

HealthMarkets, Inc.
Form 10-Q
November 10, 2011

Table of Contents

**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, 2011

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 12 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
(Do not check if a smaller
reporting company)

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 21, 2011, the registrant had 28,165,183 outstanding shares of Class A-1 Common Stock, \$.01 Par Value, and 2,823,157 outstanding shares of Class A-2 Common Stock, \$.01 Par Value.

**HEALTHMARKETS, INC.
and Subsidiaries
TABLE OF CONTENTS**

	Page
<u>PART I FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (Unaudited)</u>	
<u>Consolidated Condensed Balance Sheets as of September 30, 2011 and December 31, 2010</u>	2
<u>Consolidated Condensed Statements of Income for the Three and Nine Months Ended September 30, 2011 and 2010</u>	3
<u>Consolidated Condensed Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2011 and 2010</u>	4
<u>Consolidated Condensed Statements of Cash Flows for the Three and Nine Months Ended September 30, 2011 and 2010</u>	5
<u>Notes to Consolidated Condensed Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	33
<u>Item 4. Controls and Procedures</u>	33
<u>PART II OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	34
<u>Item 1A. Risk Factors</u>	34
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	34
<u>Item 3. Defaults Upon Senior Securities</u>	35
<u>Item 5. Other Information</u>	35
<u>Item 6. Exhibits</u>	36
<u>SIGNATURES</u>	37
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32</u>	
<u>EX-101 INSTANCE DOCUMENT</u>	
<u>EX-101 SCHEMA DOCUMENT</u>	
<u>EX-101 CALCULATION LINKBASE DOCUMENT</u>	
<u>EX-101 LABELS LINKBASE DOCUMENT</u>	
<u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>	
<u>EX-101 DEFINITION LINKBASE DOCUMENT</u>	

Table of Contents

HEALTHMARKETS, INC.
and Subsidiaries
CONSOLIDATED CONDENSED BALANCE SHEETS
(In thousands, except per share data)

	September 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
Investments:		
Securities available for sale		
Fixed maturities, at fair value (cost: 2011 \$408,533; 2010 \$644,661)	\$ 442,975	\$ 679,405
Short-term and other investments	613,513	373,023
Total investments	1,056,488	1,052,428
Cash and cash equivalents	15,060	12,874
Student loan receivables	52,906	60,312
Restricted cash	11,346	13,170
Investment income due and accrued	7,179	7,139
Reinsurance recoverable ceded policy liabilities	359,807	363,243
Agent and other receivables	25,236	32,508
Deferred acquisition costs	20,076	32,689
Property and equipment, net of accumulated depreciation of \$154,599 and \$147,493 at September 30, 2011 and December 31, 2010, respectively	39,332	41,039
Goodwill	40,384	40,384
Other intangible assets	40,351	41,947
Recoverable federal income taxes		3,443
Other assets	13,957	15,776
Assets held for sale	2,100	2,699
	\$ 1,684,222	\$ 1,719,651
LIABILITIES AND STOCKHOLDERS EQUITY		
Policy liabilities:		
Future policy and contract benefits	\$ 476,545	\$ 453,773
Claims	96,638	208,675
Unearned premiums	29,957	34,862
Other policy liabilities	30,853	7,687
Accounts payable and accrued expenses	34,357	38,131
Other liabilities	49,411	58,868
Current federal income taxes	2,994	
Deferred federal income taxes	70,555	58,883
Debt	553,420	553,420
Student loan credit facility	61,750	68,650
Net liabilities of discontinued operations	1,517	1,574
	1,407,997	1,484,523
Commitments and Contingencies (Note 11)		

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, 28,276,279 issued and 28,169,475 outstanding at September 30,
2011; 28,281,859 issued and 28,256,028 outstanding at December 31, 2010.

Class A-2, par value \$0.01 per share authorized 20,000,000 shares,

4,026,104 issued and 2,882,616 outstanding at September 30, 2011;

4,026,104 issued and 2,762,100 outstanding at December 31, 2010

Additional paid-in capital

Accumulated other comprehensive income

Retained earnings

Treasury stock, at cost (106,804 Class A-1 common shares and 1,143,488

Class A-2 common shares at September 30, 2011; 25,831 Class A-1

common shares and 1,264,004 Class A-2 common shares at December 31,
2010)

	323	323
	50,207	54,772
	22,731	21,981
	216,402	178,313
	(13,438)	(20,261)
	276,225	235,128
	\$ 1,684,222	\$ 1,719,651

See Notes to Consolidated Condensed Financial Statements.

Table of Contents

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,	
	2011	2010	2011	2010
REVENUE				
Health premiums	\$ 131,702	\$ 176,736	\$ 416,146	\$ 571,423
Life premiums and other considerations	357	380	1,213	1,529
	132,059	177,116	417,359	572,952
Investment income	6,154	9,729	22,358	31,840
Commissions and other income	20,561	18,838	62,195	49,377
Net impairment losses recognized in earnings		(765)		(765)
Realized gains, net	2,546	1,225	8,976	3,866
	161,320	206,143	510,888	657,270
BENEFITS AND EXPENSES				
Benefits, claims, and settlement expenses	83,349	57,605	279,036	279,353
Underwriting, acquisition, and insurance expenses	22,399	39,887	78,053	137,185
Other expenses	40,517	67,082	119,856	163,194
Interest expense	4,745	7,375	17,290	22,835
	151,010	171,949	494,235	602,567
Income from continuing operations before income taxes	10,310	34,194	16,653	54,703
Federal income tax expense	3,861	11,951	6,423	21,288
Income from continuing operations	6,449	22,243	10,230	33,415
Income from discontinued operations, (net of income tax expense of \$6 and \$19 for the three and nine months ended September 30, 2011, and \$6 and \$21 for the three and nine months ended September 30, 2010, respectively)	11	12	35	39
Net income	\$ 6,460	\$ 22,255	\$ 10,265	\$ 33,454
Basic earnings per share:				
Income from continuing operations	\$ 0.21	\$ 0.75	\$ 0.34	\$ 1.13
Income from discontinued operations	0.00	0.00	0.00	0.00
Net income per share, basic	\$ 0.21	\$ 0.75	\$ 0.34	\$ 1.13

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

Diluted earnings per share:				
Income from continuing operations	\$ 0.21	\$ 0.73	\$ 0.33	\$ 1.09
Income from discontinued operations	0.00	0.00	0.00	0.00
Net income per share, diluted	\$ 0.21	\$ 0.73	\$ 0.33	\$ 1.09

See Notes to Consolidated Condensed Financial Statements.

3

Table of Contents

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Net income	\$ 6,460	\$ 22,255	\$ 10,265	\$ 33,454
Other comprehensive income (loss):				
Unrealized gains on securities available for sale arising during the period	6,555	14,483	8,867	43,352
Reclassification for investment gains included in net income	(2,623)	(1,225)	(9,053)	(3,866)
Other-than-temporary impairment losses recognized in OCI				
Effect on other comprehensive income (loss) from investment securities	3,932	13,258	(186)	39,486
Unrealized gains (losses) on derivatives used in cash flow hedging during the period		(217)	(4)	(683)
Reclassification adjustments included in net income		1,217	1,344	5,190
Effect on other comprehensive income from hedging activities		1,000	1,340	4,507
Other comprehensive income before tax	3,932	14,258	1,154	43,993
Income tax expense (benefit) related to items of other comprehensive income	1,376	4,990	404	15,398
Other comprehensive income (loss) net of tax	2,556	9,268	750	28,595
Comprehensive income	\$ 9,016	\$ 31,523	\$ 11,015	\$ 62,049

See Notes to Consolidated Condensed Financial Statements.

Table of Contents

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

	Nine Months Ended	
	September 30,	
	2011	2010
Operating Activities:		
Net income	\$ 10,265	\$ 33,454
Adjustments to reconcile net income to cash (used in) provided by operating activities:		
Income from discontinued operations	(35)	(39)
Realized gains, net	(9,054)	(3,101)
Change in deferred income taxes	(3,715)	(7,087)
Depreciation and amortization	13,392	17,096
Amortization of prepaid monitoring fees	9,375	11,250
Equity based compensation expense	4,347	10,642
Other items, net	2,997	9,891
Changes in assets and liabilities:		
Investment income due and accrued	(1,002)	(2,212)
Due premiums	3	928
Reinsurance recoverable ceded policy liabilities	3,436	(421)
Other receivables	10,333	1,553
Deferred acquisition costs	12,613	24,946
Prepaid monitoring fees	(12,500)	(15,000)
Current income tax recoverable	6,437	22,642
Policy liabilities	(27,133)	(121,001)
Other liabilities and accrued expenses	(15,129)	(18,327)
Cash provided by/(used in) continuing operations	4,630	(34,786)
Cash provided by/(used in) discontinued operations	(22)	12
Net cash provided by/(used in) operating activities	4,608	(34,774)
Investing Activities:		
Student loan receivables	6,123	6,565
Securities available for sale	244,215	120,863
Short-term and other investments, net	(240,916)	54,715
Purchases of property and equipment	(6,531)	(8,459)
Intangible assets acquired		(297)
Acquisitions net of cash acquired		252
Change in restricted cash	1,824	1,742
Increase in agent receivables	(286)	(6,421)
Cash provided by continuing operations	4,429	168,960
Cash provided by discontinued operations		

Net cash provided by investing activities	4,429	168,960
Financing Activities:		
Repayment of student loan credit facility	(6,900)	(6,950)
Decrease in investment products	(1,064)	(4,144)
Change in cash overdraft	5,310	(7,055)
Proceeds from shares issued to agent plans and other	3,210	6,099
Purchases of treasury stock	(6,614)	(8,675)
Dividends paid		(119,514)
Excess tax reduction from equity based compensation	(793)	(1,287)
Cash used in continuing operations	(6,851)	(141,526)
Cash used in discontinued operations		
Net cash used in financing activities	(6,851)	(141,526)
Net change in cash and cash equivalents	2,186	(7,340)
Cash and cash equivalents at beginning of period	12,874	17,406
Cash and cash equivalents at end of period in continuing operations	\$ 15,060	\$ 10,066
Supplemental disclosures:		
Income taxes paid	\$ 6,643	\$ 9,168
Interest paid	\$ 10,375	\$ 20,823

See Notes to Consolidated Condensed Financial Statements.

