HEALTHCARE RECOVERIES INC
Form 10-Q
November 14, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

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 0-22585

HEALTHCARE RECOVERIES, INC.
(Exact Name of Registrant as Specified in its Charter)

DELAWARE (State or Other Jurisdiction of Incorporation or Organization)	61-1141758 (I.R.S. Employer Identification No.)
1400 WATTERSON TOWER, LOUISVILLE, KENTUCKY (Address of Principal Executive Offices)	40218 (Zip Code)

(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)
(502) 454-1340

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 [X] No [ ]

As of November 13, 2001, 9,791,200 shares of the Registrant's Common Stock, $0.001 par value were outstanding.

HEALTHCARE RECOVERIES, INC.
FORM 10-Q
SEPTEMBER 30, 2001

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THIS FORM 10-Q AND OTHER STATEMENTS ISSUED OR MADE FROM TIME TO TIME BY HEALTHCARE RECOVERIES, INC. OR MEMBERS OF ITS MANAGEMENT TEAM CONTAIN STATEMENTS WHICH MAY CONSTITUTE "FORWARD-LOOKING STATEMENTS" WITHIN THE MEANING OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED BY THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, 15 U.S.C.A. SECTIONS 77Z-2 AND 78U-5 (SUPP. 1996). THOSE STATEMENTS INCLUDE STATEMENTS REGARDING THE INTENT, BELIEF OR CURRENT EXPECTATIONS OF HEALTHCARE RECOVERIES, INC. AND MEMBERS OF ITS MANAGEMENT TEAM, AS WELL AS THE ASSUMPTIONS ON WHICH SUCH STATEMENTS ARE BASED. PROSPECTIVE INVESTORS ARE CAUTIONED THAT ANY SUCH FORWARD-LOOKING STATEMENTS ARE NOT GUARANTEES OF FUTURE PERFORMANCE AND INVOLVE RISKS AND UNCERTAINTIES, AND THAT ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE CONTEMPLATED BY SUCH FORWARD-LOOKING STATEMENTS. IMPORTANT FACTORS CURRENTLY KNOWN TO MANAGEMENT THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE IN FORWARD-LOOKING STATEMENTS ARE SET FORTH IN THE SAFE HARBOR COMPLIANCE STATEMENT FOR FORWARD-LOOKING STATEMENTS INCLUDED AS EXHIBIT 99.1 TO THE HEALTHCARE RECOVERIES, INC. ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2000, AND ARE HEREBY INCORPORATED HEREIN BY

REFERENCE. HEALTHCARE RECOVERIES, INC. UNDERTAKES NO OBLIGATION TO UPDATE OR REVISE FORWARD-LOOKING STATEMENTS TO REFLECT CHANGED ASSUMPTIONS OR CIRCUMSTANCES, THE OCCURRENCE OF UNANTICIPATED EVENTS OR CHANGES TO FUTURE OPERATING RESULTS OVER TIME.

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PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)

HEALTHCARE RECOVERIES, INC.

CONDENSED BALANCE SHEETS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE INFORMATION)

	SEPTEMBER 30, 2001	DECEMBER 31, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,253	$ 1,297
Restricted cash	14,917	21,647
Accounts receivable, less allowance for doubtful accounts of $444 in 2001 and $434 in 2000	9,655	7,660
Property held for sale	2,981	--
Other current assets	2,269	2,153
Total current assets	31,075	32,757
Property and equipment, at cost:		
Buildings and land	--	4,001
Furniture and fixtures	3,088	3,230
Office equipment	2,027	1,992
Computer equipment	9,923	9,039
Software	6,505	4,844
Leasehold improvements	1,467	1,308
	23,010	24,414
Accumulated depreciation and amortization	(16,344)	(13,781)
Property and equipment, net	6,666	10,633
Cost in excess of net assets acquired, net	29,573	29,143
Identifiable intangibles, net	4,512	4,934
Other assets	2,270	1,978
Total assets	$ 74,096	$ 79,445
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	$ 1,569	$ 1,231
Accrued expenses	4,846	9,906
Funds due clients	10,743	12,437

Short-term borrowings expected to be refinanced	12,000	--
Income taxes payable	989	1,385
Total current liabilities	30,147	24,959
Other liabilities	2,330	2,324
Long-term borrowings	--	14,000
Total liabilities	32,477	41,283
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.001 par value per share; 2,000 shares authorized; no shares outstanding	--	--
Common stock, $.001 par value per share; 20,000 shares authorized; 9,791 and 9,771 shares outstanding as of September 30, 2001 and December 31, 2000, respectively	12	12
Capital in excess of par value	22,750	22,637
Other	(957)	(912)
Treasury stock at cost; 1,792 shares at September 30, 2001 and 1,773 shares at December 31, 2000	(7,116)	(7,037)
Retained earnings	26,930	23,462
Total stockholders' equity	41,619	38,162
Total liabilities and stockholders' equity	$ 74,096	$ 79,445

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

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HEALTHCARE RECOVERIES, INC.

CONDENSED STATEMENTS OF INCOME
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2001 AND 2000
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE INFORMATION)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000	2001	2000
Claims revenues	$15,093	$15,113	$47,105	$47,628
Cost of services	7,646	7,322	23,089	23,430
Gross profit	7,447	7,791	24,016	24,198
Support expenses	3,984	3,951	12,939	12,906
Depreciation and amortization	1,694	1,637	4,906	4,777
Research and development	124	--	415	--
Operating income	1,645	2,203	5,756	6,515
Interest income	114	300	730	847
Interest expense	192	375	742	1,004
Other -- loss on property held for sale	980	--	980	--
Other -- Special Committee expenses	--	--	--	90

Income before income taxes	587	2,128	4,764	6,268
(Benefit) provision for income taxes	(437)	883	1,296	2,601
Net income	$ 1,024	$ 1,245	$ 3,468	$ 3,667
Basic earnings per common share	$ 0.10	$ 0.12	$ 0.35	$ 0.34
Diluted earnings per common share	$ 0.10	$ 0.12	$ 0.35	$ 0.33

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

HEALTHCARE RECOVERIES, INC.

CONDENSED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2001 AND 2000
(UNAUDITED)
(IN THOUSANDS)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000
Cash flows from operating activities:		
Net income	$ 3,468	$ 3,667
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,906	4,777
Deferred income taxes	(2)	(3)
Other	8	(7)
Loss on property held for sale	980	--
Changes in operating assets and liabilities:		
Restricted cash	1,594	2,010
Accounts receivable	(1,995)	(1,366)
Other current assets	(136)	710
Other assets	(552)	(411)
Trade accounts payable	225	(990)
Accrued expenses	(4,170)	(1,922)
Funds due clients	(1,694)	(1,801)
Income taxes payable	(396)	72
Other liabilities	6	--
Net cash provided by operating activities	2,242	4,736
Cash flows from investing activities:		
Acquisitions, net of cash acquired	2,551	(3,881)
Disposals of property and equipment	--	1,409
Purchases of property and equipment	(1,408)	(1,114)
Capitalization of internally developed software	(1,410)	(1,392)
Net cash used in investing activities	(267)	(4,978)
Cash flows from financing activities:		
Line of credit proceeds	1,500	7,700

Line of credit repayments	(3,500)	(4,200)
Repurchase of common stock	(79)	(3,772)
Issuance of common stock	105	91
Other	(45)	(529)
Net cash used in financing activities	(2,019)	(710)
Net decrease in cash and cash equivalents	(44)	(952)
Cash and cash equivalents, beginning of period	1,297	1,670
Cash and cash equivalents, end of period	$ 1,253	$ 718

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

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HEALTHCARE RECOVERIES, INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS
(UNAUDITED)

1. ORGANIZATION AND BASIS OF PRESENTATION

Healthcare Recoveries, Inc. (hereinafter referred to as the "Company" or "HCRI"), a Delaware corporation, was incorporated on June 30, 1988. The Company is a leading independent provider of outsourcing of insurance subrogation and certain other medical claims recovery and cost containment services to the private healthcare payor industry. Its primary business is medical claims recovery, and its primary product is subrogation recovery, which generally entails the identification, investigation and recovery of accident-related medical benefits incurred by its clients on behalf of their insureds, but for which other persons or entities have primary responsibility. The Company's clients' rights to recover the value of these medical benefits, arising by law or contract, are generally known as the right of subrogation and are generally paid from the proceeds of liability or workers' compensation insurance. The Company's other medical claims recovery services include provider bill auditing, contract compliance review and cost management consulting, coordination of benefits and overpayments recovery services.

The accompanying financial statements are presented in a condensed format and consequently do not include all of the disclosures normally required by accounting principles generally accepted in the United States of America or those normally made in the Company's annual financial statements. Accordingly, for further information, the reader of this Form 10-Q may wish to refer to the Company's audited financial statements as of and for the year ended December 31, 2000, contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2000, filed with the Securities and Exchange Commission on March 27, 2001.

The financial information has been prepared in accordance with the Company's customary accounting practices and has not been audited. In the opinion of management, the information presented reflects all adjustments necessary for a fair presentation of interim results. All such adjustments are of a normal and recurring nature. Certain financial statement amounts have been reclassified in the prior period to conform to the current period presentation.

2. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued

Statement of Financial Accounting Standards No. 141 (FAS 141), "Business Combinations", which provides that all business combinations should be accounted for using the purchase method of accounting and establishes criteria for the initial recognition and measurement of goodwill and other intangible assets recorded in connection with a business combination. The provisions of FAS 141 apply to all business combinations initiated after June 30, 2001 and to all business combinations accounted for by the purchase method that are completed after June 30, 2001. The Company will apply the provisions of FAS 141 to any future business combinations.

