

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

FORM 10-Q

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

For the quarterly period ended **September 30, 2016**

Commission File Number **001-31932**

CATASYS, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

88-0464853

(I.R.S. Employer Identification No.)

11601 Wilshire Boulevard, Suite 1100, Los Angeles, California 90025

(Address of principal executive offices, including zip code)

(310) 444-4300

(Registrant's telephone number, including area code)

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

Yes No

Indicate 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 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 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 November 11, 2016, there were 55,173,458 shares of the registrant's common stock, \$0.0001 par value per share, outstanding.

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In this report, except as otherwise stated or the context otherwise requires, the terms “we,” “us” “our” or the “Company” 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 - FINANCIAL INFORMATION

Item 1. Financial Statements

**CATASYS, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except for number of shares)	(unaudited) September 30, 2016	December 31, 2015
ASSETS		
Current assets		
Cash and cash equivalents	\$ 1,843	\$ 916
Receivables, net of allowance for doubtful accounts of \$0 and \$0, respectively	889	590
Prepays and other current assets	305	575
Total current assets	3,037	2,081
Long-term assets		
Property and equipment, net of accumulated depreciation of \$1,581 and \$1,491, respectively	445	412
Deposits and other assets	371	387
Total Assets	\$ 3,853	\$ 2,880
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	\$ 818	\$ 753
Accrued compensation and benefits	1,892	1,703
Deferred revenue	3,231	1,683
Other accrued liabilities	551	682
Short term debt, related party, net of discount of \$978 and \$0, respectively	8,647	-
Short term derivative liability	8,676	-
Total current liabilities	23,815	4,821
Long-term liabilities		
Deferred rent and other long-term liabilities	138	198
Capital leases	40	66
Long term debt, related party, net of discount of \$0 and \$0, respectively	-	3,662
Long term derivative liability	-	2,348
Warrant liabilities	4,441	509
Total Liabilities	28,434	11,604
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 shares authorized; 55,053,458 and 55,007,761 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	6	6
Additional paid-in-capital	253,621	253,053
Accumulated deficit	(278,208)	(261,783)
Total Stockholders' Deficit	(24,581)	(8,724)
Total Liabilities and Stockholders' Deficit	\$ 3,853	\$ 2,880

See accompanying notes to the financial statements.

CATASYS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

(In thousands, except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues				
Healthcare services revenues	\$ 1,336	\$ 538	\$ 3,287	\$ 1,443
Operating expenses				
Cost of healthcare services	1,253	720	3,381	1,655
General and administrative	2,195	1,968	6,518	7,124
Depreciation and amortization	38	30	102	94
Total operating expenses	3,486	2,718	10,001	8,873
Loss from operations	(2,150)	(2,180)	(6,714)	(7,430)
Other income	15	20	90	41
Interest expense	(3,215)	(1,209)	(4,139)	(2,321)
Loss on disposal of intangible assets	-	(88)	-	(88)
Loss on exchange of warrants	-	-	-	(4,410)
Change in fair value of derivative liability	(3,484)	(5,027)	(6,328)	(5,027)
Change in fair value of warrant liability	1,423	1,007	673	10,915
Loss from operations before provision for income taxes	(7,411)	(7,477)	(16,418)	(8,320)
Provision for income taxes	2	3	7	7
Net loss	\$ (7,413)	\$ (7,480)	\$ (16,425)	\$ (8,327)
Basic and diluted net loss from operations per share:	\$ (0.13)	\$ (0.16)	\$ (0.30)	\$ (0.23)
Basic and diluted weighted number of shares outstanding	55,044	47,638	55,020	36,181

See accompanying notes to the financial statements.

CATASYS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(unaudited)

(In thousands)	Nine Months Ended September 30,	
	2016	2015
Operating activities:		
Net loss	\$ (16,425)	\$ (8,327)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	102	94
Loss on disposal of intangible assets	-	88
Amortization of debt discount and issuance costs included in interest expense	3,673	2,166
Warrants issued for services	-	112
Provision for doubtful accounts	46	65
Deferred rent	(52)	(58)
Share-based compensation expense	523	1,223
Common stock issued for consulting services	-	172
Fair value adjustment on warrant liability	(673)	(10,915)
Loss on exchange of warrants	-	4,410
Fair value adjustment on derivative liability	6,328	5,027
Changes in current assets and liabilities:		
Receivables	(345)	71
Prepays and other current assets	270	136
Deferred revenue	1,548	1,200
Accounts payable and other accrued liabilities	554	664
Net cash used by operating activities	\$ (4,451)	\$ (3,872)
Investing activities:		
Purchases of property and equipment	\$ (102)	\$ (18)
Deposits and other assets	16	(87)
Net cash used by investing activities	\$ (86)	\$ (105)
Financing activities:		
Proceeds from the issuance of common stock and warrants	\$ -	\$ 463
Proceeds from the issuance of convertible debt, related party	-	5,910
Payments on convertible debenture	-	(2,681)
Proceeds from the issuance of senior promissory note, related party	5,505	-
Proceeds from advance from related party	225	-
Payment on advance from related party	(225)	-
Transactions costs	-	(185)
Capital lease obligations	(41)	(13)
Net cash provided by financing activities	\$ 5,464	\$ 3,494
Net increase (decrease) in cash and cash equivalents	\$ 927	\$ (483)
Cash and cash equivalents at beginning of period	916	708
Cash and cash equivalents at end of period	\$ 1,843	\$ 225
Supplemental disclosure of cash paid		
Interest	\$ -	\$ 190
Income taxes	\$ 46	\$ 40
Supplemental disclosure of non-cash activity		
Common stock issued for exercise of warrants	\$ 45	\$ -
Property and equipment acquired through capital leases and other financing	\$ 34	\$ 7

See accompanying notes to the financial statements.

Catasys, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 1. Basis of Consolidation, Presentation and Going Concern

The accompanying unaudited condensed consolidated financial statements for Catasys, Inc. and its subsidiaries have been prepared in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP") and instructions to Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of financial position, results of operations, and cash flows in conformity with U.S. GAAP. In our opinion, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included. Interim results are not necessarily indicative of the results that may be expected for the entire fiscal year. The accompanying financial information should be read in conjunction with the financial statements and the notes thereto included in our most recent Annual Report on Form 10-K for the year-ended December 31, 2015, from which the balance sheets as of December 31, 2015, have been derived.

Our financial statements have been prepared on the basis that we will continue as a going concern. At September 30, 2016, cash and cash equivalents was \$1.8 million and we had a working capital deficit of approximately \$20.8 million. In August 2016, we entered into subscription agreements with three accredited investors, including Shamus, LLC ("Shamus"), a company owned by David E. Smith, a member of our board of directors, pursuant to which we received \$2.8 million and issued five-year warrants to purchase up to an aggregate of 875,000 shares of our common stock, at an exercise price of \$1.10 per share. We have incurred significant operating losses and negative cash flows from operations since our inception. During the nine months ended September 30, 2016, our cash used in operating activities was \$4.5 million. We anticipate that we could continue 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 September 30, 2016, these conditions raised substantial doubt as to our ability to continue as a going concern. We expect our current cash resources to cover expenses into December 2016; however, delays in cash collections, revenue, or unforeseen expenditures could negatively impact our estimate. We are in need of additional capital; however, there is no assurance that additional capital can be timely raised in an amount which is sufficient for us or on terms favorable to us and our stockholders, if at all. If we do not obtain additional capital, there is 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 our stockholders.

Our ability to fund our ongoing operations and continue as a going concern is dependent on increasing the number of members that are eligible for our programs by signing new contracts and generating fees from existing and new contracts and the success of management's plans to increase revenue and continue to control expenses. We currently operate in Florida, Georgia, Illinois, Kansas, Kentucky, Louisiana, Massachusetts, Missouri, New Jersey, North Carolina, Oklahoma, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, West Virginia and Wisconsin. We provide services to commercial (employer funded), managed Medicare Advantage and managed Medicaid populations. We have generated increasing fees from our launched programs and expect to increase enrollment and fees throughout 2016. However, there can be no assurance that we will generate such fees or that new programs will launch as we expect.

Note 2. Summary of Significant Accounting Policies

Revenue Recognition

Our Catasys contracts are generally designed to provide cash fees to us on a monthly basis based on 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 the performance guarantees, we recognize the case rate ratably over the twelve months of our program.

Cost of 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. Salaries and fees charged by our third party administrators for processing claims are expensed when incurred and healthcare provider claims payments are recognized in the period in which an eligible member receives services. We contract with doctors and licensed behavioral healthcare professionals, on a fee-for-services 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 OnTrak™ database within the contracted timeframe, with all required billing elements correctly completed by the service provider.

Cash Equivalents and Concentration of Credit Risk

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents. Financial instruments that potentially subject us to a concentration of credit risk consist of cash and cash equivalents. Cash is deposited with what we believe are highly credited, quality financial institutions. The deposited cash may exceed Federal Deposit Insurance Corporation ("FDIC") insured limits. As of September 30, 2016, cash and cash equivalents exceeding federally insured limits totaled \$1.7 million.

For the nine months ended September 30, 2016, two customers accounted for approximately 80% of revenues and three customers accounted for approximately 94% of accounts receivable.

Basic and Diluted Income (Loss) per Share

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

Common equivalent shares, consisting of 7,072,926 and 3,443,612 shares for the nine months ended September 30, 2016 and 2015, respectively, issuable upon the exercise of stock options and warrants have been excluded from the diluted earnings per share calculation as their effect is anti-dilutive.

Share-Based Compensation

Our 2010 Stock Incentive Plan as amended (the "Plan"), provides for the issuance of up to 1,825,000 shares of our common stock. Incentive stock options (ISOs) under Section 422A of the Internal Revenue Code and non-qualified stock 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 September 30, 2016, we had 1,464,091 vested and unvested stock options outstanding and 303,672 shares available for future awards under the Plan.

Share-based compensation expense attributable to operations were \$174,000 and \$523,000 for the three and nine months ended September 30, 2016, respectively, compared with \$186,000 and \$1.2 million for the same periods in 2015, 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 condensed consolidated statements of operations.

Share-based compensation expense recognized for employees and directors for the three and nine months ended September 30, 2016 was \$174,000 and \$523,000, respectively, compared with \$186,000 and \$1.2 million, for the same periods in 2015, respectively.

For share-based awards issued to employees and directors, share-based compensation is attributed to expense using the straight-line single option method. Share-based compensation expense recognized in our condensed consolidated statements of operations for the three and nine months ended September 30, 2016 and 2015 is based on awards ultimately expected to vest, reduced for estimated forfeitures. Accounting rules for stock options require forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

There were no options granted to directors and employees during the three and nine months ended September 30, 2016, respectively, and 0 and 1,050,000 options granted to directors and 0 and 250,000 options granted to employees during the same period of 2015 under the Plan, respectively. Employee and director stock option activity for the three and nine months ended September 30, 2016 are as follows:

	Shares	Weighted Avg. Exercise Price
Balance December 31, 2015	1,471,000	\$ 6.49
Granted	-	\$ -
Cancelled	(7,000)	\$ 10.38
Balance March 31, 2016	<u>1,464,000</u>	<u>\$ 6.49</u>
Granted	-	\$ -
Cancelled	-	\$ -
Balance June 30, 2016	<u>1,464,000</u>	<u>\$ 6.49</u>
Granted	-	\$ -
Cancelled	-	\$ -
Balance September 30, 2016	<u>1,464,000</u>	<u>\$ 6.49</u>

The expected volatility assumptions have been based on the historical and expected volatility of our stock, measured over a period generally commensurate with the expected term. The weighted average expected option term for the three and nine months ended September 30, 2016 and 2015 reflects the application of the simplified method prescribed in SEC Staff Accounting Bulletin (“SAB”) No. 107 (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.

