

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549  
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2002

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

COMMISSION FILE NUMBER 1-16477



COVENTRY HEALTH CARE, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of  
incorporation or organization)

52-2073000

(I.R.S. Employer  
Identification Number)

6705 Rockledge Drive, Suite 900, Bethesda, Maryland 20817

(Address of principal executive offices) (Zip Code)

(301) 581-0600

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

Class

Outstanding at October 31, 2002

Common Stock \$.01 Par Value

59,888,922

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**COVENTRY HEALTH CARE, INC.**

**FORM 10-Q**

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## PART I. FINANCIAL INFORMATION

### ITEM 1: Financial Statements

#### COVENTRY HEALTH CARE, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (in thousands, except share data)

	September 30, 2002	December 31, 2001
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 173,426	\$ 312,364
Short-term investments	61,972	87,515
Accounts receivable, net	70,373	63,486
Other receivables, net	60,663	65,291
Deferred income taxes	43,509	43,509
Other current assets	7,559	6,353
Total current assets	417,502	578,518
Long-term investments	828,110	552,612
Property and equipment, net	31,931	34,327
Goodwill, net	243,746	237,392
Other intangible assets, net	25,489	24,719
Other long-term assets	31,469	23,705
Total assets	\$ 1,578,247	\$ 1,451,273
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Medical claims liabilities	\$ 470,234	\$ 460,489
Other medical liabilities	63,608	62,365
Accounts payable and other accrued liabilities	159,096	165,697
Deferred revenue	47,879	62,994
Total current liabilities	740,817	751,545
Senior notes	175,000	-
Other long-term liabilities	22,432	10,649
Total liabilities	938,249	762,194
Stockholders' equity:		
Common stock, \$.01 par value; 200,000,000 shares authorized; 68,447,657 shares issued and 59,866,886 outstanding in 2002; and 66,753,210 shares issued and 65,622,749 outstanding in 2001	684	668
Treasury stock, at cost, 8,580,771 and 1,130,461 shares in 2002 and 2001, respectively	(172,017)	(12,257)
Additional paid-in capital	529,613	541,064
Accumulated other comprehensive income	23,589	6,700
Retained earnings	258,129	152,904
Total stockholders' equity	639,998	689,079
Total liabilities and stockholders' equity	\$ 1,578,247	\$ 1,451,273

**The accompanying notes are an integral part of the condensed consolidated financial statements.**

**COVENTRY HEALTH CARE, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)  
(unaudited)

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Operating revenues:				
Managed care premiums	\$ 874,402	\$ 778,562	\$ 2,577,558	\$ 2,285,646
Management services	17,551	16,120	53,057	47,146
Total operating revenues	<u>891,953</u>	<u>794,682</u>	<u>2,630,615</u>	<u>2,332,792</u>
Operating expenses:				
Medical costs	721,985	668,844	2,150,004	1,967,390
Selling, general and administrative	109,173	95,048	322,511	281,892
Depreciation and amortization	4,812	6,574	14,187	19,409
Total operating expenses	<u>835,970</u>	<u>770,466</u>	<u>2,486,702</u>	<u>2,268,691</u>
Operating earnings	55,983	24,216	143,913	64,101
Senior notes interest and amortization expense	3,667	-	9,779	-
Other income, net	9,986	10,703	29,005	33,988
Earnings before income taxes	62,302	34,919	163,139	98,089
Provision for income taxes	22,117	13,269	57,915	37,430
Cumulative effect of change in accounting principle - SFAS No. 133, net of tax	-	-	-	878
Net earnings	<u>\$ 40,185</u>	<u>\$ 21,650</u>	<u>\$ 105,224</u>	<u>\$ 61,537</u>
Net earnings per share:				
Basic before cumulative effect - SFAS No. 133	\$ 0.68	\$ 0.33	\$ 1.77	\$ 0.93
Cumulative effect - SFAS No. 133	-	-	-	0.02
Basic EPS	<u>\$ 0.68</u>	<u>\$ 0.33</u>	<u>\$ 1.77</u>	<u>\$ 0.95</u>
Diluted before cumulative effect - SFAS No. 133	\$ 0.66	\$ 0.32	\$ 1.71	\$ 0.89
Cumulative effect - SFAS No. 133	-	-	-	0.02
Diluted EPS	<u>\$ 0.66</u>	<u>\$ 0.32</u>	<u>\$ 1.71</u>	<u>\$ 0.91</u>

**The accompanying notes are an integral part of the condensed consolidated financial statements.**

**COVENTRY HEALTH CARE, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

	Nine Months Ended	
	September 30,	
	<u>2002</u>	<u>2001</u>
Net cash provided by operating activities	\$ 119,192	\$ 107,097
Cash flows from investing activities:		
Capital expenditures, net	(8,937)	(5,520)
Sales of investments	385,376	271,464
Purchases of investments	(600,103)	(415,048)
Payments for acquisitions, net of cash acquired	(9,387)	28,965
Net cash used in investing activities	<u>(233,051)</u>	<u>(120,139)</u>
Cash flows from financing activities:		
Proceeds from issuance of stock	11,287	2,128
Payments for repurchase of stock	(206,866)	(8,996)
Proceeds from issuance of senior notes, net	170,500	-
Net cash used in financing activities	<u>(25,079)</u>	<u>(6,868)</u>
Net decrease in cash and cash equivalents	(138,938)	(19,910)
Cash and cash equivalents at beginning of period	312,364	256,229
Cash and cash equivalents at end of period	<u>\$ 173,426</u>	<u>\$ 236,319</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 7,662	\$ -
Income taxes paid, net	\$ 40,989	\$ 22,884
Non-cash item -- Restricted stock	\$ 14,417	\$ 9,091

**The accompanying notes are an integral part of the condensed consolidated financial statements.**

**COVENTRY HEALTH CARE, INC. AND SUBSIDIARIES**  
**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**A. BASIS OF PRESENTATION**

The condensed consolidated financial statements of Coventry Health Care, Inc. and Subsidiaries (“Coventry” or the “Company”) contained in this report are unaudited but reflect all normal recurring adjustments which, in the opinion of management, are necessary for the fair presentation of the results of the interim periods reflected. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States have been omitted pursuant to applicable rules and regulations of the Securities and Exchange Commission. The results of operations for the interim periods reported herein are not necessarily indicative of results to be expected for the full year. It is suggested that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s most recent Annual Report on Form 10-K for the year ended December 31, 2001, filed with the Securities and Exchange Commission on March 21, 2002.

**B. SIGNIFICANT ACCOUNTING POLICIES**

In June 2001, the Financial Accounting Standards Board (“FASB”) issued two standards related to business combinations. The first statement, Statement of Financial Accounting Standards (“SFAS”) No. 141 – “Business Combinations,” requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method and prohibits the pooling-of-interest method of accounting. SFAS No. 141 also states that acquired intangible assets should be separately recognized upon meeting certain criteria. Such intangible assets include, but are not limited to, trade and service marks, non-compete agreements, customer lists and licenses. The Company was not significantly affected by the implementation of this statement.

The second statement, SFAS No. 142 – “Goodwill and Other Intangible Assets,” requires companies to cease amortization of goodwill. Rather, goodwill and other intangible assets that have indefinite lives will be subject to a periodic assessment for impairment by applying a fair-value-based test. Impairment charges may result in future write-downs in the period in which the impairment took place. As required, the Company adopted SFAS No. 142 for the fiscal year beginning January 1, 2002, and, accordingly, goodwill was not amortized during 2002.

**C. INTANGIBLE ASSETS**

Goodwill and other intangible assets consist of costs in excess of the fair value of the net tangible assets of subsidiaries or operations acquired through September 30, 2002.

