Company-match feature of the ISOP for employees by recognizing compensation expense over the vesting period in an amount equal to the fair market value of each award at the date of grant, or, in the case of outstanding awards transferred from the Predecessor Plans, the fair market value at the date of employment. Expense on awards granted after January 1, 2010, is recognized on a straight-line basis based on the Company's policy adopted in 2006 for new plans effective after January 1, 2006. Expense on awards transferred from Predecessor Plans will continue to be recognized on a graded basis. Employee awards are equity-classified and changes in values and expense are offset to the Company's Additional Paid in Capital account on its balance sheet. Nonemployee awards are liability-classified and changes are reflected in the Other Liabilities on the balance sheet.

The liability, or cumulative paid-in capital, for matching credits is based on (i) the number of unvested credits, (ii) the prevailing fair market value of the Company's common stock as determined by the Company's Board of Directors and (iii) an estimate of the percentage of the vesting period that has elapsed.

The accounting treatment of matching credits for nonemployee agent-participants result in unpredictable stock-based compensation charges, dependent upon fluctuations in the fair market value of the Company's common stock, as determined by the Company's Board of Directors. In periods of decline in the fair market value of HealthMarkets common stock, the Company will recognize less stock-based compensation expense than in periods of appreciation. In addition, in circumstances where increases in the fair market value of the Company's common stock are followed by declines, negative stock-based compensation expense may result as the cumulative liability for unvested stock-based compensation expense is adjusted.

The Company recognized \$779,000 and \$355,000 of expense for the three and nine months ended September 30, 2010, respectively, in connection with the ISOP. The liability for nonemployee participation in the ISOP increased \$83,000 and decreased \$9.2 million for the three and nine months ended September 30, 2010, respectively. Approximately, \$6.9 million of the annual liability decrease is the result of vesting of awards and \$1.2 million of the decrease is related to the transfer to paid in capital in connection with agents becoming employees. Paid in capital for employee awards under the ISOP increased \$695,000 and \$2.6 million for the three and nine months ended September 30, 2010, respectively.

14. TRANSACTIONS WITH RELATED PARTIES

As of September 30, 2010, affiliates of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners (the Private Equity Investors) held 52.9%, 21.7%, and 10.8%, respectively, of the Company's outstanding equity securities. Certain members of the Board of Directors of the Company are affiliated with the Private Equity Investors.

Transactions with the Private Equity Investors***Transaction and Monitoring Fee Agreements***

Each of the Private Equity Investors provides to the Company ongoing monitoring, advisory and consulting services, for which the Company pays each of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners an annual monitoring fee. The annual monitoring fees are, in each case, subject to an upward adjustment in each year based on the ratio of the Company's consolidated earnings before interest, taxes, depreciation and amortization (EBITDA) in such year to consolidated EBITDA in the prior year, provided that the aggregate monitoring fees paid to all advisors pursuant to the Transaction and Monitoring Fee Agreements in any year shall not exceed the greater of \$15.0 million or 3% of consolidated EBITDA in such year. Of the aggregate annual monitoring fees of \$15.0 million for 2010, the Company paid \$12.5 million in January 2010, with \$7.7 million paid to The Blackstone Group, \$3.2 million paid to Goldman Sachs Capital Partners and \$1.6 million paid to DLJ Merchant Banking Partners. The remaining balance of \$2.5 million was paid on April 30, 2010, with \$1.5 million paid to the Blackstone Group, \$635,000 paid to Goldman Sachs Capital Partners and \$317,000 paid to DLJ Merchant Banking Partners. The Company has expensed \$11.3 million through September 30, 2010.

Table of Contents*Investment in Certain Funds Affiliated with the Private Equity Investors*

On April 20, 2007, the Company's Board of Directors approved a \$10.0 million investment by Mid-West in Goldman Sachs Real Estate Partners, L.P., a commercial real estate fund managed by an affiliate of Goldman Sachs Capital Partners. The Company has committed such investment to be funded over a series of capital calls. During 2009, the amount of the Company's original commitment was reduced by \$2.0 million, to \$8.0 million. During the second quarter of 2010, the amount of the Company's commitments was reduced by an additional \$1.6 million, to \$6.4 million. During the nine months ended September 30, 2010, the Company funded capital calls totaling \$1.2 million. As of September 30, 2010, the Company had made contributions totaling \$4.8 million, and had a remaining commitment to Goldman Sachs Real Estate Partners, L.P. of \$1.6 million.

On April 20, 2007, the Company's Board of Directors approved a \$10.0 million investment by MEGA in Blackstone Strategic Alliance Fund L.P., a hedge fund of funds managed by an affiliate of The Blackstone Group. The Company has committed such investment to be funded over a series of capital calls. During the three and nine months ended September 30, 2010, the Company funded capital calls totaling \$683,000 and \$1.6 million, respectively. As of September 30, 2010, the Company had made contributions totaling \$8.4 million; applied credits totaling \$700,000; and had a remaining commitment to The Blackstone Strategic Alliance Fund L.P. of \$900,000.

Other

From time to time, the Company may obtain goods or services from parties in which the Private Equity Investors hold an equity interest. For example, in 2010 and 2009, the Company held several events at a hotel in which an affiliate of The Blackstone Group holds an equity interest. During the three and nine months ended September 30, 2010, in connection with these events, the Company paid the hotel approximately \$421,000 and \$2.5 million, respectively. During the three and nine months ended September 30, 2009, in connection with these events, the Company paid the hotel approximately \$1.2 million and \$3.8 million, respectively. Employees of the Company traveling on business may also, from time to time, receive goods or services from entities in which the Private Equity Investors hold an equity interest.

15. INSPHERE SECURITIES, INC.

On April 13, 2010, the Company completed the acquisition of Beneficial Investment Services, Inc. (*BIS*), a broker-dealer and registered investment adviser, and changed *BIS*'s name to Insphere Securities, Inc. (*ISI*). The total cash consideration related to this acquisition was approximately \$1.6 million. *ISI* is a wholly owned subsidiary of Insphere.

On June 25, 2010, the Company determined that it would wind down the current business of *ISI* and related life agency sales offices located in Utah, Nevada and Arizona. After consideration of the expected costs of developing the recently acquired *ISI* business and the belief that the products and services available through *ISI* could be offered more efficiently to customers through contractual arrangements with third parties at an appropriate time in the future, the Company determined that a wind down of this business was necessary, and in the best interests of the Company. The Company intends to maintain operations at *ISI* as necessary for an orderly transition of customer accounts and completion of applicable business and regulatory requirements. The Company intends to have this action substantially completed in November 2010. In September, the Company filed Form *BDW* with the Financial Industry Regulatory Authority (*FINRA*) and the U.S. Securities and Exchange Commission and received notice that *ISI*'s request to withdraw as a broker/dealer was accepted and filed with *FINRA*'s Central Registration Depository system on September 3, 2010.

The Company estimates that the total pre-tax expense expected to be incurred in connection with this action will be approximately \$2.4 million, consisting of approximately \$700,000 in employee termination costs, approximately \$350,000 related to the write-down of fixed assets and intangible assets, and approximately \$1.4 million related to facility and operations termination costs. The Company has expensed \$2.3 million related to the wind down with approximately \$1.6 million expense recorded during the three months ended September 30, 2010.