As of September 30, 2016, there was \$492,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of approximately 1.24 years.

Stock Options and Warrants – Non-employees

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

There were no options issued to non-employees for the three and nine months ended September 30, 2016 and 2015. There was no share-based compensation expense relating to stock options and warrants recognized for non-employees for the three and nine months ended September 30, 2016, respectively, and \$0 and \$3,000 for the three and nine months ended September 30, 2015, respectively.

There was no non-employee stock option activity for the three and nine months ended September 30, 2016.

Common Stock

There were 45,697 shares of common stock issued in connection with a cashless warrant exercise for the three and nine months ended September 30, 2016, respectively.

There were no shares of common stock issued for investor relations or consulting services during the three and nine months ended September 30, 2016 respectively, compared to 0 and 76,000 shares issued for the same periods in 2015, respectively. Generally, the costs associated with shares issued for services are being amortized to the related expense on a straight-line basis over the related service periods.

Income Taxes

We have recorded a full valuation allowance against our otherwise recognizable deferred tax assets as of September 30, 2016. As such, we have not recorded a provision for income tax for the period ended September 30, 2016. We utilize the liability method of accounting for income taxes as set forth in ASC 740, Income Taxes. Under the liability method, deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized.

We assess our income tax positions and record tax benefits for all years subject to examination based upon our evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where there is greater than 50% likelihood that a tax benefit will be sustained, we have recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where there is less than 50% likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. Based on management's assessment of the facts, circumstances and information available, management has determined that all of the tax benefits for the period ended September 30, 2016 should be realized.

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 condensed consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure 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 I) and the lowest priority to unobservable inputs (Level III). 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 table summarizes fair value measurements by level at September 30, 2016 for assets and liabilities measured at fair value:

Balance at September 30, 2016				
<i>(Amounts in thousands)</i>	Level I	Level II	Level III	Total
Certificates of deposit	106	-	-	106
Total assets	106	-	-	106
Warrant liabilities	-	-	4,441	4,441
Derivative Liability	-	-	8,676	8,676
Total liabilities	-	-	13,117	13,117

Financial instruments classified as Level III in the fair value hierarchy as of September 30, 2016, represent our liabilities measured at market value on a recurring basis which include warrant liabilities and derivative liabilities resulting from recent debt and equity financings. In accordance with current accounting rules, the warrant liabilities and derivative liabilities are being marked-to-market each quarter-end until they are completely settled. The warrants and derivative liabilities 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. See *Warrant Liabilities* below.

The following table summarizes our fair value measurements using significant Level III inputs, and changes therein, for the three and nine months ended September 30, 2016:

<i>(Dollars in thousands)</i>	Level III Warrant Liabilities	<i>(Dollars in thousands)</i>	Level III Derivative Liabilities
Balance as of December 31, 2015	\$ 509	Balance as of December 31, 2015	\$ 2,348
Issuance of warrants	216	Issuance of warrants	-
Change in fair value	228	Change in fair value	1,337
Balance as of March 31, 2016	\$ 953	Balance as of March 31, 2016	\$ 3,685
Issuance (exercise) of warrants, net	444	Issuance (exercise) of warrants, net	-
Change in fair value	522	Change in fair value	1,507
Balance as of June 30, 2016	\$ 1,919	Balance as of June 30, 2016	\$ 5,192
Issuance (exercise) of warrants, net	3,982	Issuance (exercise) of warrants, net	-
Exercise of warrants	(37)	Expiration of warrants	-
Change in fair value	(1,423)	Change in fair value	3,484
Balance as of September 30, 2016	\$ 4,441	Balance as of September 30, 2016	\$ 8,676

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.

Warrant Liabilities

In March 2016, we entered into a promissory note with Acuitas Group Holdings, LLC (“Acuitas”), pursuant to which we received aggregate gross proceeds of \$900,000 for the issuance of the note with a principal amount of \$900,000 (the “March 2016 Promissory Note”). The March 2016 Promissory Note is due within 30 days of demand by Acuitas (the “Maturity Date”), and carries an interest rate on any unpaid principal amount of 8% per annum until the Maturity Date, after which the interest will increase to 12% per annum. In addition, we issued Acuitas five-year warrants to purchase an aggregate of 450,000 shares of our common stock, at an exercise price of \$0.47 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “March 2016 Warrants”). The number of warrants were subsequently increased to 640,909 and the exercise price of the March 2016 Warrants was subsequently reduced to \$0.33 per share based upon the May 2016 Promissory Note.

In April 2016, we amended and restated the March 2016 Promissory Note to increase the principal amount by \$400,000, for a total of \$1.3 million (the “April Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 200,000 shares of our common stock, at an exercise price of \$0.47 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “April 2016 Warrants”). The number of warrants were subsequently increased to 284,848 and the exercise price of the April 2016 Warrants was subsequently reduced to \$0.33 per share based upon the May 2016 Promissory Note.

In May 2016, we amended and restated the April 2016 Promissory Note to increase the principal amount by \$405,000, for a total of \$1.7 million (the “May Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 306,818 shares of our common stock, at an exercise price of \$0.33 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “May 2016 Warrants”).

In June 2016, we amended and restated the May 2016 Promissory Note to increase the principal amount by \$480,000, for a total of \$2.2 million (the “June 2016 Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 363,636 shares of our common stock, at an exercise price of \$0.33 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “June 2016 Warrants”).

In July 2016, we amended and restated the June 2016 Promissory Note to increase the principal amount by \$570,000, for a total of \$2.8 million (the “July 2016 Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 431,818 shares of our common stock at an exercise price of \$0.33 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “July 2016 Warrants”).

In August 2016, we entered into subscription agreements with three accredited investors, including Shamus (collectively, the “Investors”), pursuant to which we issued to the Investors short-term senior promissory notes in the aggregate principal amount of \$2.8 million (the “August 2016 Notes”) and five-year warrants to purchase up to an aggregate of 875,000 shares of our common stock, at an exercise price of \$1.10 per share (the “August 2016 Warrants”).

The August 2016 Warrants include price protection provisions pursuant to which, subject to certain exempt issuances, the then exercise price of the August 2016 Warrants will be adjusted, in the event we issue shares of our common stock for consideration per share less than the then exercise price of the August 2016 Warrants, to the lowest consideration per share for the shares issued or sold in such transaction. The price protection will be in effect until the earliest of (i) the termination date of the August 2016 Warrants, (ii) such time as the Warrants are exercised or (iii) contemporaneously with the listing of our shares of common stock on a registered national securities exchange.

In addition, in August 2016, Acuitas agreed to exchange its July 2016 Promissory Note for a short-term senior promissory note, in the aggregate principal amount of \$2.8 million plus accrued interest, in the form substantially identical to the form of the August 2016 Notes. Acuitas also agreed to exchange certain of its outstanding warrants to purchase an aggregate of 2,028,029 shares of our common stock at an exercise price of \$0.33 per share for warrants to purchase an aggregate of 2,993,561 shares of common stock at an exercise price of \$1.10 per share, in the form substantially identical to the form of the August 2016 Warrants.

The warrant liability as of September 30, 2016 was calculated using the Black-Scholes model based upon the following assumptions:

	September 30, 2016
Expected volatility	133.19%
Risk-free interest rate	0.29 - 1.14%
Weighted average expected lives in years	0.24 - 4.87
Expected dividend	0%

We have issued warrants to purchase common stock in December 2011, February 2012, April 2015, and July 2015 and August 2016. The warrants are being accounted for as liabilities in accordance with FASB accounting rules, due to anti-dilution 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.

For the three and nine months ended September 30, 2016 and 2015, we recognized a gain of \$1.4 million and \$673,000, respectively, compared with a gain of \$1.0 million and \$10.9 million for the same periods in 2015, respectively, related to the revaluation of our warrant liabilities.

Derivative Liabilities

In July 2015, we entered into a \$3.55 million 12% Original Issue Discount Convertible Debenture due January 18, 2016 with Acuitas (the "July 2015 Convertible Debenture"). The conversion price of the July 2015 Convertible Debenture is \$1.90 per share, subject to adjustments, including for issuances of common stock and common stock equivalents below the then current conversion or exercise price, as the case may be. In October 2015, we entered into an amendment of the July 2015 Convertible Debenture which extended the maturity date of the July 2015 Convertible Debenture from January 18, 2016 to January 18, 2017. In addition, the conversion price of the July 2015 Convertible Debenture was subsequently adjusted to \$0.30 per share. The July 2015 Convertible Debenture is unsecured, bears interest at a rate of 12% per annum payable in cash or shares of common stock, subject to certain conditions, at our option, and is subject to mandatory prepayment upon the consummation of certain future financings. The derivative liability associated with the July 2015 Convertible Debenture was calculated using the Black-Scholes model based upon the following assumptions:

	September 30, 2016
Expected volatility	133.19%
Risk-free interest rate	0.36%
Weighted average expected lives in years	0.30
Expected dividend	0%

The expected volatility assumption for the nine months ended September 30, 2016 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 2015 reflect the application of the simplified method set out in the SEC 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.

For the three and nine months ended September 30, 2016, we recognized a loss of \$3.5 million and \$6.3 million, respectively, compared with a \$5.0 million loss for the same periods in 2015, related to the revaluation of our derivative liability.

Recently Issued or Newly Adopted Accounting Standards

In April 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-10, *Revenue from Contracts with Customers (Topic 606)* (“ASU 2016-10”), which amends certain aspects of the Board’s new revenue standard, ASU 2014-09, *Revenue from Contracts with Customers*. The standard should be adopted concurrently with adoption of ASU 2014-09 which is effective for annual and interim periods beginning after December 15, 2017. Early adoption is permitted. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

In March 2016, the FASB issued ASU 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting* (“ASU 2016-09”), which outlines new provisions intended to simplify various aspects related to accounting for share-based payments and their presentation in the financial statements. The standard is effective for the Company beginning December 15, 2016, and interim periods within those annual periods. Early adoption is permitted. The adoption of ASU 2016-09 did not have a material effect on our consolidated financial position or results of operations.

In February 2015, the FASB issued ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis* (“ASU 2015-02”). ASU 2015-02 modifies existing consolidation guidance for reporting organizations that are required to evaluate whether they should consolidate certain legal entities. ASU 2015-02 is effective for fiscal years and interim periods within those years beginning after December 15, 2015, and requires either a retrospective or a modified retrospective approach to adoptions. Early adoption is permitted. We are currently evaluating the potential impact of this standard on our consolidated financial statements, as well as the available transition methods.

