HEALTHWAYS, INC
Form 10-Q
August 06, 2010

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

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended June 30, 2010

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File Number 000-19364

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

Delaware (State or Other Jurisdiction of Incorporation or Organization)	62-1117144 (I.R.S. Employer Identification No.)

701 Cool Springs Boulevard, Franklin, TN 37067
(Address of Principal Executive Offices) (Zip Code)

615-614-4929
(Registrant's Telephone Number, Including Area Code)

(Former name, former address and former fiscal year, if changed since last report)

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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ¨ No ¨

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

Large accelerated filer ¨ Accelerated filer x

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of August 4, 2010 there were outstanding 34,227,837 shares of the Registrant's Common Stock, par value $.001 per share.

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Part I

Item 1. Financial Statements

HEALTHWAYS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

ASSETS

	June 30, 2010	December 31, 2009
Current assets:		
Cash and cash equivalents	$ 1,082	$ 2,356
Accounts receivable, net	112,596	100,833
Prepaid expenses	10,329	10,433
Other current assets	4,282	4,945
Income taxes receivable	2,769	6,452
Deferred tax asset	22,359	24,197
Total current assets	153,417	149,216
Property and equipment:		
Leasehold improvements	40,887	40,609
Computer equipment and related software	200,579	166,448
Furniture and office equipment	28,287	28,096
Capital projects in process	8,295	23,052
	278,048	258,205
Less accumulated depreciation	(154,636)	(134,046)
	123,412	124,159
Other assets	15,292	11,498
Customer contracts, net	26,494	29,343
Other intangible assets, net	71,243	71,704
Goodwill, net	496,306	496,446
Total assets	$ 886,164	$ 882,366

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)
(Unaudited)

LIABILITIES AND STOCKHOLDERS' EQUITY

	June 30, 2010	December 31, 2009
Current liabilities:		
Accounts payable	$ 17,046	$ 29,171
Accrued salaries and benefits	30,359	58,212
Accrued liabilities	30,646	25,004
Deferred revenue	6,128	4,639
Contract billings in excess of earned revenue	75,759	70,440
Current portion of long-term debt	3,271	2,192
Current portion of long-term liabilities	3,348	3,854
Total current liabilities	166,557	193,512
Long-term debt	256,328	254,345
Long-term deferred tax liability	15,788	14,617
Other long-term liabilities	43,716	42,615
Stockholders' equity:		
Preferred stock		
$.001 par value, 5,000,000 shares		
authorized, none outstanding	—	—
Common stock		
$.001 par value, 120,000,000 shares authorized,		
34,200,161 and 33,858,917 shares outstanding	34	34
Additional paid-in capital	228,677	222,472
Retained earnings	180,132	158,880
Accumulated other comprehensive loss	(5,068)	(4,109)
Total stockholders' equity	403,775	377,277
Total liabilities and stockholders' equity	$ 886,164	$ 882,366

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except earnings per share data)
(Unaudited)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Revenues	$ 175,523	$ 177,836	$ 354,522	$ 360,572
Cost of services (exclusive of depreciation and amortization of $9,928, $8,540, $20,161, and $17,326, respectively, included below)	121,985	127,762	250,852	260,599
Selling, general & administrative expenses	18,703	18,449	35,938	37,234
Depreciation and amortization	13,341	11,949	26,895	24,199
Operating income	21,494	19,676	40,837	38,540
Gain on sale of investment	(1,163)	—	(1,163)	(2,581)
Interest expense	3,612	4,142	7,034	8,202
Legal settlement and related costs	—	—	—	39,956
Income (loss) before income taxes	19,045	15,534	34,966	(7,037)
Income tax expense (benefit)	7,207	6,658	13,714	(1,100)
Net income (loss)	$ 11,838	$ 8,876	$ 21,252	$ (5,937)
Earnings (loss) per share:				
Basic	$ 0.35	$ 0.26	$ 0.62	$ (0.18)
Diluted (1)	$ 0.34	$ 0.26	$ 0.61	$ (0.18)
Weighted average common shares and equivalents:				
Basic	34,117	33,689	34,037	33,679
Diluted (1)	34,933	34,186	34,928	33,679

(1) The assumed exercise of stock-based compensation awards for the six months ended June 30, 2009 was not considered because the impact would be anti-dilutive.

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HEALTHWAYS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
For the Six Months Ended June 30, 2010
(In thousands)
(Unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2009	$—	$34	$222,472	$158,880	$(4,109)	$377,277
Comprehensive income:						
Net income	—	—	—	21,252	—	21,252
Net change in fair value of interest rate swaps, net of income tax benefit of $518	—	—	—	—	(801)	(801)
Foreign currency translation adjustment	—	—	—	—	(158)	(158)
Total comprehensive income						20,293
Exercise of stock options	—	—	532	—	—	532
Tax effect of stock options and restricted stock units	—	—	82	—	—	82
Share-based employee compensation expense	—	—	5,591	—	—	5,591
Balance, June 30, 2010	$—	$34	$228,677	$180,132	$(5,068)	$403,775

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cash flows from operating activities:		
Net income (loss)	$ 21,252	$ (5,937)
Adjustments to reconcile net income (loss) to net cash provided by operating activities, net of business acquisitions:		
Depreciation and amortization	26,895	24,199
Amortization of deferred loan costs	869	738
Gain on sale of investment	(1,163)	(2,581)
Loss on disposal of property and equipment	28	726
Share-based employee compensation expense	5,591	5,306
Excess tax benefits from share-based payment arrangements	(806)	(56)
Increase in accounts receivable, net	(11,782)	(3,365)
Decrease (increase) in other current assets	6,152	(5,825)
(Decrease) increase in accounts payable	(6,437)	482
(Decrease) increase in accrued salaries and benefits	(27,779)	14,675
Increase (decrease) in other current liabilities	13,797	(360)
Deferred income taxes	1,908	2,305
Other	2,317	3,187
Increase in other assets	(909)	(1,018)
Payments on other long-term liabilities	(2,845)	(2,461)
Net cash flows provided by operating activities	27,088	30,015
Cash flows from investing activities:		
Change in restricted cash	—	(538)
Sale of investment	1,163	11,626
Acquisition of property and equipment	(23,384)	(22,241)
Other	(2,814)	(2,286)
Net cash flows used in investing activities	(25,035)	(13,439)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	417,450	165,200
Payments of long-term debt	(415,766)	(173,035)
Deferred loan costs	(3,166)	(784)
Excess tax benefits from share-based payment arrangements	806	56
Exercise of stock options	532	139
Repurchases of stock options	—	(736)
Change in outstanding checks	(2,881)	(6,149)
Net cash flows used in financing activities	(3,025)	(15,309)
Effect of exchange rate changes on cash	(302)	93

Net (decrease) increase in cash and cash equivalents		(1,274)		1,360
Cash and cash equivalents, beginning of period		2,356		5,157
Cash and cash equivalents, end of period	$	1,082	$	6,517

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Basis of Presentation

Our financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). In our opinion, the accompanying consolidated financial statements of Healthways, Inc. and its wholly-owned subsidiaries reflect all adjustments consisting of normal, recurring accruals necessary for a fair presentation. We have reclassified certain items in prior periods to conform to current classifications.

We have omitted certain financial information that is normally included in financial statements prepared in accordance with U.S. GAAP but that is not required for interim reporting purposes. You should read the accompanying consolidated financial statements in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

(2) Recently Issued Accounting Standards

In January 2010, the FASB issued Accounting Standards Update ("ASU") No. 2010-06, "Improving Disclosures about Fair Value Measurements", an amendment to ASC Topic 820, "Fair Value Measurements and Disclosures". This amendment requires an entity to: 1) disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers and 2) present separate information for Level 3 activity pertaining to gross purchases, sales, issuances, and settlements (rather than presenting such information on a net basis). ASU No. 2010-06 is effective for the Company for interim and annual reporting periods beginning after December 15, 2009, except for item 2) above, which is effective for interim and annual reporting periods beginning after December 15, 2010. The adoption of this ASU did not have a material impact on our results of operations or statement of financial position. We expect the adoption of item 2) above will not have a material impact on the results of operations or statement of financial position.

(3) Share-Based Compensation

We have several shareholder-approved stock incentive plans for employees and directors. We currently have three types of share-based awards outstanding under these plans: stock options, restricted stock, and restricted stock units. We believe that such awards align the interests of our employees and directors with those of our stockholders.

For the three and six months ended June 30, 2010, we recognized share-based compensation costs of $2.6 million and $5.6 million, respectively. For the three months and six months ended June 30, 2009, we recognized share-based compensation costs of $2.5 million and $5.3 million, respectively.