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Cautionary Statements Regarding Forward-Looking Statements**

In this report, unless the context otherwise requires, the terms Company, HealthMarkets, we, us, or our refer to HealthMarkets, Inc. and its subsidiaries. This report and other documents or oral presentations prepared or delivered by and on behalf of the Company contain or may contain *forward-looking statements* within the meaning of the safe harbor provisions of the United States Private Securities Litigation Reform Act of 1995. Forward-looking statements are statements based upon management's expectations at the time such statements are made. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Forward-looking statements are subject to risks and uncertainties that could cause the Company's actual results to differ materially from those contemplated in the statements. Readers are cautioned not to place undue reliance on the forward-looking statements. All statements, other than statements of historical information provided or incorporated by reference herein, may be deemed to be forward-looking statements. Without limiting the foregoing, when used in written documents or oral presentations, the terms *anticipate, believe, estimate, expect, may, objective, plan, possible, potential, project, will* and similar expressions are intended to identify forward-looking statements. In addition to the assumptions and other factors referred to specifically in connection with such statements, factors that could impact the Company's business and financial prospects include, but are not limited to, those discussed in our Annual Report on Form 10-K for the year ended December 31, 2009 under the caption *Item 1 Business, Item 1A. Risk Factors* and *Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations* and those discussed from time to time in the Company's various filings with the Securities and Exchange Commission or in other publicly disseminated written documents.

Introduction

HealthMarkets, Inc. is a holding company, the principal asset of which is its investment in its wholly owned subsidiary, HealthMarkets, LLC. HealthMarkets, LLC's principal assets are its investments in its separate operating subsidiaries, including its regulated insurance subsidiaries. HealthMarkets conducts its insurance underwriting businesses through its indirect wholly owned insurance company subsidiaries, 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), and conducts its insurance distribution business through its indirect insurance agency subsidiary, Insphere Insurance Solutions, Inc. (Insphere)

Through our Commercial Health Division, we offer a broad range of health insurance products for individuals, families, the self-employed and small businesses. Our plans are designed to accommodate individual needs and include basic hospital-medical expense plans, plans with preferred provider organization features, catastrophic hospital expense plans, as well as other supplemental types of coverage. We market these products to the self-employed and individual markets through independent agents contracted with Insphere. Certain recent developments with respect to the sale of our health insurance plans are described below in the discussion of Health Insurance Product Sales.

During 2009, the Company formed Insphere, a Delaware corporation and a wholly owned subsidiary of HealthMarkets, LLC. Insphere is a distribution company that specializes in meeting the life, health, long-term care and retirement insurance needs of small businesses and middle-income individuals and families through its portfolio of products from nationally recognized insurance carriers. Insphere is an authorized agency in all 50 states and the District of Columbia. As of October 2010, Insphere had approximately 2,700 independent agents, of which approximately 1,800 on average write health insurance applications each month, and offices in over 35 states. Insphere distributes products underwritten by the Company's insurance company subsidiaries, as well as non-affiliated insurance companies. Insphere has completed marketing agreements with a number of non-affiliated life, health, long-term care and retirement insurance carriers, including, but not limited to, Aetna, Humana and UnitedHealthcare's Golden Rule Insurance Company for individual health insurance products, John Hancock for long-term care products, ING for term life, universal life and fixed annuity products and Minnesota Life Insurance Company for life and fixed annuity products. Insphere also has a marketing arrangement with an intermediary under which Insphere's agents

obtain access to certain disability income insurance products.

Reclassification

Certain amounts in the 2009 financial statements have been reclassified to conform to the 2010 financial statement presentation.

Table of Contents**Results of Operations**

The table below sets forth certain summary information about the Company's operating results for the three and nine months ended September 30, 2010 and 2009:

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------------------------------|-------------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| | (Dollars in thousands) | | | |
| REVENUE | | | | |
| Health premiums | \$ 176,736 | \$ 239,560 | \$ 571,423 | \$ 753,203 |
| Life premiums and other considerations | 380 | 487 | 1,529 | 1,829 |
| | 177,116 | 240,047 | 572,952 | 755,032 |
| Investment income | 9,729 | 10,873 | 31,840 | 32,224 |
| Other income | 18,838 | 15,064 | 49,377 | 47,841 |
| Other-than-temporary impairment losses | (765) | (765) | (765) | (4,078) |
| Realized gains, net | 1,225 | 795 | 3,866 | 2,350 |
| | 206,143 | 266,779 | 657,270 | 833,369 |
| BENEFITS AND EXPENSES | | | | |
| Benefits, claims, and settlement expenses | 57,605 | 126,042 | 279,353 | 435,721 |
| Underwriting, acquisition, and insurance expenses | 39,765 | 80,867 | 138,432 | 260,143 |
| Other expenses | 67,204 | 25,272 | 161,947 | 67,186 |
| Interest expense | 7,375 | 7,559 | 22,835 | 25,252 |
| | 171,949 | 239,740 | 602,567 | 788,302 |
| Income from continuing operations before income taxes | 34,194 | 27,039 | 54,703 | 45,067 |
| Federal income taxes | 11,951 | 9,644 | 21,288 | 16,456 |
| Income from continuing operations | 22,243 | 17,395 | 33,415 | 28,611 |
| Income from discontinued operations, net | 12 | 55 | 39 | 106 |
| Net income | \$ 22,255 | \$ 17,450 | \$ 33,454 | \$ 28,717 |

National Health Care Reform

In March 2010, the Patient Protection and Affordable Care Act and a reconciliation measure, the Health Care and Education Reconciliation Act of 2010 (collectively, the "Health Care Reform Legislation") were signed into law. The Health Care Reform Legislation will result in broad-based material changes to the United States health care system. The Health Care Reform Legislation is expected to significantly impact our financial conditions and results of operations, including but not limited to the minimum medical loss ratio requirements applicable to our insurance subsidiaries as well to third-party insurance carriers doing business with Insphere. Provisions of the Health Care Reform Legislation become effective at various dates over the next several years and a number of additional steps are required to implement these requirements, including, without limitation, further guidance and clarification in the form of implementing regulations. Due to the complexity of the Health Care Reform Legislation, the pending status of implementing regulations and lack of interpretive guidance, and gradual implementation, the full impact of Health Care Reform Legislation on our business is not yet fully known. However, we have started to dedicate material resources and, in the future, expect to dedicate additional material resources and to incur material expenses to

implement Health Care Reform Legislation.

While not all-inclusive, we are evaluating the following material provisions of the Health Care Reform Legislation to determine the impact that these provisions will have on our financial conditions and results of operations:

establishment of a minimum medical loss ratio of 80% for the individual and small group markets beginning in 2011, with rebates to customers required for medical loss ratio amounts under the minimum;

expansion of dependent coverage to include adult children up to age 26;

elimination of most annual and all lifetime caps on the dollar value of benefits; elimination of pre-existing condition exclusions;

requirements that limit the ability of health insurance providers to vary premium based on assessment of underlying risk;

establishment of specific benefit design requirements, rating and pricing limits, additional mandated benefits and guaranteed issue requirements;

creation of health insurance exchanges with standardized plans and guarantee issue of coverage for the individual and small group markets, which plans may be an attractive option for our existing customers and cause them to cancel their coverage with us;

prohibitions on certain policy rescissions;

significant annual taxes and/or assessments on health insurance providers which may not be deductible for income tax purposes;

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and limitation on the deductibility of executive compensation under Section 162(m) of the Internal Revenue Code for health insurance providers.