Also, in June 2001, the FASB issued Statement of Financial Accounting Standards No. 142 (FAS 142), "Goodwill and Other Intangible Assets", which establishes the accounting for goodwill and other intangible assets following their recognition. FAS 142 applies to all goodwill and other intangible assets whether acquired singly, as part of a group, or in a business combination. FAS 142 provides that goodwill should not be amortized but should be tested for impairment annually using a fair-value based approach. In addition, FAS 142 provides that other intangible assets other than goodwill should be amortized over their useful lives and reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of". FAS 142 is effective for the Company beginning on January 1, 2002. Upon adoption, the Company will be required to perform a transitional impairment test under FAS 142 for all goodwill recorded as of January 1, 2002. Any impairment loss recorded as a result of completing the transitional impairment test will be treated as a change in accounting principle. The impact of the adoption of FAS 142 on the Company's results of operations for all periods beginning on or after January 1, 2002 will be to eliminate amortization of goodwill.

Management of the Company has not performed a transitional impairment test under FAS 142 and accordingly cannot estimate the impact of the adoption of FAS 142 as of January 1, 2002.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 143 (FAS 143), "Accounting for Asset Retirement Obligations". FAS 143 is effective for fiscal years beginning after June 15, 2002, and provides accounting requirements for asset retirement obligations associated with tangible long-lived assets. The Company has not yet determined the effects of this standard on its financial statements.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144 (FAS 144), "Accounting for the Impairment or Disposal of Long-Lived Assets". FAS 144 is effective for fiscal years beginning after December 15, 2001. This statement supersedes FAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of", and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations -- Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", for the disposal of a business segment. FAS 144 establishes a single accounting model, based on the framework established in FAS 121. The Company has not yet determined the effect of this standard on its financial statements.

3. CONTINGENCIES

The Company is engaged in the business of identifying and recovering subrogation and related claims of its clients, many of which arise in the

context of personal injury lawsuits. As such, the Company operates in a litigation-intensive environment. The Company has been, from time to time, and in the future expects to be, named as a party in litigation incidental to its business operations. To date, the Company has not been involved in any litigation which has had a material adverse effect upon the Company, but there can be no assurance that pending litigation or future litigation will not have a material adverse effect on the Company's business, results of operations or financial condition.

4. CREDIT FACILITY

On May 15, 2000, the Company entered into a third amendment (the "Amendment") to its February 1, 1998 revolving credit facility with National City Bank of Kentucky and the lenders named therein (the "Credit Facility"). The Company's obligations under the Credit Facility are secured by substantially all of the Company's assets, subject to certain permitted exceptions. Under the Amendment, the maturity date was extended to April 30, 2002 from January 31, 2001, the maximum borrowing capacity decreased to $40 million from $50 million, and certain other financial terms and covenants were amended. Principal amounts outstanding under the Credit Facility bear interest at a variable rate based on the Prime Rate or Eurodollar Rate, as applicable, plus the pre-determined fixed margin. At September 30, 2001, the interest rate was 4.61%. The Credit Facility contains customary covenants and events of default including, but not limited to, financial tests for interest coverage, net worth levels and leverage that may limit the Company's ability to pay dividends. It also contains a material adverse change clause. The Credit Facility was amended in June 2000, to increase the amount of other debt that the Company is permitted to maintain outstanding under another of the Credit Facility's financial covenants. As of September 30, 2001, $12 million was outstanding under the Credit Facility which has been classified as short-term borrowings expected to be refinanced on the balance sheet. (See Note 11 -- Subsequent Events.)

5. STOCK REPURCHASE PLAN

HCRI's Board approved a stock repurchase plan on March 12, 1999 under which the Company is authorized to repurchase, from time to time, up to $10 million of HCRI Common Stock in the open market, at prices per share deemed favorable by the Company. Shares may be repurchased using cash from operations and borrowed funds and may continue until such time as the Company has repurchased $10 million of HCRI

Common Stock or until it otherwise determines to terminate the stock repurchase plan. HCRI repurchased 19,500 shares of its own stock during the three and nine months ended September 30, 2001 at an average price of $4.02 per share. From inception of the program through September 30, 2001, the total number of shares repurchased was 1,792,265 at a cost of $7.1 million, or an average cost of $3.97 per share. All of the reacquired shares of Common Stock through September 30, 2001 are reflected as treasury stock on the accompanying Condensed Balance Sheets (Unaudited).

6. RELATED PARTY TRANSACTIONS

On February 12, 1999, the Board of Directors approved a loan in the amount of $350,000 to Patrick B. McGinnis, the Chairman and Chief Executive Officer of the Company, in exchange for a full recourse promissory note in the same amount from Mr. McGinnis. On June 30, 2000, at the direction of the Board of Directors and in accordance with terms authorized by it, the Company loaned Mr. McGinnis

an additional $500,000. Under these terms, the $500,000 loan to Mr. McGinnis was combined with his existing debt to the Company of $350,000 of principal and $36,520 of accrued interest. Mr. McGinnis delivered to the Company his full recourse promissory note in the amount of $886,520, bearing interest at a fixed rate of 6.62% per annum, compounded annually (the "Amended Promissory Note"), and the Company cancelled the old promissory note evidencing the prior debt. The Amended Promissory Note provides for mandatory prepayments from certain of the proceeds received by Mr. McGinnis from his sale of the Company's securities and any related transactions. At September 30, 2001, the promissory note of $886,520 and accrued interest of $70,972 were outstanding. The proceeds of these loans were to enable Mr. McGinnis to repay debts originally incurred by him to pay income taxes related to the ordinary income deemed to have been received by him on account of Common Stock granted to him in connection with the initial public offering of the Company's stock in May 1997, as well as to enable him to purchase additional stock in the initial public offering.

On June 30, 2000, pursuant to Board authorization and in accordance with the terms of the Amended Promissory Note, the Company and Mr. McGinnis entered into a deferred compensation agreement (the "Agreement"). Under the Agreement, 50% of the amount otherwise payable to Mr. McGinnis under the Company's Management Group Incentive Compensation Plan is to be deferred until the Amended Promissory Note is paid in full, with such deferred compensation then being paid in full to Mr. McGinnis within 30 days thereafter. The Company has full right of set-off against any deferred compensation under the Agreement should Mr. McGinnis default under the Amended Promissory Note. At the election of Mr. McGinnis, the payment of the deferred compensation, upon payment of the Amended Promissory Note, may be extended for a period of not more than ten years. At September 30, 2001, the amount of deferred compensation was $52,648, with accrued interest of $1,900.

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HEALTHCARE RECOVERIES, INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS -- (CONTINUED)

7. EARNINGS PER COMMON SHARE

Reconciliations of the average number of common shares outstanding used in the calculation of earnings per common share and earnings per common share assuming dilution are as follows (dollars and shares in thousands, except per share results):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000	2001	2000
Weighted average number of common shares outstanding	9,807	10,519	9,795	10,899
Add: Dilutive stock options	233	123	165	65
Number of common shares outstanding (diluted)	10,040	10,642	9,960	10,964
Net earnings for earnings per common share (basic and diluted)	$ 1,024	$ 1,245	$3,468	$ 3,667
Earnings per common share:				
Basic	$ 0.10	$ 0.12	$ 0.35	$ 0.34

Diluted	$ 0.10	$ 0.12	$ 0.35	$ 0.33

Basic earnings per common share were computed based on the weighted-average number of shares outstanding during the period. The dilutive effect of stock options was calculated using the treasury stock method. Options to purchase 935,217 and 1,304,253 shares for the three and nine month periods ended September 30, 2001, respectively, and 1,545,294 and 1,586,127 shares for the comparable periods in 2000, respectively, were not included in the computation of diluted earnings per common share because their effect would be anti-dilutive.

8. ACQUISITIONS

On January 25, 1999, HCRI acquired the assets and certain liabilities of Subro-Audit, Inc., a Wisconsin corporation ("SAI"), and a related entity, O'Donnell Leasing Co., LLP, a Wisconsin limited liability partnership ("ODL" and, together with SAI, "Subro Audit"), for approximately $24.4 million (the "Subro Audit Acquisition"), using available unrestricted cash. HCRI paid an additional $5.3 million pursuant to an earn-out arrangement. The final amount of $2.5 million was paid on June 7, 2001, and $2.8 million was paid on May 18, 2000. Approximately $4.7 million was held in escrow for the potential earn-out and was included in restricted cash at December 31, 2000. SAI is based in Wisconsin and provides subrogation recovery services with respect to an installed base of lives, which are covered by insurers, HMOs and employer-funded plans, throughout the United States of America. The Subro Audit Acquisition was accounted for using the purchase method of accounting.

On February 15, 1999, HCRI acquired the assets and certain liabilities of MedCap Medical Cost Management, Inc., a California corporation ("MedCap"), for approximately $10 million, using available unrestricted cash and borrowed funds (the "MedCap Acquisition" and, together with the Subro Audit Acquisition, the "Acquisitions"). HCRI paid approximately $4.5 million on February 15, 2000 pursuant to an amendment to the original earn-out agreement. Pursuant to the same amendment, through January 15, 2001, the Company was obligated to pay up to 50% of the fees collected in relation to certain negotiated contracts, less associated expenses, as an additional amount. The final amount, which was paid in 2000 in relation to the fees collected on those contracts, was approximately $292,000. MedCap provides a variety of medical cost management services to health insurers and HMOs, primarily in California. These services include provider

bill auditing, contract compliance review, identification of certain other payments, and cost management consulting services. The MedCap Acquisition was accounted for using the purchase method of accounting.

