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Documents

10-Q	catasys_10q-063011.htm
	Form 10-Q
EX-31.1	ex31-1.htm
	Exhibit 31.1
EX-31.2	ex31-2.htm
	Exhibit 31.2
EX-32.1	ex32-1.htm
	Exhibit 32.1
EX-32.2	ex32-2.htm
	Exhibit 32.2

Module and Segment References

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 **June 30, 2011**

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.)

11150 Santa Monica Boulevard, Suite 1500, Los Angeles, California 90025

(Address of principal executive offices, including zip code)

(310) 444-4300

(Registrant's telephone number, including area code)

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

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 August 10, 2011, there were 847,169,952 shares of registrant's common stock, \$0.0001 par value, outstanding.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

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

(In thousands, except for number of shares)

	June 30, 2011	December 31, 2010
ASSETS		
Current assets		
Cash and cash equivalents	\$ 632	\$ 4,605
Receivables, net of allowance for doubtful accounts of \$21 and \$36, respectively	89	73
Prepays and other current assets	104	183
Total current assets	825	4,861
Long-term assets		
Property and equipment, net of accumulated depreciation of \$5,667 and \$5,864 respectively	139	194
Intangible assets, net of accumulated amortization of \$2,056 and \$1,938 respectively	2,305	2,423
Deposits and other assets	212	466
Total Assets	\$ 3,481	\$ 7,944
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 1,510	\$ 1,665
Accrued compensation and benefits	625	706
Other accrued liabilities	1,109	1,036
Total current liabilities	3,244	3,407
Long-term liabilities		
Long-term debt	-	5,824
Deferred rent and other long-term liabilities	10	-
Warrant liabilities	879	8,890
Total liabilities	4,133	18,121
Stockholders' equity		
Preferred stock, \$0.0001 par value; 50,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, \$0.0001 par value; 2,000,000,000 shares authorized; 834,420,000 and 181,711,000 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively	82	18
Additional paid-in-capital	201,033	192,578
Accumulated deficit	(201,767)	(202,773)
Total Stockholders' Deficit	(652)	(10,177)
Total Liabilities and Stockholders' Equity	\$ 3,481	\$ 7,944

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 June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenues				
Healthcare services revenues	\$ 2	\$ 7	\$ 10	\$ 10
License & Management services revenues	61	104	140	224
Total revenues	\$ 63	\$ 111	\$ 150	\$ 234
Operating expenses				
Cost of healthcare services	\$ 145	\$ 51	\$ 267	\$ 75
General and administrative	2,910	3,141	5,953	6,673
Impairment losses	-	-	-	38
Depreciation and amortization	89	246	181	501
Total operating expenses	\$ 3,144	\$ 3,438	\$ 6,401	\$ 7,287
Loss from operations	\$ (3,081)	\$ (3,327)	\$ (6,251)	\$ (7,053)
Interest and other income	1	85	4	128
Interest expense	(1)	(134)	(699)	(271)
Gain on the sale of marketable securities	-	664	-	696
Loss on debt extinguishment	-	-	(41)	-
Change in fair value of warrant liability	6,040	237	8,001	894
Gain (Loss) from operations before provision for income taxes	\$ 2,959	\$ (2,475)	\$ 1,014	\$ (5,606)
Provision for income taxes	2	2	9	20
Net income (loss)	\$ 2,957	\$ (2,477)	\$ 1,005	\$ (5,626)
Basic and diluted net income (loss) per share:				
Basic net income (loss) per share	\$ 0.00	\$ (0.03)	\$ 0.00	\$ (0.08)
Basic weighted number of shares outstanding	834,420	70,918	615,657	68,388
Diluted net income (loss) per share	\$ 0.00	\$ (0.03)	\$ 0.00	\$ (0.08)
Diluted weighted number of shares outstanding	895,887	70,918	720,780	68,388

See accompanying notes to the financial statements.

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

(In thousands)	Six Months Ended	
	June 30,	
	2011	2010
Operating activities:		
Net income (loss)	\$ 1,005	\$ (5,626)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	181	501
Amortization of debt discount and issuance costs included in interest expense	558	126
Other than temporary impairment on marketable securities	-	(696)
Loss on debt extinguishment	41	-
Provision for doubtful accounts	13	19
Deferred rent	(26)	(61)
Share-based compensation expense	2,073	2,175
Fair value adjustment on warrant liability	(8,002)	(894)
Impairment losses	-	38
Gain on disposition of assets	2	-
Changes in current assets and liabilities:		
Receivables	(29)	155
Prepays and other current assets	99	(26)
Accounts payable and other accrued liabilities	190	10
Net cash used in operating activities	\$ (3,895)	\$ (4,279)
Investing activities:		
Proceeds from sales and maturities of marketable securities	\$ -	\$ 8,000
Proceeds from sales of property and equipment	7	1
Purchases of property and equipment	(18)	-
Deposits and other assets	(33)	-
Net cash provided by (used in) investing activities	\$ (44)	\$ 8,001
Financing activities:		
Transaction Costs	\$ (6)	\$ (51)
Proceeds from UBS Line of Credit	-	\$ 450
Paydown on UBS line of credit	-	\$ (6,908)
Capital lease obligations	(28)	(25)
Net cash used in financing activities	\$ (34)	\$ (6,534)
Net decrease in cash and cash equivalents	\$ (3,973)	\$ (2,812)
Cash and cash equivalents at beginning of period	4,605	4,595
Cash and cash equivalents at end of period	\$ 632	\$ 1,783
Supplemental disclosure of cash paid		
Interest	\$ -	\$ 98
Income taxes	\$ 17	\$ 34
Supplemental disclosure of non-cash activity		
Common stock issued for outside services	79	271
Common stock issued for debt settlement	141	1,235
Common stock issued for conversion of debt	6,143	-
Common stock issued for services	226	-
Common stock issued for exercise of warrants	9	-
Beneficial conversion feature related to November financing	150	-
Property and equipment acquired through capital leases and other financing	18	-

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 interim condensed consolidated financial statements for Catasys, Inc. (referred to herein as the “Company”, “Catasys”, “we”, “us” or “our”) and our subsidiaries have been prepared in accordance with the Securities and Exchange Commission (“SEC”) rules for interim financial information and do not include all information and notes required for complete financial statements. 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 in our most recent Annual Report on Form 10-K, from which the December 31, 2010 balance sheet has been derived.

Our financial statements have been prepared on the basis that we will continue as a going concern. At June 30, 2011, cash and cash equivalents amounted to \$632,000 and we had a working capital deficit of approximately \$2.4 million. We have incurred significant operating losses and negative cash flows from operations since our inception. During the six month ended June 30, 2011, our cash used in operating activities amounted \$3.9 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 June 30, 2011, these conditions raised substantial doubt as to our ability to continue as a going concern.

Our ability to fund our ongoing operations and continue as a going concern is dependent on signing and generating revenue from new contracts for our Catasys managed care programs and the success of management’s plans to increase revenue and continue to control expenses. We have launched our program in Nevada and Kansas and are currently in the process of implementing our Catasys contract in Massachusetts, which is expected to launch in August 2011. In aggregate, the contracts we have signed make our program available to 500,000 health plan members. We expect to generate revenue and cash from these contracts later this year. In addition, we have successfully reduced our operating expenses to better scale our ongoing operations.

