EDGAR Submission Header Summary

Submission Type	**8-K**
Live File	**on**
Return Copy	**on**
Submission Contact	**RDG Filings**
Submission Contact Phone Number	**1-415-643-6080**
Exchange	**NASD**
Confirming Copy	**off**
Filer CIK	**0001136174**
Filer CCC	**xxxxxxxx**
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Item IDs	**1.01**
	2.01
	2.03
	3.02
	9.01
Notify via Filing website Only	**off**
Emails	**file@rdgfilings.com**

Documents

8-K	**catasys_8k-100511.htm**
	Form 8-K
EX-4.1	**ex4-1.htm**
	Exhibit 4.1
EX-4.2	**ex4-2.htm**
	Exhibit 4.2
EX-10.1	**ex10-1.htm**
	Exhibit 10.1
EX-10.1	**ex10-2.htm**
	Exhibit 10.2
GRAPHIC	**a1.jpg**
GRAPHIC	**a2.jpg**
GRAPHIC	**a3.jpg**
GRAPHIC	**a4.jpg**

Module and Segment References

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

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): **October 5, 2011**

Catasys, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**001-31932**	**88-0464853**
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification No.)

11150 Santa Monica Boulevard, Suite 1500 **Los Angeles, California** (Address of principal executive offices)	**90025** (Zip Code)

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

(Former name or former address, if changed since last report.)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instructions A.2. below):

☐ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

☐ Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

☐ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

☐ Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Item 1.01. Entry into a Material Definitive Agreement.

On October 5, 2011, Catasys, Inc. (the "Company") entered into a Securities Purchase Agreement (the "Agreement") with David E. Smith, for $680,000 and issued a senior secured convertible note (the "Note") and a warrant to purchase an aggregate of 2,615,385 shares of the Company's common stock, par value $0.0001 per share (the "Common Stock"), at an exercise price of $0.32 per share (the "Warrant"). The exercise price and number of shares of Common Stock of the Warrant are subject to adjustment for financings and share issuances below the initial exercise price.

The Agreement contains customary affirmative covenants for facilities of this type, including covenants pertaining to financial information, notices of default, maintenance of business and insurance, collateral matters, and compliance with laws, as well as customary negative covenants for facilities of this type, including restrictions on the disposition of assets.

The Note matures on January 5, 2012 and bears interest at an annual rate of 12% payable in cash at maturity, prepayment or conversion. The Note and any accrued interest are convertible at the holder's option into common stock or the next financing the Company enters into in an amount of at least $2,000,000 (a "Qualified Financing"). The conversion price for the Note is equal to the lower of (i) $0.26 per share of Common Stock, and (ii) the lowest price per share of Common Stock into which any security is convertible in any Qualified Financing. The Note is secured by a first priority security interest in all assets of the Company on a pari passu basis with the holder of the secured note issued by the Company on August 17, 2011 (the "Socius Note").

Effective October 5, 2011, the Company entered into a Consent Agreement (the "Consent Agreement") with Socius Capital Group, LLC ("Socius"), an affiliate of Terren S. Peizer, Chairman and Chief Executive Officer of the Company, and David E. Smith. The Consent Agreement provided that the maturity date of the the Socius note be extended to January 5, 2011, and provided that consent to the Socius Note and the Note be secured by a first priority security interest in all assets of the Company on a pari passu basis.

The foregoing descriptions of the Agreement, the Consent, the Note and the Warrant do not purport to be complete and are qualified in their entirety by the documents, which are attached as Exhibits 10.1, 10.2, 4.1, and 4.2, respectively, to this Current Report on Form 8-K and incorporated herein by reference.

Item 2.01 Completion of Acquisition or Disposition of Assets.

On October 5, 2011, the Company issued a Note secured by all of the Company's assets as described in Item 1.01 of this Current Report on Form 8-K.

Item 2.03 Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant.

On October 5, 2011, the Company incurred a direct obligation to repay $680,000 as described in Item 1.01 of this Current Report on Form 8-K.

Item 3.02 Unregistered Sales of Equity Securities.