9. LOSS ON PROPERTY HELD FOR SALE

On June 29, 2001, the Company signed a letter of intent to sell its building in New Berlin, WI to a Milwaukee real estate investment company. As the agreement was subject to numerous contingencies which were not finalized until September 2001, the Company could not estimate the final sales price or range of expected loss until that time. HCRI acquired the building on January 25, 1999 in the Subro Audit Acquisition. The Company expects the loss to be approximately

$980,000 ($573,000 after-tax) and has therefore reduced the carrying value of the land and building to its estimated fair market value less the estimated selling expenses. The assets and related accumulated depreciation have been classified as "Property held for sale" under "Current assets" in the Condensed Balance Sheet at September 30, 2001. Expenses related to the sale have been recorded as "Trade accounts payable" under "Current liabilities" in the Condensed Balance Sheet at September 30, 2001. The sale is expected to be completed in November 2001.

10. INCOME TAXES

In September 2001, the Company concluded that, in light of the passage of time with respect to the filing of the Company's tax returns for years up to and including 1997, it was proper to reverse previously accrued taxes reducing the tax provision for the third quarter of 2001 by $681,000, net, or approximately $0.07 per share. This accrual related primarily to certain non-cash compensation charges taken in connection with the initial public offering of the Company's stock in 1997. Management believes that adequate amounts of tax and related interest and penalties, if any, have been provided for any adjustments that may result.

11. SUBSEQUENT EVENTS

On November 1, 2001, the Company entered into a revolving credit facility with National City Bank of Kentucky and the lenders named therein (the "Revolving Credit Facility"), and the existing Credit Facility was terminated. (See Note 4 -- Credit Facility.) The Company's obligations under the Revolving Credit Facility are secured by substantially all of the Company's assets, subject to certain permitted exceptions. The Revolving Credit Facility carries a maximum borrowing capacity of $40 million and will mature October 31, 2004. Principal amounts outstanding under the Revolving Credit Facility will bear interest at a variable rate based on the Prime Rate or Eurodollar Rate, as applicable, plus a pre-determined fixed margin. At November 1, 2001, the interest rate was 5.75% based on the Prime Rate plus the fixed margin. At November 6, 2001, the interest rate was 4.03% based on the one-month Eurodollar Rate plus the fixed margin. The Revolving Credit Facility contains customary covenants and events of default including, but not limited to, financial tests for interest coverage, net worth levels and leverage that may limit the Company's ability to pay dividends. It also contains a material adverse change clause. At November 1, 2001, $11 million was outstanding under the Revolving Credit Facility.

On November 6, 2001, HCRI entered into an interest rate swap contract to pay 3.66% and to receive the one-month LIBOR rate on a $4 million notional amount of the Credit Facility. HCRI uses derivative financial instruments to manage the risk that changes in interest rates will have on the amount of its future interest payments. Under the interest rate swap contract, HCRI agrees to pay an amount equal to a specified fixed rate of interest times a notional principal amount, and to receive in return an amount equal to a variable rate of interest times the same notional principal amount. The notional amounts of the contract are not exchanged. No other cash payments are made unless the contract is terminated prior to maturity, in which case the amount paid or received in settlement is to be established by agreement at the time of termination, and represents the net present value, at current rates of interest, of the remaining obligations to exchange payments under the terms of the contract. The interest rate swap contract was entered into with a major financial

institution in order to minimize counterparty credit risk. HCRI believes the interest rate swap transaction qualifies for hedge accounting treatment and will be accounted for in accordance with FAS 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by FAS 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities -- an Amendment of FAS 133".

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW OF COMPANY

HCRI is a leading independent provider of outsourcing of insurance subrogation and certain other medical claims recovery and cost containment services to the private healthcare payor industry. Its primary business is medical claims recovery and its primary product is subrogation recovery, which generally entails the identification, investigation and recovery of accident-related medical benefits incurred by its clients on behalf of their insureds, but for which other persons or entities have primary responsibility. The Company's clients' rights to recover the value of these medical benefits, arising by law or contract, are known generally as the right of subrogation and are generally paid from the proceeds of liability or workers' compensation insurance. The Company's other medical claims recovery services include provider bill auditing, contract compliance review and cost management consulting, coordination of benefits and overpayments recovery services. HCRI offers its services on a nationwide basis to health maintenance organizations, indemnity health insurers, self-funded employee health plans and companies that provide claims administration services to self-funded plans (referred to as "third-party administrators"). The Company had 50.7 million lives under contract from its clientele at September 30, 2001.

The Company recently announced its entry into two new businesses. Through TransPaC Solutions, the Company now offers subrogation outsourcing services to the property and casualty insurance industry. Troveris, the Company's other new business, offers to both healthcare payors and property and casualty insurers its web-enabled subrogation recovery software. This software is sold as an application service provider. See "Recent Developments -- Services to the Property and Casualty Insurance Industry" and "-- Technology Development".

ACQUISITIONS

On January 25, 1999, HCRI acquired the assets and certain liabilities of Subro-Audit (which consisted of SAI and ODL), for approximately $24.4 million, using available unrestricted cash. HCRI paid an additional $5.3 million pursuant to an earn-out arrangement. The final amount of $2.5 million was paid on June 7, 2001, and $2.8 million was paid on May 18, 2000. Approximately $4.7 million was held in escrow for the potential earn-out and was included in restricted cash at December 31, 2000. SAI is based in Wisconsin and provides subrogation recovery services with respect to an installed base of lives, which are covered by insurers, HMOs and employer-funded plans, throughout the United States of America. The Subro Audit Acquisition was accounted for using the purchase method of accounting.

On February 15, 1999, HCRI acquired the assets and certain liabilities of MedCap for approximately $10 million, using available unrestricted cash and borrowed funds. The Company paid approximately $4.5 million on February 15, 2000 pursuant to an amendment to the original earn-out agreement. Pursuant to the same amendment, through January 15, 2001, the Company was obligated to pay up to

50% of the fees collected in relation to certain negotiated contracts, less associated expenses, as an additional amount. The final amount, which was paid in 2000, in relation to the fees collected on those contracts was approximately $292,000. MedCap provides a variety of medical cost management services to health insurers and HMOs, primarily in California. These services include provider bill auditing, contract compliance review, identification of certain other payments, and cost management consulting services. The MedCap Acquisition was accounted for using the purchase method of accounting.

OVERVIEW OF OPERATIONS

For a typical new healthcare subrogation or other medical claims recovery client, it takes up to six months from the contract signing (when the lives are "sold") to complete the construction of electronic data interfaces necessary for the Company to begin providing service. At this point, the client is considered "installed." During the installation period, the Company must also hire and train quality staff necessary to provide contractual services. After installation, HCRI receives files and data from the client from which it creates an inventory of backlog.

"Backlog" is the total dollar amount of potentially recoverable claims that the Company is pursuing or auditing on behalf of its clients at a given point in time. These claims are gross figures, prior to estimates of claim settlements and rejections. Backlog increases when the Company opens new files of potentially recoverable claims and decreases when files are recovered and closed or, after further investigation, determined to be nonrecoverable. Backlog for a client will range from newly identified potential recoveries to potential recoveries that are in the late stages of the recovery process. Historically, recoveries (the amount actually recovered for the Company's clients prior to the Company's fee) have been produced from backlog in a generally predictable cycle. Any group of potential recoveries, sufficiently large in number to display statistically significant characteristics and that originates from a defined time period, tends to produce recovery results that are comparable to other groups having similar characteristics.

For the most part, the Company is paid contingency fees from the amount of claims recoveries it makes from backlog or recoveries it identifies through other cost containment and related recovery services on behalf of its clients. The Company's revenues are a function of recoveries and effective fee rates. Effective fee rates vary depending on the mix between services provided and client fee schedules. The fee schedules for each client are separately negotiated and reflect the Company's standard fee rates, the services to be provided and the anticipated volume of services. The Company grants volume discounts and, for its recovery services, negotiates a lower fee when it assumes backlog from a client because the client will have already completed some of the recovery work. Because the Company records expenses as costs are incurred and records revenues only when a file is settled, there is a lag between the recording of expenses and related revenue recognition.

The Company's expenses are determined primarily by the number of employees directly engaged in recovery activities ("cost of services") and by the number of employees engaged in a variety of support activities ("support expenses"). Recovery personnel must be hired and trained in advance of the realization of recoveries and revenues. Historically, support expenses have not grown in direct proportion to revenues.

RESULTS OF OPERATIONS

The following tables present certain key operating indicators and results

of operations data for the Company for the periods indicated:

KEY OPERATING INDICATORS(1)
(IN MILLIONS, EXCEPT FOR PERCENTAGES AND EMPLOYEES)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000	2001	2000
Cumulative lives sold, beginning of period	51.1	53.6	52.5	55.6
Lives from existing client loss, net	(2.6)(2)	(1.8)	(8.1)(2)	(4.6)(2)
Lives added from new contracts with existing clients	0.3	0.8	1.3	0.8
Lives added from contracts with new clients	1.9	0.6	5.0	1.4
Cumulative lives sold, end of period	50.7	53.2	50.7	53.2

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000	2001	2000
Lives installed, end of period	46.8	50.1	46.8	50.1
Backlog(3)	$1,389.3	$1,214.6	$1,389.3	$1,214.6
Claims recoveries	$ 56.7	$ 56.8	$ 176.3	$ 177.5
Throughput(4)	4.2%	4.8%	13.7%	15.4%
Effective fee rate	26.6%	26.6%	26.7%	26.8%
Claims revenues	$ 15.1	$ 15.1	$ 47.0	$ 47.6
Employees				
Direct operations	563	526	563	526
Support	142	154	142	154
Total employees	705	680	705	680

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(1) Excludes the operational results of TransPaC Solutions and Troveris, except number of employees. See "Recent Developments -- Services to the Property and Casualty Insurance Industry" and "-- Technology Development".