**Goodwill**

As described in the Company’s segment disclosure, assets are not allocated to specific products, and, accordingly, goodwill can not be reported by segment. As required by SFAS No. 142 the Company completed its initial impairment test of goodwill by June 30, 2002 and has determined that there was no impairment of goodwill as of January 1, 2002. The changes in the carrying amount of goodwill for the nine months ended September 30, 2002 were as follows (in thousands):

Balance as of December 31, 2001	\$ 237,392
Acquisition of NewAlliance Health Plan, Inc.	6,484
Transition cost adjustments	(130)
Impairment loss	-
Balance as of September 30, 2002	<u>\$ 243,746</u>

## Other Intangible Assets

The other intangible asset balances are as follows (in thousands):

	<b>Gross</b>			
	<b>Carrying</b>	<b>Accumulated</b>	<b>Carrying</b>	<b>Amortization</b>
	<b>Amount</b>	<b>Amortization</b>	<b>Amount</b>	<b>Period</b>
<b>As of September 30, 2002</b>				
Amortized other intangible assets:				
Customer Lists	\$ 24,510	\$ 7,116	\$ 17,394	5-15 Years
HMO Licenses	10,700	2,705	7,995	15-20 Years
Total amortized other intangible assets	<u>\$ 35,210</u>	<u>\$ 9,821</u>	<u>\$ 25,389</u>	
Unamortized other intangible assets:				
Trade Names	\$ 100	\$ -	\$ 100	---
Total unamortized other intangible assets	<u>\$ 100</u>	<u>\$ -</u>	<u>\$ 100</u>	
Total other intangible assets	<u><b>\$ 35,310</b></u>	<u><b>\$ 9,821</b></u>	<u><b>\$ 25,489</b></u>	
<b>As of December 31, 2001</b>				
Amortized other intangible assets:				
Customer Lists	\$ 21,499	\$ 5,185	\$ 16,314	5-15 Years
HMO Licenses	10,700	2,295	8,405	15-20 Years
Total amortized other intangible assets	<u><b>\$ 32,199</b></u>	<u><b>\$ 7,480</b></u>	<u><b>\$ 24,719</b></u>	

Other intangible amortization expense for the quarters ended September 30, 2002 and 2001 was \$0.8 million and \$0.5 million, respectively. Estimated intangible amortization expense is \$3.1 million for the year ending December 31, 2002, \$2.3 million for the year ending December 31, 2003 and \$2.0 million for the years ending December 31, 2004 through 2006.

The following table presents net income and earnings per share amounts restated to exclude goodwill amortization for the quarters and nine months ended September 30, 2002 and 2001 (in thousands, except per share data).

	<b>Quarters Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>
Reported net income	\$ 40,185	\$ 21,650	\$ 105,224	\$ 61,537
Goodwill amortization	-	2,244	-	6,052
Adjusted net income	<u>\$ 40,185</u>	<u>\$ 23,894</u>	<u>\$ 105,224</u>	<u>\$ 67,589</u>
Basic earnings per share	\$ 0.68	\$ 0.33	\$ 1.77	\$ 0.95
Goodwill amortization	-	0.04	-	0.09
Adjusted basic earnings per share	<u>\$ 0.68</u>	<u>\$ 0.37</u>	<u>\$ 1.77</u>	<u>\$ 1.04</u>
Diluted earnings per share	\$ 0.66	\$ 0.32	\$ 1.71	\$ 0.91
Goodwill amortization	-	0.03	-	0.09
Adjusted diluted earnings per share	<u>\$ 0.66</u>	<u>\$ 0.35</u>	<u>\$ 1.71</u>	<u>\$ 1.00</u>

## D. ACQUISITIONS

On May 1, 2002, the Company's subsidiary, HealthAmerica Pennsylvania, Inc., completed its acquisition of NewAlliance Health Plan, Inc. ("NewAlliance") in Erie, Pennsylvania. The acquisition was accounted for using the purchase method of accounting, and, accordingly, the operating results of NewAlliance have been included in the Company's consolidated financial statements since the date of acquisition. The purchase price for NewAlliance was allocated to the assets, including identifiable intangible assets and liabilities based on estimated fair values. NewAlliance had 46,226 commercial and self-funded members and served the northwestern Pennsylvania market.

On September 16, 2002, Coventry announced that it had signed a definitive agreement to acquire Mid-America Health Partners Inc. ("Mid-America"), a Kansas City, Missouri based HMO and PPO rental network. Mid-America has approximately 54,000 fully-insured commercial, 43,000 self-funded, 23,000 Medicare+Choice, and 130,000 rental PPO members. The Mid-America Medicare+Choice contract terminates December 31, 2002. Current Mid-America Medicare+Choice members may enroll in Coventry's existing product in the Kansas City market.

## E. COMPREHENSIVE INCOME

Comprehensive income for the quarters and nine months ended September 30, 2002 and 2001 was as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net earnings	\$ 40,185	\$ 21,650	\$ 105,224	\$ 61,537
Other comprehensive gain:				
Holding gain	20,939	10,492	25,030	13,337
Reclassification adjustment	942	(204)	1,154	1,199
Cumulative effect - SFAS No. 133	-	-	-	(1,439)
Sub-total	<u>21,881</u>	<u>10,288</u>	<u>26,184</u>	<u>13,097</u>
Tax provision	<u>(7,768)</u>	<u>(4,012)</u>	<u>(9,295)</u>	<u>(5,108)</u>
Comprehensive income	<u>\$ 54,298</u>	<u>\$ 27,926</u>	<u>\$ 122,113</u>	<u>\$ 69,526</u>

## F. EARNINGS PER SHARE

Basic earnings per share are based on the weighted average number of common shares outstanding during the year. Diluted earnings per share assume the exercise of all options and warrants and the vesting of all restricted stock using the treasury stock method.

The following table summarizes the earnings and the average number of common shares used in the calculation of basic and diluted earnings per share (in thousands, except for per share amounts):

	<u>Quarters Ended</u>			<u>Nine Months Ended</u>		
	<u>Earnings</u>	<u>Shares</u>	<u>Per Share Amount</u>	<u>Earnings</u>	<u>Shares</u>	<u>Per Share Amount</u>
<b>September 30, 2002</b>						
Basic earnings per share	\$ 40,185	58,980	\$ 0.68	\$ 105,224	59,510	\$ 1.77
Effect of dilutive securities:						
Options, warrants and restricted stock		1,760			2,149	
Diluted earnings per share	<u>\$ 40,185</u>	<u>60,740</u>	\$ 0.66	<u>\$ 105,224</u>	<u>61,659</u>	\$ 1.71
<b>September 30, 2001</b>						
Basic earnings per share:						
Earnings before cumulative effect - SFAS No. 133	\$ 21,650	64,969	\$ 0.33	\$ 60,659	64,951	\$ 0.93
Cumulative effect - SFAS No. 133	-	-	-	878	-	0.02
Basic earnings per share	<u>\$ 21,650</u>	<u>64,969</u>	<u>\$ 0.33</u>	<u>\$ 61,537</u>	<u>64,951</u>	<u>\$ 0.95</u>
Diluted earnings per share:						
Earnings before cumulative effect - SFAS No. 133	\$ 21,650	64,969		\$ 60,659	64,951	
Effective of diluted securities:						
Options, warrants and restricted stock		3,117			2,844	
	<u>\$ 21,650</u>	<u>68,086</u>	\$ 0.32	<u>\$ 60,659</u>	<u>67,795</u>	\$ 0.89
Cumulative effect - SFAS No. 133	-	-	-	878	-	0.02
Diluted earnings per share	<u>\$ 21,650</u>	<u>68,086</u>	<u>\$ 0.32</u>	<u>\$ 61,537</u>	<u>67,795</u>	<u>\$ 0.91</u>

## G. SENIOR NOTES

On February 1, 2002, Coventry Health Care, Inc. completed a transaction to sell \$175.0 million original 8.125% senior notes due 2012 in a private placement. These senior notes have since been registered with the Securities and Exchange Commission. The proceeds from the sale of senior notes were used to purchase, from Principal Health Care, Inc., approximately 7.1 million shares of Coventry common stock and a warrant exercisable, at that time, for approximately 3.1 million shares of Coventry common stock. The aggregate purchase price for the shares of common stock and the warrant was approximately \$176.1 million.