In August 2014, the FASB issued FASB ASU 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern*, (“ASU 2014-15”). ASU 2014-15 changes to the disclosure of uncertainties about an entity’s ability to continue as a going concern. Under U.S. GAAP, continuation of a reporting entity as a going concern is presumed as the basis for preparing financial statements unless and until the entity’s liquidation becomes imminent. Even if an entity’s liquidation is not imminent, there may be conditions or events that raise substantial doubt about the entity’s ability to continue as a going concern. Because there is no guidance in U.S. GAAP about management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern or to provide related note disclosures, there is diversity in practice whether, when, and how an entity discloses the relevant conditions and events in its financial statements. As a result, these changes require an entity’s management to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date that financial statements are issued. Substantial doubt is defined as an indication that it is probable that an entity will be unable to meet its obligations as they become due within one year after the date that financial statements are issued. If management has concluded that substantial doubt exists, then the following disclosures should be made in the financial statements: (i) principal conditions or events that raised the substantial doubt, (ii) management’s evaluation of the significance of those conditions or events in relation to the entity’s ability to meet its obligations, (iii) management’s plans that alleviated the initial substantial doubt or, if substantial doubt was not alleviated, management’s plans that are intended to at least mitigate the conditions or events that raise substantial doubt, and (iv) if the latter in (iii) is disclosed, an explicit statement that there is substantial doubt about the entity’s ability to continue as a going concern. ASU 2014-15 is effective for periods beginning after December 15, 2016. The adoption of ASU 2014-15 will not have a material effect on our consolidated financial position or results of operations.

Note 3. Related Party Disclosure

In March 2016, we entered into the March 2016 Promissory Note and issued the March 2016 Warrants to Acuitas. In April 2016, we entered into the April 2016 Promissory Note and issued the April 2016 Warrants to Acuitas. In May 2016, we entered into the May 2016 Promissory Note and issued the May 2016 Warrants to Acuitas. In June 2016, we entered into the June 2016 Promissory Note and issued the June 2016 Warrants to Acuitas. In July 2016, we entered into the July 2016 Promissory Note and issued the July 2016 Warrants to Acuitas. Acuitas exchanged all of these promissory notes and warrants for a \$2.8 million Senior Promissory Note and warrants to purchase an aggregate of 2,993,561 shares of common stock at \$1.10 per share. In addition, we have accounts payable outstanding with Mr. Peizer for travel and expenses of \$177,000 as of September 30, 2016. We also have \$1 million in deferred salary owed to Mr. Peizer as of September 30, 2016.

Note 4. Short-term Debt

In March 2016, we entered into a promissory note with Acuitas Group Holdings, LLC (“Acuitas”), pursuant to which we received aggregate gross proceeds of \$900,000 for the issuance of the note with a principal amount of \$900,000 (the “March 2016 Promissory Note”). The March 2016 Promissory Note is due within 30 days of demand by Acuitas (the “Maturity Date”), and carries an interest rate on any unpaid principal amount of 8% per annum until the Maturity Date, after which the interest will increase to 12% per annum. In addition, we issued Acuitas five-year warrants to purchase an aggregate of 450,000 shares of our common stock, at an exercise price of \$0.47 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “March 2016 Warrants”). The number of warrants were subsequently increased to 640,909 and the exercise price of the March 2016 Warrants was subsequently reduced to \$0.33 per share based upon the May 2016 Promissory Note.

In April 2016, we amended and restated the March 2016 Promissory Note to increase the principal amount by \$400,000, for a total of \$1.3 million (the “April Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 200,000 shares of our common stock, at an exercise price of \$0.47 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “April 2016 Warrants”). The number of warrants were subsequently increased to 284,848 and the exercise price of the April 2016 Warrants was subsequently reduced to \$0.33 per share based upon the May 2016 Promissory Note.

In May 2016, we amended and restated the April 2016 Promissory Note to increase the principal amount by \$405,000, for a total of \$1.7 million (the “May Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 306,818 shares of our common stock, at an exercise price of \$0.33 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “May 2016 Warrants”).

In June 2016, we amended and restated the May 2016 Promissory Note to increase the principal amount by \$480,000, for a total of \$2.2 million (the “June 2016 Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 363,636 shares of our common stock, at an exercise price of \$0.33 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “June 2016 Warrants”).

In July 2016, we amended and restated the June 2016 Promissory Note to increase the principal amount by \$570,000, for a total of \$2.8 million (the “July 2016 Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 431,818 shares of our common stock at an exercise price of \$0.33 per share, which warrants include, subject to certain exceptions, a full-ratchet anti-dilution protection (the “July 2016 Warrants”).

In August 2016, we entered into subscription agreements (each, the Subscription Agreement”) with three accredited investors, including Shamus, (collectively, the “Investors”), pursuant to which we issued to the Investors short-term senior promissory notes in the aggregate principal amount of \$2.8 million (the “August 2016 Notes”) and five-year warrants to purchase up to an aggregate of 875,000 shares of our common stock, at an exercise price of \$1.10 per share (the “August 2016 Warrants”).

The August 2016 Warrants include price protection provisions pursuant to which, subject to certain exempt issuances, the then exercise price of the August 2016 Warrants will be adjusted, in the event we issue shares of our common stock for consideration per share less than the then exercise price of the August 2016 Warrants, to the lowest consideration per share for the shares issued or sold in such transaction. The price protection will be in effect until the earliest of (i) the termination date of the August 2016 Warrants, (ii) such time as the Warrants are exercised or (iii) contemporaneously with the listing of our shares of common stock on a registered national securities exchange.

In addition, in August 2016, Acuitas agreed to exchange its July 2016 Promissory Note for a short-term senior promissory note in the aggregate principal amount of \$2.8 million including accrued interest, in the form substantially identical to the form of the August 2016 Notes. Acuitas also agreed to exchange certain of its outstanding warrants to purchase an aggregate 2,028,029 shares of our common stock at an exercise price of \$0.33 per share for warrants to purchase an aggregate 2,993,561 shares of common stock at an exercise price of \$1.10 per share.

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

The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements including the related notes, and the other financial information included elsewhere in this report. In addition to historical information, this discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included elsewhere in this report and our annual report filed on Form 10-K for the year ended December 31, 2015.

CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING INFORMATION

This report contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to the financial condition, results of operations, business strategies, operating efficiencies or synergies, competitive positions, growth opportunities for existing products, plans and objectives of management, markets for our stock and other matters. Statements in this report that are not historical facts are hereby identified as "forward-looking statements" for the purpose of the safe harbor provided by Section 21E of the Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. Such forward-looking statements, including, without limitation, those relating to the future business prospects, our revenue and income, wherever they occur, are necessarily estimates reflecting the best judgment of our senior management as of the date on which they were made, or if no date is stated, as of the date of this report. These forward-looking statements are subject to risks, uncertainties and assumptions, including those described in the "Risk Factors" in Item 1A of Part I of our most recent Annual Report on Form 10-K ("Form 10-K") for the fiscal year ended December 31, 2015 and other reports we filed with the Securities and Exchange Commission ("SEC"), that may affect the operations, performance, development and results of our business. Because the factors discussed in this report could cause actual results or outcomes to differ materially from those expressed in any forward-looking statements made by us or on our behalf, you should not place undue reliance on any such forward-looking statements. New factors emerge from time to time, and it is not possible for us to predict which factors will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. We assume no obligation and do not intend to update these forward looking statements, except as required by law.

OVERVIEW

General

We provide data analytics based specialized behavioral health management and integrated treatment services to health plans through our *OnTrak* solution. Our *OnTrak* solution is designed to improve member health and at the same time lower costs to the insurer for underserved populations where behavioral health conditions are causing or exacerbating co-existing medical conditions. The program utilizes proprietary analytics, member engagement and patient centric treatment that integrates evidence-based medical and psychosocial interventions along with care coaching in a 52-week outpatient program. Our initial focus was members with substance use disorders. Starting in the second quarter of 2015, we have expanded our solution to include depression and anxiety disorders. We currently operate in Florida, Georgia, Illinois, Kansas, Kentucky, Louisiana, Massachusetts, Missouri, New Jersey, North Carolina, Oklahoma, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, West Virginia and Wisconsin. We provide services to commercial (employer funded), managed Medicare Advantage and managed Medicaid populations.

Recent Developments

In August 2016, we entered into subscription agreements with three accredited investors, including Shamus (collectively, the "Investors"), pursuant to which we issued to the Investors short-term senior promissory notes in the aggregate principal amount of \$2.8 million (the "August 2016 Notes") and five-year warrants to purchase up to an aggregate of 875,000 shares of our common stock, at an exercise price of \$1.10 per share (the "August 2016 Warrants").

The August 2016 Warrants include price protection provisions pursuant to which, subject to certain exempt issuances, the then exercise price of the August 2016 Warrants will be adjusted, in the event we issue shares of our common stock for consideration per share less than the then exercise price of the August 2016 Warrants, to the lowest consideration per share for the shares issued or sold in such transaction. The price protection will be in effect until the earliest of (i) the termination date of the August 2016 Warrants, (ii) such time as the Warrants are exercised or (iii) contemporaneously with the listing of our shares of common stock on a registered national securities exchange.

In addition, in August 2016, Acuitas agreed to exchange its July 2016 Promissory Note for short-term senior promissory notes, in the aggregate principal amount of \$2.8 million plus accrued interest, in the form substantially identical to the form of the August 2016 Notes. Acuitas also agreed to exchange certain of its outstanding warrants to purchase an aggregate of 2,028,029 shares of our common stock at an exercise price of \$0.33 per share for warrants to purchase an aggregate of 2,993,561 shares of common stock at an exercise price of \$1.10 per share, in the form substantially identical to the form of the August 2016 Warrants.

Operations

We currently operate in Florida, Georgia, Illinois, Kansas, Kentucky, Louisiana, Massachusetts, Missouri, New Jersey, North Carolina, Oklahoma, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, West Virginia and Wisconsin. We provide services to commercial (employer funded), managed Medicare Advantage and managed Medicaid populations. We have generated increasing fees from our launched programs and expect to increase enrollment and fees throughout 2016. However, there can be no assurance that we will generate such fees or that new programs will launch as we expect.

RESULTS OF OPERATIONS

Table of Summary Consolidated Financial Information

The table below and the discussion that follows summarize our results of consolidated operations for the three and nine months ended September 30, 2016 compared to the three and nine months ended September 30, 2015:

(In thousands, except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues				
Healthcare services revenues	\$ 1,336	\$ 538	\$ 3,287	\$ 1,443
Operating expenses				
Cost of healthcare services	1,253	720	3,381	1,655
General and administrative	2,195	1,968	6,518	7,124
Depreciation and amortization	38	30	102	94
Total operating expenses	3,486	2,718	10,001	8,873
Loss from operations	(2,150)	(2,180)	(6,714)	(7,430)
Other Income	15	20	90	41
Interest expense	(3,215)	(1,209)	(4,139)	(2,321)
Loss on disposal of intangible assets	-	(88)	-	(88)
Loss on exchange of warrants	-	-	-	(4,410)
Change in fair value of derivative liability	(3,484)	(5,027)	(6,328)	(5,027)
Change in fair value of warrant liability	1,423	1,007	673	10,915
Loss from operations before provision for income taxes	(7,411)	(7,477)	(16,418)	(8,320)
Provision for income taxes	2	3	7	7
Net loss	\$ (7,413)	\$ (7,480)	\$ (16,425)	\$ (8,327)
Basic and diluted net loss from operations per share:	\$ (0.13)	\$ (0.16)	\$ (0.30)	\$ (0.23)
Basic and diluted weighted number of shares outstanding	55,044	47,638	55,020	36,181

Summary of Consolidated Operating Results

Loss from operations before provision for income taxes for the three and nine months ended September 30, 2016 was \$7.4 million and \$16.4 million, compared with a net loss of \$7.5 million and \$8.3 million for the same periods in 2015, respectively. The difference primarily relates to the change in fair value of warrant liability, the change in fair value of derivative liability, the loss on exchange of warrants, and an increase in interest expense for the three and nine months ended September 30, 2016, compared to the same periods in 2015.