(2) The nine months ended September 30, 2001 and 2000 decreases include approximately 1.9 million and 2.4 million lives, respectively, associated with clients that were acquired by non-clients. The three months and nine months ended September 30, 2001 decreases also include approximately 2.0 million lives associated with provider bill audit service clients who were not providing electronic data to the Company.

(3) Backlog is the total dollar amount of potentially recoverable claims that

the Company is pursuing or auditing on behalf of its clients at a given point in time.

(4) Throughput equals claims recoveries for the period divided by the average of backlog at the beginning and end of the period.

STATEMENTS OF INCOME AS A PERCENTAGE OF REVENUES

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000	2001	2000
Claims revenues	100.0%	100.0%	100.0%	100.0%
Cost of services	50.7	48.4	49.0	49.2
Support expenses	26.4	26.1	27.5	27.1
Depreciation and amortization	11.2	10.8	10.4	10.0
Research and development	0.8	--	0.9	--
Operating income	10.9	14.6	12.2	13.7
Other -- loss on property held for sale	6.5	--	2.1	--
Other -- Special Committee expenses	--	--	--	0.2
Income before income taxes	3.9	14.1	10.1	13.2
Net income	6.8	8.2	7.4	7.7

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED TO THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2000

Claims Revenues. Total claims revenues for the quarter ended September 30, 2001 remained consistent with the same quarter of 2000 at $15.1 million, and for the nine month period ended September 30, 2001 decreased 1.1% to $47.1 million as compared with $47.6 million in the same period of 2000. Claims recoveries for the quarter ended September 30, 2001 were $56.7 million, a slight decrease from the same quarter of 2000

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at $56.8 million. For the nine months ended September 30, 2001 claims recoveries decreased 0.7% to $176.3 million as compared to $177.5 million in the same period of 2000.

The effective fee rate for the quarter ended September 30, 2001 was the same as the prior year quarter at 26.6% and decreased to 26.7% for the nine month period ended September 30, 2001 as compared with 26.8% in the same period of 2000. The effective fee rate for the nine month period decreased primarily because of the recovery mix, with relatively more recoveries coming from clients with lower effective fee rates than in the prior year period.

Backlog increased from September 30, 2000 by $174.7 million, or 14.4%, to $1,389.3 million at September 30, 2001 despite a 3.3 million decrease in the number of lives installed. The growth in the backlog is primarily related to the provider bill audit service. Subrogation services backlog decreased about 5% compared to the prior year period, which is consistent with the decrease in installed lives.

The Company had a throughput rate of approximately 4.2% and 4.8% of average backlog during the third quarter of 2001 and 2000, respectively. The decrease in

throughput from the quarter ended September 30, 2000 is primarily due to the fact that average provider bill audit and overpayments services backlog during the 2001 quarter increased 97.4% from the comparable quarter of 2000 while recoveries decreased 7%. The decrease in throughput just described was partially offset by an increase in subrogation throughput due to a slight decrease in subrogation backlog as recoveries remained relatively flat for the quarter ended September 30, 2001, compared to the prior year quarter. Throughput for the nine month period ended September 30, 2001 also decreased from 15.4% for the comparable period of 2000 to 13.7%, for the same reasons described above. Lives installed decreased 3.3 million from 50.1 million at September 30, 2000 to 46.8 million at September 30, 2001 because of the lives lost relating to clients being acquired by non-clients and the removal of approximately 2.0 million lives associated with provider bill audit service clients who were not furnishing electronic claims data to the Company.

Cost of Services. Cost of services increased 4.4% for the quarter ended September 30, 2001 to $7.6 million, from $7.3 million for the comparable period in 2000 and was $23.1 million for the nine months ended September 30, 2001, a decrease of 1.5% from $23.4 million for the same period in 2000. As a percentage of claims revenues, cost of services increased to 50.7% for the quarter ended September 30, 2001 compared to 48.4% for the prior year quarter, due to the decrease in revenue described above and an increase in staffing levels for the provider bill audit and overpayment recovery services related to new business recently sold. For the nine months ended September 30, 2001 cost of services as a percentage of claims revenues decreased to 49.0% from 49.2% in 2000. The decrease in cost of services as a percentage of claims revenues for the comparable nine month periods resulted from certain productivity enhancements instituted in early 2000.

Support Expenses. Support expenses increased 0.8% to $3.98 million for the quarter ended September 30, 2001 from $3.95 million for the comparable quarter in 2000 and were $12.94 million and $12.91 million for the nine month periods ended September 30, 2001 and 2000, respectively. Support expenses increased as a percentage of claims revenues from 27.1% for the nine month period ended September 30, 2000 to 27.5% for the same period in 2001. The increase in support expenses as a percentage of claims revenues resulted from the decrease in revenues described above and an increase in sales and marketing expenses related to the Company's business development activities. See "Recent Developments -- Services to the Property and Casualty Insurance Industry" and "-- Technology Development". Support expenses typically do not vary in proportion to revenues.

Depreciation and Amortization. Depreciation and amortization expense increased 3.5% to $1.7 million for the quarter ended September 30, 2001 from $1.6 million for the same period in 2000, and increased 2.7% to $4.9 million for the nine months ended September 30, 2001 from $4.8 million for the comparable period in 2000. The increases were primarily in amortization expense and were attributable to the addition of intangible assets from the earn-out arrangements related to the Acquisitions.

Research and Development. The Company incurred $124,000 and $415,000 for the quarter and nine month period ended September 30, 2001, respectively, related to research and development activities in

connection with the creation of new products for the insurance industry. See "Recent Developments -- Technology Development".

Interest Income. Interest income decreased 62.0%, or $186,000, for the quarter ended September 30, 2001 as compared to the same quarter in 2000. The

decrease is due to the payment of an earn-out relating to the SAI Acquisition which occurred during the quarter ended June 30, 2001, reducing the restricted cash balance, and lower interest rates. For the nine month period ended September 30, 2001, interest income decreased $117,000, or 13.8%, for the same reasons noted above.

Interest Expense. Interest expense totaled approximately $192,000 and $375,000 for the quarters ended September 30, 2001 and 2000, respectively, and approximately $742,000 and $1,004,000 for the nine months ended September 30, 2001 and 2000, respectively. The decrease in interest expense for the quarter and nine months ended September 30, 2001, as compared with the respective periods in 2000, is due to a decrease in borrowed funds and lower applicable interest rates during 2001.

Other -- Loss on Property Held for Sale. On June 29, 2001, the Company signed a letter of intent to sell its building in New Berlin, WI to a Milwaukee real estate investment company. HCRI acquired the building on January 25, 1999 in the Subro Audit Acquisition. The Company expects the loss on the sale to be approximately $980,000 and therefore has reduced the carrying value of the land and building to its estimated fair market value less the estimated selling expenses. The sale is expected to be completed in November 2001. (See Note 9 -- Loss on Property Held for Sale.)

Other -- Special Committee Expenses. In August 1999, HCRI's Board of Directors appointed a Special Committee to evaluate strategic alternatives available to the Company, including its possible sale. During the first quarter of 2000, the Company incurred $90,000 of expenses related to the work of the committee. In March 2000, the Special Committee ceased seeking a buyer for the Company and its efforts to enhance shareholder value were assumed by the full Board of Directors.

Tax. In September 2001, the Company concluded that, in light of the passage of time with respect to the filing of the Company's tax returns for years up to and including 1997, it was proper to reverse previously accrued taxes reducing the tax provision for the third quarter of 2001 by $681,000, net, or approximately $0.07 per share. This accrual related primarily to certain non-cash compensation charges taken in connection with the initial public offering of the Company's stock in 1997. Management believes that adequate amounts of tax and related interest and penalties, if any, have been provided for any adjustments that may result.

Net Income. Net income for the quarter ended September 30, 2001 decreased $0.2 million, or 17.8%, to $1.0 million or $0.10 per diluted common share, from $1.2 million or $0.12 per diluted common share for the comparable period in 2000, and for the nine months ended September 30, 2001 decreased $0.2 million, or 5.4%, to $3.5 million, or $0.35 per diluted common share, from $3.7 million, or $0.33 per diluted common share, for the comparable period in 2000. The primary factors offsetting the decrease in claims revenue for the nine months ended September 30, 2001 were the decrease in net interest expense and the reduction in the provision for income taxes related to the reversal of the previously accrued income taxes associated with certain non-cash compensation charges related to the Company's initial public offering in 1997. The diluted earnings per share increased for the nine months ended September 30, 2001 as compared to the same period in 2000 as a result of the decrease in the number of common shares outstanding as a result of the stock repurchase plan. (See Note 5 -- Stock Repurchase Plan.)

LIQUIDITY AND CAPITAL RESOURCES

The Company's statements of cash flows for the nine months ended September 30, 2001 and 2000 are summarized below:

	NINE MONTHS ENDED SEPTEMBER 30,	
	2001	2000
	(IN THOUSANDS)	
Net cash provided by operating activities	$ 2,242	$ 4,736
Net cash used in investing activities	(267)	(4,978)
Net cash used in financing activities	(2,019)	(710)
Net decrease in cash and cash equivalents	$ (44)	$ (952)

The Company had working capital of $0.9 million at September 30, 2001, including cash and cash equivalents of $1.3 million, compared with working capital of $7.8 million at December 31, 2000. The primary reason for the decrease was the reclassification of the long-term borrowings that become due within one year to short-term obligations expected to be refinanced. (See Item 1. Financial Statements (Unaudited) -- Note 4 -- Credit Facility and Note 11 -- Subsequent Events.) In addition, restricted cash decreased $4.7 million related to the payment of the Subro-Audit Acquisition earn-out. HCRI's portion of the restricted cash was $2.5 million, which was used to pay down long-term borrowings.

