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

FORM 10-K

(Mark One)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended **December 31, 2012**

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ___to _____

Commission File Number **001-31932**

CATASYS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**88-0464853**
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification Number)

11150 Santa Monica Boulevard, Suite 1500
Los Angeles, California 90025
(Address of principal executive offices, including zip code)

(310) 444-4300
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act**:**
None

Securities registered pursuant to Section 12(g) of the Act**:**
Common Stock, Par Value $0.0001 Per Share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes ☐ No ☑

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes ☐ No ☑

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

Yes ☑ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☐	Accelerated filer ☐	Non-accelerated filer ☐ [Do not check if a smaller reporting company]	Smaller reporting company ☑

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

Yes ☐ No ☑

As of the last business day of the registrant's most recently completed fiscal year, the aggregate market value of the common stock held by non-affiliates of the registrant (without admitting that any person whose shares are not included in such calculation is an affiliate) was $2,793,831 based on the $0.14 closing bid price of the common stock on the OTC Bulletin Board on that date.

As of March 28, 2013, there were 120,811,273 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

CATASYS, INC.
Form 10-K Annual Report
For The Fiscal Year Ended December 31, 2012

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In this Annual Report on Form 10-K, except as otherwise stated or the context otherwise requires, the terms “the Company,” “we,” “us” or “our” refer to Catasys, Inc. and our wholly-owned subsidiaries. Our common stock, par value $0.0001 per share, is referred to as “common stock.”

PART I

Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed due to factors such as, among others, limited operating history, difficulty in developing, exploiting and protecting proprietary technologies, intense competition and substantial regulation in the healthcare industry. Additional information concerning factors that could cause or contribute to such differences can be found in the following discussion, as well as in Item 1A. "Risk Factors" and Item 7- "Management's Discussion and Analysis of Financial Condition and Results of Operations."

ITEM 1. BUSINESS

Overview

We are a healthcare services company, providing specialized health services designed to assist health plans, employers and unions to manage and treat their high cost substance dependence members through a network of healthcare providers and our employees. The On*Trak* substance dependence program was designed to address substance dependence as a chronic disease. The program seeks to improve member health through the delivery of integrated medical and psychosocial interventions in combination with long term "care coaching" thereby lowering overall healthcare costs. Catasys also offers the PROMETA Treatment Program for alcoholism and stimulant dependence on a private-pay basis through licensed treatment providers and a company managed treatment center that offers the PROMETA Treatment Program, as well as other treatments for substance dependencies.

We have not been profitable since our inception in 2003 and may continue to incur operating losses for at least the next twelve months.

We believe that our business and operations as outlined above are in substantial compliance with applicable laws and regulations. However, the healthcare industry is highly regulated, and the criteria are often vague and subject to change and interpretation by various federal and state legislatures, courts, enforcement and regulatory authorities. We do not manufacture, distribute or sell any medications and have no relationship with any manufacturers or distributors of medications used in the PROMETA Treatment Progam. Only a treating physician can determine if the PROMETA Treatment Program or the On*Trak* program is appropriate for any individual patient. Our future prospects are subject to the legal, regulatory, commercial and scientific risks outlined above and in Item 1.A "Risk Factors."

We are incorporated under the laws of the State of Delaware and we changed our corporate name on March 17, 2011 from Hythiam, Inc. to Catasys, Inc. In connection therewith, the management of the Company determined that it was in the best interests of the Company to change the trading symbol of the Company's common stock. Effective March 17, 2011, the common stock of the Company began trading under the symbol "CATS."

Substance Dependence

Scientific research indicates that not only can drugs interfere with normal brain functioning, but they can also have long-lasting effects that persist even after the drug is no longer being used. Data indicates that at some point changes may occur in the brain that can turn drug and alcohol abuse into substance dependence—a chronic, relapsing and sometimes fatal disease. Those dependent on drugs may suffer from compulsive drug craving and usage and be unable to stop drug use or remain drug abstinent without effective treatment. Professional medical treatment may be necessary to end this physiologically-based compulsive behavior.

Substance dependence is a worldwide problem with prevalence rates continuing to rise despite the efforts by national and local health authorities to curtail its growth. Substance dependence disorders affect many people and have wide-ranging social consequences. In 2010, an estimated 22.1 million Americans ages 12 and older were classified with substance dependence or abuse, of which only 2.6 million received treatment at a specialty substance abuse facility, according to the National Survey on Drug Use and Health published by the Substance Abuse and Mental Health Services Administration (SAMHSA), an agency of the U.S. Department of Health and Human Services.

We believe the best results in treating substance dependence can be achieved in programs such as our Catasys offering that integrate psychosocial and medical treatment modalities and provide longer term support.

Our Market

The true impact of substance dependence is often under-identified by organizations that provide healthcare benefits. The reality is that substance dependent individuals:

- are prevalent in any organization;
- cost health plans and employers a disproportionate amount of money;
- have higher rates of absenteeism and lower rates of productivity; and
- have co-morbid medical conditions which incur increased costs for the treatment of these conditions compared to a non-substance dependent population.

When considering substance dependence-related costs, many organizations have historically only looked at direct treatment costs–usually behavioral claims. The reality is that substance dependent individuals generally have overall poorer health and lower compliance, which leads to more expensive treatment for related, and even seemingly unrelated, co-occurring medical conditions. In fact, of total healthcare claims costs associated with substance dependence populations, the vast majority are medical claims and not behavioral treatment costs.

According to the U.S. Census Bureau in 2010, there were over 195 million lives in the United States covered by various private managed care programs including Preferred Provider Organizations (PPOs), Health Maintenance Organizations (HMOs), self-insured employers and managed Medicare/Medicaid programs. Each year, based on our analysis, approximately 1.9% of commercial plan members will have a substance dependence diagnosis, and that figure may be lesser or greater for specific payors depending on the health plan demographics and location. A smaller, high-cost subset of this population drives the majority of the claims costs for the overall substance dependent population. For commercial members with substance dependence and a total annual claims cost of at least $7,500, the average annual per member claims cost is $25,500, compared with an average of $3,250 for a commercial non-substance dependent member, according to our research.

Our Solutions: On*Trak* and the PROMETA Treatment Program

On*Trak*™

Our On*Trak* integrated substance dependence solution combines evidence based medical and psychosocial treatments with elements of population health management and ongoing member support to help organizations treat members with substance dependence to improve member health and lower the overall costs of these members. We believe the benefits of Catasys include improved clinical outcomes and decreased costs for the payor, and improved quality of life and productivity for the member.

We believe On*Trak* is the only program of its kind dedicated exclusively to substance dependence. The On*Trak* substance dependence program was developed by addiction experts with years of clinical experience in the substance dependence field. This experience has helped to form key areas of expertise that we believe sets Catasys apart from other solutions, including member engagement, working directly with the member treatment team and a more fully integrated treatment offering.

Our On*Trak* integrated substance dependence program includes the following components: member identification and engagement, enrollment/referral, provider network, outpatient medical treatment, outpatient psychosocial treatment, care coaching, monitoring and reporting, and our proprietary web based clinical information platform (eOn*Trak*).

We assist health plans to identify those members who incur significant costs and may be appropriate for enrollment into On*Trak*. We then enroll targeted members into the Catasys program through direct mailings and telephonic outreach, and through referral through health plan sources. After enrollment/referral, our contracted specially trained network of providers provide treatments utilizing integrated medical and psychosocial treatment modalities, including our proprietary On*Trak* Relapse Prevention Program to help members develop improved coping skills and a recovery support network. Throughout the treatment process, our care coaches work directly with members to keep them engaged in treatment by proactively supporting members to enhance motivation, minimize lapses and enable lifestyle modifications consistent with the recovery goals. We also link providers and care coaches to member information through our eOn*Trak* web based clinical information platform, enabling each provider to be better informed with a member's treatment in order to assist in providing the best possible care. Periodically we will provide outcomes reporting on clinical and financial metrics to our customers to demonstrate the extent of the program's value.

Early clinical and financial outcomes from the On*Trak* program have been promising with On*Trak* enrolled members achieving an average gross cost reduction of more than 50%. In addition, to date more than 80% of members who have remained eligible have been retained in the program.

PROMETA® Treatment Program

Our PROMETA Treatment Program is an integrated, physician-based outpatient addiction treatment program that combines three components–medical treatment, nutritional support and psychosocial therapy to help people address addiction to alcohol and stimulants (e.g. cocaine and methamphetamine).

Historically, the disease of addiction has been treated primarily through behavioral intervention, with fairly high relapse rates. The PROMETA Treatment Program can be initiated in three days, with a two-day follow-up treatment three weeks later. The initiation of treatment under PROMETA involves the oral and intravenous administration of pharmaceuticals in a medically directed and supervised setting. The medications used in the PROMETA Treatment Program have been approved by the Food and Drug Administration (FDA) for uses other than treatment of substance dependence. Treatment generally takes place on an outpatient basis at a properly equipped outpatient setting or clinic, or at a hospital or other in-patient facility, by physicians and healthcare providers who have licensed the rights to use our PROMETA Treatment Program. Following the initial treatment, our treatment program recommends that patients receive one month of prescription medication, nutritional supplements, nutritional guidelines designed to assist in recovery, and individualized psychosocial or other recovery-oriented therapy chosen by the patient in conjunction with their treatment provider.

Our Strategy

Our business strategy is to provide a quality integrated medical and behavioral program to help health plans and other organizations treat and manage substance dependent populations to improve health and reduce total healthcare costs associated with members with substance dependence. We intend to grow our business through increased adoption of our On*Trak* integrated substance dependence solutions by managed care health plans, employers, unions and other third-party payors.

Key elements of our business strategy include:

- Demonstrating the potential for improved clinical outcomes and reduced cost associated with using our Catasys programs with key managed care and other third-party payors;
- Educating third-party payors on the disproportionately high cost of their substance dependent population;
- Providing our Catasys integrated substance dependence solutions to third-party payors for reimbursement on a case rate, fee for service, or monthly fee basis; and
- Generating outcomes data from our On*Trak* program to demonstrate cost reductions and utilization of this outcomes data to facilitate broader adoption.

As an early entrant into offering integrated medical and behavioral programs for substance dependence, Catasys will be well positioned to address increasing market demand. Our On*Trak* program will help fill the gap that exists today: a lack of programs that focus on smaller populations with disproportionately higher costs and that improve patient care while controlling overall treatment costs.

On*Trak* – *Integrated Substance Dependence Solutions*

According to the U.S. Census Bureau in 2010, there were over 195 million lives in the United States covered by various managed care programs, including PPOs, HMOs, self-insured employers and managed Medicare/Medicaid programs. We believe our greatest opportunities for growth are in this market segment.

Our proprietary On*Trak* integrated substance dependence solutions are designed to improve treatment outcomes and lower the utilization of medical and behavioral health plan services by high utilizing and high risk enrollees. Our On*Trak* substance dependence programs include medical and psychosocial interventions, a proprietary web based clinical information platform and database, clinical algorithms, psychosocial programs and integrated care coaching services.

Another important aspect of the Catasys program is that the program is flexible and can be altered in a modular way to enable us to partner with payors to meet their needs. As a service delivery model, the On*Trak* program can be modified to cover particular populations and provide for varying levels of service. In this way On*Trak* can work with payors to identify, engage and treat a broader spectrum of patients struggling with substance dependence in a way that is consistent with payors' business needs.

Our value proposition to our customers includes that the On*Trak* program is designed for the following benefits:

- A specific program aimed at addressing high-cost conditions by improving patient care and reducing overall healthcare costs can benefit health plans that do not have or do not wish to dedicate the capacity, ability or focus to develop these programs internally;
- Increased worker productivity by reducing workplace absenteeism, compensation claims and job related injuries;
- Decreased emergency room and inpatient utilization;
- Decreased readmission rates; and
- Healthcare cost savings (including medical, behavioral and pharmaceutical).

Managed Treatment Center

We currently manage one out-patient psychiatric and treatment practice located in Los Angeles, California (d/b/a the Center To Overcome Addiction.). We manage the business components of the treatment practice and license the PROMETA Treatment Program and use of the name and trademark in exchange for management and licensing fees under the terms of a full business service management agreement. The treatment center operates in an outpatient psychiatric office and offers the PROMETA Treatment Program as well as a full range of other behavioral health services on a private pay and insurance reimbursed basis. Under generally accepted accounting principles in the United States (GAAP), the revenues and expenses of the managed treatment center is included in our consolidated financial statements.

Self-pay Patients – Licensees

Another source of our revenues to date has been from license fees derived from the licensing of our PROMETA Treatment Program to physicians and other licensed treatment providers. We plan to continue to provide licenses to our existing licensees for the treatment of substance dependencies using our PROMETA Treatment Program, but no longer seek new licensees or promote this program. Due to the reduction in our emphasis and investment in the self-pay business, the number of licensees has substantially declined and we do not expect to expand this line of business at this time.

Our Operations

Healthcare Services

The On*Trak* integrated substance dependence solution combines innovative medical and psychosocial treatments with elements of population health management and ongoing member support to help organizations treat and manage substance dependent populations to impact both the medical and behavioral health costs associated with substance dependence and the related co-morbidities.

As of March 2013, we have contracts for our On*Trak* program with one large physician group and five health plans. We are enrolling patients under all of these contracts except for one that was signed in March 2013 and is expected to commence operations in the second quarter of this year.

We are currently marketing our On*Trak* integrated substance dependence solutions to managed care health plans for reimbursement on a case rate, fee for service, or monthly fee basis, which involves educating third party payors on the disproportionately high cost of their substance dependent population and demonstrating the potential for improved clinical outcomes and reduced cost associated with using our Catasys programs.

License and Management Services

To date, our license and management services revenues has been derived from license fees for the use of the PROMETA Treatment Program in treating self-pay patients, and consolidation of self-pay patient revenues from our managed treatment center. Under our licensing agreements, we provide physicians and other licensed treatment providers access to our PROMETA Treatment Program. We receive a fee for the licensed technology, generally on a per patient basis. As of December 31, 2012, we had active licensing agreements with three treatment providers in three states. We do not anticipate entering into a significant number of additional licenses at this time.

As we mentioned above, we currently manage one out-patient psychiatric practice under a licensing agreement, located in Los Angeles, California. We do not operate our own healthcare facilities, employ our own treating physicians or provide medical advice or treatment to patients. We provide services, which assist health plans to manage their substance dependence populations, and access to tools that physicians may use to treat their patients as they determine appropriate. The hospitals, licensed healthcare facilities and physicians that contract for the use of our technology own their facilities or professional licenses, and control and are responsible for the clinical activities provided on their premises. Patients receive medical care in accordance with orders from their attending physicians. Licensed physicians with rights to use the PROMETA Treatment Program exercise their independent medical judgment in determining the use and specific application of our treatment programs, and the appropriate course of care for each patient.

Competition

Healthcare Services

Our On*Trak* product offering focuses primarily on substance dependence and is marketed to health plans and other payers. While we believe our products and services are unique, we operate in highly competitive markets. We compete with other healthcare management service organizations, including managed behavioral health organizations (MBHOs) that manage behavioral health benefits, perform utilization reviews, provide case management and patient coaching, and pay their network of providers for behavioral health services delivered. Most of our competitors are significantly larger and have greater financial, marketing and other resources than us. We compete with companies such as Hummingbird, One Health Solutions, and Health Integrated that offer coaching, social media, and in the case of Health Integrated, more comprehensive products to address the costs of members with substance dependence and other behavioral health conditions. One Health Solutions, a behavioral change technology and social networking site for people in recovery, has conducted a pilot with a national health plan that purported to show a reduction in in-patient readmissions for substance dependence treatment and has reported a pilot with a large managed behavioral health organization that has exceeded expectations on duration and frequency of participant engagment. We believe our product is the most comprehensive to focus exclusively on substance dependence and focus on the overall health and cost of members.

In addition, customers that managed care companies may seek to provide similar specialty healthcare services directly to their members, rather than by contracting with us for such services. Behavioral health conditions, including substance dependence, are typically managed for insurance companies by internal divisions or third-parties (MBHOs) frequently under capitated arrangements. Under such arrangements, MBHOs are paid a fixed monthly fee and must pay providers for provided services, which gives such entities an incentive to decrease cost and utilization of services by members. We compete to differentiate our integrated program for high utilizing substance dependence members from the population of utilization management programs that MBHOs offer.

We believe that our ability to offer customers a comprehensive and integrated substance dependence solution, including the utilization of innovative medical and psychosocial treatments and engagement methodologies, and our unique technology platform will enable us to compete effectively. However, there can be no assurance that we will not encounter more effective competition in the future, which would limit our ability to maintain or increase our business.

Once we contract with a third-party payor we outreach to eligible members to enroll them in our On*Trak* program. In this enrollment process we compete against numerous other providers of substance dependence treatment programs, facilities and providers for those members that elect to receive treatment for substance dependence (see Treatment Programs below). We believe we provide members lower cost and more comprehensive solutions, but members may choose to receive care from other providers. To the extent a member selects a different provider that is part of a health plan network of providers the cost of such treatment may be paid in whole or in part by our health plan customer.

License and Management Services

PROMETA Treatment Program

Our PROMETA Treatment Program focuses on licensing the PROMETA Treatment Program to treatment programs, including medical practices and treatment centers. We compete with many types of substance dependence treatment methods, treatment facilities and other service providers. Conventional forms of treatment for alcohol dependence are usually divided into the following phases:

- Detoxification, which is typically conducted in medically directed and supervised environments;
- Rehabilitation, which is often conducted through short- or long-term therapeutic facilities or programs, most of which do not offer medical management options; and
- Psychosocial care that is provided via structured outpatient treatment programs.

Conventional forms of treatment for stimulant dependence generally consist only of relapse prevention (psychosocial and recovery oriented therapy), conducted through therapeutic programs. Regardless of the approach, there is great variability in the duration of treatment procedures, level of medical supervision, price to the patients, and success rates.

Treatment Programs

There are over 13,500 facilities reporting to the SAMHSA that provide substance dependence treatment. Well-known examples of residential treatment programs include the Betty Ford Center®, Caron Foundation®, Hazelden® and Sierra Tucson®. In addition, individual physicians may provide substance dependence treatment in the course of their practices. Many of these traditional treatment programs have established name recognition, and their treatments may be covered in large part by insurance or other third party payors. Treatments using our PROMETA Treatment Program are not covered by insurance.

Traditional treatment approaches for substance dependence focus mainly on group therapy, abstinence and behavioral modification, while the disease's underlying physiology and pathology is rarely addressed, resulting in fairly high relapse rates.

Treatment Medications

There are currently no generally accepted medical treatments for methamphetamine dependence. Anti-depressants and dopamine agonists have been investigated as possible maintenance therapies, but none have been FDA approved or are generally accepted for medical practice.

Several classes of pharmaceutical agents have been investigated as potential maintenance agents (e.g., anti-depressants and dopamine agonists) for cocaine dependence; however, none are FDA approved for treatment of cocaine dependence or generally accepted widely in medical practice. Their effects are variable in terms of providing symptomatic relief, and many of the agents may cause side effects or may not be well tolerated by patients.

There are a number of companies developing or marketing medications for reducing craving in the treatment of alcoholism. Currently available medications include:

- The addiction medication naltrexone, an opiate receptor antagonist, is marketed by a number of generic pharmaceutical companies as well as under the trade names ReVia® and Depade® for treatment of alcohol dependence;

- VIVITROL®, an extended release formulation of naltrexone manufactured by Alkermes, is administered via monthly injections for the treatment of alcohol dependence in patients who are able to abstain from drinking in an outpatient setting, and are not actively drinking prior to treatment initiation. Alkermes reported that in clinical trials, when used in combination with psychosocial support, VIVITROL was shown to reduce the number of drinking days and heavy drinking days and to prolong abstinence in patients who abstained from alcohol the week prior to starting treatment;

- Campral® Delayed-Release Tablets (acamprosate calcium), an NMDA receptor antagonist taken two to three times per day on a chronic or long-term basis and marketed by Forest Laboratories. Clinical studies supported the effectiveness in the maintenance of abstinence for alcohol-dependent patients who had undergone inpatient detoxification and were already abstinent from alcohol; and

- Tropiramate (Topamax®), a drug manufactured by Ortho-McNeill Jannssen, which is approved for the treatment of seizures. A multi-site clinical trial reported in October 2007 found that tropiramate significantly reduced heavy drinking days in alcohol-dependent individuals.

Development of Our Technology

Much of our proprietary, patented and patent–pending, substance dependence technology known as the PROMETA Treatment Program, was developed by Dr. Juan José Legarda, a European scientist educated at University of London who has spent most of his professional career conducting research related to substance abuse. In 2002, Dr. Legarda filed Patent Cooperation Treaty (PCT) applications in Spain to protect treatment programs that he developed for dependencies to alcohol and cocaine. We acquired the rights to these patent filings in March 2003 through a technology purchase and license agreement with Dr. Legarda's company, Tratamientos Avanzados de la Adiccion S.L., to which we pay a royalty of three percent of the amount the patient pays for treatment using our treatment programs. After acquiring these rights, we filed U.S. patent applications and other national phase patent applications based on the PCT filings, as well as provisional U.S. patent applications to protect aspects of additional treatment programs for alcohol, cocaine and other addictive stimulants.

We have four issued U.S. patents for our PROMETA Treatment Program for the treatment of cocaine dependency, methamphetamine dependency, certain symptoms associated with alcohol dependence, and anxiety disorders. At this time we intend only to maintain these U.S. patents and certain international patents related to obsessive compulsive disorder.

Three of our issued U.S. patents will expire in 2023 and the fourth in 2028.

Trademarks

We rely on a combination of trademark, trade secret and copyright laws and contractual restrictions to protect the proprietary aspects of our technology. Our branded trade names on which we rely include the following:

- On*Trak*™;
- eOn*Trak*™; and
- PROMETA®.

We require that, as a condition of their employment, employees assign to us their interests in inventions, original works of authorship, copyrights and similar intellectual property rights conceived or developed by them during their employment with us.

Financial Information about Segments

We manage and report our operations through two business segments: Healthcare Services and License and Management Services. The Healthcare Services segment includes the On*Trak* integrated substance dependence solutions marketed to health plans, employers and unions. The License and Management services segment provides licensing, administrative and management services to licensees that administer PROMETA and other treatment programs, including a managed treatment center that is licensed and managed by us.

Employees

As of December 31, 2012, we employed 32 full-time and 1 part-time employees. We are not a party to any labor agreements and none of our employees are represented by a labor union.

Our Offices

Our principal executive offices are located at 11150 Santa Monica Boulevard, Suite 1500, Los Angeles, California 90025 and our telephone number is (310) 444-4300.

Company Information

We are incorporated under the laws of the State of Delaware. We make our annual reports on Form 10-K, our proxy statements, our quarterly reports on Form 10-Q, our current reports on Form 8-K, and any amendments to these reports available free of charge through links on our corporate website as soon as reasonably practicable after such reports are filed with, or furnished to, the Securities and Exchange Commission (SEC). Our corporate website is located on the Internet at http://www.catasyshealth.com. We have not incorporated by reference in this Annual Report on Form 10-K the information on, or accessible through, our website. The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Additionally, the SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, which can be found at http://www.sec.gov.

ITEM 1A. RISK FACTORS

You should carefully consider and evaluate all of the information in this report, including the risk factors listed below. Risks and uncertainties in addition to those we describe below, that may not be presently known to us, or that we currently believe are immaterial, may also harm our business and operations. If any of these risks occurs, our business, results of operations and financial condition could be harmed, the price of our common stock could decline, and future events and circumstances could differ significantly from those anticipated in the forward-looking statements contained in this report.

Risks related to our business

We have a limited operating history, expect to continue to incur substantial operating losses and may be unable to obtain additional financing, causing our independent auditors to express substantial doubt about our ability to continue as a going concern.

We have been unprofitable since our inception in 2003 and expect to incur substantial additional operating losses and negative cash flow from operations for at least the next twelve months. As of December 31, 2012, these conditions raised substantial doubt as to our ability to continue as a going concern. At December 31, 2012, cash and cash equivalents amounted to approximately $3.2 million. During the twelve-months ended December 31, 2012, our cash and cash equivalents used in operating activities amounted to $6.2 million. Although we have recently taken actions to decrease expenses, increase revenues, and obtain additional financing, there can be no assurance that we will be successful in our efforts. We may not be successful in raising necessary funds on acceptable terms or at all, and we may not be able to offset this by sufficient reductions in expenses and increases in revenue. If this occurs, we may be unable to meet our cash obligations as they become due and we may be required to further delay or reduce operating expenses and curtail our operations, which would have a material adverse effect on us.

We may fail to successfully manage and grow our business, which could adversely affect our results of operations, financial condition and business.

Continued expansion could put significant strain on our management, operational and financial resources. The need to comply with the rules and regulations of the SEC will continue to place significant demands on our financial and accounting staff, financial, accounting and information systems, and our internal controls and procedures, any of which may not be adequate to support our anticipated growth. We may not be able to effectively hire, train, retain, motivate and manage required personnel. Our failure to manage growth effectively could limit our ability to satisfy our reporting obligations, or achieve our marketing, commercialization and financial goals. Recent actions to reduce costs and streamline our operations could place further demands on our personnel, which could hinder our ability to effectively execute on our business strategies.

We will need additional funding, and we cannot guarantee that we will find adequate sources of capital in the future.

We have incurred negative cash flows from operations since inception and have expended, and expect to continue to expend, substantial funds to grow our business. As of March 28, 2013, we estimate that our existing cash, cash equivalents and marketable securities will be sufficient to fund our operating expenses and capital requirements into July 2013. Actual cash fees collected and expenses incurred may significantly impact this estimate. We will require additional funds before we achieve positive cash flows and we may never become cash flow positive.

If we raise additional funds by issuing equity securities, such financing will result in further dilution to our stockholders. Any equity securities issued also may provide for rights, preferences or privileges senior to those of holders of our common stock. If we raise additional funds by issuing additional debt securities, these debt securities would have rights, preferences and privileges senior to those of holders of our common stock, and the terms of the debt securities issued could impose significant restrictions on our operations. If we raise additional funds through collaborations and licensing arrangements, we might be required to relinquish significant rights to our technology or products, or to grant licenses on terms that are not favorable to us.

We do not know whether additional financing will be available on commercially acceptable terms, or at all. If adequate funds are not available or are not available on commercially acceptable terms, we may need to continue to downsize, curtail program development efforts or halt our operations altogether.

Our treatment programs may not be as effective as we believe them to be, which could limit our revenue growth.

Our belief in the efficacy of our On*Trak* solution is based on a limited experience with a relatively small number of patients. Such results may not be statistically significant, have not been subjected to close scientific scrutiny, and may not be indicative of the long-term future performance and safety of treatment with our programs. If the initially indicated results cannot be successfully replicated or maintained over time, utilization of our programs could decline substantially. Our success is dependent on our ability to enroll third-party payor members in our On*Trak* programs. Large scale outreach and enrollment efforts have not been conducted and we may not be able to achieve the anticipated enrollment rates.

Our On*Trak* Program may not become widely accepted, which could limit our growth.

Our ability to achieve further marketplace acceptance for our On*Trak* Program may be dependent on our ability to contract with a sufficient number of third party payors and to demonstrate financial and clinical outcomes from those agreements. If we are unable to secure sufficient contracts to achieve recognition or acceptance of our On*Trak* program or if our program does not demonstrate the expected level of clinical improvement and cost savings it is unlikely we will be able to achieve widespread market acceptance.

Disappointing results for our Catasys Program or failure to attain our publicly disclosed milestones, could adversely affect market acceptance and have a material adverse effect on our stock price.

Disappointing results, later-than-expected press release announcements or termination of evaluations, pilot programs or commercial On*Trak* programs could have a material adverse effect on the commercial acceptance of our programs, our stock price and on our results of operations. In addition, announcements regarding results, or anticipation of results, may increase volatility in our stock price. In addition to numerous upcoming milestones, from time to time we provide financial guidance and other forecasts to the market. While we believe that the assumptions underlying projections and forecasts we make publicly available are reasonable, projections and forecasts are inherently subject to numerous risks and uncertainties. Any failure to achieve milestones, or to do so in a timely manner, or to achieve publicly announced guidance and forecasts, could have a material adverse effect on our results of operations and the price of our common stock.