On October 5, 2011, the Company issued the Note and the Warrant as described in Item 1.01 of this Current Report on Form 8-K. The issuance was exempt from registration pursuant to the exemption afforded by Rule 506 of Regulation D promulgated under the Securities Act of 1933, as amended.

Item 9.01 Financial Statements and Exhibits

(d) Exhibits.

No.	Description
4.1	Secured Convertible Promissory Note, dated October 5, 2011
4.2	Warrant, dated October 5, 2011
10.1	Securities Purchase Agreement, dated October 5, 2011
10.2	Consent Agreement, dated October 5, 2011

SIGNATURES

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

CATASYS, INC.

Date: October 7, 2011

By: /s/ SUSAN E. ETZEL
Susan E. Etzel
Chief Financial Officer

Exhibit 4.1

THIS NOTE AND THE SECURITIES ISSUABLE UPON CONVERSION OF THIS NOTE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR QUALIFIED UNDER ANY STATE SECURITIES LAW, AND MAY NOT BE OFFERED FOR SALE OR SOLD UNLESS A REGISTRATION STATEMENT UNDER THE SECURITIES ACT AND APPLICABLE STATE SECURITIES LAWS SHALL BE EFFECTIVE WITH RESPECT THERETO OR AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT AND/OR QUALIFICATION UNDER APPLICABLE STATE SECURITIES LAWS IS AVAILABLE IN CONNECTION WITH SUCH OFFER OR SALE. THIS NOTE DOES NOT REQUIRE PHYSICAL SURRENDER HEREOF IN ORDER TO EFFECT A PARTIAL PAYMENT, REDEMPTION OR CONVERSION HEREOF. ACCORDINGLY, THE OUTSTANDING PRINCIPAL AMOUNT OF THIS NOTE MAY BE LESS THAN THE PRINCIPAL AMOUNT SHOWN BELOW.

CATASYS, INC.

SECURED CONVERTIBLE PROMISSORY NOTE

Issue Date: October 5, 2011 $680,000.00

FOR VALUE RECEIVED, **CATASYS, INC.**, a Delaware corporation (the "***Company***"), hereby promises to pay to the order of **David E. Smith**, or his successors or assigns (the "***Holder***") the sum of Six Hundred and Eighty Thousand Dollars ($680,000.00) in same day funds on or before 90 calendar days from the Issue Date (the "***Maturity Date***"), unless this Secured Convertible Promissory Note (this "***Note***") is earlier converted pursuant to Section 3 hereof.

The following terms shall apply to this Note:

1. DEFINITIONS.

"Applicable Interest Rate" means an annual rate equal to twelve percent (12%) prior to any Event of Default, and twenty-four percent (24%) after the occurrence of any Event of Default, computed on the basis of a 365-day year and calculated using the actual number of days elapsed since the Issue Date or the date on which Interest was most recently paid.

"Business Day" means any day other than a Saturday, a Sunday or a day on which the New York Stock Exchange is closed or on which banks are authorized by law to close in New York, New York.

"Common Stock" means the common stock of the Company, $0.0001 par value per share, and any securities into which such common stock may hereafter be reclassified.

"Conversion Date" means the date of closing of the Qualified Financing pursuant to which the Company has received at least $2,000,000.00.

"Highest Lawful Rate" means the maximum non-usurious rate of interest, as in effect from time to time, which may be charged, contracted for, reserved, received or collected by the Holder in connection with this Note under applicable law.

"*Issue Date*" means the date first written above.

"*Maturity Date*" has the meaning set forth in the preamble of this Note.

"*Principal Market*" means the principal securities exchange or market on which the Common Stock is listed or traded.

"*Qualified Financing*" means the first round of equity financing (which shall include any convertible debt, convertible preferred stock or other equity-linked derivative security financing) in a single or series of related transactions, which raises gross proceeds to the Company of at least Two Million Dollars ($2,000,000) in the aggregate.

"*Qualified Financing Securities*" means the Company's securities issued and sold at the Qualified Financing.