Net cash provided by operating activities was $2.2 million, a decrease of $2.5 million for the nine months ended September 30, 2001, compared to the same period in 2000, primarily as a result of the payment of $3.0 million during the quarter ended September 30, 2001 related to the DeGarmo lawsuit that was reported as settled in the year ended December 31, 2000.

Net cash used in investing activities includes the $2.5 million released back to the Company from restricted cash related to the Subro-Audit Acquisition earn-out as discussed above. Purchases of property and equipment for the nine months ended September 30, 2001 were approximately $2.8 million, including the capitalization of $1.4 million of internally developed software. The Company anticipates capital expenditures for the year to be approximately $3.5 million.

Net cash used in financing activities for the nine months ended September 30, 2001 reflects $2.0 million in net cash payments with respect to the Company's credit facility.

On November 1, 2001, the Company entered into a revolving credit facility with National City Bank of Kentucky and the lenders named therein (the "Revolving Credit Facility"). The Company's obligations under the Revolving Credit Facility are secured by substantially all of the Company's assets, subject to certain permitted exceptions. The Revolving Credit Facility carries a maximum borrowing capacity of $40 million and will mature October 31, 2004. Principal amounts outstanding under the Revolving Credit Facility will bear interest at a variable rate based on the Prime Rate or Eurodollar Rate, as applicable, plus a pre-determined fixed margin. At November 1, 2001, the interest rate was 5.75% based on the Prime Rate plus the fixed margin. At November 6, 2001, the interest rate was 4.03% based on the one-month Eurodollar Rate plus the fixed margin. The Revolving Credit Facility contains customary covenants and events of default including, but not limited to, financial tests for interest coverage, net worth levels and leverage that may limit the

Company's ability to pay dividends. It also contains a material adverse change clause. At November 1, 2001, $11 million was outstanding under the Revolving Credit Facility. (See Item 1. Financial Statements (Unaudited) -- Note 4 -- Credit Facility and Note 11 -- Subsequent Events.)

At September 30, 2001 and December 31, 2000, the Company reported on its balance sheets, as a current asset, restricted cash of $14.9 million and $21.6 million, respectively. Restricted cash at September 30, 2001 and December 31, 2000 represented claims recoveries effected by HCRI for its clients. At December 31, 2000, it also included an escrowed amount of $4.7 million for the potential earn-out in connection with the Subro-Audit Acquisition. At September 30, 2001 and December 31, 2000, HCRI reported on its balance

sheets, as a current liability, funds due clients of $10.7 million and $12.4 million, respectively, representing claims recoveries to be distributed to clients, net of the fee earned on such recoveries.

In light of its acquisition strategy, the Company is currently assessing its opportunities for capital formation. The Company believes that its available cash resources, together with the borrowings available under the Revolving Credit Facility and other potential sources of funding, will be sufficient to meet its current operating requirements and acquisition and internal development activities.

EXTERNAL FACTORS

The business of recovering subrogation and other claims for healthcare payors is subject to a wide variety of external factors. Prominent among these are factors that would materially change the healthcare payment, fault-based liability or workers' compensation systems. Examples of these factors include, but are not limited to, 1) the non-availability of recovery from such sources as property and casualty and workers' compensation coverages, 2) law changes that limit the use of or access to claims and medical records, or 3) the ability of healthcare payors to recover related claims and audit medical records. Because the Company's profitability depends in large measure upon obtaining and using claims data and medical records, the non-availability or decrease in their availability could have a material adverse effect on the Company.

Moreover, because the Company's revenues are derived from the recovery of the costs of medical treatment, material changes in such costs will tend to affect the Company's backlog or its rate of backlog growth, as well as its revenue or its rate of revenue growth. The healthcare industry, and particularly the business of healthcare payors, is subject to various external factors that may have the effect of significantly altering the costs of healthcare and the environment for the sale or delivery of medical claims recovery and cost containment services. The Company is unable to predict which of these factors, if any, could have a potentially material impact on healthcare payors and through them, the healthcare recovery and cost containment industry.

CONCENTRATION OF CLIENTS

The Company provides services to healthcare plans that as of September 30, 2001 covered approximately 50.7 million lives. HCRI's clients are national and regional healthcare payors, large third-party administrators or self-insured corporations. HCRI's largest client is UnitedHealth Group. For the nine month periods ended September 30, 2001 and 2000, UnitedHealth Group generated 27% and 24% of HCRI's revenues, respectively. The loss of this account could have a material adverse effect on the Company's business, results of operations and financial condition.

The Company has recently become aware that the Ingenix strategic business unit of UnitedHealth Group ("UHG") has developed a subrogation recovery outsourcing service that competes with that of the Company. Ingenix, primarily a health data and information company, is offering its subrogation service to "internal clients" (i.e., health plans and self-insured employer groups served by Uniprise, the strategic business unit of UHG that provides claims administration) and unrelated "external" clients. The Company sells its subrogation recovery services to UHG through Uniprise, which is the entity with which the Company has its service contract. To date, the Company has received termination notices from Uniprise with respect to approximately 4.6 million lives that it believes have been awarded to Ingenix. Of those 4.6 million lives, approximately 3.3 million lives have not yet been reported as "lost" in the Key Operating Indicators table above, because the effectiveness of the termination has not yet occurred. Approximately 2.4 million of the lives were covered in a termination notice received by the Company on November 13, 2001. Year-to-date, the Company has acquired approximately 1.6 million lives from UHG, through its relationship with Uniprise.

The Company is unaware of any executive-level decision at either UHG or Uniprise to favor Ingenix as the subrogation vendor for the so-called internal clients. However, there can be no assurance that such a decision will not be forthcoming or that even absent such a decision, that Ingenix will not compete away material portions of the Company's business with Uniprise's (and UHG's) "internal clients" or with "external clients."

HCRI's revenues are earned under written contracts with its clients that generally provide for contingency fees from recoveries under a variety of pricing regimes. The pricing arrangements offered by HCRI to its clients include a fixed fee percentage, a fee percentage that declines as the number of lives covered by the client and subject to HCRI's service increases and a fee percentage that varies with HCRI's recovery performance.

HCRI performs its services on a reasonable efforts basis and does not obligate itself to deliver any specific result. Contracts with its customers are generally terminable on 60 to 180 days' notice by either party, although in a few cases the contracts extend over a period of years. HCRI's contracts generally provide that in the event of termination, HCRI is entitled to complete the recovery process on the existing backlog or to receive a cash payment designed to approximate the gross margin that would otherwise have been earned from the recovery on the backlog of the terminating client. On September 30, 2001, HCRI had backlog of $1,389.3 million.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (FAS 141), "Business Combinations", which provides that all business combinations should be accounted for using the purchase method of accounting and establishes criteria for the initial recognition and measurement of goodwill and other intangible assets recorded in connection with a business combination. The provisions of FAS 141 apply to all business combinations initiated after June 30, 2001 and to all business combinations accounted for by the purchase method that are completed after June 30, 2001. The Company will apply the provisions of FAS 141 to any future business combinations.

Also, in June 2001, the FASB issued Statement of Financial Accounting Standards No. 142 (FAS 142), "Goodwill and Other Intangible Assets", which establishes the accounting for goodwill and other intangible assets following

their recognition. FAS 142 applies to all goodwill and other intangible assets whether acquired singly, as part of a group, or in a business combination. FAS 142 provides that goodwill should not be amortized but should be tested for impairment annually using a fair-value based approach. In addition, FAS 142 provides that other intangible assets other than goodwill should be amortized over their useful lives and reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of". FAS 142 is effective for the Company beginning on January 1, 2002. Upon adoption, the Company will be required to perform a transitional impairment test under FAS 142 for all goodwill recorded as of January 1, 2002. Any impairment loss recorded as a result of completing the transitional impairment test will be treated as a change in accounting principle. The impact of the adoption of FAS 142 on the Company's results of operations for all periods beginning on or after January 1, 2002 will be to eliminate amortization of goodwill. Management of the Company has not performed a transitional impairment test under FAS 142 and accordingly cannot estimate the impact of the adoption of FAS 142 as of January 1, 2002.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 143 (FAS 143), "Accounting for Asset Retirement Obligations". FAS 143 is effective for fiscal years beginning after June 15, 2002, and provides accounting requirements for asset retirement obligations associated with tangible long-lived assets. The Company has not yet determined the effects of this standard on its financial statements.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144 (FAS 144), "Accounting for the Impairment or Disposal of Long-Lived Assets". FAS 144 is effective for fiscal years beginning after December 15, 2001. This statement supersedes FAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of", and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations -- Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", for the disposal of a business segment. FAS No. 144 establishes a single accounting model, based on the framework established in FAS No. 121. The Company has not yet determined the effect of this standard on its financial statements.

RECENT DEVELOPMENTS

APPOINTMENT OF DIRECTORS

On August 3, 2001, the Board of Directors, through its Nominating Committee, nominated Lauren N. Patch to the Board of Directors to fill a newly created directorship. Mr. Patch's nomination was approved by the Board of Directors on August 3, 2001, as permitted under the Company's Certificate of Incorporation and Bylaws. Mr. Patch will hold office until the next succeeding Annual Meeting, at which time his directorship will be subject to a vote of the Company's stockholders.

Effective October 31, 2000, Elaine J. Robinson resigned as a director of the Company. Under the Company's Certificate of Incorporation and Bylaws, a vacancy on the Board of Directors created by a resignation may be filled by a majority vote of the remaining directors. A director so chosen to fill the vacancy would hold office until the next succeeding Annual Meeting. The Board of Directors, through its Nominating Committee, nominated Herbert A. Denton to fill the vacant position. Mr. Denton's nomination was approved by the remaining directors on May 11, 2001.