A number of these requirements could have a material adverse effect on our financial condition and results of operations. In addition, a number of state legislatures have enacted or are contemplating significant health insurance reforms, either in response to the Health Care Reform Legislation or independently (to the extent not addressed by federal legislation). The Health Care Reform Legislation, as well as state health insurance reforms, could increase our costs, require us to revise the way in which we conduct business, result in the elimination of certain products or business lines, lead to the lower revenues and expose us to an increased risk of liability. Any delay or failure to conform our business to the requirements of the Health Care Reform Legislation and state health insurance reforms could disrupt our operations, lead to regulatory issues, damage our relationship with existing customers and our reputation generally, adversely affect our ability to attract new customers and result in other adverse consequences.

With respect to the minimum loss ratio requirements effective beginning in 2011, we expect that a mandated minimum loss ratio of 80% for the individual and small group markets will have a material adverse impact on our financial condition and results of operations. Historically, the Company has experienced significantly lower medical loss ratios, has not been able to price premiums for its individual health insurance policies at this level and may not be able to operate profitably at an 80% minimum medical loss ratio. The 80% minimum medical loss ratio is subject to adjustment by HHS if HHS determines that the requirement is disruptive to the market. In addition, rules addressing certain material aspects of this requirement have not yet been established, including defining which expenses should be classified as medical and which should be classified as non-medical for purposes of the calculation, as well as which taxes, fees and assessment may be excluded from premium calculations. Subject to the outcome of final rulemaking, a minimum medical loss ratio at or near the 80% level could, at an appropriate time in the future, compel us to discontinue the underwriting and marketing of individual health insurance and/or to non-renew coverage of our existing individual health customers in one or more states pursuant to applicable state and federal requirements. This requirement may have a material adverse effect on the level of base commissions and override commissions that Insphere receives from third party insurance carriers. We believe that an 80% minimum medical loss ratio is significantly higher than the loss ratios historically experienced by the third party health insurance carriers doing business with Insphere. As a result, these carriers may reduce commissions, overrides and other administrative expenses in order to comply with the minimum loss ratio requirements. At this time, we are not able to project with certainty the extent to which the minimum medical loss ratio requirement will impact our revenues and results of operations, but the impact is expected to be material.

The Company's review of the requirements of the Health Care Reform Legislation described above, and its potential impact on the Company's health insurance product offerings, is ongoing. See discussion of Health Insurance Product Sales below.

Health Insurance Product Sales

The Company's review of the requirements of the Health Care Reform Legislation described above, and its potential impact on the Company's health insurance product offerings, is ongoing. In addition, the Company continuously evaluates the sale by Insphere of third party products underwritten by non-affiliated insurance carriers. In the states where such third party products are available, they have, to a great extent, replaced the sale of the Company's own health insurance products. In the first nine months of 2010, Insphere's sale of health insurance products underwritten by United Healthcare's Golden Rule Insurance Company and Aetna, in the aggregate, exceeded the sale of the Company's products by nearly a seven-to-one margin. As a result of this trend, in the second quarter of 2010, the Company determined that it would discontinue the sale of the Company's traditional scheduled benefit health insurance products and significantly reduce the number of states in which the Company will market all of its health insurance products in the future. After September 23, 2010, the effective date for many aspects of the Health Care Reform Legislation, the Company discontinued marketing its health insurance products in all but a limited number of states in which Insphere does not currently have access to third-party health insurance products. The Company expects to continue marketing and to place an increasing emphasis on its supplemental product portfolio, which is generally not subject to the Health Care Reform Legislation. This decision is not expected to affect the Company's in-force block of health insurance business. However, the Company intends to make all adjustments to such in-force business as may be required by the Health Care Reform Legislation or legislation that may be adopted in certain states (such as

California, Maine and Massachusetts) that could potentially require, in such states, benefit modifications in the Company's in-force block of health insurance business.

Table of Contents**Ratings**

The Company's principal insurance subsidiaries historically have been assigned financial strength ratings from A.M. Best Company (A.M. Best), Fitch Ratings (Fitch) and Standard & Poor's (S&P). These rating agencies have all assigned a credit or issuer default rating to HealthMarkets, Inc. In the second quarter of 2010, the Company requested that Fitch withdraw the insurer financial strength ratings of MEGA, Mid-West and Chesapeake and the issuer default rating of the HealthMarkets, Inc., and requested that S&P withdraw the counterparty credit and financial strength ratings of MEGA, Mid-West and Chesapeake and the counterparty credit rating of HealthMarkets, Inc. Fitch and S&P subsequently withdrew these ratings in accordance with the Company's request. The Company's request, which occurred after ratings downgrades by Fitch and S&P, reflects the growing emphasis which the Company places on the sale of third-party health insurance products underwritten by non-affiliated insurance carriers and the belief that ratings from three separate ratings agencies are not necessary to support the sale of health insurance products underwritten by the Company's principal insurance subsidiaries. The ratings of the Company and its principal insurance subsidiaries by A.M. Best have been maintained. In the second quarter of 2010, A.M. Best affirmed the financial strength ratings of MEGA, Mid-West and Chesapeake, and the issuer credit rating of HealthMarkets, as set forth below:

| | | |
|---------------------|---------------------------|--------------------|
| Mega | Financial Strength Rating | B++ (Good) |
| Mid-West | Financial Strength Rating | B++ (Good) |
| Chesapeake | Financial Strength Rating | B++ (Good) |
| HealthMarkets, Inc. | Issuer Credit Rating | bb (Speculative) |

The A.M. Best ratings above carry a negative outlook.

In evaluating a company, independent rating agencies review such factors as the company's capital adequacy, profitability, leverage and liquidity, book of business, quality and estimated market value of assets, adequacy of policy liabilities, experience and competency of management and operating profile. A.M. Best's financial strength ratings currently range from A++ (Superior) to F (In Liquidation). A.M. Best's ratings are based upon factors relevant to policyholders, agents, insurance brokers and intermediaries and are not directed to the protection of investors. A.M. Best's issuer credit rating is a current opinion of an obligor's ability to meet its senior obligations. A.M. Best's issuer credit ratings range from aaa (Exceptional) to rs (Regulatory Supervision/Liquidation).

Business Segments

The Company operates four business segments: the Insurance segment, Insphere, Corporate, and Disposed Operations. The Insurance segment includes the Company's Commercial Health Division (formerly the Self-Employed Agency Division). Insphere includes net commission revenue, agent incentives, marketing costs and costs associated with the creation and development of Insphere. Corporate includes investment income not allocated to the Insurance segment, realized gains or losses, interest expense on corporate debt, the Company's student loan business, general expenses relating to corporate operations and operations that do not constitute reportable operating segments. Disposed Operations includes the remaining run out of the former Medicare Division and the former Other Insurance Division as well as the residual operations from the disposition of other businesses prior to 2009.