A summary of our stock options as of June 30, 2010 and changes during the six months then ended is presented below:

Options	Shares (000s)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($000s)
Outstanding at January 1, 2010	4,936	$ 18.46		
Granted	855	15.37		
Exercised	(128)	4.61		
Forfeited or expired	(118)	23.21		
Outstanding at June 30, 2010	5,545	18.21	5.15	$4,277
Exercisable at June 30, 2010	3,498	19.28	3.33	3,590

The weighted-average grant-date fair value of options granted during the three and six months ended June 30, 2010 was $8.28 and $8.97, respectively.

The following table shows a summary of our restricted stock and restricted stock units ("nonvested shares") as of June 30, 2010 as well as activity during the six months then ended:

Nonvested Shares	Shares (000s)	Weighted-Average Grant Date Fair Value
Nonvested at January 1, 2010	1,015	$ 22.21
Granted	141	15.26
Vested	(212)	16.15
Forfeited	(18)	26.51
Nonvested at June 30, 2010	926	22.44

(4) Income Taxes

Our effective tax rate decreased to 37.8% for the three months ended June 30, 2010 compared to 42.9% for the three months ended June 30, 2009, primarily due to an earn-out adjustment recorded during the three months ended June 30, 2010 (see Note 6), as well as a change in the geographic mix of our earnings during the three months ended June 30, 2010.

Our effective tax rate increased to an expense of 39.2% for the six months ended June 30, 2010 compared to a benefit of 15.6% for the six months ended June 30, 2009, primarily due to a change to a pretax profit for the six months ended June 30, 2010 from a pretax loss for the six months ended June 30, 2009, as well as certain unrecognized tax benefits and tax interest accruals related to the six months ended June 30, 2009.

We file income tax returns in the U.S. Federal jurisdiction and in various state and foreign jurisdictions. Tax years remaining subject to examination in these jurisdictions include 2007 to present.

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(5) Derivative Investments and Hedging Activities

We use derivative instruments to manage risks related to interest rates and foreign currencies. We record all derivatives at estimated fair value as either assets or liabilities on the balance sheet and recognize the unrealized gains and losses in either the balance sheet or statement of operations, depending on whether the derivative is designated as a hedging instrument. As permitted under our master netting arrangements, the fair value amounts of our derivative instruments are presented on a net basis by counterparty in the consolidated balance sheet.

Interest Rate

We currently maintain six interest rate swap agreements to reduce our exposure to interest rate fluctuations on our floating rate debt commitments (see Note 7 for further information). These interest rate swap agreements effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations with interest rates ranging from 3.375% to 3.855%, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR, and we pay a fixed rate of interest. We have designated these interest rate swap agreements as qualifying cash flow hedges.

Foreign Currency

We enter into foreign currency options and/or forward contracts in order to minimize our earnings exposure to fluctuations in foreign currency exchange rates. Our foreign currency exchange contracts do not qualify for hedge accounting treatment under U.S. GAAP. We routinely monitor our foreign currency exposures to maximize the overall effectiveness of our foreign currency hedge positions. We do not execute transactions or hold derivative financial instruments for trading or other purposes.

Fair Values of Derivative Instruments

The estimated gross fair values of derivative instruments at June 30, 2010, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists, were as follows:

(In $000s)	Foreign currency exchange contracts	Interest rate swap agreements
Assets:		
Derivatives not designated as hedging instruments:		
Other current assets	$339	$—
Total assets	$339	$—
Liabilities:		
Derivatives not designated as hedging instruments:		
Accrued liabilities	$75	$—
Derivatives designated as hedging instruments:		
Accrued liabilities	—	703
Other long-term liabilities	—	7,707
Total liabilities	$75	$8,410

See also Note 6.

Cash Flow Hedges

Derivative instruments that are designated and qualify as cash flow hedges are recorded at estimated fair value in the balance sheet, with the effective portion of the gains and losses being reported in other comprehensive income ("OCI") or loss. These gains and losses are reclassified into earnings in the same period during which the hedged transaction affects earnings or the period in which all or a portion of the hedge becomes ineffective. As of June 30, 2010, we expect to reclassify $4.6 million of net losses on interest rate swap agreements from accumulated OCI to interest expense within the next 12 months due to the scheduled payment of interest associated with floating rate debt.

As of June 30, 2010, we are a party to the following interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay the following fixed rates of interest:

Swap #	Original Notional Amount (in $000s)	Fixed Interest Rate	Termination Date
1	30,000	3.760%	March 30, 2011
2	40,000	3.433%	December 30, 2011
3	50,000	3.688%	December 30, 2011
4	40,000	3.855%	December 30, 2011
5	57,500	3.385%	December 31, 2013(1)
6	57,500	3.375%	December 31, 2013(2)

(1) This swap agreement becomes effective January 1, 2012. The principal value of this swap agreement will amortize over a 24-month period.
(2) This swap agreement becomes effective January 3, 2012. The principal value of this swap agreement will amortize over a 24-month period.

We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

Gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. The following table shows the effect of our cash flow hedges on the consolidated statement of operations (or when applicable, the consolidated balance sheet) during the three and six months ended June 30, 2010:

(In $000s)	Three Months Ended June 30, 2010			Six Months Ended June 30, 2010		
Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income	Amount of Gain (Loss) Reclassified from Accumulated OCI into Income	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective	Amount of Gain (Loss) Reclassified from Accumulated OCI into Income

		(Effective Portion)	(Effective Portion)		Portion)	(Effective Portion)
Interest rate swap agreements, gross of tax effect	$(2,048)	Interest expense	$(1,371)	$(4,293)	Interest expense	$(2,974)

During the three and six months ended June 30, 2010, there were no gains or losses on cash flow hedges recognized in income resulting from hedge ineffectiveness.

Derivative Instruments Not Designated as Hedging Instruments

Our foreign currency exchange contracts require current period mark-to-market accounting, with any change in fair value being recorded each period in the statement of operations in selling, general and administrative expenses. At June 30, 2010, we had forward contracts with notional amounts of $4.7 million to exchange foreign currencies, primarily the Australian dollar and Euro, that were entered into to hedge forecasted foreign net income (loss) and intercompany debt.

These forward contracts did not have a material effect on our consolidated statement of operations during the three and six months ended June 30, 2010.

(6) Fair Value Measurements

We account for certain assets and liabilities at fair value. Fair value is defined as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date, assuming the transaction occurs in the principal or most advantageous market for that asset or liability.

Fair Value Hierarchy

The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. We categorize each of our fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1: Quoted prices in active markets for identical assets or liabilities;
Level 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-based valuation techniques in which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and
Level 3: Unobservable inputs that are supported by little or no market activity and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents our assets and liabilities measured at fair value on a recurring basis at June 30, 2010:

(In 000s)	Level 2	Level 3	Gross Fair Value	Netting (1)	Net Fair Value
Assets:					
Foreign currency exchange contracts	$ 339	$ —	$ 339	$ (35)	$ 304
Liabilities:					
Foreign currency exchange contracts	$ 75	$ —	$ 75	$ (35)	$ 40
Interest rate swap agreements	8,410	—	8,410	—	8,410
Contingent consideration liability	—	1,563	1,563	—	1,563

(1) This column reflects the impact of netting derivative assets and liabilities by counterparty when a legally enforceable master netting agreement exists.

The fair values of forward foreign currency exchange contracts are valued using broker quotations of similar assets or liabilities in active markets. The fair values of interest rate swap agreements are primarily determined based on the present value of future cash flows using internal models and third-party pricing services with observable inputs, including interest rates, yield curves and applicable credit spreads.

The contingent consideration liability represents the fair value of a multi-year earn-out arrangement in connection with a business combination entered into during the fourth quarter of 2009. The fair value was determined using a discounted cash flow model based on management's estimate of future cash flows. During the three months ended June 30, 2010, we revised our estimate of future cash flows, resulting in a net decrease of $1.5 million in the fair value of the contingent consideration liability, which was recorded to other income. The change in the contingent consideration liability during the three and six months ended June 30, 2010 is shown below:

(In $000s)	Contingent Consideration Liability	
Balance, January 1, 2010 and April 1, 2010	$	3,043
Adjustment to liability		(1,480)
Balance, June 30, 2010	$	1,563

Fair Value of Other Financial Instruments

In addition to foreign currency exchange contracts and interest rate swap agreements, the estimated fair values of which are disclosed above, the estimated fair value of each class of financial instruments at June 30, 2010 was as follows:

- Cash and cash equivalents – The carrying amount of $1.1 million approximates fair value because of the short maturity of those instruments (less than three months).

- Long-term debt –The estimated fair value of outstanding borrowings under our credit agreement is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The estimated fair value and carrying amount of outstanding borrowings under the Fourth Amended Credit Agreement (see Note 7) at June 30, 2010 are $242.8 million and $258.0 million, respectively.