SERVICES TO THE PROPERTY AND CASUALTY INSURANCE INDUSTRY

On February 14, 2001, the Company disclosed, among other things, its entry into the subrogation outsourcing market that serves property and casualty ("P&C") insurers. The Company is offering its services to the P&C market under the brand name "TransPaC Solutions". The Company currently provides subrogation outsourcing services to seven P&C clients, under various contractual arrangements including closed claims studies, referrals and full outsourcing. The Company has established a full-time direct sales force of three individuals experienced in P&C sales and marketing. The Company's target market for its P&C subrogation services is P&C insurers that have reported below average subrogation recovery results or for various other reasons are interested in outsourcing either all or a portion of their subrogation work.

The Company believes that the market for P&C subrogation outsourcing in the United States is substantial and that the potential savings from subrogation recoveries will vary depending upon the P&C line of business. The Company believes that total potential subrogation recoveries in the automobile insurance market exceed $6 billion per year. Based on its research and early experience with two clients, the Company believes that there is an opportunity to increase total subrogation recoveries across a wide spectrum of automobile insurers. The Company's initial marketing strategy is to offer its services to smaller, regionally oriented automobile insurers which generally lack the resources to maximize subrogation recoveries.

The Company believes that it has an opportunity to leverage its healthcare subrogation expertise and resources to provide service to the P&C markets. The primary difference between the two markets is in the acquisition of claims data for investigation of subrogation potential. The P&C industry does not have standard data definitions regarding claims as does the health insurance industry. Nevertheless, the Company used its healthcare subrogation expertise to build data interfaces with its first two P&C customers, and it has created proprietary business processes to acquire paper-based and/or imaged claims data from its customers' claims adjusting offices and archives.

The Company has assessed the competitive environment for P&C subrogation outsourcing, and believes that the competition is fragmented and characterized by claims adjusting companies that operate on a local or regional basis and law firms that specialize in low volume, but legally complex, subrogation claims. The Company has identified only one competitor that attempts to serve a national market. It believes that this competitor has enjoyed limited success because it is owned and controlled by a P&C insurer.

The Company previously disclosed that it expected to incur losses from TransPaC Solutions in 2001 of $0.05 to $0.07 per diluted share for the full year 2001, and that break-even operations would not be achieved until 2002. The Company now estimates that it will incur losses of $0.06 to $0.07 per diluted share for 2001 and still expects to achieve break-even operations in 2002. The Company estimates that it will earn gross margins comparable to its healthcare recovery services in providing P & C subrogation recovery services. The Company cautions that the foregoing forecasts and estimates are not guarantees of future performance and that actual results of TransPaC Solutions will be dependent upon future facts and circumstances, many of

which are outside the control of management of the Company. See "Safe Harbor Compliance Statement on Forward Looking Statements" included as Exhibit 99.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 and hereby incorporated herein by reference.

TECHNOLOGY DEVELOPMENT

During the nine months ended September 30, 2001, the Company incurred expenses of approximately $415,000 for research and development costs to develop new products for the insurance industry. The Company expects to incur additional expenses of between $1.3 million and $1.7 million for research and development with respect to these products over the next twelve months. In addition, as of September 30, 2001, the Company has capitalized approximately $764,000 of costs in accordance with accounting principles generally accepted in the United States of America for the development of software for sale to unrelated parties. The Company expects to capitalize additional costs of approximately $750,000 for such development over the next twelve months.

Many participants in the health insurance market do not outsource subrogation services. The Company currently estimates that 40% to 50% of the private health insurance and health benefits markets do not outsource subrogation recoveries. Public sector markets, such as Medicaid and Medicare, have virtually no outsourcing of subrogation recoveries. These programs typically rely on their claims administration contractors to provide subrogation services as part of a bundled service contract. Like the health insurance market, the Company believes that certain participants in the P&C insurance market are less likely to outsource subrogation services. The Company believes mutual insurers have organizational and cultural biases against outsourcing and larger P&C insurers have sufficient resources to develop relatively sophisticated internal departments.

In light of these market conditions, the Company began the internal development of a web-enabled subrogation software application. The Company will sell these products as an application service provider ("ASP"), under the trade name "Troveris", both to the health insurance and benefits market and to the P&C market. During the second quarter of 2001, the Company completed and is offering for sale a health insurance application. During the third quarter of 2001, the Company completed and offered for sale a commercially available P&C application.

The Troveris marketing strategy combines the opportunity for an internal subrogation department to gain operating efficiency through the functionality of state-of-the-art desktop software and to leverage its ability to produce recoveries through the purchase of unbundled components of the Company's traditional subrogation outsourcing services. The Troveris software application allows the Company to administer these customized relationships using the same proprietary processes as it uses for those customers who purchase turnkey subrogation outsourcing services. An additional benefit of the Troveris software application is that the Company believes that it will substantially reduce future expenses for maintaining software applications that it uses to provide turnkey outsourcing services.

The Company anticipates that during the fourth quarter of 2001, it will begin migrating its own subrogation operations to the Troveris application. The Company currently expects the migration to be completed in the third quarter of 2002. At that time, the Company expects to abandon its legacy subrogation system, thereby reducing its technology expense, net of the expense of maintaining the Troveris application, by at least $600,000 per year. The Troveris application will also enable the Company to expand its ability to manage its knowledge workers via telecommuting arrangements. While the Company believes it can achieve the foregoing transition and corresponding reduction of expenses in the outlined timeframe, future facts and circumstances could change these estimates. See "Safe Harbor Compliance Statement for Forward-Looking Statements" included as Exhibit 99.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 and hereby incorporated herein by reference.

The Company is not aware of any competition in subrogation software in an

ASP model for the health insurance industry, and it can only identify a single large competitor in the P&C insurance industry. This competitor is partially owned and controlled by a major P&C insurer, and the Company believes that this relationship will reduce the ability of the competitor to sell its services to other P&C insurers.

STOCK REPURCHASE PLAN

HCRI's Board approved a stock repurchase plan on March 12, 1999 under which the Company is authorized to repurchase, from time to time, up to $10 million of HCRI Common Stock in the open market, at prices per share deemed favorable by the Company. Shares may be repurchased using cash from operations and borrowed funds and may continue until such time as the Company has repurchased $10 million of HCRI Common Stock or until it otherwise determines to terminate the stock repurchase plan. HCRI repurchased 19,500 shares of its own stock during the three and nine months ended September 30, 2001, at an average price of $4.02. From inception of the program through September 30, 2001, the total number of repurchased shares is 1,792,265 at a cost of $7.1 million, or an average cost of $3.97 per share. All of the reacquired shares of Common Stock through September 30, 2001 are reflected as treasury stock on the accompanying Condensed Balance Sheets (Unaudited).

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

An element of market risk exists for the Company from changes in interest rates related to its Revolving Credit Facility, which matures October 31, 2004. The impact on earnings and value of any debt on the Company's balance sheets are subject to change as a result of movements in market rates and prices as a portion of the Revolving Credit Facility is subject to variable interest rates. However, the Company does not expect changes in interest rates to have a material effect on its financial position, results of operations or cash flows in 2001. As of November 6, 2001, the Company had $11.0 million outstanding under its Revolving Credit Facility. Through the interest rate swap contract the Company has entered into, the Company has fixed the interest rate on $4 million of the Revolving Credit Facility at 5.41% or 5.66% (contingent on the status of a financial ratio). The remaining $7 million outstanding had an interest rate of 4.03%. See Part I. Financial Statements. Note 11 -- Subsequent Events and "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources".

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

OVERVIEW AND LITIGATION HISTORY

The Company is engaged in the business of identifying and recovering subrogation and related claims of its clients, many of which arise in the context of personal injury lawsuits. As such, the Company operates in a litigation intensive environment. Moreover, management of the Company has observed that, in parallel with widely-reported legislative concerns with the healthcare payment system, there also has occurred an increase in litigation, actual and threatened, including class actions brought by nationally prominent attorneys, directed at healthcare payors and related parties.

The Company has, since its founding in 1988, been involved with many litigation matters related to its subrogation business, sometimes as a defendant and sometimes on behalf of its defendant client. Plaintiffs' attorneys attempting to defeat the clients' subrogation liens often threaten litigation against the Company and its clients as a negotiating tactic. Most of the lawsuits that have been filed against the Company or its clients concern the entitlement to recover a specific, individual subrogation claim or the amount of the subrogation claim. Typically, these actions do not ask for punitive damages, are not pled as class actions, and do not have wide implications with respect to the Company's ongoing business practices.

To date, however, the Company has encountered seven noteworthy instances in addition to the lawsuits described under "-- Current Litigation", in which lawsuits were filed against it or its clients that sought punitive damages, were pled as class actions or otherwise made claims or requested relief that could have materially affected the Company's business practices. The risk profile for this sort of business practices litigation includes not only the usual considerations of the potential amount, effect, and likelihood of loss, but also specifically the potential for punitive damages and class certification, the possible effects of an adverse verdict on the Company's business practices, and the likelihood of specific plaintiffs' attorneys bringing similar actions in other jurisdictions.

Each of these cases has been completely resolved, by decision of a court or settlement by the parties, but prior to resolution the Company did not regard all of these cases as being material in and of themselves. In management's opinion, these seven cases share a common profile with each other and with the lawsuits described below under the caption "-- Current Litigation".

Four of the seven lawsuits named the Company as a defendant and were pled as class actions. Two of the cases, one filed in federal court and the other in state court, alleged that the Company violated state and federal laws on fair debt collection practices. In the state court action, the court granted the Company's motion for summary judgment on all claims in the complaint, which the court of appeals affirmed. In the federal court action, the Company settled the matter, prior to the court's ruling on the Company's motion for summary judgment, for a nominal amount.