"*Trading Day*" means a Business Day on which shares of Common Stock are purchased and sold on the Principal Market.

All definitions contained in this Note are equally applicable to the singular and plural forms of the terms defined. The words "hereof," "herein" and "hereunder" and words of similar import referring to this Note refer to this Note as a whole and not to any particular provision of this Note. Any capitalized term used but not defined herein has the meaning specified in the Securities Purchase Agreement.

2. INTEREST.

(a) Interest Rate. This Note shall bear interest on the unpaid principal amount hereof (**"*Interest*"**) at a rate per annum equal to the Applicable Interest Rate.

(b) Interest Payments. The Company shall pay accrued and unpaid Interest (unless this Note is converted pursuant to the terms hereof) (i) on the Maturity Date and (ii) on any date on which the entire principal amount of this Note is paid in full (whether through conversion or otherwise). The Company shall pay Interest in cash by wire transfer of immediately available funds.

3. CONVERSION.

(a) Conversion upon Qualified Financing. Upon a Qualified Financing that occurs prior to the Maturity Date, Holder may, at its sole option, by written notice convert all or any part of the entire unpaid principal amount of this Note, together with any Interest accrued but unpaid thereon, into Qualified Financing Securities (a "***Financing Conversion***"). Upon a Conversion, the Holder shall be entitled to receive, and shall be issued, the same type and number of Qualified Financing Securities (the "***Financing Conversion Securities***") as such Holder would have received had such Holder invested any such amount in such Qualified Financing. The issuance of the Conversion Securities upon a Conversion shall be upon the same terms and subject to the same conditions as are applicable to the Qualified Financing Securities issued in the Qualified Financing.

(b) Conversion into Common Stock. The Holder may, at its sole option, by written notice convert all or any part of the entire unpaid principal amount of this Note, together with any Interest accrued but unpaid thereon, into shares of Common Stock (a "***Common Conversion***"). (Either of a Financing Conversion and Common Conversion are referred to herein as a "***Conversion***.") Upon a Common Conversion, the Holder shall be entitled to receive, and shall be issued, the number of shares of Common Stock (the "***Common Conversion Securities***") equal to the amount converted multiplied by a price per share equal to the lower of (i) $0.26 per share of Common Stock and (ii) the lowest price per share of Common Stock into which any security is convertible in any Qualified Financing (Either of the Financing Conversion Securities and Common Conversion Securities are referred to herein as "***Conversion Securities***.")

(c) Conversion Mechanics. The Holder shall not be required to physically surrender this Note to the Company in order to effect any Conversion. Upon a Conversion, the Holder shall be deemed to be the holder of record of the Conversion Securities upon the Conversion Date. As soon as practicable after the Conversion Date, the Company shall, at its expense, issue and deliver to Holder (i) one or more certificates (bearing such legends as are required by applicable state and federal securities laws in the opinion of counsel to the Company) for the applicable Conversion Securities, registered in the name of Holder, free of any and all liens, encumbrances or other impediments to clear title and (ii) if applicable, and if requested by the Holder, cash in the aggregate amount of any accrued, unpaid and unconverted Interest. No fractional Conversion Securities shall be issued upon conversion of this Note, and any fractional Conversion Securities to which the Holder would otherwise be entitled shall be rounded up to the nearest whole Conversion Security and issued to the Holder along with the other Conversion Securities. Upon the Conversion or payment, as applicable, of all amounts due Holder in accordance with this terms of this Note, this Note shall be cancelled and no further amounts shall be due hereunder. Any full or partial payment or Conversion by Holder shall have no impact on the Warrant issued pursuant to the Securities Purchase Agreement concurrently herewith.