(7) Long-Term Debt

On March 30, 2010, we entered into the Fourth Amended and Restated Credit Agreement (the "Fourth Amended Credit Agreement"). The Fourth Amended Credit Agreement provides us with a $55.0 million revolving credit facility from March 30, 2010 to December 1, 2011 (the "2011 Revolving Credit Facility") and a $345.0 million revolving credit facility from March 30, 2010 to December 1, 2013 (the "2013 Revolving Credit Facility"), including a swingline sub facility of $20.0 million and a $75.0 million sub facility for letters of credit. The Fourth Amended Credit Agreement also provides a continuation of the term loan facility provided pursuant to the Third Amended and Restated Credit Agreement, of which $193.0 million remained outstanding on June 30, 2010, and an uncommitted incremental accordion facility of $200.0 million.

Revolving advances under the Fourth Amended Credit Agreement are drawn first under the 2013 Revolving Credit Facility, with any advances in excess of $345.0 million being drawn under the 2011 Revolving Credit Facility. Revolving advances under the 2011 Revolving

Credit Facility generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Revolving advances under the 2013 Revolving Credit Facility generally bear interest, at our option, at 1) LIBOR plus a spread of 1.875% to 2.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.375% to 1.250%. Term loan borrowings bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate. See Note 5 for a description of our interest rate swap agreements. The Fourth Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of the unused commitments under the 2011 Revolving Credit Facility and 0.275% and 0.425% of the unused commitments under the 2013 Revolving Credit Facility. The Fourth Amended Credit Agreement is secured by guarantees from most of the Company's domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

We are required to repay outstanding revolving loans on the applicable commitment termination date, which is December 1, 2011 for the 2011 Revolving Credit Facility and December 1, 2013 for the 2013 Revolving Credit Facility. We are required to repay term loans in quarterly principal installments aggregating $0.5 million each, which commenced on March 31, 2007. The entire unpaid principal balance of the term loans is due and payable at maturity on December 1, 2013.

The Fourth Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of 1) total funded debt to EBITDA, 2) fixed charge coverage, and 3) net worth. The Fourth Amended Credit Agreement also restricts the payment of dividends and limits the amount of repurchases of the Company's common stock. As of June 30, 2010, we were in compliance with all of the covenant requirements of the Fourth Amended Credit Agreement.

As described in Note 5 above, as of June 30, 2010, we are a party to six interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay a fixed rate of interest.

(8) Commitments and Contingencies

Securities Class Action Litigation

Beginning on June 5, 2008, Healthways and certain of its present and former officers and/or directors were named as defendants in two putative securities class actions filed in the U.S. District Court for the Middle District of Tennessee, Nashville Division. On August 8, 2008, the court ordered the consolidation of the two related cases, appointed lead plaintiff and lead plaintiff's counsel, and granted lead plaintiff leave to file a consolidated amended complaint.

The amended complaint, filed on September 22, 2008, alleged that the Company and the individual defendants violated Sections 10(b) of the Securities Exchange Act of 1934 (the "Act") and that the individual defendants violated Section 20(a) of the Act as "control persons" of Healthways. The amended complaint further alleges that certain of the individual defendants also violated Section 20A of the Act based on their stock sales. The plaintiff purports to bring these claims for unspecified monetary damages on behalf of a class of investors who purchased Healthways stock between July 5, 2007 and August 25, 2008.

In support of these claims, the lead plaintiff alleges generally that, during the proposed class period, the Company made misleading statements and omitted material information regarding (1) the purported loss or restructuring of certain contracts with customers, (2) the Company's participation in the Medicare Health

Support ("MHS") pilot program for the Centers for Medicare & Medicaid Services, and (3) the Company's guidance for fiscal year 2008. The defendants filed a motion to dismiss the amended complaint on November 13, 2008. On March 9, 2009, the Court denied the defendants' motion to dismiss. On April 27, 2010, the parties reached an agreement in principle to settle this matter for $23.6 million. The District Court must approve this settlement after notice to the class before it may be considered final. The Court has preliminarily approved the settlement and scheduled a hearing for final approval of the settlement on September 24, 2010. In July 2010, all parties to the litigation effected a settlement and stipulation agreement pursuant to which the Company's insurers made all required payments to a qualified settlement fund. As a result of the Company's insurance coverage, this settlement is not expected to result in any charge to the Company.

Shareholder Derivative Lawsuits

Also, on June 27, 2008 and July 24, 2008, respectively, two shareholders filed putative derivative actions purportedly on behalf of Healthways in the Chancery Court for the State of Tennessee, Twentieth Judicial District, Davidson County, against certain directors and officers of the Company. These actions are based upon substantially the same facts alleged in the securities class action litigation described above. The plaintiffs are seeking to recover damages in an unspecified amount and equitable and/or injunctive relief.

On August 13, 2008, the Court consolidated these two lawsuits and appointed lead counsel. On October 3, 2008, the Court ordered that the consolidated action be stayed until the motion to dismiss in the securities class action had been resolved by the District Court. By stipulation of the parties, the plaintiffs filed their consolidated complaint on May 9, 2009. On June 19, 2009, the defendants filed a motion to dismiss the consolidated complaint. The Court granted the defendants' motion to dismiss on October 14, 2009. The plaintiffs filed a notice of appeal on November 12, 2009.

ERISA Lawsuits

Additionally, on July 31, 2008, a purported class action alleging violations of the Employee Retirement Income Security Act ("ERISA") was filed in the U.S. District Court for the Middle District of Tennessee, Nashville Division against Healthways, Inc. and certain of its directors and officers alleging breaches of fiduciary duties to participants in the Company's 401(k) plan. The central allegation is that Company stock was an imprudent investment option for the 401(k) plan.

An amended complaint was filed on September 29, 2008, naming as defendants the Company, the Board of Directors, certain officers, and members of the Investment Committee charged with administering the 401(k) plan. The amended complaint alleged that the defendants violated ERISA by failing to remove the Company stock fund from the 401(k) plan when it allegedly became an imprudent investment, by failing to disclose adequately the risks and results of the MHS pilot program to 401(k) plan participants, and by failing to seek independent advice as to whether to continue to permit the plan to hold Company stock. It further alleged that the Company and its directors should have been more closely monitoring the Investment Committee and other plan fiduciaries. The amended complaint sought damages in an undisclosed amount and other equitable relief. The defendants filed a motion to dismiss on October 29, 2008. On January 28, 2009, the Court granted the defendants' motion to dismiss the plaintiff's claims for breach of the duty to disclose with regard to any non-public information and information beyond the specific disclosure requirements of ERISA and denied Defendants' motion to dismiss as to the remainder of the plaintiff's claims. A period of discovery ensued.

On May 12, 2009, the plaintiff filed a motion for class certification. After the plaintiff failed, without explanation, to appear for his scheduled deposition, the Court issued an Order on July 10, 2009 warning the plaintiff that his failure to participate in the lawsuit could result in sanctions, including but not limited to dismissal. After the plaintiff's failure to participate continued, on July 23, 2009, the defendants filed a motion to dismiss for failure to prosecute the action. On August 6, 2009, the parties filed a stipulation of dismissal with

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prejudice as to the named plaintiff but otherwise without prejudice, and the Court entered an Order to that effect on the same date.

On February 1, 2010, a new named plaintiff filed another putative class action complaint in the United States District Court for the Middle District of Tennessee, Nashville Division, alleging ERISA violations in the administration of the Company's 401(k) plan. The new complaint is identical to the original complaint, including the allegations and the requests for relief. Defendants' answer to this complaint was filed on March 22, 2010. A scheduling order was entered on April 1, 2010, and discovery commenced thereafter. On April 30, 2010, Plaintiff filed a motion for class certification. On June 23, 2010, the parties reached an agreement in principle to settle this matter for $1,250,000, with such settlement being funded by the Company's fiduciary liability insurance carrier. The District Court must approve this settlement after notice to the class before it may be considered final. The class settlement will be reduced to writing and presented to the Court for preliminary approval in the coming weeks.

Outlook

We are also subject to other contractual disputes, claims and legal proceedings that arise from time to time in the ordinary course of our business. We currently are involved in a contractual dispute with a customer regarding fees paid to us as part of a former contractual relationship. We believe we performed our services in compliance with the contractual requirements and the customer's assertions are without merit. In the event the parties are unable to resolve the dispute, the parties will proceed to arbitration as specified in the applicable agreement. While we are unable to estimate a range of potential losses, we do not believe that the contractual disputes or any of the legal proceedings pending against us as of the date of this report will have a material adverse effect on our liquidity or financial condition; however, we may settle disputes, claims, sustain judgments or incur expenses relating to these matters in a particular fiscal quarter which may adversely affect our results of operations. As these matters are subject to inherent uncertainties, our view of these matters may change in the future.