The two other lawsuits, both filed in federal court, charged the Company with a variety of violations of laws and sought punitive damages. The complaints alleged, among other things, that the Company committed negligence, fraud and breach of its duties under ERISA by attempting to recover and actually recovering, by subrogation, the reasonable value of medical benefits which were provided by the Company's clients under capitation or discounted-fee-for-service arrangements. One of these lawsuits was settled, after the court denied class certification, for a nominal amount paid by the Company's client, a co-defendant in the case. The other case, DeGarmo et al. v. Healthcare Recoveries, Inc., was settled in mid-July 2001 for $3 million and nonmonetary terms that management regards as immaterial to the Company's ongoing business.

Although the Company was not named as a defendant in any of them, there have been three other lawsuits involving the Company's clients that implicated the Company's business practices. The complaints in these cases alleged, among other things, violation of state law with respect to the payment of plaintiffs' attorneys' fees and unfair trade practices, violation of the federal Health Maintenance Organization Act of

1973, misrepresentation of the rightful amounts of subrogation claims, and impermissible enforcement of recovery rights. Two of these cases resulted in

judgments in favor of the Company's clients after litigation of the merits before trial and appellate courts. The other case was settled for an immaterial amount.

Management believes that the lawsuits described above will not, as a general matter, have precedential value for either the cases described below under the caption "-- Current Litigation" or for any future litigation matters (all these cases being referred to as the "Pending and Potential Cases"). Indeed, the courts hearing the Pending and Potential Cases may not even become aware of the outcomes in the seven lawsuits described above. Management expects that each of the Pending and Potential Cases will be decided on its own merits under the relevant state and federal laws, which will vary from case to case and jurisdiction to jurisdiction. The descriptions of the outcomes in the seven cases dealing with business practices have been included in order to describe the contexts for this kind of litigation and the Company's relative successes in handling past business practices litigation, but are not necessarily predictive of the outcomes of any of the Pending and Potential Cases.

Moreover, there can be no assurance that the Company will not be subject to further class action litigation similar to that described below under the caption "-- Current Litigation", that existing and/or future class action litigation against the Company and its clients will not consume significant management time and/or attention or that the cost of defending and resolving such litigation will not be material.

CURRENT LITIGATION

On October 1, 1999, a First Amended Class Action Complaint ("Amended Complaint") was filed against HCRI in the United States District Court for the Southern District of Florida, in a putative class action brought by William Conte and Aaron Gideon, individually and on behalf of all others similarly situated. In that complaint, Conte v. Healthcare Recoveries, Inc., No. 99-10062, plaintiffs assert that HCRI's subrogation recovery efforts on behalf of its clients violate a number of state and federal laws, including the Fair Debt Collection Practices Act and the Florida Consumer Collection Practices Act. The Complaint also seeks a declaratory judgment that HCRI, as the subrogation agent for various healthcare payors, is not entitled to assert and recover upon subrogation or reimbursement liens it asserts on settlements obtained from third party tortfeasors when the settlement is in an amount less than the amount required to fully compensate (or "make whole") the injured party for all elements of damage caused by the tortfeasor. Plaintiffs purport to represent a class consisting of all participants or beneficiaries of ERISA plans nationwide whose net recovery of damages through judgments, settlements or otherwise against liable third parties has been reduced or potentially reduced by HCRI's alleged assertion and/or recovery of unlawful subrogation/reimbursement rights of its clients. Each count of the Complaint seeks compensatory and/or statutory damages as well as exemplary and punitive damages. Plaintiffs also seek injunctive relief, prejudgment interest, costs and attorneys' fees.

On November 5, 1999, HCRI filed a motion to dismiss the Amended Complaint. On June 29, 2001, the court issued a decision dismissing plaintiffs' common law claims for fraud and unjust enrichment as well as plaintiffs' claims under the federal Fair Debt Collection Practices Act and the Florida Consumer Collection Practices Act. The court did not, however, dismiss the remaining count of the Complaint, which seeks a declaratory judgment and damages under ERISA based on HCRI's alleged violation of the "make whole" rule. On July 16, 2001, HCRI filed a motion for reconsideration or reargument with respect to that portion of the court's June 29, 2001 opinion on the motion to dismiss that sustained, as a pleading matter, Count I of the complaint. Plaintiffs' motion to certify a nationwide class, which HCRI opposed, has been fully briefed and remains pending before the court.

On October 20, 1999, a class action complaint ("Baker Complaint") was filed against HCRI and one HCRI client in the Circuit Court of Jefferson County, Alabama, Darrell DeWayne Baker v. Healthcare Recoveries, Inc., United Healthcare of Alabama, and Fictitious Party Defendants A, B, C et al. On December 6, 1999, the defendants removed the lawsuit to the United States District Court for the Northern District of Alabama, Southern Division. On January 3, 2000, a First Amended Complaint was filed, retaining all counts from the original complaint and seeking an additional declaratory judgment that the health plan and

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HCRI have a right to recover through subrogation only the actual benefits paid to medical providers on behalf of the class. The Baker Complaint, as amended, asserts claims on behalf of two putative subclasses, both consisting of members nationwide of the client health plan, who either: (1) allegedly paid inflated subrogation claims due to alleged failure by the health plan or by HCRI to disclose discounts in the health plan's payments to medical providers; or (2) allegedly were denied coverage of certain claims by the health plan. The plaintiffs assert claims against HCRI under a variety of theories including unjust enrichment, breach of contract, breach of fiduciary duty and violations of RICO. Plaintiffs demand, on behalf of the putative classes, compensatory damages, punitive damages, treble damages under RICO, and reasonable attorneys' fees.

On January 27, 2000, the defendants filed a motion to dismiss the Amended Complaint, which remains pending. The court has not yet addressed the question of whether to certify the putative class.

On October 28, 1999, a class action Plaintiff's Original Petition ("Petition") was filed against HCRI and one HCRI client in the District Court for the 150th Judicial District, Bexar County, Texas, Joseph R. Cajas, on behalf of himself and all others similarly situated v. Prudential Health Care Plan, Inc. and Healthcare Recoveries, Inc. The plaintiff asserts that HCRI's subrogation recovery efforts on behalf of its client Prudential Health Care Plan, Inc. ("Prudential") violated a number of common law duties, as well as the Texas Insurance Code and the Texas Business and Commerce Code. The Petition alleges that HCRI, as the subrogation agent for Prudential, made fraudulent misrepresentations in the course of unlawfully pursuing subrogation and reimbursement claims that plaintiffs assert are unenforceable because (1) prepaid medical service plans may not exercise rights of subrogation and reimbursement; (2) the subrogation and reimbursement claims asserted by the Company are not supported by contract documents that provide enforceable recovery rights and/or do not adequately describe the recovery rights; and (3) the sums recovered pursuant to such claims unlawfully exceed the amount Prudential paid for medical goods and services. HCRI was served with the Petition in early November 1999, and has answered, denying all allegations. The court has not yet addressed the question of whether to certify the putative class.

In late 1999, the Cajas plaintiff's counsel filed two lawsuits in Texas and South Carolina that raise issues similar to those in the Cajas lawsuit. On December 7, 1999, a class action complaint ("Complaint") was filed against HCRI and one HCRI client in the United States District Court for the Western District of Texas, San Antonio Division, Timothy Patrick Franks, on behalf of himself and similarly situated persons v. Prudential Health Care Plan, Inc. and Healthcare Recoveries, Inc. The Complaint asserted claims on behalf of members of ERISA governed health plans and alleged that HCRI's subrogation recovery efforts on behalf of its client Prudential violated a number of common law duties, as well as the terms of certain ERISA plan documents, RICO, the federal Fair Debt Collection Practices Act, the Texas Insurance Code and the Texas Business and Commerce Code. The Complaint alleged that HCRI, as the subrogation agent for

Prudential, made fraudulent misrepresentations in the course of unlawfully pursuing subrogation and reimbursement claims that plaintiffs assert are unenforceable because (1) prepaid medical service plans may not exercise rights of subrogation and reimbursement; (2) the subrogation and reimbursement claims asserted by the Company are not supported by contract documents that provide enforceable recovery rights and/or do not adequately describe the recovery rights; and (3) the sums recovered pursuant to such claims unlawfully exceed the amount Prudential paid for medical goods and services. The Complaint further alleged that HCRI unlawfully pursued subrogation and reimbursement claims by (1) failing to pay pro rata attorney's fees to attorneys who represented purported class members with respect to tort claims underlying the subrogation and reimbursement claims; and (2) recovering subrogation and reimbursement claims from purported class members who have not been fully compensated for their injuries. Plaintiffs, on behalf of the purported class, demanded compensatory damages, punitive damages, and treble damages under RICO, costs and reasonable attorneys' fees. On January 18, 2000, the defendants filed a motion to dismiss the Complaint.

In response to the defendants' motion, on February 28, 2001, the court rendered its opinion and entered an order dismissing all of the plaintiff's claims with the exception of the plaintiff's claim for attorney fees, which remains pending before the court for disposition. On March 14, 2001, HCRI filed an answer to the Complaint denying all of the plaintiff's allegations. Also on March 14, 2001, the plaintiff filed a motion to alter or amend the court's ruling on the motion to dismiss. The court has ordered additional discovery related to the motion but has not yet ruled on the motion, nor has the court addressed the issue of class certification.