4. EVENTS OF DEFAULT. Upon the occurrence of any of the following events (each, an "***Event of Default***"):

(a) the Company or any of its subsidiaries shall (i) apply for or consent to the appointment of a receiver, trustee or liquidator of itself or of its property, (ii) be unable, or admit in writing its inability, to pay its debts as they mature, (iii) make a general assignment for the benefit of creditors, (iv) be adjudicated a bankrupt or insolvent, (v) file a voluntary petition in bankruptcy, or a petition or answer seeking reorganization or an arrangement with creditors to take advantage of any insolvency law, or an answer admitting the material allegations of a bankruptcy, reorganization or insolvency petition filed against it, (vi) take corporate action for the purpose of effecting any of the foregoing, or (vii) have an order for relief entered against it in any proceeding under the United States Bankruptcy Code;

(b) an order, judgment or decree shall be entered, without the application, approval or consent of the Company or any of its subsidiaries, by any court of competent jurisdiction, approving a petition seeking reorganization of the Company or any of its subsidiaries, or appointing a receiver, trustee or liquidator of the Company or any of its subsidiaries, or of all or a substantial part of its assets, and such order, judgment or decree shall not be dismissed within thirty (30) consecutive days thereof;

(c) the Company or any of its subsidiaries shall fail to pay as and when due any principal or Interest hereunder;

(d) the Company breaches any condition or obligation under this Note, the Transaction Documents, or any other material agreement to which Company is a party, and such breach continues uncured for thirty (30) days after receipt of notice thereof; or

(e) the Company or any of its subsidiaries shall cease, substantially curtail, or substantially reduce its business operations;

then, and in every such event and at any time thereafter, the Holder, at its election, and without presentment, demand, notice of any kind, all of which are expressly waived by the Company, may (i) declare the entire outstanding balance of principal and Interest thereon immediately due and payable, together with all costs of collection, including attorneys' fees, and (ii) whether or not the actions referred to in (i) above have been taken, exercise any or all of the Holder's other rights and remedies available to the Holder under applicable law.

5. HOLDER COSTS. The Company agrees to promptly pay, on demand, all of the losses, costs, and expenses (including, without limitation, attorneys' fees and disbursements) which the Holder incurs in connection with enforcement of this Note, or the protection or preservation of the Holder's rights under this Note, whether by judicial proceeding or otherwise. Such costs and expenses include, without limitation, those incurred in connection with any workout or refinancing, or any bankruptcy, insolvency, liquidation or similar proceedings.

6. PREPAYMENT. This Note may be prepaid by the Company at any time prior to issuance of a notice of conversion by Holder.

7. COMPANY WAIVERS. The Company hereby waives diligence, demand, presentment, protest or notice of any kind. The Company agrees to make all payments under this Note without setoff or deduction and regardless of any counterclaim or defense.

8. SECURITY.

(a) Security Interest. As security for the due and prompt payment and performance of all payment obligations under this Note and any modifications, replacements and extensions hereof (collectively, "Secured Obligations"), the Company hereby pledges and grants a first priority security interest to the Holder, on a pari passu basis with the holder of the Secured Convertible Promissory Note dated August 17, 2011, in all assets of the Company, whether now owned or hereafter acquired, including without limitation all intellectual property (collectively, the "Collateral").

(b) Financing Statement; Further Assurances. The Company agrees, concurrently with executing this Note, that the Holder may file a UCC-1 financing statement relating to the Collateral in favor of the Holder, and any similar financing statements in any jurisdiction in which the Holder reasonably determines such filing to be necessary. The Company further agrees that at any time and from time to time the Company shall promptly execute and deliver all further instruments and documents that the Holder may request in order to perfect and protect the security interest granted hereby, or to enable the Holder to exercise and enforce its rights and remedies with respect to any Collateral following an Event of Default.

(c) Default. Following an Event of Default, the Company shall deliver the Collateral, including original certificates or other instruments representing any Collateral, to the Holder to hold as secured party, and Company shall, if requested by the Holder, execute a securities account control agreement. In addition, the Holder shall have all rights of a secured party under the Uniform Commercial Code, including without limitation the right to foreclose on all or any of the Collateral, in any order.