Revenues

During the nine months ended September 30, 2016, we have launched *OnTrak* in new populations, which has resulted in a significant increase in the number of patients enrolled in our programs compared with the same period in 2015. For the nine months ended September 30, 2016, enrollment increased by more than 59% over the same period in 2015. Recognized revenue increased by \$798,000 and \$1.8 million, or 148% and 128%, for the three and nine months ended September 30, 2016, compared with the same periods in 2015, respectively. We reserve a portion, and in some cases all, of the revenue related to these contracts as the revenue is subject to performance guarantees, or in the instance of case rates received upon enrollment and other fees in advance, recognized ratably over the period of enrollment. Deferred revenue increased by \$1.5 million from December 31, 2015, and was \$3.2 million as of September 30, 2016.

Cost of Healthcare Services

Cost of healthcare services consist primarily of salaries related to our care coaches, healthcare provider claims, payments to our network of physicians and psychologists, and fees charged by our third party administrators for processing these claims. The increase of \$533,000 and \$1.7 million for the three and nine months ended September 30, 2016, compared with the same periods in 2015, respectively, relates primarily to the increase in the number of members being treated, the addition of care coaches and community care coordinators to our staff to manage the increasing number of enrolled members, and the addition of staff in preparation for anticipated future increases in members eligible for *OnTrak*.

General and Administrative Expenses

Total general and administrative expense increased by \$227,000 for the three months ended September 30, 2016 and decreased by \$606,000 for the nine months ended September 30, 2016, compared with the same periods in 2015, respectively. The decrease for the nine months ended September 30, 2016 was primarily due to a decrease in share-based compensation expense related to stock options issued to our board of directors during 2015, investor relations services and legal services.

Depreciation and Amortization

Depreciation and amortization was immaterial for the three and nine months ended September 30, 2016 and 2015, respectively.

Interest Expense

Interest expense increased by \$2.0 million and \$1.8 million, respectively, for the three and nine months ended September 30, 2016 compared with the same periods in 2015, respectively. The increase relates to the issuance of warrants as part of the August 2016 financing during the nine months ended September 30, 2016.

Loss on Exchange of Warrant

The loss of \$4.4 million on the exchange of warrants related to the exchange of 21,277,220 warrants for 21,277,220 shares of common stock in May 2015 for the nine months ended September 30, 2015.

Change in fair value of derivative liability

The change in fair value of derivative liabilities decreased by \$1.5 million for the three months ended September 30, 2016 and increased by \$1.3 million for the nine months ended September 30, 2016 compared with the same period in 2015. The derivative liability was the result of the issuance of the July 2015 Convertible Debenture.

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

Change in fair value of warrant liability

We have issued warrants to purchase common stock in December 2011, February 2012, April 2015, July 2015 and August 2016. The warrants are being accounted for as liabilities in accordance with FASB accounting rules, due to anti-dilution provisions in some warrants that protect the holders from declines in our stock price, 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 increase in the change in fair value for the warrants was \$416,000 for the three months ended September 30, 2016 and 2015, and a decrease of \$10.2 million for the nine months ended September 30, 2016 compared with the same period in 2015.

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

LIQUIDITY AND CAPITAL RESOURCES

Liquidity and Going Concern

As of November 11, 2016, we had a balance of approximately \$950,000 cash on hand. We had a working capital deficit of approximately \$20.8 million as of September 30, 2016. We have incurred significant operating losses and negative operating cash flows since our inception. We could continue to incur negative cash flows and operating losses for the next twelve months. Our current cash burn rate is approximately \$450,000 per month. We expect our current cash resources to cover expenses into December 2016; however, delays in cash collections, revenue, or unforeseen expenditures could impact this estimate. We are in need of additional capital; however, there is no assurance that additional capital can be timely raised in an amount which is sufficient for us or on terms favorable to us and our stockholders, if at all. If we do not obtain additional capital, there is 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 our stockholders.

In August 2016, we entered into subscription agreements with three accredited investors, including Shamus (collectively, the "Investors"), pursuant to which we issued to the Investors short-term senior promissory notes in the aggregate principal amount of \$2.8 million and five-year warrants to purchase up to an aggregate of 875,000 shares of our common stock, at an exercise price of \$1.10 per share (the "August 2016 Warrants").

Our ability to fund our ongoing operations and continue as a going concern is dependent on increasing the number of members that are eligible for our programs by signing new contracts and generating fees from existing and new contracts and the success of management's plans to increase revenue and continue to control expenses. We currently operate in Florida, Georgia, Illinois, Kansas, Kentucky, Louisiana, Massachusetts, Missouri, New Jersey, North Carolina, Oklahoma, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, West Virginia and Wisconsin. We provide services to commercial (employer funded), managed Medicare Advantage and managed Medicaid populations. We have generated fees from our launched programs and expect to increase enrollment and fees throughout 2016. However, there can be no assurance that we will generate such fees or that new programs will launch as we expect. We are in need of additional capital, however; there is no assurance that additional capital can be timely raised in an amount which is sufficient for us or on terms favorable to us and 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 our stockholders.

Cash Flows

We used \$4.5 million of cash for operating activities during the nine months ended September 30, 2016 compared with \$3.9 million in the same period in 2015, respectively. The increase in cash used in operating activities reflects the increase in the number of members being treated, the addition of care coaches and community care coordinators to our staff to manage the increasing number of enrolled members, and the addition of staff in preparation for anticipated future increases in members eligible for *OnTrak*. Significant non-cash adjustments to operating activities for the nine months ended September 30, 2016 included share-based compensation expense of \$523,000, amortization of debt discount and issuance costs of \$3.7 million, and fair value adjustment on derivative liability of \$6.3 million, offset by a fair value adjustment on warrant liability of \$673,000.

Capital expenditures for the nine months ended September 30, 2016 were not material. We anticipate that capital expenditures will increase in the future as we replace our computer systems that are reaching their useful lives, upgrade equipment to support our increased number of enrolled members, and enhance the reliability and security of our systems. These future capital expenditure requirements will depend upon many factors, including obsolescence or failure of our systems, progress with expanding the adoption of our solution, and our marketing efforts, 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 \$5.5 million for the nine months ended September 30, 2016, compared with net cash provided by financing activities of \$3.5 million for the nine months ended September 30, 2015. Cash provided by financing activities for the nine months ended September 30, 2016 consisted of the net proceeds from the promissory notes provided by Acuitas in March, April, May, June and July 2016, and the proceeds from the senior promissory notes provided by investors in August 2016 leaving a balance of \$52,000 in cash and cash equivalents at September 30, 2016.

As discussed above, we currently expend cash at a rate of approximately \$450,000 per month. We also anticipate cash inflow to increase during 2016 as we continue to service our executed contracts and sign new contracts. We expect our current cash resources to cover our operations into December 2016; however, delays in cash collections, revenue, or unforeseen expenditures could impact this estimate. We are in need of additional capital; however, there is no assurance that additional capital can be timely raised in an amount which is sufficient for us or on terms favorable to us and 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 our stockholders.

OFF BALANCE SHEET ARRANGEMENTS

As of September 30, 2016, 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 of America ("U.S. GAAP"). U.S. 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 the fair value of warrants, the estimation of the fair value of derivative liabilities, and share-based compensation expense, involve our most significant judgments and estimates that are material to our consolidated financial statements. They are discussed further below.

Warrant Liabilities

We have issued warrants to purchase common stock in December 2011, February 2012, April 2015, July 2015 and August 2016. The warrants are being accounted for as liabilities in accordance with FASB accounting rules due to anti-dilution 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.

For the three and nine months ended September 30, 2016, we recognized a gain of \$1.4 million and \$673,000, respectively, compared with a gain of \$1.0 million and \$10.9 million for the same periods in 2015, respectively, related to the revaluation of our warrant liabilities.

We will continue to mark the warrants to market value each reporting period, using the Black-Scholes pricing model until they are completely settled or expire.

Derivative Liabilities

In July 2015, we entered into a \$3.55 million 12% Original Issue Discount Convertible Debenture due January 18, 2016 with Acuitas (the "July 2015 Convertible Debenture"). The conversion price of the July 2015 Convertible Debenture was \$1.90 per share, subject to adjustments, including for issuances of common stock and common stock equivalents below the then current conversion or exercise price, as the case may be. In October 2015, we entered into an amendment of the July 2015 Convertible Debenture which extended the maturity date of the July 2015 Convertible Debenture from January 18, 2016 to January 18, 2017. In addition, the conversion price of the July 2015 Convertible Debenture was subsequently adjusted to \$0.30 per share. The July 2015 Convertible Debenture is unsecured, bears interest at a rate of 12% per annum payable in cash or shares of common stock, subject to certain conditions, at our option, and is subject to mandatory prepayment upon the consummation of certain future financings. The derivative liability associated with the July 2015 Convertible Debenture was calculated using the Black-Scholes model based upon the following assumptions:

	Sept 30, 2016
Expected volatility	133.19%
Risk-free interest rate	0.36%
Weighted average expected lives in years	0.30
Expected dividend	0%

The expected volatility assumption for the nine months ended September 30, 2016 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 2015 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.

For the three and nine months ended September 30, 2016, we recognized a loss of \$3.5 million and \$6.3 million, respectively, compared with a \$5.0 million loss for the same periods in 2015, related to the revaluation of our derivative liability.

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 compensation expense from the amounts reported. The weighted average expected option term for the nine months ended September 30, 2016 and 2015, 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 for the three and nine months ended September 30, 2016 and 2015.

RECENT ACCOUNTING PRONOUNCEMENTS

In April 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-10, *Revenue from Contracts with Customers (Topic 606)* (“ASU 2016-10”), which amends certain aspects of the Board’s new revenue standard, ASU 2014-09, *Revenue from Contracts with Customers*. The standard should be adopted concurrently with adoption of ASU 2014-09 which is effective for annual and interim periods beginning after December 15, 2017. Early adoption is permitted. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

In March 2016, the FASB issued ASU 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting* (“ASU 2016-09”), which outlines new provisions intended to simplify various aspects related to accounting for share-based payments and their presentation in the financial statements. The standard is effective for the Company beginning December 15, 2016, and interim periods within those annual periods. Early adoption is permitted. The adoption of ASU 2016-09 did not have a material effect on our consolidated financial position or results of operations.

In February 2015, the FASB issued ASU, *Consolidation (Topic 810): Amendments to the Consolidation Analysis* (“ASU 2015-02”). ASU 2015-02 modifies existing consolidation guidance for reporting organizations that are required to evaluate whether they should consolidate certain legal entities. ASU 2015-02 is effective for fiscal years and interim periods within those years beginning after December 15, 2015, and requires either a retrospective or a modified retrospective approach to adoptions. Early adoption is permitted. We are currently evaluating the potential impact of this standard on our consolidated financial statements, as well as the available transition methods.