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, commission revenue, 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 from continuing operations before income taxes, and assets by operating segment are set forth in the tables below:

| | |
|---------------------------|------------------------------------|
| Three Months Ended | Nine Months Ended September |
| September 30, | 30, |

| | 2010 | 2009 | 2010 | 2009 |
|---------------------------------------------------|----------------|----------------|----------------|----------------|
| | (In thousands) | | | |
| <i>Revenue from continuing operations:</i> | | | | |
| Insurance Commercial Health Division: | \$ 192,151 | \$ 259,625 | \$ 620,755 | \$ 816,213 |
| Insphere: | 11,511 | | 24,524 | |
| Corporate: | 4,762 | 5,001 | 17,173 | 8,997 |
| Intersegment Eliminations: | (3,027) | (516) | (7,116) | (516) |
| Total revenues excluding disposed operations | 205,397 | 264,110 | 655,336 | 824,694 |
| Disposed Operations: | 746 | 2,669 | 1,934 | 8,675 |
| Total revenue from continuing operations | \$ 206,143 | \$ 266,779 | \$ 657,270 | \$ 833,369 |

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| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------------------------------------------------------------|---------------------------------------------|---------------|--------------------------------------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (In thousands) | | | |
| <i>Income (loss) from continuing operations before federal income taxes:</i> | | | | |
| Insurance Commercial Health Division: | \$ 89,474 | \$ 44,494 | \$ 187,883 | \$ 108,944 |
| Insphere: | (23,341) | (3,842) | (69,862) | (3,842) |
| Corporate: | (33,088) | (16,744) | (65,326) | (53,163) |
| Total operating income excluding disposed operations | 33,045 | 23,908 | 52,695 | 51,939 |
| Disposed Operations | 1,149 | 3,131 | 2,008 | (6,872) |
| Total income from continuing operations before federal income taxes | \$ 34,194 | \$ 27,039 | \$ 54,703 | \$ 45,067 |

Commercial Health Division

Set forth below is certain summary financial and operating data for the Company's Commercial Health Division for the three and nine months ended September 30, 2010 and 2009:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------|---------------------------------------------|---------------|--------------------------------------------|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (Dollars in thousands) | | | |
| Revenue | | | | |
| Earned premium revenue | \$ 176,816 | \$ 237,937 | \$ 572,367 | \$ 748,468 |
| Investment income | 5,916 | 6,311 | 17,089 | 20,510 |
| Other income | 9,419 | 15,377 | 31,299 | 47,235 |
| Total revenue | 192,151 | 259,625 | 620,755 | 816,213 |
| Benefits and Expenses | | | | |
| Benefit expenses | 58,554 | 127,545 | 281,528 | 425,330 |
| Underwriting and policy acquisition expenses | 40,828 | 79,384 | 139,460 | 255,372 |
| Other expenses | 3,295 | 8,202 | 11,884 | 26,567 |
| Total expenses | 102,677 | 215,131 | 432,872 | 707,269 |
| Operating income | \$ 89,474 | \$ 44,494 | \$ 187,883 | \$ 108,944 |
| <i>Other operating data:</i> | | | | |
| Loss ratio | 33.1% | 53.6% | 49.2% | 56.8% |
| Expense ratio | 23.1% | 33.4% | 24.4% | 34.1% |
| Combined ratio | 56.2% | 87.0% | 73.6% | 90.9% |
| Submitted annualized volume | \$ 10,337 | \$ 75,633 | \$ 48,827 | \$ 277,864 |

Loss Ratio. The loss ratio is defined as benefits expense as a percentage of earned premium revenue.

Expense Ratio. The expense ratio is defined as underwriting, acquisition and insurance expenses as a percentage of earned premium revenue.

Submitted Annualized Volume. Submitted annualized premium volume in any period is the aggregate annualized premium amount associated with health insurance applications submitted by the Company's agents in such period for underwriting by the Company's insurance subsidiaries.

Three Months Ended September 30, 2010 versus 2009

The Commercial Health Division reported earned premium revenue of \$176.8 million during the three months ended September 30, 2010 compared to \$237.9 million in the corresponding period of 2009, a decrease of \$61.1 million or 26%, which is due to a decrease in policies in force. The decrease in policies in force reflects an attrition rate that exceeds the pace of new sales, and is evident in the reduction in submitted annualized premium volume for business written by the Company's insurance subsidiaries, from \$75.6 million in 2009 to \$10.3 million in 2010, due primarily to the distribution of products underwritten by non-affiliated carriers.

The Commercial Health Division reported operating income of \$89.5 million in 2010 compared to operating income of \$44.5 million in 2009, an increase of \$45.0 million or 101%. Operating income as a percentage of earned premium revenue (*i.e.*, operating margin) for 2010 was 50.6% compared to the operating margin of 18.7% in 2009, which is generally attributable to a decrease in the loss ratio, as discussed below, and a decrease in underwriting, acquisition and insurance expenses.

The loss ratio for the quarter reflects an update to the completion factors used at the end of the third quarter of 2010 to reflect more recent patterns of claim payments. The majority of the Company's claim liabilities are estimated using the developmental method, which involves the use of completion factors for most incurral months, supplemented with additional estimation techniques, such as loss ratio estimates, in the most recent incurral months. This method applies completion factors to claim payments in order to estimate the ultimate amount of the claim. These completion factors are derived from historical experience and are dependent on the incurred dates of the claim, as well as the dates a payment is made against the claim. Through September 2010, the Company has seen an ongoing decrease in the time period from incurral to payment of a claim, resulting in higher completion factors and lower reserves. In response to these trends, in the third quarter of 2010, the Company used more recent experience to develop the completion factors

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for the current reporting period, resulting in a decrease in claim liabilities of \$30.6 million recognized during the three months ended September 30, 2010. The Company will continue to evaluate and update completion factors on an ongoing basis, as appropriate, and will evaluate the impact (if any) that Health Care Reform Legislation may have on the completion factors. The decrease in loss ratio for the quarter also reflects the Company's refinement of a previously estimated claims liability, established in the fourth quarter of 2009, arising from a review of claim processing for state mandated benefits. As a result of this refinement, during the three months ended September 30, 2010, the Company recognized a decrease in claim liabilities of \$15.9 million. Excluding the adjustments for completion factors and the refinement described above, the loss ratio for the quarter would have been approximately 59.4%.

Underwriting, acquisition and insurance expenses decreased by \$38.6 million, or 49%, to \$40.8 million in 2010 from \$79.4 million in 2009. This decrease reflects the variable nature of commission expenses and premium taxes included in these amounts which generally vary in proportion to earned premium revenue. Beginning in the fourth quarter of 2008, we initiated certain cost reduction programs which are being reflected as a decrease in the expense ratio. Furthermore, due to the commencement of the sale of the third-party health insurance products underwritten by non-affiliated insurance carriers, the average policy duration of the existing HealthMarkets carriers' business has increased, which has caused a decrease in the overall effective commission rate. Generally, first year commission rates paid to agents are higher than renewal year commission rates.

Other income and other expenses both decreased in the current period compared to the prior year period. Other income largely consists of fee and other income received for sales of association memberships by our independent agent sales force for which other expenses are incurred for bonuses and other compensation provided to the agents. Sales of association memberships by our independent agent sales force tend to move in tandem with sales of health insurance policies; consequently, this decrease in other income and other expense is consistent with the decline in earned premium.