(d) Powers of the Holder. The Company hereby appoints the Holder as Company's true and lawful attorney-in-fact to perform any and all of the following acts, which power is coupled with an interest, is irrevocable until the Secured Obligations are paid and performed in full, and may be exercised from time to time by the Holder in its discretion: To take any action and to execute any instrument which the Holder may deem reasonably necessary or desirable to accomplish the purposes of this Section 8(d) and, more broadly, this Note including, without limitation: (i) during the continuance of any Event of Default hereunder, to receive, endorse and collect all instruments or other forms of payment made payable to the Company representing any dividend, interest payment or other distribution in respect of the Collateral or any part thereof and to give full discharge for the same, when and to the extent permitted by this Note, (ii) to perform or cause the performance of any obligation of the Company hereunder in the Company's name or otherwise, (iii) during the continuance of any Event of Default hereunder, to liquidate any Collateral pledged to the Holder hereunder and to apply proceeds thereof to the payment of the Secured Obligations or to place such proceeds into a cash collateral account or to transfer the Collateral into the name of the Holder, all at the Holder's sole discretion, (iv) to enter into any extension, reorganization or other agreement relating to or affecting the Collateral, and, in connection therewith, to deposit or surrender control of the Collateral, (v) to accept other property in exchange for the Collateral, (vi) to make any compromise or settlement the Holder deems desirable or proper, and (vii) to execute on the Company's behalf and in the Company's name any documents required in order to give the Holder a continuing first lien upon the Collateral or any part thereof.

(e) Full Recourse Note. This is a full recourse Note. Accordingly, notwithstanding that the Company's obligations under this Note are secured by the Collateral, in the event of a material default hereunder, the Holder shall have full recourse to all the other assets of Company. Moreover, the Holder shall not be required to proceed against or exhaust any Collateral, or to pursue any Collateral in any particular order, before the Holder pursues any other remedies against Company or against any of Company's assets.

9. MISCELLANEOUS.

(a) Notices. Any and all notices or other communications or deliveries required or permitted to be provided hereunder shall be in writing and shall be deemed given and effective on the earliest of (i) the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section, or via electronic mail, prior to 6:30 p.m. (New York City time) on a Trading Day and an electronic confirmation of delivery is received by the sender, (ii) the next Trading Day after the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section on a day that is not a Trading Day or later than 6:30 p.m. (New York City time) on any Trading Day, (iii) the Trading Day following the date of mailing, if sent by nationally recognized overnight courier service, or (iv) upon actual receipt by the party to whom such notice is required to be given by personal delivery.

(b) Amendments; Waivers; No Oral Changes. No provision of this Note may be waived or amended except in a written instrument signed by the Company and the Holder. No waiver of any default with respect to any provision, condition or requirement of this Note shall be deemed to be a continuing waiver in the future or a waiver of any subsequent default or a waiver of any other provision, condition or requirement hereof, nor shall any delay or omission of either party to exercise any right hereunder in any manner impair the exercise of any such right. This Note may not be modified, amended, waived, extended, changed, discharged or terminated orally or by any act or failure to act on the part of the Holder or the Company, but only by an agreement in writing signed by both parties.

(c) Lost or Stolen Note. Upon receipt by the Company of evidence of the loss, theft, destruction or mutilation of this Note, and (in the case of loss, theft or destruction) of indemnity or security reasonably satisfactory to the Company, and upon surrender and cancellation of this Note, if mutilated, the Company shall execute and deliver to the Holder a new Note identical in all respects to this Note.

(d) Governing Law. This Note shall be governed by and construed in accordance with the laws of the State of New York applicable to contracts made and to be performed entirely within the State of New York, without giving effect to conflict of law principles thereof.

(e) Headings. The headings in this Note are for purposes of reference only, and shall not limit or otherwise affect the meaning hereof.