Table of Contents

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, 2010 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, 2011 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2011. 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, 2010.

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).

Reclassification

Certain amounts in the 2010 financial statements have been reclassified to conform to the 2011 financial statement presentation.

2. CHANGE IN ACCOUNTING PRINCIPLE

Effective January 1, 2011, the Company changed the method used to calculate its policy liabilities for the majority of its health insurance products because it believes that the new method will be preferable in light of, among other factors, certain changes required by Health Care Reform Legislation.

For the majority of health insurance products in the Commercial Health Division, the Company's claims liabilities are estimated using the developmental method. The Company establishes the claims liabilities based upon claim incurral dates, supplemented with certain refinements as appropriate. Prior to January 1, 2011, for products introduced prior to 2008, the Company used a technique for calculating claims liabilities referred to as the Modified Incurred Date (MID) technique. Under the MID technique, claims liabilities for the cost of all medical services related to a distinct accident or sickness are based on the earliest date of diagnosis or treatment, even though the medical services associated with such accident or sickness might not be rendered to the insured until a later financial reporting period. Claims liabilities based on the earliest date of diagnosis generally result in larger initial claims liabilities which complete over a longer period of time than claims estimation techniques using dates of service. Under the MID technique, the Company modifies the original incurred date coding by establishing a new incurral date if: (i) there is a break of more than six months in the occurrence of a covered benefit service or (ii) if claims payments continue for more than thirty-six months without a six month break in service.

For products introduced in 2008 and later, claims payments are considered incurred on the date the service is rendered, regardless of whether the sickness or accident is distinct or the same. This is referred to as the Service Date

Table of Contents

(SD) technique. This is consistent with the assumptions used in the pricing of these products and the policy language. At December 31, 2010, the Company had claims liabilities for products using the SD technique in the amount of \$10.6 million, representing approximately 8% of the total claims liabilities of the Commercial Health Division. The use of the SD technique in establishing claims liabilities requires the establishment of a future policy benefit reserve while the MID technique does not. For the reasons discussed below, we believe that it is preferable to estimate the Company's claims liabilities using the SD technique, and to apply such technique for claims liabilities previously calculated based on the MID technique.

As previously disclosed, in March 2010, Health Care Reform Legislation was signed into law. The Health Care Reform Legislation requires, beginning in 2011, a mandated minimum loss ratio (MLR) of 80% for the individual and small group markets. If MLR is below the mandated minimum, the Health Care Reform Legislation generally requires that the insurer return the amount of premium that is in excess of the required MLR to the policyholder in the form of rebates. The MLR is calculated for each of our insurance subsidiaries on a state-by-state basis in each state where the Company has issued major medical business. The Interim Final Rule from the Department of Health and Human Services (HHS) indicates that the MLR calculation shall utilize data on incurred claims for the calendar year, paid through March of the following year.

Any refund of premiums in excess of the required MLR will be based on the completion of claims three months after the calendar year end. Based on the MLR calculation requiring only three additional months of claims and the SD technique being the most prevalent method of estimating claims liabilities in the health insurance industry, the Company believes that the SD technique is the preferable method for calculating the MLR. The Company also believes that using the SD method for the settlement of the MLR calculation will reduce uncertainty regarding the ultimate amount of incurred claims, as the MID technique estimates claims over a longer settlement period. The calculation of the MLR using the Company's current data results in claims for a given incurred year that are approximately 95% complete three months after the valuation date using the SD technique, whereas claims are approximately 82% complete 3 months after the valuation date using the MID technique. Additionally, the use of the MID technique for financial reporting purposes, with the settlement of the MLR calculated on a SD basis, may result in an over accrual of the claims liabilities on the financial statements as a result of the Company's accrual for rebates in the MLR calculation.

In light of the changes resulting from the Health Care Reform Legislation, and given that the Company's insurance contracts would support the use of either reserving technique, the Company, after discussions with its domiciliary insurance regulators on the preferred methodology for calculating rebates under the MLR requirements of the Health Care Reform Legislation, determined that the SD method is preferable in determining the estimation of its claims liabilities. For the in-force policies utilizing the MID technique for estimation of claims liabilities, effective January 1, 2011, the Company changed the method used to calculate its claims liabilities from the MID technique to the SD technique. Consistent with the Company's products introduced in 2008 and later, the Company established a reserve for future policy benefits for products introduced prior to 2008.

The Company has determined it is impracticable to determine the period-specific effects of the change in reserving methodology from MID to SD on all prior periods since retrospective application requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates at previous reporting dates. Based on the guidance of *ASC 250-10-45 Accounting Changes - Change in Accounting Principle* if the cumulative effect of applying a change in accounting principle to all prior periods is determinable, but it is impracticable to determine the period-specific effects of that change to all prior periods presented, the cumulative effect of the change to the new accounting principle shall be applied to the carrying amounts of assets and liabilities as of beginning of the earliest period to which the new accounting principle can be applied. As such the Company accounted for the change effective January 1, 2011 by recording the cumulative effect of the change in accounting at that date.

Effective January 1, 2011, as a result of this change, the Company recorded the following: (i) a decrease in the amount of \$77.9 million to claims and claims administration liabilities, (ii) an increase in the amount of \$35.1 million to future policy and contract benefits, (iii) an increase in the amount of \$15.0 million to deferred federal income tax liability and (iv) an increase in the amount of \$27.8 million to retained earnings.

3. CONCENTRATIONS

Insphere maintains marketing agreements for the distribution of health benefits plans with a number of non-affiliated insurance carriers as well as the Company's own insurance subsidiaries. The non-affiliated carriers include, among others, United Healthcare's Golden Rule Insurance Company, Humana and Aetna, for which Insphere distributes individual health insurance products. The products offered by these third-party carriers and the Company's insurance subsidiaries offer

Table of Contents

coverage and benefit variations that may fit one consumer better than another. In the markets where Inspere has commenced distribution of these third-party carrier products, these products have, to a great extent, replaced the sale of the Company's own health benefit plans. During the nine months ended September 30, 2011, approximately 78% of health benefit plan sales marketed by Inspere were underwritten by these three third-party carriers.

Additionally, during the nine months ended September 30, 2011, the Company's insurance subsidiaries generated approximately 57% of premium revenue from new and existing business from the following 10 states:

	Percentage
California	14%
Texas	7%
Maine	7%
Florida	6%
Washington	5%
Massachusetts	5%
Illinois	4%
North Carolina	3%
Pennsylvania	3%
Georgia	3%
	57%

4. RECENT ACCOUNTING PRONOUNCEMENTS

In October 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2010-26, *Financial Services – Insurance (ASC Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (ASU 2010-26), which clarifies what costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. Costs that should be capitalized include (1) incremental direct costs of successful contract acquisition and (2) certain costs related directly to successful acquisition activities (underwriting, policy issuance and processing, medical and inspection, and sales force contract selling) performed by the insurer for the contract. Advertising costs should be included in deferred acquisition costs only if the capitalization criteria in the U.S. GAAP direct-response advertising guidance are met. All other acquisition-related costs should be charged to expense as incurred. The provisions of ASU 2010-26 are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011, and should be applied prospectively. Retrospective application is permitted, and early adoption is permitted at the beginning of an entity's annual reporting period. The Company is currently in the process of determining the impact of adoption of the provisions of ASU 2010-26.

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. Certain disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements are effective for fiscal years beginning after December 15, 2010. The Company implemented these additional disclosure items in the first quarter of 2011.

On May 12, 2011, the International Accounting Standards Board (IASB) and the FASB issued IFRS 13, *Fair Value Measurement*, and FASB ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, respectively, to provide largely identical guidance about fair value measurement and disclosure requirements. Issuing these standards completes a major project of the Boards' joint work to improve and converge IFRS and U.S. GAAP. The new standards do not extend the use of fair value but, rather, provide guidance about how fair value should be applied where it already is required or permitted under IFRS or U.S. GAAP. For U.S. GAAP, most of the changes are clarifications of existing guidance or wording changes to align with IFRS 13. A public entity is required to apply the ASU prospectively for interim and annual periods beginning after December 15, 2011. Early adoption is not permitted for a public entity. The Company is currently in the process of

determining the impact of adoption of the provisions of ASU 2011-04.

In June 2011, the FASB issued ASU 2011-05 *Presentation of Comprehensive Income*. This ASU eliminates the option in U.S. GAAP to present other comprehensive income in the statement of changes in equity. For a public entity, the ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The guidance does not change whether items are reported in net income or other comprehensive income or when items in other comprehensive income are reclassified to net income; accordingly, adoption of ASU 2011-05 will not impact the operating results, financial position or liquidity of the Company.

Table of Contents

In September 2011, the FASB issued ASU 2011-08 *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. Under the amendments in this update, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is necessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Early adoption is permitted. The Company is currently in the process of determining the impact of adoption of the provisions of ASU 2011-08.

5. 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:

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

Table of Contents

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, 2011, 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 \$110.8 million of

Corporate bonds and municipal classified as Level 2, \$89.7 million of Other Bonds classified as Level 2 and \$594,000 of Commercial-backed investments classified as Level 3. The Corporate bonds and municipal investments classified as Level 2 noted above includes \$105.7 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. The \$89.7 million of Other bonds classified as Level 2 was received from a unit of the CIGNA Corporation as consideration for the receipt of the former Star HRG assets.