As of August 10, 2011, we had a balance of approximately \$232,000 cash on hand. We had working capital deficit of approximately \$2.4 million at June 30, 2011 and have continued to deplete our cash position subsequent to June 30, 2011. We have incurred significant net losses and negative operating cash flows since our inception. We could continue to incur negative cash flows and net losses for the next twelve months. Our current cash burn rate is approximately \$450,000 per month, excluding non-current accrued liability payments. We expect our current cash resources to cover expenses into August 2011, however delays in cash collections, revenue, or unforeseen expenditures could impact this estimate. We will need to immediately obtain additional capital and there is no assurance that additional capital can be raised in an amount which is sufficient for us or on terms favorable to our stockholders, if at all. If we do not immediately obtain additional capital, there is a significant doubt as to whether we can continue to operate as a going concern and we will need to curtail or cease operations or seek bankruptcy relief. If we discontinue operations, we may not have sufficient funds to pay any amounts to stockholders. We engaged a placement agent in July 2011 to assist us with raising additional capital.

Based on the provisions of our management services agreement (“MSA”) between us and our managed professional medical corporation, we have determined that it constitutes a variable interest entity, and that we are the primary beneficiary as defined in Financial Accounting Standards Board (“FASB”) Interpretation No. 46R “Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51” (“FIN 46R”). Accordingly, we are required to consolidate the revenue and expenses of our managed professional medical corporation. See Management Service Agreement heading under Note 2, Summary of Significant Accounting Policies, for more discussion.

All intercompany transactions and balances have been eliminated in consolidation.

Note 2. Summary of Significant Accounting Policies

Revenue Recognition

Healthcare Services

Our Catasys contracts are generally designed to provide revenues 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.

License and Management Services

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

The revenues of our managed treatment centers, which we include in our consolidated financial statements, are derived from charging fees directly to patients for medical and mental health treatments, including the PROMETA Treatment Program. Revenues from patients treated with PROMETA at our managed treatment center are recorded based on the number of days of treatment completed during the period as a percentage of the total number treatment days for the PROMETA Treatment Program. Revenues relating to the continuing care portion of the PROMETA Treatment Program are deferred and recorded over the period during which the continuing care services are provided. Revenues related to other mental health and medical services are recognized when services are provided.

Cost of Healthcare Services

Healthcare Services

Healthcare services cost of services is recognized in the period in which an eligible member actually receives services. We contract with various healthcare providers, including licensed medical and behavioral healthcare professionals on a contracted fee-for-service basis to provide services to members enrolled in our programs. Healthcare services costs also include direct labor costs for our employees who work directly with members.

License and Management Services

License and management services represent direct costs that are incurred in connection with licensing our treatment programs and providing administrative services in accordance with the various technology license and services agreements, and are associated directly with the revenue that we recognize. Consistent with our revenue recognition policy, the costs associated with providing these services are recognized when services have been rendered, which for our license agreements is in the period in which patient treatment commences, and for our managed treatment center is in the periods in which medical treatment is provided. Such costs include royalties paid for the use of the PROMETA Treatment Program for patients treated by all licensees, and direct labor costs, continuing care expense, medical supplies and program medications for patients treated at our managed treatment center.

Comprehensive Income (Loss)

Our comprehensive income (loss) is as follows:

(In thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Net income (loss)	\$ 2,957	\$ (2,477)	\$ 1,005	\$ (5,626)
Net unrealized gain (loss) on marketable securities available for sale	-	-	-	(17)
Other comprehensive gain:				
Net unrealized gain (loss) on marketable securities available for sale	-	(666)	-	(679)
Comprehensive income (loss)	\$ 2,957	\$ (3,143)	\$ 1,005	\$ (6,322)

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 common shares 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 common and dilutive common equivalent shares outstanding during the period.

The following is a reconciliation of the weighted average common shares used to calculate basic net income (loss) per share to the weighted average common and potential common shares used to calculate diluted net income (loss) per share for the three and six months ended June 30, 2011 and 2010.

	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2011	2010	2011	2010
Numerator				
Net income (loss)	\$ 2,957	\$ (2,477)	\$ 1,005	\$ (5,626)
Denominator				
Weighted-average common shares outstanding	834,420	70,918	615,657	68,388
Shares used in calculation - basic	834,420	70,918	615,657	68,388
Stock options and warrants	61,467	-	105,122	
Shares used in calculation - diluted	895,887	70,918	720,779	68,388
Net income (loss) per share				
Basic	\$ 0.00	\$ (0.03)	\$ 0.00	\$ (0.08)
Diluted	\$ 0.00	\$ (0.03)	\$ 0.00	\$ (0.08)

For the three and six months ended June 30, 2011, common equivalent shares, consisting of 61,467,341, and 105,122,118, of incremental common shares, respectively, issuable upon the exercise of stock options and warrants were excluded from the diluted earnings per share calculation because their effect is anti-dilutive.

Share-Based Compensation

Our 2010 Stock Incentive Plan, as amended (“the Plan”), provides for the issuance of up to 231 million shares of our common stock. Incentive stock options (ISOs) under Section 422A of the Internal Revenue Code and non-qualified options (NSOs) are authorized under the Plan. We have granted stock options to executive officers, employees, members of our board of directors, and certain outside consultants. The terms and conditions upon which options become exercisable vary among grants, but option rights expire no later than ten years from the date of grant and employee and board of director awards generally vest over three to five years. At June 30, 2011, we had 216,167,387 vested and unvested shares outstanding and 13,938,009 shares available for future awards.

Share-based compensation expense attributable to continuing operations amounted to \$1.0 million and \$2.1 million for the three and six months ended June 30, 2011, compared to \$1.1 million and \$2.2 million for the same periods in 2010.

Stock Options – Employees and Directors

We measure and recognize compensation expense for all share-based payment awards made to employees and directors based on estimated fair values on the date of grant. We estimate the fair value of share-based payment awards using the Black Scholes option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the consolidated statements of operations subsequent to January 1, 2006. We account for share-based awards to employees and directors using the intrinsic value method under previous FASB rules, allowable prior to January 1, 2006. Under the intrinsic value method, no share-based compensation expense had been recognized in our consolidated statements of operations for awards to employees and directors because the exercise price of our stock options equaled the fair market value of the underlying stock at the date of grant.

Share-based compensation expense attributable to continuing operations recognized for employees and directors for the three and six months ended June 30, 2011 amounted to \$909,000 and \$1.9 million compared to \$1.0 million, \$1.8 million in 2010.

Share-based compensation expense recognized in our consolidated statements of operations for the three and six months ended June 30, 2011 and 2010, includes compensation expense for share-based payment awards granted prior to, but not yet vested, as of January 1, 2006 based on the grant date fair value estimated in accordance with the pro-forma provisions of Statement of Financial Accounting Standards (“SFAS”) 123, and for the share-based payment awards granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of the Accounting Standards Council (“ASC”) 718. 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 consolidated statements of operations for the three and six months ended June 30, 2011 and 2010, 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.

During the three and six months ended June 30, 2011, there were 650,000 options granted to employees at the weighted average per share exercise price of \$0.018, the fair market value of our common stock at the dates of grant. There were no options issued to employees for the same period in 2010. Employee and director stock option activity for the three and six months ended June 30, 2011, was as follows:

	Shares	Weighted Avg. Exercise Price
Balance December 31, 2010	206,418,600	\$ 0.11
Cancelled	(13,700)	\$ 0.68
Balance March 31, 2011	<u>206,404,900</u>	<u>\$ 0.11</u>
Granted	650,000	\$ 0.02
Cancelled	(728,000)	\$ 0.12
Balance June 30, 2011	<u>206,326,900</u>	<u>\$ 0.11</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 six months ended June 30, 2011 and 2010, reflects the application of the simplified method prescribed in SEC Staff Accounting Bulletin (SAB) No. 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.