Senior notes interest expense and amortization of issuance costs for the quarter and nine months ended September 30, 2002 was approximately \$3.7 million and \$9.8 million, respectively. Interest on the notes is payable on February 15 and August 15 each year. During the third quarter of 2002, the Company paid approximately \$7.7 million of interest on the notes.

## H. RESTRICTED STOCK AWARDS AND SHARE REPURCHASE PROGRAM

In the second quarter of 2002, the Company awarded 505,500 shares of restricted stock with varying vesting periods through May 2006. The fair value of the restricted shares, at the grant date, is amortized over the vesting period. The restricted stock shares were granted at a weighted-average fair value of \$28.52. The Company recorded compensation expense related to restricted stock grants, including restricted stock previously awarded in 2001, of approximately \$3.9 million and \$1.8 million for the quarter and nine months ended September 30, 2002, respectively. The deferred portion of the restricted stock is \$18.3 million.

On December 20, 1999, the Company announced a program to purchase up to 5% of its outstanding common stock. In August 2002, the Company's Board of Directors approved the repurchase of an additional 5% of the Company's outstanding common stock. Stock repurchases may be made from time to time at prevailing prices in the open market, by block purchase or in private transactions. As a part of this program, the Company purchased 1,043,200 shares of the Company's common stock in 2002 for its treasury at an aggregate cost of \$30.5 million. The total remaining common shares the Company is authorized to repurchase under the program, including the new authorization, is approximately 3.7 million.

## I. SEGMENT INFORMATION

The Company currently has three reportable segments: Commercial, Medicare and Medicaid products. The products are provided to a cross section of employer groups and individuals throughout the Company's health plans. Commercial products include health maintenance organization ("HMO"), preferred provider organization ("PPO"), and point-of-service ("POS") products. HMO products provide comprehensive health care benefits to members through a primary care physician. PPO and POS products permit members to participate in managed care but allow them the flexibility to utilize out-of-network providers in exchange for increased out-of-pocket costs. The Company provides comprehensive health benefits to members participating in Medicare and Medicaid programs and receives premium payments from federal and state governments.

The Company evaluates the performance of its operating segments and allocates resources based on gross margin. Assets are not allocated to specific products, and, accordingly, can not be reported by segment. The following tables summarize the Company's reportable segments through gross margin and include a medical loss ratio ("MLR") calculation:

<b>Quarters Ended September 30,</b> <b>(in thousands, except percentages)</b>					
	<b>Commercial</b>	<b>Medicare</b>	<b>Medicaid</b>	<b>Total</b>	
<b>2002</b>					
Revenues	\$ 667,845	\$ 105,534	\$ 101,023	\$ 874,402	
Gross Margin	\$ 121,096	\$ 14,732	\$ 16,589	\$ 152,417	
MLR	81.9%	86.0%	83.6%	82.6%	
<b>2001</b>					
Revenues	\$ 592,111	\$ 89,751	\$ 96,700	\$ 778,562	
Gross Margin	\$ 88,156	\$ 8,646	\$ 12,916	\$ 109,718	
MLR	85.1%	90.4%	86.6%	85.9%	
<b>Nine Months Ended September 30,</b> <b>(in thousands, except percentages)</b>					
	<b>Commercial</b>	<b>Medicare</b>	<b>Medicaid</b>	<b>Total</b>	
<b>2002</b>					
Revenues	\$ 1,916,590	\$ 314,222	\$ 346,746	\$ 2,577,558	
Gross Margin	\$ 328,259	\$ 45,160	\$ 54,135	\$ 427,554	
MLR	82.9%	85.6%	84.4%	83.4%	
<b>2001</b>					
Revenues	\$ 1,746,372	\$ 262,624	\$ 276,650	\$ 2,285,646	
Gross Margin	\$ 241,910	\$ 32,216	\$ 44,130	\$ 318,256	
MLR	86.2%	87.7%	84.0%	86.1%	

Following are reconciliations of reportable segment information to financial statement amounts (in thousands):

	<b>Quarters Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>
Revenues:				
Reportable segments	\$ 874,402	\$ 778,562	\$2,577,558	\$ 2,285,646
Management services	17,551	16,120	53,057	47,146
Total revenues	<u>\$ 891,953</u>	<u>\$ 794,682</u>	<u>\$2,630,615</u>	<u>\$ 2,332,792</u>
Earnings before income taxes:				
Gross margin from reportable segments	\$ 152,417	\$ 109,718	\$ 427,554	\$ 318,256
Management services revenue	17,551	16,120	53,057	47,146
Selling, general and administrative expense	109,173	95,048	322,511	281,892
Depreciation and amortization expense	4,812	6,574	14,187	19,409
Senior notes interest and amortization expense	3,667	-	9,779	-
Other income, net	9,986	10,703	29,005	33,988
Earnings before income taxes	<u>\$ 62,302</u>	<u>\$ 34,919</u>	<u>\$ 163,139</u>	<u>\$ 98,089</u>

## J. COMMITMENTS AND CONTINGENCIES

### Legal Proceedings

In the normal course of business, the Company has been named as a defendant in various lawsuits seeking coverage for treatment, payments for denied claims, medical malpractice actions, and various other miscellaneous claims seeking monetary damages. These actions are in various stages of proceedings and some may ultimately be brought to trial. Incidents occurring to date may result in the assertion of additional claims. With respect to these pending actions, the Company maintains commercial insurance programs with varying deductibles, for which the Company holds reserves. In the opinion of management, the outcome of these actions should not have a material adverse effect on the financial position or results of operations of the Company.

The Company generally purchases commercial insurance to insure itself against various legal claims, including general liability, Directors & Officers, Errors & Omissions, and medical malpractice. Due to recent unfavorable changes in the commercial insurance market, the Company has recently elected to self-insure certain Errors & Omissions risks, including medical malpractice claims. Coverage for general liability, Directors & Officers and other risks have not changed materially from past practices. The Company maintains reserves against its self-insured risks.

On April 16, 2001, the Company was served with an Amended Complaint filed in the United States District Court for the Southern District of Florida, Miami Division, MDL No. 1334, styled In Re: Humana, Inc., Managed Care Litigation, Charles B. Shane, M.D., et al. Vs. Humana, Inc., et al. This matter, as to Coventry, is a purported class action lawsuit filed by a group of physicians against the Company and 11 other managed care organizations and healthcare insurers. The lawsuit alleges violations of the federal Racketeer Influenced and Corrupt Organizations statute and the "prompt pay" statutes in certain states, various state law tort claims, and breach of the physicians' provider contracts for failure to pay claims in accordance with the contractual provisions. The lawsuit seeks declaratory, injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments.

Recently, the Court granted the plaintiffs' motion to file a Second Amended Complaint, which added additional plaintiffs and another defendant. The Company has filed a motion to dismiss the Second Amended Complaint and to compel arbitration of the plaintiffs' claims. Although the Company can not predict the outcome, management believes this suit is without merit and intends to defend its position vigorously.