(f) Transfer; Successors and Assigns. The terms of this Note shall inure to the benefit of and bind the parties hereto and their successors and assigns. As used herein the term "Company" shall include the undersigned Company and any other person or entity who may subsequently become liable for the payment hereof; provided however, that the Company shall not have the right to assign this Note or its obligations or rights hereunder without the prior written consent of the Holder. The term "Holder" shall include the named Holder as well as any other person or entity to whom this Note or any interest in this Note is conveyed, transferred or assigned. The person signing this Note on behalf of the Company represents and warrants that he or she has full authority to do so and that this Note binds the Company in accordance with its terms, and that there are no other agreements, judgments, or other circumstances which would cause this Note to not be fully binding against the Company. In the event Holder takes any action to enforce any provision of this Note, either through legal proceedings or otherwise, the Company shall reimburse the Holder for attorneys' fees and all other costs and expenses so incurred.

(g) Usury. Anything herein to the contrary notwithstanding, if during any period for which interest is computed hereunder the amount of interest, together with all fees, charges and other payments which are treated as interest under applicable law, as provided for herein or in any other document executed in connection herewith, would exceed the amount of such interest computed on the basis of the Highest Lawful Rate, the Company shall not be obligated to pay, and the Holder shall not be entitled to charge, collect, receive, reserve or take, interest in excess of the Highest Lawful Rate.

IN WITNESS WHEREOF, the Company has caused this Note to be signed in its name by its duly authorized officer on the date first above written.

CATASYS, INC.

By: /s/ Susan Etzel
Susan Etzel, Chief Financial Officer

Exhibit 4.2

NEITHER THIS WARRANT NOR THE SECURITIES ISSUABLE UPON EXERCISE OF THIS WARRANT HAVE BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR QUALIFIED UNDER THE LAWS OF ANY STATE IN RELIANCE UPON AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OR PURSUANT TO AN AVAILABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND IN ACCORDANCE WITH APPLICABLE STATE SECURITIES LAWS AS SUPPORTED BY A LEGAL OPINION OF COUNSEL TO THE TRANSFEROR TO SUCH EFFECT, THE SUBSTANCE OF WHICH SHALL BE REASONABLY ACCEPTABLE TO THE COMPANY. THE SECURITIES ISSUABLE UPON EXERCISE OF THIS WARRANT MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT OR OTHER LOAN OR FINANCING ARRANGEMENT SECURED BY SUCH SECURITIES.

CATASYS, INC.

WARRANT

Warrant No. 100520111 Date of Original Issuance: October 5, 2011

Catasys, Inc., a Delaware corporation (the **"Company"**), hereby certifies that, for value received, **David E. Smith**, or his registered assigns (the **"Holder"**), is entitled to purchase from the Company up to a total of that number of shares of common stock, par value $0.0001 per share (the **"Common Stock"**), of the Company (each such share, a **"Warrant Share"** and all such shares, the **"Warrant Shares"**) as is determined by dividing $680,000.00 by $0.26 or, in the event of a Qualified Financing, the price per share of the securities issued in the Qualified Financing (as determined in accordance with Section 9(c)(ii) hereof) multiplied by a factor equal to twice the product of the number of warrants issued in a Qualified Financing divided by the number of shares of Common Stock issued in a Qualified Financing, but in no event shall the factor be less than one (1), at an exercise price equal to $0.32 per share (as adjusted from time to time as provided in Section 9, the **"Exercise Price"**), at any time and from time to time from and after the Original Issuance date and through and including the five-year anniversary of such date (the **"Expiration Date"**), and subject to the following terms and conditions:

1. Definitions. In addition to the terms defined elsewhere in this Warrant, capitalized terms that are not otherwise defined herein shall have the meanings given to such terms in the Securities Purchase Agreement of even date herewith to which the Company and the original Holder are parties (the "**Purchase Agreement**").

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

3. Registration of Transfers. The Company shall register the transfer of any portion of this Warrant in the Warrant Register, upon surrender of this Warrant, with the Form of Assignment attached hereto duly completed and signed, to the Company at its address specified herein. Upon any such registration or transfer, a new Warrant to purchase Common Stock, in substantially the form of this Warrant (any such new Warrant, a **"New Warrant"**), evidencing the portion of this Warrant so transferred shall be issued to the transferee and a New Warrant evidencing the remaining portion of this Warrant not so transferred, if any, shall be issued to the transferring Holder. The acceptance of the New Warrant by the transferee thereof shall be deemed the acceptance by such transferee of all of the rights and obligations of a holder of a Warrant.