Nine Months Ended September 30, 2010 versus 2009

The Commercial Health Division reported earned premium revenue of \$572.4 million during the nine months ended September 30, 2010 compared to \$748.5 million in the corresponding period of 2009, a decrease of \$176.1 million or 23.6%, which is due to a decrease in policies in force. The decrease in policies in force reflects an attrition rate that exceeds the pace of new sales, and is evident in the reduction in submitted annualized premium volume for business written by the Company's insurance subsidiaries, from \$277.9 million in 2009 to \$48.8 million in 2010, due primarily to the distribution of products underwritten by non-affiliated carriers.

The Commercial Health Division reported operating income of \$187.9 million in 2010 compared to operating income of \$108.9 million in 2009, an increase of \$79.0 million or 72.5%. Operating margin for 2010 was 32.8% compared to the operating margin of 14.6% in 2009, which is generally attributable to a decrease in the loss ratio and a decrease in underwriting, acquisition and insurance expenses.

The loss ratio reflects an update to the completion factors used at the end of the third quarter of 2010 to reflect more recent patterns of claim payments. In response to these claim payment trends, in the third quarter of 2010, the Company used more recent experience to develop the completion factors, resulting in a decrease in claim liabilities of \$30.6 million recognized during the three months ended September 30, 2010. The decrease in loss ratio also reflects the Company's refinement of a previously estimated claims liability, established in the fourth quarter of 2009, arising from a review of claim processing for state mandated benefits. As a result of this refinement, during the nine months ended September 30, 2010, the Company recognized a decrease in claim liabilities of \$19.6 million. Excluding the adjustments for completion factors and the refinement described above, the loss ratio for the nine months ended September 30, 2010 would have been approximately 58.0%.

Underwriting, acquisition and insurance expenses decreased by \$115.9 million, or 45.5%, to \$139.5 million in 2010 from \$255.4 million in 2009. This decrease reflects the variable nature of commission expenses and premium taxes included in these amounts which generally vary in proportion to earned premium revenue. We initiated certain cost reduction programs beginning in the fourth quarter of 2008, which are being reflected as a decrease in the expense ratio. Furthermore, due to the commencement of the sale of the third-party health insurance products underwritten by non-affiliated insurance carriers, the average policy duration of the existing HealthMarkets carriers' business has increased, which has caused a decrease in the overall effective commission rate. Generally, first year commission rates

paid to agents are higher than renewal year commission rates.

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Other income and other expenses both decreased in the current period compared to the prior year period. Other income largely consists of fee and other income received for sales of association memberships by our independent agent sales force for which other expenses are incurred for bonuses and other compensation provided to the agents. Sales of association memberships by our independent agent sales force tend to move in tandem with sales of health insurance policies; consequently, this decrease in other income and other expense is consistent with the decline in earned premium.

Insphere

During the second quarter of 2009, we formed Insphere, an authorized insurance agency in 50 states and the District of Columbia specializing in small business and middle-income market life, health, long-term care and retirement insurance. Insphere distributes products underwritten by our insurance subsidiaries, as well as non-affiliated insurance companies.

Set forth below is certain summary financial and operating data for Insphere for the three and nine months ended September 30, 2010 and 2009:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (Dollars in thousands) | | | |
| Revenue | | | | |
| Commission revenue | \$ 10,014 | \$ | \$ 21,647 | \$ |
| Investment income | 139 | | 247 | |
| Other income | 1,358 | | 2,630 | |
| Total revenue | 11,511 | | 24,524 | |
| Expenses | | | | |
| Commission expenses | 6,166 | | 12,776 | |
| Agent incentives | 6,167 | 155 | 18,990 | 155 |
| Other expenses | 22,519 | 3,687 | 62,620 | 3,687 |
| Total expenses | 34,852 | 3,842 | 94,386 | 3,842 |
| Operating loss | \$ (23,341) | \$ (3,842) | \$ (69,862) | \$ (3,842) |

Three and Nine Months Ended September 30, 2010

Insphere generates revenue primarily from base commissions and override commissions received from insurance carriers whose policies are purchased through Insphere's independent agents. The commissions are typically based on a percentage of the premiums paid by insureds to the carrier. In some instances, Insphere also receives bonus payments for achieving certain sales volume thresholds. Insphere typically receives commission payments on a monthly basis for as long as a policy remains active. As a result, much of our revenue for a given financial reporting period relates to policies sold prior to the beginning of the period and is recurring in nature. Commission rates are dependent on a number of factors, including the type of insurance product and the particular insurance company underwriting the policy. During the three and nine months ended September 30, 2010, the Company earned commission revenue of approximately \$10.0 million and \$21.6 million, respectively, of which \$1.6 million and \$3.0 million were generated from the sale of insurance products underwritten by the Company's insurance subsidiaries.

For the three and nine months ended September 30, 2010, Insphere reported other expenses of \$22.5 million and \$62.6 million, respectively. Other expenses associated with Insphere are related to employee compensation, lead costs, costs associated with our new field offices and other expenses related to the continued development of Insphere.

During the three months ended September 30, 2010 the Company made the decision to consolidate some of its agent sales offices and therefore closed 22 leased facilities. During this period Insphere recorded a lease impairment charge

in the amount of \$1.2 million. Additionally, the Insphere business segment incurred costs during the quarter of \$961,000 (excluding lease impairments) for the wind-down of Insphere Securities, Inc. related to employee termination costs, write-down of fixed assets and intangible assets and operations termination costs. These charges are reflected in Other expenses in the table above.

Corporate

Corporate includes investment income not otherwise allocated to the Insurance segment, realized gains and losses on sales, interest expense on corporate debt, the Company's student loan business, general expense relating to corporate operations and operations that do not constitute reportable operating segments.

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Set forth below is a summary of the components of operating income (loss) at Corporate for the three and nine months ended September 30, 2010 and 2009:

| | Three Months Ended | | Nine Months Ended | |
|---------------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| | (In thousands) | | | |
| <i>Operating income (loss):</i> | | | | |
| Investment income on equity | \$ 3,220 | \$ 2,969 | \$ 10,737 | \$ 6,703 |
| Net investment impairment losses recognized in earnings | (765) | | (765) | (4,078) |
| Realized gains, net | 1,225 | 795 | 3,866 | 2,350 |
| Interest expense on corporate debt | (7,375) | (7,559) | (22,835) | (24,386) |
| Student loan operations | (64) | (279) | (185) | (258) |
| General corporate expenses and other | (29,329) | (12,670) | (56,144) | (33,494) |
| Operating loss | \$ (33,088) | \$ (16,744) | \$ (65,326) | \$ (53,163) |

Three Months Ended September 30, 2010 versus 2009

Corporate reported an operating loss in 2010 of \$33.1 million compared to \$16.7 million in 2009 for an overall increase in the operating loss of \$16.4 million. The change in operating loss is primarily due to the following items:

The Company recognized an impairment loss of \$765,000 on one of its investments during the three months ended September 30, 2010. The Company did not incur any investment impairments during the three months ended September 30, 2009. The impairment charge resulted from other than temporary reductions in the fair value of the investment compared to the cost basis.