In August 2014, the FASB issued FASB ASU 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, ("ASU 2014-15"). ASU 2014-15 changes to the disclosure of uncertainties about an entity's ability to continue as a going concern. Under U.S. GAAP, continuation of a reporting entity as a going concern is presumed as the basis for preparing financial statements unless and until the entity's liquidation becomes imminent. Even if an entity's liquidation is not imminent, there may be conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. Because there is no guidance in U.S. GAAP about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern or to provide related note disclosures, there is diversity in practice whether, when, and how an entity discloses the relevant conditions and events in its financial statements. As a result, these changes require an entity's management to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that financial statements are issued. Substantial doubt is defined as an indication that it is probable that an entity will be unable to meet its obligations as they become due within one year after the date that financial statements are issued. If management has concluded that substantial doubt exists, then the following disclosures should be made in the financial statements: (i) principal conditions or events that raised the substantial doubt, (ii) management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations, (iii) management's plans that alleviated the initial substantial doubt or, if substantial doubt was not alleviated, management's plans that are intended to at least mitigate the conditions or events that raise substantial doubt, and (iv) if the latter in (iii) is disclosed, an explicit statement that there is substantial doubt about the entity's ability to continue as a going concern. ASU 2014-15 is effective for periods beginning after December 15, 2016. The adoption of ASU 2013-15 will not have a material effect on our consolidated financial position or results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Disclosure Controls

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 Rules 13a-15(e) and 15d-15(e) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") as of September 30, 2016. Based on this evaluation, our principal executive officer and our principal financial officer have concluded that as of September 30, 2016, 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 over Financial Reporting

There were no changes in our internal controls over financial reporting during the three months ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in our most recent Annual Report on Form 10-K.

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

In July 2016, we amended and restated the June 2016 Promissory Note to increase the amount by \$570,000, for a total of \$2.8 million (the “July 2016 Promissory Note”). In connection with the amendment, we issued Acuitas five-year warrants to purchase an additional 431,818 shares of our common stock at an exercise price of \$0.33 per share, which warrants include, subject to certain exception, full-ratchet anti-dilution protection (the “July 2016 Warrants”).

In August 2016, we entered into subscription agreements with three accredited investors, including Shamus (collectively, the “Investors”), pursuant to which we issued to the Investors short-term senior promissory notes in the aggregate principal amount of \$2.8 million (the “August 2016 Notes”) and five-year warrants to purchase up to an aggregate of 875,000 shares of our common stock, at an exercise price of \$1.10 per share (the “August 2016 Warrants”).

In addition, in August 2016, Acuitas agreed to exchange its July 2016 Promissory Note for short-term senior promissory notes, in the aggregate principal amount of \$2.8 million plus accrued interest, in the form substantially identical to the form of the August 2016 Notes. Acuitas also agreed to exchange certain of its outstanding warrants to purchase an aggregate of 2,028,029 shares of our common stock at an exercise price of \$0.33 per share for warrants to purchase an aggregate of 2,993,561 shares of common stock at an exercise price of \$1.10 per share, in the form substantially identical to the form of the August 2016 Warrants.

The warrants were issued without registration pursuant to exemption afforded by Section 4(a)(2) of the Securities Act of 1933, as amended.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

- | | |
|-------------|--|
| Exhibit 4.1 | Form of the Fifth Amended and Restated Promissory Note, dated July 5, 2016 (incorporated by reference to Exhibit 4.7 of Catasys, Inc.’s Form 10-Q filed with the Securities and Exchange Commission on August 15, 2016). |
| Exhibit 4.2 | Form of Common Stock Purchase Warrant, dated July 5, 2016 (incorporated by reference to Exhibit 4.8 of Catasys, Inc.’s Form 10-Q filed with the Securities and Exchange Commission on August 15, 2016). |

Exhibit 4.3	Form of the Sixth Amended and Restated Promissory Note, dated July 21, 2016 (incorporated by reference to Exhibit 4.9 of Catasys Inc.'s Form 10-Q filed with the Securities and Exchange Commission on August 15, 2016).
Exhibit 4.4	Form of Common Stock Purchase Warrant, dated July 21, 2016 (incorporated by reference to Exhibit 4.10 of Catasys, Inc.'s Form 10-Q filed with the Securities and Exchange Commission on August 15, 2016).
Exhibit 4.4	Form of Senior Promissory Note, dated August 15, 2016 (incorporated by reference to Exhibit 4.13 of Catasys, Inc.'s Form 10-Q filed with the Securities and Exchange Commission on August 15, 2016).
Exhibit 4.5	Form of Common Stock Purchase Warrant, dated August 15, 2016 (incorporated by reference to Exhibit 4.14 of Catasys, Inc.'s Form 10-Q filed with the Securities and Exchange Commission on August 15, 2016).
Exhibit 4.6*	Form of Exchange Agreement, dated August 15, 2016, by and between Catasys, Inc. and Acuitas Group Holdings, LLC.
Exhibit 31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1**	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 32.2**	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS*	XBRL Instance
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation
101.DEF*	XBRL Taxonomy Extension Definition
101.LAB*	XBRL Taxonomy Extension Labels
101.PRE*	XBRL Taxonomy Extension Presentation

* filed herewith.

** furnished herewith.

SIGNATURES

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

CATASYS, INC.

Date: November 14, 2016

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

Date: November 14, 2016

By: /s/ SUSAN ETZEL
Susan Etzel
Chief Financial Officer
(Principal Financial and Accounting Officer)

AGREEMENT

THIS AGREEMENT (this “**Agreement**”) is dated as of August 15, 2016, by and between Catasys, Inc., a Delaware corporation with offices located at 11601 Wilshire Blvd., Suite 1100, Los Angeles, California 90025 (the “**Company**”), and Acuitas Group Holdings, LLC (“**Acuitas**”).

- (1) As of August 15, 2016, Acuitas holds (i) certain demand senior promissory notes that have been issued by the Company to Acuitas in the period commencing on March 30, 2016 and ending on August 15, 2016 (the “**Issuance Period**”), in the aggregate principal amount of \$2,755,000 and the aggregate interest amount of \$57,697.67 in principal and interest (the “**Notes**”); and (ii) warrants to purchase up to 2,028,029 shares of common stock, par value \$0.0001 per share, of the Company (the “**Common Stock**”), at an exercise price of \$0.33 per share, issued by the Company to Acuitas in connection with the issuances of the Notes (the “**Warrants**”), as set forth on Schedule I attached hereto.
- (2) The Company and Acuitas desire to enter into this Agreement, pursuant to which the Company shall exchange as of the date hereof the Notes and the Warrants for an aggregate of \$2,812,796.67 short-term senior promissory notes (the “**Exchanged Notes**”), in the form substantially attached hereto as Exhibit A, and for five-year warrants to purchase an aggregate of 2,993,561 shares of the Company’s Common Stock, at an exercise price of \$1.10 per share (the “**Exchanged Warrants**”), in the form substantially attached hereto as Exhibit B, as set forth on Schedule I attached hereto.

IN WITNESS WHEREOF, Acuitas and the Company have caused this Agreement to be duly executed as of the date first written above.

COMPANY:

CATASYS, INC.

By: /s/ Susan Etzel
Name: Susan Etzel
Title: Chief Financial Officer

ACUITAS:

ACUITAS GROUP HOLDINGS, LLC, INC.

By: /s/ Terren S. Peizer
Name: Terren S. Peizer
Title: Managing Director

Schedule I

Notes			Warrants			
Original Issuance Date	Amount	Number of Shares underlying of Warrants	Original Issuance Date	Current Exercise Price	Expiration Date	
1.	03/30/16	\$ 900,000	640,909	03/30/16	\$ 0.33	03/30/21
2.	04/27/16	\$ 400,000	284,848	04/27/16	\$ 0.33	04/27/21
3.	05/24/16	\$ 405,000	306,818	05/24/16	\$ 0.33	05/24/21
4.	06/02/16	\$ 230,000	174,242	06/02/16	\$ 0.33	06/02/21
5.	06/22/16	\$ 250,000	189,394	06/22/16	\$ 0.33	06/22/21
6.	07/05/16	\$ 420,000	318,182	07/05/16	\$ 0.33	07/05/21
7.	07/21/16	\$ 150,000	113,636	07/21/16	\$ 0.33	07/21/21
8.						
9.						
10.						
11.						
12.						
13.						
Total:	\$ 2,755,000	2,028,029				

Exhibit A

Form of Exchanged Notes

\$2,812,796.67

Issue Date: August 15, 2016

For value received, **CATASYS, INC.**, a Delaware corporation (“**Borrower**”), hereby promises to pay to the order of **ACUITAS GROUP HOLDINGS, LLC**, or its successors or assigns (“**Holder**”), located at 11601 Wilshire Blvd, Suite 1100, Los Angeles, CA 90025, the principal sum of \$2,812,796.67 (the “**Principal Amount**”), plus interest at the applicable Interest Rate (as defined in paragraph 2 hereof) on the unpaid Principal Amount hereof, pursuant to the terms of this Senior Promissory Note (the “**Note**”).

1. **Maturity Date.** This Note shall be repaid in full on or before the four (4) month anniversary of the Issue Date (such date, the “**Maturity Date**”). The outstanding Principal Amount of the Note, including all accrued (and theretofore unpaid) interest shall be due and payable on the Maturity Date.
 2. **Interest Rate.** Interest on the unpaid Principal Amount of this Note shall accrue on the outstanding Principal Amount thereof from the Issue Date at a per annum interest rate equal to 8.0% (the “**Interest Rate**”), but in no event more than the maximum interest rate permitted by applicable law. Interest shall be payable on the last business day of each full calendar month following the Issue Date. Interest on the Note shall be computed on the basis of a 365-day year. Notwithstanding anything to the contrary, in the event the Principal Amount and all interest accrued thereon has not been paid to Holder in full on the Maturity Date, the then-outstanding Principal Amount shall thereafter bear interest at the default rate of ten percent (10%) per annum.
 3. **Payments.** Any payment on this Note shall be made by wire transfer of immediately available funds to an account designated by the Holder or by check sent to the Holder’s address set forth in the records of the Borrower or to such other address as the Holder may designate for such purpose from time to time by written notice to the Borrower, in such coin or currency of the United States as at the time of payment shall be legal tender for the payment of public and private debts. All payments shall be applied first to any applicable fees and expenses owed to Holder under this Note, if any, then to accrued and unpaid interest and thereafter to outstanding principal.
 4. **Prepayment.**
 - (a) **Optional Prepayment:** Borrower may, without premium or penalty, at any time and from time to time, upon ten (10) days’ prior written notice to holder, prepay all or a part of the outstanding unpaid Principal Amount, together with accrued but unpaid interest thereon computed to the date of prepayment.
-

- (b) Mandatory Prepayment: In the event of a closing by the Borrower of the sale of Borrower's securities in a public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, resulting in at least \$10,000,000 of gross proceeds to the Borrower, the Borrower shall, within ten (10) days of the closing of such transaction, prepay the entire outstanding unpaid Principal Amount, together with accrued but unpaid interest thereon computed to the date of prepayment.
5. Representations and Warranties. Borrower makes the following representations, warranties and agreements in favor of Holder, which representations and warranties shall survive the execution of this Note and shall remain true, accurate and in full force and effect until all obligations of Borrower under this Note have been satisfied and paid in full:
- (a) Borrower is a duly organized and validly existing corporation and in good standing under the laws of the State of Delaware, and has the power and authority to enter into and perform its obligations under this Note; and
 - (b) Borrower has duly executed and delivered this Note, and this Note is a legal, valid and binding obligation of Borrower, enforceable against Borrower in accordance with its terms.
6. Covenants. Borrower covenants and agrees that, on and after the date hereof, and until the unpaid principal amount of this Note and all accrued but unpaid interest thereon and any other obligations of Borrower hereunder are paid and performed in full and satisfied, Borrower shall comply with each of the following covenants, unless compliance therewith shall have been waived in writing by Holder:
- (a) Borrower will pay when due all its payment obligations hereunder, in the manner and at the time and place specified in this Note or otherwise by Holder in writing;
 - (b) Borrower will not without the prior written consent of Holder guarantee any obligations other than in the ordinary course of business.
 - (c) Borrower shall not pay any cash dividends or make any other distributions (other than distributions in the form of common stock made pro rata to all common stockholders) while this Note remains unpaid; and
 - (d) Borrower shall not repay any indebtedness of the Borrower to any party, including other Notes, but excluding repayment to any affiliate of the Borrower (as defined in Rule 405 under the Securities Act of 1933, as amended), unless this Note is contemporaneously paid in full. For the avoidance of doubt, the conversion of outstanding affiliated debt into equity, or the extension of the term thereof, or the exchange thereof for indebtedness on substantially the same terms as this Note, with a principal amount equal to the principal amount of such outstanding debt plus accrued and unpaid interest shall not be considered a repayment hereunder.
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7. Events of Default. The following shall constitute Events of Default:

- (a) Failure by Borrower to pay the principal of or accrued interest on this Note within five (5) business days following the date when due.
 - (b) The insolvency of the Borrower, the commission of any act of bankruptcy by the Borrower, the execution by the Borrower of a general assignment for the benefit of creditors, the filing by or against the Borrower of any petition in bankruptcy or any petition for relief under the provisions of the federal bankruptcy act or any other state or federal law for the relief of Borrower and the continuation of such petition without dismissal for a period of thirty (30) days or more, the appointment of a receiver or trustee to take possession of any property or assets of the Borrower or the attachment of or execution against any property or assets of the Borrower.
 - (c) Any representation or warranty made by the Borrower in this Note or the Subscription Agreement will be false in any material respect when so made or the Borrower defaults in the due observance or performance of any term, covenant or agreement of the Borrower contained in this Note or the Subscription Agreement.
 - (d) The Borrower or any subsidiary shall default in any of its respective obligations under any other note or any mortgage, credit agreement or other facility, indenture agreement, factoring agreement or other instrument under which there may be issued, or by which there may be secured or evidenced any indebtedness for borrowed money or money due under any long term leasing or factoring arrangement of Borrower or any subsidiary, whether such indebtedness now exists or shall hereafter be created and such default shall result in such indebtedness becoming or being declared due and payable prior to the date on which it would otherwise become due and payable, provided that any applicable cure period related to such default under the terms of such note, mortgage, credit agreement or other facility, agreement or instrument is applicable.
 - (e) The Borrower shall (a) be a party to any Change of Control Transaction (as defined below) or (b) agrees to sell or dispose of all or in excess of 50% of its assets in one or more transactions (other than sales of the Borrower's equipment and whether or not such sale would constitute a Change of Control Transaction). "Change of Control Transaction" means the occurrence of any of: (i) an acquisition after the date hereof by an individual or legal entity or "group" (as described in Rule 13d-5(b)(1) promulgated under the Securities Exchange Act of 1934, as amended) of effective control (whether through legal or beneficial ownership of capital stock of Borrower, by contract or otherwise) of in excess of 50% of the voting securities of Borrower, (ii) a replacement at one time or over time of more than one-half of the members of Borrower's board of directors which is not approved by a majority of those individuals who are members of the board of directors on the date hereof (or by those individuals who are serving as members of the board of directors on any date whose nomination to the board of directors was approved by a majority of the members of the board of directors who are members on the date hereof), (iii) the merger of Borrower with or into another entity that is not wholly-owned by Borrower, consolidation or sale of 50% or more of the assets of Borrower in one or a series of related transactions, or (iv) the execution by Borrower of an agreement to which Borrower is a party or by which it is bound, providing for any of the events set forth above in (i), (ii) or (iii).
-

8. Remedies. Upon the occurrence of an Event of Default specified in Section 7(a), Holder may, by written notice to Borrower, declare this Note due and payable, whereupon the principal amount of this Note, together with all accrued and unpaid interest thereon and all other amounts payable hereunder, shall become immediately due and payable without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived, anything contained herein or in the documents evidencing the same to the contrary notwithstanding. Upon the occurrence of an Event of Default specified in Section 7(b), the unpaid principal balance of, and all other sums payable with regard to, this Note shall automatically and immediately become due and payable, in all cases without any action on the part of Holder. No right or remedy herein conferred upon or reserved to the Holder is intended to be exclusive of any other right or remedy, and every right and remedy will, to the extent permitted by law, be cumulative and in addition to every other right and remedy given hereunder or now or hereafter existing at law or in equity or otherwise.

9. Miscellaneous.

(a) *Waiver and Amendment*. Any provision of this Note may be amended or modified only by a writing signed by both Borrower and Holder. No waiver or consent with respect to this Note will be binding or effective unless it is set forth in writing and signed by the party against whom such waiver is asserted. No delay or failure on the part of either party in exercising any right or remedy under this Note will operate as a waiver of such right or any other right. A waiver given on one occasion will not be construed as a bar to, or as a waiver of, any right or remedy on any future occasion.

(b) *Governing Law; Jurisdiction*. This Note will be governed by and construed in accordance with the internal laws of the State of New York, without reference to that body of law relating to conflict of laws or choice of law. The Borrower and Holder each hereby submit to the exclusive jurisdiction of any state or federal court of competent jurisdiction in the state, county and city of New York for purposes of all legal proceedings arising out of or relating to this Note. Each of the Borrower and Holder irrevocably waives, to the fullest extent permitted by law, any objection which it may now or hereafter have to the laying of the venue of any such proceeding brought in such a court and any claim that any such proceeding brought in such a court has been brought in an inconvenient forum.

(c) *Severability; Headings*. The invalidity or unenforceability of any term or provision of this Note will not affect the validity or enforceability of any other term or provision hereof. The headings in this Note are for convenience of reference only and will not alter or otherwise affect the meaning of this Note.

(d) *Attorneys' Fees.* Other than as set forth in the Subscription Agreement, Borrower and Holder shall each be responsible for legal fees incurred in connection with the negotiation, execution, and delivery of this Note.

(e) *Assignment.* This Note may not be assigned or delegated by Borrower, whether by voluntary assignment or transfer, operation of law, or otherwise, without the prior written consent of Holder.

(f) *Notice.* Any notice required or permitted under this Note shall be given in writing and will be deemed effectively given upon personal delivery; upon confirmed transmission by electronic mail or facsimile; or three (3) days following deposit with the United States Post Office, by certified or registered mail, postage prepaid, addressed to the party's address set forth above or at such other address as such party may specify by written notice given in accordance with this Section.

(g) *Waiver of Jury Trial.* **EACH PARTY HERETO HEREBY IRREVOCABLY WAIVES, TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, ANY RIGHT IT MAY HAVE TO A TRIAL BY JURY IN ANY LEGAL PROCEEDING DIRECTLY OR INDIRECTLY ARISING OUT OF OR RELATING TO THIS NOTE OR THE TRANSACTIONS CONTEMPLATED HEREBY OR THEREBY (WHETHER BASED ON CONTRACT, TORT OR ANY OTHER THEORY).**

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IN WITNESS WHEREOF, Borrower and Holder have executed this Note as of the date first stated above:

BORROWER

CATASYS, INC.

By: /s/ Susan Etzel

Name: Susan Etzel

Title: Chief Financial Officer

HOLDER

/s/ Terren S. Peizer

Exhibit B

Form of Exchanged Warrants

Warrant Shares: 2,993,561

Initial Exercise Date: August 15, 2016

THIS COMMON STOCK PURCHASE WARRANT (the “Warrant”) certifies that, for value received, ACUITAS GROUP HOLDINGS, LLC or its assigns (the “Holder”) is entitled, upon the terms and subject to the limitations on exercise and the conditions hereinafter set forth, at any time on or after the date hereof (the “Initial Exercise Date”) and on or prior to the close of business on the five year anniversary of the Initial Exercise Date (the “Termination Date”) but not thereafter, to subscribe for and purchase from Catasys, Inc., a Delaware corporation (the “Company”), up to 2,993,561 shares (as subject to adjustment hereunder, the “Warrant Shares”) of Common Stock. The purchase price of one share of Common Stock under this Warrant shall be equal to the Exercise Price, as defined in Section 1(b).

Section 1. Exercise.

a) Exercise of Warrant. Exercise of the purchase rights represented by this Warrant may be made, in whole or in part, at any time or times on or after the Initial Exercise Date and on or before the Termination Date by delivery to the Company (or such other office or agency of the Company as it may designate by notice in writing to the registered Holder at the address of the Holder appearing on the books of the Company) of a duly executed facsimile copy (or e-mail attachment) of the Notice of Exercise in the form annexed hereto and within three (3) Trading Days of the date said Notice of Exercise is delivered to the Company, the Company shall have received payment of the aggregate Exercise Price of the shares thereby purchased by wire transfer or cashier’s check drawn on a United States bank or, if available, pursuant to the cashless exercise procedure specified in Section 1(c) below. Notwithstanding anything herein to the contrary, the Holder shall not be required to physically surrender this Warrant to the Company until the Holder has purchased all of the Warrant Shares available hereunder and the Warrant has been exercised in full, in which case, the Holder shall surrender this Warrant to the Company for cancellation within three (3) Trading Days of the date the final Notice of Exercise is delivered to the Company. Partial exercises of this Warrant resulting in purchases of a portion of the total number of Warrant Shares available hereunder shall have the effect of lowering the outstanding number of Warrant Shares purchasable hereunder in an amount equal to the applicable number of Warrant Shares purchased. The Holder and the Company shall maintain records showing the number of Warrant Shares purchased and the date of such purchases. The Company shall deliver any objection to any Notice of Exercise within one (1) Business Day of receipt of such notice. **The Holder and any assignee, by acceptance of this Warrant, acknowledge and agree that, by reason of the provisions of this paragraph, following the purchase of a portion of the Warrant Shares hereunder, the number of Warrant Shares available for purchase hereunder at any given time may be less than the amount stated on the face hereof.**

b) Exercise Price. The exercise price per share of the Common Stock under this Warrant shall be **\$1.10**, subject to adjustment hereunder (the “Exercise Price”).

c) Cashless Exercise. If at any time after the Initial Exercise Date, there is no effective registration statement registering, or no current prospectus available for, the resale of the Warrant Shares by the Holder, then this Warrant may also be exercised, in whole or in part, at such time by means of a “cashless exercise” in which the Holder shall be entitled to receive a number of Warrant Shares equal to the quotient obtained by dividing $[(A-B) (X)]$ by (A), where:

(A) = the VWAP on the five (5) Trading Days immediately preceding the date on which Holder delivers the Notice of Exercise to exercise this Warrant by means of a “cashless exercise,” as set forth in the applicable Notice of Exercise;

(B) = the Exercise Price of this Warrant, as adjusted hereunder; and

(X) = the number of Warrant Shares that would be issuable upon exercise of this Warrant in accordance with the terms of this Warrant if such exercise were by means of a cash exercise rather than a cashless exercise.

If Warrant Shares are issued in such a cashless exercise, the parties acknowledge and agree that in accordance with Section 3(a)(9) of the Securities Act, the Warrant Shares shall take on the characteristics of the Warrants being exercised, and the holding period of the Warrant Shares being issued may be tacked on to the holding period of this Warrant. The Company agrees not to take any position contrary to this Section 2(c), provided that no other transaction~~s~~ have taken place between the Company and Holder that might be integrated in such a manner as to disqualify the cashless exercise of the warrant from 3(a)(9).