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, 2011				
	Level 1	Level 2	Level 3	Total
	(In thousands)			
U.S. and U.S. Government agencies	\$ 4,578	\$ 20,106	\$	\$ 24,684
Corporate bonds and municipals		259,179		259,179
Residential-backed issued by agencies		50,503		50,503
Commercial-backed issued by agencies		1,741		1,741
Residential-backed		303		303
Commercial-backed		12,275	594	12,869
Asset-backed		4,011		4,011
Other bonds		89,685		89,685
Other invested assets ⁽¹⁾ .			2,098	2,098
Short-term investments ⁽²⁾	591,366			591,366
	\$ 595,944	\$ 437,803	\$ 2,692	\$ 1,036,439

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

(2) Amount excludes \$20.0 million of short-term other investments which are not subject to fair value measurement.

Liabilities at Fair Value at September 30, 2011				
	Level 1	Level 2	Level 3	Total
	(In thousands)			
Agent and employee plans			5,143	5,143

Table of Contents

	Assets at Fair Value at December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
U.S. and U.S. Government agencies	\$ 4,611	\$ 51,655	\$	\$ 56,266
Corporate bonds and municipals		402,883		402,883
Residential-backed issued by agencies		72,684		72,684
Commercial-backed issued by agencies		5,392		5,392
Residential-backed		2,410		2,410
Commercial-backed		44,367	916	45,283
Asset-backed		8,095		8,095
Other bonds		86,392		86,392
Other invested assets ⁽¹⁾			2,000	2,000
Short-term investments ⁽²⁾	347,121			347,121
	\$ 351,732	\$ 673,878	\$ 2,916	\$ 1,028,526

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

(2) Amount excludes \$23.9 million of short-term other investments which are not subject to fair value measurement.

	Liabilities at Fair Value at December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
Interest rate swaps	\$	\$ 2,367	\$	\$ 2,367
Agent and employee plans			6,238	6,238
	\$	\$ 2,367	\$ 6,238	\$ 8,605

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.

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, 2011, 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.

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.

Table of Contents*Short-term investments*

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

Derivatives

For the period ended December 31, 2010, the Company's derivative instruments were 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. As of April 11, 2011 all derivative instruments have matured.

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 12 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, 2011.

**Changes in Level 3 Assets and Liabilities Measured at Fair Value
For the Three Months Ended September 30, 2011**

	Beginning Balance	Unrealized Gains or (Losses)	Sales or Redemption	Settlements	Realized Gains or (Losses)(1)	Transfer in/(out) of Level 3, Net	Ending Balance
ASSETS							
Commercial-backed	\$ 704	\$ (11)	\$ (103)	\$ 3	\$	\$	\$ 593
Other invested assets	2,648	(540)		(9)			2,099
	\$ 3,352	\$ (551)	\$ (103)	\$ (6)	\$	\$	\$ 2,692
LIABILITIES							
Agent and employee stock plans	\$ 4,217	\$ 100	\$	\$ 826	\$	\$	\$ 5,143

**Changes in Level 3 Assets and Liabilities Measured at Fair Value
For the Nine Months Ended September 30, 2011**

	Beginning Balance	Unrealized Gains or (Losses)	Sales or Redemption	Settlements	Realized Gains or (Losses)(1)	Transfer in/(out) of Level 3, Net	Ending Balance
ASSETS							
Commercial-backed	\$ 916	\$ (30)	\$ (302)	\$ 9	\$	\$	\$ 593
Other invested assets	2,000	116		(17)			2,099

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

\$ 2,916	\$ 86	\$ (302)	\$ (8)	\$	\$ 2,692
----------	-------	----------	--------	----	----------

LIABILITIES

Agent and employee
stock plans

\$ 6,238	\$ 330	\$	\$ (1,425)	\$	\$ 5,143
----------	--------	----	------------	----	----------

During the nine months ended September 30, 2011, 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.

Table of Contents**6. INVESTMENTS**

The Company's investments consist of the following at September 30, 2011 and December 31, 2010:

	September 30, 2011	December 31, 2010
	(In thousands)	
Securities available for sale		
Fixed maturities	\$ 442,975	\$ 679,405
Short-term and other investments	613,513	373,023
Total investments	\$ 1,056,488	\$ 1,052,428

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

	September 30, 2011				Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Non-credit Loss Recognized in OCI	
	(In thousands)				
U.S. and U.S. Government agencies	\$ 23,910	\$ 774	\$	\$	\$ 24,684
Corporate bonds and municipals	240,501	19,548	(870)		259,179
Residential-backed issued by agencies	47,087	3,416			50,503
Commercial-backed issued by agencies	1,703	38			1,741
Residential-backed	303				303
Commercial-backed	12,543	327	(1)		12,869
Asset-backed	4,090	218	(16)	(281)	4,011
Other bonds	78,396	11,289			89,685
Total fixed maturities	\$ 408,533	\$ 35,610	\$ (887)	\$ (281)	\$ 442,975

	December 31, 2010				Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Non-credit Loss Recognized in OCI	
	(In thousands)				
U.S. and U.S. Government agencies	\$ 55,338	\$ 1,006	\$ (78)	\$	\$ 56,266
Corporate bonds and municipals	383,188	21,133	(1,438)		402,883
Residential-backed issued by agencies	68,932	3,827	(75)		72,684
Commercial-backed issued by agencies	5,156	236			5,392

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

Residential-backed	2,344	66			2,410
Commercial-backed	43,261	2,022			45,283
Asset-backed	8,046	346	(16)	(281)	8,095
Other bonds	78,396	7,996			86,392
Total fixed maturities	\$ 644,661	\$ 36,632	\$ (1,607)	\$ (281)	\$ 679,405

The amortized cost and fair value of available for sale fixed maturities at September 30, 2011, 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, 2011	
	Amortized	
	Cost	Fair Value
	(In thousands)	
<i>Maturity:</i>		
One year or less	\$ 34,289	\$ 34,484
Over 1 year through 5 years	70,144	73,639
Over 5 years through 10 years	223,003	249,470
Over 10 years	15,371	15,955
	342,807	373,548
Mortgage-backed and asset-backed securities	65,726	69,427
Total fixed maturities	\$ 408,533	\$ 442,975

See Note 5 of Notes to Consolidated Condensed Financial Statements for additional disclosures on fair value measurements.

Table of Contents

A summary of net investment income by source is set forth below:

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	2010		2010	
	(In thousands)			
Fixed maturities	\$ 5,509	\$ 8,559	\$ 19,163	\$ 27,160
Equity securities				
Short-term and other investments	194	390	1,907	1,866
Agent receivables	59	163	232	857
Student loan interest income	799	1,030	2,461	3,153
	6,561	10,142	23,763	33,036
Less investment expenses	407	413	1,405	1,196
	\$ 6,154	\$ 9,729	\$ 22,358	\$ 31,840

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. Net realized capital gains for the three and nine months ended 2011 and 2010 were as follows:

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	2010		2010	
	(In thousands)			
Other-than-temporary impairment (OTTI) losses	\$	\$ (765)	\$	\$ (765)
Portion of OTTI losses recognized in (released from) other comprehensive income				
Net impairment losses recognized in earnings		(765)		(765)
Net realized capital gains, excluding OTTI losses on securities ⁽¹⁾	2,546	1,225	8,976	3,866
Realized gains, net	\$ 2,546	\$ 460	\$ 8,976	\$ 3,101

(1) Includes \$78,000 of realized losses recorded in the quarter ended September 30, 2011 associated with the planned future sale of Company-owned assets

Fixed maturities

Proceeds from the sale and call of investments in fixed maturities were \$61.3 million and \$189.4 million for the three and nine months ended September 30, 2011, respectively, and \$32.0 million and \$109.7 million for the three and nine months ended September 30, 2010, respectively. Proceeds from maturities, sinking and principal reductions amounted to \$11.6 million and \$61.1 million for the three and nine months ended September 30, 2011, respectively, and \$8.8 million and \$38.5 million for the three and nine months ended September 30, 2010, respectively. During the three and nine months ended September 30, 2011, the Company realized gross gains of \$2.6 million and \$9.1 million, respectively, on the sale and call of fixed maturity investments. During the three and nine months ended September 30, 2010, the Company realized gross gains of \$1.2 million and \$3.9 million, respectively, on the sale and

call of fixed maturity investments. The Company realized no gross losses in 2011 and 2010 on fixed maturities.

Table of Contents*Other than temporary impairment (OTTI)*

During the nine months ended September 30, 2011, the Company recognized no OTTI losses.

Set forth below is a summary of cumulative OTTI losses on debt securities held by the Company at September 30, 2011, 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 credit losses recognized for securities still held at January 1, 2011	Additions to OTTI securities where no credit losses were recognized prior to January 1, 2011	Additions to OTTI securities where credit losses have been recognized prior to January 1, 2011	Reductions for		Cumulative OTTI credit losses recognized for securities still held at September 30, 2011
			Reductions for securities sold during the period (Realized)	Increases in cash flows expected to be collected that are recognized over the remaining life of the security	
\$ 4,104	\$	\$	\$ (586)	\$	\$ 3,518

*Unrealized Gains and Losses**Fixed maturities*

Set forth below is a summary of gross unrealized losses in its fixed maturities as of September 30, 2011 and December 31, 2010:

Description of Securities	Unrealized Loss Less Than 12 Months		September 30, 2011 Unrealized Loss		Total	
	Fair Value	Unrealized Losses	12 Months or Longer Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and U.S. Government agencies	\$	\$	\$	\$	\$	\$
Residential-backed issued by agencies						
Commercial-backed issued by agencies						
Residential-backed Commercial-backed	350	1			350	1
Asset-backed	282	16	981		1,263	16
Corporate bonds and municipals	5,970	39	20,031	831	26,001	870
Other bonds						

Total	\$ 6,602	\$ 56	\$ 21,012	\$ 831	\$ 27,614	\$ 887
-------	----------	-------	-----------	--------	-----------	--------

Description of Securities	Unrealized Loss Less Than 12 Months		December 31, 2010 Unrealized Loss 12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and U.S. Government agencies	\$ 16,254	\$ 78	\$	\$	\$ 16,254	\$ 78
Residential-backed issued by agencies	4,810	75			4,810	75
Commercial-backed issued by agencies			426		426	
Residential-backed Commercial-backed Asset-backed			3,296	16	3,296	16
Corporate bonds and municipals	7,124	57	30,967	1,381	38,091	1,438
Other bonds						
Total	\$ 28,188	\$ 210	\$ 34,689	\$ 1,397	\$ 62,877	\$ 1,607

Unrealized Losses Less Than 12 Months

Of the \$56,000 in unrealized losses that had existed for less than twelve months at September 30, 2011, no security had an unrealized loss in excess of 10% of the security's cost.