Our industry is highly competitive, and we may not be able to compete successfully.

The healthcare business, in general, and the substance dependence treatment business in particular, are highly competitive. We compete with many types of substance dependence treatment methods, treatment facilities and other service providers, many of whom are more established and better funded than we are. Many of these other treatment methods and facilities are well established in the same markets we target, have substantial sales volume, and are provided and marketed by companies with much greater financial resources, facilities, organization, reputation and experience than we have. The historical focus on the use of psychological or behavioral therapies, as opposed to medical or physiological treatments for substance dependence, may create further resistance to penetrating the substance dependence treatment market.

Our competitors may develop and introduce new processes and products that are equal or superior to our programs in treating alcohol and substance dependencies. Accordingly, we may be adversely affected by any new processes and technology developed by our competitors.

There are approximately 13,500 facilities reporting to the SAMHSA that provide substance abuse treatment on an inpatient or outpatient basis. Well known examples of residential treatment programs include the Betty Ford Center®, Caron Foundation®, Hazelden® and Sierra Tucson®. In addition, individual physicians may provide substance dependence treatment in the course of their practices. While we believe our products and services are unique, we operate in highly competitive markets. We compete with other healthcare management service organizations and disease management companies, including MBHOs, HMOs, PPOs, third-party administrators and other specialty healthcare and managed care companies. Most of our competitors are significantly larger and have greater financial, marketing and other resources than us. We believe that our ability to offer customers a comprehensive and integrated substance dependence solution, including the utilization of innovative medical and psychosocial treatments, and our unique technology platform will enable us to compete effectively. However, there can be no assurance that we will not encounter more effective competition in the future, which would limit our ability to maintain or increase our business.

We depend on key personnel, the loss of which could impact the ability to manage our business.

Our future success depends on the performance of our senior management and operating personnel.

The loss of the services of any key member of management and operating personnel could have a material adverse effect on our ability to manage our business.

We and our Chief Executive Officer are a party to litigation, which, if determined adversely to us, could adversely affect our cash flow and financial results.

We and our Chief Executive Officer are party to a litigation in which the plaintiffs assert causes of action for conversion, a request for an order to set aside fraudulent conveyance and breach of contract. While the litigation was resolved in our favor the plaintiff has indicated they will file an appeal of the verdict. Further, we believe the plaintiffs' claims are without merit and we intend to continue to vigorously defend the case, there can be no assurance that the appeal and related litigation will ultimately be resolved in our favor. If this case is decided against us or our Chief Executive Officer, it may cause us to pay substantial damages, and other related fees. Regardless of whether this litigation is resolved in our favor, any lawsuit to which we are a party will likely be expensive and time consuming to defend or resolve. This could also divert management's time and attention away from business operations, which could harm our business. Costs of defense and any damages resulting from litigation, a ruling against us or a settlement of the litigation could adversely affect our cash flows and financial results. Please see Item 3 - "Legal Proceedings" for more information.

We may be subject to future litigation, which could result in substantial liabilities that may exceed our insurance coverage.

All significant medical treatments and procedures, including treatment utilizing our programs, involve the risk of serious injury or death. Even under proper medical supervision, withdrawal from alcohol may cause severe physical reactions. While we have not been the subject of any such claims, our business entails an inherent risk of claims for personal injuries and substantial damage awards. We cannot control whether individual physicians will apply the appropriate standard of care, or conform to our treatment programs in determining how to treat their patients. While our agreements typically require physicians to indemnify us for their negligence, there can be no assurance they will be willing and financially able to do so if claims are made. In addition, our license agreements require us to indemnify physicians, hospitals or their affiliates for losses resulting from our negligence.

We currently have insurance coverage for personal injury claims, directors' and officers' liability insurance coverage, and errors and omissions insurance. We may not be able to maintain adequate liability insurance at acceptable costs or on favorable terms. We expect that liability insurance will be more difficult to obtain and that premiums will increase over time and as the volume of patients treated with our programs increases. In the event of litigation, we may sustain significant damages or settlement expense (regardless of a claim's merit), litigation expense and significant harm to our reputation.

If third-party payors fail to provide coverage and adequate payment rates for our programs, our revenue and prospects for profitability will be harmed.

Our future revenue growth will depend in part upon our ability to contract with third-party payors, such as self-insured employers, insurance plans, and unions for our On*Trak* program. To date, we have not received a significant amount of revenue from our On*Trak* substance dependence programs from managed care organizations and other third-party payors, and acceptance of our On*Trak* substance dependence programs is critical to the future prospects of our business. In addition, third-party payors are increasingly attempting to contain healthcare costs, and may not cover or provide adequate payment for treatment using our programs. Adequate third-party reimbursement might not be available to enable us to realize an appropriate return on investment in research and product development, and the lack of such reimbursement could have a material adverse effect on our operations and could adversely affect our revenues and earnings.

We may not be able to achieve promised savings for our On*Trak* contracts, which could result in pricing levels insufficient to cover our costs or ensure profitability.

We anticipate that many or all of our On*Trak* contracts will be based upon anticipated or guaranteed levels of savings for our customers and achieving other operational metrics resulting in incentive fees based on savings. If we are unable to meet or exceed promised savings or achieve agreed upon operational metrics, or favorably resolve contract billing and interpretation issues with our customers, we may be required to refund from the amount of fees paid to us any difference between savings that were guaranteed and the savings, if any, which were actually achieved; or we may fail to earn incentive fees based on savings. Accordingly, during or at the end of the contract terms, we may be required to refund some or all of the fees paid for our services. This exposes us to significant risk that contracts negotiated and entered into may ultimately be unprofitable. In addition, managed care operations are at risk for costs incurred to provide agreed upon services under our program. Therefore, failure to anticipate or control costs could have materially adverse effects on our business.

Our ability to utilize net operating loss carryforwards may be limited.

As of December 31, 2012, we had net operating loss carryforwards (NOLs) of approximately $169 million for federal income tax purposes that will begin to expire in 2024. These NOLs may be used to offset future taxable income, to the extent we generate any taxable income, and thereby reduce or eliminate our future federal income taxes otherwise payable. Section 382 of the Internal Revenue Code imposes limitations on a corporation's ability to utilize NOLs if it experiences an ownership change as defined in Section 382. In general terms, an ownership change may result from transactions increasing the ownership of certain stockholders in the stock of a corporation by more than 50 percent over a three-year period. In the event that an ownership change has occurred, or were to occur, utilization of our NOLs would be subject to an annual limitation under Section 382 determined by multiplying the value of our stock at the time of the ownership change by the applicable long-term tax-exempt rate as defined in the Internal Revenue Code. Any unused annual limitation may be carried over to later years. We may be found to have experienced an ownership change under Section 382 as a result of events in the past or the issuance of shares of common stock upon a conversion of notes, or a combination thereof. If so, the use of our NOLs, or a portion thereof, against our future taxable income may be subject to an annual limitation under Section 382, which may result in expiration of a portion of our NOLs before utilization.

Risks related to our intellectual property

Confidentiality agreements with employees, licensees and others may not adequately prevent disclosure of trade secrets and other proprietary information.

In order to protect our proprietary technology and processes, we rely in part on confidentiality provisions in our agreements with employees, licensees, treating physicians, and others. These agreements may not effectively prevent disclosure of confidential information and may not provide an adequate remedy in the event of unauthorized disclosure of confidential information. In addition, others may independently discover trade secrets and proprietary information. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our proprietary rights, and failure to obtain or maintain trade secret protection could adversely affect our competitive business position. We have had several instances in which it was necessary to send a formal demand to cease and desist using our programs to treat patients due to breach of confidentiality provisions in our agreements, and in one instance have had to file a lawsuit to enforce these provisions.

We may be subject to claims that we infringe the intellectual property rights of others, and unfavorable outcomes could harm our business.

Our future operations may be subject to claims, and potential litigation, arising from our alleged infringement of patents, trade secrets, trademarks or copyrights owned by other third parties. Within the healthcare, drug and bio-technology industry, many companies actively pursue infringement claims and litigation, which makes the entry of competitive products more difficult. We may experience claims or litigation initiated by existing, better-funded competitors and by other third parties. Court-ordered injunctions may prevent us from continuing to market existing products or from bringing new products to market and the outcome of litigation and any resulting loss of revenues and expenses of litigation may substantially affect our ability to meet our expenses and continue operations.

Risks related to our industry

The recently enacted healthcare reforms pose risks and uncertainties that may have a material adverse affect on our business.

There may be risks and uncertainties arising from the recently enacted healthcare reform and the implementing regulations that will be issued in the future. If we fail to comply with these laws or are unable to deal with these risks and uncertainties in an effective manner, our financial condition and results of operations could be adversely affected.

Our policies and procedures may not fully comply with complex and increasing regulation by state and federal authorities, which could negatively impact our business operations.

Our PROMETA Treatment Program is not subject to approval by the FDA, and while the drugs incorporated in the PROMETA Treatment Program have been approved for other indications, they are not FDA approved for the treatment of alcohol or substance dependency. We have not sought, and do not intend to seek, FDA approval for the drugs as they are used in the PROMETA Treatment Program. It is possible that in the future the FDA could require us to seek FDA approval for the drugs as they are used in the PROMETA Treatment Program.

The healthcare industry is highly regulated and continues to undergo significant changes as third-party payors, such as Medicare and Medicaid, traditional indemnity insurers, managed care organizations and other private payors, increase efforts to control cost, utilization and delivery of healthcare services. Healthcare companies are subject to extensive and complex federal, state and local laws, regulations and judicial decisions. The U.S. Congress and state legislatures are considering legislation that could limit funding for the services furnished by our licensees. In addition, the FDA regulates development, testing, labeling, manufacturing, marketing, promotion, distribution, record-keeping and reporting requirements for prescription drugs, medical devices and biologics. Other regulatory requirements apply to dietary supplements, including vitamins. Compliance with laws and regulations enforced by the FDA or other government agencies that have broad discretion in applying such laws and regulations may be required for our programs or other medical programs or services developed or used by us. Many healthcare laws and regulations applicable to our business are complex, applied broadly and subject to interpretation by courts and government agencies. Regulatory, political and legal action and pricing pressures could prevent us from marketing some or all of our products and services for a period of time or permanently. Our failure, or the failure of our licensees, to comply with applicable healthcare laws and regulations may result in the imposition of civil or criminal sanctions that we cannot afford, or require redesign or withdrawal of our programs from the market.

We or our healthcare professionals may be subject to regulatory, enforcement and investigative proceedings, which could adversely affect our financial condition or operations.

We or one or more of our healthcare professionals could become the subject of regulatory, enforcement, or other investigations or proceedings, and our relationships, business structure, and interpretations of applicable laws and regulations may be challenged. The defense of any such challenge could result in substantial cost and a diversion of management's time and attention. In addition, any such challenge could require significant changes to how we conduct our business and could have a material adverse effect on our business, regardless of whether the challenge ultimately is successful. If determination is made that we or one or more of our healthcare professionals has failed to comply with any applicable laws or regulations, our business, financial condition and results of operations could be adversely affected.

Failure to comply with FTC or similar state laws could result in sanctions or limit the claims we can make.

Our promotional activities and materials, including advertising to consumers and professionals, and materials provided to licensees for their use in promoting our treatment programs, are regulated by the Federal Trade Commission (FTC) under the FTC Act, which prohibits unfair and deceptive acts and practices, including claims which are false, misleading or inadequately substantiated. The FTC typically requires competent and reliable scientific tests or studies to substantiate express or implied claims that a product or service is safe or effective. If the FTC were to interpret our promotional materials as making express or implied claims that our treatment programs are safe or effective for the treatment of alcohol, cocaine or methamphetamine addiction, or any other claims, it may find that we do not have adequate substantiation for such claims. Allegations of a failure to comply with the FTC Act or similar laws enforced by state attorneys general and other state and local officials could result in administrative or judicial orders limiting or eliminating the claims we can make about our treatment programs, and other sanctions including substantial financial penalties.

Our business practices may be found to constitute illegal fee-splitting or corporate practice of medicine, which may lead to penalties and adversely affect our business.

Many states, including California where our principal executive offices and our managed treatment center is located, have laws that prohibit business corporations, such as us, from practicing medicine, exercising control over medical judgments or decisions of physicians or other health care professionals (such as nurses or nurse practitioners), or engaging in certain business arrangements with physicians or other health care professionals, such as employment of physicians and other health care professionals or fee-splitting. The state laws and regulations and administrative and judicial decisions that enumerate the specific corporate practice and fee-splitting rules vary considerably from state to state and are enforced by both the courts and government agencies, each with broad discretion. Courts, government agencies or other parties, including physicians, may assert that we are engaged in the unlawful corporate practice of medicine, fee-splitting, or payment for referrals by providing administrative and other services in connection with our treatment programs, by consolidating the revenues of the physician practices we manage, by licensing our technology for a license fee (which could be characterized as a portion of the patient fees), or by subleasing space and providing turn-key business management to affiliated medical groups in exchange for management and licensing fees. As a result of such allegations, we could be subject to civil and criminal penalties, our contracts could be found invalid and unenforceable, in whole or in part, or we could be required to restructure our contractual arrangements. If so, we may be unable to restructure our contractual arrangements on favorable terms, which would adversely affect our business and operations.

Our business practices may be found to violate anti-kickback, physician self-referral or false claims laws, which may lead to penalties and adversely affect our business.

The healthcare industry is subject to extensive federal and state regulation with respect to kickbacks, physician self-referral arrangements, false claims and other fraud and abuse issues.

The federal anti-kickback law (the “Anti-Kickback Law”) prohibits, among other things, knowingly and willfully offering, paying, soliciting, receiving, or providing remuneration, directly or indirectly, in exchange for or to induce either the referral of an individual, or the furnishing, arranging for, or recommending of an item or service that is reimbursable, in whole or in part, by a federal health care program. “Remuneration” is broadly defined to include anything of value, such as, for example, cash payments, gifts or gift certificates, discounts, or the furnishing of services, supplies, or equipment. The Anti-Kickback Law is broad, and it prohibits many arrangements and practices that are lawful in businesses outside of the health care industry.

Recognizing the breadth of the Anti-Kickback Law and the fact that it may technically prohibit many innocuous or beneficial arrangements within the health care industry, the OIG has issued a series of regulations, known as the “safe harbors.” Compliance with all requirements of a safe harbor immunizes the parties to the business arrangement from prosecution under the Anti-Kickback Law. The failure of a business arrangement to fit within a safe harbor does not necessarily mean that the arrangement is illegal or that the OIG will pursue prosecution. Still, in the absence of an applicable safe harbor, a violation of the Anti-Kickback Law may occur even if only one purpose of an arrangement is to induce referrals. The penalties for violating the Anti-Kickback Law can be severe. These sanctions include criminal and civil penalties, imprisonment, and possible exclusion from the federal health care programs. Many states have adopted laws similar to the Anti-Kickback Law, and some apply to items and services reimbursable by any payor, including private insurers.

In addition, the federal ban on physician self-referrals, commonly known as the Stark Law, prohibits, subject to certain exceptions, physician referrals of Medicare patients to an entity providing certain “designated health services” if the physician or an immediate family member of the physician has any financial relationship with the entity. A “financial relationship” is created by an investment interest or a compensation arrangement. Penalties for violating the Stark Law include the return of funds received for all prohibited referrals, fines, civil monetary penalties, and possible exclusion from the federal health care programs. In addition to the Stark Law, many states have their own self-referral bans, which may extend to all self-referrals, regardless of the payor.

The federal False Claims Act imposes liability on any person or entity that, among other things, knowingly presents, or causes to be presented, a false or fraudulent claim for payment to the federal government. Under the False Claims Act, a person acts knowingly if he has actual knowledge of the information or acts in deliberate ignorance or in reckless disregard of the truth or falsity of the information. Specific intent to defraud is not required. Violations of other laws, such as the Anti-Kickback Law or the FDA prohibitions against promotion of off-label uses of drugs, can lead to liability under the federal False Claims Act. The qui tam provisions of the False Claims Act allow a private individual to bring an action on behalf of the federal government and to share in any amounts paid by the defendant to the government in connection with the action. The number of filings of qui tam actions has increased significantly in recent years. When an entity is determined to have violated the False Claims Act, it may be required to pay up to three times the actual damages sustained by the government, plus civil penalties of between $5,500 and $11,000 for each false claim. Conduct that violates the False Claims Act may also lead to exclusion from the federal health care programs. Given the number of claims likely to be at issue, potential damages under the False Claims Act for even a single inappropriate billing arrangement could be significant. In addition, various states have enacted similar laws modeled after the False Claims Act that apply to items and services reimbursed under Medicaid and other state health care programs, and, in several states, such laws apply to claims submitted to all payors.

On May 20, 2009, the Federal Enforcement and Recovery Act of 2009, or FERA, became law, and it significantly amended the federal False Claims Act. Among other things, FERA eliminated the requirement that a claim must be presented to the federal government. As a result, False Claims Act liability extends to any false or fraudulent claim for government money, regardless of whether the claim is submitted to the government directly, or whether the government has physical custody of the money. FERA also specifically imposed False Claims Act liability if an entity "knowingly and improperly avoids or decreases an obligation to pay or transmit money or property to the Government." As a result, the knowing and improper failure to return an overpayment can serve as the basis for a False Claims Act action. In March 2010, Congress passed the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010, collectively the ACA, which also made sweeping changes to the federal False Claims Act. The ACA also established that Medicare and Medicaid overpayments must be reported and returned within 60 days of identification or when any corresponding cost report is due.

Finally, the Health Insurance Portability and Accountability Act of 1996 and its implementing regulations created the crimes of health care fraud and false statements relating to health care matters. The health care fraud statute prohibits knowingly and willfully executing a scheme to defraud any health care benefit program, including a private insurer. The false statements statute prohibits knowingly and willfully falsifying, concealing, or covering up a material fact or making any materially false, fictitious, or fraudulent statement in connection with the delivery of or payment for health care benefits, items, or services. A violation of this statute is a felony and may result in fines, imprisonment, or exclusion from the federal health care programs.

Federal or state authorities may claim that our fee arrangements, our agreements and relationships with contractors, hospitals and physicians, or other activities violate fraud and abuse laws and regulations. If our business practices are found to violate any of these laws or regulations, we may be unable to continue with our relationships or implement our business plans, which would have an adverse effect on our business and results of operations. Further, defending our business practices could be time consuming and expensive, and an adverse finding could result in substantial penalties or require us to restructure our operations, which we may not be able to do successfully.

Our business practices may be subject to state regulatory and licensure requirements.

Our business practices may be regulated by state regulatory agencies that generally have discretion to issue regulations and interpret and enforce laws and rules. These regulations can vary significantly from jurisdiction to jurisdiction, and the interpretation of existing laws and rules also may change periodically. Some of our business and related activities may be subject to state health care-related regulations and requirements, including managed health care, utilization review (UR) or third-party administrator-related regulations and licensure requirements. These regulations differ from state to state, and may contain network, contracting, and financial and reporting requirements, as well as specific standards for delivery of services, payment of claims, and adequacy of health care professional networks. If a determination is made that we have failed to comply with any applicable state laws or regulations, our business, financial condition and results of operations could be adversely affected.

We may be subject to healthcare anti-fraud initiatives, which may lead to penalties and adversely affect our business.

State and federal government agencies are devoting increased attention and resources to anti-fraud initiatives against healthcare providers and the entities and individuals with whom they do business, and such agencies may define fraud expansively to include our business practices, including the receipt of fees in connection with a healthcare business that is found to violate any of the complex regulations described above. While to our knowledge we have not been the subject of any anti-fraud investigations, if such a claim were made, defending our business practices could be time consuming and expensive, and an adverse finding could result in substantial penalties or require us to restructure our operations, which we may not be able to do successfully.

Our use and disclosure of patient information is subject to privacy and security regulations, which may result in increased costs.

In conducting research or providing administrative services to healthcare providers in connection with the use of our treatment programs, we may collect, use, disclose, maintain and transmit patient information in ways that will be subject to many of the numerous state, federal and international laws and regulations governing the collection, use, disclosure, storage, privacy and security of patient-identifiable health information, including the administrative simplification requirements of the Health Insurance Portability and Accountability Act of 1996 and its implementing regulations (HIPAA) and the Health Information Technology for Economic and Clinical Health Act of 2009 (HITECH). The HIPAA Privacy Rule restricts the use and disclosure of patient information ("Protected Health Information" or "PHI"), and requires safeguarding that information. The HIPAA Security Rule and HITECH establish elaborate requirements for safeguarding PHI transmitted or stored electronically. HIPAA applies to covered entities, which may include healthcare facilities and also includes health plans that will contract for the use of our programs and our services. HIPAA and HITECH require covered entities to bind contractors that use or disclose protected health information (or "Business Associates") to compliance with certain aspects of the HIPAA Privacy Rule and all of the HIPAA Security Rule. In addition to contractual liability, Business Associates are also directly subject to regulation by the federal government. Direct liability means that we are subject to audit, investigation and enforcement by federal authorities. HITECH imposes new breach notification obligations requiring us to report breaches of "Unsecured Protected Health Information" or Protected Health Information that has not been encrypted or destroyed in accordance with federal standards. Business Associates must report such breaches so that their covered entity customers may in turn notify all affected patients, the federal government, and in some cases, local or national media outlets. We may be required to indemnify our covered entity customers for costs associated with breach notification and the mitigation of harm resulting from breaches that we cause. If we are providing management services that include electronic billing on behalf of a physician practice or facility that is a covered entity, we may be required to conduct those electronic transactions in accordance with the HIPAA regulations governing the form and format of those transactions. Services provided under our Catasys program not only require us to comply with HIPAA and HITECH but also Title 42 Part 2 of the Code of Federal Regulations ("Part 2"). Part 2 is a federal, criminal law that severely restricts our ability to use and disclose drug and alcohol treatment information obtained from federally-supported treatment facilities. Our operations must be carefully structured to avoid liability under this law. Our Catasys program qualifies as a federally funded treatment facility which requires us to disclose information on members only in compliance with Title 42. In addition to the federal privacy regulations, there are a number of state laws governing the privacy and security of health and personal information. The penalties for violation of these laws vary widely and the area is rapidly evolving. We believe that we have taken the steps required of us to comply with health information privacy and security laws and regulations in all jurisdictions, both state and federal. However, we may not be able to maintain compliance in all jurisdictions where we do business. Failure to maintain compliance, or changes in state or federal privacy and security laws could result in civil and/or criminal penalties and could have a material adverse effect on our business, including significant reputational damage associated with a breach. If regulations change or it is determined that we are not in compliance with privacy regulations we may be required to modify aspects of our program which may adversely affect program results and our business or profitability. Under HITECH, we are subject to prosecution or administrative enforcement and increased civil and criminal penalties for non-compliance, including a new, four-tiered system of monetary penalties. We are also subject to enforcement by state attorneys general who were given authority to enforce HIPAA under HITECH.

Our business arrangements with health care providers may be deemed to be franchises, which could negatively impact our business operations.

Franchise arrangements in the United States are subject to rules and regulations of the FTC and various state laws relating to the offer and sale of franchises. A number of the states in which we operate regulate the sale of franchises and require registration of the franchise offering circular with state authorities and the delivery of a franchise offering circular to prospective franchisees. State franchise laws often limit, among other things, the duration and scope of non-competitive provisions, the ability of a franchisor to terminate or refuse to renew a franchise and the ability of a franchisor to designate sources of supply. Franchise laws and regulations are complex, apply broadly and are subject to interpretation by courts and government agencies. Federal or state authorities or healthcare providers with whom we contract may claim that the agreements under which we license rights to our technology and trademarks and provide services violate these laws and regulations. Violations of these laws are punishable by monetary fines, civil and criminal penalties, and forfeiture of amounts collected in violation of such laws. If our business practices are found to constitute franchises, we could be subject to civil and criminal penalties, our contracts could be found invalid and unenforceable, in whole or in part, or we could be required to restructure our contractual arrangements. We may be unable to continue with our relationships or restructure them on favorable terms, which would have an adverse effect on our business and results of operations. We may also be required to furnish prospective franchisees with a franchise offering circular containing prescribed information, and restrict how we market to or deal with healthcare providers, potentially limiting and substantially increasing our cost of doing business.

Certain of our professional healthcare employees, such as nurses, must comply with individual licensing requirements.

All of our healthcare professionals who are subject to licensing requirements, such as our care coaches, are licensed in the state in which they provide professional services in person. While we believe our nurses provide coaching and not professional services, one or more states may require our healthcare professionals to obtain licensure if providing services telephonically across state lines to the state's residents. Healthcare professionals who fail to comply with these licensure requirements could face fines or other penalties for practicing without a license, and we could be required to pay those fines on behalf of our healthcare professionals. If we are required to obtain licenses for our nurses in states where they provide telephonic coaching it would significantly increase the cost of providing our product. In addition, new and evolving agency interpretations, federal or state legislation or regulations, or judicial decisions could lead to the implementation of out-of-state licensure requirements in additional states, and such changes would increase the cost of services and could have a material effect on our business.

Risks related to our common stock

Our common stock is thinly traded, and it is therefore susceptible to wide price swings.

Our common stock is traded on the OTC Bulletin Board under the symbol "CATS." Thinly traded stocks are more susceptible to significant and sudden price changes than stocks that are widely followed by the investment community and actively traded on an exchange. The liquidity of our common stock depends upon the presence in the marketplace of willing buyers and sellers. We cannot assure you that you will be able to find a buyer for your shares. In the future, if we successfully list the common stock on a securities exchange or obtain trading authorization, we will not be able to assure you that an organized public market for our securities will develop or that there will be any private demand for the common stock. We could also subsequently fail to satisfy the standards for continued national securities exchange trading, such as standards having to do with a minimum share price, the minimum number of public shareholders or the aggregate market value of publicly held shares. Any holder of our securities should regard them as a long-term investment and should be prepared to bear the economic risk of an investment in our securities for an indefinite period.

Our common stock is considered a "penny stock" and may be difficult to sell.

Our common stock is subject to certain rules and regulations relating to "penny stock." Penny stocks are generally equity securities with a price of less than $5.00 (other than securities registered on certain national securities exchanges, provided that current price and volume information with respect to transactions in such securities is provided by the exchange or system). The penny stock rules require a broker−dealer, prior to a transaction in a penny stock not otherwise exempt from the rules, to deliver a standardized risk disclosure document that provides information about penny stocks and the risks in the penny stock market. The broker−dealer must also provide the customer with current bid and offer quotations for the penny stock, the compensation of the broker−dealer and its salesperson in the transaction, and monthly account statements showing the market value of each penny stock held in the customer's account. In addition, the penny stock rules generally require that prior to a transaction in a penny stock, the broker−dealer make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's written agreement to the transaction. These disclosure requirements may have the effect of reducing the level of trading activity in the secondary market for a stock that becomes subject to the penny stock rules. Since the Company's securities are subject to the penny stock rules, investors in the Company may find it more difficult to sell their securities.

Failure to maintain effective internal controls could adversely affect our operating results and the market for our common stock.

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we maintain internal control over financial reporting that meets applicable standards. As with many smaller companies with small staff, material weaknesses in our financial controls and procedures may be discovered. If we are unable, or are perceived as unable, to produce reliable financial reports due to internal control deficiencies, investors could lose confidence in our reported financial information and operating results, which could result in a negative market reaction and adversely affect our ability to raise capital.

Approximately 72% of our stock is controlled by our chairman and chief executive officer, who has the ability to substantially influence the election of directors and other matters submitted to stockholders.