General corporate expenses and other increased by \$16.7 million from the prior year. The increases in the expenses are primarily due to severance of \$4.9 million, acceleration of stock awards expense of \$8.4 and other compensation of \$1.9 million associated with the previously announced changes to the Company's executive management team.

Nine Months Ended September 30, 2010 versus 2009

Corporate reported an operating loss in 2010 of \$65.3 million compared to \$53.2 million in 2009 for an overall increase in operating loss of \$12.2 million. The change in operating loss is primarily due to the following items:

Investment income on equity increased by \$4.0 million due to additional investment income earned on the Company's equity method investments and the additional investment income of \$3.7 million recognized in 2010 from the consolidation of Grapevine into the Company's results of operations.

Net investment impairment losses recognized in earnings decreased by \$3.3 million during the nine months ended September 30, 2010 compared the prior year period. The Company recognized impairment losses of \$765,000 on other-than-temporary impairments on one security during the nine months ended September 30, 2010 compared to impairment losses of \$4.1 million on 3 securities during the same period in 2009. The impairment charges resulted from other than temporary reductions in the fair value of these investments compared to the cost basis (see Note 3 of Notes to Consolidated Condensed Financial Statements for additional information).

Interest expense on corporate debt decreased by \$1.6 million, from \$24.4 million during the nine months ended September 30, 2009, to \$22.8 million during the nine months ended September 30, 2010. This decrease is due to a lower interest rate environment in 2010 compared to 2009. However, partially offsetting this decrease was the additional interest expense of \$3.6 million incurred during 2010 associated with the debt related to Grapevine.

General corporate expenses and other increased by \$22.7 million from the prior year. The increases in the expenses are mainly due to an increase in employee termination cost of \$5.0 million as the Company continues to align the workforce to current business levels. In addition, the Company incurred an increase in the expense primarily due to severance and stock based compensation expenses of \$15.1 million associated with the previously announced changes to the Company's executive management team.

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The Company expects net investment income to decrease over the next eighteen months due to cash received from the maturity of higher yielding fixed income securities being reinvested into cash and short term investments to facilitate the repayment of the term loan maturing in 2012.

Disposed Operations

Our Disposed Operations segment includes our former Medicare Division and our former Other Insurance Division, as well as the disposition of other businesses prior to 2009.

The table below sets forth income (loss) for our Disposed Operations for the three and nine months ended September 30, 2010 and 2009:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------------------------------------------------|-------------------------------------|----------|------------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (In thousands) | | | |
| <i>Income (loss) from Disposed Operations before federal income taxes:</i> | | | | |
| Medicare Insurance Division | \$ 250 | \$ 2,584 | \$ 811 | \$ (7,743) |
| Other Insurance Division | 898 | 739 | 1,233 | 3,153 |
| Life Insurance Division | 13 | (191) | (33) | (2,458) |
| Other disposed operations | (12) | (1) | (3) | 176 |
| Total Disposed Operations | \$ 1,149 | \$ 3,131 | \$ 2,008 | \$ (6,872) |

Liquidity and Capital Resources**Consolidated Operations**

Historically, the Company's primary sources of cash on a consolidated basis have been premium revenue from policies issued, investment income, and fees and other income. The primary uses of cash have been payments for benefits, claims and commissions under those policies, servicing of the Company's debt obligations, and operating expenses.

The Company has entered into several financing agreements designed to strengthen both its capital base and liquidity, the most significant of which are described below. The following table also sets forth additional information with respect to the Company's debt:

| | Maturity Date | Interest Rate at September 30, 2010 | September 30, | December 31, |
|------------------------------------|------------------|-------------------------------------------|------------------|-----------------|
| | | | 2010 | 2009 |
| (In thousands) | | | | |
| <i>2006 credit agreement:</i> | | | | |
| Term loan | 2012 | 1.538%(a) | \$ 362,500 | \$ 362,500 |
| \$75 million revolver | | | | |
| Grapevine Note | 2021 | 6.712% | 72,350 | |
| <i>Trust preferred securities:</i> | | | | |
| UICI Capital Trust I | 2034 | 3.876%(a) | 15,470 | 15,470 |
| HealthMarkets Capital Trust I | 2036 | 3.342%(a) | 51,550 | 51,550 |
| HealthMarkets Capital Trust II | 2036 | 8.367%(a) | 51,550 | 51,550 |
| Total | | | \$ 553,420 | \$ 481,070 |
| Student Loan Credit Facility | (b) | 0.000%(c) | 70,400 | 77,350 |
| Total | | | \$ 623,820 | \$ 558,420 |

- (a) See Note 7 of Notes to Consolidated Condensed Financial Statements.
- (b) 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. See Note 7 of Notes to Consolidated Condensed Financial Statements.
- (c) The interest rate on each series of notes resets monthly in a Dutch auction process. See Note 7 of Notes to Consolidated Condensed Financial Statements for additional information on the Student Loan Credit Facility. In April 2006, the Company borrowed \$500.0 million under a term loan credit facility and issued \$100.0 million of Floating Rate Junior Subordinated Notes (see Note 7 of Notes to Consolidated Condensed Financial Statements). We regularly monitor our liquidity position, including cash levels, credit line, principal investment commitments, interest and principal payments on debt, capital expenditures and matters relating to liquidity and to compliance with regulatory requirements. We maintain a line of credit in excess of anticipated liquidity requirements. As of September 30, 2010, HealthMarkets had a \$75.0 million unused line of credit, of which \$67.9 million was available to the Company. The unavailable balance of \$7.1 million relates to letters of credit outstanding with the Company's insurance operations.

Table of Contents***Holding Company***

HealthMarkets, Inc. is a holding company, the principal asset of which is its investment in its wholly owned subsidiary, HealthMarkets, LLC (collectively referred to as the holding company). The holding company's ability to fund its cash requirements is largely dependent upon its ability to access cash, by means of dividends or other means, from its separate operating subsidiaries, including its regulated insurance subsidiaries and Insphere.

Domestic insurance companies require prior approval by insurance regulatory authorities for the payment of dividends that exceed certain limitations based on statutory surplus and net income. During 2010, based on the 2009 statutory net income and statutory capital and surplus levels, the Company's domestic insurance companies are eligible to pay, without prior approval of the regulatory authorities, aggregate dividends in the ordinary course of business to HealthMarkets, LLC of approximately \$97.9 million. During the second quarter of 2010, one of the Company's domestic insurance companies paid ordinary dividends totaling \$49.5 million leaving a remaining amount for ordinary dividends of \$48.4 million available on December 31, 2010.

As it has done in the past, the Company will continue to assess the results of operations of the regulated domestic insurance companies to determine the prudent dividend capability of the subsidiaries. This is consistent with our practice of maintaining risk-based capital ratios at each of our domestic insurance subsidiaries significantly in excess of minimum requirements.

HealthMarkets, LLC provides working capital to its wholly-owned subsidiary, Insphere, pursuant to a \$50 million Loan Agreement dated August 24, 2009. The Loan Agreement was amended on April 30, 2010, to increase the amount from \$50 million to \$100 million. As of September 30, 2010 and December 31, 2009, Insphere had an outstanding balance owed to HealthMarkets, LLC of \$69.2 million and \$19.6 million, respectively.

At September 30, 2010, HealthMarkets, Inc. and HealthMarket, LLC, in the aggregate, held cash and cash equivalents in the amount of \$125.7 million.