Contractual Commitment

In January 2008, we entered into a perpetual license agreement and 25-year strategic relationship agreement. We have remaining contractual cash obligations of $32.5 million related to these agreements, $12.5 million of which will occur ratably from July 2010 through December 2012, and the remaining $20.0 million of which will occur ratably over a 20-year period beginning in 2013.

(9) Sale of Investment

In January 2009, a private company in which we held preferred stock was acquired by a third party. As part of this sale, we received two payments totaling $11.6 million in January and February 2009 and recorded a gain of $2.6 million during the first quarter of 2009. During the second quarter of 2010, we recognized a gain of $1.2 million related to the receipt of a final escrow payment.

(10) Comprehensive Income (Loss)

Comprehensive income (loss), net of income taxes, was $11.3 million and $10.7 million for the three months ended June 30, 2010 and 2009, respectively, and $20.3 million and ($5.5) million for the six months ended June 30, 2010 and 2009, respectively.

(11) Earnings (Loss) Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted earnings (loss) per share for the three and six months ended June 30, 2010 and 2009:

(In 000s, except per share data)	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Numerator:				
Net income (loss) - numerator for basic earnings (loss) per share	$ 11,838	$ 8,876	$ 21,252	$ (5,937)
Denominator:				
Shares used for basic earnings (loss) per share	34,117	33,689	34,037	33,679
Effect of dilutive securities outstanding:				
Non-qualified stock options	456	253	493	—
Restricted stock units	360	244	398	—
Shares used for diluted earnings (loss) per share(1)	34,933	34,186	34,928	33,679
Earnings (loss) per share:				
Basic	$ 0.35	$ 0.26	$ 0.62	$ (0.18)
Diluted (1)	$ 0.34	$ 0.26	$ 0.61	$ (0.18)
Dilutive securities outstanding not included in the computation of earnings (loss) per share because their effect is antidilutive:				
Non-qualified stock options	3,935	4,234	3,601	4,314
Restricted stock units	83	592	3	713

(1) The assumed exercise of stock-based compensation awards for the six months ended June 30, 2009 was not considered because the impact would have been anti-dilutive.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Founded in 1981, Healthways, Inc. provides specialized, comprehensive solutions to help people improve physical, emotional and social well-being, reducing both direct healthcare costs and costs associated with the loss of health-related employee productivity.

We provide highly specific and personalized interventions for each individual in a population, irrespective of health status, age or payor. Our evidence-based health, prevention and well-being services are made available to consumers via phone, direct mail, the Internet, face-to-face consultations and venue-based interactions.

In North America, our customers include health plans, governments, employers, pharmacy benefit managers, and hospitals in all 50 states, the District of Columbia and Puerto Rico. We also provide health improvement programs and services in Germany, Brazil and Australia. We operate care enhancement and coaching centers worldwide staffed with licensed health professionals. Our fitness center network encompasses approximately 15,000 U.S. locations. We also maintain an extensive network of over 37,000 complementary and alternative medicine and chiropractic practitioners, which offers convenient access to the significant number of individuals who seek health services outside of the traditional healthcare system.

Our guiding philosophy and approach to market is predicated on the fundamental belief that healthier people cost less and are more productive. As described more fully below, our programs are designed to help keep healthy people healthy, mitigate or eliminate lifestyle risk factors that can lead to disease, and optimize care for those with chronic illness.

First, our programs are designed to help keep healthy people healthy by:

- fostering wellness and disease prevention through total population screening, health risk assessments and supportive interventions; and
- providing access to health improvement programs, such as fitness, weight management, and complementary and alternative medicine.

Our prevention programs focus on education, physical fitness, health coaching, behavior change techniques and support, and evidence-based interventions to drive adherence to proven standards of care, medication regimens and physicians' plans of care. We believe this approach optimizes the health status of member populations and reduces the short- and long-term direct healthcare costs for participants, including costs associated with the loss of health-related employee productivity.

Second, our programs are designed to mitigate or eliminate lifestyle risk factors that can lead to disease by:

- promoting the reduction of lifestyle behaviors that lead to poor health or chronic conditions; and
- providing educational materials and personal interactions with highly trained nurses and other healthcare professionals to create and sustain healthier behaviors for those individuals at-risk or in the early stages of chronic conditions.

We enable our customers to engage everyone in their covered populations through specific interventions that are sensitive to each individual's health risks and needs. Our products are designed to motivate people to make positive lifestyle changes and accomplish individual goals, such as increasing physical activity for seniors through the Healthways SilverSneakers® fitness program or overcoming nicotine addiction through the QuitNet® on-line smoking cessation community.

Finally, our programs are designed to optimize care for those with chronic illness by:

- incorporating the latest, evidence-based clinical guidelines into interventions to optimize patient health outcomes;
- developing care support plans and motivating members to set attainable goals for themselves;
- providing local market resources to address acute episodic interventions;
- coordinating members' care with their healthcare providers;
- providing software licensing and management consulting in support of well-being improvement services; and
- providing high-risk care management for members at risk for hospitalization due to complex conditions.

Our approach is to use proprietary, analytic models to identify individuals who are likely to incur future high costs without intervention, including those who have specific gaps in care that can be addressed to reduce disease progression and related medical spending.

We recognize that each individual plays a variety of roles in his or her pursuit of health, often simultaneously. By providing the full spectrum of services to meet each individual's needs, we believe our interventions can be delivered at scale and in a manner that reflects those unique needs over time. We believe creating real and sustainable behavior change generates measurable, long-term cost savings and improved business performance.

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which are based upon current expectations and involve a number of risks and uncertainties. Forward-looking statements include all statements that do not relate solely to historical or current facts, and can be identified by the use of words like "may," "believe," "will," "expect," "project," "estimate," "anticipate," "plan," or "continue." In order for us to use the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, we caution you that the following important factors, among others, may affect these forward-looking statements. Consequently, actual operations and results may differ materially from those expressed in the forward-looking statements. The important factors include but are not limited to:

- our ability to sign and implement new contracts for our solutions;
- our ability to retain existing customers and to renew or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;
- our ability to accurately forecast performance and the timing of revenue recognition under the terms of our customer contracts ahead of data collection and reconciliation in order to provide forward-looking guidance;
- the impact of recently enacted national healthcare reform legislation on our operations and/or the demand for our services;
- the impact of any new or proposed legislation, regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, including the potential expansion to Phase II for Medicare Health Support programs and any legislative or regulatory changes with respect to Medicare Advantage;

- our ability to reach mutual agreement with the Centers for Medicare & Medicaid Services (“CMS”) with respect to results under Phase I of Medicare Health Support;
- our ability to anticipate the rate of market acceptance of our solutions in potential international markets;
- our ability to accurately forecast the costs necessary to implement our strategy of establishing a presence in international markets;
- the risks associated with foreign currency exchange rate fluctuations and our ability to hedge against such fluctuations;
- the risks associated with a significant concentration of our revenues with a limited number of customers;
- our ability to effect cost savings and clinical outcomes improvements under our contracts and reach mutual agreement with customers with respect to cost savings, or to effect such savings and improvements within the time frames contemplated by us;
- our ability to collect contractually earned performance incentive bonuses;
- our ability to achieve estimated annualized revenue in backlog in the manner and within the timeframe we expect, which is based on certain estimates regarding the implementation of our services;
- our ability and/or the ability of our customers to enroll participants and to estimate their level of participation in our programs in a manner and within the timeframe anticipated by us;
- the ability of our customers to provide timely and accurate data that is essential to the operation and measurement of our performance under the terms of our contracts;
- our ability to favorably resolve contract billing and interpretation issues with our customers;
- our ability to service our debt and make principal and interest payments as those payments become due;
- the risks associated with changes in macroeconomic conditions, which may reduce the demand and/or the timing of purchases for our services from customers or potential customers, reduce the number of covered lives of our existing customers, restrict our ability to obtain additional financing, or impact the availability of credit under our Fourth Amended Credit Agreement;
- counterparty risk associated with our interest rate swap agreements and foreign currency exchange contracts;
- our ability to integrate acquired businesses or technologies into our business;
- the impact of any impairment of our goodwill or other intangible assets;
- our ability to develop new products and deliver outcomes on those products;
- our ability to implement our new integrated data and technology solutions platform within the timeframe and cost estimates that we expect;
- our ability to obtain adequate financing to provide the capital that may be necessary to support our operations and to support or guarantee our performance under new contracts;
- unusual and unforeseen patterns of healthcare utilization by individuals with diabetes, cardiac, respiratory and/or other diseases or conditions for which we provide services;
- the ability of our customers to maintain the number of covered lives enrolled in the plans during the terms of our agreements;
- the impact of litigation involving us and/or our subsidiaries;
- the impact of future state, federal, and international healthcare and other applicable legislation and regulations on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;
- current geopolitical turmoil, the continuing threat of domestic or international terrorism, and the potential emergence of a health pandemic; and
- other risks detailed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 and other filings with the Securities and Exchange Commission.