327,500, 137,188,535 and 567,916 shares are beneficially held of record by Reserva Capital, LLC, Crede CG II, LLC (“Crede”) and Bonmore, LLC, respectively, whose sole managing member is our Chairman and Chief Executive Officer, which represents approximately 72% of our beneficial ownership. As a result, he has and is expected to continue to have the ability to significantly influence the election of our Board of Directors and the outcome of all other issues submitted to our stockholders. His interest may not always coincide with our interests or the interests of other stockholders, and they may act in a manner that advances their best interests and not necessarily those of other stockholders. One consequence to this substantial influence or control is that it may be difficult for investors to remove management of our Company. It could also deter unsolicited takeovers, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices.

Our stock price may be subject to substantial volatility, and the value of our stockholders' investment may decline.

The market price of our common stock has experienced downward substantial volatility. The price at which our common stock will trade may fluctuate as a result of a number of factors, including the number of shares available for sale in the market, quarterly variations in our operating results and actual or anticipated announcements of pilots and scientific studies of the effectiveness of our PROMETA Treatment Program, our On*Trak* Program, announcements regarding new or discontinued On*Trak* Program contracts, new products or services by us or competitors, regulatory investigations or determinations, acquisitions or strategic alliances by us or our competitors, recruitment or departures of key personnel, the gain or loss of significant customers, changes in the estimates of our operating performance, actual or threatened litigation, market conditions in our industry and the economy as a whole.

Numerous factors, including many over which we have no control, may have a significant impact on the market price of our common stock, including:

- announcements of new products or services by us or our competitors;
- current events affecting the political, economic and social situation in the United States and other countries where we operate;
- trends in our industry and the markets in which we operate;
- changes in financial estimates and recommendations by securities analysts;
- acquisitions and financings by us or our competitors;
- the gain or loss of a significant customer;
- quarterly variations in operating results;
- volatility in rates of exchanges between the US dollar and the currencies of the foreign countries in which we operate;
- the operating and stock price performance of other companies that investors may consider to be comparable;
- purchases or sales of blocks of our securities; and
- issuances of stock.

Furthermore, stockholders may initiate securities class action lawsuits if the market price of our stock drops significantly, which may cause us to incur substantial costs and could divert the time and attention of our management.

Future sales of common stock by existing stockholders, or the perception that such sales may occur, could depress our stock price.

The market price of our common stock could decline as a result of sales by, or the perceived possibility of sales by, our existing stockholders. We have completed a number of private placements of our common stock and other securities over the last several years, and we have effective resale registration statements pursuant to which the purchasers can freely resell their shares into the market. In addition, most of our outstanding shares are eligible for public resale pursuant to Rule 144 under the Securities Act of 1933, as amended. As of March 28, 2013, approximately 69 million shares of our common stock are held by our affiliates and may be sold pursuant to an effective registration statement or in accordance with the volume and other limitations of Rule 144 or pursuant to other exempt transactions. Future sales of common stock by significant stockholders, including those who acquired their shares in private placements or who are affiliates, or the perception that such sales may occur, could depress the price of our common stock.

Future issuances of common stock and hedging activities may depress the trading price of our common stock.

Any future issuance of equity securities, including the issuance of shares upon direct registration, upon satisfaction of our obligations, compensation of vendors, exercise of outstanding warrants, or effectuation of a reverse stock split, of which we have already received approval from our stockholders, could dilute the interests of our existing stockholders, and could substantially decrease the trading price of our common stock. As of March 28, 2013, we have outstanding options to purchase approximately 5,082,158 shares of our common stock and warrants to purchase approximately 111,038,270 shares of our common stock at prices ranging from $0.07 to $342.40 per share. We may issue equity securities in the future for a number of reasons, including to finance our operations and business strategy, in connection with acquisitions, to adjust our ratio of debt to equity, to satisfy our obligations upon the exercise of outstanding warrants or options or for other reasons.

There may be future sales or other dilution of our equity, which may adversely affect the market price of our common stock.

In the future, we may need to raise additional funds through public or private financing, which might include sales of equity securities. The issuance of any additional shares of common stock or securities convertible into, exchangeable for, or that represent the right to receive common stock or the exercise of such securities could be substantially dilutive to holders of our common stock. Holders of shares of our common stock have no preemptive rights that entitle holders to purchase their pro rata share of any offering of shares of any class or series. The market price of our common stock could decline as a result of sales of shares of our common stock made after this offering or the perception that such sales could occur. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our stockholders bear the risk of our future offerings reducing the market price of our common stock and diluting their interests in us.

Provisions in our certificate of incorporation and Delaware law could discourage a change in control, or an acquisition of us by a third party, even if the acquisition would be favorable to you.

Our certificate of incorporation and the Delaware General Corporation Law contain provisions that may have the effect of making more difficult or delaying attempts by others to obtain control of our Company, even when these attempts may be in the best interests of stockholders. For example, our certificate of incorporation also authorizes our Board of Directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Delaware law also imposes conditions on certain business combination transactions with “interested stockholders.” These provisions and others that could be adopted in the future could deter unsolicited takeovers or delay or prevent changes in our control or management, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices. These provisions may also limit the ability of stockholders to approve transactions that they may deem to be in their best interests.

We do not expect to pay dividends in the foreseeable future.

We have paid no cash dividends on our common stock to date, and we intend to retain our future earnings, if any, to fund the continued development and growth of our business. As a result, we do not expect to pay any cash dividends in the foreseeable future. Further, any payment of cash dividends will also depend on our financial condition, results of operations, capital requirements and other factors, including contractual restrictions to which we may be subject, and will be at the discretion of our Board of Directors.

A number of our outstanding warrants contain anti-dilution provisions that, if triggered, could cause substantial dilution to our then-existing stockholders and adversely affect our stock price.

A number of our outstanding warrants contain anti-dilution provisions. As a result, if we, in the future, issue or grant any rights to purchase any of our common stock or other securities convertible into our common stock, for a per share price less than the exercise price of our warrants, the exercise price, or in the case of some of our warrants the exercise price and number of shares of common stock, will be reduced. If our available funds and cash generated from operations are insufficient to satisfy our liquidity requirements in the future, then we may need to raise substantial additional funds in the future to support our working capital requirements and for other purposes. If shares of our common stock or securities exercisable for our common stock are issued in consideration of such funds at an effective per share price lower than our existing warrants, then the anti-dilution provisions would be triggered, thus possibly causing substantial dilution to our then-existing shareholders if such warrants are exercised. Such anti-dilution provisions may also make it more difficult to obtain financing.

The exercise of our outstanding warrants may result in a dilution of our current stockholders' voting power and an increase in the number of shares eligible for future resale in the public market which may negatively impact the market price of our stock.

The exercise of some or all of our outstanding warrants could significantly dilute the ownership interests of our existing stockholders. As of March 28, 2013, we had outstanding warrants to purchase an aggregate of 111,038,270 shares of common stock at exercise prices ranging from $0.07 to $100.00 per share. To the extent warrants are exercised, additional shares of common stock will be issued, and such issuance may dilute existing stockholders and increase the number of shares eligible for resale in the public market.

In addition to the dilutive effects described above, the exercise of those warrants would lead to a potential increase in the number of shares eligible for resale in the public market. Sales of substantial numbers of such shares in the public market could adversely affect the market price of our shares.

Certain investors are parties to securities purchase agreements with the Company that would permit them to receive additional shares of our common stock upon a reverse stock split, which could cause substantial dilution to our then-existing stockholders.

The Company has entered into securities purchase agreements with several investments that provide that in the event that the Company effectuates a reverse stock split of its common stock within 24 months of the closing date of the securities purchase agreement (the “Reverse Split”) and the volume weighted average price (“VWAP”) of the common stock during the 20 trading days following the effective date of the Reverse Split (the “VWAP Period”) declines from the closing price on the trading date immediately prior to the effective date of the Reverse Split, that the Company issue additional shares of common stock (the “Adjustment Shares"). In the event that the Company issues such Adjustment Shares this could cause substantial dilution to our then-existing shareholders. This provision could also make it more difficult to obtain financing.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not Applicable.

ITEM 2. PROPERTIES

Information concerning our principal facilities, all of which were leased at December 31, 2012, is set forth below:

Location	Use	Approximate Area in Square Feet
11150 Santa Monica Blvd. Los Angeles, California	Principal executive and administrative offices	10,700

Our principal executive and administrative offices are located in Los Angeles, California and consist of leased office space totaling approximately 10,700 square feet. In December 2010, we amended and extended the lease for three years. Our base rent is currently approximately $36,000 per month, subject to annual adjustments, with aggregate minimum lease commitments at March 28, 2013, totaling approximately $320,000. Concurrent with the three year extension, the Board of Directors approved a sublease of approximately one-third of the office space to Xoftek, Inc. an affiliate of our Chairman and Chief Executive Officer. Xoftek, Inc. will pay the Company pro-rata rent during the three-year lease period.

We have a related party receivable from Xoftek, Inc. in the amount of $173,000 as of December 31, 2012, which represents unpaid monthly rent related to a January 1, 2011 sublease agreement.

We believe that the current office space is adequate to meet our needs.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we may be involved in litigation relating to claims arising out of our operations in the normal course of business. As of the date of this Annual Report on Form 10-K, we are not currently involved in any legal proceeding that we believe has a material adverse effect on our business, financial condition or operating results. We are however involved in litigation ("Isaka Matter") as described below.

On or about August 18, 2006, plaintiffs Isaka Investments, Ltd., Sand Hill Capital International Inc. and Richbourg Financial, Ltd. ("Plaintiffs") filed a complaint in the Los Angeles Superior Court, entitled *Isaka Investments, Ltd., Sand Hill Capital International, Inc. and Richbourg Financial, Ltd. vs. Xino Corporation*, an entity from which our Company had acquired certain assets, and a number of other additional individuals and entities, including our Company, our Company's Chairman and Chief Executive Officer, Terren S. Peizer, and other members of the Company's Board of Directors. The Board of Directors and other parties were dismissed by way of demurrer. In July 2007, Plaintiffs filed their second amended complaint, asserting causes of action for conversion, a request for an order to set aside an alleged fraudulent conveyance and breach of contract against our Company, Mr. Peizer, and others. In August 2007, our Company and Mr. Peizer, among others, filed an answer to the second amended complaint denying liability and asserting numerous affirmative defenses. In June 2008, our Company, Mr. Peizer, and others, filed a motion for summary judgment, or alternatively, summary adjudication, and in October 2008, the Court granted summary adjudication as to each cause of action and consequently summary judgment in favor of our Company and Mr. Peizer, among others. Plaintiffs appealed the summary judgment and in October 2010, the Court of Appeal reversed the trial court's ruling. The Court of Appeal's decision was not on the merits, but rather provides that there are sufficient material issues of fact for the case to be tried. The Court of Appeal issued a remittitur in December 2010, and Plaintiffs filed a motion for leave to amend the second amended complaint, which was granted in June 2011. In June 2011, Plaintiffs filed their third amended complaint and, in August 2011, in response to a demurrer filed by the Company, Mr. Peizer and others, the Court held that Plaintiffs' third amended complaint was not pled with sufficient specificity to state the causes of action alleged therein. In September 2011, Plaintiffs filed a fourth amended complaint, alleging causes of action for breach of fiduciary duty, fraudulent transfer, conversion, fraud, breach of contract, unfair business practices and wrongful interference with contractual relations and prospective business advantage. The Company filed a demurrer related to the fourth amended complaint in September 2011. At the hearing, the Court sustained, without leave to amend, the demurrers to the causes of action for breach of fiduciary duty and wrongful interference with contractual relations and prospective business advantage. In October 2011, the Company, Mr. Peizer and others, filed an answer to the fourth amended complaint, denying liability and asserting numerous affirmative defenses. In April 2012, the Court conducted a bench trial on the issue of whether the Plaintiffs have standing to pursue the causes of action alleged in their Fourth Amended Complaint other than the causes of action for conversion and breach of contract. At the conclusion of the trial, the Court ruled that Plaintiffs lack standing to pursue any causes of action other than for conversion and breach of contract. A Statement of Decision and Order of Dismissal was signed by the Court on July 18, 2012. Thereafter, the Plaintiffs filed an ex parte application to reopen the evidence which was denied by the Court. The Plaintiffs also filed a motion to amend their complaint seeking to add back in the claims that they lost at trial. The motion to amend was denied. On July 3, 2012, September 5, 2012 and October 15, 2012, the Plaintiffs filed Petitions for Writs of Mandate in the Court of Appeal. The Writs were summarily denied by the Court of Appeal. On October 9, 2012, the Court commenced hearings regarding the trial of the conversion and breach of contract causes of action. On October 15, 2012, the parties, through their counsel of record, stipulated to a bench trial on the admissibility and enforceability of a 2007 settlement agreement between Xino Corporation and the Company (the "Settlement Agreement"). Thus, the parties submitted the issue to the Court for a bench trial to determine whether the Settlement Agreement was admissible and effective to bar the two remaining claims. The Court held that the Settlement Agreement was admissible and enforceable to release the remaining claims. Accordingly, judgment was entered for the Company on November 19, 2012. Plaintiffs filed a notice of appeal on December 10, 2012. On March 26, 2013, Plaintiffs filed their opening brief in the Court of Appeal. The Company's response will be due on April 26, 2013 unless it requests an extension. The Company has had very limited settlement discussions and the Company believes Plaintiffs' claims are without merit and intends to continuously, and vigorously, defend the case.

ITEM 4. MINE SAFETY AND DISCLOSURE

Not Applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is traded on the OTC Bulletin Board under the symbol "CATS." The following table sets forth below, for the periods indicated, the high and low bid prices for our common stock, as reported by the OTC Bulletin Board.

	Closing Sales Price	
2012	High	Low
4th Quarter	$ 0.16	$ 0.11
3rd Quarter	0.24	0.13
2nd Quarter	0.30	0.15
1st Quarter	0.30	0.20

	Closing Sales Price	
2011	High	Low
4th Quarter	$ 0.56	$ 0.19
3rd Quarter	0.50	0.20
2nd Quarter	3.20	0.40
1st Quarter	4.40	2.00

Stockholders

As of March 28, 2013, there were approximately 112 stockholders of record of our 120,811,273 outstanding shares of common stock.

Dividends

We have never declared or paid any dividends. We may, as our Board of Directors deems appropriate, continue to retain all earnings for use in our business or may consider paying dividends in the future.

Unregistered Sales of Securities

In November 2012, we issued 12,500 restricted shares of common stock to a consultant for investor relation services to be performed beginning November 2012 and ending May 2013. These securities were issued without registration pursuant to the exemption afforded by Section 4(2) of the Securities Act of 1933, as a transaction by us not involving any public offering.

Issuer Purchase of Equity Securities

None.

ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed due to factors such as, among others, limited operating history, difficulty in developing, exploiting and protecting proprietary technologies, intense competition and substantial regulation in the healthcare industry. Additional information concerning factors that could cause or contribute to such differences can be found in the following discussion, as well as in Item 1.A - "Risk Factors."

OVERVIEW

General

We are a healthcare services company, providing specialized health services designed to assist health plans, employers and unions to manage and treat their high cost substance dependence members through a network of healthcare providers and our employees. The On*Trak* substance dependence program was designed to address substance dependence as a chronic disease. The program seeks to lower costs and improve member health through the delivery of integrated medical and psychosocial interventions in combination with long term "care coaching." We also offer the PROMETA Treatment Program for alcoholism and stimulant dependence on a private-pay basis through licensed treatment providers and a company managed treatment center that offers the PROMETA Treatment Program, as well as other treatments for substance dependencies.

Our Strategy

Our business strategy is to provide a quality integrated medical and behavioral program to help organizations treat and manage substance dependent populations to impact total healthcare costs associated with members with a substance dependence diagnosis. We intend to grow our business through increased adoption of our On*Trak* integrated substance dependence solutions by managed care health plans, employers, unions and other third-party payors.

Key elements of our business strategy include:

- Demonstrating the potential for improved clinical outcomes and reduced cost associated with using our Catasys programs with key managed care and other third-party payors;
- Educating third-party payors on the disproportionately high cost of their substance dependent population;
- Providing our Catasys integrated substance dependence solutions to third-party payors for reimbursement on a case rate or monthly fee; and
- Generating outcomes data from our On*Trak* program to demonstrate cost reductions and utilization of this outcomes data to facilitate broader adoption.

As an early entrant into offering integrated medical and behavioral programs for substance dependence, Catasys will be well positioned to address increasing market demand. Our On*Trak* program will help fill the gap that exists today: a lack of programs that focus on smaller populations with disproportionately higher costs and that improve patient care while controlling overall treatment costs.

As of March 2013, we are in contact with organizations representing approximately 13.7 million covered lives. We consider the process to have moved to a second stage when we are asked to perform data analysis for the prospect organization or the prospect organization has asked for a formal proposal. We are currently in the data analysis/proposal phase or further with organizations representing approximately 3 million covered lives. As noted in more detail below, the fact that we have moved into the second phase or beyond with a prospect organization provides no assurance that we will ultimately enter into a contract with such prospect. Even if contracts are entered into with such organizations, there is no assurance that a substantial number, or even a significant number, of their covered lives would enroll in our programs. The sales cycle with respect to the execution of such contracts is a fairly long one and there may be substantial delays at any point in the process. Further, organizations may decide to not move forward at any time and we may remove an organization from the pipeline if we feel that we are unlikely to make future progress towards a contract or that our limited sales resources are better employed on other prospects. Even if we advance to what we may consider to be the final stages, including contract negotiations, things may happen to delay or prevent the execution of such contracts.

We currently have contracts with organizations covering approximately 500,000 lives, excluding the contract we signed in March with a national health plan. The number of covered lives included in the contracts we have signed varies on a month to month basis, sometimes substantially, due to changes in members' program eligibility status, members' coverage and changes in the number and/or composition of health plan customers. We estimate that in order for us to break even on a cash flow basis, we will need to have contracts with organizations covering approximately 1,500,000 lives. Based on projected enrollment rate of 20% this would be expected to result in having approximately 1,500 enrollees at full projected enrollment which is expected no less than a year after enrollment commences. This assumption is based on our generating our current standard pricing of $8,500 in annual fees per enrollee in the form of monthly fees. Not all of our contracts pay us on our standard monthly fee basis. Other fee arrangements include payment per member visit to our network providers and case rates upon enrollment. These fee arrangements may result in fees being billed significantly faster or slower than they would be under our standard monthly fee arrangements, which could significantly impact the number of enrollees needed to break even. In some of our contracts we are required to pay all or a portion of our fees back in the event that the total cost of our enrolled members does not decrease by at least the amount of our fees. In addition, some of our contracts require us to refund a portion of our fees to the extent that members do not remain enrolled in the program for some length of time, but in no event greater than one year. Our assumptions on costs are based largely on our historical costs to date and estimated future utilization by enrolled members. However, due to the limited amount of history that we have had with enrollees (primarily less than a full year) it is uncertain whether our experience to date will necessarily be predictive of the actual costs in the future. Accordingly, any reduction in fees, the inability to achieve a 20% enrollment rate, the inability to generate incentive fees based on reducing members' overall costs, inability to keep members enrolled, or increase in the cost of services could adversely impact these break-even projections. In addition, should our overhead unrelated to the cost of servicing enrollees increase, our break-even point would also be adversely impacted. For example, an increase in our marketing and promotional budget in an effort to accelerate the contract enrollment process, lower than expected enrollment rates or higher than expected costs to build our provider networks and such similar expenses could adversely impact the break-even projections. There is no assurance that we will ever generate enough fees to generate a positive cash flow. See "Risks related to our business" under the "Risk Factors" section for more information.

Reporting

We manage and report our operations through two business segments: healthcare services and license and management services. The healthcare services segment includes On*Trak* and its integrated substance dependence solutions marketed to health plans, employers and unions through a network of licensed and company managed healthcare providers. The license and management segment provides licensing, administrative and management services to licensees that administer the PROMETA Treatment Program and other treatment programs, including a managed treatment center that is licensed and managed by us.

We evaluate segment performance based on total assets, revenue and income or loss before provision for income taxes. Our assets are included within each discrete reporting segment. In the event that any services are provided to one reporting segment by the other, the transactions are valued at the market price. No such services were provided during the year ended December 31, 2012 and 2011.

Summary financial information for our two reportable segments is as follows:

Results of Operations

The table below and the discussion that follows summarize our results of operations and certain selected operating statistics for the last two fiscal years:

CATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Audited

(In thousands, except per share amounts)	**Twelve Months Ended December 31, 2012**	**2011**
Revenues		
Healthcare services revenues	$ 375	$ 24
License and management services revenues	166	243
Total revenues	541	267
Operating expenses		
Cost of services	816	571
General and administrative	8,341	11,145
Impairment losses	656	267
Depreciation and amortization	289	349
Total operating expenses	10,102	12,332
Loss from operations	(9,561)	(12,065)
Interest and other income	-	4
Interest expense	(4,811)	(3,189)
Loss on debt extinguishment	-	(41)
Change in fair value of warrant liability	2,724	7,186
Loss before provision for income taxes	(11,648)	(8,105)
Provision for income taxes	(5)	14
Net Loss	$ (11,643)	$ (8,119)
Basic and diluted net income (loss) per share:*		
Net loss per share*	$ (0.20)	$ (0.44)
Weighted number of shares outstanding*	57,801	18,439

* The financial statements have been retroactively restated to reflect the 40-for-1 reverse stock split that occurred on September 6, 2011.

Summary of Consolidated Operating Results

Loss from operations before provision for income taxes for the twelve months ended December 31, 2012 amounted to $11.6 million compared with $8.1 million for the twelve months ended December 31, 2011. Overall, the loss from operations increased by $3.5 million for the fiscal year ended December 31, 2012. The increase was primarily due to a smaller gain on change in fair value of warrant liabilities during 2012, an increase in interest expense related to our 2012 financings, offset by a decrease in operating expenses and an increase in revenue during 2012. General and administrative expenses decreased by $2.8 million for the fiscal year ended December 31, 2012, as we continued to streamline operations during 2011 and 2012. In addition, we recorded impairment charges totaling $656,000 related to intellectual property underlying the PROMETA Treatment Program.

In 2012, we continued to focus our attention on our healthcare services segment and repositioning ourselves in the marketplace. As a result, our revenues increased by $274,000 mostly from the revenue related to our healthcare services segment.

Included in the loss from operations before provision for taxes, were consolidated non-cash charges for depreciation and amortization expense of $289,000 and $349,000, and share-based compensation expense of $2.2 million and $4.4 million, for the years ended December 31, 2012 and 2011, respectively.

In 2012, our loss before provision for income taxes included a $2.7 million increase in the fair value of warrants compared with a $7.2 million increase in 2011.

Reconciliation of Segment Results

The following table summarizes and reconciles the loss from operations of our reportable segments to the loss before provision for income taxes from our consolidated statements of operations for the years ended December 31, 2012 and 2011:

(In thousands)	Twelve Months Ended December 31, 2012	2011
Healthcare Services	$ (9,752)	$ (6,450)
License & Management services	(1,896)	(1,655)
Loss from continuing operations before provision for income taxes	$ (11,648)	$ (8,105)

Healthcare Services

The following table summarizes the operating results for healthcare services for the years ended December 31, 2012 and 2011:

(in thousands)	Twelve Months Ended December 31, 2012	2011
Revenues	$ 375	$ 24
Operating Expenses		
Cost of healthcare services	$ 563	$ 347
General and administrative expenses		
Salaries and benefits	5,354	7,690
Other expenses	2,111	2,396
Depreciation and amortization	12	5
Total operating expenses	$ 8,040	$ 10,438
Loss from operations	$ (7,665)	$ (10,414)
Interest and other income	-	4
Interest expense	(4,811)	(3,185)
Loss on debt extinguishment	-	(41)
Change in fair value of warrant liabilities	2,724	7,186
Income/(loss) before provision for income taxes	$ (9,752)	$ (6,450)

Year Ended December 31, 2012 Compared With Year Ended December 31, 2011

Revenues

As of December 2012, five On*Trak* Program contracts were operational. Recognized revenue increased by $351,000, or 1463% for the period ended December 31, 2012, compared with the same period in 2011. Most of the revenue related to these contracts are initially recorded to deferred revenue as the revenue is subject to performance guarantees, or in the case of case rates received upon enrollment, recognized ratably over the period of enrollment. Deferred revenue was $278,000 as of December 31, 2012, which if we were able to recognize would have increased revenue by $629,000, or 2521%, compared with the same period in 2011.

Cost of Healthcare Services

Cost of healthcare services consists primarily of salaries related to our care coaches, healthcare provider claims payments, and fees charged by our third party administrator for processing these claims. The increase in these costs reflects the increase in enrolled members being serviced under our On*Trak* program.

General and Administrative Expenses

General and administrative expense decreased to $7.5 million for the year ended December, 31, 2012, compared with $10.1 million for the same period in 2011. Total general and administrative expense decreased by $2.6 million in 2012 when compared with 2011. The decrease was due to reductions in all expense categories, and primarily due to salaries and benefits and outside services, resulting from the continued streamlining of operations to focus on managed care opportunities in our healthcare services segment.

Interest Expense

Interest expense for the year ended December 31, 2012 increased by $1.6 million compared with the same period in 2011 due to the multiple financings that occurred during 2012 and the secured convertible promissory note that was converted into common stock at the end of 2011.

Loss on Debt Extinguishment

In April 2010, the holder of certain claims against us in the amount of $1,005,000, due for services provided to us which had not been paid, filed a complaint against us in California state court. On April 8, 2010, the court approved our settlement of the complaint in exchange for issuing 125,000 shares of our common stock pursuant to Section 3 (a)(10) of the Securities Act of 1933 as amended. In accordance with the approved settlement the number of shares is subject to adjustment 180 days subsequent to the issuance of the shares. Pursuant to the terms of the agreement, the number of shares were adjusted and 15,125 shares were subsequently issued, which resulted in a loss on settlement of claims in the amount of $41,000, for the year ended December 31, 2011. There was no such loss for the year ended December 31, 2012.

Change in Fair Value of Warrant Liabilities

We issued warrants to purchase common stock in November 2007, July 2010, October 2010, November 2010, December 2011, February 2012, April 2012, May 2012, September 2012, and December 2012, and when we amended and restated the Highbridge senior secured note in July 2008. The warrants are being accounted for as liabilities in accordance with Financial Accounting Standards Board (“FASB”) accounting rules, due to provisions in some warrants that protect the holders from declines in our stock price and a requirement to deliver registered shares upon exercise of the warrants, which is considered outside our control. The warrants are marked-to-market each reporting period, using the Black-Scholes pricing model, until they are completely settled or expire.

The change in fair value of the warrants amounted to a net gain of $2.7 million for the year ended December 31, 2012, compared with a net gain of $7.2 million for the same period in 2011.

We will continue to mark the warrants to market value each quarter-end until they are completely settled.

Depreciation and Amortization

Depreciation and amortization was insignificant for the years ended December 31, 2012 and 2011, respectively.

License and Management Services

The following table summarizes the operating results for license and management services for the years ended December 31, 2012 and 2011:

(In thousands, except patient treatment data)	**Twelve months ended December 30,**	
	2012	**2011**
Revenues		
U.S. licensees	$ 14	$ 61
Managed treatment center	152	182
Total license and management revenues	$ 166	$ 243
Operating expenses		
Cost of license and management services	$ 254	$ 222
General and administrative expenses		
Salaries and benefits	587	662
Other expenses	288	399
Impairment losses	656	267
Depreciation and amortization	277	344
Total operating expenses	$ 2,062	$ 1,894
Loss from operations	$ (1,896)	$ (1,651)
Interest expense	-	(4)
Loss before provision for income taxes	$ (1,896)	$ (1,655)
PROMETA patients treated		
U.S. licensees	5	15
Managed treatment center	3	5
	8	20
Average revenue per patient treated (a)		
U.S. licensees	$ 2,730	$ 4,060
Managed treatment center	4,333	6,700
Overall average	3,331	4,720

(a) The average revenue per patient treated excludes administrative fees and other non-PROMETA patient revenues.