The Company may be the target of other lawsuits generally claiming that managed care companies overcharge consumers, misrepresent the scope of covered services and misrepresent that they deliver quality health care. Although the Company may be the target of these types of lawsuits, the Company believes there is no valid basis for the assertion of such claims.

#### **Federal Employees Health Benefits Program**

The Company contracts with the Office of Personnel Management ("OPM") to provide managed health care services under the Federal Employee Health Benefits Program ("FEHBP"). These contracts with the OPM and applicable government regulations establish premium rating requirements for this program. The OPM conducts periodic audits of its contractors to, among other things, verify that the premiums established under its contracts are in compliance with the community rating and other requirements under the FEHBP. The OPM may seek premium refunds or institute other sanctions against health plans that participate in the program.

One of the Company's subsidiaries has received draft audit reports from the OPM that questioned approximately \$31.1 million of charges for contract years 1993 – 1999 that were paid to this subsidiary under the FEHBP. The OPM asserts that it was overcharged by this amount because allegedly it did not receive discounts that were offered to similarly sized subscriber groups. The reports recommend that if these amounts are deemed to be due, approximately \$5.5 million in lost investment income charges should also be recovered with respect to such overcharges, with additional interest continuing to accrue until repayment of the overcharged amounts. This matter has also been referred to the Office of the U.S. Attorney for consideration of a possible civil action. The Company has responded to the OPM and the U.S. Attorney with respect to the amounts questioned during these audits and has provided additional information to support its positions. Although the Company can not predict the outcome of this matter, management believes, after consultation with legal counsel, that the ultimate resolution of this matter will not have a material adverse effect on the accompanying financial statements.

#### **K. SUBSEQUENT EVENTS**

At the time of this filing, no such events have occurred.

## **ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations Quarters and Nine months Ended September 30, 2002 and 2001**

The statements contained in this Form 10-Q that are not historical are forward-looking statements subject to risks and uncertainties and made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements, which are based on assumptions and estimates and describe the Company's future plans, strategies and expectations, are generally identifiable by the use of the words "anticipate," "will," "believe," "estimate," "expect," "intend," "seek," or similar expressions. These forward-looking statements include all statements that are not statements of historical fact as well as those regarding our intent, belief or expectations including, but not limited to, the discussions of our operating and growth strategy, projections of revenue, income or loss and future operations.

These forward-looking statements may be affected by a number of factors, including, but not limited to, the "Risk Factors" contained in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2001. Actual operations and results may differ materially from those expressed in these forward-looking statements. Among the factors that may materially affect our business are increases in medical costs, difficulties in increasing premiums due to competitive pressures, price restrictions under Medicaid and Medicare, issues relating to marketing of products or accreditation or certification of our products by private or governmental bodies and imposition of regulatory restrictions, cost, or penalties. Other factors that may materially affect our business include issues related to difficulties in obtaining or maintaining favorable contracts with health care providers, credit risks on global capitation arrangements, financing costs and contingencies, the ability to increase membership and premium rates, issues relating to continued growth through acquisitions, and litigation risk. Unless this Form 10-Q indicates otherwise or the context otherwise requires, the terms "we," "our," "our Company," "the Company" or "us" as used in this Form 10-Q refer to Coventry Health Care, Inc. and its subsidiaries.

The following discussion and analysis relates to our financial condition and results of operations for the quarters and nine months ended September 30, 2002 and 2001. This discussion and analysis should be read in conjunction with the condensed consolidated financial statements and other data presented herein as well as "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in our Annual Report on Form 10-K for the year ended December 31, 2001. Our Annual Report on Form 10-K, current reports and recent press releases can be found free of charge on the Internet at [www.cvtv.com](http://www.cvtv.com).

### **General Overview**

We are a leading publicly traded managed health care company with approximately 1.88 million members. We operate a diversified portfolio of local market health plans serving 12 markets, primarily in the Mid-Atlantic, Midwest and Southeast regions. We offer employers a broad range of commercial managed care products that vary with respect to the level of benefits provided, the costs paid by employers and members, and the extent to which members' access to providers is subject to referral or preauthorization requirements. We offer underwritten or "risk" products, including health maintenance organizations ("HMO"s), preferred provider organizations ("PPO"s) and point of service ("POS") plans. In addition, we recently began offering defined contribution health plans. Our risk products also include state-sponsored managed Medicaid programs and Medicare+Choice programs in selected markets where we believe we can achieve profitable growth based upon favorable reimbursement levels, provider costs and regulatory climates. For our risk products, we receive premiums in exchange for assuming underwriting risks and performing sales, marketing and administrative functions. We also offer "non-risk" products, including access to our provider networks and management services, to employers that self-insure employee health benefits. The management services we provide typically include network management, claims processing, utilization review and quality assurance. For our non-risk products, we receive fees for the access to our provider networks and the management services we provide, but we do not have underwriting risk.

## **Revenues**

We generate revenues from managed care premiums and management services. Our managed care premiums are derived from our commercial risk products (HMO, PPO and POS products) and our government programs (Medicaid and Medicare+Choice products). Premiums for our commercial PPO and POS products are typically lower than our HMO premiums due to medical underwriting and higher deductibles and co-payments that are required of the PPO and POS members. We provide comprehensive health benefits to members participating in government programs and receive premium payments from federal and state governments. Premium rates for the Medicaid and Medicare+Choice products are established by governmental regulatory agencies and may be reduced by regulatory action.

Our management services revenues result from operations in which our health plans provide administrative and other services to self-insured employers and to employer group beneficiaries that have elected benefit coverage. We receive an administrative fee for these services, but do not assume underwriting risk. Certain of our management services contracts include performance and utilization management standards that affect the fees received for these services. In addition, we offer a product to other third party payors, under which we provide rental of and access to our PPO network, claims repricing and utilization review, but do not assume underwriting risk.

## **Expenses**

Our primary operating expenses are medical cost, selling, general and administrative expense and depreciation and amortization expense. Our medical costs include medical claims paid under contractual relationships with a wide variety of providers and capitation payments. Medical costs also include an estimate of claims incurred but not reported ("IBNR"). In determining our IBNR liabilities, we employ plan by plan standard actuarial reserve methods that are specific to the plan's membership, product characteristics, geographic territories and provider network. We also consider utilization frequency and unit costs of inpatient, outpatient, pharmacy and other medical expenses, as well as claim payment backlogs and the timing of provider reimbursements. Estimates are reviewed by our actuarial, finance and accounting personnel and other appropriate health plan and corporate personnel. Judgments are then made as to the necessity for reserves in addition to the estimated amounts. Changes in assumptions for medical costs caused by changes in actual experience, changes in the delivery system, changes in pricing due to ancillary capitation and fluctuations in the claims backlog could cause these estimates to change in the near term. We continually monitor and review our IBNR reserves, and as actual settlements are made or accruals adjusted, reflect these differences in current operations. We currently believe that our estimates for IBNR liabilities are adequate to satisfy our ultimate medical claims liability after all medical claims have been reported.