We undertake no obligation to update or revise any such forward-looking statements.

Customer Contracts

Contract Terms

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month ("PMPM") by the number of members covered by our services during the month. We typically set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In addition, some of our services, such as the SilverSneakers fitness program, are billed on a fee for service basis.

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers, either directly or through their health plans or pharmacy benefit manager, typically have one to three-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts provide that a portion of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's healthcare costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 3% of revenues recorded during the six months ended June 30, 2010 were performance-based and were subject to final reconciliation as of June 30, 2010. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts and the timing and amount of revenue recognition associated with performance-based fees. Some contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

Technology

Our solutions require sophisticated analytical, data management, Internet and computer-telephony solutions based on state-of-the-art technology. These solutions help us deliver our services to large populations within our customer base. Our predictive modeling capabilities allow us to identify and stratify those participants who are most at risk for an adverse health event. We incorporate behavior-change science with consumer-friendly interactions such as face-to-face, telephonic, print materials and web portals to facilitate consumer preferences for engagement and convenience. We use sophisticated data analytical and reporting solutions to validate the impact of our programs on clinical and financial outcomes. We continue to invest heavily in technology and are continually expanding and improving our proprietary clinical, data management, and reporting systems to continue to meet the information management requirements of our services. The behavior change techniques incorporated in our technology identify an individual's readiness to change and provide personalized support through appropriate messaging and convenient venues to motivate and sustain healthy behaviors.

Contract Revenues

Our contract revenues depend on the contractual terms we establish and maintain with customers to provide our services to their members. Some of our contracts allow the customer to terminate early. Restructurings of contracts and possible terminations at, or prior to, renewal could have a material negative impact on our results of operations and financial condition.

Approximately 18% of our revenues for the three and six months ended June 30, 2010 were derived from one customer. The loss of this customer or any other large customer or a reduction in the profitability of a contract with any large customer could have a material negative impact on our results of operations, cash flows, and financial condition.

Business Strategy

The World Health Organization defines health as "…not only the absence of infirmity and disease, but also a state of physical, mental, and social well-being."

Our business strategy reflects our passion to enhance health and well-being, and as a result, reduce overall costs and improve workforce engagement, yielding better business performance for our customers. Our programs are designed to:

- keep healthy people healthy;
- mitigate or eliminate lifestyle risk factors that can lead to disease; and
- optimize care for those with chronic illness.

Through our solutions, we work to optimize the health and well-being of entire populations, one person at a time, domestically and internationally, thereby creating value by reducing overall costs and improving productivity for individuals, families, health plans, governments and employers.

We believe it is critical to impact an entire population's underlying health status and well-being in a long-term, cost effective way. Believing that what gets measured gets acted upon, in January 2008, we entered into an exclusive, 25-year relationship with Gallup to provide a national, daily pulse of individual and collective well-being. The Gallup-Healthways Well-Being IndexTM is the result of a unique partnership in well-being measurement and research that is based on surveys of 1,000 Americans every day, seven days a week. Under the agreement, Gallup evaluates and reports on the well-being of individuals of countries, states and communities; Healthways provides similar services for companies, families and individuals.

To enhance health and well-being within their respective populations, our current and prospective customers require solutions that focus on the underlying drivers of healthcare demand, address worsening health status, reverse or slow unsustainable cost trends, foster healthy behaviors, mitigate health risks, and manage chronic conditions. Our strategy is to deliver programs that engage individuals and help them enhance their health status and well-being regardless of their starting point. We believe we can achieve health and well-being improvements in a population and generate significant cost savings and increases in productivity by providing effective programs that support the individual throughout his or her health journey.

We are adding and enhancing solutions to extend our reach and effectiveness and to meet increasing demand for integrated solutions. The flexibility of our programs allows customers to provide those services they deem appropriate for their organizations. Customers may select from certain single program options up to a total-population approach, in which all members of a customer's population are eligible to receive our services.

Our strategy includes as a priority the ongoing development of an order-of-magnitude increase in our value proposition through, most recently, the introduction of our total population management (WholeHealth) solution. This solution, in addition to improving health and reducing direct healthcare costs, targets a much larger improvement in employer profitability by reducing the impact of lost productivity for health-related reasons. With the success of our total population management solution, we expect to gain an even greater competitive advantage in responding to employers' needs for a healthier, higher-performing and less costly workforce.

Our strategy also includes the further enhancement of our proprietary next generation technology platform known as Embrace. This platform, which is essential to our total population management solution, enables us to integrate data from all the healthcare and other entities interacting with an individual. Embrace enables the delivery of our integrated solutions and ongoing communications between the individual and his/her

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medical and health experts, using any method desired, including venue-based face-to-face; print; phone; mobile and remote devices; on-line; emerging modalities; and any combination thereof.

We plan to increase our competitive advantage in delivering our services by leveraging our scalable, state-of-the-art call centers, medical information content, behavior change processes and techniques, strategic relationships, health provider networks, fitness center relationships, and proprietary technologies and techniques. We anticipate we will continue to enhance, expand and further integrate capabilities, pursue opportunities in domestic government and international markets, and enhance our information technology platform. We may add some of these new capabilities and technologies through internal development, strategic alliances with other entities and/or through selective acquisitions or investments.

Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009. We prepare the consolidated financial statements in conformity with U.S. GAAP, which requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and related disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

We believe the following accounting policies are the most critical in understanding the estimates and judgments that are involved in preparing our financial statements and the uncertainties that could impact our results of operations, financial condition and cash flows.

Revenue Recognition

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month ("PMPM") by the number of members covered by our services during the month. We typically set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In addition, some of our services, such as the SilverSneakers fitness program, are billed on a fee for service basis.

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers, either directly or through their health plans or pharmacy benefit manager, typically have one to three-year terms. Some of our contracts allow the customer to terminate early.

Some of our contracts provide that a portion of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's healthcare costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 3% of revenues recorded during the six months ended June 30, 2010 were performance-based and were subject to final reconciliation as of June 30, 2010. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts and the timing and amount of revenue recognition associated with performance-based fees. Some contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We generally bill our customers each month for the entire amount of the fees contractually due for the prior month's enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Deferred revenues arise from contracts which permit upfront billing and collection of fees covering the entire contractual service period, generally 12 months.

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Contractually, we cannot bill for any incentive bonus until after contract settlement. Fees for service are typically billed in the month after the services are provided.

We recognize revenue as follows: 1) we recognize the fixed portion of PMPM fees and fees for service as revenue during the period we perform our services; 2) we recognize the performance-based portion of the monthly fees based on the most recent assessment of our performance, which represents the amount that the customer would legally be obligated to pay if the contract were terminated as of the latest balance sheet date; and 3) we recognize additional incentive bonuses based on the most recent assessment of our performance, to the extent we consider such amounts collectible.

We assess our level of performance for our contracts based on medical claims and other data that the customer is contractually required to supply. A minimum of four to six months' data is typically required for us to measure performance. In assessing our performance, we may include estimates such as medical claims incurred but not reported and a medical cost trend compared to a baseline year. In addition, we may also provide contractual allowances for billing adjustments (such as data reconciliation differences) as appropriate.

In 2005, we began participating in two Medicare Health Support pilots, which concluded in January 2008 and July 2008, respectively. Substantially all of the fees under these pilots were performance-based. Our original cooperative agreements required that, by the end of the third year, we achieve a cumulative net savings (total savings for the intervention population as compared to the control group less fees received from CMS) of 5.0%. Under an amendment to our agreement for our stand-alone Medicare Health Support pilot in Maryland and the District of Columbia, we began serving a "refresh population" of approximately 4,500 beneficiaries on August 1, 2006, which was measured as a separate cohort for two years, by the end of which the program was required to achieve a 2.5% cumulative net savings when compared to a new control cohort. In April 2008, we signed an amendment to our Medicare Health Support protocol with CMS, which changed the financial performance target for both the initial and the refresh populations to budget neutrality. In late April 2009, we received the final reconciliation report from CMS' independent financial reconciliation contractor. Based upon this final reconciliation report as well as our performance over the term of the pilots, we have recognized $9.5 million of cumulative performance-based fees related to these pilots and $12.2 million of fixed fees. At June 30, 2010, approximately $57.8 million of performance-based fees related to these pilots was recorded in contract billings in excess of earned revenue, $50.3 million of which related to fees collected, and the remaining $7.5 million of which related to fees billed but not collected due to CMS withholding payment of these fees. We submitted our objections to the final reconciliation report and engaged in discussions with CMS regarding our objections. We, along with several other participating organizations in the Medicare Health Support pilots, have submitted a proposal to CMS to resolve the issues related to the reconciliation; however, such proposal remains subject to approval by the United States government.