Year Ended December 31, 2012 Compared With Year Ended December 31, 2011

Revenues

Revenue decreased by $77,000 for the year ended December 31, 2012 compared with the same period in 2011, primarily due to reductions in revenues related to the PROMETA treatment program caused by our continued focus on managed care opportunities in our healthcare services segment. We reduced personnel in our licensing operations, decreased promotional expenses, and curtailed our managed treatment center operations. These actions resulted in a decline in licensed sites contributing to revenue and in the number of patients treated. The number of licensed sites that contributed to revenues in 2012 decreased from 6 to 3 and the number of patients treated with the PROMETA Treatment Program decreased by 60% in 2012 compared with 2011. The change in average revenue per patient treated at US licensed sites and the managed treatment center was immaterial between 2012 and 2011**.**

Cost of License and Management Services

Cost of license and management services consists of royalties we pay for the use of the PROMETA Treatment Program, and costs incurred by our consolidated managed treatment center for direct labor costs for physicians and nursing staff, continuing care expense, medical supplies and treatment program medicine costs. The costs of license and management services remained consistent between 2012 and 2011.

General and Administrative Expenses

General and administrative expense amounted to $875,000 million for the year ended December 31, 2012, compared with $1.1 million for the same period in 2011. The decrease was due to reductions in all expense categories, and primarily due to salaries and benefits, rent, and outside services, resulting from the continued streamlining of operations to focus on managed care opportunities in our healthcare services segment.

Impairment Losses

For the period ended December 31, 2012, we determined that the carrying value of certain intangible assets was not recoverable and exceeded the fair value based upon an eight-year revenue projection and other assumptions. We recorded impairment charges totaling $656,000 related to intellectual property related to the PROMETA Treatment Program that is currently non-revenue generating. There were $267,000 in impairment charges related to intellectual property recorded for the year ended December 31, 2011.

At December 31, 2012 and 2011, respectively, there were no impairment charges related to property, plant, and equipment.

Interest Expense

Interest expense for the year ended December 31, 2012 and 2011, respectively was immaterial.

Liquidity and Capital Resources

Liquidity and Going Concern

As of March 28, 2013, we had a balance of approximately $1.6 million cash on hand. We had working capital deficit of approximately $376,000 at December 31, 2012 and have continued to deplete our cash position subsequent to December 31, 2012. We have incurred significant net losses and negative operating cash flows since our inception. We could continue to incur negative cash flows and net losses for the next twelve months. Our current cash burn rate is approximately $450,000 per month, excluding non-current accrued liability payments. We expect our current cash resources to cover expenses into July 2013, however delays in cash collections, revenue, or unforeseen expenditures could impact this estimate. We are in need to obtain additional capital and while we are currently in discussions with our existing shareholders regarding additional financing there is no assurance that additional capital can be raised in an amount which is sufficient for us or on terms favorable to our stockholders, if at all. If we do not obtain additional capital, there is a significant doubt as to whether we can continue to operate as a going concern and we will need to curtail or cease operations or seek bankruptcy relief. If we discontinue operations, we may not have sufficient funds to pay any amounts to stockholders.

In April 2012, we entered into securities purchase agreements with several investors, including Crede CG II, Ltd. ("Crede"), an affiliate of Terren S. Peizer, our Chairman and Chief Executive Officer, and David Smith, one of our affiliates, relating to the sale and issuance of an aggregate of 21,440,050 shares of common stock, and warrants to purchase an aggregate of 21,440,050 shares of common stock at an exercise price of $0.16 per share, for an aggregate gross proceeds of approximately $3,430,000.

In May 2012, we entered into a securities purchase agreement with an accredited investor on the same terms of the securities purchase agreements disclosed above, relating to the sale and issuance of 250,000 shares of common stock and warrants to purchase an aggregate of 250,000 shares of common stock, at an exercise price of $0.16 per share, for gross proceeds of $40,000.

In September 2012, we entered into securities purchase agreements with several investors, including Crede and David Smith, relating to the sale and issuance of an aggregate of 17,190,000 shares of common stock, and warrants to purchase an aggregate of 17,190,000 shares of common stock, at an exercise price of $0.10 per share, for an aggregate gross proceeds of approximately $1.7 million.

In December 2012, we entered into securities purchase agreements with several investors, including Crede and David Smith, relating to the sale and issuance of an aggregate of 47,121,432 shares of common stock, and warrants to purchase an aggregate of 47,121,432 shares of common stock, at an exercise price of $0.07 per share, for an aggregate gross proceeds of approximately $3.3 million.

We have a related party receivable from Xoftek, Inc., an affiliate of Terren S. Peizer, our Chairman and Chief Executive Officer, in the amount of $173,000 at December 31, 2012, which represents unpaid monthly rent related to a January 1, 2011 sublease agreement.

Our ability to fund our ongoing operations and continue as a going concern is dependent on signing and generating fees from existing and new contracts for our Catasys managed care programs and the success of management's plans to increase revenue and continue to control expenses. We are operating programs in Kansas, Massachusetts, Oklahoma and Louisiana. In March 2013, we signed an agreement with a national health plan to provide services to their members in New Jersey, which we expect to commence enrollment in the second quarter of 2013. We have begun to generate fees from the launched programs, increased fees in 2012 compared to the prior year both in aggregate and on a quarterly basis, and expect to increase enrollment and fees throughout 2013. However, there can be no assurance that we will generate such fees. In addition, we continue to seek ways to streamline our operating expenses.

Over the last two years, management took actions that have resulted in reduced annual operating expenses. These reductions have been offset by increased expenditures related to contract implementations. We anticipate increasing the number of personnel and incurring additional operating costs throughout 2013 to service our contracts as they become operational. We have continued to focus on promoting our On*Trak* program.

In addition, we and our Chief Executive Officer are party to a litigation in which the plaintiffs assert causes of action for conversion, a request for an order to set aside fraudulent conveyance and breach of contract. While we believe the plaintiffs' claims are without merit and we intend to continue to vigorously defend the case, there can be no assurance that the litigation will be resolved in our favor. If this case is decided against us or our Chief Executive Officer, it may cause us to pay substantial damages, and other related fees. Regardless of whether this litigation is resolved in our favor, any lawsuit to which we are a party will likely be expensive and time consuming to defend or resolve. Costs of defense and any damages resulting from litigation, a ruling against us or a settlement of the litigation could have a significant negative impact on our liquidity, including our cash flows.

Cash Flows

We used $6.2 million of cash for continuing operating activities during the year ended December 31, 2012 compared with $6.8 million in 2011. Significant non-cash adjustments to operating activities for the year ended December 31, 2012, included amortization of debt discount and issuance costs of $4.8 million, share-based compensation expense of $2.2 million, offset by fair value adjustment on warrant liability of $2.7 million.

Capital expenditures for the year ended 2012 were not material. Our future capital expenditure requirements will depend upon many factors, including progress with our marketing efforts, the time and costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other proprietary rights, the necessity of, and time and costs involved in obtaining, regulatory approvals, competing technological and market developments, and our ability to establish collaborative arrangements, effective commercialization, marketing activities and other arrangements.

Our net cash provided by financing activities was $8.5 million year ended December 31, 2012, compared with net cash provided by financing activities of $3.0 million for the year ended December 31, 2011. Cash provided by financing activities for the twelve months ended December 31, 2012 consisted of the net proceeds from the securities offerings in April 2012, May 2012, September 2012, and December 2012, leaving a balance of $3.2 million in cash and cash equivalents at December 31, 2012.

As discussed above, we currently expend cash at a rate of approximately $450,000 per month, excluding non-current accrued liability payments. We also anticipate cash inflow during 2013 as we continue to service our executed contracts. We expect our current cash resources to cover expenses into July 2013, however delays in cash collections, revenue, or unforeseen expenditures could impact this estimate. We are in need to obtain additional capital and while we are currently in discussions with our existing shareholders regarding additional financing, there is no assurance that additional capital can be raised in an amount which is sufficient for us or on terms favorable to our stockholders, if at all. If we do not obtain additional capital, there is a significant doubt as to whether we can continue to operate as a going concern and we will need to curtail or cease operations or seek bankruptcy relief. If we discontinue operations, we may not have sufficient funds to pay any amounts to stockholders.

Bridge Financing

In August 2011, we entered into a securities purchase agreement with Crede, pursuant to which we received $650,000 and issued the August 2011 Bridge Note and the August 2011 Bridge Warrant. As described below, the August 2011 Bridge Note was subsequently amended and on December 27, 2011, converted into common stock.

In October 2011, we entered into a securities purchase agreement with David Smith, pursuant to which we received $680,000 and issued the October 2011 Bridge Note and the October 2011 Bridge Warrant. As described below, the October 2011 Bridge Note was subsequently amended and on December 27, 2011, converted into common stock.

On November 2, 2011, we entered into the November 2, 2011 Amended and Restated Bridge Notes pursuant to which we amended and restated the secured convertible notes with each of Crede and David Smith to increase the outstanding principal amounts under the August 2011 Bridge Note and the October 2011 Bridge Note by $160,000 and $100,000, respectively. In connection therewith, we issued the November 2, 2011 Bridge Warrants. As described below, the November 2, 2011 Amended and Restated Bridge Notes were subsequently amended and on December 27, 2011, converted into common stock.

On November 15, 2011, we entered into the November 15, 2011 Amended and Restated Bridge Notes pursuant to which we further amended and restated the secured convertible notes with Crede and David Smith to increase the outstanding principal amount under the November 2, 2011 Amended and Restated Bridge Notes by $160,000 and $100,000, respectively. In connection therewith, we issued the November 15, 2011 Bridge Warrants. As described below, the November 15, 2011 Amended and Restated Bridge Notes were subsequently amended and on December 27, 2011, converted into common stock.

On November 30, 2011, we entered into the November 30, 2011 Amended and Restated Bridge Note pursuant to which we further amended and restated the secured convertible note with Crede to increase the outstanding principal amount under the November 15, 2011 Amended and Restated secured convertible note by $235,000. In connection therewith, we issued the November 30, 2011 Bridge Warrant. As described below, the November 30, Amended and Restated Bridge Note was subsequently amended and on December 27, 2011, converted into common stock.

On December 8, 2011, we entered into the Smith Third Amended and Restated Bridge Note and the Crede Fourth Amended and Restated Bridge Note to increase the outstanding principal amount under the outstanding notes to each of Crede and David Smith to $45,000 and $155,000, respectively. In connection therewith, we issued the December 2011 Bridge Warrants. As described below, the Smith Third Amended and Restated Bridge Note and the Crede Fourth Amended and Restated Bridge Note converted into common stock on December 27, 2011.

As described above, in connection with the December 2011 offering, Crede and David Smith agreed to convert their outstanding convertible notes in the aggregate principal amount of $2,285,000, plus accrued interest, into common stock. As a result, Crede and David Smith received 4,946,495 and 4,069,435 shares, respectively. In connection with the December 2011 offering, the previous warrants issued to each of Crede and David Smith became exercisable for an aggregate of 8,333,333 and 6,900,000, respectively, since the December 2011 offering qualified as a Qualified Financing.

Off-Balance Sheet Arrangements

As of December 31, 2012, we had no off-balance sheet arrangements.

Critical Accounting Estimates

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). GAAP requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. We base our estimates on experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that may not be readily apparent from other sources. On an on-going basis, we evaluate the appropriateness of our estimates and we maintain a thorough process to review the application of our accounting policies. Our actual results may differ from these estimates.

We consider our critical accounting estimates to be those that (1) involve significant judgments and uncertainties, (2) require estimates that are more difficult for management to determine, and (3) may produce materially different results when using different assumptions. We have discussed these critical accounting estimates, the basis for their underlying assumptions and estimates and the nature of our related disclosures herein with the audit committee of our Board of Directors. We believe our accounting policies related to share-based compensation expense, the impairment assessments for intangible assets, and estimation of the fair value of warrant liabilities involve our most significant judgments and estimates that are material to our consolidated financial statements. They are discussed further below.

Share-based compensation expense

We account for the issuance of stock, stock options and warrants for services from non-employees based on an estimate of the fair value of options and warrants issued using the Black-Scholes pricing model. This model's calculations include the exercise price, the market price of shares on grant date, weighted average assumptions for risk-free interest rates, expected life of the option or warrant, expected volatility of our stock and expected dividend yield.

The amounts recorded in the financial statements for share-based compensation expense could vary significantly if we were to use different assumptions. For example, the assumptions we have made for the expected volatility of our stock price have been based on the historical volatility of our stock, measured over a period generally commensurate with the expected term. If we were to use a different volatility than the actual volatility of our stock price, there may be a significant variance in the amounts of share-based expense from the amounts reported. Based on the 2012 assumptions used for the Black-Scholes pricing model, a 50% increase in stock price volatility would have increased the fair values of options by approximately 25%. The weighted average expected option term for 2012 and 2011 reflects the application of the simplified method set out in SEC Staff Accounting Bulletin No. 107, which defines the life as the average of the contractual term of the options and the weighted average vesting period for all option tranches.

From time to time, we retain terminated employees as part-time consultants upon their resignation from the Company. Because the employees continue to provide services to us, their options continue to vest in accordance with the original terms. Due to the change in classification of the option awards, the options are considered modified at the date of termination. The modifications are treated as exchanges of the original awards in return for the issuance of new awards. At the date of termination, the unvested options are no longer accounted for as employee awards and are accounted for as new non-employee awards. The accounting for the portion of the total grants that have already vested and have been previously expensed as equity awards is not changed. There were no employees moved to consulting status in 2012.

Impairment of Intangible Assets

We have capitalized significant costs for acquiring patents and other intellectual property directly related to our products and services. We review our intangible assets for impairment whenever events or circumstances indicate that the carrying amount of these assets may not be recoverable. In reviewing for impairment, we compare the carrying value of such assets to the estimated undiscounted future cash flows expected from the use of the assets and/or their eventual disposition. If the estimated undiscounted future cash flows are less than their carrying amount, we record an impairment loss to recognize a loss for the difference between the assets' fair value and their carrying value. Since we have not recognized significant revenue to date, our estimates of future revenue may not be realized and the net realizable value of our capitalized costs of intellectual property or other intangible assets may become impaired.

During the twelve months ended December 31, 2012, we did not acquire any new intangible assets and as of December 31, 2012, all of our intangible assets consisted of intellectual property, which is not subject to renewal or extension. At December 31, 2011, we determined that the carrying value of certain intangible assets was not recoverable and exceeded the fair value based on the five-year revenue projections and other assumptions. We recorded impairment charges totaling $267,000 related to intellectual property for additional indications for the use of the PROMETA Treatment Program that is currently non-revenue generating. For the year ended December 31, 2012, we determined that the remaining lives of certain intangibles exceeded their economic useful lives and therefore accelerated amortization and recorded an impairment charge of $34,000. We also revisited our intentions to continue doing business internationally and concluded that we will not be pursing any international opportunities at this time. As such, we wrote off all intangibles related to our international Cayman entity and recorded an impairment loss of $155,000. In addition, we concluded that the carrying value of certain intellectual property did not exceed their fair market value and recorded an additional impairment charge of $467,000. As such, for the year ended December 31, 2012, we recorded total impairment charges of $656,000, compared to $267,000 for the same period in 2011.

Warrant Liabilities

We issued warrants to purchase common stock in November 2007, July 2010, October 2010, November 2010, December 2011, February 2012, April 2012, May 2012, September 2012, and December 2012, and when we amended and restated the Highbridge senior secured note in July 2008. The warrants are being accounted for as liabilities in accordance with Financial Accounting Standards Board ("FASB") accounting rules, due to provisions in some warrants that protect the holders from declines in our stock price and a requirement to deliver registered shares upon exercise of the warrants, which is considered outside our control. The warrants are marked-to-market each reporting period, using the Black-Scholes pricing model, until they are completely settled or expire.

The change in fair value of the warrants amounted to a net gain of $2.7 million for the year ended December 31, 2012, compared with a net gain of $7.2 million for the same period in 2011.

We will continue to mark the warrants to market value each quarter-end until they are completely settled.

Recently Issued or Newly Adopted Accounting Pronouncements

In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement" ("ASU 2011-04"), which amended ASC 820, "Fair Value Measurements" ("ASC 820"), providing a consistent definition and measurement of fair value, as well as similar disclosure requirements between GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles, clarifies the application of existing fair value measurement and expands the disclosure requirements. ASU 2011-04 became effective for us beginning January 1, 2012. The adoption of ASU 2011-04 did not have a material effect on our consolidated financial statements or disclosures.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income" ("ASU 2011-05"). ASU 2011-05 requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. ASU 2011-05 became effective for us beginning January 1, 2012. The adoption of ASU 2011-05 did not have a material effect on our consolidated financial statements or disclosures.

In September 2011, the FASB issued ASU 2011-08, "Testing Goodwill for Impairment" ("ASU 2011-08"), which amends the guidance in ASC 350-20, "Intangibles—Goodwill and Other – Goodwill". ASU 2011-08 provides entities with the option of performing a qualitative assessment before calculating the fair value of the reporting unit when testing goodwill for impairment. If the fair value of the reporting unit is determined, based on qualitative factors, to be more likely than not less than the carrying amount of the reporting unit, the entities are required to perform a two-step goodwill impairment test. ASU 2011-08 became effective for us beginning January 1, 2012. The adoption of ASU 2011-08 did not have a material effect on our consolidated financial statements or disclosures.

Effects of Inflation

Our most liquid assets are cash and cash equivalents. Because of their liquidity, these assets are not directly affected by inflation. Because we intend to retain and continue to use our equipment, furniture and fixtures and leasehold improvements, we believe that the incremental inflation related to replacement costs of such items will not materially affect our operations. However, the rate of inflation affects our expenses, such as those for employee compensation and contract services, which could increase our level of expenses and the rate at which we use our resources.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements and related financial information required to be filed hereunder are indexed under Item 15 of this report and are incorporated herein by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We have evaluated, with the participation of our principal executive officer and our principal financial officer, the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation our principal executive officer and our principal financial officer have concluded that, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms, and is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control

There were no changes in our internal controls over financial reporting during the fourth quarter of our year ended December 31, 2012, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) and for assessing the effectiveness of our internal control over financial reporting. Our internal control system is designed to provide reasonable assurance to our management and Board of Directors regarding the preparation and fair presentation of published financial statements in accordance with United States generally accepted accounting principles (GAAP).

Our internal control over financial reporting is supported by written policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP and that our receipts and expenditures are being made only in accordance with authorizations of our management and our Board of Directors; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2012, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control-Integrated Framework. Management's assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of our internal control over financial reporting. Based upon this assessment, our management believes that, as of December 31, 2012, our internal control over financial reporting was effective based on those criteria.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions and that the degree of compliance with the policies or procedures may deteriorate.

ITEM 9B. OTHER INFORMATION

On March 27, 2013, we entered into a new employment agreement with Ms. Etzel. Effective January 1, 2013, the employment agreement has a term of two (2) years, after which Ms. Etzel will be employed on an at-will basis. Under the terms of her employment agreement, Ms. Etzel is entitled to an annual base salary of $150,000 and she may be eligible to an annual bonus, to be determined solely by the Company, contingent on achieving certain individual goals and milestones and the overall performance and profitability of the Company.

The employment agreement may be terminated by the Company at any time, with or without Good Cause (as such term is defined in the employment agreement). If the Company terminates the employment with Good Cause or if Ms. Etzel resigns, the Company will pay Ms. Etzel her then applicable salary prorated through the date of termination, together with any benefits accrued through the date of termination and all of her unvested option will terminate. If the Company terminates the employment without Good Cause, Ms. Etzel will be entitled to her then applicable salary prorated through the date of termination, together with any benefits accrued through the date of termination, all of her unvested stock options will vest immediately and the Company will continue to pay Ms. Etzel her base salary for a period of three (3) months after the termination date. In addition, Ms. Etzel will be entitled to COBRA continuation coverage for a period of three (3) months from the termination date.

Ms. Etzel's employment agreement also includes covenants to keep certain information confidential and not to solicit employees and customers for a period of two (2) years after Ms. Etzel is no longer employed by the Company.

Under the terms of this agreement, Ms. Etzel is also entitled to certain fringe benefits such as medical, dental, vision, life and disability insurance and 401(k) benefits.

The foregoing description of the employment agreement is not complete and is subject to, and qualified in its entirety by, the full text of the employment agreement with Ms. Etzel, a copy of which is filed as Exhibit 10.41 to this Annual Report on Form 10-K.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The following table lists our executive officers and directors serving at December 31, 2012. Our executive officers are elected annually by our Board of Directors and serve at the discretion of the Board of Directors. Each current director is serving a term that will expire at the Company's next annual meeting. There are no family relationships among any of our directors or executive officers.

Name	Age	Position	Officer/ Director Since
Terren S. Peizer	53	Director, Chairman of the Board and Chief Executive Officer	2003
Richard A. Anderson	43	Director, President and Chief Operating Officer	2003
Susan E.Etzel	39	Chief Financial Officer	2011
Andrea Grubb Barthwell, M.D.	58	Director, Chair of the Compensation Committee, Member of the Audit Committee, and Member of the Nominations and Governance Committee	2005
Kelly J. McCrann	57	Director, Chair of the Nominations and Governance Committee, Member of the Audit Committee, Member of the Compensation Committee	2010
Jay A. Wolf	40	Lead Director, Chair of the Audit Committee, Member of the Nominations and Governance Committee, Member of the Compensation Committee	2008

Terren S. Peizer is the founder of our Company and has served as our Chief Executive Officer and Chairman of our Board of Directors since our inception in February 2003. Since September 2009, he has served as the Managing Director of Crede Capital Group, LLC, an industry leader in investing in micro and small capitalization equities. He has served on the board of Xcorporeal, Inc. since August 2007 and was executive chairman until October 2008. Mr. Peizer has been the largest beneficial stockholder and has held various senior executive positions with several technology and biotech companies. He has assisted companies by assembling management teams, boards of directors and scientific advisory boards, formulating business and financial strategies, and investor relations. Mr. Peizer has a background in venture capital, investing, mergers and acquisitions, corporate finance, and previously held senior executive positions with the investment banking firms Goldman Sachs, First Boston and Drexel Burnham Lambert. He received his B.S.E. in Finance from The Wharton School of Finance and Commerce.

Richard A. Anderson has served as a director since July 2003 and as a member of our management team since April 2005. He has been our President and Chief Operating Officer since July 2008. He has twenty years of experience in business development, strategic planning, operations, and financial management, more than a decade of that in the healthcare field. He was the chief financial officer of Clearant, Inc., a bio-services company, from November 1999 until March 2005, and served as a director from November 1999 to March 2006. Mr. Anderson was previously a director and founding member of PriceWaterhouseCoopers LLP’s, Los Angeles office transaction support group, where he was involved in operational and financial due diligence, valuations and structuring for high technology companies. He received a B.A. in Business Economics from University of California, Santa Barbara.

Susan Etzel, has served as the Company's Chief Financial Officer since July 2011 and prior to that was the Company's Corporate Controller since February 2011. Prior to joining the Company, she acted as the Controller of Clearant, Inc., a developer of a universal pathogen inactivation technology, from July 2005 until February 2011. She received a Bachelor of Business Economics with an emphasis in Accounting from the University of California, Santa Barbara. She is also a Certified Public Accountant.

Andrea Grubb Barthwell, M.D., F.A.S.A.M., has served as a director since 2005. Since 2005, Dr. Barthwell has been the founder and Chief Executive Officer of the global health care and policy-consulting firm EMGlobal LLC and Director at Two Dreams Outer Banks Treatment Center. President George W. Bush nominated Dr. Barthwell in December 2001 to serve as Deputy Director for Demand Reduction in the Office of National Drug Control Policy (ONDCP). The United States Senate confirmed her nomination on January 28, 2002. As a member of the President's sub-cabinet, Dr. Barthwell was a principal advisor in the Executive Office of the President (EOP) on policies aimed at reducing the demand for illicit drugs. Following post-graduate training at the University of Chicago and Northwestern University Medical Center, she began her practice in the Chicago area. Dr. Barthwell served as President of the Encounter Medical Group (EMG, an affiliate of EMGlobal), was a founding member of the Chicago Area AIDS Task Force, hosted a weekly local cable show on AIDS, and is a past president of the American Society of Addiction Medicine. She is also a member of Treatment Partners LLC. Dr. Barthwell received the Betty Ford Award, given by the Association for Medical Education and Research in Substance Abuse and has been named by her peers as one of the "Best Doctors in America" in addiction medicine. Dr. Barthwell has an extensive knowledge of the behavioral healthcare industry and of federal policy and funding priorities. Dr. Barthwell received a Bachelor of Arts degree in Psychology from Wesleyan University, where she serves on the Board of Trustees, and a Doctor of Medicine from the University of Michigan Medical School.

Kelly J. McCrann has served as a director of the Company since December 9, 2010. Mr. McCrann has over 30 years of experience managing and operating healthcare companies. Since March 2012, Mr. McCrann has served as the Chief Executive Officer of AdvoServ., a healthcare services company. From July 2011 to February 2012, Mr. McCrann served as the CEO of Crescent Healthcare, Inc., a provider of intravenous immune globulin therapy to patients with chronic disorders. Mr. McCrann served as Chairman and Chief Executive Officer of Xcorporeal, Inc., a medical device company from October 2008 to March 2010. Mr. McCrann was responsible for product development, strategic partnerships and facilitating the sale of the company. From June 2007 through September 2008, Mr. McCrann served as President of Dental Operations of HealthMarkets Inc. Previously, he served as Senior Vice President of DaVita Inc., from March 2006 to May 2007, where he was responsible for all home based renal replacement therapies for the United States' second largest kidney dialysis provider. Prior to that, Mr. McCrann was the Chief Executive Officer and President of PacifiCare Dental and Vision, Inc and has held executive positions at Professional Dental Associates, Inc., Coram Healthcare Corporation, HMSS, Inc. and American Medical International and began his career as a consultant with McKinsey & Company. Mr. McCrann currently serves on the board of directors of Loma Linda University Medical Center and Sound Surgical Technologies, Inc. He is a former director of Fempartners, Inc., Nepho Plus, Inc., OrthoSynetics, Inc. and Xcorporeal, Inc. Mr. McCrann is a graduate of University of California, Los Angeles and the Harvard Business School.

Jay A. Wolf, Mr. Wolf is currently a Managing Member of Juniper Capital Partners, LLC, a Merchant Bank focused on investing in distressed assets. From October 2009 until December of 2010, Mr. Wolf served as the principal of Wolf Capital LP, an investment advisory firm focused on small cap public companies. From November 2003 until September 2009, Mr. Wolf was a partner at Trinad Capital LLC, an activist hedge fund focused on micro-cap public companies. During his work at Trinad, Mr. Wolf assisted distressed and early stage public companies through active board participation, the assembly of management teams and business and financial strategies. Prior to his work at Trinad, Mr. Wolf served as executive vice president of Corporate Development for Wolf Group Integrated Communications Ltd. Prior to that, Mr. Wolf worked at Canadian Corporate Funding, Ltd., a Toronto-based merchant bank as an analyst in the firms senior debt department and subsequently for Trillium Growth Capital, the firms venture capital fund. Mr. Wolf is our lead independent director and also serves as the Chairman of our Audit Committee. Mr. Wolf is the Executive Chairman of IndiePub Entertainment, Inc. (IPUB). He is a former director of Asianada, Inc., ProLink Holdings Corp., Mandalay Media, Inc., Atrinsic, Inc., Shells Seafood Restaurants, Inc., Optio Software, Inc., Xcorporeal Operations, Inc., Zane Acquisition I, Inc., Zane Acquisition II, Inc., Starvox Communications, Inc. and Noble Medical Technologies, Inc. Mr. Wolf is also a member of the board of governors of Cedars-Sinai Hospital. Mr. Wolf was Chief Operating Officer and Chief Financial Officer of Starvox Communications, Inc. from March 2005 to March 2007.On March 26, 2008, StarVox Communications, Inc. filed a voluntary petition for liquidation under Chapter 7 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Northern District of California, San Jose. Shells Seafood Restaurants, Inc., a company for which Mr. Wolf formerly served as a director, filed a voluntary petition for reorganization under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Middle District of Florida, Tampa Division, on September 2, 2008. Mr. Wolf received his B.A from Dalhousie University. Mr. Wolf's broad range of investment and operations experience, which includes senior and subordinated debt lending, private equity and venture capital investments, mergers and acquisitions advisory work and public equity investments, equip him with the qualifications and skills to serve on our board of directors.