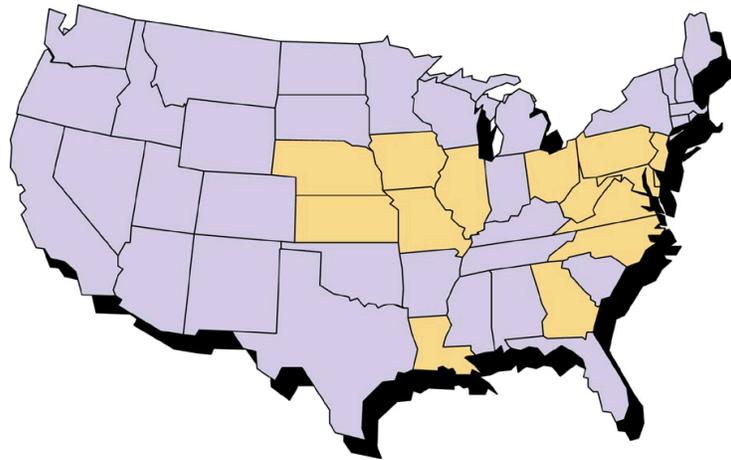
In addition to the procedures for determining reserves as discussed above, we review the actual payout of claims relating to prior period accruals. Medical costs are affected by a variety of factors, including the severity and frequency of claims. These factors are difficult to predict and may not be entirely within our control. We continually refine our actuarial practices to incorporate new cost events and trends.

## Membership

The following tables show the total membership as of September 30, 2002 and 2001 and the percentage change in membership between those dates:

Membership by market:	September 30,		Percent Change
	2002	2001	
Carolinas	104,423	134,790	(22.5%)
Delaware	105,249	154,139	(31.7%)
Georgia	81,561	54,218	50.4%
Iowa	84,232	90,526	(7.0%)
Kansas	186,546	185,712	0.4%
Louisiana	68,015	60,298	12.8%
Nebraska	37,919	44,507	(14.8%)
Pennsylvania	628,815	485,798	29.4%
St. Louis	365,713	387,518	(5.6%)
Virginia	138,165	165,146	(16.3%)
West Virginia	79,007	89,158	(11.4%)
Total membership	1,879,645	1,851,810	1.5%

Risk membership:	September 30,		Percent Change
	2002	2001	
Commercial	1,210,145	1,260,942	(4.0%)
Medicare	58,992	52,017	13.4%
Medicaid	261,617	219,609	19.1%
Total risk membership	1,530,754	1,532,568	(0.1%)
Non-risk membership	348,891	319,242	9.3%
Total membership	1,879,645	1,851,810	1.5%



Total membership increased by 1.5% from the prior year's third quarter. The increase is attributable to the acquisition of NewAlliance in the second quarter of 2002 offset by a decline in Commercial membership resulting from the loss of a large group in our Kansas market in the first quarter of 2002 and in our Carolina market in the fourth quarter of 2001. Medicaid membership increased due to an expansion into additional counties and the withdrawal of a competitor in our Missouri market and due to the introduction of a new product in our Pennsylvania market offset by our exit from the Delaware Medicaid business representing approximately 43,000 members. Non-risk membership increased as a result of the acquisition mentioned above and from additional organic membership obtained in our Georgia market.

## **Acquisitions**

On May 1, 2002, our subsidiary, HealthAmerica Pennsylvania, Inc., completed its acquisition of NewAlliance Health Plan, Inc. ("NewAlliance") in Erie, Pennsylvania. The acquisition was accounted for using the purchase method of accounting, and, accordingly, the operating results of NewAlliance have been included in our consolidated financial statements since the date of acquisition. The purchase price for NewAlliance was allocated to the assets, including identifiable intangible assets and liabilities based on estimated fair values. NewAlliance had approximately 46,000 commercial and self-funded members and served the northwestern Pennsylvania market.

On September 16, 2002, we announced that we had signed a definitive agreement to acquire Mid-America Health Partners Inc. ("Mid-America"), a Kansas City, Missouri based HMO and PPO rental network. Mid-America has approximately 54,000 fully-insured commercial, 43,000 self-funded, 23,000 Medicare+Choice, and 130,000 rental PPO members. The Mid-America Medicare+Choice contract terminates December 31, 2002. Current Mid-America Medicare+Choice members may enroll in Coventry's existing product in the Kansas City market.

We operate PPO rental networks in several of our markets, most notably Georgia, North Carolina, and Iowa, and will initiate inclusion of these member counts in overall membership figures in conjunction with this acquisition. Included in the acquisition are long-term provider and employer group agreements with the current owners. The transaction is expected to close in December of 2002.

## **Legal Proceedings**

In the normal course of business, we have been named as a defendant in various lawsuits seeking coverage for treatment, payments for denied claims, medical malpractice actions, and various other miscellaneous claims seeking monetary damages. These actions are in various stages of proceedings and some may ultimately be brought to trial. Incidents occurring to date may result in the assertion of additional claims. With respect to these pending actions, we maintain commercial insurance programs with varying deductibles, for which we hold reserves. In the opinion of management, the outcome of these actions should not have a material adverse effect on our financial position or results of operations.

We generally purchase commercial insurance to insure ourselves against various legal claims, including general liability, Directors & Officers, Errors & Omissions, and medical malpractice. Due to recent unfavorable changes in the commercial insurance market, we have recently elected to self-insure certain Errors & Omissions risks, including medical malpractice claims. Coverage for general liability, Directors & Officers and other risks have not changed materially from past practices. We maintain reserves against our self-insured risks.

On April 16, 2001, we were served with an Amended Complaint filed in the United States District Court for the Southern District of Florida, Miami Division, MDL No. 1334, styled In Re: Humana, Inc., Managed Care Litigation, Charles B. Shane, M.D., et al. vs. Humana, Inc., et al. This matter, as it relates to us, is a purported class action lawsuit filed by a group of physicians against us and 11 other managed care organizations and healthcare insurers. The lawsuit alleges violations of the federal Racketeer Influenced and Corrupt Organizations statute and the "prompt pay" statutes in certain states, various state law tort claims, and breach of the physicians' provider contracts for failure to pay claims in accordance with the contractual provisions. The lawsuit seeks declaratory, injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments. Recently, the Court granted the plaintiffs' motion to file a Second Amended Complaint, which added additional plaintiffs and another

defendant. We have filed a motion to dismiss the Second Amended Complaint and to compel arbitration of the plaintiffs' claims. Although we can not predict the outcome, management believes this suit is without merit and intends to defend our position vigorously.

We may be the target of other lawsuits generally claiming that managed care companies overcharge consumers, misrepresent the scope of covered services and misrepresent that they deliver quality health care. Although we may be the target of these types of lawsuits, we believe there is no valid basis for the assertion of such claims.

## Results of Operations

The following summary table is provided to facilitate a more meaningful discussion regarding the comparison of our operations for the quarters and nine months ended September 30, 2002 and 2001 (in thousands, except percentages and membership data).