4. Exercise and Duration of Warrants. This Warrant shall be exercisable by the registered Holder at any time and from time to time on or after the date hereof to and including the Expiration Date. At 5:00 p.m., New York City time on the Expiration Date, the fair market value of that portion of this Warrant not exercised prior thereto shall automatically be deemed exercised pursuant to Cashless Excercise.

5. Delivery of Warrant Shares.

(a) To effect exercises hereunder, the Holder shall not be required to physically surrender this Warrant unless the aggregate Warrant Shares represented by this Warrant is being exercised. Upon delivery of the Exercise Notice to the Company at its address for notice set forth herein and upon payment of the Exercise Price multiplied by the number of Warrant Shares that the Holder intends to purchase hereunder, the Company shall promptly issue and deliver to the Holder, a certificate for the Warrant Shares issuable upon such exercise, which, unless otherwise required by the Purchase Agreement or applicable law, shall be free of restrictive legends. A "**Date of Exercise**" means the date on which the Holder shall have delivered to Company: (i) the Exercise Notice, appropriately completed and duly signed and (ii) if such Holder is not utilizing the cashless exercise provisions set forth in this Warrant, payment of the Exercise Price for the number of Warrant Shares so indicated by the Holder to be purchased.

(b) The Company's obligations to issue and deliver Warrant Shares in accordance with the terms hereof are absolute and unconditional, irrespective of any action or inaction by the Holder to enforce the same. Nothing herein shall limit a Holder's right to pursue any other remedies available to it hereunder, at law or in equity including, without limitation, a decree of specific performance and/or injunctive relief with respect to the Company's failure to timely deliver certificates representing shares of Common Stock upon exercise of the Warrant as required pursuant to the terms hereof, and the Company shall pay all of the Holder's costs, expenses and fees in connection therewith, include attorneys' fees.

6. Charges, Taxes and Expenses. Issuance and delivery of certificates for shares of Common Stock upon exercise of this Warrant shall be made without charge to the Holder for any issue or transfer tax, withholding tax, transfer agent fee or other incidental tax or expense in respect of the issuance of such certificates, all of which taxes and expenses shall be paid by the Company.

7. Replacement of Warrant. If this Warrant is mutilated, lost, stolen or destroyed, the Company shall issue or cause to be issued in exchange and substitution for and upon cancellation hereof, or in lieu of and substitution for this Warrant, a New Warrant, but only upon receipt of evidence reasonably satisfactory to the Company of such loss, theft or destruction. All costs associated with the issuance of any New Warrant shall be the sole responsibility of the Company. If a New Warrant is requested as a result of a mutilation of this Warrant, then the Holder shall deliver such mutilated Warrant to the Company as a condition precedent to the Company's obligation to issue the New Warrant.

8. Reservation of Warrant Shares. The Company shall comply with the Warrant Share reservation requirements of Section 5.12 of the Purchase Agreement. The Company covenants that all Warrant Shares shall, upon issuance and the payment of the applicable Exercise Price in accordance with the terms hereof, be duly and validly authorized, issued and fully paid and nonassessable.

9. Certain Adjustments. The Exercise Price and number of Warrant Shares issuable upon exercise of this Warrant are subject to adjustment from time to time as set forth in this Section 9.

(a) Stock Dividends and Splits. If the Company, at any time while this Warrant is outstanding, (i) pays a stock dividend on its Common Stock or otherwise makes a distribution on any class of capital stock that is payable in shares of Common Stock, (ii) subdivides outstanding shares of Common Stock into a larger number of shares, or (iii) combines outstanding shares of Common Stock into a smaller number of shares, then in each such case the Exercise Price shall be multiplied by a fraction of which the numerator shall be the number of shares of Common Stock outstanding immediately before such event and of which the denominator shall be the number of shares of Common Stock outstanding immediately after such event. Any adjustment made pursuant to clause (i) of this paragraph shall become effective immediately after the record date for the determination of stockholders entitled to receive such dividend or distribution, and any adjustment pursuant to clause (ii) or (iii) of this paragraph shall become effective immediately after the effective date of such subdivision or combination. If any event requiring an adjustment under this paragraph occurs during the period that an Exercise Price is calculated hereunder, then the calculation of such Exercise Price shall be adjusted appropriately to reflect such event.