Involvement in certain legal proceedings

Other than as set forth in Mr. Wolf's biography above or in "Item 3 - Legal Proceedings," none of our directors or executive officers has during the past ten years:

- been convicted in a criminal proceeding or been subject to a pending criminal proceeding (excluding traffic violations and other minor offences);

- had any bankruptcy petition filed by or against the business or property of the person, or of any partnership, corporation or business association of which he was a general partner or executive officer, either at the time of the bankruptcy filing or within two years prior to that time;

- been subject to any order, judgment, or decree, not subsequently reversed, suspended or vacated, of any court of competent jurisdiction or federal or state authority, permanently or temporarily enjoining, barring, suspending or otherwise limiting, his involvement in any type of business, securities, futures, commodities, investment, banking, savings and loan, or insurance activities, or to be associated with persons engaged in any such activity;

- been found by a court of competent jurisdiction in a civil action or by the Securities and Exchange Commission ("SEC") or the Commodity Futures Trading Commission to have violated a federal or state securities or commodities law, and the judgment has not been reversed, suspended, or vacated;

- been the subject of, or a party to, any federal or state judicial or administrative order, judgment, decree, or finding, not subsequently reversed, suspended or vacated (not including any settlement of a civil proceeding among private litigants), relating to an alleged violation of any federal or state securities or commodities law or regulation, any law or regulation respecting financial institutions or insurance companies including, but not limited to, a temporary or permanent injunction, order of disgorgement or restitution, civil money penalty or temporary or permanent cease-and-desist order, or removal or prohibition order, or any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity; or

- been the subject of, or a party to, any sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act (15 U.S.C. 78c(a)(26))), any registered entity (as defined in Section 1(a)(29) of the Commodity Exchange Act (7 U.S.C. 1(a)(29))), or any equivalent exchange, association, entity or organization that has disciplinary authority over its members or persons associated with a member.

Section 16(a) beneficial ownership reporting compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended (Exchange Act), requires our directors and executive officers, and persons who own more than 10% of our outstanding common stock, to file with the SEC, initial reports of ownership and reports of changes in ownership of our equity securities. Such persons are required by SEC regulations to furnish us with copies of all such reports they file.

To our knowledge, based solely on a review of the copies of such reports furnished to us and written or oral representations that no other reports were required for such persons, all Section 16(a) filing requirements applicable to our officers, directors and greater than 10% beneficial owners have been complied except for the following: one Form 4 report was not timely filed by Terren Peizer as to one transaction, and one Form 4 report was not timely filed by David Smith as to one transaction.

Code of Ethics

Our Board of Directors has adopted a code of ethics applicable to our chief executive officer, chief financial officer and persons performing similar functions. Our code of ethics is listed hereto as Exhibit 14.1 and is accessible on our website at http://www.catasyshealth.com. Disclosure regarding any amendments to, or waivers from, provisions of the code of ethics will be included in a Current Report on Form 8-K within four business days following the date of the amendment waiver.

Independence of the Board of Directors

Our common stock is traded on the OTC Bulletin Board. The Board of Directors has determined that a majority of the members of the Board of Directors qualify as "independent," as defined by the listing standards of the NASDAQ. Consistent with these considerations, after review of all relevant transactions and relationships between each director, or any of his family members, and the Company, its senior management and its independent auditors, the Board has determined further that Mr. Wolf, Mr. McCrann, and Dr. Barthwell are independent under the listing standards of NASDAQ. In making this determination, the Board of Directors considered that there were no new transactions or relationships between its current independent directors and the Company, its senior management and its independent auditors since last making this determination.

Committees of the Board of Directors

Audit committee

The audit committee consists of three directors, Mr. Wolf, Dr. Barthwell and Mr. McCrann. The Board of Directors has determined that each of the members of the audit committee are independent as defined by the NASDAQ rules, meet the applicable requirements for audit committee members, including Rule 10A-3(b) under the Exchange Act, and Mr. Wolf qualifies as audit committee financial experts as defined by Item 401(h)(2) of Regulation S-K. The duties and responsibilities of the audit committee include (i) selecting, evaluating and, if appropriate, replacing our independent registered accounting firm, (ii) reviewing the plan and scope of audits, (iii) reviewing our significant accounting policies, any significant deficiencies in the design or operation of internal controls or material weakness therein and any significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation and (iv) overseeing related auditing matters.

Nominations and governance committee

The nominations and governance committee consists of up to three directors who are independent as defined by the NASDAQ rules. The committee consists of Mr. McCrann, Mr. Wolf, and Dr. Barthwell, and did not hold any meetings during 2012. The committee nominates new directors and periodically oversees corporate governance matters.

The charter of the nominations and governance committee provides that the committee will consider board candidates recommended for consideration by our stockholders, provided the stockholders provide information regarding candidates as required by the charter or reasonably requested by us within the timeframe proscribed in Rule 14a-8 of Regulation 14A under the Exchange Act, and other applicable rules and regulations. Recommendation materials are required to be sent to the nominations and governance committee c/o Catasys, Inc., 11150 Santa Monica Blvd., Suite 1500, Los Angeles, California 90025. There are no specific minimum qualifications required to be met by a director nominee recommended for a position on the board of directors, nor are there any specific qualities or skills that are necessary for one or more of our board of directors to possess, other than as are necessary to meet any requirements under the rules and regulations applicable to us. The nominations and governance committee considers a potential candidate's experience, areas of expertise, and other factors relative to the overall composition of the board of directors.

The nominations and governance committee considers director candidates that are suggested by members of the board of directors, as well as management and stockholders. Although it has not previously done so, the committee may also retain a third-party executive search firm to identify candidates. The process for identifying and evaluating nominees for director, including nominees recommended by stockholders, involves reviewing potentially eligible candidates, conducting background and reference checks, interviews with the candidate and others (as schedules permit), meeting to consider and approve the candidate and, as appropriate, preparing and presenting to the full board of directors an analysis with respect to particular recommended candidates. The nominations and governance committee endeavors to identify director nominees who have the highest personal and professional integrity, have demonstrated exceptional ability and judgment, and, together with other director nominees and members, are expected to serve the long term interest of our stockholders and contribute to our overall corporate goals.

Compensation committee

The compensation committee consists of three directors who are independent as defined by the NASDAQ rules. The committee consists of Dr. Andrea Grubb Barthwell (chairman) and Mr. Jay Wolf, and did not hold any meetings during 2012. The compensation committee reviews and recommends to the board of directors for approval the compensation of our executive officers.

ITEM 11. EXECUTIVE COMPENSATION

Summary Compensation Table

The following table sets forth the total compensation paid during the last two fiscal years ended December 2011 and 2012 to (1) our Chief Executive Officer, and (2) our two next most highly compensated executive officers who earned more than $100,000 during the fiscal year ended December 31, 2012 and were serving as executive officers as of such date.

Name and Principal Position	Year	Salary ($) (1)	Option Awards (2)	All Other Compensation ($) (3)	Total ($)
Terren S. Peizer,	2012	450,000	-	17,614	467,614
Chairman & Chief	2011	450,000	-	12,348	462,348
Executive Officer					
Richard A. Anderson,	2012	365,269	-	31,338	396,607
President and	2011	355,560	-	26,816	382,376
Chief Operating Officer					
Etzel, Susan	2012	150,000	-	-	150,000
Chief Financial Officer	2011	115,000	12,027	-	127,027

(1) Mr. Peizer, Mr. Anderson, and Ms. Etzel deferred part of their salary for the 2012 and 2011 year.
(2) Ms. Etzel was granted 16,250 options during 2011 with a fair-value of $12,027. No equity awards were granted during the 2012 year.
(3) Includes group life insurance premiums, medical benefits, and parking for each officer.

Narrative Disclosures to Summary Compensation Table

Executive employment agreements

Chief Executive Officer

We entered into a five-year employment agreement with our Chairman and Chief Executive Officer, Terren S. Peizer, effective as of September 29, 2003, which automatically renewed for an additional five years upon completion of the initial term. Mr. Peizer currently receives an annual base salary of $450,000 in 2012 and 2011, with annual bonuses targeted at 100% of his base salary based on goals and milestones established and reevaluated on an annual basis by mutual agreement between Mr. Peizer and the Board of Directors. His base salary and bonus target will be adjusted each year to not be less than the median compensation of similarly positioned CEO's of similarly situated companies. Mr. Peizer receives executive benefits including group medical and dental insurance, term life insurance equal to 150% of his salary, accidental death and long-term disability insurance, grossed up for taxes. There were no options granted to Mr. Peizer during 2012 or 2011. All unvested options vest immediately in the event of a change in control, termination without good cause or resignation with good reason. In the event that Mr. Peizer is terminated without good cause or resigns with good reason prior to the end of the term, he will receive a lump sum equal to the remainder of his base salary and targeted bonus for the year of termination, plus three years of additional salary, bonuses and benefits. If any of the provisions above result in an excise tax, we will make an additional "gross up" payment to eliminate the impact of the tax on Mr. Peizer.

President and Chief Operating Officer

We entered into a four-year employment agreement with our President and Chief Operating Officer, Richard A. Anderson effective April 19, 2005, as amended on July 16, 2008. Mr. Anderson's agreement renewed for an additional four year term in 2010. Mr. Anderson currently receives an annual base salary of $365,269 in 2012 and $355,560 in 2011, with annual bonuses targeted at 50% of his base salary based on achieving certain milestones. Mr. Anderson's compensation will be adjusted each year by an amount not less than the Consumer Price Index. Mr. Anderson received executive benefits including group medical and dental insurance, term life insurance, accidental death and long-term disability insurance. There were no equity awards granted to Mr. Anderson in 2012 or 2011. All unvested options will vest immediately in the event of a change in control, termination without cause or resignation with good reason. In the event of termination without good cause or resignation with good reason prior to the end of the term, upon execution of a mutual general release, Mr. Anderson will receive a lump sum equal to one year of salary and bonus, and will receive continued medical benefits for one year unless he becomes eligible for coverage under another employer's plan. If he is terminated without cause or resigns with good reason within twelve months following a change in control, upon execution of a general release he will receive a lump sum equal to eighteen months salary, 150% of the targeted bonus, and will receive continued medical benefits for eighteen months unless he becomes eligible for coverage under another employer's plan.

Chief Financial Officer

Ms. Susan Etzel, our Chief Financial Officer, has been employed by the Company on an "at-will" basis since in July 2011 with an annual salary of $150,000. In May 2011, Ms. Etzel was granted options to purchase 16,250 shares of our common stock at an exercise price of $0.80 per share, the fair market value on the date of the grant, vesting monthly over three years with a one year cliff and monthly thereafter, effective from the date of the grant.

On March 27, 2013, we entered into a new employment agreement with Ms. Etzel. Effective January 1, 2013, the employment agreement has a term of two (2) years, after which Ms. Etzel will be employed on an at-will basis. Under the terms of her employment agreement, Ms. Etzel is entitled to an annual base salary of $150,000 and she may be eligible to an annual bonus, to be determined solely by the Company, contingent on achieving certain individual goals and milestones and the overall performance and profitability of the Company.

The employment agreement may be terminated by the Company at any time, with or without Good Cause (as such term is defined in the employment agreement). If the Company terminates the employment with Good Cause or if Ms. Etzel resigns, the Company will pay Ms. Etzel her then applicable salary prorated through the date of termination, together with any benefits accrued through the date of termination and all of her unvested option will terminate. If the Company terminates the employment without Good Cause, Ms. Etzel will be entitled to her then applicable salary prorated through the date of termination, together with any benefits accrued through the date of termination, all of her unvested stock options will vest immediately and the Company will continue to pay Ms. Etzel her base salary for a period of three (3) months after the termination date. In addition, Ms. Etzel will be entitled to COBRA continuation coverage for a period of three (3) months from the termination date.

Ms. Etzel's employment agreement also includes covenants to keep certain information confidential and not to solicit employees and customers for a period of two (2) years after Ms. Etzel is no longer employed by the Company.

Under the terms of this agreement, Ms. Etzel is also entitled to certain fringe benefits such as medical, dental, vision, life and disability insurance and 401(k) benefits.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

The following table sets forth all outstanding equity awards held by our named executive officers as of December 31, 2012.

Name	Number of Securities Underlying Unexercised Options (#) Exercisable (1)	Number of Securities Underlying Unexercised Options (#) Unexercisable	Option Exercise Price ($)	Option Expiration Date
Terren S. Peizer	25,000	-	$ 12.32	09/29/13
	11,500	-	12.32	02/07/18
	13,500	-	12.32	06/20/18
	23,975	-	19.36	10/27/19
	1,485,000	-	1.76	12/06/20
	1,558,975	-		
Richard A. Anderson	3,000	-	11.20	09/29/13
	6,375	-	11.20	04/28/15
	625	-	11.20	07/27/16
	7,325	-	11.20	02/07/18
	8,613	-	11.20	06/20/18
	12,450	-	17.60	10/27/19
	1,485,000	-	1.60	12/06/20
	1,523,388	-		
Susan Etzel	**8,574**	**7,676**	0.800	05/24/21

(1) Options granted in May 2011 have a one-year cliff, with one-third vesting on the first anniversary and the remainder over the next 24 months.

POTENTIAL PAYMENTS UPON TERMINATION OR CHANGE-IN-CONTROL

Potential payments upon termination

The following summarizes the payments that the named executive officers would have received if their employment had terminated on December 31, 2012.

If Mr. Peizer's employment had terminated due to disability, he would have received insurance and other fringe benefits for a period of one year thereafter, with a value equal to $16,000. If Mr. Peizer had been terminated without good cause or resigned for good reason, he would have received a lump sum payment of $2,717,000, based upon: (i) three years of additional salary at $450,000 per year; (ii) three years of additional bonus of $450,000 per year; and (iii) three years of fringe benefits, with a value equal to $48,000.

If Mr. Anderson had been or is terminated without good cause or resigned for good reason, he would have received a lump sum of $545,000 based upon one year's salary plus the full targeted bonus of 50% of base salary. In addition, medical benefits would continue for up to one year, with a value equal to $30,000.

Potential payments upon change in control

Upon a change in control, the unvested stock options of each of our named executive officers would have vested, with the values set forth above.

If Mr. Peizer had been terminated without good cause or resigned for good reason within twelve months following a change in control, he would have received a lump sum payment of $2,717,000, as described above, plus a tax gross up of $713,000.

If Mr. Anderson had been terminated without good cause or resigned for good reason within twelve months following a change in control, he would have received a lump sum of $818,000, based upon one-and-a-half year's salary plus one-and-a-half the full targeted bonus of 50% of base salary. In addition, medical benefits would continue for up to one-and-a-half years, with a value equal to $45,000.

DIRECTOR COMPENSATION

The following table provides information regarding compensation that was earned or paid to the individuals who served as non-employee directors during the year ended December 31, 2012. Except as set forth in the table, during 2012, directors did not earn nor receive cash compensation or compensation in the form of stock awards, option awards or any other form.

Name	Option awards ($) (1)	Total
Andrea Barthwell, MD	90,947	90,947
Jay Wolf	99,190	99,190
Kelly McCran	121,122	121,122

Notes to director compensation table:

(1) Amounts reflect the compensation expense recognized in the Company's financial statements in 2012 for non-employee director stock options granted in 2012 and in previous years, in accordance with FASB accounting rules. As such, these amounts do not correspond to the compensation actually realized by each director for the period. See notes to consolidated financial statements in this report for further information on the assumptions used to value stock options granted to non-employee directors.

Outstanding equity awards by non-employee directors as of December 31, 2012, were as follows:

	Options outstanding	Aggregate grant date fair market value options outstanding
Andrea Grubb Barthwell, MD	282,500	$ 953,350
Jay Wolf	282,500	619,071
Kelly McCrann	270,000	304,897
	835,000	$ 1,877,318

There were a total of 835,000 stock options granted to non-employee directors outstanding at December 31, 2012, with an aggregate grant date fair value of $1,877,318, the last of which will vest in December 2013. There were no options granted during 2012 and 2011.

EQUITY COMPENSATION PLAN INFORMATION

The following table provides certain aggregate information with respect to all of the Company's equity compensation plans in effect as of December 31, 2012.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and right	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders (1)	**117,152,583**	**$ 0.30**	**12,595,477**
Equity compensation plans not approved by security holders	**-**		**-**
Total	**117,152,583**	**$ 0.30**	**12,595,477**

1) These plans consist of 5,082,158 outstanding options and 112,070,425 outstanding warrants.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth certain information with respect to the beneficial ownership of our common stock as of March 28, 2013 for (a) each stockholder known by us to own beneficially more than 5% of our common stock (b) our named executive officers, (c) each of our directors, and (d) all of our current directors and executive officers as a group. Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power with respect to the securities. We deem shares of common stock that may be acquired by an individual or group within 60 days of March 28, 2013 pursuant to the exercise of options or warrants to be outstanding for the purpose of computing the percentage ownership of such individual or group, but are not deemed to be outstanding for the purpose of computing the percentage ownership of any other person shown in the table. Except as indicated in footnotes to this table, we believe that the stockholders named in this table have sole voting and investment power with respect to all shares of common stock shown to be beneficially owned by them based on information provided to us by these stockholders. Percentage of ownership is based on 120,761,373 shares of common stock outstanding on March 28, 2013.

Name of beneficial owner (1)	Common stock beneficially owned (2)	Options & warrants exercisable (3)	Total common stock beneficially owned	Percent of class (3)	Calc Percent of class (3)	Adjusted shares
Directors and Named Executive Officers:						
Terren S. Peizer (4)	67,667,351	70,416,600	138,083,951	72.2%	72.2%	191,227,873
Richard A. Anderson (5)	-	1,523,388	1,523,388	1.2%	1.2%	122,334,661
Susan Etzel (6)	-	9,476	9,476	*	*	120,820,749
Andrea Barthwell, M.D. (7)	-	282,500	282,500	*	*	121,093,773
Kelly McCran (8)	-	195,000	-	*	*	121,006,273
Jay A. Wolf (9)	1,208,177	282,500	1,490,677	1.2%	1.2%	121,093,773
Five Percent or More Beneficial Owners:						
Dave E. Smith (10)	31,440,709	29,591,858	61,032,567	40.6%	40.6%	150,403,131
* Less than 1%						
All directors and named executive officers as a group (6 persons)	68,875,528	72,709,464	141,389,992	73.1%		193,520,737.00

(1) Except as set forth below, the mailing address of all individuals listed is c/o Catasys, Inc., 11150 Santa Monica Boulevard, Suite 1500, Los Angeles, California 90025**.**

(2) The number of shares beneficially owned includes shares of common stock in which a person has sole or shared voting power and/or sole or shared investment power. Except as noted below, each person named reportedly has sole voting and investment powers with respect to the common stock beneficially owned by that person, subject to applicable community property and similar laws.

(3) On March 28, 2013, there were 120,811,273 shares of common stock outstanding. Common stock not outstanding but which underlies options and rights (including warrants) vested as of or vesting within 60 days after March 28, 2013, is deemed to be outstanding for the purpose of computing the percentage of the common stock beneficially owned by each named person (and the directors and executive officers as a group), but is not deemed to be outstanding for any other purpose.

(4) Consists of warrants to purchase 68,857,625 shares of common stock, and options to purchase 1,558,975 shares of common stock. 327,500, 66,771,935 and 567,916 shares are held of record by Reserva Capital LLC, Crede CG II Ltd. and Bonmore, LLC, respectively, where Mr. Peizer serves as Managing Director and may be deemed to beneficially own or control. Mr. Peizer disclaims beneficial ownership of any such securities.

(5) Includes options to purchase 1,523,388 shares of common stock, which are exercisable within the next 60 days.

(6) Includes options to purchase 9,476 shares of common stock, which are exercisable within the next 60 days.

(7) Includes options to purchase 282,500 shares of common stock, which are exercisable within the next 60 days.

(8) Includes options to purchase 195,000 shares of common stock, which are exercisable within the next 60 days.

(9) Consists of options to purchase 282,500 shares of common stock held by Jay Wolf. Family members, David Wolf and Mary Wolf, hold 51,717 shares and 129,292 shares, respectively.

(10) Based solely on a schedule 13D/A filed by David E. Smith with the SEC on December 10, 2012. Consists of warrants to purchase 29,591,858 shares of common stock, which are exercisable within the next 60 days. The address for Mr. Smith is c/o Coast Asset Management, LLC, 11150 Santa Monica Blvd, Suite 1400, Los Angeles, CA 90025.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Review and Approval of Transactions with Related Persons

Either the audit committee or the Board of Directors approves all related party transactions. The procedure for the review, approval or ratification for related party transactions involves discussing the transaction with management, discussing the transaction with the external auditors, reviewing financial statements and related disclosures and reviewing the details of major deals and transactions to ensure that they do not involve related transactions. Members of management have been informed and understand that they are to bring related party transactions to the audit committee or the Board of Directors for pre-approval. These policies and procedures are evidenced in the audit committee charter and our code of ethics.

Certain Transactions

On December 9, 2010, the Board approved a related-party sublease of approximately one-third of our principal corporate offices located at 11150 Santa Monica Blvd., Los Angeles, CA to Xoftek, Inc., an affiliate of our Chairman and CEO.

In August 2011, the Company entered into a securities purchase agreement with Crede, pursuant to which in exchange for $650,000, the Company issued the August 2011 Bridge Note and the August 2011 Bridge Warrant. The August 2011 Bridge Note and the August 2011 Bridge Warrant are more fully described above in "Management's Discussion and Analysis of Financial Condition and Results of Operations."

In October 2011, we entered into a securities purchase agreement with David Smith, pursuant to which in exchange for $680,0000, the Company issued the October 2011 Bridge Note the October 2011 Bridge Warrant. The October 2011 Bridge Note and the October 2011 Bridge Warrant are more fully described above in "Management's Discussion and Analysis of Financial Condition and Results of Operations." David Smith is an affiliate of the Company and beneficially owns 16,821,851 shares of common stock of the Company or 40.6 percent.

On November 2, 2011, we entered into the November 2, 2011 Amended and Restated Bridge Note pursuant to which we amended and restated secured convertible notes with each of Crede and David Smith to increase the outstanding principal amounts under the August 2011 Bridge Note and the October 2011 Bridge Note by $160,000 and $100,000, respectively. In connection therewith, we issued the November 2, 2011 Bridge Warrants. The November 2, 2011 Amended and Restated Bridge Notes and the November 2, 2011 Bridge Warrants are more fully described above in "Management's Discussion and Analysis of Financial Condition and Results of Operations."

On November 15, 2011, we entered into the November 15, 2011 Amended and Restated Bridge Notes pursuant to which we further amended and restated secured convertible notes with Crede and David Smith to increase the outstanding principal amount under the November 2, 2011 Amended and Restated Bridge Notes by $160,000 and $100,000, respectively. In connection therewith, we issued the November 15, 2011 Bridge Warrants. The November 15, 2011 Amended and Restated Bridge Notes and the November 15, 2011 Bridge Warrants are more fully described above in the "Management's Discussion and Analysis of Financial Condition and Results of Operations."

On November 30, 2011, we entered into the November 30, 2011 Amended and Restated Bridge Note with Crede to increase the outstanding principal amount under the November 15, 2011 Amended and Restated Bridge Notes by $235,000. In connection therewith, we issued the November 30, 2011 Bridge Warrant. The November 30, 2011 Amended and Restated Bridge Note and the November 30, 2011 Bridge Warrant are more fully described above in the "Management's Discussion and Analysis of Financial Condition and Results of Operations."

On December 8, 2011, we entered into the Smith Third Amended and Restated Bridge Note and the Crede Fourth Amended and Restated Bridge Note to increase the outstanding principal amount under the outstanding notes to each of Crede and David Smith to $45,000 and $155,000, respectively. In connection therewith, we issued the December 2011 Bridge Warrants. The Smith Third Amended and Restated Bridge Note and the Crede Fourth Amended and Restated Bridge Note and the December 2011 Bridge Warrants are more fully described above in the "Management's Discussion and Analysis of Financial Condition and Results of Operations."

On December 20, 2011, the Company entered into a securities purchase agreement with several investors, including Crede, relating to the sale and issuance by the Company to the investors of an aggregate of 3,249,998 units, each unit consisting of (i) one share of common stock and (ii) a five-year warrant to purchase one share of common stock at an exercise price of $0.30 per share (the “December 2011 Offering Warrants”). Each unit was sold at $0.30 (the “December 2011 Offering”). The December 2011 Offering closed on December 27, 2011. In connection with the December 2011 Offering, Crede and David Smith agreed to convert their outstanding convertible notes in the aggregate principal amount of $2,285,000, plus accrued interest, into common stock. The net proceeds of the December 2011 Offering after deducting placement agent’s fees and offering expenses, was approximately $778,000. The December 2011 Offering is more fully described above in the “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” The total amount invested by each of Crede and David Smith was $1.4 million and $1.0 million, respectively. In addition, on December 27, 2011, the Company increased the number of warrants issued to each of Crede and David Smith for an aggregate of 8,333,333 and 6,900,000 shares respectively, as a result of the consummation of a Qualified Financing. The securities were issued pursuant to the exemption afforded by Rule 506 of Regulation D promulgated under the Securities Act.

In April 2012, we entered into securities purchase agreements with several investors, including Crede and David Smith, relating to the sale and issuance of an aggregate of 21,440,050 shares of common stock, and warrants to purchase an aggregate of 21,440,050 shares of common stock at an exercise price of $0.16 per share, for aggregate gross proceeds of approximately $3,430,000.

In May 2012, we entered into a securities purchase agreement with an accredited investor on the same terms of the securities purchase agreements disclosed above, relating to the sale and issuance of 250,000 shares of common stock and warrants to purchase an aggregate of 250,000 shares of common stock at an exercise price of $0.16 per share, for gross proceeds of $40,000.

In September 2012, we entered into securities purchase agreements with several investors, including Crede and David Smith, relating to the sale and issuance of an aggregate of 17,190,000 shares of common stock, and warrants to purchase an aggregate of 17,190,000 shares of common stock at an exercise price of $0.10 per share, for aggregate gross proceeds of approximately $1.7 million.

In December 2012, we entered into securities purchase agreements with several investors, including Crede and David Smith, relating to the sale and issuance of an aggregate of 47,121,432 shares of common stock, and warrants to purchase an aggregate of 47,121,432 shares of common stock at an exercise price of $0.07 per share for aggregate gross proceeds of approximately $3.3 million.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The firm of Rose, Snyder & Jacobs LLP has served as our independent registered public accounting firm for our 2012 fiscal year, and will continue to serve as our independent registered public accounting firm for the 2013 fiscal year unless the audit committee deems it advisable to make a substitution.

Aggregate fees incurred by us for the fiscal years ended December 31, 2012 and 2011, by Rose, Snyder & Jacobs LLP and other service providers were as follows:

	2012	2011
Audit fees	$ 74,000	$ 74,010
Audit-related fees	2,000	20,500
Total	$ 76,000	$ 94,510

The audit committee has considered whether the provision of non-audit services by Rose, Snyder & Jacobs LLP is compatible with maintaining Rose, Snyder & Jacobs’ LLP independence.

Audit committee pre-approvals

All auditing and non-auditing services provided to us by the independent auditors are pre-approved by the audit committee or in certain instances by the chair of the audit committee pursuant to delegated authority. Each year the audit committee discusses and outlines the scope and plan for the audit and reviews and approves all known audit and non-audit services and fees to be provided by and paid to the independent auditors. During the year, the specific audit and non-audit services or fees not previously negotiated or approved by the audit committee are negotiated or approved in advance by the audit committee or by the chair of the audit committee pursuant to delegated authority. In addition, during the year the chief financial officer and the audit committee monitor actual fees to the independent auditors for audit and non-audit services.