As of June 30, 2011, there was \$2,273,740 of total unrecognized compensation costs 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 1.78 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, expected life of the option or warrant, expected volatility of our stock and expected dividends.

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

For the three and six months ended June 30, 2011, we issued 8,344,000 options at a \$0.071 strike price as compensation for consulting services. There were no options and warrants granted for the same period in 2010. For the three and six months ended June 30, 2011 share-based compensation expense attributable to continuing operations relating to stock options and warrants related to non-employees amounted to \$32,000 and was immaterial for same period in 2010.

Non-employee stock option activity for the three and six months ended June 30, 2011, was as follows:

	Shares	Weighted Avg. Exercise Price
Balance December 31, 2010	1,537,000	\$ 3.46
Granted	8,344,000	\$ 0.07
Balance March 31, 2011	<u>9,881,000</u>	<u>\$ 0.60</u>
Granted	-	\$ -
Balance June 30, 2011	<u>9,881,000</u>	<u>\$ 0.60</u>

Common Stock

There were 32,134,000 shares issued of common stock in the three and six months ending June 30, 2011, respectively, valued at \$1,028,000. For the same period in 2010, we issued 5,045,000 and 6,140,335 shares of common stock, respectively valued at \$1,017,000 and \$1,507,000 in exchange for various services and in settlement of claims. The costs associated with shares issued for services are being amortized to share-based compensation expense on a straight-line basis over the related service periods. For the three and six months ended June 30, 2011 and 2010, share-based compensation expense relating to all common stock issued for consulting services was \$55,000 and \$134,000 compared to \$211,000 and \$377,000, respectively.

On March 17, 2011 the \$5.9 million debenture notes including interest accrued through the same date, converted into 620,574,548 shares of common stock.

Employee Stock Purchase Plan

We have a qualified employee stock purchase plan ("ESPP"), approved by our stockholders, which allows qualified employees to participate in the purchase of designated shares of our common stock at a price equal to 85% of the lower of the closing price at the beginning or end of each specified stock purchase period. There were no shares of our common stock issued pursuant to the ESPP and, thus, no expense incurred for the three and six months ended June 30, 2011 and 2010, respectively.

Income Taxes

The Company has recorded a full valuation allowance against its otherwise recognizable deferred tax assets as of June 30, 2011. The Company utilizes the liability method of accounting for income taxes as set forth in ASC 740. 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. In determining the need for valuation allowances the Company considers projected future taxable income and the availability of tax planning strategies. After evaluating all positive and negative historical and perspective evidences, management has determined it is more likely than not that the Company's deferred tax assets will not be recognized.

The Company assesses its income tax positions and records tax benefits for all years subject to examination based upon the Company's evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where there is a greater than 50% likelihood that a tax benefit will be sustained, the Company has 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, managements has determined that all of the tax benefits for the period ended June 30, 2011 should be recognized.

Marketable Securities

Investments include certificates of deposit with maturity dates greater than three months when purchased. These investments are classified as available-for-sale investments, are reflected in current assets as marketable securities and are stated at fair market value in accordance with FASB accounting rules related to investment in debt securities. Unrealized gains and losses are reported in stockholders' equity in our consolidated balance sheet in "accumulated other comprehensive income (loss)." Realized gains and losses are recognized in the statement of operations on the specific identification method in the period in which they occur. Declines in estimated fair value judged to be other-than-temporary are recognized as an impairment charge in the statement of operations in the period in which they occur.

Our marketable securities consisted of investments with the following maturities and approximate fair market values as of June 30, 2011 and December 31, 2010:

<i>(in thousands)</i>	<u>Fair Market Value</u>	<u>Less than 1 Year</u>	<u>More than 10 Years</u>
Balance at December 31, 2010			
Certificates of deposit	\$ 133	\$ 133	\$ -
Balance at June 30, 2011			
Certificates of deposit	\$ 159	\$ 159	\$ -

Fair Value Measurements

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

<u>Level Input:</u>	<u>Input Definition:</u>
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 June 30, 2011, for assets and liabilities measured at fair value:

	2011			
<i>(Dollars in thousands)</i>	Level I	Level II	Level III	Total
Certificates of deposit	159	-	-	159
Total assets	159	-	-	159
Warrant liabilities	-	-	879	879
Total liabilities	-	-	879	879
<i>(Dollars in thousands)</i>				
Intangible assets	-	-	2,305	2,305
Total assets	-	-	2,305	2,305

Financial instruments classified as Level 3 in the fair value hierarchy as of June 30, 2011, represent our liabilities measured at market value on a recurring basis which include warrant liabilities resulting from recent debt and equity financings. In accordance with current accounting rules, the warrant liabilities are being marked to market each quarter-end until they are completely settled. The warrants are valued using the Black-Scholes option-pricing model, using both observable and unobservable inputs and assumptions consistent with those used in our estimate of fair value of employee stock options. See *Warrant Liabilities* below.

The following table summarizes our fair value measurements using significant Level III inputs, and changes therein, for the three and six months ended June 30, 2011:

<i>(Dollars in thousands)</i>	Level III Warrant Liabilities
Balance as of December 31, 2010	\$ 8,890
Transfers in/(out) of Level III	(9)
Change in Fair Value	(1,961)
Net purchases (sales)	-
Net unrealized gains (losses)	-
Net realized gains (losses)	-
Balance as of March 31, 2011	\$ 6,920
Transfers in/(out) of Level III	-
Change in Fair Value	(6,040)
Net purchases (sales)	-
Net unrealized gains (losses)	-
Net realized gains (losses)	-
Balance as of June 30, 2011	\$ 880

Intangible Assets

As of June 30, 2011, the gross and net carrying amounts of intangible assets that are subject to amortization are as follows:

Gross Carrying Amount	Accumulated Amortization	Net Balance	Amortization Period (in years)
\$ 4,361	\$ (2,056)	\$ 2,305	11-16

During the three and six months ended June 30, 2011, we did not acquire any new intangible assets and at June 30, 2011, all of our intangible assets consisted of intellectual property, which is not subject to renewal or extension. For the three and six months ended June 30, 2011, we relied upon the 2009 external valuation and internal analysis at December 31, 2010, which supported the independent, comprehensive valuation analysis and report intended to provide us with guidance with respect to (i) the determination of the fair value of certain patent rights ("PROMETA Rights") or the ("Patents") for the PROMETA Treatment Program (the "PROMETA Program") and, (ii) appropriate useful lives over which the Patents should be amortized (the "Valuation Opinion and Report"). This Valuation Opinion and Report was and will be used by us to fulfill our obligations under ASC 820 to determine the fair value of intangible assets on our balance sheet for financial reporting purposes. In order to assist the third party in its valuation analysis: Management performed a comprehensive review of our business, operations, and prospects of the patents on a standalone basis, the historical performance of the Company in relation to the Patents, future expectations relating to the Patents and financial statement projections related to the Patents. Management provided revenue projections for the PROMETA Program, including revenue derived from Catasys Health which includes use of the PROMETA Program, over the remaining useful life of the Patents.

Additionally, it is important to note that our overall business model, business operations and future prospects of our business have not changed materially since we performed the reviews and analysis noted above, with the exception of the timing and annualized amounts of expected revenue.

Estimated remaining amortization expense for intangible assets for the current year and each of the next five years ending December 31 is as follows:

(In thousands)	
Year	Amount
2011	\$ 118
2012	\$ 236
2013	\$ 236
2014	\$ 236
2015	\$ 236

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.