Contractual Obligations and Off Balance Sheet Arrangements

A summary of HealthMarkets' contractual obligations is included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. There have been no material changes in the Company's contractual obligations or off balance sheet commitments since December 31, 2009.

Critical Accounting Policies and Estimates

The Company's discussion and analysis of its financial condition and results of operations are based on its consolidated condensed financial statements, which have been prepared in accordance with United States generally accepted accounting principles. The preparation of these consolidated condensed financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to the valuation of assets and liabilities requiring fair value estimates, including investments and allowance for bad debts, the amount of health and life insurance claims and liabilities, the realization of deferred acquisition costs, the carrying value of goodwill and intangible assets, the amortization period of intangible assets, stock-based compensation plan forfeitures, the realization of deferred taxes, reserves for contingencies, including reserves for losses in connection with unresolved legal matters and other matters that affect the reported amounts and disclosure of contingencies in the financial statements. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Reference is made to the discussion of these critical accounting policies and estimates contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 under the caption *Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates*.

Impact on Medical Loss Ratio from Update of Completion Factors

The majority of the Company's claim liabilities are estimated using the developmental method, which involves the use of completion factors for most incurral months, supplemented with additional estimation techniques, such as loss ratio estimates, in the most recent incurral months. This method applies completion factors to claim payments in order to estimate the ultimate amount of the claim. These completion factors are derived from historical experience and are

dependent on the incurred dates of the claim, as well as the dates a payment is made against the claim.

The loss ratio for the quarter reflects an update to the completion factors used at the end of the third quarter of 2010 to reflect more recent patterns of claim payments. Through September 2010, the Company has seen an ongoing decrease in the time period from incurral to payment of a claim, resulting in higher completion factors and lower reserves. In response to these trends, in the third quarter, the Company used more recent experience to develop the completion factors, resulting in a decrease in claim liabilities of \$30.6 million recognized during the three months ended September 30, 2010. The Company will continue to evaluate and update completion factors on an ongoing basis, as appropriate, and will evaluate the impact, if any, that Health Care Reform Legislation may have on the completion factors.

The decrease in loss ratio for the quarter also reflects the Company's refinement of a previously estimated claim liability, established in the fourth quarter of 2009, arising from a review of claim processing for state mandated benefits. As a result of this refinement, during the three months ended September 30, 2010, the Company recognized a decrease in claim liabilities of \$15.9 million.

Amortization of Intangible Assets 2010 Change in Estimate

Other intangible assets include the acquisition of the right to certain renewal commissions from Special Investment Risks, Ltd (SIR). Previously, SIR sold health insurance policies that were either issued by a third-party insurance company and coinsured by the Company, or policies that were issued directly by the Company. Effective January 1, 1997, the Company acquired the agency force of SIR, and in accordance with the terms of the asset sale agreement, SIR retained the right to receive certain commissions and renewal commissions. On May 19, 2006, the Company and SIR entered into a termination agreement, pursuant to which SIR received an aggregate of \$47.5 million from the Company and all future commission payments owed to SIR under the asset sale agreement were discharged in full.

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On January 1, 2010, the Company transferred a portion of the intangible asset related to SIR from the Commercial Health Division to Insphere as a result of the reorganization of the Company's agent sales force and the launch of Insphere, with which these agents are now associated. At the time of such transfer, the Company re-evaluated the amortization periods recorded in both the Commercial Health Division and Insphere. Based on such evaluation, the Company determined that the portion related to Insphere should continue to be amortized through 2029. The Company also determined that due to the decrease in the number of health policies issued through the Commercial Health Division, the portion of the intangible asset that remains with the Commercial Health Division will be amortized over a remaining period of 60 months. These changes resulted in an increase in Underwriting, insurance and acquisition expense on the consolidated condensed statement of income of \$315,000 and \$1.2 million for the three and nine months ended September 30, 2010. The Company recorded amortization expense associated with other intangible assets of \$696,000 and \$2.3 million for the three and nine months ended September 30, 2010, respectively.

Student Loans

In connection with the Company's exit from the Life Insurance Division business, HealthMarkets, LLC entered into a definitive Stock Purchase Agreement (as amended, the Stock Purchase Agreement) pursuant to which Wilton Reassurance Company or its affiliates (Wilton) agreed to purchase the Company's student loan funding vehicles, CFLD-I, Inc. (CFLD-I) and UICI Funding Corp. 2 (UFC2), and the related student association. The Stock Purchase Agreement was terminated in 2009 and the closing of this transaction did not occur. In accordance with the terms of the Coinsurance 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 September 30, 2010, approximately \$1.9 million of student loans have been funded.

Regulatory and Legislative Matters

The business of insurance is primarily regulated by the states and is also affected by a range of legislative developments at the state and federal levels. Recently adopted legislation and regulations may have a significant impact on the Company's business and future results of operations. Reference is made to the discussion under the caption Business Regulatory and Legislative Matters in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. See Note 10 of Notes to Consolidated Condensed Financial Statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has not experienced significant changes related to its market risk exposures during the quarter ended September 30, 2010. Reference is made to the information contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 in Item 7A *Quantitative and Qualitative Disclosures about Market Risk*.

ITEM 4. CONTROLS AND PROCEDURES**Disclosure Controls and Procedures**

The Company maintains a set of disclosure controls and procedures designed to ensure that information required to be disclosed in reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. In addition, the disclosure controls and procedures ensure that information required to be disclosed is accumulated and communicated to management, including the principal executive officer and principal financial officer, allowing timely decisions regarding required disclosure. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Exchange Act. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

Table of Contents**Change in Internal Control over Financial Reporting**

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION**ITEM 1. LEGAL PROCEEDINGS**

The Company is a party to various material legal proceedings, which are described in Note 10 of Notes to Consolidated Condensed Financial Statements included herein and/or in the Company's Annual Report on Form 10-K filed for the year ended December 31, 2009 under the caption *Item 3. Legal Proceedings*. The Company and its subsidiaries are parties to various other pending legal proceedings arising in the ordinary course of business, including some asserting significant damages arising from claims under insurance policies, disputes with agents and other matters. Based in part upon the opinion of counsel as to the ultimate disposition of such lawsuits and claims, management believes that the liability, if any, resulting from the disposition of such proceedings, after consideration of applicable reserves and/or potentially available insurance coverage benefits, will not be material to the Company's consolidated financial condition or results of operations. Except as discussed in Note 10 of the Notes to Consolidated Condensed Financial Statements included herein, 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.

ITEM 1A. RISK FACTORS

Reference is made to the risk factors discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 in Part I, Item 1A. Risk Factors, as updated by our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 and the quarter ended June 30, 2010 (collectively the Quarterly Reports) which could materially affect the Company's business, financial condition or future results. The risks described in the Company's Annual Report on Form 10-K, as updated by the Quarterly Reports, are not the only risks the Company faces. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

The Company has not experienced material changes to the risk factors disclosed in its Annual Report on Form 10-K, as updated by the Quarterly Reports, except that we have modified the risk factor relating to the material amount of our outstanding debt, as set forth below.