Unrealized Losses 12 Months or Longer

Of the \$831,000 in unrealized losses that had existed for twelve months or longer at September 30, 2011, no security had an unrealized loss in excess of 10% of the security's cost.

Table of Contents

All issuers of securities we own remain current on all contractual payments. 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, credit ratings, performance of underlying collateral and effective yields. Additionally, HealthMarkets considers whether it has the intent to sell the security and whether it is more likely than not that the Company will be required to sell the debt security before the fair value reverts to its cost basis, which may be at maturity of the security. Based on such review, the Company believes that, as of September 30, 2011, the unrealized losses in these investments were caused by an increase in market interest rates and tighter liquidity conditions in the current markets than when the securities were purchased and therefore, is temporary.

7. 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 are issued 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.

As previously disclosed, the Company's arrangements with the party previously originating student loans terminated in 2010. The Company is attempting to find a replacement for the Company's previous originator and lender of student loans; 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. The Company does not believe this will have a material impact to the consolidated financial statements.

8. DEBT

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

	Principal Amount at September 30, 2011	Maturity Date	Interest Rate(a)	Interest Expense			
				Three Months Ended September 30,		Nine Months Ended September 30,	
				2011	2010	2011	2010
<i>2006 credit agreement:</i>							
Term loan	\$ 362,500	2012	1.246%	\$ 1,159	\$ 2,540	\$ 4,830	\$ 8,571
\$75 Million revolver (non-use fee)		(b)			70	50	210
Grapevine Note	72,350	2021	6.712%	1,226	1,220	3,638	3,632
<i>Trust preferred securities:</i>							
UICI Capital Trust I	15,470	2034	3.786%	149	154	444	450
HealthMarkets Capital Trust I	51,550	2036	3.397%	436	467	1,305	1,330
HealthMarkets Capital Trust II	51,550	2036	3.397%	436	1,102	2,496	3,271
<i>Other:</i>							
Interest on Deferred Tax Gain			3.500%	514	536	1,566	1,591
Amortization of financing fees				825	1,286	2,961	3,780
Total	\$ 553,420			\$ 4,745	\$ 7,375	\$ 17,290	\$ 22,835
Student Loan Credit Facility	61,750	(c)	0.000%(d)				

Total	\$ 615,170	\$ 4,745	\$ 7,375	\$ 17,290	\$ 22,835
-------	------------	----------	----------	-----------	-----------

- (a) Represents the interest rate at September 30, 2011.
- (b) The \$75 million revolver matured on April 5, 2011 and was not renewed.
- (c) 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).
- (d) The interest rate on each series of SPE Notes resets monthly in a Dutch auction process and is capped by several interest rate triggers. It is currently capped at zero by a Net Loan Rate calculation driven by the rate of return of the student loans less certain allowed note fees.

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, 2011, 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 indebtedness outstanding of \$362.5 million is due in full upon the maturity of the term loan on April 5, 2012. The Company expects to have the necessary capital to repay the term loan

Table of Contents

in full at maturity. Pursuant to the credit agreement, the \$75.0 million revolving credit facility matured on April 5, 2011 and was not renewed.

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% until June 15, 2011 when the principal amount began to accrue interest at a floating rate equal to three-month LIBOR plus 3.05%.

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 a note receivable in the amount of \$78.4 million from a unit of CIGNA Corporation (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.

The fair value of the Company's debt, exclusive of indebtedness outstanding under the secured student loan credit facility, was \$491.3 million and \$499.2 million at September 30, 2011 and December 31, 2010, 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.

Student Loan Credit Facility

At September 30, 2011 and December 31, 2010, the Company had an aggregate of \$61.8 million and \$68.7 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, 2011 and December 31, 2010, indebtedness outstanding under the Student Loan Credit Facility was secured by student loans and accrued interest in the carrying amount of \$53.1 million and \$60.5 million, respectively, and by a pledge of cash, cash equivalents and other qualified investments of \$8.7 million and \$8.0 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 in 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,

Table of Contents

delinquent and advance payments, payouts or prepayments. During the three and nine months ended September 30, 2011, respectively, the Company made principal payments of approximately \$2.3 million and \$6.9 million on the SPE notes.

At September 30, 2011 and December 31, 2010, the carrying amount of outstanding indebtedness secured by student loans approximated the fair value, as interest rates on such indebtedness reset monthly.

9. DERIVATIVES

HealthMarkets uses derivative instruments, specifically interest rate swaps, as part of its risk management activities to protect against the risk of changes in prevailing interest rates adversely affecting future cash flows associated with certain debt. The Company accounts for such interest rate swaps in accordance with 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 5 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.

As of April 11, 2011, the remaining interest rate swap agreement has matured.

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, 2011 and December 31, 2010:

	Asset Derivatives			Liability Derivatives		
	Balance Sheet	September 30, 2011	December 31, 2010	Balance Sheet	September 30, 2011	December 31, 2010
	Location	Fair Value	Fair Value	Location	Fair Value	Fair Value
(In thousands)						
Derivatives designated as hedging instruments under ASC Topic 815:						
Interest rate swaps	Other assets	\$	\$	Other liabilities	\$	\$ 2,367
Total derivatives		\$	\$		\$	\$ 2,367

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, 2011 and 2010:

Derivative Instruments in Hedging Relationships for the Three Months Ended September 30, 2011 and 2010

Location of Gain	Amount of Interest Expense (Income)	Location of (Gain)
------------------	-------------------------------------	--------------------

	Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion)		Location of Gain (Loss) from Accumulated OCI into Income (Effective Portion)	Amount of Interest Expense (Income) Reclassified from Accumulated OCI into Income (Expense) (Effective Portion)		Location of Loss Recognized in Income on Derivative (Ineffective Portion)	Amount of (Gain) Loss Recognized in Income on Derivative (Ineffective Portion)	
	2011	2010		2011	2010		2011	2010
Interest rate swaps	\$	\$ 1,489	Interest Expense	\$	\$ 1,339	Investment income	\$	\$ 129

Derivative Instruments in Hedging Relationships for the Nine Months Ended September 30, 2011 and 2010

	Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion)		Location of Gain (Loss) from Accumulated OCI into Income (Effective Portion)	Amount of Interest Expense (Income) Reclassified from Accumulated OCI into Income (Expense) (Effective Portion)		Location of Loss Recognized in Income on Derivative (Ineffective Portion)	Amount of (Gain) Loss Recognized in Income on Derivative (Ineffective Portion)	
	2011	2010		2011	2010		2011	2010
Interest rate swaps	\$ 1,340	\$ 3,506	Interest Expense	\$ 1,308	\$ 3,715	Investment income	\$ 35	\$ 257

Table of Contents

During 2011 and 2010, the Company did not have any derivative instruments not designated as hedging instruments.

There were no components of the derivative instruments that were excluded from the assessment of hedge effectiveness.

10. NET INCOME PER SHARE

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
	(In thousands, except per share amounts)			
Income from continuing operations	\$ 6,449	\$ 22,243	\$ 10,230	\$ 33,415
Income from discontinued operations	11	12	35	39
Net income available to common shareholders	\$ 6,460	\$ 22,255	\$ 10,265	\$ 33,454
Weighted average shares outstanding, basic	30,570	29,815	30,402	29,702
Dilutive effect of stock options and other shares	828	808	821	889
Weighted average shares outstanding, dilutive	31,398	30,623	31,223	30,591
<i>Basic earnings per share:</i>				
From continuing operations	\$ 0.21	\$ 0.75	\$ 0.34	\$ 1.13
From discontinued operations	0.00	0.00	0.00	0.00
Net income per share, basic	\$ 0.21	\$ 0.75	\$ 0.34	\$ 1.13
<i>Diluted earnings per share:</i>				
From continuing operations	\$ 0.21	\$ 0.73	\$ 0.33	\$ 1.09
From discontinued operations	0.00	0.00	0.00	0.00
Net income per share, basic	\$ 0.21	\$ 0.73	\$ 0.33	\$ 1.09

11. 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, 2010 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

On July 6, 2010, HealthMarkets, Inc., MEGA and Mid-West were named as defendants in a putative class action (*Jeffrey Cutter, Rina Discepolo, on behalf of themselves and others similarly situated v. HealthMarkets, Inc. et al.*) pending in the Norfolk County Superior Court, Commonwealth of Massachusetts, Case No. 1:10-cv:11488-JLT. On August 13, 2010, this matter was removed to the United States District Court for the District of Massachusetts. The complaint alleges that the named plaintiffs (former district sales leaders contracted with the Company's insurance subsidiaries) were employees (rather than independent contractors) under Massachusetts law and are therefore

entitled, among other relief, to recover certain business costs under the Massachusetts Wage Act. On July 21, 2011, the Court certified the class and on September 26, 2011, the First Circuit Court of Appeals denied defendants' motion to appeal the class certification.