All of the services provided by Rose, Snyder & Jacobs LLP described above under the caption "Audit-related fees," were approved by our audit committee pursuant to our audit committee's pre-approval policies.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a)(1),(2) **Financial Statements**

The Financial Statements and Financial Statement Schedules listed on page F-1 of this document are filed as part of this filing.

(a)(3) **Exhibits**

The following exhibits are filed as part of this report:

Exhibit No.	Description
2.1	Stock Purchase Agreement between WoodCliff Healthcare Investment Partners, LLC and Core Corporate Consulting Group, Inc., dated January 14, 2009, incorporated by reference to Exhibit 10.1 of the Catasys Inc.'s current report on Form 8-K/A filed with the Securities and Exchange Commission on January 26, 2009.
3.1	Certificate of Incorporation of Catasys, Inc., filed with the Secretary of State of the State of Delaware on September 29, 2003, incorporated by reference to exhibit of the same number of Catasys Inc.'s Form 8-K filed with the Securities and Exchange Commission on September 30, 2003.
3.2	Certificate of Amendment to Certificate of Incorporation of Catasys, Inc., incorporated by reference to exhibit of the same number to Catasys, Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2010.
3.3	Certificate of Amendment, as corrected by the Certificate of Correction, to Certificate of Incorporation of Catasys, Inc., incorporated by reference to exhibit of the same number to Catasys, Inc's Registration Statement on Form S-1/A filed with Securities and Exchange Commission on September 9, 2011.
3.4	Certificate of Amendment of the Certificate of Incorporation of Catasys, Inc., incorporated by reference to exhibit 3.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 10, 2012.
3.5	By-Laws of Catasys, Inc., a Delaware corporation, incorporated by reference to exhibit of the same number of Catasys, Inc.'s Form 8-K filed with the Securities and Exchange Commission on September 30, 2003.
4.1	Specimen Common Stock Certificate, incorporated by reference to exhibit of the same number to Catasys Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2005.
4.2	Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on April 13, 2012
4.3	Secured Convertible Promissory Note issued to David E. Smith, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 7, 2011.
4.4	Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 19, 2011.
4.5	Amended and Restated Secured Convertible Promissory Note issued to David E. Smith, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 8, 2011.
4.6	Amended and Restated Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 8, 2011.
4.7	Second Amended and Restated Secured Convertible Promissory Note issued to David E. Smith, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 18, 2011.
4.8	Second Amended and Restated Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 18, 2011.

4.9	Third Amended and Restated Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 6, 2011.
4.10	Third Amended and Restated Secured Convertible Promissory Note issued to David E. Smith, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 14, 2011
4.11	Fourth Amended and Restated Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 14, 2011.
4.12	Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on February 28, 2012.
4.13	Secured Convertible Promissory Note issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 20, 2010.
4.14	Secured Convertible Promissory Note issued to Esousa Holdings, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 20, 2010.
4.15	Form of Warrant incorporated by reference to Exhibit 4.2 of Catasys, Inc.'s Registrations Statement on Form S-1/A filed with the Securities and Exchange Commission on May 17, 2010.
4.16	Warrant issued to David E. Smith, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 7, 2011.
4.17	Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 19, 2011.
4.18	Amended and Restated Warrant issued to David E. Smith, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 8, 2011.
4.19	Amended and Restated Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 8, 2011.
4.20	Second Amended and Restated Warrant issued to David E. Smith, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 18, 2011.
4.21	Second Amended and Restated Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 18, 2011.
4.22	Third Amended and Restated Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 6, 2011.
4.23	Third Amended and Restated Warrant issued to David E. Smith, incorporated by reference to exhibit 4.3 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 14, 2011.
4.24	Fourth Amended and Restated Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.4 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 14, 2011.
4.25	Form of Warrant incorporated by reference to Exhibit 4.1 of Catasys, Inc.'s Form 8-K filed with the Securities and Exchange Commission on December 27, 2011.
4.26	Form of Warrant incorporated by reference to Exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 6, 2012.
4.27	Form of Warrant incorporated by reference to Exhibit 4.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on September 18, 2012.
4.28	Form of Warrant incorporated by reference to Exhibit 4.1 of Catasys, Inc's current report on Form 8-K filed with the Securities and Exchange Commission on April 20, 2012.
4.29	Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on April 13, 2012.
4.30	Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on February 28, 2012.

4.31	Warrant issued to Crede Capital Group, LLC, incorporated by reference to exhibit 4.3 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 20, 2010.
4.32	Warrant issued to Esousa Holdings, LLC, incorporated by reference to exhibit 4.4 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 20, 2010.
4.33	Warrant issued on November 16, 2010, incorporated by reference to exhibit of the same number of Catasys Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2010.
10.1	2003 Stock Incentive Plan, incorporated by reference to Exhibit 99.1 of Catasys Inc.'s Form 8-K filed with the Securities and Exchange Commission on September 30, 2003.
10.2*	Employment Agreement between Catasys, Inc. and Terren S. Peizer, dated September 29, 2003, incorporated by reference to exhibit of the same number to Catasys Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2005.
10.3*	Employment Agreement between Catasys, Inc. and Richard A. Anderson, dated April 19, 2005, incorporated by reference to exhibit of the same number to Catasys Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2005.
10.5	2007 Stock Incentive Plan, incorporated by reference to the Catasys Inc.'s Revised Definitive Proxy on Form DEFR14A filed with the Securities and Exchange Commission on May 11, 2007.
10.6	Redemption Agreement between Catasys, Inc. and Highbridge International, LLC., dated November 7, 2007, incorporated by reference to exhibit of the same number to Catasys, Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2007.
10.7	Securities and Purchase Agreement between Catasys, Inc. and Highbridge International, LLC, dated January 17, 2007, incorporated by reference to Exhibit 10.4 of Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on January 18, 2007.
10.8	Registration Rights Agreement between Catasys, Inc. and Highbridge International, LLC, dated January 17, 2007, incorporated by reference to Exhibit 10.5 of Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on January 18, 2007.
10.9	Pledge Agreement between Catasys, Inc. and Highbridge International, LLC, dated January 17, 2007, incorporated by reference to Exhibit 10.8 of Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on January 18, 2007.
10.10	Security Agreement between Catasys, Inc. and Highbridge International, LLC, dated January 17, 2007, incorporated by reference to Exhibit 10.9 of Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on January 18, 2007.
10.11	Securities Purchase Agreement between Catasys, Inc. and Highbridge International, LLC, dated November 6, 2007, incorporated by reference to Exhibit 10.1 of Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 7, 2007.
10.12*	Amendment to Employment Agreement of Richard A. Anderson, dated July 16, 2008, incorporated by reference to Exhibit 10.1 of Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on July 18, 2008.
10.13	Amendment and Exchange Agreement with Highbridge International LLC, dated July 31, 2008, incorporated by reference to Exhibit 10.1 of the Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 1, 2008.
10.14	Amended and Restated Senior Secured Note with Highbridge International LLC, dated July 31, 2008, incorporated by reference to Exhibit 10.2 of the Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 1, 2008.
10.15	Amended and Restated Warrant to Purchase Common Stock with Highbridge International LLC, dated July 31, 2008, incorporated by reference to Exhibit 10.3 of the Catasys Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 1, 2008.
10.18	Order for Settlement of Claims between Catasys, Inc. and The Trinity Group-I, Inc., dated January 21, 2010, incorporated by reference to exhibit of same number to Catasys Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2009.
10.19	Settlement Agreement between Catasys, Inc. and Lincoln PO FBOP Limited Partnership, dated March 23, 2010, incorporated by reference to exhibit of same number to Catasys Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2009.
10.20	Order Approving Stipulation for Settlement of Claims between Catasys, Inc. and The Trinity Group-I, Inc., dated April 8, 2010, incorporated by reference to exhibit of same number to Catasys Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2009.

10.21	2010 Stock Incentive Plan incorporated by reference to exhibit 10.1 of Catasys, Inc's Form 8-K filed with the Securities and Exchange Commission on December 16, 2010.
10.22	Eighth Amendment to lease by and between Catasys, Inc. and the Irvine Company, LLC, incorporated by reference to exhibit of the same number to Catasys, Inc.'s annual report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2010.
10.23	Securities Purchase Agreement between Catasys, Inc. and accredited investors dated October 19, 2010, incorporated by reference to Exhibit 4.1, 4.2, 4.3, 4.4, 10.1, 10.2, and 10.3 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 19, 2010.
10.24	Consulting Services Agreement between Catasys, Inc. and John V. Rigali, dated March 23, 2010, incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on March 29, 2010.
10.25	Seventh Amendment to Lease between Catasys, Inc. and The Irvine Company LLC, dated April 29, 2010, incorporated by reference to Exhibit 10.31 of Catasys, Inc.'s quarterly report on Form 10-Q filed with the Securities and Exchange Commission on May 13, 2010.
10.26	Securities Purchase Agreement between Catasys, Inc. and investors, dated June 29, 2010, incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on June 30, 2010.
10.27	Amendment No. 3 to Lease (3Net) between Catasys, Inc. and Lincoln Holdings, LLC, dated July 27, 2010, incorporated by reference to Exhibit 10.32 of Catasys, Inc.'s quarterly report filed with the Securities and Exchange Commission on August 16, 2010.
10.28	Placement Agent Agreement between Rodman & Renshaw, LLC and Catasys, Inc., dated July 22, 2011, incorporated by reference to exhibit 10.30 of Catasys, Inc.'s registrations statement on Form S-1/A filed with the Securities and Exchange Commission on July 22, 2011.
10.29	Securities Purchase Agreement between Crede Capital Partners, LLC and Catasys, Inc., incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on August 19, 2011.
10.30	Securities Purchase Agreement between David E. Smith and Catasys, Inc., incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 7, 2011.
10.31	Consent Agreement between Crede Capital Partners, LLC and David E. Smith, incorporated by reference to Exhibit 10.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on October 7, 2011.
10.32	Amended and Restated Consent Agreement between Crede Capital Partners, LLC and David E. Smith, incorporated by reference to Exhibit 10.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 8, 2011.
10.33	Second Amended and Restated Consent Agreement between Crede Capital Partners, LLC and David E. Smith, incorporated by reference to Exhibit 10.2 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on November 17, 2011.
10.34	Third Amended and Restated Consent Agreement between Crede Capital Partners, LLC and David E. Smith, incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 8-K filed with the Securities and Exchange Commission on December 14, 2011.
10.35	Securities Purchase Agreement between Catasys, Inc. and accredited investors dated December 20, 2011, incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 10-K filed with the Securities and Exchange Commission on December 27, 2011.
10.36	Securities Purchase Agreement between Catasys, Inc. and accredited investors dated April 17, 2012, incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 10-K filed with the Securities and Exchange Commission on April 20, 2012.
10.37	Securities Purchase Agreement between Catasys, Inc. and accredited investors dated September 13, 2012, incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 10-K filed with the Securities and Exchange Commission on September 18, 2012.
10.38	Securities Purchase Agreement between Catasys, Inc. and accredited investors dated December 4, 2012, incorporated by reference to Exhibit 10.1 of Catasys, Inc.'s current report on Form 10-K filed with the Securities and Exchange Commission on December 6, 2012.

10.41*	Employment Agreement between Catasys, Inc. and Susan Etzel, dated March 27, 2013.
21.1	Subsidiaries of the Company.
23.1	Consent of Independent Registered Public Accounting Firm – Rose, Snyder & Jacobs LLP.
31.1	Certification by the Chief Executive Officer, pursuant to Rule 13-a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by the Chief Financial Officer, pursuant to Rule 13-a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification by the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following materials from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2012 are formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations, (iii) Consolidated Statements of Cash Flows, (iv) Statement of Stockholders' Equity, and (v) Notes to Condensed Financial Statements.

* Management contract or compensatory plan or arrangement.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CATASYS, INC.

Date: April 1, 2013

By: /s/ TERREN S. PEIZER
Terren S. Peizer
Chief Executive Officer
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title(s)	Date
/s/ TERREN S. PEIZER Terren S. Peizer	Chairman of the Board of Directors and Chief Executive Officer (Principal Executive Officer)	April 1, 2013
/s/ SUSAN ETZEL Susan Etzel	Chief Financial Officer (Principal Financial and Accounting Officer)	April 1, 2013
/s/ RICHARD A. ANDERSON Richard A. Anderson	President, Chief Operating Officer and Director	April 1, 2013
/s/ JAY A. WOLF Jay A. Wolf	Lead Director	April 1, 2013
/s/ KELLY McCRANN Kelly McCrann	Director	April 1, 2013
/s/ ANDREA GRUBB BARTHWELL, M.D. Andrea Grubb Barthwell, M.D.	Director	April 1, 2013

CATASYS, INC. AND SUBSIDIARIES

Index to Consolidated Financial Statements and Financial Statement Schedules

Financial Statements

Financial Statement Schedules

All financial statement schedules are omitted because they are not applicable, not required, or the information is shown in the Financial Statements or Notes thereto.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Catasys, Inc.

We have audited the accompanying consolidated balance sheets of Catasys, Inc. and Subsidiaries (the “Company”) as of December 31, 2012 and 2011, and the related consolidated statements of operations, stockholders’ equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial positions of Catasys, Inc. and Subsidiaries as of December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company has incurred significant operating losses and negative cash flows from operations during the year ended December 31, 2012. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans regarding those matters also are described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Rose, Snyder & Jacobs LLP

Encino, California

March 28, 2013

CATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In thousands, except for number of shares)	December 31, 2012	December 31, 2011
ASSETS		
Current assets		
Cash and cash equivalents	$ 3,153	$ 771
Receivables, net of allowance for doubtful accounts of $0 and $0, respectively	69	53
Receivables from related party	173	127
Prepaids and other current assets	227	408
Total current assets	3,622	1,359
Long-term assets		
Property and equipment, net of accumulated depreciation of $4,668 and $5,717, respectively	59	89
Intangible assets, net of accumulated amortization of $892 and $2,035, respectively	1,048	1,920
Deposits and other assets	205	212
Total Assets	$ 4,934	$ 3,580
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	$ 1,642	$ 1,527
Accrued compensation and benefits	958	669
Deferred revenue	278	59
Other accrued liabilities	1,120	1,275
Total current liabilities	3,998	3,530
Long-term liabilities		
Deferred rent and other long-term liabilities	18	18
Capital leases	18	-
Warrant liabilities	14,658	4,528
Total liabilities	18,692	8,076
Stockholders' deficit		
Preferred stock, $0.0001 par value; 50,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, $0.0001 par value; 500,000,000 and 2,000,000,000 shares authorized at December 31, 2012 and December 31, 2011, respectively; 120,227,940 and 33,901,458 shares issued and outstanding at December 31, 2012 and December 31, 2011, respectively	12	4
Additional paid-in-capital	208,765	206,392
Accumulated deficit	(222,535)	(210,892)
Total stockholders' deficit	(13,758)	(4,496)
Total Liabilities and Stockholders' Deficit	$ 4,934	$ 3,580

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)	**Twelve Months Ended December 31,**	
	2012	**2011**
Revenues		
Healthcare services revenues	$ 375	$ 24
License and management services revenues	166	243
Total revenues	541	267
Operating expenses		
Cost of services	816	571
General and administrative	8,341	11,145
Impairment losses	656	267
Depreciation and amortization	289	349
Total operating expenses	10,102	12,332
Loss from operations	(9,561)	(12,065)
Interest and other income	-	4
Interest expense	(4,811)	(3,189)
Loss on debt extinguishment	-	(41)
Change in fair value of warrant liability	2,724	7,186
Loss before provision for income taxes	(11,648)	(8,105)
Provision for income taxes	(5)	14
Net Loss	$ (11,643)	$ (8,119)
Basic and diluted net income (loss) per share:*		
Net loss per share*	$ (0.20)	$ (0.44)
Weighted number of shares outstanding*	57,801	18,439

* The financial statements have been retroactively restated to reflect the 40-for-1 reverse stock split that occurred on September 6, 2011.

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(Amounts in thousands)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Other Comprehensive Income	Accumulated Deficit	Total
Balance at December 31, 2010	4,542,775	18	$ 192,578	$ -	$ (202,773)	$ (10,177)
Common stock issued for outside services	800,000	1	411	-	-	412
Common stock issued in registered direct offering, net of expenses	27,780,271	64	9,025	-	-	9,089
Common stock issued as debt payment	15,129	-	41	-	-	41
Stock options and warrants issued for employee and outside services	510,000	-	4,157	-	-	4,157
40:1 Reverse-stock split adjustment	63	(80)	80	-	-	0
Exercise of options and warrants	3,220	-	9	-	-	9
Common stock issued for outside services	250,000	-	92	-	-	92
Net loss	-	-	-	-	(8,119)	(8,119)
Balance at December 31, 2011*	33,901,458	4	$ 206,392	$ -	$ (210,892)	$ (4,496)
Common stock issued for outside services	325,000	-	73	-	-	73
Common stock issued in private placement, net of expenses	86,001,482	8	409	-	-	417
Share-based Compensation Expense	-	-	1,891	-	-	1,891
Net loss	-	-	-	-	(11,643)	(11,643)
Balance at December 31, 2012*	120,227,940	12	$ 208,765	$ -	$ (222,535)	$ (13,758)

* The financial statements have been retroactively restated to reflect the 40-for-1 reverse stock split that occurred on Setpember 6, 2011.

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	Twelve Months Ended December 30, 2012	2011
Operating activities:		
Net loss	$ (11,643)	$ (8,119)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	289	349
Amortization of debt discount and issuance costs included in interest expense	4,793	2,978
Loss on debt extinguishment	-	41
Provision for doubtful accounts	(4)	10
Deferred rent	-	(17)
Share-based compensation expense	2,190	4,394
Fair value adjustment on warrant liability	(2,724)	(7,186)
Impairment losses	656	267
(Gain) or loss on disposition of assets	(1)	2
Changes in current assets and liabilities:		
Receivables	(58)	(117)
Prepaids and other current assets	(105)	24
Deferred revenue	219	-
Accounts payable and other accrued liabilities	237	535
Net cash used in operating activities	$ (6,151)	$ (6,839)
Investing activities:		
Proceeds from sales of property and equipment	$ -	$ 8
Purchases of property and equipment	(11)	(18)
Deposits and other assets	(5)	(33)
Net cash used in investing activities	$ (16)	$ (43)
Financing activities:		
Proceeds from the issuance of common stock and warrants	$ 7,586	$ 975
Proceeds from financing notes	975	2,285
Transaction costs	-	(172)
Capital lease obligations	(12)	(40)
Net cash provided by financing activities	$ 8,549	$ 3,048
Net increase (decrease) in cash and cash equivalents	$ 2,382	$ (3,834)
Cash and cash equivalents at beginning of period	771	4,605
Cash and cash equivalents at end of period	$ 3,153	$ 771
Supplemental disclosure of cash paid		
Income taxes	$ 107	$ 28
Supplemental disclosure of non-cash activity		
Common stock issued for outside services	$ 73	$ 411
Common stock issued for debt settlement	$ -	$ 41
Common stock issued for converson of debt	$ 975	$ 8,486
Common stock issued for services	$ 387	$ 429
Common stock issued for exercise of warrants	$ -	$ 9
Beneficial conversion feature related to financing	$ 253	$ 306
Property and equipment acquired through capital leases and other financing	$ 33	$ 18

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

Note 1. Summary of Significant Accounting Policies

Description of Business

We are a healthcare services company, providing specialized health services designed to assist health plans, employers and unions to manage and treat their high cost substance dependence members through a network of healthcare providers and our employees. The On*Trak* substance dependence program was designed to address substance dependence as a chronic disease. The program seeks to lower costs and improve member health through the delivery of integrated medical and psychosocial interventions in combination with long term “care coaching.” We also offer the PROMETA Treatment Program for alcoholism and stimulant dependence on a private-pay basis through licensed treatment providers and a company managed treatment center that also offers other mental health services.

We manage and report our operations through two business segments: healthcare services and license and management services. The healthcare services segment includes On*Trak* and its integrated substance dependence solutions marketed to health plans, employers and unions through a network of licensed and company managed healthcare providers. The license and management segment provides licensing, administrative and management services to licensees that administer the PROMETA Treatment Program and other treatment programs, including a managed treatment center that is licensed and managed by us.

Basis of Consolidation and Presentation and Going Concern

Our consolidated financial statements include the accounts of the company, our wholly-owned subsidiaries, and a company managed professional medical corporation. Based on the provisions of the management service agreement between us and a medical corporation, we have determined that the medical corporation is a variable interest entity (VIE), and that we are the primary beneficiary as defined in the Financial Accounting Standards Board (FASB) rules for accounting for variable interest entities. Accordingly, we are required to consolidate the revenues and expenses of the managed medical corporation.

Our financial statements have been prepared on the basis that we will continue as a going concern. At December 31, 2012, cash and cash equivalents amounted to $3.2 million and we had a working capital deficit of approximately $376,000. We have incurred significant operating losses and negative cash flows from operations since our inception. During the year ended December 31, 2012, our cash used in operating activities amounted $6.2 million. We anticipate continuing to incur negative cash flows and net losses for the next twelve months. The financial statements do not include any adjustments relating to the recoverability of the carrying amount of the recorded assets or the amount of liabilities that might result from the outcome of this uncertainty. As of December 31, 2012, these conditions raised substantial doubt as to our ability to continue as a going concern.

Our ability to fund our ongoing operations and continue as a going concern is dependent on signing and generating fees from existing and new contracts for our Catasys managed care programs and the success of management’s plans to increase revenue and continue to control expenses. We are operating programs in Kansas, Massachusetts, Oklahoma and Louisiana. In March 2013, we signed an agreement with a national health plan to provide services to their members in New Jersey, which we expect to commence enrollment in the second quarter of 2013. We have begun to generate fees from the launched programs, increased fees in 2012 compared to the prior year both in aggregate and quarterly basis, and expect to increase enrollment and fees throughout 2013. However, there can be no assurance that we will generate such fees. In addition, we continue to seek ways to streamline our operating expenses.

We and our Chief Executive Officer are party to a litigation in which the plaintiffs assert causes of action for conversion, a request for an order to set aside fraudulent conveyance and breach of contract. While we believe the plaintiffs’ claims are without merit and we intend to continue to vigorously defend the case, there can be no assurance that the litigation will be resolved in our favor. If this case is decided against us or our Chief Executive Officer, it may cause us to pay substantial damages, and other related fees. Regardless of whether this litigation is resolved in our favor, any lawsuit to which we are a party will likely be expensive and time consuming to defend or resolve. Costs of defense and any damages resulting from litigation, a ruling against us or a settlement of the litigation could have a significant negative impact our liquidity, including our cash flows.

All inter-company transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States (GAAP) requires management to make estimates and assumptions that affect the reported amounts in the financial statements and disclosed in the accompanying notes. Significant areas requiring the use of management estimates include expense accruals, accounts receivable allowances, accrued claims payable, premium deficiencies, the useful life of depreciable assets, the evaluation of asset impairment, the valuation of warrant liabilities, and shared-based compensation. Actual results could differ from those estimates.

Revenue Recognition

Healthcare Services

Our Catasys contracts are generally designed to provide revenues to us on a monthly basis based on enrolled members or to provide a case rate when members are enrolled and a share of the savings generated from enrolled members. To the extent our contracts may include a minimum performance guarantee, we reserve a portion of the monthly fees that may be at risk until the performance measurement period is completed. To the extent we receive case rates that are not subject to performance guarantees we recognize the case rate ratably over twelve months.

License and Management Services

Our license and management services revenues are derived from licensing our PROMETA Treatment Program and providing administrative services to hospitals, treatment facilities and other healthcare providers, and from revenues generated by our managed treatment center. We record revenues earned based on the terms of our licensing and management contracts, which require the use of judgment, including the assessment of the collectability of receivables. Licensing agreements typically provide for a fixed fee on a per-patient basis, payable to us following the providers' commencement of the use of our program to treat patients. For revenue recognition purposes, we treat the program licensing and related administrative services as one unit of accounting. We record the fees owed to us under the terms of the agreements at the time we have performed substantially all required services for each use of our program, which for our license agreements is in the period in which the provider begins using the program for medically directed and supervised treatment of a patient.

The revenues of our managed treatment center, which we include in our consolidated financial statements, are derived from charging fees directly to patients for treatment and are recorded when services are provided. Revenues from patients treated with our proprietary treatment program at our managed treatment center are recorded based on the number of days of treatment completed during the period as a percentage of the total number treatment days for the treatment program.

Cost of Services

Healthcare Services

Cost of healthcare services consists primarily of salaries related to our care coaches, healthcare provider claims payments, and fees charged by our third party administrators for processing these claims. Healthcare services cost of services is recognized in the period in which an eligible member receives services. Our Catasys subsidiary contracts with various healthcare providers, including licensed behavioral healthcare professionals, on a contracted rate basis. We determine that a member has received services when we receive a claim or in the absence of a claim, by utilizing member data recorded in the On*Trak* database within the contracted timeframe, with all required billing elements correctly completed by the service provider.

License and Management Services

Cost of license and management services represent direct costs that are incurred in connection with licensing our treatment programs and providing administrative services in accordance with the various technology license and services agreements, and are associated directly with the revenue that we recognize. Consistent with our revenue recognition policy, the costs associated with providing these services are recognized when services have been rendered, which for our license agreements is in the period in which patient treatment commences, and for our managed treatment center is in the periods in which medical treatment is provided. Such costs include royalties, direct labor costs, medical supplies and medications.

Share-Based Compensation

Our 2010 Stock Incentive Plan, as amended ("the Plan"), provides for the issuance of up to 18,250,000 shares of our common stock. Incentive stock options (ISOs) under Section 422A of the Internal Revenue Code and non-qualified options (NSOs) are authorized under the Plan. We have granted stock options to executive officers, employees, members of our board of directors, and certain outside consultants. The terms and conditions upon which options become exercisable vary among grants, but option rights expire no later than ten years from the date of grant and employee and board of director awards generally vest over three to five years. At December 31, 2012, we had an aggregate of 5,082,158 vested and unvested shares outstanding and 12,595,477 shares available for future awards.

Total share-based compensation expense on a consolidated basis amounted to $2.2 million and $4.4 million for the years ended December 31, 2012 and 2011, respectively.

Stock Options – Employees and Directors

We measure and recognize compensation expense for all share-based payment awards made to employees and directors based on estimated fair values on the date of grant. We estimate the fair value of share-based payment awards using the Black-Scholes option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the consolidated statements of operations.

The estimated weighted average fair values of options granted during 2012 and 2011 were $0.33 and $0.57 per share, respectively, and were calculated using the Black-Scholes pricing model based on the following assumptions:

	2012	2011
Expected volatility	151%	143%
Risk-free interest rate	1.02%	2.14%
Weighted average expected lives in years	6.0	5-6
Expected dividend	0%	0%

The expected volatility assumption for 2012 was based on the historical volatility of our stock, measured over a period generally commensurate with the expected term. The weighted average expected lives in years for 2012 and 2011 reflect the application of the simplified method set out in Security and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) 107 (and as amended by SAB 110), which defines the life as the average of the contractual term of the options and the weighted average vesting period for all option tranches. We use historical data to estimate the rate of forfeitures assumption for awards granted to employees.

We have elected to adopt the detailed method prescribed in FASB's accounting rules for share-based compensation expense for calculating the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee share-based compensation awards that were outstanding upon adoption of such rules on January 1, 2006.

Stock Options and Warrants – Non-employees

We account for the issuance of stock options and warrants for services from non-employees by estimating the fair value of stock options and warrants issued using the Black-Scholes pricing model. This model's calculations incorporate the exercise price, the market price of shares on grant date, the weighted average risk-free interest rate, expected life of the option or warrant, expected volatility of our stock and expected dividends.