If data is insufficient or incomplete to measure performance, or interim performance measures indicate that we are not meeting performance targets, we do not recognize performance-based fees subject to refund as revenues but instead record them in a current liability account entitled "contract billings in excess of earned revenue." Only in the event we do not meet performance levels by the end of the measurement period, typically one year, are we contractually obligated to refund some or all of the performance-based fees. We would only reverse revenues that we had already recognized if performance to date in the measurement period, previously above targeted levels, subsequently dropped below targeted levels. Historically, any such adjustments have been immaterial to our financial condition and results of operations.

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile healthcare claims and clinical data. As of June 30, 2010, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years totaled approximately $35.9 million, all of which was based on actual data received from our customers. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to customer data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, data reconciliation differences, or adjustments to incentive bonuses may cause us to recognize or reverse revenue in a current fiscal year that pertains to services provided during a prior fiscal year. During the six months ended June 30, 2010, we recognized a net increase in revenue of approximately $3.9 million that related to services provided prior to January 1, 2010.

Impairment of Intangible Assets and Goodwill

We review goodwill for impairment on an annual basis (during the fourth quarter of our fiscal year) or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable.

We estimate the fair value of each reporting unit using a discounted cash flow model and reconcile the aggregate fair value of our reporting units to our consolidated market capitalization. The discounted cash flow model requires significant judgments, including management's estimate of future cash flows, which is dependent on internal forecasts, estimation of the long-term growth rate for our business, the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the estimate of fair value and goodwill impairment for each reporting unit.

If we determined that the carrying value of goodwill was impaired based upon an impairment review, we would calculate any impairment using a fair-value-based goodwill impairment test as required by U.S. GAAP. The fair value of a reporting unit is the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date.

Except for trade names which have an indefinite life and are not subject to amortization, we amortize identifiable intangible assets, such as acquired technologies and customer contracts, using the straight-line method over their estimated useful lives. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. We estimate the fair value of trade names using a present value technique, which requires management's estimate of future revenues attributable to these trade names, estimation of the long-term growth rate for these revenues, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the estimate of fair value for the trade names.

If we determine that the carrying value of other identifiable intangible assets may not be recoverable, we calculate any impairment using an estimate of the asset's fair value based on the estimated price that would be received to sell the asset in an orderly transaction between market participants.

Future events could cause us to conclude that impairment indicators exist and that goodwill and/or other intangible assets associated with our acquired businesses are impaired. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns. Accounting for income taxes requires significant judgment in determining income tax provisions, including determination of deferred tax assets, deferred tax liabilities, and any valuation allowances that might be required against deferred tax assets, and in evaluating tax positions.

We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. U.S. GAAP also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, or cash flows.

Share-Based Compensation

We measure and recognize compensation expense for all share-based payment awards based on estimated fair values at the date of grant. Determining the fair value of share-based awards at the grant date requires judgment in developing assumptions, which involve a number of variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards and expected stock option exercise behavior. In addition, we also use judgment in estimating the number of share-based awards that are expected to be forfeited.

Results of Operations

The following table shows the components of the statements of operations for the three and six months ended June 30, 2010 and 2009 expressed as a percentage of revenues.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of services (exclusive of depreciation and amortization included below)	69.5 %	71.8%	70.8%	72.3%
Selling, general and administrative expenses	10.7 %	10.4%	10.1%	10.3%
Depreciation and amortization	7.6 %	6.7%	7.6%	6.7%
Operating income	12.2 %	11.1%	11.5%	10.7%
Gain on sale of investment	(0.7)%	—	(0.3)%	(0.7)%
Interest expense	2.1 %	2.3%	2.0%	2.3%
Legal settlement and related costs	—	—	—	11.1%
Income (loss) before income taxes (1)	10.9 %	8.7%	9.9%	(2.0)%
Income tax expense (benefit)	4.1 %	3.7%	3.9%	(0.3)%
Net income (loss) (1)	6.7 %	5.0%	6.0%	(1.6)%

(1) Figures may not add due to rounding.

Revenues

Revenues decreased $2.3 million and $6.1 million, or 1.3% and 1.7%, respectively, for the three and six months ended June 30, 2010 compared to the same periods in 2009, primarily due to contract restructurings and terminations with certain customers, somewhat offset by increased revenues from the commencement of contracts with new customers and from an increase in participation in our fitness center programs as well as in the number of members eligible to participate in such programs.

Cost of Services

Cost of services (excluding depreciation and amortization) as a percentage of revenues decreased to 69.5% for the three months ended June 30, 2010 compared to 71.8% for the three months ended June 30, 2009, primarily due to the following:

- a decrease in the level of short-term incentive compensation based on the Company's year-to-date financial performance against established internal targets for these periods;
- a decrease in salaries and benefits expense, primarily due to certain employee reductions in 2009 and a net decrease in health insurance costs related to changes in employee medical plan design, which included a number of wellness initiatives aimed at improving employee health, in 2010; and

- a more favorable cost structure within our fitness center programs, primarily related to certain contract restructurings and the integration of two fitness center networks into a single, common network.

These decreases were partially offset by an increase in cost of services as a percentage of revenues, primarily due to a higher portion of our revenue being generated by fitness center and certain health improvement programs, which typically have a higher cost of services as a percentage of revenue than our other programs.

Cost of services (excluding depreciation and amortization) as a percentage of revenues decreased to 70.8% for the six months ended June 30, 2010 compared to 72.3% for the six months ended June 30, 2009, primarily due to the following:

- a decrease in the level of short-term incentive compensation based on the Company's year-to-date financial performance against established internal targets for these periods;
- a decrease in salaries and benefits expense, primarily due to 1) a restructuring of the Company, which was largely completed during the fourth quarter of calendar 2008 but for which some terminations continued into early 2009; 2) certain other employee reductions in 2009; and 3) a net decrease in health insurance costs related to changes in employee medical plan design, which included a number of wellness initiatives aimed at improving employee health, in 2010;
- cost savings related to certain operational efficiencies; and
- a more favorable cost structure within our fitness center programs, primarily related to certain contract restructurings and the integration of two fitness center networks into a single, common network.

These decreases were somewhat offset by an increase in cost of services as a percentage of revenues primarily due to a higher portion of our revenue being generated by fitness center and certain health improvement programs, which typically have a higher cost of services as a percentage of revenue than our other programs.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues for the three and six months ended June 30, 2010 remained relatively consistent with the comparable periods in 2009.

Depreciation and Amortization

Depreciation and amortization expense increased $1.4 million and $2.7 million, or 11.6% and 11.1%, respectively, for the three and six months ended June 30, 2010 compared to the same periods in 2009, primarily due to increased depreciation expense resulting from the implementation of our new Embrace platform and other capital expenditures related to computer software, which we anticipate will also result in increased depreciation expense for the remainder of 2010 compared to the same period in 2009.

Gain on Sale of Investment

In January 2009, a private company in which we held preferred stock was acquired by a third party. As part of this sale, we received two payments totaling $11.6 million in January and February 2009 and recorded a gain of $2.6 million during the first quarter of 2009. During the second quarter of 2010, we recognized a gain of $1.2 million related to the receipt of a final escrow payment. We do not expect to receive any further payments related to this sale.

Interest Expense

Interest expense for the three and six months ended June 30, 2010 decreased $0.5 million and $1.2 million, respectively, compared to the three and six months ended June 30, 2009, primarily as a result of a decrease in floating interest rates on outstanding borrowings under our credit agreement during the three and six months ended June 30, 2010 compared to the three and six months ended June 30, 2009.

Legal Settlement and Related Costs

In March 2009, our Board of Directors approved a settlement of a qui tam lawsuit filed in 1994 on behalf of the United States government related to the Company's former Diabetes Treatment Center of America business. As a result of the settlement, which was effective as of April 1, 2009, we incurred a charge of approximately $40 million, including a $28 million payment to the United States government and payment of approximately $12 million for other costs and fees related to the settlement, including the estimated legal costs and expenses of the plaintiff's attorneys.

Income Tax Expense

Our effective tax rate decreased to 37.8% for the three months ended June 30, 2010 compared to 42.9% for the three months ended June 30, 2009, primarily due to an earn-out adjustment recorded during the three months ended June 30, 2010, as well as a change in the geographic mix of our earnings during the three months ended June 30, 2010.