Variable Interest Entities

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

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

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

Management Services Agreement

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

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

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

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

We have also agreed to provide a credit facility to the treatment center to be available as a working capital loan, with interest at the Prime Rate plus 2%. Funds are advanced pursuant to the terms of the MSA described above. The notes are due on demand or upon termination of the respective MSA. At June 30, 2011, there was one outstanding credit facility under which \$10.9 million was outstanding. Our maximum exposure to loss could exceed this amount, and cannot be quantified as it is contingent upon the amount of losses incurred by the treatment center that we are required to fund under the credit facility.

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

The amounts and classification of assets and liabilities of the VIE included in our Consolidated Balance Sheets at June 30, 2011 and December 31, 2010 are as follows:

<i>(in thousands)</i>	June 30, 2011	December 31, 2010
Cash and cash equivalents	\$ 31	\$ 17
Receivables, net	7	7
Total assets	<u>\$ 38</u>	<u>24</u>
Accounts payable	13	13
Note payable to Catasys, Inc.	10,896	10,444
Total liabilities	<u>\$ 10,909</u>	<u>10,457</u>

Warrant Liabilities

We have issued warrants of our common stock in November 2007, September 2009, July 2010, September 2010, October 2010, and November 2010, and when we amended and restated the senior secured note in July 2008. The warrant agreements include provisions that require us to record them as a liability, at fair value, pursuant to FASB accounting rules, including provisions in some warrants that protect the holders from declines in our stock price and a requirement to deliver registered shares upon exercise, which is considered outside of our control. The warrant liabilities are marked to market each reporting period and changes in fair value are recorded as a non-operating gain or loss in our statement of operations, until they are completely settled or expire. The fair value of the warrants is determined each reporting period using the Black-Scholes option pricing model, and is affected by changes in inputs to that model including our stock price, expected stock price volatility, interest rates and expected term.

For the three and six months ended June 30, 2011, we recognized non-operating gains of \$6.0 million and \$8.0 million compared to \$237,000 and \$894,000, for the three and six months ended June 30, 2010, respectively, related to the revaluation of our warrant liabilities.

Recent Accounting Pronouncements

Recently Adopted Accounting Guidance

In January 2010, the FASB issued Accounting Standards Update ASU No. 2010-06, "Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements". This guidance requires new disclosures related to recurring and nonrecurring fair value measurements. The guidance requires disclosure of transfers of assets and liabilities between Level 1 and Level 2 of the fair value measurement hierarchy, including the reasons and the timing of the transfers and information on purchases, sales, issuance, and settlements on a gross basis in the reconciliation of the assets and liabilities measured under Level 3 of the fair value measurement hierarchy. The adoption of this guidance is effective for interim and annual reporting periods beginning after December 15, 2009. We have adopted this guidance in the financial statements presented herein, which did not have a material impact on our consolidated financial position or results of operations.

In October 2009, the FASB issued guidance under the *Multiple Element Revenue Arrangements* topic of the Codification which requires separation of the consideration received in such arrangements by establishing a selling price hierarchy for determining the selling price of a deliverable, which will be based on available information in the following order: vendor-specific objective evidence, third-party evidence, or estimated selling price. It also eliminates the residual method of allocation, requires that the consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method, which allocates any discount in the arrangement to each deliverable on the basis of each deliverable's selling price, and requires that a vendor determine its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a standalone basis. These changes became effective for us on January 1, 2011, but did not have a material impact on our financial position or results of operations.

In June 2009, the FASB issued Statement No. 167 which is a revision to FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities." This guidance amends the consolidation guidance applicable to variable interest entities. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. The adoption of this guidance is effective January 1, 2010. We have adopted this guidance in the financial statements presented herein, which did not have a material impact on our consolidated financial position or results of operations.

Recent Accounting Guidance Not Yet Adopted

In January 2010, the FASB issued guidance to amend the disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll forward activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance will become effective for us with the reporting period beginning January 1, 2012. Other than requiring additional disclosures, the adoption of this new guidance will not have a material impact on our financial statements.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, "*Comprehensive Income (Topic 220): Presentation of Comprehensive Income*," ("ASU 2011-05"). ASU 2011-05 eliminates the option to report other comprehensive income and its components in the statement of changes in equity. ASU 2011-05 requires that all non owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. This new guidance is to be applied retrospectively. We are required to adopt this standard as of the beginning of 2013. The adoption of this standard will only impact the presentation of our financial statements.

Note 3. Segment Information

We manage and report our operations through two business segments: healthcare services and license and management services. We evaluate segment performance based on total assets, revenue and income or loss before provision for income taxes. Our assets are included within each discrete reporting segment. In the event that any services are provided to one reporting segment by the other, the transactions are valued at the market price. No such services were provided during the three and six months ended June 30, 2011 and 2010. Summary financial information for our two reportable segments is as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Healthcare services				
Revenues	\$ 2	\$ 7	\$ 10	\$ 10
Income (Loss) before provision for income taxes	3,295	(511)	1,687	(1,175)
Assets *	1,014	-	1,014	-
License & Management services				
Revenues	\$ 61	\$ 104	\$ 140	\$ 224
Loss before provision for income taxes	(336)	(1,964)	(673)	(4,431)
Assets *	2,467	7,486	2,467	7,486
Consolidated continuing operations				
Revenues	\$ 63	\$ 111	\$ 150	\$ 234
Income (Loss) before provision for income taxes	2,959	(2,475)	1,014	(5,606)
Assets *	3,481	7,486	3,481	7,486

* Assets are reported as of June 30.

(In thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Healthcare Services	3,295	(511)	1,687	(1,175)
License & Management services	\$ (336)	\$ (1,964)	\$ (673)	\$ (4,431)
Income (Loss) from continuing operations before provision for income taxes	\$ 2,959	\$ (2,475)	\$ 1,014	\$ (5,606)

Healthcare Services

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

We are currently marketing our integrated substance dependence solutions to managed care health plans on a case rate or monthly fee, which involves educating third party payors on the disproportionately high cost of their substance dependent population and demonstrating the potential for improved clinical outcomes and reduced cost associated with using our Catasys programs. We launched our program in Nevada in May 2011 and Kansas in June 2011. We are in the process of implementing our previously announced contract in Massachusetts. In aggregate the contracts that we have signed to date make our program available to approximately 500,000 health plan members.

The following table summarizes the operating results for Healthcare Services for the three and six months ended June 30, 2011 and 2010:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Revenues	\$ 2	\$ 7	\$ 10	\$ 10
Operating Expenses				
Cost of healthcare services	\$ 129	\$ -	\$ 235	-
General and administrative expenses				
Salaries and benefits	1,935	502	\$ 3,968	\$ 1,121
Other expenses	682	16	1,385	64
Research and development	-	-	-	-
Impairment charges	-	-	-	-
Depreciation and amortization	2	-	2	-
Total operating expenses	\$ 2,748	\$ 518	\$ 5,590	\$ 1,185
Loss from operations	\$ (2,746)	\$ (511)	\$ (5,580)	\$ (1,175)
Interest and other income	1	-	4	-
Interest expense	-	-	(697)	-
Loss on debt extinguishment	-	-	(41)	-
Change in fair value of warrant liabilities	6,040	-	8,001	-
Income (Loss) before provision for income taxes	\$ 3,295	\$ (511)	\$ 1,687	\$ (1,175)

License and Management Services

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

The following table summarizes the operating results for License and Management services for the three and six months ended June 30, 2011 and 2010:

(In thousands, except patient treatment data)