	Quarters Ended			Nine Months Ended		
	September 30,		Increase	September 30,		Increase
	2002	2001	(Decrease)	2002	2001	(Decrease)
<b>Operating revenues:</b>						
Managed care premiums	\$ 874,402	\$ 778,562	\$ 95,840	\$ 2,577,558	\$ 2,285,646	\$ 291,912
Management services	17,551	16,120	1,431	53,057	47,146	5,911
Total operating revenues	<u>\$ 891,953</u>	<u>\$ 794,682</u>	<u>\$ 97,271</u>	<u>\$ 2,630,615</u>	<u>\$ 2,332,792</u>	<u>\$ 297,823</u>
<b>Operating expenses:</b>						
Medical costs	\$ 721,985	\$ 668,844	\$ 53,141	\$ 2,150,004	\$ 1,967,390	\$ 182,614
Selling, general and administrative	109,173	95,048	14,125	322,511	281,892	40,619
Depreciation and amortization	4,812	6,574	(1,762)	14,187	19,409	(5,222)
Total operating expenses	<u>\$ 835,970</u>	<u>\$ 770,466</u>	<u>\$ 65,504</u>	<u>\$ 2,486,702</u>	<u>\$ 2,268,691</u>	<u>\$ 218,011</u>
Operating earnings	\$ 55,983	\$ 24,216	\$ 31,767	\$ 143,913	\$ 64,101	\$ 79,812
Net earnings	\$ 40,185	\$ 21,650	\$ 18,535	\$ 105,224	\$ 61,537	\$ 43,687
Diluted earnings per share						
before cumulative effect - SFAS No. 133	\$ 0.66	\$ 0.32	\$ 0.34	\$ 1.71	\$ 0.89	\$ 0.82
Diluted earnings per share	\$ 0.66	\$ 0.32	\$ 0.34	\$ 1.71	\$ 0.91	\$ 0.80
<b>Medical loss ratios:</b>						
Commercial	81.9%	85.1%	(3.2%)	82.9%	86.2%	(3.3%)
Medicare	86.0%	90.4%	(4.4%)	85.6%	87.7%	(2.1%)
Medicaid	83.6%	86.6%	(3.0%)	84.4%	84.0%	0.4%
Total	<u>82.6%</u>	<u>85.9%</u>	<u>(3.3%)</u>	<u>83.4%</u>	<u>86.1%</u>	<u>(2.7%)</u>
<b>Administrative ratio:</b>						
Selling, general and administrative	12.2%	12.0%	0.2%	12.3%	12.1%	0.2%

### Quarters Ended September 30, 2002 and 2001

Managed care premium revenue increased from the prior year's third quarter by 12.3%, as a result of the acquisition previously mentioned as well as the acquisition of Blue Ridge Health Alliance, Inc. acquired on September 1, 2001. Rate increases on renewals that occurred throughout all markets are also contributing factors to the increase in premium revenue. Average Commercial yields increased by 13.9% over third quarter 2001 on a per member per month basis, to \$186.48. We will continue to be diligent in attempting to obtain adequate premium increases, and expect Commercial rate increases on renewals to exceed 15% for the entire year of 2002.

Management services revenue increased from the prior year's third quarter due to the increase in non-risk membership discussed above.

Medical costs increased from the prior year's third quarter primarily due to the additional expenses associated with acquisitions but also due to general medical cost trends. Our medical loss ratio was 82.6% for the quarter, a

3.3% improvement from the prior year's third quarter. A lower Commercial medical loss ratio was the main driver of the overall medical loss ratio improvement. Rate increases have been outpacing general medical trend as a result of pricing discipline and managing patient care.

Selling, general and administrative expense increased from the prior year's third quarter due to an increase of broker commissions resulting from organic growth and due to the acquisitions mentioned above. Selling, general and administrative expense as a percentage of revenue increased slightly by 0.2%.

Depreciation and amortization decreased 26.8% from prior year's third quarter as a result of the adoption of SFAS No. 142. As mentioned previously, and in accordance with SFAS No. 142, we no longer amortize goodwill but instead will periodically test for impairment (see notes B and C to the condensed consolidated financial statements for more information).

Senior notes interest and amortization expense was incurred for the third quarter of 2002 due to the issuance of our senior notes on February 1, 2002, as described below in "Liquidity and Capital Resources."

Other income, net decreased from the quarter ended September 30, 2001 as a result of lower interest rates during 2002 compared with 2001, offset by earnings from cash placed in short-term and long-term investments to achieve higher yields.

Our provision for income taxes increased from prior year's third quarter due to an increase in earnings before taxes offset by a decrease in the effective tax rate. Excluding amortization of goodwill, the effective tax rate was 35.5% for both quarters ended September 30, 2002 and 2001.

#### **Nine Months Ended September 30, 2002 and 2001**

Managed care premium revenue increased by 12.8% from the nine months ended September 30, 2001, primarily as a result of rate increases that occurred throughout 2001 and 2002 but also as a result of the increase in membership described earlier. Average Commercial yields increased by \$20.44 per member per month from the corresponding period of 2001 to \$182.10 per member per month. We will continue to be diligent in attempting to obtain adequate premium increases, and expect Commercial rate increases on renewals to exceed 15% for the entire year of 2002.

Management services revenue increased from the nine months ended September 30, 2001, almost entirely due to the increase in non-risk membership discussed above.

Medical costs increased from the nine months ended September 30, 2001 due to the additional expenses associated with acquisitions mentioned above and due to general medical cost trends. Our medical loss ratio improved 2.7% from the prior year, to 83.4%. The improvement was attributable to lower Commercial utilization and premium increases as mentioned above.

Selling, general and administrative expense increased from the nine months ended September 30, 2001 primarily due to the acquisitions mentioned above coupled with increased broker commissions on organic growth. Selling, general and administrative expense as a percentage of revenue increased slightly by 0.2%.

Depreciation and amortization decreased 26.9% from the prior year as a result of the adoption of SFAS No. 142. As mentioned previously, and in accordance with SFAS No. 142, we no longer amortize goodwill but will instead perform periodic impairment testing (see notes B and C to the condensed consolidated financial statements for more information).

Senior notes interest and amortization expense was incurred during 2002 due to the issuance of our senior notes on February 1, 2002, as described below in "Liquidity and Capital Resources."

Other income, net decreased from the nine months ended September 30, 2001 primarily due to lower interest rates during 2002 compared to 2001 offset by earnings from cash placed in short-term and long-term investments to

achieve higher yields. Also contributing is a loss on our only derivative investment and losses on sales of investments.

Our provision for income taxes increased from prior year due to an increase in earnings before taxes offset by a decrease in the effective tax rate. Excluding amortization of goodwill, the effective tax rate was 35.5% and 36.0% for the nine months ended September 30, 2002 and 2001, respectively. This decrease in the tax rate is the result of strategic tax planning.

### **Restricted Stock Awards and Share Repurchase Program**

In the second quarter of 2002, we awarded 505,500 shares of restricted stock with varying vesting periods through May 2006. The fair value of the restricted shares, at the grant date, is amortized over the vesting period. The restricted stock shares were granted at a weighted-average fair value of \$28.52. We recorded compensation expense related to restricted stock grants, including restricted stock previously awarded in 2001, of approximately \$3.9 million and \$1.8 million for the quarter and nine months ended September 30, 2002, respectively. The deferred portion of the restricted stock is \$18.3 million.

On December 20, 1999, we announced a program to purchase up to 5% of our outstanding common stock. In August 2002, our Board of Directors approved the repurchase of an additional 5% of our outstanding common stock. Stock repurchases may be made from time to time at prevailing prices in the open market, by block purchase or in private transactions. As a part of this program, we purchased 1,043,200 shares of our common stock in 2002 for our treasury at an aggregate cost of \$30.5 million. The total remaining common shares we are authorized to repurchase under the program, including the new authorization, is approximately 3.7 million.

### **Liquidity and Capital Resources**

#### **Consolidated**

Our total cash and investments, consisting of cash and cash equivalents and short-term and long-term investments, but excluding deposits of \$18.7 million restricted under state regulations, increased \$122.1 million to \$1.0 billion at September 30, 2002. The increase is a result of cash flow from operations and unrealized gains on investments.

Net cash provided by operating activities for the nine months ended September 30, 2002 increased over the prior year due to an increase in net earnings offset by a decrease in deferred revenue related to the timing of Medicare premium payments of \$30.4 million. Net cash used in investing activities increased for the nine months ended September 30, 2002 as a result of an increase in the amount of cash placed in short-term and long-term investments to achieve higher yielding investments and a decrease in cash obtained from acquisitions. Net cash used in financing activities for the nine months ended September 30, 2002 increased over the prior year, primarily due to the repurchase of shares of our common stock and a warrant, offset by proceeds from the issuance of our senior notes mentioned below.