Our effective tax rate increased to an expense of 39.2% for the six months ended June 30, 2010 compared to a benefit of 15.6% for the six months ended June 30, 2009, primarily due to a change to a pretax profit for the six months ended June 30, 2010 from a pretax loss for the six months ended June 30, 2009, as well as certain unrecognized tax benefits and tax interest accruals related to the six months ended June 30, 2009.

We anticipate that our effective tax rate for the remainder of calendar 2010 will remain consistent with the effective rate for the six months ended June 30, 2010; however, we will continue to monitor and adjust the rate based upon changes in the geographic mix of our earnings, adjustments to uncertain tax positions, and consideration of other tax issues affecting the company.

Liquidity and Capital Resources

Operating activities for the six months ended June 30, 2010 provided cash of $27.1 million compared to $30.0 million for the six months ended June 30, 2009. The decrease in operating cash flow is primarily due to the following:

- payments during the six months ended June 30, 2010 related to short-term incentive compensation earned and accrued over the sixteen months ended December 31, 2009;
- decreased cash collections on accounts receivable for the six months ended June 30, 2010 compared to the six months ended June 30, 2009; and
- the timing of several significant vendor payments.

These decreases in operating cash flow were mostly offset by an increase in operating cash flow primarily due to income tax payments, which were higher during the six months ended June 30, 2009 primarily due to a change in the timing of estimated tax payments resulting from the change in our fiscal year.

Investing activities during the six months ended June 30, 2010 used $25.0 million in cash, which primarily consisted of capital expenditures associated with our new Embrace platform.

Financing activities during the six months ended June 30, 2010 used $3.0 million in cash, primarily due to deferred loan costs incurred in connection with the Fourth Amended and Restated Credit Agreement as well as the settlement of certain checks outstanding at December 31, 2009, partially offset by net proceeds from borrowings under our credit agreement.

On March 30, 2010, we entered into the Fourth Amended and Restated Credit Agreement (the "Fourth Amended Credit Agreement"). The Fourth Amended Credit Agreement provides us with a $55.0 million revolving credit facility from March 30, 2010 to December 1, 2011 (the "2011 Revolving Credit Facility") and a $345.0 million revolving credit facility from March 30, 2010 to December 1, 2013 (the "2013 Revolving Credit Facility"), including a swingline sub facility of $20.0 million and a $75.0 million sub facility for letters of credit. The Fourth Amended Credit Agreement also provides a continuation of the term loan facility provided pursuant to the Third Amended and Restated Credit Agreement, of which $193.0 million remained outstanding on June 30, 2010, and an uncommitted incremental accordion facility of $200.0 million. As of June 30, 2010, availability under our revolving credit facility totaled $226.1 million.

Revolving advances under the Fourth Amended Credit Agreement are drawn first under the 2013 Revolving Credit Facility, with any advances in excess of $345.0 million being drawn under the 2011 Revolving Credit Facility. Revolving advances under the 2011 Revolving Credit Facility generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Revolving advances under the 2013 Revolving Credit Facility generally bear interest, at our option, at 1) LIBOR plus a spread of 1.875% to 2.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.375% to 1.250%. Term loan borrowings bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate. See below for a description of our interest rate swap agreements. The Fourth Amended Credit Agreement also provides for a fee ranging between 0.150% and 0.300% of the unused commitments under the 2011 Revolving Credit Facility and 0.275% and 0.425% of the unused commitments under the 2013 Revolving Credit Facility. The Fourth Amended Credit Agreement is secured by guarantees from most of the Company's domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

We are required to repay outstanding revolving loans on the applicable commitment termination date, which is December 1, 2011 for the 2011 Revolving Credit Facility and December 1, 2013 for the 2013 Revolving Credit Facility. We are required to repay term loans in quarterly principal installments aggregating $0.5 million each, which commenced on March 31, 2007. The entire unpaid principal balance of the term loans is due and payable at maturity on December 1, 2013.

The Fourth Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of 1) total funded debt to EBITDA, 2) fixed charge coverage, and 3) net worth. The Fourth Amended Credit Agreement also restricts the payment of dividends and limits the amount of repurchases of the Company's common stock. As of June 30, 2010, we were in compliance with all of the covenant requirements of the Fourth Amended Credit Agreement.

As of June 30, 2010, we are a party to the following interest rate swap agreements for which we receive a variable rate of interest based on LIBOR and for which we pay the following fixed rates of interest:

Swap #	Original Notional Amount (in $000s)	Fixed Interest Rate	Termination Date
1	30,000	3.760%	March 30, 2011
2	40,000	3.433%	December 30, 2011
3	50,000	3.688%	December 30, 2011
4	40,000	3.855%	December 30, 2011
5	57,500	3.385%	December 31, 2013(1)
6	57,500	3.375%	December 31, 2013(2)

(1) This swap agreement becomes effective January 1, 2012. The principal value of this swap agreement will amortize over a 24-month period.
(2) This swap agreement becomes effective January 3, 2012. The principal value of this swap agreement will amortize over a 24-month period.

We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

We believe that cash flows from operating activities, our available cash, and our expected available credit under the Fourth Amended Credit Agreement will continue to enable us to meet our contractual obligations and to fund our current operations for the foreseeable future. However, if our operations require significant additional financing resources, such as capital expenditures for technology improvements, additional call centers and/or letters of credit or other forms of financial assurance to guarantee our performance under the terms of new contracts, or if we are required to refund performance-based fees pursuant to contract terms, we may need to raise additional capital by expanding our existing credit facility and/or issuing debt or equity. If we face a limited ability to arrange such financing, it may restrict our ability to effectively operate our business. Current economic conditions, including turmoil and uncertainty in the financial services industry, have created constraints on liquidity and the ability of some entities to obtain credit from banks or in the capital markets. We cannot assure you that we would always be able to secure additional financing if needed and, if such funds were available, whether the terms or conditions would be acceptable to us.

If contract development accelerates or acquisition opportunities arise, we may need to issue additional debt or equity to provide the funding for these increased growth opportunities. We may also issue equity in connection with future acquisitions or strategic alliances. We cannot assure you that we would be able to issue additional debt or equity on terms that would be acceptable to us.

Recently Issued Accounting Standards

In January 2010, the FASB issued Accounting Standards Update ("ASU") No. 2010-06, "Improving Disclosures about Fair Value Measurements", an amendment to ASC Topic 820, "Fair Value Measurements and Disclosures". This amendment requires an entity to: 1) disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers and 2) present separate information for Level 3 activity pertaining to gross purchases, sales, issuances, and settlements (rather than presenting such information on a net basis). ASU No. 2010-06 is effective for the Company for interim and annual reporting periods beginning after December 15, 2009, except for item 2) above, which is effective for interim and annual reporting periods beginning after December 15, 2010. The adoption of this ASU did not have a material impact on our results of operations or statement of financial position. We expect the adoption of item 2) above will not have a material impact on the results of operations or statement of financial position.

Item 3.Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk related to interest rate changes, primarily as a result of the Fourth Amended Credit Agreement, which bears interest based on floating rates. Revolving advances under the 2011 Revolving Credit Facility generally bear interest, at our option, at 1) LIBOR plus a spread of 0.875% to 1.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.000% to 0.250%. Revolving advances under the 2013 Revolving Credit Facility generally bear interest, at our option, at 1) LIBOR plus a spread of 1.875% to 2.750% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate, plus a spread of 0.375% to 1.250%. Term loan borrowings bear interest, at our option, at 1) LIBOR plus 1.50% or 2) the greater of the federal funds rate plus 0.5%, or the prime rate.

In order to manage our interest rate exposure under the Fourth Amended Credit Agreement, we have entered into six interest rate swap agreements effectively converting our floating rate debt to fixed obligations with interest rates ranging from 3.375% to 3.855%.

A one-point interest rate change would have resulted in interest expense fluctuating approximately $0.5 million for the six months ended June 30, 2010.

As a result of our investment in international initiatives, as of June 30, 2010 we are also exposed to foreign currency exchange rate risks. Because a significant portion of these risks is economically hedged with currency options and forwards contracts and because our international initiatives are not yet material to our consolidated results of operations, a 10% change in foreign currency exchange rates would not have had a material impact on our results of operations or financial position for the six months ended June 30, 2010. We do not execute transactions or hold derivative financial instruments for trading purposes.

Item 4.Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of our "disclosure controls and procedures" (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act")) as of June 30, 2010. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective. They are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting during the three months ended June 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

Item 1.Legal Proceedings

Securities Class Action Litigation

Beginning on June 5, 2008, Healthways and certain of its present and former officers and/or directors were named as defendants in two putative securities class actions filed in the U.S. District Court for the Middle District of Tennessee, Nashville Division. On August 8, 2008, the court ordered the consolidation of the two related cases, appointed lead plaintiff and lead plaintiff's counsel, and granted lead plaintiff leave to file a consolidated amended complaint.