As previously disclosed, on October 20, 2010, HealthMarkets, Inc., MEGA, Mid-West and certain of the Company's private equity investors were named as defendants in an action filed by the City Attorney for Los Angeles on behalf of the State of California (*People of the State of California v. HealthMarkets et al.*) in the Superior Court for the State of California, Los Angeles County Central District, Case No. BC447836. In March 2011, this matter was transferred to the Complex Case Division of the Los Angeles County Central District. Plaintiff alleges, among other things, that the insurance company defendants violated the California Unfair Competition Law by improperly marketing limited forms of health insurance for which coverage was allegedly misrepresented as being comprehensive in nature. Plaintiff further alleges that the insurance company defendants violated the California False Advertising Law by using various forms of false advertising in connection with the sale and distribution of their insurance coverage. Plaintiff seeks civil penalties under California Law in the amount of \$2,500 for each violation, as well as equitable relief in the form of restitution for the value of all money or property that the defendants allegedly acquired by means of unfair competition, deceptive marketing

Table of Contents

and false advertising. In August 2011, the Court dismissed The Blackstone Group and Goldman Sachs defendants from this matter on the basis that the plaintiff had not plead facts with sufficient specificity to constitute a valid cause of action against these parties.

The Company is mounting a vigorous defense of these actions. However, given the early stage of each matter, the Company is unable to determine at this time what, if any, impact they may have on the Company's consolidated financial condition or 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 16 of Notes to the Company's Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, to determine if settlement of such matters would be in the best interests of the Company and its stockholders. The costs associated with any such settlement could be substantial and, in certain cases, could result in an earnings charge in any particular quarter in which we enter into a settlement agreement. Although we have recorded litigation reserves which represent our best estimate on probable losses, both known and incurred but not reported, our recorded reserves might prove to be inadequate to cover an adverse result or settlement for extraordinary matters. Therefore, costs associated with the various litigation matters to which we are subject and any earnings charge recorded in connection with a settlement agreement could have a material adverse effect on our consolidated results of operations in a period, depending on the results of our operations for the particular period.

Regulatory Matters

As previously disclosed, in 2006, the Rhode Island Office of the Health Insurance Commissioner commenced a targeted market conduct examination regarding the small employer market practices of MEGA in the State of Rhode Island. In October 2011, MEGA resolved this matter on terms that include a financial penalty in the amount of \$225,000; restitution of certain claims and refund of a portion of premiums and association dues in the aggregate amount of approximately \$2.3 million; and an agreement by MEGA and Mid-West not to write any new health benefit plans in Rhode Island for a period of three years. (MEGA and Mid-West had previously discontinued, on a voluntarily basis, the marketing of their health benefit plans in Rhode Island in 2007). The resolution of this matter, after consideration of applicable reserves and/or potentially available insurance coverage benefits, did not have a material adverse effect on the Company's consolidated financial condition or results of operations.

The Company's insurance subsidiaries are subject to various other pending market conduct or 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, as lead regulators, and three other monitoring states—Oklahoma, Texas and California (collectively, the Monitoring Regulators). The settlement agreement provides, among other things, for a re-examination by the Monitoring Regulators. If the re-examination is unfavorable, the Company's principal insurance subsidiaries are subject to additional penalties of up to \$10 million. In the first quarter of 2011, the Monitoring Regulators initiated a re-examination to assess performance with respect to the standards of the regulatory settlement agreement. Field work for the re-examination was completed in July 2011 and the Company received a draft report regarding the re-examination from the Monitoring Regulators in October 2011. The Company is currently reviewing the draft report and evaluating a response. 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, 2010 under the caption "Item 3 Legal Proceedings" and in Note 16 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

Table of Contents

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 business, including but not limited to the minimum medical loss ratio requirements applicable to its insurance subsidiaries as well to health 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. Due to the complexity of the Health Care Reform Legislation, the pending status of certain implementing regulations and interpretive guidance, and gradual implementation, the full impact of Health Care Reform Legislation on the Company's business is not yet fully known. However, we have made material changes to our business as a result of the Health Care Reform Legislation, including, to the extent required by this legislation, adjustments to our in-force block of business issued prior to March 24, 2010. These adjustments include, but are not limited to, removal of lifetime maximums on benefits, extension of dependent coverage through age 26, meeting new HHS reporting requirements and adopting limitations on most policy rescissions. These changes generally became effective on January 1, 2011 (for most of our plans the effective date of the new plan year), although certain states may require an earlier effective date. In addition to these changes, health benefit plans issued on or after March 24, 2010 are subject to more extensive benefit changes, including but not limited to first dollar preventive care benefits as well as the elimination of annual limits on essential benefits covered by the policies (subject to the availability of a waiver for small employer group plans and certain individual plans, which the Company has received for Maine, Washington and North Carolina in 2011 and through 2013). The Company has made all state form and rate filings necessary to include these new requirements in the limited number of states in which our insurance subsidiaries continue to offer health benefit plans. The Company's review of the requirements of the Health Care Reform Legislation, and its potential impact on the Company's health insurance product offerings, is ongoing and we expect to dedicate additional resources and to incur additional expenses (including but not limited to additional material claims expenses) as a result of Health Care Reform Legislation. Depending on the outcome of certain potential developments with respect to the Health Care Reform Legislation, this legislation could have a material adverse effect on the Company's financial condition and results of operations. With respect to the minimum loss ratio requirements effective beginning in 2011, a mandated minimum loss ratio of 80% for the individual and small group markets is expected to have a significant impact on the revenues of our insurance subsidiaries and our business generally. In addition, beginning in 2011, the mandated medical loss ratio requirements have adversely affected the level of base commissions and override commissions that Insphere receives from the Company's insurance subsidiaries and third party insurance carriers. The 80% minimum medical loss ratio for the individual market is subject to adjustment, on a state-by-state basis, if HHS determines that the requirement is disruptive to the market. In response to requests by state insurance departments, HHS has granted an adjustment to the MLR standards in a number of states. For additional information, see the caption entitled Business Regulatory and Legislative Matters in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

12. 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, 2011, 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 \$9.58.

As previously disclosed above in Note 2 *Change in Accounting Principle*, the Company changed the method used to calculate its policy liabilities for the majority of its health insurance products. As a result of this change in

accounting principle, effective January 1, 2011, the Company increased its retained earnings by an amount of \$27.8 million.

13. SEGMENT INFORMATION

The Company operates four business segments: Commercial Health, Insphere, Corporate, and Disposed Operations. Through our Commercial Health Division, we underwrite and administer a broad range of health and supplemental insurance products. Insphere includes net commission revenue, agent incentives, marketing costs and costs associated with

Table of Contents

the continuing development of Insphere. Corporate includes investment income not allocated to the other segments, realized gains or losses, interest expense on corporate debt, the Company's student loan activity, general expenses relating to corporate operations and operations that do not constitute reportable operating segments. Disposed Operations includes the remaining run out of the Other Insurance Division as well as the residual operations from the disposition and wind down of other businesses prior to 2010.

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,	
	2011	2010	2011	2010
	(In thousands)			
<i>Revenue from continuing operations:</i>				
Commercial Health Division:	\$ 141,867	\$ 192,151	\$ 448,538	\$ 620,755
Insphere:	18,423	11,511	52,687	24,524
Corporate:	5,572	4,762	21,639	17,173
Intersegment Eliminations:	(4,933)	(3,027)	(13,184)	(7,116)
Total revenues excluding disposed operations	160,929	205,397	509,680	655,336
Disposed Operations:	391	746	1,208	1,934
Total revenue from continuing operations	\$ 161,320	\$ 206,143	\$ 510,888	\$ 657,270

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands)			
<i>Income (loss) from continuing operations before federal income taxes:</i>				
Commercial Health Division:	\$ 30,343	\$ 89,474	\$ 75,923	\$ 187,883
Insphere:	(12,400)	(23,341)	(39,614)	(69,862)
Corporate:	(8,300)	(33,088)	(20,949)	(65,326)
Total operating income excluding disposed operations	9,643	33,045	15,360	52,695
Disposed Operations	667	1,149	1,293	2,008
Total income from continuing operations before federal income taxes	\$ 10,310	\$ 34,194	\$ 16,653	\$ 54,703

Assets by operating segment at September 30, 2011 and December 31, 2010 are set forth in the table below:

	September 30, 2011	December 31, 2010
	(In thousands)	
<i>Assets:</i>		
Commercial Health Division:	\$ 408,873	\$ 490,088
Insphere:	65,206	77,139
Corporate:	834,801	769,105
Total assets excluding assets of Disposed Operations	1,308,880	1,336,332
Disposed Operations	375,342	383,319
Total assets	\$ 1,684,222	\$ 1,719,651

Disposed Operations assets at September 30, 2011 and December 31, 2010 primarily represent a reinsurance recoverable for the ceding of the former Life Insurance Division business as a result of coinsurance agreements entered into in 2008.

14. AGENT AND EMPLOYEE STOCK-BASED COMPENSATION PLANS

Stock Plan Awards

In the third quarter of 2011, the Company granted 684,000 non-qualified stock option awards under the Second Amended and Restated HealthMarkets 2006 Management Option Plan (Plan). 70,000 of the options granted will vest in 20% increments over a five year period. 614,000 of the options granted will cliff vest on December 31, 2014 subject to applicable vesting criteria, including performance criteria established for one-half (or 307,000) of these options. Each of the stock option awards has an exercise price equal to the fair market value per share at the date of grant. Expense of \$56,000 has been recognized in the three months ended September 30, 2011 in connection with these newly issued awards.

Table of Contents***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 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.