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Revenues				
U.S. licensees	\$ 16	\$ 30	\$ 41	\$ 75
Managed treatment centers	45	74	99	149
Total license and management revenues	\$ 61	\$ 104	\$ 140	\$ 224
Operating expenses				
Cost of license and management services	\$ 15	\$ 51	\$ 32	\$ 75
General and administrative expenses				
Salaries and benefits	181	856	376	1,853
Other expenses	113	1,767	225	3,635
Impairment losses	-	-	-	38
Depreciation and amortization	87	246	179	501
Total operating expenses	\$ 396	\$ 2,920	\$ 812	\$ 6,102
Loss from operations				
Interest and other income	-	85	-	128
Interest expense	(1)	(134)	(2)	(271)
Gain on the sale of marketable securities	-	664	-	696
Change in fair value of warrant liabilities	-	237	-	894
Loss before provision for income taxes	\$ (336)	\$ (1,964)	\$ (674)	\$ (4,431)
PROMETA patients treated				
U.S. licensees	4	7	11	18
Managed treatment centers	1	5	4	14
	5	12	15	32
Average revenue per patient treated (a)				
U.S. licensees	\$ 3,913	\$ 4,371	\$ 3,695	\$ 4,191
Managed treatment centers	12,000	9,100	7,125	7,008
Overall average	5,530	6,342	4,610	5,424

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

Note 4. Debt Outstanding

The following table shows the total principal amount, related interest rates and maturities of debt outstanding, as of June 30, 2011 and December 31, 2010:

(dollars in thousands, except where otherwise noted)	<u>June 30,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>
Long-term debt		
Secured Convertible Promissory Note due November 9, 2012; interest payable at maturity (12% at December 31, 2010). \$5,965,000 principal net of \$141,000 unamortized discount at December 31, 2010.	\$ -	\$ 5,824
Debt converted to common stock in March 2011		
Total Short-term debt	<u>\$ -</u>	<u>\$ 5,824</u>

In November 2010, the Company completed a private placement with certain accredited investors, including Socius, an affiliate of our Chairman and Chief Executive Officer, and Mr. Jay Wolf, a director of the Company, for gross proceeds of \$6.9 million (the "Offering"). Of the gross proceeds, \$503,000 represented the exchange of the Bridge Notes and accrued interest and \$215,000 represented the cancellation of an accrued compensation liability to our Chairman and CEO. The Company incurred approximately \$364,000 in financial advisory, legal and other fees in relation to the offering. In addition, the Company issued warrants to purchase 5,670,000 shares of common stock at an exercise price \$0.01 per share to the financial advisors. The Company issued 100,000,000 shares of common stock at a price of \$0.01 per share and sold \$5.9 million in aggregate principal of 12% senior secured convertible notes (the "Notes") to the investors on a pro rata basis. The Notes were to mature on the second anniversary of the closing. The Notes were secured by a first priority security interest in all of the Company's assets. The Notes and any accrued interest convert automatically into common stock either (a) if and when sufficient shares become authorized or (b) upon a reverse stock split at a conversion price of \$0.01 per share, subject to certain adjustments, including certain share issuances below \$0.01 per share. The Company agreed to use its best efforts to file a proxy statement seeking shareholder approval to increase the number of authorized shares or effect a reverse stock split within 30 days of closing. The Company filed a proxy statement in January 2011 and the stockholders approved both proposals listed above and the Board of Directors decided to implement the increase in authorized shares of common stock. The Company filed an amendment to its Certificate of Incorporation, effective March 17, 2011, which increased the authorized shares of common stock and the Notes with accrued interest automatically converted to common stock. In addition, each non-affiliated investor in the Offering investing \$2,000,000 or more received five-year warrants. One non-affiliated investor received 21,960,000 warrants to purchase shares of the Company's common stock at an exercise price of \$0.01 per share.

On March 17, 2011 the Notes including interest accrued through the same date, converted into 620,574,548 shares of common stock.

Note 5. Subsequent Events

On July 22, 2011, the Company entered into an agreement with a Placement Agent to raise capital. As part of the agreement the Company agreed to pay the Placement Agent 7% of the aggregate gross proceeds raised in the placement, warrants to purchase common stock equal to 5% of the aggregate number of shares sold in the Placement, a 1% expense allowance, and a \$10,000 advance to be applied toward the expense allowance. There is no assurance that the Placement Agent will be successful with respect to securing a financing.

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 in this report. For ease of reference, "we," "us" or "our" refer to Catasys, Inc., our wholly-owned subsidiaries and The PROMETA Center, Inc. unless otherwise stated.

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 stock of Catasys 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 and Section 27A of the Securities Act of 1933. Such forward-looking statements, including, without limitation, those relating to the future business prospects, revenue and income of Catasys, wherever they occur, are necessarily estimates reflecting the best judgment of the senior management of Catasys on 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 II herein and Item 1A of Part I of our most recent Annual Report on Form 10-K, 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. The Company assumes no obligation and does not intend to update these forward looking statements, except as required by law.

OVERVIEW

General

We are a healthcare services management company, providing specialized behavioral health management services for substance abuse to health plans, employers and unions through a network of licensed healthcare providers and its employees. The Catasys substance dependence program (Ontrak™) was designed to address substance dependence as a chronic disease. The program seeks to lower costs and improve member health through the delivery of integrated medical and psychosocial interventions combining elements of traditional disease management and on-going "care coaching", including our proprietary PROMETA® Treatment Program for alcoholism and stimulant dependence. The PROMETA Treatment Program, which integrates behavioral, nutritional and medical components, is also available on a private-pay basis through licensed treatment providers and a company managed treatment center that offers the PROMETA Treatment Program, as well as other treatments for substance dependencies.

Operations

We have launched our integrated substance dependence solutions for third-party payors in Nevada and Kansas in May 2011 and June 2011, respectively. We are in the process of implementing our previously announced contract in Massachusetts. We believe that our Catasys offerings will address a high cost segment of the healthcare market for substance dependence, and we are currently marketing our Catasys integrated substance dependence solutions to managed care health plans on a case rate or monthly fee, which involves educating third party payors on the disproportionately high cost of their substance dependent population and demonstrating the potential for improved clinical outcomes and reduced cost associated with using our Catasys programs.

Under our licensing agreements, we provide physicians and other licensed treatment providers access to our PROMETA Treatment Program, education and training in the implementation and use of the licensed technology. The patient's physician determines the appropriateness of the use of the PROMETA Treatment Program. We receive a fee for the licensed technology and related services generally on a per patient basis. While we continue to maintain licensing agreements with physicians, hospitals and treatment providers for 8 sites in the United States, the number of active sites has decreased as a result of our streamline operations, removing field support personnel and significant reductions or eliminations of advertising related to the private pay business. Two of the company's sites contributed to revenue in the three months ended June 30, 2011 and four sites contributed to revenue in the six months ended June 30, 2011. We may enter into agreements on a selective basis with additional healthcare providers to increase the availability of the PROMETA Treatment Program, but generally only in markets we are presently operating or where such sites will provide support for our Catasys products. As such revenues are generally related to the number of patients treated, key indicators of our financial performance for the PROMETA Treatment Program will be the number of facilities and healthcare providers that license our technology, and the number of patients that are treated by those providers using our PROMETA Treatment Program. We are currently evaluating and considering additional actions to streamline our operations that may impact the licensing operations as we continue to focus on managed care plans through our healthcare services segment.

We currently manage, under a licensing agreement, one treatment center located in Santa Monica, California (dba The Center to Overcome Addiction). We manage the business components of the treatment center and license the PROMETA Treatment Program and use of the name in exchange for management and licensing fees under the terms of full business service management agreements. The center offers treatment with the PROMETA Treatment Program for dependencies on alcohol, cocaine and methamphetamines and also offers medical and psychosocial interventions for other substance dependencies and mental health disorders. The revenues and expenses of this center is included in our consolidated financial statements under accounting standards applicable to variable interest entities. We are currently evaluating and considering additional actions to streamline our operations that may impact the managed treatment center.