The amended complaint, filed on September 22, 2008, alleged that the Company and the individual defendants violated Sections 10(b) of the Securities Exchange Act of 1934 (the "Act") and that the individual defendants violated Section 20(a) of the Act as "control persons" of Healthways. The amended complaint further alleges that certain of the individual defendants also violated Section 20A of the Act based on their stock sales. The plaintiff purports to bring these claims for unspecified monetary damages on behalf of a class of investors who purchased Healthways stock between July 5, 2007 and August 25, 2008.

In support of these claims, the lead plaintiff alleges generally that, during the proposed class period, the Company made misleading statements and omitted material information regarding (1) the purported loss or restructuring of certain contracts with customers, (2) the Company's participation in the Medicare Health Support ("MHS") pilot program for the Centers for Medicare & Medicaid Services, and (3) the Company's guidance for fiscal year 2008. The defendants filed a motion to dismiss the amended complaint on November 13, 2008. On March 9, 2009, the Court denied the defendants' motion to dismiss. On April 27, 2010, the parties reached an agreement in principle to settle this matter for $23.6 million. The District Court must approve this settlement after notice to the class before it may be considered final. The Court has preliminarily approved the settlement and scheduled a hearing for final approval of the settlement on September 24, 2010. In July 2010, all parties to the litigation effected a settlement and stipulation agreement pursuant to which the Company's insurers made all required payments to a qualified settlement fund. As a result of the Company's insurance coverage, this settlement is not expected to result in any charge to the Company.

Shareholder Derivative Lawsuits

Also, on June 27, 2008 and July 24, 2008, respectively, two shareholders filed putative derivative actions purportedly on behalf of Healthways in the Chancery Court for the State of Tennessee, Twentieth Judicial District, Davidson County, against certain directors and officers of the Company. These actions are based upon substantially the same facts alleged in the securities class action litigation described above. The plaintiffs are seeking to recover damages in an unspecified amount and equitable and/or injunctive relief.

On August 13, 2008, the Court consolidated these two lawsuits and appointed lead counsel. On October 3, 2008, the Court ordered that the consolidated action be stayed until the motion to dismiss in the securities class action had been resolved by the District Court. By stipulation of the parties, the plaintiffs filed their consolidated complaint on May 9, 2009. On June 19, 2009, the defendants filed a motion to dismiss the consolidated complaint. The Court granted the defendants' motion to dismiss on October 14, 2009. The plaintiffs filed a notice of appeal on November 12, 2009.

ERISA Lawsuits

Additionally, on July 31, 2008, a purported class action alleging violations of the Employee Retirement Income Security Act ("ERISA") was filed in the U.S. District Court for the Middle District of Tennessee,

Nashville Division against Healthways, Inc. and certain of its directors and officers alleging breaches of fiduciary duties to participants in the Company's 401(k) plan. The central allegation is that Company stock was an imprudent investment option for the 401(k) plan.

An amended complaint was filed on September 29, 2008, naming as defendants the Company, the Board of Directors, certain officers, and members of the Investment Committee charged with administering the 401(k) plan. The amended complaint alleged that the defendants violated ERISA by failing to remove the Company stock fund from the 401(k) plan when it allegedly became an imprudent investment, by failing to disclose adequately the risks and results of the MHS pilot program to 401(k) plan participants, and by failing to seek independent advice as to whether to continue to permit the plan to hold Company stock. It further alleged that the Company and its directors should have been more closely monitoring the Investment Committee and other plan fiduciaries. The amended complaint sought damages in an undisclosed amount and other equitable relief. The defendants filed a motion to dismiss on October 29, 2008. On January 28, 2009, the Court granted the defendants' motion to dismiss the plaintiff's claims for breach of the duty to disclose with regard to any non-public information and information beyond the specific disclosure requirements of ERISA and denied Defendants' motion to dismiss as to the remainder of the plaintiff's claims. A period of discovery ensued.

On May 12, 2009, the plaintiff filed a motion for class certification. After the plaintiff failed, without explanation, to appear for his scheduled deposition, the Court issued an Order on July 10, 2009 warning the plaintiff that his failure to participate in the lawsuit could result in sanctions, including but not limited to dismissal. After the plaintiff's failure to participate continued, on July 23, 2009, the defendants filed a motion to dismiss for failure to prosecute the action. On August 6, 2009, the parties filed a stipulation of dismissal with prejudice as to the named plaintiff but otherwise without prejudice, and the Court entered an Order to that effect on the same date.

On February 1, 2010, a new named plaintiff filed another putative class action complaint in the United States District Court for the Middle District of Tennessee, Nashville Division, alleging ERISA violations in the administration of the Company's 401(k) plan. The new complaint is identical to the original complaint, including the allegations and the requests for relief. Defendants' answer to this complaint was filed on March 22, 2010. A scheduling order was entered on April 1, 2010, and discovery commenced thereafter. On April 30, 2010, Plaintiff filed a motion for class certification. On June 23, 2010, the parties reached an agreement in principle to settle this matter for $1,250,000, with such settlement being funded by the Company's fiduciary liability insurance carrier. The District Court must approve this settlement after notice to the class before it may be considered final. The class settlement will be reduced to writing and presented to the Court for preliminary approval in the coming weeks.

Outlook

We are also subject to other contractual disputes, claims and legal proceedings that arise from time to time in the ordinary course of our business. We currently are involved in a contractual dispute with a customer regarding fees paid to us as part of a former contractual relationship. We believe we performed our services in compliance with the contractual requirements and the customer's assertions are without merit. In the event the parties are unable to resolve the dispute, the parties will proceed to arbitration as specified in the applicable agreement. While we are unable to estimate a range of potential losses, we do not believe that the contractual disputes or any of the legal proceedings pending against us as of the date of this report will have a material adverse effect on our liquidity or financial condition; however, we may settle disputes, claims, sustain judgments or incur expenses relating to these matters in a particular fiscal quarter which may adversely affect our results of operations. As these matters are subject to inherent uncertainties, our view of these matters may change in the future.

Contractual Commitment

In January 2008, we entered into a perpetual license agreement and 25-year strategic relationship agreement. We have remaining contractual cash obligations of $32.5 million related to these agreements, $12.5 million of which will occur ratably from July 2010 through December 2012, and the remaining $20.0 million of which will occur ratably over a 20-year period beginning in 2013.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the risks and uncertainties previously reported under the caption “Part I — Item 1A. Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, the occurrence of which could materially and adversely affect our business, prospects, financial condition and operating results. The risks previously reported and described in the Annual Report on Form 10-K for the fiscal year ended December 31, 2009 and in this report are not the only risks facing our business. Additional risks and uncertainties not currently known to us or those we currently deem to be immaterial may also materially and adversely affect our business operations.

There have been no material changes to our risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, except that we modified our risk factor relating to healthcare reform, as set forth below, due to the enactment of healthcare reform legislation.

Recently enacted healthcare reform may result in a reduction to our revenues from government health plans and private insurance companies.

In March 2010, President Obama signed the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act of 2010 (collectively “PPACA”) into law. Among other things, PPACA seeks to decrease the number of uninsured individuals and expand coverage through the expansion of public programs and private sector health insurance and a number of health insurance market reforms. PPACA also contains several provisions that encourage the utilization of preventive services and wellness programs, such as those provided by the Company. However, PPACA also contains various provisions that directly affect the customers or prospective customers that contract for our services and may increase their costs and/or reduce their revenues. While we believe that our programs and services specifically assist our customers in controlling their costs, it is possible that these provisions will adversely affect the profitability of our customers in such a manner that the demand for our programs and services would be reduced. Because of the many variables involved, including PPACA’s complexity, lack of implementing regulations or interpretive guidance, gradual implementation, and possible amendment or repeal, we are unable to predict all of the ways in which PPACA could impact the Company.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Removed and Reserved

Item 5. Other Information

Not Applicable.

Item 6. Exhibits

(a) Exhibits

10.1	2007 Stock Incentive Plan, as amended
10.2	Non-Qualified Stock Option Agreement for Directors
10.3	Restricted Stock Unit Agreement for Directors
10.4	Capital Accumulation Plan, as amended and restated
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

Healthways, Inc.
(Registrant)

Date	August 6, 2010	By	/s/ Mary A. Chaput Mary A. Chaput Chief Financial Officer (Principal Financial Officer)
Date	August 6, 2010	By	/s/ Alfred Lumsdaine Alfred Lumsdaine Chief Accounting Officer (Principal Accounting Officer)