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 account on the balance sheet. The liability for nonemployee awards 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 results 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 \$1.3 million and \$3.9 million of expense for the three and nine months ended September 30, 2011, respectively, in connection with the ISOP. The liability for nonemployee participation in the ISOP increased \$853,000 and decreased \$1.0 million for the three and nine months ended September 30, 2011, respectively. Included in the change in liability for the nine months ended September 30, 2011 was a decrease of approximately \$3.6 million as a result of vesting of awards which was partially offset by additional expense recognized during the period. Additional paid-in capital for employee awards under the ISOP increased \$445,000 and decreased \$1.0 million for the three and nine months ended September 30, 2011, respectively. Approximately, \$2.4 million of the decrease in Additional paid-in capital is the result of vesting of awards which was partially offset by additional expense recognized during the quarter.

15. TRANSACTIONS WITH RELATED PARTIES

As of September 30, 2011, affiliates of The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners (the Private Equity Investors) held 53.0%, 21.8%, and 10.9%, 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 pursuant to Transaction and Monitoring Fee Agreements, for which the Company pays The Blackstone Group, Goldman Sachs Capital Partners and DLJ Merchant Banking Partners, in the aggregate, annual monitoring

fees of at least \$12.5 million. 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

Table of Contents

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 \$12.5 million paid in January 2011, \$7.7 million was paid to The Blackstone Group, \$3.2 million was paid to Goldman Sachs Capital Partners and \$1.6 million was paid to DLJ Merchant Banking Partners. The Company has expensed \$9.4 million through September 30, 2011.

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. In 2011, the Company did not fund any capital calls. As of September 30, 2011, the Company 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. In 2011, the Company funded a capital call in the amount of \$132,000 and received capital distributions of \$1.8 million and received a distribution of earnings of \$317,000. As of September 30, 2011, the Company had a remaining commitment to The Blackstone Strategic Alliance Fund L.P. of \$458,000.

16. ASSETS HELD FOR SALE

In the second quarter of 2011, the Company classified as Assets held for sale on its consolidated condensed balance sheet the value of one of its buildings and the adjoining land located on the campus of its home office in North Richland Hills, Texas. The value of the building and the land was reduced to the fair value based upon an acceptable offer the Company received from an unaffiliated third party. The offer was below the Company's net book value and therefore the Company wrote-down the net book value of the building to fair value. The amount expensed in the second quarter as a result of the write-down of the building was approximately \$544,000. In addition the Company has expensed approximately \$78,000 in the third quarter of 2011 primarily related to broker commissions. The Company expects the sale to occur before the end of the year, subject to satisfaction of usual and customary closing conditions for a transaction of this nature.

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, 2010 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

Table of Contents

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 underwrite and administer a broad range of health and supplemental 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 currently market our health insurance products to the self-employed and individual markets through independent agents contracted with Insphere in a limited number of states in which Insphere does not have access to third-party health benefit plans.

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 September 30, 2011, Insphere had approximately 3,000 independent agents, of which approximately 1,900 on average write health insurance applications each month, and offices in over 34 states. Insphere distributes products underwritten by the Company's insurance company subsidiaries and maintains marketing agreements with a number of non-affiliated insurance carriers, including, but not limited to, Aetna, Humana and UnitedHealthcare's Golden Rule Insurance Company.

As a result of the enactment of Health Care Reform Legislation, as well as the growing emphasis on the distribution of third party products through Insphere, 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. After September 23, 2010, the effective date for many aspects of the Health Care Reform Legislation, the Company discontinued marketing all of its health benefit plans in all but a limited number of states in which Insphere does not currently have access to third-party health benefit plans. For additional information, see the caption entitled "Business Commercial Health Division" in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

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, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
REVENUE				
Health premiums	\$ 131,702	\$ 176,736	\$ 416,146	\$ 571,423
Life premiums and other considerations	357	380	1,213	1,529
	132,059	177,116	417,359	572,952
Investment income	6,154	9,729	22,358	31,840
Other income	20,561	18,838	62,195	49,377
Other-than-temporary impairment losses		(765)		(765)
Realized gains, net	2,546	1,225	8,976	3,866
	161,320	206,143	510,888	657,270
BENEFITS AND EXPENSES				
Benefits, claims, and settlement expenses	83,349	57,605	279,036	279,353
Underwriting, acquisition, and insurance expenses	22,399	39,887	78,053	137,185

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

Other expenses	40,517	67,082	119,856	163,194
Interest expense	4,745	7,375	17,290	22,835
	151,010	171,949	494,235	602,567
Income from continuing operations before income taxes	10,310	34,194	16,653	54,703
Federal income taxes	3,861	11,951	6,423	21,288
Income from continuing operations	6,449	22,243	10,230	33,415
Income from discontinued operations, net	11	12	35	39
Net income	\$ 6,460	\$ 22,255	\$ 10,265	\$ 33,454

National Health Care Reform Legislation

In March 2010, Health Care Reform Legislation was signed into law, which 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

Table of Contents

business, including but not limited to the minimum medical loss ratio requirements applicable to our insurance subsidiaries as well to health 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. Due to the complexity of the Health Care Reform Legislation, the pending status of certain implementing regulations and interpretive guidance, and gradual implementation, the full impact of Health Care Reform Legislation on our business is not yet fully known. However, we have dedicated material resources and, in the future, expect to dedicate additional resources and to incur additional expenses (including but not limited to additional claims expenses) as a result of Health Care Reform Legislation.

With respect to the minimum loss ratio requirements effective beginning in 2011, a mandated minimum loss ratio of 80% for the individual and small group markets is expected to have a significant impact on the revenues of our insurance subsidiaries and our business generally. 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 issue rebates to customers, 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. The 80% minimum medical loss ratio for the individual market is subject to adjustment, on a state-by-state basis, if HHS determines that the requirement is disruptive to the market. In response to requests by state insurance departments, HHS has granted an adjustment to the MLR standards in a number of states.

In addition, beginning in 2011, the mandated medical loss ratio requirements have adversely affected the level of base commissions and override commissions that Insphere receives from the Company's insurance subsidiaries and third party insurance carriers. In order to comply with the 80% minimum medical loss ratio requirement, many of these carriers, including the Company's insurance subsidiaries, have reduced commissions and overrides. In the fourth quarter of 2010, Insphere received notice from a number of its health carriers that compensation levels in 2011 would be significantly lower than 2010 levels. As a result of these reductions, Insphere has lowered the level of commissions paid to its agents for the sale of products underwritten by these carriers. At this time, we are not able to project with certainty the full 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.

To the extent required by the Health Care Reform Legislation, the Company has made the adjustments to its in-force block of business issued prior to March 24, 2010, including but not limited to removal of lifetime maximums on benefits, extension of dependent coverage through age 26, meeting new HHS reporting requirements and adopting limitations on most policy rescissions. These changes generally became effective on January 1, 2011 (for most of our plans the effective date of the new plan year), although certain states may require an earlier effective date. In addition to these changes, health benefit plans issued on or after March 24, 2010 are subject to more extensive benefit changes, including but not limited to first dollar preventive care benefits as well as the elimination of annual limits on essential benefits covered by the policies (subject to the availability of a waiver for small employer group plans and certain individual plans, which the Company has received for Maine, Washington and North Carolina). The Company has made all state form and rate filings necessary to include these new requirements in the limited number of states in which our insurance subsidiaries continue to offer health benefit plans. The Company's review of the requirements of the Health Care Reform Legislation, and its potential impact on the Company's health insurance product offerings, is ongoing.

For additional information, see the caption entitled "Business Regulatory and Legislative Matters" in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

Excess of Loss Reinsurance Agreement

As discussed above, Health Care Reform Legislation resulted in a number of changes to the Company's in force block of business, including elimination of a number of policy benefit limits. In an effort to mitigate the risk of loss associated with large medical claims, effective April 1, 2011, the Company's principal insurance subsidiaries entered into an excess of loss reinsurance agreement with Zurich American Insurance Company. Under the reinsurance agreement, the Company retains liability in the amount of \$1 million per member, per year and the reinsurer is responsible for amounts in excess of \$1 million per member, per year. The reinsurance agreement is limited to membership in effect on or after the contract date and covers incurred claims through the remainder of 2011 and paid

by the end of 2012.

Business Segments

The Company operates four business segments: Commercial Health, Insphere, Corporate, and Disposed Operations. Through our Commercial Health Division, we underwrite and administer a broad range of health and supplemental insurance products. Insphere includes net commission revenue, agent incentives, marketing costs and costs associated with

Table of Contents

the continuing development of Insphere. Corporate includes investment income not allocated to the other segments, 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 2010.

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,	
	2011	2010	2011	2010
	(In thousands)			
<i>Revenue from continuing operations:</i>				
Commercial Health Division:	\$ 141,867	\$ 192,151	\$ 448,538	\$ 620,755
Insphere:	18,423	11,511	52,687	24,524
Corporate:	5,572	4,762	21,639	17,173
Intersegment Eliminations:	(4,933)	(3,027)	(13,184)	(7,116)
Total revenues excluding disposed operations	160,929	205,397	509,680	655,336
Disposed Operations:	391	746	1,208	1,934
Total revenue from continuing operations	\$ 161,320	\$ 206,143	\$ 510,888	\$ 657,270

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands)			
<i>Income (loss) from continuing operations before federal income taxes:</i>				
Commercial Health Division:	\$ 30,343	\$ 89,474	\$ 75,923	\$ 187,883
Insphere:	(12,400)	(23,341)	(39,614)	(69,862)
Corporate:	(8,300)	(33,088)	(20,949)	(65,326)
Total operating income excluding disposed operations	9,643	33,045	15,360	52,695
Disposed Operations	667	1,149	1,293	2,008
Total income from continuing operations before federal income taxes	\$ 10,310	\$ 34,194	\$ 16,653	\$ 54,703

Commercial Health Division

Edgar Filing: HealthMarkets, Inc. - Form 10-Q

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, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
Revenue				
Earned premium revenue	\$ 132,068	\$ 176,816	\$ 417,366	\$ 572,367
Investment income	3,422	5,916	10,564	17,089
Other income	6,377	9,419	20,608	31,299
Total revenue	141,867	192,151	448,538	620,755
Benefits and Expenses				
Benefit expenses	83,801	58,554	279,525	281,528
Underwriting, acquisition and insurance expenses	26,083	40,828	87,404	139,460
Other expenses	1,640	3,295	5,686	11,884
Total expenses	111,524	102,677	372,615	432,872
Operating income	\$ 30,343	\$ 89,474	\$ 75,923	\$ 187,883
<i>Other operating data:</i>				
Loss ratio	63.5%	33.1%	67.0%	49.2%
Expense ratio	19.7%	23.1%	20.9%	24.4%
Combined ratio	83.2%	56.2%	87.9%	73.6%

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.