For options and warrants issued as compensation to non-employees for services that are fully vested and non-forfeitable at the time of issuance, the estimated value is recorded in equity and expensed when the services are performed and benefit is received. For unvested shares, the change in fair value during the period is recognized in expense using the graded vesting method.

From time to time, we have retained terminated employees as part-time consultants upon their resignation from the company. Because the employees continue to provide services to us, their options continue to vest in accordance with the original terms. Due to the change in classification of the option awards, the options are considered modified at the date of termination. The modifications are treated as exchanges of the original awards in return for the issuance of new awards. At the date of termination, the unvested options are no longer accounted for as employee awards under FASB's accounting rules for share-based expense but are instead accounted for as new non-employee awards. The accounting for the portion of the total grants that have already vested and have been previously expensed as equity awards is not changed. We recorded no expense in 2012 and $36,000 in 2011, associated with modified liability awards.

Income Taxes

We account for income taxes using the liability method in accordance with Accounting Standards Committee ("ASC") 740 "Income Taxes" (formerly SFAS 109, "Accounting for Income Taxes"). To date, no current income tax liability has been recorded due to our accumulated net losses. Deferred tax assets and liabilities are recognized for temporary differences between the financial statement carrying amounts of assets and liabilities and the amounts that are reported in the tax returns. Deferred tax assets and liabilities are recorded on a net basis; however, our net deferred tax assets have been fully reserved by a valuation allowance due to the uncertainty of our ability to realize future taxable income and to recover our net deferred tax assets.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes" (incorporated into ASC 740), which clarifies the accounting for uncertainty in income taxes. FIN 48 requires that companies recognize in the consolidated financial statements the impact of a tax position if that position is more likely than not of being sustained on audit based on the technical merits of the position. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods and disclosure. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. We adopted FIN 48 on January 1, 2007, with no impact to our consolidated financial statements.

Basic and Diluted Loss per Share

Basic loss per share is computed by dividing the net loss to common stockholders for the period by the weighted average number of common shares outstanding during the period. Diluted loss per share is computed by dividing the net loss for the period by the weighted average number of common and dilutive common equivalent shares outstanding during the period.

Common equivalent shares, consisting of approximately 117,152,583 and 26,441,996 of incremental common shares as of December 31, 2012 and 2011, respectively, issuable upon the exercise of stock options and warrants, have been excluded from the diluted loss per share calculation because their effect is anti-dilutive.

Cash and Cash Equivalents

We invest available cash in short-term commercial paper and certificates of deposits. Liquid investments with an original maturity of three months or less when purchased are considered to be cash equivalents.

Marketable Securities

Investments include certificates of deposits with maturity dates greater than three months when purchased. These investments are classified as deposits, are reflected in current assets as other assets and are stated at fair market value.

Our marketable securities consisted of investments with the following maturities as of December 31, 2012 and 2011:

Marketable Securities

(in thousands)	Fair Market Value	Less than 1 Year	More than 10 Years
Balance at December 31, 2011			
Certificates of deposit	$ 159	$ 159	$ -
Balance at December 31, 2012			
Certificates of deposit	$ 175	$ 175	$ -

The carrying value of all securities presented above approximated fair market value at December 31, 2012 and 2011, respectively.

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

Level Input:	**Input Definition:**
Level I	Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
Level II	Inputs, other than quoted prices included in Level I, that are observable for the asset or liability through corroboration with market data at the measurement date.
Level III	Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The following tables summarize fair value measurements by level at December 31, 2012 and 2011 for assets and liabilities measured at fair value on a recurring basis:

	Balance at December 31, 2011			
(Amounts in thousands)	**Level I**	**Level II**	**Level III**	**Total**
Certificates of deposit	159	-	-	159
Total assets	159	-	-	159
Warrant liabilities	-	-	4,528	4,528
Total liabilities	-	-	4,528	4,528

	Balance at December 31, 2012			
(Amounts in thousands)	**Level I**	**Level II**	**Level III**	**Total**
Certificates of deposit	175	-	-	175
Total assets	175	-	-	175
Warrant liabilities	-	-	14,658	14,658
Total liabilities	-	-	14,658	14,658

We measure warrant liabilities issued from our debt and equity financings on a recurring basis. In accordance with current accounting rules, the warrant liabilities are being marked-to-market each quarter-end until they are completely settled. The warrants are valued using the Black-Scholes option pricing model, using both observable and unobservable inputs and assumptions consistent with those used in our estimate of fair value of employee stock options. Significant increases (decreases) in any of these inputs could result in significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the expected term is accompanied by a change in the assumption used for the risk free rate and the expected stock. See *Warrant Liabilities* below.

The following table summarizes our fair value measurements using significant Level III inputs, and changes therein, for the years ended December 31, 2012 and 2011:

Level III inputs

(Amounts in thousands)	**Level III Warrant Liabilities**
Balance as of December 31, 2010	$ 8,890
Transfers in/(out) of Level III	2,824
Change in Fair Value	(7,186)
Net purchases (sales)	-
Net unrealized gains (losses)	-
Net realized gains (losses)	-
Balance as of December 31, 2011	$ 4,528
Transfers in/(out) of Level III	12,854
Change in Fair Value	(2,724)
Net purchases (sales)	-
Net unrealized gains (losses)	-
Net realized gains (losses)	-
Balance as of December 31, 2012	$ 14,658

Fair Value Information about Financial Instruments Not Measured at Fair Value

FASB rules regarding fair value disclosures of financial instruments requires disclosure of fair value information about certain financial instruments for which it is practical to estimate that value. The carrying amounts reported in our consolidated balance sheets for cash, cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair value because of the immediate or short-term maturity of these financial instruments. There was no outstanding debt for the years ending December 31, 2012 and 2011, respectively. Considerable judgment is required to develop estimates of fair value. Accordingly, the estimates are not necessarily indicative of the amounts we could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Intangible Assets

Intellectual Property

Intellectual property consists primarily of the costs associated with acquiring certain technology, patents, patents pending, know-how and related intangible assets with respect to programs for treatment of dependence to alcohol, cocaine, methamphetamines and other addictive stimulants. These long-term assets are stated at cost and are being amortized on a straight-line basis over the life of the respective patents, or patent applications, which is approximately eight years at December 31, 2012.

Impairment of Long-Lived Assets

Long-lived assets such as property, equipment and intangible assets subject to amortization are reviewed for impairment whenever events or circumstances indicate that the carrying amount of these assets may not be recoverable. In reviewing for impairment, we compare the carrying value of such assets to the estimated undiscounted future cash flows expected from the use of the assets and their eventual disposition. When the estimated undiscounted future cash flows are less than their carrying amount, an impairment loss is recognized equal to the difference between the assets' fair value and their carrying value.

We performed an impairment analysis on intellectual property at December 31, 2012. For certain intangible assets, we considered numerous factors and we determined that the carrying value was not recoverable, and exceeded the fair-value. We recorded an impairment charge of $656,000 for these assets at December 31, 2012. We determined that the estimated lives of the remaining intellectual property properly reflected the current remaining economic lives of the assets.

We performed an impairment analysis on intellectual property at December 31, 2011. For certain intangible assets, we considered numerous factors and we determined that the carrying value was not recoverable, and exceeded the fair value. We recorded an impairment charge totaling $267,000 for these assets at December 31, 2011. We determined that the estimated lives of the remaining intellectual property properly reflected the current remaining economic lives of the assets.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Additions and improvements to property and equipment are capitalized at cost. Expenditures for maintenance and repairs are charged to expense as incurred. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets, which range from two to seven years for furniture and equipment. Leasehold improvements are amortized over the lesser of the estimated useful lives of the assets or the related lease term, which is typically five to seven years. Construction in progress is not depreciated until the related asset is placed into service.

Capital Leases

Assets held under capital leases include furniture and computer equipment, and are recorded at the lower of the net present value of the minimum lease payments or the fair value of the leased asset at the inception of the lease. Depreciation expense is computed using the straight-line method over the estimated useful lives of the assets. All lease agreements meet at least one of the four requirements of a capital lease in accordance with ASC 840 of the codification.

Variable Interest Entities

Generally, an entity is defined as a variable interest entity (VIE) under current accounting rules if it has (a) equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (b) equity investors that cannot make significant decisions about the entity's operations, or that do not absorb the expected losses or receive the expected returns of the entity. When determining whether an entity that is a business qualifies as a VIE, we also consider whether (i) we participated significantly in the design of the entity, (ii) we provided more than half of the total financial support to the entity, and (iii) substantially all of the activities of the VIE either involve us or are conducted on our behalf. A VIE is consolidated by its primary beneficiary, which is the party that absorbs or receives a majority of the entity's expected losses or expected residual returns.

As discussed in Note 2 – *Management Services Agreement*, we have entered into an MSA with a professional medical corporation. Under this MSA, the equity owner of the affiliated medical group has only a nominal equity investment at risk, and we absorb or receive a majority of the entity's expected losses or expected residual returns. We participate significantly in the design of this management services agreement. We also agree to provide a working capital loan to allow for the medical group to pay for its obligations. Substantially all of the activities of this managed medical corporation either involve us or are conducted for our benefit, as evidenced by the facts that (i) the operations of the managed medical corporation are conducted primarily using our licensed protocols and (ii) under the MSA, we agree to provide and perform all non-medical management and administrative services for the respective medical group. Payment of our management fee is subordinate to payments of the obligations of the medical group, and repayment of the working capital loan is not guaranteed by the equity owner of the affiliated medical group or other third party. Creditors of the managed medical corporations do not have recourse to our general credit.

Based on the design and provisions of this MSA and the working capital loan provided to the medical group, we have determined that the managed medical corporation is a VIE, and that we are the primary beneficiary as defined in current accounting rules. Accordingly, we are required to consolidate the revenues and expenses of such managed medical corporation.

Warrant Liabilities

In August 2011, we entered into a securities purchase agreement with Crede CG II, LLC ("Crede"), an affiliate of Terren S. Peizer, our Chairman and Chief Executive Officer, pursuant to which we received $650,000 and issued the August 2011 Bridge Note and the August 2011 Bridge Warrant. The August 2011 Bridge Warrant expires on August 17, 2016. The August 2011 Bridge Warrant contains anti-dilution provisions. As a result, if we, in the future, issue or grant any rights to purchase any of our common stock, or other security convertible into our common stock, for a per share price less than the exercise price of the August 2011 Bridge Warrant, the exercise price of the August 2011 Bridge Warrant will be reduced to such lower price, subject to customary exceptions.

In October 2011, we entered into a securities purchase agreement with David Smith, one of our affiliates, pursuant to which we received $680,000 and issued the October 2011 Bridge Note and the October 2011 Bridge Warrant. The October 2011 Bridge Warrant expires on October 5, 2016, and contains the same material terms as the August 2011 Bridge Warrant.

On November 2, 2011, we entered into amended and restated secured convertible notes with each of Crede and David Smith to increase the outstanding principal amounts under the August 2011 Bridge Note and the October 2011 Bridge Note by $160,000 and $100,000, respectively (the "November 2, 2011 Amended and Restated Bridge Notes"). In connection therewith, we issued warrants to purchase common stock to each of Crede and Mr. Smith in the amounts of 615,385 and 384,615, respectively, or in the event of a Qualified Financing, an amount equal to the price per share of securities issued in the Qualified Financing multiplied by a factor equal to twice the product of the number of warrants issued in the Qualified Financing divided by the number of shares of common stock issued in the Qualified Financing at a purchase price of $0.32 per share (the "November 2, 2011 Bridge Warrants") The exercise price of and number of shares of common stock underlying the November 2, 2011 Bridge Warrants are subject to adjustment for financings and share issuances below the initial exercise price.

On November 15, 2011, we entered into the November 15, 2011 amended and restated secured convertible note with Crede and David Smith to increase the outstanding principal amount under the November 2, 2011 Amended and Restated Bridge Notes by $160,000 and $100,000, respectively (the "November 15, 2011 Amended and Restated Bridge Notes"). In connection therewith, we issued warrants to purchase common stock to each of Crede and David Smith in the amounts of 615,385 and 384,615, respectively, or an additional amount in the event of a Qualified Financing on the same terms as the November 2, 2011 warrants. All other material terms are the same as the November 2, 2011 Bridge Warrants.

On November 30, 2011, we entered into a November 30, 2011 amended and restated secured convertible note (the “November 30, 2011 Amended and Restated Bridge Note”) with Crede to increase the outstanding principal amount under the November 15, 2011 Amended and Restated Bride Note by $235,000. In connection therewith, we issued warrants to purchase 903,846 shares of common stock or an additional amount in the event of a Qualified Financing on the same terms as the November 15, 2011 warrants. All other material terms are the same as the November 15, 2011 Bridge Warrants.

On December 8, 2011, we entered into a third amended and restated secured convertible note (the “Smith Third Amended and Restated Bridge Note”) and a fourth amended and restated secured convertible note (the “Crede Fourth Amended and Restated Bridge Note”) to increase the outstanding principal amount under the outstanding notes to each of Crede and David smith to $45,000 and $155,000, respectively. In connection therewith, we issued warrants to purchase common stock to each of Crede and Smith in the amounts of 173,077 and 596,154, respectively (the “December 2011 Bridge Warrants”) or an additional amount in the event of a Qualified Financing on the same terms as the November 30, 2011 Bridge Warrants.

Effective December 8, 2011, the Company entered into a Third Amendment to the Consent Agreement (the “Third Consent Amendment”) with Crede and David Smith to amend the Consent Agreement dated October 5, 2011, as amended on November 2, 2011 and November 15, 2011 (the “Consent Agreement”), to adjust David Smith’s and Crede’s respective sharing percentages in recoveries against collateral securing the Smith Third Amended and Restated Bridge Note and the Crede Fourth Amended and Restated Bridge Note in order to reflect the increased principal amounts thereunder.

On December 20, 2011, the Company entered into a securities purchase agreement with several investors, including Crede, relating to the sale and issuance by the Company to the investors of an aggregate of 3,249,998 units, each unit consisting of (i) one share of common stock and (ii) a five-year warrant to purchase one share of common stock at an exercise price of $0.30 per share (the “December 2011 Offering Warrants”). Each unit was sold at $0.30 (the “December 2011 Offering”). The December 2011 Offering closed on December 27, 2011. In connection with the December 2011 Offering, Crede and David Smith agreed to convert their outstanding convertible notes in the aggregate principal amount of $2,285,000, plus accrued interest, into common stock. The net proceeds of the December 2011 Offering after deducting placement agent’s fees and offering expenses, was approximately $778,000. In connection with the December 2011 Offering, the Company issued the placement agent, Rodman & Renshaw five year warrants to purchase 162,500 shares of common stock with an exercise price of $0.375 per share. The December 2011 Offering Warrants are exercisable immediately. The exercise price and the number of shares of common stock purchasable upon the exercise of each December 2011 Offering Warrant are subject to adjustment in the event of stock dividends, distributions, and splits. In addition, the December 2011 Offering Warrants have anti-dilution provisions, where the exercise price is adjusted downward in the event that common stock or common stock equivalents are issued by the Company at a price below the exercise price of the December 2011 Offering Warrants with certain exceptions. In addition, in the event of a fundamental transaction (as such term is defined in the December 2011 Offering Warrants), that is an all cash transaction, a Rule 13e-3 transaction or a fundamental transaction involving a person not traded on a national securities exchange, at the holder’s option, the Company (or its successor) would be required within 30 days after consummation of the fundamental transaction to purchase the December 2011 Offering Warrant from the holder by paying to the holder cash in an amount equal to the Black-Scholes value of the remaining unexercised portion of the December 2011 Offering Warrant on the date of the consummation of such fundamental transaction. In connection with the December 2011 Offering, the previous warrants issued to each of Crede and David Smith became exercisable for an aggregate of 8,333,333 and 6,900,000, respectively, since the December 2011 Offering qualified as a Qualified Financing.

In April 2012, we entered into security purchase agreements with several investors, including Crede and David Smith, relating to the sale and issuance of an aggregate of 21,440,050 shares of common stock and warrants (the “April Warrants”) to purchase an aggregate of 21,440,050 shares of common stock at an exercise price of $0.16 per share for aggregate gross proceeds of approximately $3,430,000 (the “April Offering”). The Agreements provide that in the event that the Company effectuates a Reverse Split and the VWAP period declines from the closing price on the trading date immediately prior to the effective date of the Reverse Split, that the Company shall issue the Adjustment Shares. The number of Adjustment Shares shall be calculated as the lesser of (a) 20% of the number of shares of common stock originally purchased by such investor and still held by the investor as of the last day of the VWAP Period, and (b) the number of shares originally purchased by such investor and still held by such Investor as of the last day of the VWAP Period multiplied by the percentage decline in the VWAP during the VWAP Period. All prices and number of shares of common stock shall be adjusted for the Reverse Split and any other stock splits or stock dividends.

The April Warrants expire in April 2017, and contain anti-dilution provisions. As a result, if we, in the future, issue or grant any rights to purchase any of our common stock, or other securities convertible into our common stock, for a per share price less than the exercise price of the April Warrants, the exercise price of the April Warrants will be reduced to such lower price, subject to customary exceptions. In the event that Adjustment Shares are issued, the number of shares that may be purchased under the April Warrants shall be increased by an amount equal to the Adjustment Shares. In addition, the exercise price is subject to adjustment in the event that the VWAP during the VWAP period is less than the exercise price prior to the VWAP Period.

In May 2012, we entered into a securities purchase agreement with an accredited investor, on the same terms of Agreements disclosed above, relating to the sale and issuance of 250,000 shares of common stock and warrants to purchase an aggregate of 250,000 shares of common stock at an exercise price of $0.16 per share, for gross proceeds of $40,000.

In May 2012, we issued warrants to purchase an aggregate of 120,000 shares of common stock at an exercise price of $0.16 per share, associated with financing costs.

In June 2012, we issued 12,500 restricted shares of common stock to a consultant for investor relation services to be performed beginning June 2012 and ending November 2012.

In September 2012, we entered into securities purchase agreements with several investors including Crede and David Smith, relating to the sale and issuance of an aggregate of 17,190,000 shares of the Company's common stock and warrants (the "September Warrants") to purchase an aggregate of 17,190,000 shares of common stock, at an exercise price of $0.10 per share, for aggregate gross proceeds of approximately $1.7 million (the "September Offering"). The foregoing issuances triggered anti-dilution provisions in certain of the Company's outstanding warrants. As a result, the exercise price of these warrants decreased to $0.10 per share, however, the number of shares issuable under these warrants remained unchanged. The September Agreements provide that in the event that the Company effectuates a Reverse Split of its common stock within 24 months of the closing date of the September Offering and the VWAP of the common stock during the VWAP Period declines from the closing price on the trading date immediately prior to the effective date of the Reverse Split, that the Company shall issue Adjustment Shares. The number of Adjustment Shares shall be calculated as the lesser of (a) 20% of the number of shares of common stock originally purchased by such investor and still held by the investor as of the last day of the VWAP Period, and (b) the number of shares originally purchased by such investor and still held by such Investor as of the last day of the VWAP Period multiplied by the percentage decline in the VWAP during the VWAP Period. All prices and number of shares of common stock shall be adjusted for the Reverse Split and any other stock splits or stock dividends.

The September Warrants expire in September 2017, and contain anti-dilution provisions. As a result, if we, in the future, issue or grant any rights to purchase any of our common stock, or other securities convertible into our common stock, for a per share price less than the exercise price of the September Warrants, the exercise price of the September Warrants will be reduced to such lower price, subject to customary exceptions. In the event that Adjustment Shares are issued, the number of shares that may be purchased under the September Warrants shall be increased by an amount equal to the Adjustment Shares. In addition, the exercise price is subject to adjustment in the event that the VWAP during the VWAP period is less than the exercise price prior to the VWAP Period.

In November 2012, we issued 12,500 restricted shares of common stock to a consultant for investor relation services to be performed beginning November 2012 and ending May 2013.

In December 2012, we entered into securities purchase agreements with several investors including Crede and David Smith, relating to the sale and issuance of an aggregate of 47,121,432 shares of the Company's common stock and warrants (the "December Warrants") to purchase an aggregate of 47,121,432 shares of common stock, at an exercise price of $0.07 per share, for aggregate gross proceeds of approximately $3.3 million (the "December Offering"). The foregoing issuances triggered anti-dilution provisions in certain of the Company's outstanding warrants. As a result, the exercise price of these warrants decreased to $0.07 per share, however, the number of shares issuable under these warrants remained unchanged. The December Agreements provide that in the event that the Company effectuates a Reverse Split of its common stock within 24 months of the closing date of the December Offering and the VWAP of the common stock during the VWAP Period declines from the closing price on the trading date immediately prior to the effective date of the Reverse Split, that the Company shall issue Adjustment Shares. The number of Adjustment Shares shall be calculated as the lesser of (a) 20% of the number of shares of common stock originally purchased by such investor and still held by the investor as of the last day of the VWAP Period, and (b) the number of shares originally purchased by such investor and still held by such Investor as of the last day of the VWAP Period multiplied by the percentage decline in the VWAP during the VWAP Period. All prices and number of shares of common stock shall be adjusted for the Reverse Split and any other stock splits or stock dividends.

The December Warrants expire in December 2017, and contain anti-dilution provisions. As a result, if we, in the future, issue or grant any rights to purchase any of our common stock, or other securities convertible into our common stock, for a per share price less than the exercise price of the September Warrants, the exercise price of the September Warrants will be reduced to such lower price, subject to customary exceptions. In the event that Adjustment Shares are issued, the number of shares that may be purchased under the December Warrants shall be increased by an amount equal to the Adjustment Shares. In addition, the exercise price is subject to adjustment in the event that the VWAP during the VWAP period is less than the exercise price prior to the VWAP Period.

For the years ended December 31, 2012 and 2011, we recognized a gain of $2.7 million and $7.2 million, respectively, related to the revaluation of our warrant liabilities.

Concentration of Credit Risk

Financial instruments, which potentially subject us to a concentration of risk, include cash and accounts receivable. All of our customers are based in the United States at this time and we are not subject to exchange risk for accounts receivable.

The Company maintains its cash in domestic financial institutions subject to insurance coverage issued by the Federal Deposit Insurance Corporation (FDIC). Under FDIC rules, the company is entitled to aggregate coverage as defined by the Federal regulation per account type per separate legal entity per financial institution. The Company has incurred no losses as a result of any credit risk exposures.

For the year ended December 31, 2012, three customers accounted for approximately 91% of revenues and five customers accounted for approximately 98% of accounts receivable.

Recently Issued or Newly Adopted Accounting Pronouncements

In May 2011, the FASB issued Accounting Standards Update ("ASU") 2011-04, "Fair Value Measurement" ("ASU 2011-04"), which amended ASC 820, "Fair Value Measurements" ("ASC 820"), providing a consistent definition and measurement of fair value, as well as similar disclosure requirements between GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles, clarifies the application of existing fair value measurement and expands the disclosure requirements. ASU 2011-04 became effective for us beginning January 1, 2012. The adoption of ASU 2011-04 did not have a material effect on our consolidated financial statements or disclosures.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income" ("ASU 2011-05"). ASU 2011-05 requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. ASU 2011-05 became effective for us beginning January 1, 2012. The adoption of ASU 2011-05 did not have a material effect on our consolidated financial statements or disclosures.

In September 2011, the FASB issued ASU 2011-08, “Testing Goodwill for Impairment” (“ASU 2011-08”), which amends the guidance in ASC 350-20, “Intangibles—Goodwill and Other – Goodwill”. ASU 2011-08 provides entities with the option of performing a qualitative assessment before calculating the fair value of the reporting unit when testing goodwill for impairment. If the fair value of the reporting unit is determined, based on qualitative factors, to be more likely than not less than the carrying amount of the reporting unit, the entities are required to perform a two-step goodwill impairment test. ASU 2011-08 became effective for us beginning January 1, 2012. The adoption of ASU 2011-08 did not have a material effect on our consolidated financial statements or disclosures.

Note 2. Management Services Agreement

We have an executed Management Services Agreement (MSA) with a medical professional corporation and related treatment center, with terms generally ranging from five to ten years and provisions to continue on a month-to-month basis following the initial term, unless terminated for cause. Under the MSA, we license to the treatment center the right to use our proprietary treatment programs and related trademarks and provide all required day-to-day business management services, including, but not limited to:

- general administrative support services;
- information systems;
- recordkeeping;
- scheduling;
- billing and collection;
- marketing and local business development; and
- obtaining and maintaining all federal, state and local licenses, certifications and regulatory permits.

The treatment center retains the sole right and obligation to provide medical services to its patients and to make other medically related decisions, such as the choice of medical professionals to hire or medical equipment to acquire and the ordering of drugs.

In addition, we provide medical office space to the treatment center on a non-exclusive basis, and we are responsible for all costs associated with rent and utilities. The treatment center pays us a monthly fee equal to the aggregate amount of (a) our costs of providing management services (including reasonable overhead allocable to the delivery of our services and including salaries, rent, equipment, and tenant improvements incurred for the benefit of the medical group, provided that any capitalized costs will be amortized over a five year period), (b) 10%-15% of the foregoing costs, and (c) any performance bonus amount, as determined by the treatment center at its sole discretion. The treatment center’s payment of our fee is subordinate to payment of the treatment center's obligations, including physician fees and medical group employee compensation.

We have also agreed to provide a credit facility to the treatment center to be available as a working capital loan, with interest at the Prime Rate plus 2%. Funds are advanced pursuant to the terms of the MSA described above. The notes are due on demand or upon termination of the respective MSA. At December 31, 2012 and 2011, there was one outstanding credit facility under which $12.3 million and $11.4 million was outstanding, respectively. Our maximum exposure to loss could exceed this amount, and cannot be quantified as it is contingent upon the amount of losses incurred by the treatment center that we are required to fund under the credit facility.

Under the MSA, the equity owner of the affiliated treatment center has only a nominal equity investment at risk, and we absorb or receive a majority of the entity’s expected losses or expected residual returns. We participate significantly in the design of the MSA. We also agree to provide a working capital loan to allow for the treatment center to pay for its obligations. Substantially all of the activities of these managed medical corporations either involve us or are conducted for our benefit, as evidenced by the facts that (i) the operations of the managed medical corporation is conducted primarily using our licensed protocols and (ii) under the MSA, we agree to provide and perform all non-medical management and administrative services for the respective treatment center. Payment of our management fee is subordinate to payments of the obligations of the treatment center, and repayment of the working capital loans is not guaranteed by the equity owner of the affiliated treatment center or other third party. Creditors of the managed medical corporation do not have recourse to our general credit. Based on these facts, we have determined that the managed medical corporation is a VIE and that we are the primary beneficiary as defined in current accounting rules. Accordingly, we are required to consolidate the assets, liabilities, revenues and expenses of the managed treatment center.

The amounts and classification of assets and liabilities of the VIE included in our consolidated balance sheets at December 31, 2012 and 2011 are as follows:

(in thousands)	December 31, 2012	December 31, 2011
Cash and cash equivalents	$ 11	$ 28
Receivables, net	19	14
Total assets	$ 30	42
Accounts payable	15	16
Note payable to Catasys, Inc.	12,267	11,365
Total liabilities	$ 12,282	11,381

Note 3. Accounts Receivable

Accounts receivables consisted of the following as of December 31, 2012 and 2011:

(in thousands)	December 31, 2012	2011
Healthcare fees	$ 50	$ 28
License fees	-	4
Patient fees receivable	19	14
Other	-	7
Total receivables	$ 69	$ 53
Less allowance for doubtful accounts	-	-
Total receivables, net	$ 69	$ 53

We use the specific identification method for recording the provision for doubtful accounts, which was $0 and $10,000 as of December 31, 2012 and 2011, respectively. Accounts written off against the allowance for doubtful accounts totaled $0 and $46,000 for the years ended December 31, 2012 and 2011, respectively.

Note 4. Receivable – Related Party

In December 2010, we entered into a three-year sublease agreement with Xoftek, Inc., an affiliate of our Chairman and CEO, to sublease approximately one-third of our office space for a three-year term for a month rent of approximately $11,000 per month. The related party receivable as of December 31, 2012 and 2011 was $173,000 and $127,000, respectively. We have received approximately $81,000 in payments as of December 31, 2012.