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On December 22, 1999, a purported class action complaint ("Complaint") was filed against HCRI and one HCRI client in the Court of Common Pleas of Richland County, South Carolina, Estalita Martin et al. vs. Companion Health Care Corp., and Healthcare Recoveries, Inc. On January 21, 2000, defendant Companion Healthcare Corp. ("CHC") filed an Answer and Counterclaim and plaintiff Martin filed a First Amended Complaint ("Amended Complaint"). The Amended Complaint asserts that HCRI's subrogation recovery efforts on behalf of its client CHC violated a number of common law duties, as well as the South Carolina Unfair Trade Practices Act. The Amended Complaint alleges that HCRI, as the subrogation agent for CHC, made fraudulent misrepresentations in the course of unlawfully pursuing subrogation and reimbursement claims that plaintiffs assert are unenforceable because (1) prepaid medical service plans may not exercise rights of subrogation and reimbursement; (2) the subrogation and reimbursement claims asserted by the Company are not supported by contract documents that provide enforceable recovery rights and/or do not adequately describe the recovery rights; and (3) the sums recovered pursuant to such claims unlawfully exceed the amount CHC was entitled to collect for such medical goods and services. The Amended Complaint further alleges that HCRI and CHC unlawfully pursued subrogation and reimbursement claims by (1) failing to pay pro rata costs and attorney's fees to attorneys who represented purported class members with respect to tort claims underlying the subrogation and reimbursement claims; and (2) failing to include in subrogation and reimbursement claims all applicable discounts that CHC received for such medical goods and services. Plaintiffs, on behalf of the purported class, demand compensatory damages, punitive damages, and treble damages, disgorgement of unjust profits, costs, and prejudgment interest and attorneys' fees. HCRI was served with the original Complaint in late December 1999 and answered denying all allegations. HCRI filed a motion to dismiss in August 2000. By an order dated June 6, 2001, the court dismissed all claims in the suit with prejudice. Plaintiff moved for a reconsideration of the dismissal. On June 27, 2001, the court denied the motion for reconsideration. Plaintiff filed a notice of appeal on July 20, 2001.

On March 12, 2001, a Complaint ("Complaint") was filed against HCRI in the United States District Court for the Eastern District of Louisiana, in a putative class action brought by Kyle M. Hamilton. In that action, Hamilton v. Healthcare Recoveries, Inc., No. 01-650, plaintiff asserts that HCRI's subrogation recovery efforts on behalf of its clients violate certain Louisiana state laws, the federal Fair Debt Collection Practices Act and the Louisiana Unfair Trade Practices Act. The Complaint alleges that HCRI intentionally and negligently interfered with the plaintiff's and the putative class members' rights to settle certain personal injury claims. The Complaint further alleges that HCRI unlawfully pursued subrogation and reimbursement claims that plaintiff asserts are unenforceable because the clauses in HCRI's clients' coverage documents that create such recovery rights are rendered null and void by Louisiana statutes that generally prohibit coordination of benefits with individually underwritten insurance coverages. Plaintiff purports to represent a class consisting of all persons covered under group health policies that were issued or delivered in the State of Louisiana and who received any communication from HCRI attempting to enforce any clauses that allegedly were rendered null and void by Louisiana law. Plaintiff seeks on behalf of the purported class compensatory and statutory damages, interest, costs, attorneys' fees and such additional damages and relief as may be allowed by any applicable law. On July 17, 2001, the court granted a Motion for Summary Judgment filed by HCRI as concerned the plaintiff's Fair Debt Collection Practices Act claim, dismissing those claims with prejudice. The Court denied HCRI's Motion for Summary Judgment, without prejudice to the right of HCRI to reassert its Motion, with respect to the plaintiff's state law claims. The Court ordered that the parties submit Memoranda addressing whether the Court still had subject matter jurisdiction, given dismissal of the federal claim. On August 21, 2001, the Court ruled that it lacked subject matter jurisdiction, thus dismissing the remaining claims, without prejudice. On August 31, 2001, the plaintiff filed a Motion for Reconsideration of the Court's Ruling with regard to subject matter jurisdiction and also filed a Motion for Leave of Court to file an Amended Complaint, seeking to add new theories of recovery against HCRI based upon state law. On October 3, 2001, the Court denied both motions. Plaintiff recently filed an appeal to the 5th Circuit United States Court of Appeals.

In addition to filing the appeal in federal court, the Hamilton plaintiff on October 1, 2001 filed a new complaint in the Civil District Court for the Parish of Orleans, Louisiana, in a putative class action styled Hamilton v. Healthcare Recoveries, Inc., 2001-15989. This state court action asserts claims substantially similar to those in the federal court action. HCRI has not yet filed a response to the Complaint.

The Cajas, Franks, Baker and Martin lawsuits, or any one of them, if successful, could prevent the Company from recovering the "reasonable value" of medical treatment under discounted fee for service ("DFS"), capitation and other payment arrangements. The Conte, Cajas, Franks, Baker and Martin lawsuits, or any one or more of them, if successful, could require the Company to refund, on behalf of its clients, recoveries in a material number of cases. In addition, an adverse outcome in any of the above referenced lawsuits could impair materially HCRI's ability to assert subrogation or reimbursement claims on behalf of its clients in the future.

In terms of the Company's business practices and the allegations underlying the Cajas, Franks, Baker and Martin cases, at the end of 1993 HCRI had ceased the practice of recovering the "reasonable value" of medical treatment provided by medical providers under DFS arrangements with HCRI's clients. From that date, the Company's policy has been not to recover the "reasonable value" of medical treatment in DFS arrangements. However, HCRI historically and currently recovers the "reasonable value" of medical treatment provided under capitation arrangements and other payment arrangements with medical providers on behalf of

those clients that compensate medical providers under these payment mechanisms, to the extent that these benefits are related to treatment of the injuries as to which clients have recovery rights. The Company believes that its clients' contracts, including the contracts that provide for recovery under DFS, capitation and other payment arrangements are enforceable under the laws potentially applicable in these cases. As a result, and taking into account the underlying facts in each of these cases, the Company believes it has meritorious grounds to defend these lawsuits, it intends to defend the cases vigorously, and it believes that the defense and ultimate resolution of the lawsuits should not have a material adverse effect upon the business, results of operations or financial condition of the Company. Nevertheless, if any of these lawsuits or one or more other lawsuits seeking relief under similar theories were to be successful, it is likely that such resolution would have a material adverse effect on the Company's business, results of operations and financial condition.

Management of the Company has observed that, in parallel with widely-reported legislative concerns with the healthcare payment system, there also has occurred an increase in litigation, actual and threatened, including class actions brought by nationally prominent attorneys, directed at healthcare payors and related parties. As a result of the foregoing, there can be no assurance that the Company will not be subject to further class action litigation, that existing and/or future class action litigation against the Company and its clients will not consume significant management time and/or attention or that the cost of defending and resolving such litigation will not be material.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

The following list of Exhibits includes both exhibits submitted with this Form 10-Q as filed with the Commission and those incorporated by reference to other filings:

2.1 -- Asset Purchase Agreement, dated as of December 4, 1998, by and among the Registrant, MedCap Medical Cost Management, Inc. and Marcia Deutsch (incorporated by reference to Exhibit 2.1 of Registrant's Current Report on Form 8-K, filed December 11, 1998, File No. 0-22585).

2.2 -- Amendment to Asset Purchase Agreement, dated as of December 8, 1999, by and among the Registrant, MedCap Medical Cost Management, Inc. and Marcia Deutsch (incorporated by reference to Exhibit 2.1 of Registrant's Current Report on Form 8-K, filed December 20, 1999, File No. 0-22585).

2.3 -- Asset Purchase Agreement, dated as of January 3, 1999, by and among the Registrant, Subro-Audit, Inc., O'Donnell Leasing Co., LLP, Kevin O'Donnell and Leah Lampone (incorporated by reference to Exhibit 2.1 of Registrant's Current Report on Form 8-K, filed January 11, 1999, File No. 0-22585).

2.4 -- Amendment to Asset Purchase Agreement by and among the Registrant, Subro-Audit, Inc., O'Donnell Leasing Co., LLP, Kevin O'Donnell and Leah Lampone, dated as of January 25, 1999 (incorporated by reference to Exhibit 2.2 of Registrant's Current Report on Form 8-K, filed February 3, 1999, File No. 0-22585).

3.1 -- Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of Registrant's Amendment No. 2 to Registration Statement on Form S-1, File No. 333-23287).

3.2 -- Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.2 of Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000).

4.1 -- Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 of Registrant's Amendment No. 1 to Registration Statement on Form S-1, File No. 333-23287).

4.2 -- Rights Agreement, dated February 12, 1999, between the Registrant and National City Bank of Kentucky, as Rights Agent, which includes as Exhibit A the Form of Certificate of Designations of the Preferred Stock, as Exhibit B the Form of Right Certificate and as Exhibit C the Summary of Rights to Purchase Preferred Stock (incorporated by reference to Exhibit 4.1 of Registrant's Form 8-A, filed February 16, 1999, File No. 0-22585).

99.1 -- Healthcare Recoveries, Inc. Private Securities Litigation Reform Act of 1995 Safe Harbor Compliance Statement for Forward-Looking Statements (incorporated by reference to Exhibit 99.1 of Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000).

(b) Reports on Form 8-K

ITEM REPORTED	FINANCIAL STATEMENTS FILED	DATE OF REPORT	FILE DATE
Item 5 -- Text of South Carolina Litigation Press Release	No	July 16, 2001	July 17, 2001
Item 5 -- Text of Earnings Release and Slide Show Presentation	No	August 7, 2001	August 13, 2001

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SIGNATURES

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

HEALTHCARE RECOVERIES, INC.

Date: November 14, 2001 /s/ PATRICK B. MCGINNIS

Patrick B. McGinnis
Chairman, President and
Chief Executive Officer

Date: November 14, 2001 /s/ DOUGLAS R. SHARPS

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Douglas R. Sharps
Executive Vice President and Chief Financial Officer Principal Financial and Accounting Officer

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