We have a material amount of debt outstanding that contains restrictive covenants and our inability to service and repay our debt obligations could have a material adverse effect on our financial condition and results of operations

We have a material amount of debt outstanding (see Note 7 of Notes to Consolidated Financial Statements). In connection with the Merger on April 5, 2006, HealthMarkets, LLC entered into a credit agreement providing for, among other things, a \$500 million term loan facility. The term loan facility will expire on April 5, 2012. At September 30, 2010, \$362.5 million remained outstanding on the term loan facility, which indebtedness bears interest at the London inter-bank offered rate (LIBOR) plus a borrowing margin of 1.00%. Our indebtedness could have an adverse effect on our business and future operations, including requiring us to dedicate a substantial portion of cash flow from operations to pay principal and interest on our debt, which would reduce funds available to fund working capital, capital expenditures and general operating requirements; increasing our vulnerability to general adverse economic and industry conditions or a downturn in our business; placing us at a competitive disadvantage compared to competitors that have less debt; limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate; and impairing our ability to obtain additional financing in the future for working capital, capital expenditures or general corporate purposes. In addition, the credit agreement requires us to comply with various covenants that impose restrictions on our operations, including our ability to incur additional indebtedness, make investments or other restricted payments, sell or otherwise dispose of assets and engage in certain other activities. The credit agreement also establishes a number of financial covenants, including maximum total leverage ratio requirements and minimum adjusted statutory surplus requirements. The restrictive covenants under our credit agreement could restrict our ability to pursue our business strategies. Any failure to comply with these restrictive covenants could result in an event of default under the credit agreement which could have a material

adverse effect on our financial condition and results of operations. We believe that we will be in position to repay the term loan facility at maturity. However, our ability to repay this facility depends upon certain factors beyond our control, including receipt of regulatory approvals required to access capital from our insurance subsidiaries through extraordinary

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dividends. In addition, we cannot fully anticipate the future condition of the Company or the credit markets and we may have unexpected costs and liabilities. There can be no assurance that we will be successful in our efforts to repay the terms loan facility or, in the absence of repayment, renew, extend or refinance our debt, and if we are not successful, our liquidity and financial condition would be significantly adversely impacted. If it becomes necessary to renew, extend or refinance our debt, due to our credit rating, the current economic conditions or the credit market environment, we may not be able to do so and, if we are able to do so, the terms are expected to be less favorable than those of the current term loan facility and may impose additional financial risks to our financial condition and results of operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

During the quarter ended September 30, 2010, the Company issued an aggregate of 76,140 unregistered shares of its Class A-1 common stock to an executive officer of the Company. In particular, an executive officer of the Company purchased 76,140 shares of the Company's Class A-1 common stock for aggregate consideration of \$558,867.60 (or \$7.34 per share). Such sale of securities was made in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended (and/or Regulation D promulgated thereunder) for transactions by an issuer not involving a public offering. The proceeds of such sale were used for general corporate purposes.

Issuer Purchases of Equity Securities

The following table sets forth the Company's purchases of HealthMarkets, Inc. Class A-1 common stock during each of the months in the three months ended September 30, 2010:

| Period | Total Number of Shares Purchased⁽¹⁾ | Average Price Paid per Share (\$) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under The Plan or Program |
|-------------------|-------------------------------------------------------------------|------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|
| 7/1/10 to 7/31/10 | | | | |
| 8/1/10 to 8/31/10 | 5,723 | \$ 7.34 | | |
| 9/1/10 to 9/30/10 | 14,925 | 7.34 | | |
| Totals | 20,648 | \$ 7.34 | | |

(1) The number of shares purchased other than through a publicly announced plan or program includes 20,648 shares purchased from former or current employees of the Company.

The following table sets forth the Company's purchases of HealthMarkets, Inc. Class A-2 common stock during each of the months in the three months ended September 30, 2010:

| Period | Total Number of Shares Purchased⁽¹⁾ | Average Price Paid per Share (\$) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under The Plan or Program |
|-------------------|-------------------------------------------------------------------|------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|
| 7/1/10 to 7/31/10 | 2,578 | \$ 7.00 | | |
| 8/1/10 to 8/31/10 | 59,302 | 7.34 | | |
| 9/1/10 to 9/30/10 | 29,295 | 7.34 | | |
| Totals | 91,175 | \$ 7.33 | | |

- (1) The number of shares purchased other than through a publicly announced plan or program includes 91,175 shares purchased from former or current participants of the stock accumulation plan established for the benefit of the Company's insurance agents.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

(a) Exhibits.

| Exhibit No. | Description |
|--------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1 | Letter Agreement, dated as of August 27, 2010, amending the terms of the Employment Agreement between HealthMarkets, Inc. and Steven P. Erwin, filed as Exhibit 10.1 to the Current Report on Form 8-K dated August 27, 2010, File No. 001-14953, and incorporated by reference herein. |
| 10.2 | Employment Agreement, effective as of September 24, 2010, between HealthMarkets, Inc. and Kenneth Fasola, filed as Exhibit 10.1 to the Current Report on Form 8-K dated September 24, 2010, File No. 001-14953, and incorporated by reference herein. |
| 10.3 | Nonqualified Stock Option Agreement, effective as of September 27, 2010, between HealthMarkets, Inc. and Kenneth Fasola, filed as Exhibit 10.2 to the Current Report on Form 8-K dated September 24, 2010, File No. 001-14953, and incorporated by reference herein. |
| 10.4 | Restricted Share Agreement, effective as of September 27, 2010, between HealthMarkets, Inc. and Kenneth Fasola, filed as Exhibit 10.3 to the Current Report on Form 8-K dated September 24, 2010, File No. 001-14953, and incorporated by reference herein. |
| 10.5 | Form of Subscription Agreement between HealthMarkets, Inc. and Kenneth Fasola, filed as Exhibit 10.4 to the Current Report on Form 8-K dated September 24, 2010, File No. 001-14953, and incorporated by reference herein. |
| 10.6 | Transition Agreement, effective as of September 27, 2010, between HealthMarkets, Inc. and Phillip J. Hildebrand, filed as Exhibit 10.5 to the Current Report on Form 8-K dated September 24, 2010, File No. 001-14953, and incorporated by reference herein. |
| 10.7 | Employment Agreement, dated as of October 26, 2010, between HealthMarkets, Inc. and B. Curtis Westen filed as Exhibit 10.1 to the Current Report on Form 8-K dated October 26, 2010, File No. 001-14953, and incorporated by reference herein. |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification, executed by Phillip J. Hildebrand, Chief Executive Officer of HealthMarkets, Inc. |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification, executed by K. Alec Mahmood, Senior Vice President and Chief Financial Officer of HealthMarkets, Inc. |
| 32 | Certifications required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350), executed by Phillip J. Hildebrand, Chief Executive Officer of HealthMarkets, Inc. and K. Alec Mahmood, Senior Vice President and Chief Financial Officer of HealthMarkets, Inc. |

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SIGNATURES

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

HEALTHMARKETS, INC
(Registrant)

Date: November 11, 2010

/s/ Phillip J. Hildebrand
Phillip J. Hildebrand
Chief Executive Officer

Date: November 11, 2010

/s/ K. Alec Mahmood
K. Alec Mahmood
Senior Vice President and Chief Financial
Officer
(Principal Financial Officer)