“VWAP” means, for any date, the price determined by the first of the following clauses that applies: (a) if the Common Stock is then listed or quoted on a Trading Market, the daily volume weighted average price of the Common Stock for such date (or the nearest preceding date) on the Trading Market on which the Common Stock is then listed or quoted as reported by Bloomberg L.P. (based on a Trading Day from 9:30 a.m. (New York City time) to 4:02 p.m. (New York City time)), (b) if the Common Stock is not then listed or quoted for trading on OTCQB or OTCQX and if prices for the Common Stock are then reported in the “Pink Sheets” published by OTC Markets, Inc. (or a similar organization or agency succeeding to its functions of reporting prices), the most recent bid price per share of the Common Stock so reported, or (c) in all other cases, the fair market value of a share of Common Stock as determined by an independent appraiser selected in good faith by the then Holders of a majority in interest of the aggregate Warrants issued concurrent with the Subscription Agreements dated August 15, 2016 then outstanding and reasonably acceptable to the Company, the fees and expenses of which shall be paid by the Company.

d) Mechanics of Exercise.

i. Delivery of Warrant Shares Upon Exercise. Warrant Shares purchased hereunder shall be transmitted by the Transfer Agent to the Holder by crediting the account of the Holder’s or its designee’s balance account with The Depository Trust Company through its Deposit or Withdrawal at Custodian system (“DWAC”) if the Company is then a participant in such system and either (A) there is an effective registration statement permitting the issuance of the Warrant Shares to or resale of the Warrant Shares by the Holder or (B) the Warrant Shares are eligible for resale by the Holder without volume or manner-of-sale limitations pursuant to Rule 144, and otherwise by physical delivery of a certificate, registered in the Company’s share register in the name of the Holder or its designee, for the number of Warrant Shares to which the Holder is entitled pursuant to such exercise to the address specified by the Holder in the Notice of Exercise by the date that is one (1) Trading Day after the delivery to the Company of the Notice of Exercise (such date, the “Warrant Share Delivery Date”). The Warrant Shares shall be deemed to have been issued, and Holder or any other person so designated to be named therein shall be deemed to have become a holder of record of such shares for all purposes, as of the date that the Notice of Exercise is delivered, provided that payment to the Company of the Exercise Price (or by cashless exercise, if permitted) and all taxes required to be paid by the Holder, if any, pursuant to Section 1(d)(iv) having been paid within three (3) Trading Days of delivery of Notice of Exercise.

ii. Delivery of New Warrants Upon Exercise. If this Warrant shall have been exercised in part, the Company shall, at the request of a Holder and upon surrender of this Warrant certificate, at the time of delivery of the Warrant Shares, deliver to the Holder a new Warrant evidencing the rights of the Holder to purchase the unpurchased Warrant Shares called for by this Warrant, which new Warrant shall in all other respects be identical with this Warrant.

iii. No Fractional Shares or Scrip. No fractional shares or scrip representing fractional shares shall be issued upon the exercise of this Warrant. As to any fraction of a share which the Holder would otherwise be entitled to purchase upon such exercise, the Company shall, at its election, either pay a cash adjustment in respect of such final fraction in an amount equal to such fraction multiplied by the Exercise Price or round up to the next whole share.

iv. Charges, Taxes and Expenses. Issuance of Warrant Shares shall be made without charge to the Holder for any issue or transfer tax or other incidental expense in respect of the issuance of Warrant Shares, all of which taxes and expenses shall be paid by the Company, and such Warrant Shares shall be issued in the name of the Holder or in such name or names as may be directed by the Holder; provided, however, that in the event that Warrant Shares are to be issued in a name other than the name of the Holder, this Warrant when surrendered for exercise shall be accompanied by the Assignment Form attached hereto duly executed by the Holder and the Company may require, as a condition thereto, the payment of a sum sufficient to reimburse it for any transfer tax incidental thereto. The Company shall pay all Transfer Agent fees required for same-day processing of any Notice of Exercise and all fees to the Depository Trust Company (or another established clearing corporation performing similar functions) required for same-day electronic delivery of the Warrant Shares.

v. Compensation for Buy-In on Failure to Timely Deliver Warrant Shares Upon Exercise. In addition to any other rights available to the Holder, if the Company fails to cause the Transfer Agent to transmit to the Holder the Warrant Shares in accordance with the provisions of Section 2(d)(i) above pursuant to an exercise on or before the Warrant Share Delivery Date, and if after such date the Holder is required by its broker to purchase (in an open market transaction or otherwise) or the Holder's brokerage firm otherwise purchases, shares of Common Stock to deliver in satisfaction of a sale by the Holder of the Warrant Shares which the Holder anticipated receiving upon such exercise (a "Buy-In"), then the Company shall (A) pay in cash to the Holder the amount, if any, by which (x) the Holder's total purchase price (including brokerage commissions, if any) for the shares of Common Stock so purchased exceeds (y) the amount obtained by multiplying (1) the number of Warrant Shares that the Company was required to deliver to the Holder in connection with the exercise at issue times (2) the price at which the sell order giving rise to such purchase obligation was executed, and (B) at the option of the Holder, either reinstate the portion of the Warrant and equivalent number of Warrant Shares for which such exercise was not honored (in which case such exercise shall be deemed rescinded) or deliver to the Holder the number of shares of Common Stock that would have been issued had the Company timely complied with its exercise and delivery obligations hereunder. For example, if the Holder purchases Common Stock having a total purchase price of \$11,000 to cover a Buy-In with respect to an attempted exercise of shares of Common Stock with an aggregate sale price giving rise to such purchase obligation of \$10,000, under clause (A) of the immediately preceding sentence the Company shall be required to pay the Holder \$1,000. The Holder shall provide the Company written notice indicating the amounts payable to the Holder in respect of the Buy-In and, upon request of the Company, evidence of the amount of such loss. Nothing herein shall limit a Holder's right to pursue any other remedies available to it hereunder, at law or in equity including, without limitation, a decree of specific performance and/or injunctive relief with respect to the Company's failure to timely deliver shares of Common Stock upon exercise of the Warrant as required pursuant to the terms hereof.

v. Closing of Books. The Company will not close its stockholder books or records in any manner which prevents the timely exercise of this Warrant, pursuant to the terms hereof.

Section 2. Certain Adjustments.

a) Stock Dividends and Stock Splits. If the Company, at any time while this Warrant is outstanding: (i) pays a stock dividend or otherwise makes a distribution or distributions payable in shares of Common Stock on shares of Common Stock or any Common Stock Equivalents (which, for avoidance of doubt, shall not include any shares of Common Stock issued by the Company upon exercise of this Warrant), (ii) subdivides outstanding shares of Common Stock into a larger number of shares, (iii) combines (including by way of a reverse stock split) outstanding shares of Common Stock into a smaller number of shares or (iv) issues, in the event of a reclassification of shares of the Common Stock, any shares of capital stock of the Company, then the Exercise Price shall be multiplied by a fraction of which the numerator shall be the number of shares of Common Stock (excluding any treasury shares of the Company) outstanding immediately before such event and of which the denominator shall be the number of shares of Common Stock outstanding immediately after such event, and the number of shares issuable upon exercise of this Warrant shall be proportionately adjusted such that the aggregate Exercise Price of this Warrant shall remain unchanged. Any adjustment made pursuant to this Section 2(a) shall become effective immediately after the record date for the determination of stockholders entitled to receive such dividend or distribution and shall become effective immediately after the effective date in the case of a subdivision, combination or re-classification.

b) Subsequent Equity Sales. If and whenever during the period starting on the Initial Exercise and continuing until the earliest of (i) the Termination Date, (ii) such time as the Warrant is exercised or (iii) contemporaneously with the listing of the Common Stock on a registered national securities exchange (the "Applicable Period"), the Company issues, sells or delivers, or is deemed to have issued, sold or delivered, any Common Stock in a transaction, other than an Exempt Issuance, for consideration per share less than a price equal to the Exercise Price in effect immediately prior to such issuance, sale or delivery or deemed issuance (such Exercise Price then in effect is referred to as the "Applicable Price") (the foregoing a "Dilutive Issuance"), then immediately after such Dilutive Issuance, the Exercise Price then in effect shall be reduced to the lowest consideration per share for shares issued or sold in such transaction, but in no event shall the adjusted Exercise Price shall be reduced to a price lower than the par value of the Company's shares of Common Stock. An Exempt Issuance shall mean the issuance of (i) shares of Common Stock, options or any other equity securities to employees, officers, directors or consultants of the Company pursuant to any stock or option plan, (ii) securities upon the exercise or exchange of or conversion of any securities issued hereunder and/or other securities exercisable or exchangeable for or convertible into shares of Common Stock issued and outstanding as of the issuance date of this Warrant, (iii) securities issued pursuant to acquisitions or strategic transactions, (iv) securities issued by the Company pursuant to any of the Company's agreements and/or obligations existing as of the issuance date of this Warrant, (v) securities issued by the Company to vendors and other service providers, and (v) up to one percent (1%) of the number of shares of Common Stock outstanding on August 15, 2016 for any other purpose not set forth in subsection (i) through (v) hereof. Notwithstanding any other provision included in this Warrant, the Holder agrees to cooperate with the Company and to amend this Warrant, without any further consideration, to the extent necessary to assist the Company in its listing of the Common Stock on a national securities exchange provided that no increase in the Exercise Price or reduction in the number of Warrant Shares receivable shall be required.

c) Calculations. All calculations under this Section 2 shall be made to the nearest cent or the nearest 1/100th of a share, as the case may be. For purposes of this Section 2, the number of shares of Common Stock deemed to be issued and outstanding as of a given date shall be the sum of the number of shares of Common Stock (excluding treasury shares, if any) issued and outstanding.

d) Notice to Holder. Whenever the Exercise Price is adjusted pursuant to any provision of this Section 2, the Company shall promptly deliver to each Holder a notice setting forth the Exercise Price after such adjustment and setting forth a brief statement of the facts requiring such adjustment. To the extent that any notice provided in this Warrant constitutes, or contains, material, non-public information regarding the Company or any of the Subsidiaries, the Company shall simultaneously file such notice with the Commission pursuant to a Current Report on Form 8-K.