Our investment guidelines emphasize investment grade fixed income instruments in order to provide liquidity to meet future payment obligations and minimize the risk of principal. The fixed income portfolio includes government and corporate securities with an average quality rating of "AA" and an average contractual maturity of 3.64 years as of September 30, 2002. We believe that since our long-term investments are available-for-sale, the amount of such investments should be added to current assets when assessing our working capital and liquidity. On such basis, current assets plus long-term investments available-for-sale less current liabilities increased to \$504.8 million at September 30, 2002 from \$379.6 million at December 31, 2001.

On February 1, 2002, we completed the purchase of approximately 7.1 million shares of our common stock and a warrant exercisable, at that time, for approximately 3.1 million shares of our common stock, owned by Principal Health Care, Inc. The aggregate purchase price for the shares of common stock and the warrant was approximately \$176.1 million. The purchase of the shares and warrant from Principal Health Care, Inc. ended their ownership of our common stock. The stock repurchase program mentioned earlier excludes the shares and warrant purchased from Principal Health Care, Inc. We financed the stock and warrant repurchase with the proceeds from the sale of \$175.0 million of our 8.125% senior notes due February 15, 2012. Interest on the notes is payable on February 15 and August 15 each year, beginning August 15, 2002. During the third quarter of 2002, we paid approximately \$7.7 million of interest on the notes.

### **Health Plans**

Our HMOs and our insurance company subsidiary, Coventry Health and Life Insurance Company (“CH&L”), are required by state regulatory agencies to maintain minimum surplus balances. Risk-based capital (“RBC”) is a method of measuring the minimum amount of capital deemed appropriate for a managed care organization to support its overall business operations with consideration for its size and risk profile. The majority of states in which we operate health plans have adopted a RBC policy that recommends the health plans maintain statutory reserves at or above the ‘Company Action Level’ which is currently equal to 200% of their RBC (250% for CH&L). Although not all states have adopted the RBC policy, the total surplus in excess of 200% for all of our HMO subsidiaries was approximately \$127.3 million at September 30, 2002, up from \$69.4 million at December 31, 2001. The increase is primarily due to current year’s earnings from our HMO subsidiaries and capital contributions made by the parent offset by dividends paid to the parent. The December 31, 2001 surplus represents original and any revised balances resulting from amended statutory filings.

CH&L had excess surplus of approximately \$10.6 million and \$3.4 million at September 30, 2002 and December 31, 2001, respectively. The increase is primarily due to income from the year 2002.

The RBC policy and other regulations enforced by state agencies limit the amount of dividends the parent may receive from its HMOs and CH&L. Excluding funds held by entities subject to regulation, we had cash and investments of approximately \$152.4 million and \$101.8 million at September 30, 2002 and December 31, 2001, respectively. The cash and investments are available to make interest or principal payments on the senior notes or any other debt that we may incur, to make loans to or investments in subsidiaries, to fund acquisitions, for stock repurchases and for general corporate purposes. We have entered into agreements with certain of our regulated subsidiaries to provide additional capital, if necessary, to prevent the subsidiary’s impairment of net worth requirements.

### **Other**

Projected capital investments in 2002 of approximately \$13.0 million consist primarily of computer hardware, software and related equipment costs associated with the development and implementation of improved operational and communications systems. As of September 30, 2002, approximately \$8.9 million has been spent.

The United States Department of Health and Human Services has issued rules, as mandated by the Health Insurance Portability and Accountability Act of 1996, which, among other things, impose security and privacy requirements with respect to individually identifiable patient data, including a member’s transactions with health care providers and payors, as well as requirements for the standardization of certain electronic transaction code sets and provider identifiers. The compliance date for these privacy requirements is April 14, 2003. We have spent approximately \$2.0 million on compliance matters for the nine months ended September 30, 2002. We anticipate spending approximately \$4.4 million in 2002, of which approximately \$1.7 million will be capitalized, related to our compliance with the electronic transaction code sets, provider identifier standards, and security and patient information privacy standards.

The nature of our operations is such that cash receipts from premium revenues are typically received up to three months prior to the expected cash payment for related medical costs. The demand for our products and services are

subject to many economical fluctuations, risks and uncertainties that could materially affect the way we do business. Please refer to the *Risk Factors* section contained in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2001. Management believes that our cash flows generated from operations, cash and investments, and excess funds in certain of our regulated subsidiaries will be sufficient to fund continuing operations, capital expenditures, and debt interest costs at least through September 30, 2003.

### **Risk-Sensitive Financial Instruments and Position**

We have established policies and procedures to manage our exposure to changes in the fair value of our investments. These policies include an emphasis on credit quality, management of portfolio duration, maintaining or increasing investment income through high coupon rates and actively managing profile and security mix depending upon market conditions.

Our projections of hypothetical net losses in fair value of our market rate sensitive instruments, should potential changes in market rates occur, are presented below. The analysis is based on a hypothetical change in interest rates of 100, 200 and 300 basis points. Changes in interest rates may affect the fair value of our investment portfolio and may result in unrealized gains or losses. Gains or losses would be realized upon the sale of these investments. While we believe that the potential market rate change is reasonably possible, actual results may differ.

<b>Increase (Decrease) in fair value of portfolio</b>					
<b>given an interest rate (decrease) increase of X basis points</b>					
<b>As of September 30, 2002</b>					
<b>(in thousands)</b>					
<b>(300)</b>	<b>(200)</b>	<b>(100)</b>	<b>100</b>	<b>200</b>	<b>300</b>
\$ 76,903	\$ 51,269	\$ 25,634	\$ (25,634)	\$ (51,269)	\$ (76,903)

### **Legislation and Regulation**

Numerous proposals have been introduced in the United States Congress and various state legislatures relating to managed care reform. Certain reform proposals would adversely affect managed care; others are more neutral. Although the provisions of any legislation adopted at the state or federal level can not be accurately predicted at this time, management believes that the ultimate outcome of currently proposed legislation would not have a material adverse effect on our results of operations in the short-term.

Pursuant to the Health Insurance Portability and Accountability Act of 1996 mandate, the Department of Health and Human Services released a final rule regarding standards for privacy of individually identifiable health information on December 20, 2000, with an effective date for compliance of April 14, 2003. On August 14, 2002, the Department of Health and Human Services issued an additional final rule amending the standards for privacy of individually identifiable health information. We expect to institute all necessary modifications to systems and business processes by the compliance date.

The Department of Health and Human Services also released its final rule for electronic data standards on August 17, 2000 with an effective date for compliance of October 16, 2002. The compliance date has been extended by legislation until October 16, 2003 for companies that file a compliance plan. We filed a compliance plan and expect to institute all necessary modifications to systems and business processes by the later compliance date.

Our industry is heavily regulated and the laws and rules governing the industry and interpretations of those laws and rules are subject to frequent change. Existing or future laws could have significant effect on our operations.

## **Federal Employees Health Benefits Program**

We contract with the Office of Personnel Management (“OPM”) to provide managed health care services under the Federal Employee Health Benefits Program (“FEHBP”). These contracts with the OPM and applicable government regulations establish premium rating requirements for this program. The OPM conducts periodic audits of its contractors to, among other things, verify that the premiums established under its contracts are in compliance with the community rating and other requirements under the FEHBP. The OPM may seek premium refunds or institute other sanctions against health plans that participate in the program.