RESULTS OF OPERATIONS

Table of Summary Consolidated Financial Information

The table below and the discussion that follows summarize our results of consolidated continuing operations for the three and six months ended June 30, 2011 and 2010:

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Revenues				
Healthcare services revenues	\$ 2	\$ 7	\$ 10	\$ 10
License & Management services revenues	61	104	140	224
Total revenues	\$ 63	\$ 111	\$ 150	\$ 234
Operating expenses				
Cost of healthcare services	\$ 145	\$ 51	\$ 267	\$ 75
General and administrative	2,910	3,141	5,953	6,673
Impairment losses	-	-	-	38
Depreciation and amortization	89	246	181	501
Total operating expenses	\$ 3,144	\$ 3,438	\$ 6,401	\$ 7,287
Loss from operations	\$ (3,081)	\$ (3,327)	\$ (6,251)	\$ (7,053)
Interest and other income	1	85	4	128
Interest expense	(1)	(134)	(699)	(271)
Gain on the sale of marketable securities	-	664	-	696
Loss on debt extinguishment	-	-	(41)	-
Change in fair value of warrant liability	6,040	237	8,001	894
Gain (Loss) from operations before provision for income taxes	\$ 2,959	\$ (2,475)	\$ 1,014	\$ (5,606)
Provision for income taxes	2	2	9	20
Net income (loss)	\$ 2,957	\$ (2,477)	\$ 1,005	\$ (5,626)
Basic and diluted net income (loss) per share:				
Basic net income (loss) per share	\$ 0.00	\$ (0.03)	\$ 0.00	\$ (0.08)
Basic weighted number of shares outstanding	<u>834,420</u>	<u>70,918</u>	<u>615,657</u>	<u>68,388</u>
Diluted net income (loss) per share	\$ 0.00	\$ (0.03)	\$ 0.00	\$ (0.08)
Diluted weighted number of shares outstanding	<u>895,887</u>	<u>70,918</u>	<u>720,780</u>	<u>68,388</u>

Summary of Consolidated Operating Results

The net income from continuing operations before provision for income taxes was \$3.0 million and \$1.0 million during the three and six months ended June 30, 2011, compared to a net loss of \$2.5 million and \$5.6 million during the three and six months ended June 30, 2010. The change was primarily due to the \$7.1 million gain in the change in fair value of the warrant liability, a decrease of \$886,000 in operating expenses, resulting mainly from actions to streamline our healthcare services operations, and a \$320,000 decrease in depreciation, partially offset by a \$428,000 increase in interest expense related to the November 2010 financing (as described below) note payables.

Revenues

Revenue decreased by \$48,000 and \$84,000 for the three and six months ended June 30, 2011, compared to the same period in 2010, due mainly to a decline in licensed sites contributing to revenue and in the number of patients treated at our U.S. licensed sites and the managed treatment center. This was partially offset by an increase in non-prometa revenue at the Center to Over Addiction. The number of patients treated decreased by 58% and 53% in the three and six months ended June 30, 2011 compared to the same period in 2010. The average revenue per patient treated at U.S. licensed sites and at PROMETA Centers decreased by \$800 during the three and six months ended June 30, 2011, compared to the same period in 2010.

Cost of Healthcare Services

Cost of healthcare services consists of royalties we pay for the use of the PROMETA Treatment Program, and costs incurred by our consolidated managed treatment center (The Center to Overcome Addiction) for direct labor costs for physicians and nursing staff, continuing care expense, medical supplies and treatment program medicine costs. The increase in these costs is primarily due to an increase in direct labor costs related to the recently executed contracts for the Ontrak program.

General and Administrative Expenses

Total general and administrative expenses decreased by \$231,000 and \$720,000 in the three and six months ended June 30, 2011 compared to the same period in 2010. This decrease is attributable to a \$488,000 decrease in salaries and benefits and \$170,000 in other general and administrative expenses as a result of the streamlining of our operations. For the three and six months ended June 30, 2011, general and administrative expenses included \$1.0 million and \$2.1 million, in non-cash expense for share-based compensation, respectively.

Depreciation and amortization decreased by \$157,000 and \$320,000 during the three and six months ended June 30, 2011, compared to the same period in 2010, primarily due to disposal of fixed assets in 2010.

Research and Development

Research and development expenses were immaterial for the three and six months ended June 30, 2011 and 2010, respectively.

Impairment Losses

There was no impairment loss related to property plant and equipment for the three and six months ended June 30, 2011, compared to \$0 and \$38,000 for the three and six months ended June 30, 2010. There was no impairment charge related to intellectual property in the three and six months ended June 30, 2011 and 2010, respectively.

Interest Expense

Interest expense increased by \$428,000 for the six months ended June 30, 2011 compared to the same period in 2010 due to interest recorded on the note payables issued in association with the November 2010 financing. During the 3 months ending June 30, 2011 interest expense decreased by \$133,000 compared to the same period in 2010 due to the conversion of notes and interest payable into common stock.

Change in fair value of warrant liability

We issued warrants of our common stock in November 2007, September 2009, July 2010, October 2010, November 2010, and when we amended and restated the Highbridge senior secured note in July 2008. The warrants are being accounted for as liabilities in accordance with Financial Accounting Standards Board ("FASB") accounting rules, due to provisions in some warrants that protect the holders from declines in our stock price and a requirement to deliver registered shares upon exercise of the warrants, which is considered outside our control. The warrants are marked-to-market each reporting period, using the Black-Scholes pricing model, until they are completely settled or expire.

The change in fair value of the warrants amounted to a net gain of \$5.8 million and \$7.1 million for the three and six months ended June 30, 2011, compared to the same period in 2010.

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

LIQUIDITY AND CAPITAL RESOURCES

Liquidity and Going Concern

As of August 10, 2011, we had a balance of approximately \$232,000 cash on hand. We had working capital deficit of approximately \$1.8 million at June 30, 2011 and have continued to deplete our cash position subsequent to June 30, 2011. We have incurred significant net losses and negative operating cash flows since our inception. We could continue to incur negative cash flows and net losses for the next twelve months. Our current cash burn rate is approximately \$450,000 per month, excluding non-current accrued liability payments. We expect our current cash resources to cover expenses into August 2011, however delays in cash collections, revenue, or unforeseen expenditures could impact this estimate. We will need to immediately obtain additional capital and there is no assurance that additional capital can be raised in an amount which is sufficient for us or on terms favorable to our stockholders, if at all. If we do not immediately obtain additional capital, there is a significant doubt as to whether we can continue to operate as a going concern and we will need to curtail or cease operations or seek bankruptcy relief. If we discontinue operations, we may not have sufficient funds to pay any amounts to stockholders. We engaged a placement agent in July 2011 to assist us with raising additional capital.

In July 2010, we closed on \$2 million of a registered direct financing with certain institutional investors which represented \$1.7 million in net proceeds to our Company.

In October 2010, we entered into Securities Purchase Agreements with certain accredited investors, including Socius Capital Group, LLC ("Socius"), an affiliate of our Chairman and Chief Executive Officer, pursuant to which such investors purchased \$500,000 of 12% senior secured convertible notes (the "Bridge Notes") and warrants to purchase shares of our common stock.