Table of Contents*Three Months Ended September 30, 2011 versus 2010*

The Commercial Health Division reported earned premium revenue of \$132.1 million during the three months ended September 30, 2011 compared to \$176.8 million in the corresponding period of 2010, a decrease of \$44.7 million or 25.3%, which is due to a continued decrease in policies in force. The decrease in policies in force reflects the Company's emphasis on the distribution of health insurance products underwritten by non-affiliated carriers and the discontinuation in marketing health benefit plans underwritten by the Company's insurance subsidiaries in all but a limited number of states. Beginning in 2011, the decrease in earned premium also reflects the recording of an accrual for an estimated medical loss ratio rebate payable under the Health Care Reform Legislation.

The Commercial Health Division reported operating income of \$30.3 million in 2011 compared to operating income of \$89.5 million in 2010, a decrease of \$59.2 million or 66.1%. Operating income as a percentage of earned premium revenue (*i.e.*, operating margin) for 2011 was 23.0% compared to the operating margin of 50.6% in 2010, which is generally attributable to an increase in the loss ratio, as a result of the new minimum loss ratio requirements. The Company updated its loss reserve analysis used at the end of the third quarter to reflect more recent patterns of paid claims in both 2011 and 2010. The impact on the operating margin as a result of the update of its loss reserve analysis was larger in 2010 than in 2011. Additionally, the results for the third quarter of 2010 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.

Underwriting, acquisition and insurance expenses decreased for the quarter by \$14.7 million, or 36.0%, to \$26.1 million in 2011 from \$40.8 million in 2010. 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. Additionally, we continue to initiate certain cost reduction programs which are reflected as a decrease in the expense ratio.

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 prior to the formation of Insphere, for which other expenses are incurred for bonuses and other compensation provided to the agents. The majority of these association memberships were sold along with health policies and as premium continues to decrease we expect the revenue and expense generated from these association memberships to decrease also.

Nine Months Ended September 30, 2011 versus 2010

The Commercial Health Division reported earned premium revenue of \$417.4 million during the nine months ended September 30, 2011 compared to \$572.4 million in the corresponding period of 2010, a decrease of \$155.0 million or 27.1%, which is due to a decrease in policies in force. As discussed above, the decrease in policies in force reflects the Company's emphasis on the distribution of health insurance products underwritten by non-affiliated carriers and the recording of an accrual for an estimated medical loss ratio rebate payable under the Health Care Reform Legislation.

The Commercial Health Division reported operating income of \$75.9 million in 2011 compared to operating income of \$187.9 million in 2010, a decrease of \$112.0 million or 59.6%. Operating income as a percentage of earned premium revenue (*i.e.*, operating margin) for 2011 was 18.2% compared to the operating margin of 32.8% in 2010, which is generally attributable to an increase in the loss ratio. The Company updated its loss reserve analysis used at the end of the third quarter to reflect more recent patterns of paid claims in both 2011 and 2010. The impact on the operating margin as a result of the update of its loss reserve analysis was larger in 2010 than in 2011. Additionally, the results for the nine months ended September 30, 2010 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 \$19.6 million. The increase in the loss ratio in 2011 also reflects the new minimum loss ratio requirements and certain large claims incurred during the period as a result of the removal of lifetime maximums on policy benefits.

Underwriting, acquisition and insurance expenses decreased by \$52.1 million, or 37.3%, to \$87.4 million in 2011 from \$139.5 million in 2010. 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. Additionally, we continue to initiate certain cost reduction programs to reduce those costs that do not vary in proportion to premium.

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 prior to the formation of

Table of Contents

Insphere, for which other expenses are incurred for bonuses and other compensation provided to the agents. The majority of these association memberships were sold along with health policies and as premium continues to decrease we expect the revenue and expense generated from these association memberships to decrease also.

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, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
Revenue				
Commission revenue	\$ 17,901	\$ 10,014	\$ 51,196	\$ 21,647
Investment income	257	139	752	247
Other income	265	1,358	739	2,630
Total revenue	18,423	11,511	52,687	24,524
Expenses				
Commission expenses	9,513	6,166	28,001	12,776
Agent incentives	6,885	6,167	19,519	18,990
Other expenses	14,425	22,519	44,781	62,620
Total expenses	30,823	34,852	92,301	94,386
Operating loss	\$(12,400)	\$(23,341)	\$(39,614)	\$(69,862)

Three Months Ended September 30, 2011 versus 2010

For the three months ended September 30, 2011, the Company earned commission revenue of approximately \$17.9 million of which \$3.8 million was generated from the sale of insurance products underwritten by the Company's insurance subsidiaries. The remaining amount of commission revenue of \$14.1 million was generated from third-party carriers. Insphere did not begin writing business until the fourth quarter of 2009 and as a result the revenue for the nine months ended September 30, 2011 is significantly greater than the comparable period in 2010. Partially offsetting Insphere's growth in sales is the impact of certain elements of Health Care Reform. Beginning in 2011, in response to Health Care Reform, both the Company's insurance subsidiaries and certain third-party carriers have decreased the level of commissions paid to Insphere.

Commission expense of \$9.5 million includes commissions and overrides paid to our independent agents. Commissions are generally based on a percentage of the premiums paid by the insured to the carrier. The increase in commission expense over the prior year primarily trends with commission revenue. However, beginning in the third quarter of 2010, Insphere increased its commission rates paid to its agents to incorporate some of the costs previously included in Agent incentives.

Agent incentives of \$6.9 million primarily include production and agent recruiting bonuses paid to our independent agents as well as lead generation costs incurred to facilitate the production of commission revenue. The decrease in Agent incentives as a percentage of Commission revenue from prior year reflects the adjustment to commission rates, in the third quarter of 2010, to incorporate some of these costs as discussed above. In addition, beginning in the last half of 2010, the agents started sharing some of the costs of purchasing customer leads which reduced a portion of the

lead generation costs for the Company.

For the three months ended September 30, 2011, Insphere reported other expenses of \$14.4 million. Other expenses associated with Insphere are related to employee compensation, costs associated with our field offices, depreciation and amortization, and other administrative expenses. Other expenses also reflect the significant amount of development to support multiple carriers and enhance the Insphere distribution channel by equipping our agents with efficient technology to cross-sell products. Other expenses have decreased from prior year as a result of both cost cutting initiatives and a reduction in costs associated with the development of Insphere.

Table of Contents*Nine Months Ended September 30, 2011 versus 2010*

For the nine months ended September 30, 2011, the Company earned commission revenue of approximately \$51.2 million of which \$9.9 million was generated from the sale of insurance products underwritten by the Company's insurance subsidiaries. The remaining amount of commission revenue of \$41.3 million was generated from third-party carriers with approximately 88% generated from five carriers. Insphere did not begin writing business until the fourth quarter of 2009 and as a result the revenue for the nine months ended September 30, 2011 is significantly greater than the comparable period in 2010. Partially offsetting Insphere's growth in sales is the impact of certain elements of Health Care Reform. Beginning in 2011, in response to Health Care Reform, both the Company's insurance subsidiaries and certain third-party carriers have decreased the level of commissions paid to Insphere.

The increase in commission expense from \$12.8 million incurred during the nine months ended September 30, 2010 to \$28.0 million incurred during the nine months ended September 30, 2011, primarily trends with commission revenue. However, beginning in the third quarter of 2010, Insphere increased its commission rates paid to its agents to incorporate some of the costs previously included in Agent incentives.

Agent incentives of \$19.5 million primarily include production and agent recruiting bonuses paid to our independent agents as well as lead generation costs incurred to facilitate the production of commission revenue. The decrease in Agent incentives as a percentage of Commission revenue from the prior year reflects the adjustment to commission rates to incorporate some of these costs as discussed above. In addition, beginning in the last half of 2010, the agents started sharing some of the costs of purchasing customer leads which reduced some of the lead generation costs for the Company.

For the nine months ended September 30, 2011, Insphere reported other expenses of \$44.8 million. Other expenses associated with Insphere are related to employee compensation, costs associated with our field offices, depreciation and amortization, and other administrative expenses. Other expenses also reflect the significant amount of development to build-out technology to support multiple carriers and enhance the Insphere distribution channel by equipping our agents with efficient technology to cross-sell products. Other expenses have decreased from prior year as a result of both cost cutting initiatives and a reduction in costs associated with the development of Insphere.

The Company continues to evaluate new distribution opportunities and continues efforts to expand its portfolio and the size of its field force by developing additional marketing arrangements. We believe the implementation of these new opportunities, along with its current cost reduction program, will help mitigate future operating losses.

Corporate

Corporate includes investment income not otherwise allocated to the other segments, 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.