e) Fundamental Transaction. If, at any time while this Warrant is outstanding, (i) the Company, directly or indirectly, in one or more related transactions effects any merger or consolidation of the Company with or into another Person, (ii) the Company, directly or indirectly, effects any sale, lease, license, assignment, transfer, conveyance or other disposition of all or substantially all of its assets in one or a series of related transactions, (iii) any, direct or indirect, purchase offer, tender offer or exchange offer (whether by the Company or another Person) is completed pursuant to which holders of Common Stock are permitted to sell, tender or exchange their shares for other securities, cash or property and has been accepted by the holders of 50% or more of the outstanding Common Stock, (iv) the Company, directly or indirectly, in one or more related transactions effects any reclassification, reorganization or recapitalization of the Common Stock or any compulsory share exchange pursuant to which the Common Stock is effectively converted into or exchanged for other securities, cash or property, or (v) the Company, directly or indirectly, in one or more related transactions consummates a stock or share purchase agreement or other business combination (including, without limitation, a reorganization, recapitalization, spin-off or scheme of arrangement) with another Person or group of Persons whereby such other Person or group acquires more than 50% of the outstanding shares of Common Stock (not including any shares of Common Stock held by the other Person or other Persons making or party to, or associated or affiliated with the other Persons making or party to, such stock or share purchase agreement or other business combination) (each a "Fundamental Transaction"), then, upon any subsequent exercise of this Warrant, the Holder shall have the right to receive, for each Warrant Share that would have been issuable upon such exercise immediately prior to the occurrence of such Fundamental Transaction, at the option of the Holder (without regard to any limitation in Section 2(e) on the exercise of this Warrant), the number of shares of Common Stock of the successor or acquiring corporation or of the Company, if it is the surviving corporation, and any additional consideration (the "Alternate Consideration") receivable as a result of such Fundamental Transaction by a holder of the number of shares of Common Stock for which this Warrant is exercisable immediately prior to such Fundamental Transaction (without regard to any limitation in Section 2(e) on the exercise of this Warrant). For purposes of any such exercise, the determination of the Exercise Price shall be appropriately adjusted to apply to such Alternate Consideration based on the amount of Alternate Consideration issuable in respect of one share of Common Stock in such Fundamental Transaction, and the Company shall apportion the Exercise Price among the Alternate Consideration in a reasonable manner reflecting the relative value of any different components of the Alternate Consideration. If holders of Common Stock are given any choice as to the securities, cash or property to be received in a Fundamental Transaction, then the Holder shall be given the same choice as to the Alternate Consideration it receives upon any exercise of this Warrant following such Fundamental Transaction. The Company shall cause any successor entity in a Fundamental Transaction in which the Company is not the survivor (the "Successor Entity") to assume in writing all of the obligations of the Company under this Warrant and the other Transaction Documents in accordance with the provisions of this Section 3(e) pursuant to written agreements in form and substance reasonably satisfactory to the Holder and approved by the Holder (without unreasonable delay) prior to such Fundamental Transaction and shall, at the option of the Holder, deliver to the Holder in exchange for this Warrant a security of the Successor Entity evidenced by a written instrument substantially similar in form and substance to this Warrant which is exercisable for a corresponding number of shares of capital stock of such Successor Entity (or its parent entity) equivalent to the shares of Common Stock acquirable and receivable upon exercise of this Warrant (without regard to any limitations on the exercise of this Warrant) prior to such Fundamental Transaction, and with an exercise price which applies the exercise price hereunder to such shares of capital stock (but taking into account the relative value of the shares of Common Stock pursuant to such Fundamental Transaction and the value of such shares of capital stock, such number of shares of capital stock and such exercise price being for the purpose of protecting the economic value of this Warrant immediately prior to the consummation of such Fundamental Transaction), and which is reasonably satisfactory in form and substance to the Holder. Upon the occurrence of any such Fundamental Transaction, the Successor Entity shall succeed to, and be substituted for (so that from and after the date of such Fundamental Transaction, the provisions of this Warrant and the other Transaction Documents referring to the "Company" shall refer instead to the Successor Entity), and may exercise every right and power of the Company and shall assume all of the obligations of the Company under this Warrant and the other Transaction Documents with the same effect as if such Successor Entity had been named as the Company herein.

Section 3. Transfer of Warrant.

a) Transferability. Subject to compliance with any applicable securities laws, this Warrant and all rights hereunder (including, without limitation, any registration rights) are transferable, in whole or in part, upon surrender of this Warrant at the principal office of the Company or its designated agent, together with a written assignment of this Warrant substantially in the form attached hereto duly executed by the Holder or its agent or attorney and funds sufficient to pay any transfer taxes payable upon the making of such transfer. Upon such surrender and, if required, such payment, the Company shall execute and deliver a new Warrant or Warrants in the name of the assignee or assignees, as applicable, and in the denomination or denominations specified in such instrument of assignment, and shall issue to the assignor a new Warrant evidencing the portion of this Warrant not so assigned, and this Warrant shall promptly be cancelled. Notwithstanding anything herein to the contrary, the Holder shall not be required to physically surrender this Warrant to the Company unless the Holder has assigned this Warrant in full, in which case, the Holder shall surrender this Warrant to the Company within three (3) Trading Days of the date the Holder delivers an assignment form to the Company assigning this Warrant full. The Warrant, if properly assigned in accordance herewith, may be exercised by a new holder for the purchase of Warrant Shares without having a new Warrant issued.

b) New Warrants. This Warrant may be divided or combined with other Warrants upon presentation hereof at the aforesaid office of the Company, together with a written notice specifying the names and denominations in which new Warrants are to be issued, signed by the Holder or its agent or attorney. Subject to compliance with Section 4(a), as to any transfer which may be involved in such division or combination, the Company shall execute and deliver a new Warrant or Warrants in exchange for the Warrant or Warrants to be divided or combined in accordance with such notice. All Warrants issued on transfers or exchanges shall be dated the Initial Exercise Date and shall be identical with this Warrant except as to the number of Warrant Shares issuable pursuant thereto.

c) Warrant Register. The Company shall register this Warrant, upon records to be maintained by the Company for that purpose (the "Warrant Register"), in the name of the record Holder hereof from time to time. The Company may deem and treat the registered Holder of this Warrant as the absolute owner hereof for the purpose of any exercise hereof or any distribution to the Holder, and for all other purposes, absent actual notice to the contrary.

d) Transfer Restrictions. If, at the time of the surrender of this Warrant in connection with any transfer of this Warrant, the transfer of this Warrant shall not be either (i) registered pursuant to an effective registration statement under the Securities Act and under applicable state securities or blue sky laws or (ii) eligible for resale without volume or manner-of-sale restrictions or current public information requirements pursuant to Rule 144.

e) Representation by the Holder. The Holder, by the acceptance hereof, represents and warrants that it is acquiring this Warrant and, upon any exercise hereof, will acquire the Warrant Shares issuable upon such exercise, for its own account and not with a view to or for distributing or reselling such Warrant Shares or any part thereof in violation of the Securities Act or any applicable state securities law, except pursuant to sales registered or exempted under the Securities Act.

Section 4. Miscellaneous.

a) No Rights as Stockholder Until Exercise. This Warrant does not entitle the Holder to any voting rights, dividends or other rights as a stockholder of the Company prior to the exercise hereof as set forth in Section 1(d)(i).

b) Loss, Theft, Destruction or Mutilation of Warrant. The Company covenants that upon receipt by the Company of evidence reasonably satisfactory to it of the loss, theft, destruction or mutilation of this Warrant or any stock certificate relating to the Warrant Shares, and in case of loss, theft or destruction, of indemnity or security reasonably satisfactory to it (which, in the case of the Warrant, shall not include the posting of any bond), and upon surrender and cancellation of such Warrant or stock certificate, if mutilated, the Company will make and deliver a new Warrant or stock certificate of like tenor and dated as of such cancellation, in lieu of such Warrant or stock certificate.

c) Saturdays, Sundays, Holidays, etc. If the last or appointed day for the taking of any action or the expiration of any right required or granted herein shall not be a Business Day, then, such action may be taken or such right may be exercised on the next succeeding Business Day.

d) Authorized Shares.

The Company covenants that, during the period the Warrant is outstanding, it will reserve from its authorized and unissued Common Stock a sufficient number of shares to provide for the issuance of the Warrant Shares upon the exercise of any purchase rights under this Warrant. The Company further covenants that its issuance of this Warrant shall constitute full authority to its officers who are charged with the duty of issuing the necessary Warrant Shares upon the exercise of the purchase rights under this Warrant. The Company will take all such reasonable action as may be necessary to assure that such Warrant Shares may be issued as provided herein without violation of any applicable law or regulation, or of any requirements of the Trading Market upon which the Common Stock may be listed. The Company covenants that all Warrant Shares which may be issued upon the exercise of the purchase rights represented by this Warrant will, upon exercise of the purchase rights represented by this Warrant and payment for such Warrant Shares in accordance herewith, be duly authorized, validly issued, fully paid and nonassessable and free from all taxes, liens and charges created by the Company in respect of the issue thereof (other than taxes in respect of any transfer occurring contemporaneously with such issue).

Except and to the extent as waived or consented to by the Holder, the Company shall not by any action, including, without limitation, amending its certificate of incorporation or through any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other voluntary action, avoid or seek to avoid the observance or performance of any of the terms of this Warrant, but will at all times in good faith assist in the carrying out of all such terms and in the taking of all such actions as may be necessary or appropriate to protect the rights of Holder as set forth in this Warrant against impairment. Without limiting the generality of the foregoing, the Company will (i) not increase the par value of any Warrant Shares above the amount payable therefor upon such exercise immediately prior to such increase in par value, (ii) take all such action as may be necessary or appropriate in order that the Company may validly and legally issue fully paid and nonassessable Warrant Shares upon the exercise of this Warrant and (iii) use commercially reasonable efforts to obtain all such authorizations, exemptions or consents from any public regulatory body having jurisdiction thereof, as may be, necessary to enable the Company to perform its obligations under this Warrant.

Before taking any action which would result in an adjustment in the number of Warrant Shares for which this Warrant is exercisable or in the Exercise Price, the Company shall obtain all such authorizations or exemptions thereof, or consents thereto, as may be necessary from any public regulatory body or bodies having jurisdiction thereof.

e) Jurisdiction. All questions concerning the construction, validity, enforcement and interpretation of this Warrant shall be determined in accordance with the laws of the State of New York.

f) Restrictions. The Holder acknowledges that the Warrant Shares acquired upon the exercise of this Warrant, if not registered and the Holder does not utilize cashless exercise, will have restrictions upon resale imposed by state and federal securities laws.

g) Limitation of Liability. No provision hereof, in the absence of any affirmative action by the Holder to exercise this Warrant to purchase Warrant Shares, and no enumeration herein of the rights or privileges of the Holder, shall give rise to any liability of the Holder for the purchase price of any Common Stock or as a stockholder of the Company, whether such liability is asserted by the Company or by creditors of the Company.

h) Successors and Assigns. Subject to applicable securities laws, this Warrant and the rights and obligations evidenced hereby shall inure to the benefit of and be binding upon the successors and permitted assigns of the Company and the successors and permitted assigns of Holder. The provisions of this Warrant are intended to be for the benefit of any Holder from time to time of this Warrant and shall be enforceable by the Holder or holder of Warrant Shares.

- i) Amendment. This Warrant may be modified or amended or the provisions hereof waived with the written consent of the Company and the Holder.
- j) Severability. Wherever possible, each provision of this Warrant shall be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Warrant shall be prohibited by or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity, without invalidating the remainder of such provisions or the remaining provisions of this Warrant.
- k) Headings. The headings used in this Warrant are for the convenience of reference only and shall not, for any purpose, be deemed a part of this Warrant.

(Signature Page Follows)

IN WITNESS WHEREOF, the Company has caused this Warrant to be executed by its officer thereunto duly authorized as of the date first above indicated.

CATASYS, INC.

By: /s/ Susan Etzel
Name: Susan Etzel
Title: Chief Financial Officer

Exhibit 31.1

CERTIFICATION

I, Terren S. Peizer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Catasys, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2016

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

Exhibit 31.2

CERTIFICATION

I, Susan Etzel, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Catasys, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2016

/s/ SUSAN ETZEL

Susan Etzel

Chief Financial Officer

(Principal Financial and Accounting Officer)

Exhibit 32.1

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Catasys, Inc. (the "Company") for the quarter ended September 30, 2016, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Terren S. Peizer, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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

November 14, 2016
Date

Exhibit 32.2

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Catasys, Inc. (the "Company") for the quarter ended September 30, 2016, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Susan Etzel, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ SUSAN ETZEL

Susan Etzel

Chief Financial Officer

(Principal Financial and Accounting Officer)

November 14, 2016

Date