In November 2010, we completed a private placement with certain accredited investors, including Socius, an affiliate of our Chairman and Chief Executive Officer, and Mr. Jay Wolf, a director of the Company, for gross proceeds of \$6.9 million (the "Offering"). Of the gross proceeds, \$503,000 represented the exchange of the Bridge Notes and accrued interest and \$215,000 represented the cancellation of an accrued compensation liability to our Chairman and CEO. The Company incurred approximately \$364,000 in financial advisory, legal and other fees in relation to the offering. In addition, the Company issued warrants to purchase 5,670,000 shares of common stock at an exercise price \$0.01 per share to the financial advisors. The Company issued 100,000,000 shares of common stock at a price of \$0.01 per share and sold \$5.9 million in aggregate principal of 12% senior secured convertible notes (the "Notes") to the investors on a pro rata basis. The Notes were to mature on the second anniversary of the closing. The Notes were secured by a first priority security interest in all of the Company's assets. The Notes and any accrued interest convert automatically into common stock either (a) if and when sufficient shares become authorized or (b) upon a reverse stock split at a conversion price of \$0.01 per share, subject to certain adjustments, including certain share issuances below \$0.01 per share. The Company agreed to use its best efforts to file a proxy statement seeking shareholder approval to increase the number of authorized shares or effect a reverse stock split within 30 days of closing. The Company filed a proxy statement in January 2011 and the stockholders approved both proposals listed above and the Board of Directors decided to implement the increase in authorized shares of common stock. The Company filed an amendment to its Certificate of Incorporation, effective March 17, 2011, which increased the authorized shares of common stock and the Notes with accrued interest automatically converted to common stock. In addition, each non-affiliated investor in the Offering investing \$2,000,000 or more would receive five-year warrants. One non-affiliated investor received 21,960,000 warrants to purchase shares of the Company's common stock at an exercise price of \$0.01 per share. The net cash proceeds to the Company from the Offering were estimated to be \$6.4 million inclusive of the October transaction and after offering expenses.

Our ability to fund our ongoing operations and continue as a going concern is dependent on signing and generating revenue from existing and new contracts for our Catasys managed care programs and the success of management's plans to increase revenue and continue to control expenses. We have launched our program in Nevada in May 2011 and Kansas in June 2011 and are currently in the process of implementing our Catasys contract in Massachusetts. In aggregate, the contracts we have signed make our program available to approximately 500,000 health plan members. We expect to generate revenue and cash from these contracts later this year. However, there can be no assurance that we will generate such revenue. In addition, we have continued to reduce our operating expenses to better scale our ongoing operations.

Over the last two years, management took actions that have resulted in reduced annual operating expenses. We have renegotiated certain leasing and vendor agreements to obtain more favorable pricing and to restructure payment terms with vendors, and have paid some expenses through the issuance of common stock. In the fourth quarter of 2010 and the first quarter of 2011, management reduced costs through new lease arrangements on its corporate headquarters and streamlining personnel and other operating costs. These reductions have been somewhat offset by increased expenditures related to contract implementations. We anticipate increasing the number of personnel and incurring additional operating costs during 2011 to service our contracts as they become operational. During the year ended December 31, 2010, we settled, through the issuance of common stock, approximately \$1.2 million of liabilities. In previous periods, we have exited markets for our licensee operations that we have determined would not provide short-term profitability. We have continued to reduce expenditures for our licensee operations and focused on our promoting our Ontrak program.

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

Cash Flows

We used \$3.9 million of cash for operating activities during the six months ended June 30, 2011, compared to \$4.3 million of cash for operating activities during the same period last year. Use of funds in operating activities include general and administrative expense (excluding share-based compensation expense), and the cost of healthcare services, which totaled approximately \$4.1 million for the six months ended June 30, 2011 compared to \$4.6 million for the same period in 2010. This decrease in net cash used reflects the decline in such expenses from our efforts to streamline operations.

Capital expenditures for the three and six months ended June 30, 2011 were not material. Our future capital expenditure requirements will depend upon many factors, including progress with our marketing efforts, required replacement of existing equipment, the time and costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other proprietary rights, the necessity of, and time and costs involved in obtaining, regulatory approvals, competing technological and market developments, and our ability to establish collaborative arrangements, effective commercialization, marketing activities and other arrangements.

As discussed above, we currently expend cash at a rate of approximately \$450,000 per month, excluding non-current accrued liability payments. We also anticipate cash inflow to increase in the second half of 2011 as we implement our recently executed contracts and we expect our current cash resources to cover expenses into August 2011. However, there can be no assurance that these contracts will produce cash and any delays in cash collections, revenue, or unforeseen expenditures, could impact this estimate. We are seeking additional sources of capital, including through the placement agent we engaged in July 2011, but there is no assurance that additional capital can be raised in an amount which is sufficient for us or on terms favorable to our stockholders, if at all. If we do not obtain additional capital immediately, there is significant doubt as to whether we can continue to operate as a going concern. 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.

Senior Secured Note

In January 2007, we entered into a securities purchase agreement pursuant to which we sold to Highbridge International LLC (Highbridge) (a) \$10 million original principal amount of a senior secured note and (b) warrants to purchase up to approximately 250,000 shares of our common stock (adjusted to 285,185 shares as of December 31, 2007). The note bore interest at a rate of prime plus 2.5%, interest payable quarterly commencing in April 2007, and originally matured in January 2010. The note was redeemable at our option anytime prior to maturity at a redemption price ranging from 103% to 110% of the principal amount during the first 18 months and was originally redeemable at the option of Highbridge beginning in July 2008. We paid \$5 million in principal under this note through the issuance of common stock in conjunction with a financing in 2007.

In August, 2009, we amended and restated the senior secured note with Highbridge to extend the maturity date from January 15, 2010 to July 15, 2010, and Highbridge agreed to give up its optional redemption rights. We also committed to exercising our right to sell our ARS in accordance with the terms of the rights offering by UBS, who sold them to us, and use the proceeds from the sale to redeem the note and to provisions that we would use a portion of any capital raised to redeem the note. We also amended all 1.8 million warrants that had been previously issued to Highbridge to purchase shares of our common stock, to change the exercise price to \$0.28 per share, and extend the expiration date to five years from the amendment date. In July 2010, we paid off the outstanding balance of the note from the net proceeds of the ARS redemptions.

During the year ended December 31, 2010, we issued common stock which triggered an anti-dilution adjustment to the 1.3 million warrants associated with the 2009 amended and restated senior and secured note held by Highbridge LLC. The adjustment resulted in an increase to the number of warrants outstanding in the amount of 1,960,000. We paid this note in full upon maturity in July 2010.

OFF BALANCE SHEET ARRANGEMENTS

As of June 30, 2011, we had no off-balance sheet arrangements.

CRITICAL ACCOUNTING ESTIMATES

Critical Accounting Estimates

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

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

Warrant Liabilities

We have issued warrants of our common stock in November 2007, September 2009, July 2010, October 2010, November 2010, and when we amended and restated the Highbridge senior secured note in July 2008. The warrant agreements include provisions that require us to record them as a liability, at fair value, pursuant to FASB accounting rules, including provisions in some warrants that protect the holders from declines in our stock price and a requirement to deliver registered shares upon exercise, which is considered outside of our control. The warrant liabilities are marked-to-market each reporting period and changes in fair value are recorded as a non-operating gain or loss in our statement of operations, until they are completely settled or expire. The fair value of the warrants is determined each reporting period using the Black-Scholes option pricing model, and is affected by changes in inputs to that model including our stock price, expected stock price volatility, interest rates and expected term.

The change in fair value of the warrant liabilities amounted to a net gain of \$6.0 million and \$8.0 million for the three and six months ended June 30, 2011 compared to net gain of \$237,000 and \$894,000 for the three and six months ended June 30, 2010, respectively. The gains resulted mainly from a decline in the Company's stock price. We will continue to re-measure the warrant liabilities at fair value each quarter-end until they are completely settled or expire.