Set forth below is a summary of the components of operating loss at Corporate for the three and nine months ended September 30, 2011 and 2010:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands)			
<i>Operating loss:</i>				
Investment income on equity	\$ 1,600	\$ 3,220	\$ 8,312	\$ 10,737
Net investment impairment losses recognized in earnings		(765)		(765)
Realized gains, net	2,546	1,225	8,976	3,866
Interest expense on corporate debt	(4,744)	(7,375)	(17,287)	(22,835)
Student loan operations	(53)	(64)	(112)	(185)
General corporate expenses and other	(7,649)	(29,329)	(20,838)	(56,144)
Operating loss	\$ (8,300)	\$ (33,088)	\$ (20,949)	\$ (65,326)

Table of Contents

Three Months Ended September 30, 2011 versus 2010

Corporate reported an operating loss in 2011 of \$8.3 million compared to \$33.1 million in 2010 for an overall decrease in the operating loss of \$24.8 million. The change in operating loss is primarily due to the following items:

The increase in realized gains during 2011 is the result of the sale of various fixed maturities during the period to increase liquidity to repay the Company's term loan in April 2012.

Interest expense on corporate debt decreased for the three months ended September 30, 2011 compared to the same period in 2010 as a result of the maturing of the last of the Company's interest rate swaps in April 2011. The Company's interest rate swaps caused the Company to pay a fixed rate higher than the current variable rate incurred on its debt. Additionally, during the second quarter of 2011, some of the Company's fixed rate debt became variable at a significantly lower interest rate. For additional information on the Company's debt, see Note 8 of the Notes to Consolidated Condensed Financial Statements included herein.

General corporate expenses and other decreased significantly in the three months ended September 30, 2011 compared to the same period in 2010. The decrease is primarily the result of cost incurred in 2010 related to severance, acceleration of stock awards expense and other compensation associated with changes to the Company's executive management team in the third quarter of 2010. Additionally, the Company continues to implement cost reduction activities including reductions in salary and related expenses as well as reductions in other corporate overhead costs.

Nine Months Ended September 30, 2011 versus 2010

Corporate reported an operating loss in 2011 of \$20.9 million compared to \$65.3 million in 2010 for an overall decrease in the operating loss of \$44.4 million. The change in operating loss is primarily due to the following items:

As discussed above the increase in realized gains during 2011 is the result of the sale of various fixed maturities during the period to increase liquidity to repay the Company's term loan in April 2012.

Interest expense on corporate debt decreased for the nine months ended September 30, 2011 compared to the same period in 2010 as a result of the maturing of one of the Company's interest rate swaps in April 2010 and the final interest rate swap in April 2011. The Company's interest rate swaps caused the Company to pay a fixed rate higher than the current variable rate incurred on the debt. As discussed above in Note 8, the Company's remaining interest rate swap expired on April 11, 2011.

General corporate expenses and other decreased by \$35.3 million from the prior year. As discussed above, the Company recognized significant costs incurred in 2010 related to severance, acceleration of stock awards expense and other compensation associated with changes to the Company's executive management team in the third quarter of 2010. Additionally, the Company continues to implement cost reduction activities including reductions in salary and related expenses as well as reductions in other corporate overhead costs.

Liquidity and Capital Resources

Consolidated Operations

The Company's primary sources of cash on a consolidated basis are premium revenue from policies issued, commission earned on the sale of non-affiliated insurance company products, investment income, and fees and other income. The primary uses of cash have been payments for benefits, claims, commissions, servicing of the Company's debt obligations, and operating expenses.

Table of Contents

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, 2011	September 30, 2011	December 31, 2010
<i>2006 credit agreement:</i>				
Term loan	2012	1.246%	\$ 362,500	\$ 362,500
\$75 million revolver	(a)			
Grapevine Note	2021	6.712%	72,350	72,350
<i>Trust preferred securities:</i>				
UICI Capital Trust I	2034	3.786%	15,470	15,470
HealthMarkets Capital Trust I	2036	3.397%	51,550	51,550
HealthMarkets Capital Trust II	2036	3.397%	51,550	51,550
Total			\$ 553,420	\$ 553,420
Student Loan Credit Facility	(b)	0.000%(c)	61,750	68,650
Total			\$ 615,170	\$ 622,070

(a) The \$75 million revolver matured on April 5, 2011 and was not renewed.

(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. The indebtedness outstanding under the term loan credit facility of \$362.5 million is due in full upon the maturity of the term loan on April 5, 2012. The Company believes it will have the necessary capital to repay the term loan in full at maturity. See Note 8 of Notes to Consolidated Condensed Financial Statements for additional disclosure regarding the Company's debt.

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.

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.

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 2011, based on the 2010 statutory net income and statutory capital and surplus levels, the Company's 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 \$169.4 million. The Company's insurance companies paid ordinary dividends of \$118.0 million to HealthMarkets, LLC through September 30, 2011. In addition, on September 9, 2011, the Company's insurance subsidiary, Mid-West National Life Insurance Company of Tennessee declared an extraordinary dividend in the amount of \$61.1 million to be paid upon approval by the Texas Department of Insurance. This extraordinary dividend is currently pending approval from the Texas Department of Insurance. Additionally, the Company's insurance subsidiary, The MEGA Life and Health Insurance Company (MEGA) declared an extraordinary dividend in the amount of \$159.4 million on October 10, 2011, and paid its parent company, HealthMarkets, LLC on November 1, 2011. As it has done in the past, the Company will continue to assess the results of operations of the regulated insurance companies to determine the prudent dividend capability of the subsidiaries.

HealthMarkets, LLC provides working capital to its wholly-owned subsidiary, Insphere, pursuant to a \$100 million Loan Agreement. As of September 30, 2011 and December 31, 2010, Insphere had an outstanding balance owed to HealthMarkets, LLC of \$91.9 million and \$79.9 million, respectively.

At September 30, 2011, HealthMarkets, Inc. and HealthMarkets, LLC, in the aggregate, held cash and cash equivalents in the amount of \$267.8 million.

Table of Contents**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, 2010. There have been no material changes in the Company's contractual obligations or off balance sheet commitments since December 31, 2010.

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, 2010 under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations - *Critical Accounting Policies and Estimates*."

Effective January 1, 2011, the Company changed the method used to calculate its policy liabilities for the majority of its health insurance products because it believes that the new method will be preferable in light of, among other factors, certain changes required by Health Care Reform Legislation. As a result of this change, the Company recorded the following: (i) a decrease in the amount of \$77.9 million to claims and claims administration liabilities, (ii) an increase in the amount of \$35.1 million to future policy and contract benefits, (iii) an increase in the amount of \$15.0 million to deferred federal income tax liability and (iv) an increase in the amount of \$27.8 million to retained earnings. See Note 2 - *Change in Accounting Principle* in Notes to Consolidated Condensed Financial Statements.

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, 2010. See Note 11 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, 2011. Reference is made to the information contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 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,

Table of Contents

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.

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 11 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, 2010 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 11 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, 2010 in Part I, Item 1A. Risk Factors, 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.

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

During the quarter ended September 30, 2011, the Company issued an aggregate of 22,453 unregistered shares of its Class A-1 common stock. In particular, employee participants in the HealthMarkets, Inc. InVest Stock Ownership Plan purchased 22,453 shares of the Company's Class A-1 common stock for aggregate consideration of \$210,000 (or \$9.37 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.

Table of Contents**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, 2011:

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
7/1/11 to 7/31/11		\$ N/A		
8/1/11 to 8/31/11	7,978	9.37		
9/1/11 to 9/30/11	2,645	9.37		
Totals	10,623	\$ 9.37		

(1) The number of shares purchased other than through a publicly announced plan or program includes 84,383 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, 2011:

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
7/1/11 to 7/31/11	23,211	\$ 9.35		
8/1/11 to 8/31/11	122,418	9.37		
9/1/11 to 9/30/11	25,438	9.37		
Totals	171,067	\$ 9.37		

(1) The number of shares purchased other than through a publicly announced plan or program includes 171,067 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.

35

Table of Contents

ITEM 6. EXHIBITS

(a) Exhibits.

Exhibit No.	Description
10.1	Employment Agreement, effective as of August 17, 2011, between HealthMarkets, Inc. and K. Alec Mahmood, filed as Exhibit 10.1 to the Current Report on Form 8-K dated August 17, 2011, File No. 001-14953, and incorporated by reference herein.
10.2	Seperation Agreement, dated as of September 1, 2011, between Healthmarkets, Inc. and B. Curtis Westen, filed as Exhibit 10.1 to the Current Report on Form 8-K/A dated September 1, 2011, File No. 001-14953, and incorporated by reference herein.
10.3	Independent Contractor Consulting Agreement, dated as of September 1, 2011, between Healthmarkets, Inc. and B. Curtis Westen, filed as Exhibit 10.2 to the Current Report on Form 8-K/A dated September 1, 2011, File No. 001-14953, and incorporated by reference herein.
31.1	Rule 13a-14(a)/15d-14(a) Certification, executed by Kenneth J. Fasola, 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 Kenneth J. Fasola, Chief Executive Officer of HealthMarkets, Inc. and K. Alec Mahmood, Senior Vice President and Chief Financial Officer of HealthMarkets, Inc.
101	The following materials from HealthMarkets Form 10-Q for the period ended September 30, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Condensed Balance Sheets, (ii) Consolidated Condensed Statements of Income, (iii) Consolidated Condensed Statement of Comprehensive Income, (iv) Consolidated Condensed Statements of Cash Flows, and (v) Notes to the Consolidated Condensed Financial Statements, tagged as blocks of text.

Table of Contents

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 10, 2011

/s/ Kenneth J. Fasola
Kenneth J. Fasola
Chief Executive Officer

Date: November 10, 2011

/s/ K. Alec Mahmood
K. Alec Mahmood
Senior Vice President and Chief Financial
Officer (Principal Financial Officer)
37