Note 5. Property and Equipment

Property and equipment consisted of the following as of December 31, 2012 and 2011:

(in thousands)	2012	2011
Furniture and equipment	$ 3,169	$ 3,216
Leasehold improvements	1,558	2,590
Total property and equipment	4,727	5,806
Less accumulated depreciation and amortization	(4,668)	(5,717)
Total property and equipment, net	$ 59	$ 89

Depreciation expense was $73,000 and $113,000 for the years ended December 31, 2012 and 2011, respectively.

Note 6. Intangible Assets

Intellectual property consists primarily of the costs associated with acquiring certain technology, patents, patents pending, know-how and related intangible assets with respect to programs for treatment of dependence to alcohol, cocaine, methamphetamine, and other addictive stimulants. Intellectual property is being amortized on a straight-line basis from the date costs are incurred over the remaining life of the respective patents or patent applications, which is approximately eight years at December 31, 2012. As of December 31, 2012 and 2011, intangible assets were as follows:

(in thousands)	2012	2011
Intellectual property	$ 1,940	$ 3,955
Less accumulated amortization	(892)	(2,035)
Total Intangibles, net	$ 1,048	$ 1,920

Amortization expense for all intangible assets amounted to $216,000 and $236,000 for the years ended December 31, 2012 and 2011, respectively. Estimated amortization expense for intellectual property for the next five years ending December 31, is approximately $520,000.

PROMETA Treatment Program

In March 2003, we entered into a technology purchase and license agreement (Technology Agreement) with Tratamientos Avanzados de la Adicción S.L. (Tavad), a Spanish corporation, to acquire, on an exclusive basis, all of the rights, title and interest to use and/or sell the products and services. In addition, the Technology Agreement gave us the right to license the intellectual property owned by Tavad with respect to a method for the treatment of alcohol and cocaine dependence, known as the PROMETA Treatment Program, on a worldwide basis except in Spain (as amended in September 2003). We have granted Tavad a security interest in the intellectual property to secure the payments and performance obligations under the Technology Agreement. As consideration for the intellectual property acquired, we issued to Tavad approximately 836,000 shares of our common stock in September 2003 at a fair market value of $2.50 per share, plus warrants to purchase approximately 532,000 shares of our common stock at an exercise price of $2.50 per share, valued at approximately $192,000. Warrants for 160,000 shares that were exercisable at any time through September 29, 2008 have expired, and the remaining warrants for 372,000 shares become exercisable equally over five years and expire ten years from date of grant.

In addition to the purchase price for the above intellectual property, we agreed to pay a royalty fee to Tavad equal to three percent (3%) (six percent (6%) in Europe) of gross revenues from the PROMETA Treatment Program using the acquired intellectual property for so long as we (or any licensee) use the acquired intellectual property. For purposes of the royalty calculations, gross revenue is defined as all payments made by patients for the treatment, including payments made to our licensees. Royalty fees, which totaled $1,000 and $6,000 for the years ended December 31, 2012 and 2011, respectively, are reflected in cost of services expense in our consolidated statements of operations as revenues are recognized.

The total cost of the assets acquired, plus additional costs incurred by us related to filing patent applications on such assets, have been reflected in our consolidated balance sheets in long-term assets as intangible assets. Related amortization, which commenced on July 1, 2003, is being recorded on a straight-line basis over a 20-year estimated useful life.

Note 7. Capital Lease Obligations

We lease certain computer equipment under agreements entered into during 2012 that are classified as capital leases. The computer equipment under capital leases is included in furniture and equipment on our consolidated balance sheets was $31,000 and $18,000 at December 31, 2012 and 2011, respectively. Accumulated depreciation of the leased equipment at December 31, 2012 and 2011, was approximately $4,000 and $5,000, respectively.

The future minimum lease payments required under the capital leases and the present values of the net minimum lease payments, as of December 31, 2012, are as follows:

(in thousands)	Amount
Year ending December 31,	
2013	$ 15
2014	13
2015	8
Total minimum lease payments	36
Less amounts representing interest	(5)
Capital lease obligations, net of interest	31
Less current maturities of capital lease obligations	(13)
Long-term capital lease obligations	$ 18

Note 8. Income Taxes

As of December 31, 2012, the Company had net federal operating loss carry forwards and state operating loss carry forwards of approximately $169 million and $144.6 million, respectively. The net federal operating loss carry forwards begin to expire in 2024, and net state operating loss carry forwards begin to expire in 2014. The majority of the foreign net operating loss carry forwards expire over the next seven years.

The primary components of temporary differences which give rise to our net deferred tax assets are as follows:

(in thousands)	2012	2011
Federal, state and foreign net operating losses	$ 66,120	$ 63,347
Stock based compensation	7,943	7,455
Accrued liabilities	344	133
Other temporary differences	(2,668)	(2,159)
Valuation allowance	(71,739)	(68,776)
	$ -	$ -

The Company has provided a valuation allowance in full on its net deferred tax assets in accordance with ASC 740 Income Taxes (formerly SFAS No. 109, "Accounting for Income Taxes"). Because of the Company's continued losses, management assessed the realizability of its net deferred tax assets as being less than the more-likely-than-not criteria set forth by ASC 740. Furthermore, certain portions of the Company's net operating loss carryforwards were acquired, and therefore subject to further limitation set forth under the federal tax code, which could further limit the Company's ability to realize its deferred tax assets.

A reconciliation between the statutory federal income tax rate and the effective income tax rate for the years ended December 31, is as follows:

	2012	2011
Federal statutory rate	-34.0%	-34.0%
State taxes, net of federal benefit	2.8%	-11.0%
Non-deductible goodwill	0.0%	0.0%
ISO / ESPP	4.5%	1.5%
Other	-0.9%	-0.7%
Change in valuation allowance	27.6%	44.3%
Tax provision	0.0%	0.1%

Current accounting rules require that companies recognize in the consolidated financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. We file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. Tax years that remain subject to examinations by tax authorities are 2008 through 2011. The federal and material foreign jurisdictions statutes of limitations began to expire in 2008. There are no current income tax audits in any jurisdictions for open tax years and, as of December 31, 2012, there have been no material changes to our tax positions.

The Company has adopted guidance issued by the FASB that clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold of more likely than not and a measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In making this assessment, a company must determine whether it is more likely than not that a tax position will be sustained upon examination, based solely on the technical merits of the position and must assume that the tax position will be examined by taxing authorities. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. There were no interest and penalties for the years ended December 31, 2012 and 2011, respectively. The Company files income tax returns with the Internal Revenue Service (“IRS”) and the state of California. For jurisdictions in which tax filings are prepared, the Company is no longer subject to income tax examinations by state tax authorities for tax years through 2007, and by the IRS for tax years through 2008. The Company’s net operating loss carryforwards are subject to IRS examination until they are fully utilized and such tax years are closed.

Note 9. Equity Financings

In December, 2011, the Company entered into a securities purchase agreement with several investors, including Crede, relating to the sale and issuance by the Company to the investors of an aggregate of 3,249,998 units, each unit consisting of (i) one share of common stock and (ii) a five-year warrant to purchase one share of common stock at an exercise price of $0.30 per share (the “December 2011 Offering Warrants”). Each unit was sold at $0.30 (the “December 2011 Offering”). The December 2011 Offering closed on December 27, 2011. In connection with the December 2011 Offering, Crede and David Smith agreed to convert their outstanding convertible notes in the aggregate principal amount of $2,285,000, plus accrued interest, into common stock. The net proceeds of the December 2011 Offering after deducting placement agent’s fees and offering expenses, was approximately $778,000. The December 2011 Offering was conducted pursuant to a registration statement on Form S-1 (File No. 333-173659). In connection with the December 2011 Offering, the Company issued the placement agent, Rodman & Renshaw five year warrants to purchase 162,500 shares of common stock with an exercise price of $0.375 per share. The December 2011 Offering Warrants are exercisable immediately. The exercise price and the number of shares of common stock purchasable upon the exercise of each December 2011 Offering Warrant are subject to adjustment in the event of stock dividends, distributions, and splits. In addition, the December 2011 Offering Warrants have half-ratchet anti-dilution provisions, where the exercise price is adjusted downward in the event that common stock or common stock equivalents are issued by the Company at a price below the exercise price of the December 2011 Offering Warrants with certain exceptions. In addition, in the event of a fundamental transaction (as such term is defined in the December 2011 Offering Warrants), that is an all cash transaction, a Rule 13e-3 transaction or a fundamental transaction involving a person not traded on a national securities exchange, at the holder’s option, the Company (or its successor) would be required within 30 days after consummation of the fundamental transaction to purchase the December 2011 Offering Warrant from the holder by paying to the holder cash in an amount equal to the Black-Scholes value of the remaining unexercised portion of the December 2011 Offering Warrant on the date of the consummation of such fundamental transaction. In connection with the December 2011 Offering, the previous warrants issued to each of Crede and David Smith became exercisable for an aggregate of 8,333,333 and 6,900,000, respectively, since the December 2011 Offering qualified as a Qualified Financing.

In April 2012, we entered into security purchase agreements with several investors, including Crede and David Smith, relating to the sale and issuance of an aggregate of 21,440,050 shares of common stock and warrants (the “April Warrants”) to purchase an aggregate of 21,440,050 shares of common stock at an exercise price of $0.16 per share for aggregate gross proceeds of approximately $3,430,000 (the “April Offering”). The Agreements provide that in the event that the Company effectuates a Reverse Split and the VWAP period declines from the closing price on the trading date immediately prior to the effective date of the Reverse Split, that the Company shall issue the Adjustment Shares. The number of Adjustment Shares shall be calculated as the lesser of (a) 20% of the number of shares of common stock originally purchased by such investor and still held by the investor as of the last day of the VWAP Period, and (b) the number of shares originally purchased by such investor and still held by such Investor as of the last day of the VWAP Period multiplied by the percentage decline in the VWAP during the VWAP Period. All prices and number of shares of common stock shall be adjusted for the Reverse Split and any other stock splits or stock dividends.

In May 2012, we entered into a securities purchase agreement with an accredited investor, on the same terms of Agreements disclosed above, relating to the sale and issuance of 250,000 shares of common stock and warrants to purchase an aggregate of 250,000 shares of common stock at an exercise price of $0.16 per share for gross proceeds of $40,000.

In September 2012, we entered into securities purchase agreements with several investors including Crede and David Smith, relating to the sale and issuance of an aggregate of 17,190,000 shares of the Company’s common stock and warrants (the “September Warrants”) to purchase an aggregate of 17,190,000 shares of common stock, at an exercise price of $0.10 per share, for aggregate gross proceeds of approximately $1.7 million (the “September Offering”). The foregoing issuances triggered anti-dilution provisions in certain of the Company’s outstanding warrants. As a result, the exercise price of these warrants decreased to $0.10 per share, however, the number of shares issuable under these warrants remained unchanged. The September Agreements provide that in the event that the Company effectuates a Reverse Split of its common stock within 24 months of the closing date of the September Offering and the VWAP of the common stock during the VWAP Period declines from the closing price on the trading date immediately prior to the effective date of the Reverse Split, that the Company shall issue Adjustment Shares. The number of Adjustment Shares shall be calculated as the lesser of (a) 20% of the number of shares of common stock originally purchased by such investor and still held by the investor as of the last day of the VWAP Period, and (b) the number of shares originally purchased by such investor and still held by such Investor as of the last day of the VWAP Period multiplied by the percentage decline in the VWAP during the VWAP Period. All prices and number of shares of common stock shall be adjusted for the Reverse Split and any other stock splits or stock dividends.

In December 2012, we entered into securities purchase agreements with several investors including Crede and David Smith, relating to the sale and issuance of an aggregate of 47,121,432 shares of the Company’s common stock and warrants (the “December Warrants”) to purchase an aggregate of 47,121,432 shares of common stock, at an exercise price of $0.07 per share, for aggregate gross proceeds of approximately $3.3 million (the “December Offering”). The foregoing issuances triggered anti-dilution provisions in certain of the Company’s outstanding warrants. As a result, the exercise price of these warrants decreased to $0.07 per share, however, the number of shares issuable under these warrants remained unchanged. The December Agreements provide that in the event that the Company effectuates a Reverse Split of its common stock within 24 months of the closing date of the December Offering and the VWAP of the common stock during the VWAP Period declines from the closing price on the trading date immediately prior to the effective date of the Reverse Split, that the Company shall issue Adjustment Shares. The number of Adjustment Shares shall be calculated as the lesser of (a) 20% of the number of shares of common stock originally purchased by such investor and still held by the investor as of the last day of the VWAP Period, and (b) the number of shares originally purchased by such investor and still held by such Investor as of the last day of the VWAP Period multiplied by the percentage decline in the VWAP during the VWAP Period. All prices and number of shares of common stock shall be adjusted for the Reverse Split and any other stock splits or stock dividends.

Note 10. Share-based Compensation

The Plan provides for the issuance of up to 18,250,000 shares of our common stock. Incentive stock options, under Section 422A of the Internal Revenue Code, non-qualified options, stock appreciation rights, limited stock appreciation rights and restricted stock grants are authorized under the Plan. We grant all such share-based compensation awards at no less than the fair market value of our stock on the date of grant, and have granted stock and stock options to executive officers, employees, members of our Board of Directors and certain outside consultants. The terms and conditions upon which options become exercisable vary among grants; however, option rights expire no later than ten years from the date of grant and employee and Board of Director awards generally vest over three to five years on a straight-line basis. At December 31, 2012, we had 5,082,158 vested and unvested stock options outstanding and 12,595,477 shares reserved for future awards. Total share-based compensation expense amounted to $2.2 million and $4.4 million for the years ended December 31, 2012 and 2011, respectively.

Stock Options – Employees and Directors

During 2012 and 2011, we granted options to employees and directors for 80,000 and 276,000 shares, respectively, at the weighted average per share exercise prices of $0.33 and $0.57, respectively, the fair market value of our common stock on the dates of grants. The estimated fair value of options granted to employees and directors during 2012 and 2011 was $24,294 and $145,522, respectively, calculated using the Black-Scholes pricing model with the assumptions described in Note 1 – *Summary of Significant Accounting Policies, Share-based Compensation*.

Stock option activity for employee and director grants is summarized as follows:

	Shares	**Weighted Avg. Exercise Price**
Balance, December 31, 2010	5,161,000	$ 4.73
2011		
Granted	276,000	0.57
Canceled	(628,000)	2.74
Balance, December 31, 2011	4,809,000	$ 4.74
2012		
Granted	80,000	0.33
Canceled	(28,000)	4.62
Balance, December 31, 2012	4,861,000	$ 4.72

The weighted average remaining contractual life and weighted average exercise price of options outstanding as of December 31, 2012 were as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Shares**	**Weighted Average Remaining Life (yrs)**	**Weighted Average Price**	**Shares**	**Weighted Average Price**
$0.00 to $10.00	3,854,000	8.04	$ 1.56	3,618,000	$ 1.63
$10.01 to $100.00	1,005,000	7.86	16.65	915,000	16.71
$100.01 to $320.00	2,000	5.07	115.40	2,000	115.40
	4,861,000	8.00	$ 4.73	4,535,000	$ 4.72

At December 31, 2012 and 2011, the number of options exercisable was 4,535,000 and 3,103,000, respectively, at weighted-average exercise prices of $4.72 and $5.21, respectively.

Share-based compensation expense relating to stock options granted to employees and directors was $1.8 million and $4.3 million for the years ended December 31, 2012 and 2011, respectively.

As of December 31, 2012, there were $233,000 of unrecognized compensation costs related to non-vested share-based compensation arrangements granted to employees and directors under the Plans. These costs are expected to be recognized over a weighted-average period of 1.63 years.

Stock Options and Warrants – Non-employees

In addition to stock options granted under the Plan, we have also granted options and warrants to purchase our common stock to certain non-employees that have been approved by our Board of Directors. We granted options and warrants of 806,000 and 459,000 during 2012 and 2011, respectively.

Stock option and warrant activity for non-employee grants for services is summarized as follows:

	Shares	**Weighted avg. exercise price**
Balance, December 31, 2010	38,000	$ 139.41
2011		
Granted	459,000	1.56
Exercised	(250,000)	0.49
Canceled	(26,000)	141.79
Balance, December 31, 2011	221,000	$ 9.98
2012		
Granted	-	-
Exercised	-	-
Canceled	-	-
Balance, December 31, 2012	221,000	$ 9.98

Warrants granted to non-employees outstanding at December 31, 2012 are summarized as follows:

Description	Shares	Weighted Average Exercise Price
Warrants issued for intellectual property	9,000	$ 100.00
Warrants issued in connection with equity offering	106,413,000	0.18
Warrants issued in connection with debt agreement	4,842,000	0.08
Warrants issued for services	806,000	0.30
	112,070,000	$ 0.18

We granted 806,000 warrants to non-employees for services during the year ended December 31, 2012, with a weighted average exercise price of $0.30. No warrants were granted to non-employees for services in 2011.

Share-based compensation expense relating to stock options and warrants granted to non-employees amounted to $91,000 and $273,000 for the years ended December 31, 2012 and 2011, respectively.

Common Stock

During 2012 and 2011, we issued 25,000 and 1,050,000 shares of common stock, respectively, for consulting services valued at $4,000 and $504,000, respectively. Generally, these costs are amortized to share-based expense on a straight-line basis over the related service periods, generally ranging from six months to one year. Share-based compensation expense relating to all common stock issued for consulting services was $272.000 and $237,000 for the years ended December 31, 2012 and 2011, respectively.

Employee Stock Purchase Plan

Our qualified employee stock purchase plan (ESPP), approved by our Board of Directors and shareholders and adopted in June 2006, provides that eligible employees (employed at least 90 days) have the option to purchase shares of our common stock at a price equal to 85% of the lesser of the fair market value as of the first day or the last day of each offering period. Purchase options are granted semi-annually and are limited to the number of whole shares that can be purchased by an amount equal to up to 10% of a participant's annual base salary. As of December 31, 2012, there were no shares of our common stock issued pursuant to the ESPP. There was no share-based compensation expense relating to the ESPP for the years ended December 31, 2012 and 2011, respectively.

Note 11. Segment Information

We manage and report our operations through two business segments: healthcare services and license and management services. We evaluate segment performance based on total assets, revenue and income or loss before provision for income taxes. Our assets are included within each discrete reporting segment. In the event that any services are provided to one reporting segment by the other, the transactions are valued at the market price. No such services were provided during the years ended December 31, 2012 and 2011.

Healthcare Services

Catasys's integrated substance dependence solutions combine innovative medical and psychosocial treatments with elements of traditional disease management and ongoing member support to help organizations treat and manage substance dependent populations to impact both the medical and behavioral health costs associated with substance dependence and the related co-morbidities.

We are currently marketing our integrated substance dependence solutions to managed care health plans on a case rate or monthly fee, which involves educating third party payors on the disproportionately high cost of their substance dependent population and demonstrating the potential for improved clinical outcomes and reduced cost associated with using our Catasys programs. We have programs in Kansas, Massachusetts, Louisiana, and Oklahoma.

License and Management

Our license and management services segment is focused on delivering solutions for those suffering from alcohol, cocaine, methamphetamine and other substance dependencies by developing, licensing and commercializing innovative physiological, nutritional, and behavioral treatment programs. Treatment with our PROMETA Treatment Programs, which integrate behavioral, nutritional, and medical components, are available through physicians and other licensed treatment providers who have entered into licensing agreements with us for the use of our treatment programs. Also included in this segment is a licensed and managed treatment center, which offers a range of addiction treatment and mental health services, including the PROMETA Treatment Programs for dependencies on alcohol, cocaine and methamphetamines.

Summary financial information for our two reportable segments is as follows:

(in thousands)	**Twelve Months Ended December 31, 2012**	**2011**
Healthcare services		
Revenues	$ 375	$ 24
Income/(loss) before provision for income taxes	(9,752)	(6,450)
Assets *	3,846	1,551
License and management services		
Revenues	$ 166	$ 243
Loss before provision for income taxes	(1,896)	(1,655)
Assets *	1,088	2,029
Consolidated continuing operations		
Revenues	$ 541	$ 267
Income/(loss) before provision for income taxes	(11,648)	(8,105)
Assets *	4,934	3,580

* Assets are reported as of December 31.

Note 12. Commitments and Contingencies

Operating Lease Commitments

We incurred rent expense of approximately $290,000 and $320,000 for the years ended December 31, 2012 and 2011, respectively.

Our principal executive and administrative offices are located in Los Angeles, California and consist of leased office space totaling approximately 10,700 square feet. The initial term of the lease expired in December 2010. In December 2010, we amended and extended the lease for three years. Our base rent is currently approximately $36,000 per month, subject to annual adjustments, with aggregate minimum lease commitments at March 28, 2013, totaling approximately $320,000. Concurrent with the three year extension, the Board of Directors approved a sublease of approximately one-third of the office space to Xoftek, Inc. an affiliate of our Chairman and CEO. Xoftek, Inc. will pay the company pro-rata rent during the three-year lease period.

We have a related party receivable from Xoftek, Inc. in the amount of $173,000 as of December 31, 2012, which represents unpaid monthly rent related to a January 1, 2011 sublease agreement.

In April 2005, we entered into a five-year lease for approximately 5,400 square feet of medical office space in Santa Monica, California, which is occupied by The Center to Overcome Addiction, which operates under a full service management agreement with us. Our base rent was approximately $19,000 per month. In May 2010, we entered into an amendment to our lease for this facility calling for the deferral of a portion of the rent for a period of seven months and a reduction in our medical office space to approximately 2,700 square feet. As a result of the amendment our rent was reduced by approximately $8,000 per month beginning June 1, 2010 and ending December 31, 2010. According to the terms of the agreement beginning January 1, 2010, the base rent and the deferred rent were due in installments with all rents to be paid prior to the termination of the lease in August 2010. In August 2010, with all base and deferred rents paid in full, we entered into another amendment to our lease for a six-month extension after which it converted to a month-to-month lease. In June 2012, we terminated our month-to-month lease and relocated operations to our principle offices in Los Angeles, California.

In August 2006, we entered into a 62-month lease for 4,000 square feet of medical office space, located in San Francisco, California, at an initial base rent of approximately $11,000 per month, commencing in January 2007. The space was occupied by a managed treatment center through January 31, 2008 under an MSA. In March 2010, the Company settled the outstanding lease commitment for $200,000 to be paid in monthly installments from March 2010 through February 2011. All payments under this settlement agreement have subsequently been paid in full.

Rent expense is calculated using the straight-line method based on the total minimum lease payments over the initial term of the lease. Landlord tenant improvement allowances and rent expense exceeding actual rent payments are accounted for as deferred rent liability in the balance sheet and amortized on a straight-line basis over the initial term of the respective leases.

Future minimum payments, by year and in the aggregate, under non-cancelable operating leases with initial or remaining terms of one year or more, consist of the following at December 31, 2012:

(In thousands) **Year**	**Amount**
2013	$ 427

Clinical Research Commitments

In prior years, we committed to unrestricted grants for clinical research study in the amount of $400,000, payable based on achieving certain milestones. As of December 31, 2012, we had approximately $356,000 remaining commitment for that clinical research study.

Legal Proceedings

As of the date of this report, we are not currently involved in any legal proceeding that we believe has a material adverse effect on our business, financial condition or operating results. We are however involved in litigation ("Isaka Matter") as described below.

On or about August 18, 2006, plaintiffs Isaka Investments, Ltd., Sand Hill Capital International Inc. and Richbourg Financial, Ltd. ("Plaintiffs") filed a complaint in the Los Angeles Superior Court, entitled *Isaka Investments, Ltd., Sand Hill Capital International, Inc. and Richbourg Financial, Ltd. vs. Xino Corporation*, an entity from which our Company had acquired certain assets, and a number of other additional individuals and entities, including our Company, our Company's Chairman and Chief Executive Officer, Terren S. Peizer, and other members of the Company's Board of Directors. The Board of Directors and other parties were dismissed by way of demurrer. In July 2007, Plaintiffs filed their second amended complaint, asserting causes of action for conversion, a request for an order to set aside an alleged fraudulent conveyance and breach of contract against our Company, Mr. Peizer, and others. In August 2007, our Company and Mr. Peizer, among others, filed an answer to the second amended complaint denying liability and asserting numerous affirmative defenses. In June 2008, our Company, Mr. Peizer, and others, filed a motion for summary judgment, or alternatively, summary adjudication, and in October 2008, the Court granted summary adjudication as to each cause of action and consequently summary judgment in favor of our Company and Mr. Peizer, among others. Plaintiffs appealed the summary judgment and in October 2010, the Court of Appeal reversed the trial court's ruling. The Court of Appeal's decision was not on the merits, but rather provides that there are sufficient material issues of fact for the case to be tried. The Court of Appeal issued a remittitur in December 2010, and Plaintiffs filed a motion for leave to amend the second amended complaint, which was granted in June 2011. In June 2011, Plaintiffs filed their third amended complaint and, in August 2011, in response to a demurrer filed by the Company, Mr. Peizer and others, the Court held that Plaintiffs' third amended complaint was not pled with sufficient specificity to state the causes of action alleged therein. In September 2011, Plaintiffs filed a fourth amended complaint, alleging causes of action for breach of fiduciary duty, fraudulent transfer, conversion, fraud, breach of contract, unfair business practices and wrongful interference with contractual relations and prospective business advantage. The Company filed a demurrer related to the fourth amended complaint in September 2011. At the hearing, the Court sustained, without leave to amend, the demurrers to the causes of action for breach of fiduciary duty and wrongful interference with contractual relations and prospective business advantage. In October 2011, the Company, Mr. Peizer and others, filed an answer to the fourth amended complaint, denying liability and asserting numerous affirmative defenses. In April 2012, the Court conducted a bench trial on the issue of whether the Plaintiffs have standing to pursue the causes of action alleged in their Fourth Amended Complaint other than the causes of action for conversion and breach of contract. At the conclusion of the trial, the Court ruled that Plaintiffs lack standing to pursue any causes of action other than for conversion and breach of contract. A Statement of Decision and Order of Dismissal was signed by the Court on July 18, 2012. Thereafter, the Plaintiffs filed an ex parte application to reopen the evidence which was denied by the Court. The Plaintiffs also filed a motion to amend their complaint seeking to add back in the claims that they lost at trial. The motion to amend was denied. On July 3, 2012, September 5, 2012 and October 15, 2012, the Plaintiffs filed Petitions for Writs of Mandate in the Court of Appeal. The Writs were summarily denied by the Court of Appeal. On October 9, 2012, the Court commenced hearings regarding the trial of the conversion and breach of contract causes of action. On October 15, 2012, the parties, through their counsel of record, stipulated to a bench trial on the admissibility and enforceability of a 2007 settlement agreement between Xino Corporation and the Company (the "Settlement Agreement"). Thus, the parties submitted the issue to the Court for a bench trial to determine whether the Settlement Agreement was admissible and effective to bar the two remaining claims. The Court held that the Settlement Agreement was admissible and enforceable to release the remaining claims. Accordingly, judgment was entered for the Company on November 19, 2012. Plaintiffs filed a notice of appeal on December 10, 2012. On March 26, 2013, Plaintiffs filed their opening brief in the Court of Appeal. The Company's response will be due on April 26, 2013 unless it requests an extension. The Company has had very limited settlement discussions and the Company believes Plaintiffs' claims are without merit and intends to continuously, and vigorously, defend the case.

The Company believes it will prevail, but a range of loss could not be determined, should it not prevail, but we believe it would not have a material adverse effect on our financial statements.

Note 13. Subsequent Events

In March 2013, the Company entered into a contract with a national health plan to provide our On*Trak* Program to their members in New Jersey. We expect to commence enrollment in the second quarter of 2013.

Note 14. Restatement of Financial Statements

The financial statements have been retroactively restated to reflect the 40 to 1 reverse stock split that occurred on September 6, 2011.