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. Based on the 2010 assumptions used for the Black-Scholes pricing model, a 50% increase in stock price volatility would have increased the fair values of options by approximately 25%. The weighted average expected option term for the three and six months ended June 30, 2011 reflects the application of the simplified method set out in SEC Staff Accounting Bulletin No. 107, which defines the life as the average of the contractual term of the options and the weighted average vesting period for all option tranches.

From time to time, we have retained terminated employees as part-time consultants upon their resignation from our Company. Because the employees continued to provide services to us, their options continued to vest in accordance with the original terms. Due to the change in classification of the option awards, the options were considered modified at the date of termination. The modifications were treated as exchanges of the original awards in return for the issuance of new awards. At the date of termination, the unvested options were no longer accounted for as employee awards and were 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 six months ended June 30, 2011.

Impairment of Intangible Assets

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

During the three and six months ended June 30, 2011 we did not acquire any new intangible assets and at June 30, 2011, all of our intangible assets consisted of intellectual property, which is not subject to renewal or extension. For the three and six months ended June 30, 2011, we relied upon the 2009 external valuation and internal analysis at December 31, 2010, which supported the independent, comprehensive valuation analysis and report intended to provide us with guidance with respect to (i) the determination of the fair value of certain patent rights ("PROMETA Rights") or the ("Patents") for the PROMETA Treatment Program (the "PROMETA Program") and, (ii) appropriate useful lives over which the Patents should be amortized (the "Valuation Opinion and Report"). This Valuation Opinion and Report was and will be used by us to fulfill our obligations under ASC 820 to determine the fair value of intangible assets on our balance sheet for financial reporting purposes. In order to assist the third party in its valuation analysis: Management performed a comprehensive review of our business, operations, and prospects of the patents on a standalone basis, the historical performance of the Company in relation to the Patents, future expectations relating to the Patents and financial statement projections related to the Patents. Management provided revenue projections for the PROMETA Program, including revenue derived from Catasys Health which includes use of the PROMETA Program, over the remaining useful life of the Patents.

Additionally, it is important to note that our overall business model, business operations and future prospects of our business have not changed materially since we performed the reviews and analysis noted above, with the exception of the timing and annualized amounts of expected revenue.

Valuation of Marketable Securities

Investments include certificates of deposit with maturity dates greater than three months when purchased, which are classified as available-for-sale investments and reflected in current or long-term assets, as appropriate, as marketable securities at fair market value. Unrealized gains and losses are reported in our Consolidated Balance Sheet within accumulated other comprehensive loss and within other comprehensive loss. Realized gains and losses and declines in value judged to be “other-than-temporary” are recognized as a non-reversible impairment charge in the Statement of Operations on the specific identification method in the period in which they occur.

We regularly review the fair value of our investments. If the fair value of any of our investments falls below our cost basis in the investment, we analyze the decrease to determine whether it represents an other-than-temporary decline in value. In making our determination for each investment, we consider the following factors:

- How long and by how much the fair value of the investments have been below cost;
- The financial condition of the issuers;
- Any downgrades of the investment by rating agencies;
- Default on interest or other terms; and
- Our intent and ability to hold the investments long enough for them to recover their value.

RECENT ACCOUNTING PRONOUNCEMENTS

Recent Accounting Pronouncements

Recently Adopted

In January 2010, the FASB issued Accounting Standards Update ASU No. 2010-06, “Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements”. This guidance requires new disclosures related to recurring and nonrecurring fair value measurements. The guidance requires disclosure of transfers of assets and liabilities between Level 1 and Level 2 of the fair value measurement hierarchy, including the reasons and the timing of the transfers and information on purchases, sales, issuance, and settlements on a gross basis in the reconciliation of the assets and liabilities measured under Level 3 of the fair value measurement hierarchy. The adoption of this guidance is effective for interim and annual reporting periods beginning after December 15, 2009. We have adopted this guidance in the financial statements presented herein, which did not have a material impact on our consolidated financial position or results of operations.

In October 2009, the FASB issued guidance under the *Multiple Element Revenue Arrangements* topic of the Codification which requires separation of the consideration received in such arrangements by establishing a selling price hierarchy for determining the selling price of a deliverable, which will be based on available information in the following order: vendor-specific objective evidence, third-party evidence, or estimated selling price. It also eliminates the residual method of allocation, requires that the consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method, which allocates any discount in the arrangement to each deliverable on the basis of each deliverable’s selling price, and requires that a vendor determine its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a standalone basis. These changes became effective for us on January 1, 2011, which did not have a material impact on our financial position or results of operations.

In June 2009, the FASB issued Statement No. 167 which is a revision to FASB Interpretation No. 46(R), “Consolidation of Variable Interest Entities.” This guidance amends the consolidation guidance applicable to variable interest entities. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. The adoption of this guidance is effective January 1, 2010. We have adopted this guidance in the financial statements presented herein, which did not have a material impact 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 chief executive officer and our chief financial officer, the effectiveness of our system of disclosure controls and procedures as defined in the Securities and Exchange Act of 1934, as amended, Rule 13a-15 and rule 15d-15(e) as of the end of the period covered by this report. Based on this evaluation our chief executive officer and our chief financial officer have determined that they are effective as of the end of the period covered by this report. There were no changes in the internal controls over financial reporting that occurred during the quarter ended June 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Changes in Internal Control Over Financial Reporting

There are no changes in our controls over financial reporting during the three and six months ended June 30, 2011 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

There have been no material changes in our legal proceedings from those disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Item 1A. Risk Factors

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

We have incurred negative cash flows from operations since inception and have expended, and expect to continue to expend, substantial funds to grow our business. We currently estimate that our existing cash, cash equivalents and marketable securities will only be sufficient to fund our operating expenses and capital requirements into August 2011. We will need to immediately obtain additional capital and there is no assurance that additional capital can be raised in an amount which is sufficient for us or on terms favorable to our stockholders, if at all. If we do not immediately obtain additional capital, there is a significant doubt as to whether we can continue to operate as a going concern and we will need to curtail or cease operations or seek bankruptcy relief. If we discontinue operations, we may not have sufficient funds to pay any amounts to stockholders.

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

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

In March 2011, we issued 1,000,000 restricted shares of common stock to a consultant for investor relation services to be performed beginning January 1, 2011 and ending March 31, 2011. These securities were issued without registration pursuant to the exemption afforded by Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act") a transaction by us not involving any public offering.

In July 2011, we issued 6,375,000 restricted shares of common stock to each of two consultants for investor relation services to be performed beginning June 23, 2011 and ending September 23, 2011. These securities were issued without registration pursuant to the exemption afforded by Rule 506 of Regulation D promulgated under the Securities Act.

Item 3. Defaults Upon Senior Securities

None.

Item 4. [Removed and Reserved]

Item 5. Other Information

None.

Item 6. Exhibits

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
Exhibit 101@	The following materials from Catasys, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) the unaudited Condensed Consolidated Balance Sheets, (ii) the unaudited Condensed Consolidated Statements of Operations, (iii) the unaudited Condensed Consolidated Statements of Cash Flows, and (iv) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.
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

@Users of the XBRL data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

** XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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: August 12, 2011

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

Date: August 12, 2011

By: /s/ SUSAN ETZEL
Susan Etzel
Chief Financial Officer
(Principal Financial and Accounting 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: August 12, 2011

/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: August 12, 2011

/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 June 30, 2011, 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)

August 12, 2011

Date

**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 June 30, 2011, 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)

August 12, 2011

Date