One of our subsidiaries has received draft audit reports from the OPM that questioned approximately \$31.1 million of charges for contract years 1993 – 1999 that were paid to this subsidiary under the FEHBP. The OPM asserts that it was overcharged by this amount because allegedly it did not receive discounts that were offered to similarly sized subscriber groups. The reports recommend that if these amounts are deemed to be due, approximately \$5.5 million in lost investment income charges should also be recovered with respect to such overcharges, with additional interest continuing to accrue until repayment of the overcharged amounts. This matter has also been referred to the Office of the U.S. Attorney for consideration of a possible civil action. We have responded to the OPM and the U.S. Attorney with respect to the amounts questioned during these audits and have provided additional information to support our positions. Although we can not predict the outcome of this matter, management believes, after consultation with legal counsel, that the ultimate resolution of this matter will not have a material adverse effect on our operations.

### ITEM 3: Quantitative and Qualitative Disclosures of Market Risk

Our only material risk of investments in financial instruments is in our debt securities portfolio. We invest primarily in marketable state and municipal, U.S. Government and agencies, corporate, and mortgage-backed debt securities. Effective January 1, 2001, we adopted SFAS No. 133 (as amended by SFAS No. 137 and SFAS No. 138). Accordingly, a transition gain of \$0.9 million, net of tax, based on the valuation at December 31, 2000, was recorded in the first quarter of 2001 related to one financial instrument classified as derivative in nature. We do not typically invest in derivative financial instruments.

We have established policies and procedures to manage our exposure to changes in the fair value of our investments. These policies include an emphasis on credit quality, management of portfolio duration, maintaining or increasing investment income through high coupon rates and actively managing profile and security mix depending upon market conditions. We have classified all of our investments as available-for-sale. The fair value of our investments at September 30, 2002 was \$890.1 million. Our investments at September 30, 2002 mature according to their contractual terms, as follows, in thousands (actual maturities may differ because of call or prepayment rights):

	<u>Amortized Cost</u>	<u>Fair Value</u>
<b>As of September 30, 2002</b>		
Maturities:		
Within 1 year	\$ 102,455	\$ 102,801
1 to 5 years	294,202	310,461
6 to 10 years	197,444	208,171
Over 10 years	<u>250,218</u>	<u>259,290</u>
Total short-term and long-term debt securities	\$ 844,319	\$ 880,723
Preferred stock	9,191	9,359
Total short-term and long-term securities	<u>\$ 853,510</u>	<u>\$ 890,082</u>

We believe our investment portfolio is diversified and expect no material loss to result from the failure to perform by the issuer of the debt securities we hold. The mortgage-backed securities are insured by several associations, including Government National Mortgage Administration and Federal National Mortgage Administration.

Our projections of hypothetical net losses in fair value of our market rate sensitive instruments, should potential changes in market rates occur, are presented below. The analysis is based on a hypothetical change in interest rates of 100, 200 and 300 basis points. Changes in interest rates may affect the fair value of our investment portfolio and may result in unrealized gains or losses. Gains or losses would be realized upon the sale of these investments. While we believe that the potential market rate change is reasonably possible, actual results may differ.

<b>Increase (Decrease) in fair value of portfolio given an interest rate (decrease) increase of X basis points As of September 30, 2002 (in thousands)</b>					
<u>(300)</u>	<u>(200)</u>	<u>(100)</u>	<u>100</u>	<u>200</u>	<u>300</u>
\$ 76,903	\$ 51,269	\$ 25,634	\$ (25,634)	\$ (51,269)	\$ (76,903)

**ITEM 4: Controls and Procedures**

Within ninety days prior to the filing date of this quarterly report, we performed an evaluation, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our “disclosure controls and procedures” (as defined in the Securities Exchange Act of 1934 Rules 13a-14(c) and 15d-14(c)). Based upon our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective. There have been no significant changes in our internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation.

## **PART II. OTHER INFORMATION**

### **ITEM 1: Legal Proceedings**

In the normal course of business, we have been named as a defendant in various lawsuits seeking coverage for treatment, payments for denied claims, medical malpractice actions, and various other miscellaneous claims seeking monetary damages. These actions are in various stages of proceedings and some may ultimately be brought to trial. Incidents occurring to date may result in the assertion of additional claims. With respect to these pending actions, we maintain commercial insurance programs with varying deductibles, for which we hold reserves. In the opinion of management, the outcome of these actions should not have a material adverse effect on our financial position or results of operations.

We generally purchase commercial insurance to insure ourselves against various legal claims, including general liability, Directors & Officers, Errors & Omissions, and medical malpractice. Due to recent unfavorable changes in the commercial insurance market, we have recently elected to self-insure certain Errors & Omissions risks, including medical malpractice claims. Coverage for general liability, Directors & Officers and other risks have not changed materially from past practices. We maintain reserves against our self-insured risks.

On April 16, 2001, we were served with an Amended Complaint filed in the United States District Court for the Southern District of Florida, Miami Division, MDL No. 1334, styled In Re: Humana, Inc., Managed Care Litigation, Charles B. Shane, M.D., et al. vs. Humana, Inc., et al. This matter, as it relates to us, is a purported class action lawsuit filed by a group of physicians against us and 11 other managed care organizations and healthcare insurers. The lawsuit alleges violations of the federal Racketeer Influenced and Corrupt Organizations statute and the “prompt pay” statutes in certain states, various state law tort claims, and breach of the physicians’ provider contracts for failure to pay claims in accordance with the contractual provisions. The lawsuit seeks declaratory, injunctive, compensatory and equitable relief as well as restitution, costs, fees and interest payments. Recently, the Court granted the plaintiffs’ motion to file a Second Amended Complaint, which added additional plaintiffs and another defendant. We have filed a motion to dismiss the Second Amended Complaint and to compel arbitration of the plaintiffs’ claims. Although we can not predict the outcome, management believes this suit is without merit and intends to defend our position vigorously.

We may be the target of other lawsuits generally claiming that managed care companies overcharge consumers, misrepresent the scope of covered services and misrepresent that they deliver quality health care. Although we may be the target of these types of lawsuits, we believe there is no valid basis for the assertion of such claims.

**ITEMS 2, 3, 4 and 5: Not Applicable**

## ITEM 6: Exhibits and Reports on Form 8-K

### (a) Exhibit Listing

<b>Exhibit No.</b>	<b>Description of Exhibit</b>
99.1	Certification pursuant to 18 U.S.C. section 1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002 made by Allen F. Wise, President, Chief Executive Officer and Director.
99.2	Certification pursuant to 18 U.S.C. section 1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002 made by Dale B. Wolf, Executive Vice President, Chief Financial Officer and Treasurer.

### (b) Reports on Form 8-K

In connection with the resignation of Thomas J. Graf from the Board of Directors of Coventry Health Care, Inc. on August 29, 2002, we filed a current report on Form 8-K with the Securities and Exchange Commission on September 11, 2002.

**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.

COVENTRY HEALTH CARE, INC.

(Registrant)

Date: November 11, 2002

By: /s/ Allen F. Wise

Allen F. Wise

President, Chief Executive Officer and Director

Date: November 11, 2002

By: /s/ Dale B. Wolf

Dale B. Wolf

Executive Vice President, Chief Financial Officer  
and Treasurer

Date: November 11, 2002

By: /s/ John J. Ruhlmann

John J. Ruhlmann

Vice President and Controller

## CERTIFICATIONS

I, Allen F. Wise, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Coventry Health Care, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 11, 2002

By: /s/ Allen F. Wise

Allen F. Wise

President, Chief Executive Officer and Director

## CERTIFICATIONS

I, Dale B. Wolf, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Coventry Health Care, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - d) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - e) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - c) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - d) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 11, 2002

By: /s/ Dale B. Wolf

Dale B. Wolf  
Executive Vice President, Chief Financial Officer  
and Treasurer

## INDEX TO EXHIBITS

### Reg. S-K: Item 601

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