(b) Fundamental Transactions. If, at any time while this Warrant is outstanding, (1) the Company effects any merger or consolidation of the Company with or into another Person, (2) the Company effects any sale of all or substantially all of its assets in one or a series of related transactions, or (3) the Company effects any reclassification of the Common Stock or any compulsory share exchange pursuant to which the Common Stock is effectively converted into or exchanged for other securities, cash or property (in any such case, a **"Fundamental Transaction"**), then the Holder shall have the right thereafter to receive, upon exercise of this Warrant, the same amount and kind of securities, cash or property as it would have been entitled to receive upon the occurrence of such Fundamental Transaction if it had been, immediately prior to such Fundamental Transaction, the holder of the number of Warrant Shares then issuable upon exercise in full of this Warrant (the **"Alternate Consideration"**). For purposes of any such exercise, the determination of the Exercise Price shall be appropriately adjusted to apply to such Alternate Consideration based on the amount of Alternate Consideration issuable in respect of one share of Common Stock in such Fundamental Transaction, and the Company shall apportion the Exercise Price among the Alternate Consideration in a reasonable manner reflecting the relative value of any different components of the Alternate Consideration. If holders of Common Stock are given any choice as to the securities, cash or property to be received in a Fundamental Transaction, then the Holder shall be given the same choice as to the Alternate Consideration it receives upon any exercise of this Warrant following such Fundamental Transaction. The terms of any agreement pursuant to which a Fundamental Transaction is effected shall include terms requiring any such successor or surviving entity to comply with the provisions of this paragraph (b) and insuring that the Warrant (or any such replacement security) will be similarly adjusted upon any subsequent transaction analogous to a Fundamental Transaction.

(c) Certain Diluting Issuances. (i) If the Company shall, at any time or from time to time, issue or distribute any shares of Common Stock, or be deemed to have issued shares of Common Stock as provided herein, other than Excluded Stock (as defined in Section 9(c)(iv) below) (each such event, including any event described in paragraphs (ii)(C) and (ii)(D) below, being herein called a "**Common Stock Distribution**"), without consideration or for a consideration per share less than the Exercise Price on the date of such Common Stock Distribution or on the first date of the announcement of such Common Stock Distribution, whichever is greater (the "**New Issuance Price"**), then, effective immediately after the open of business on the day following such Common Stock Distribution, the Exercise Price as in effect immediately prior to such Common Stock Distribution shall be reduced to an amount equal to the New Issuance Price.

The provisions of this paragraph (c), including by operation of subsections (C) or (D) of paragraph (ii) below, shall not operate to adjust in any manner the number of shares of Common Stock subject to purchase upon exercise of this Warrant, or to result in an increase in the Exercise Price.

(ii) For the purposes of any adjustment of the Exercise Price pursuant to paragraph (i) above, the following provisions shall be applicable:

(A) In the case of the issuance, sale or distribution of Common Stock for cash in a public offering or private placement, the consideration received therefor shall be deemed to be the amount received by the Company therefor before deducting therefrom any discounts, commissions or placement fees payable by the Company to any underwriter or placement agent in connection therewith;

(B) In the case of the issuance of Common Stock for a consideration in whole or in part other than cash, the consideration other than cash received by the Company shall be deemed to be the fair market value of such consideration, as determined in good faith by the Board of Directors of the Company, irrespective of any accounting treatment;

(C) In the case of the issuance, sale, distribution or granting (whether directly or by assumption in a merger or otherwise) of any rights to subscribe for or to purchase, or any warrants or options for the purchase of, Common Stock or any stock or securities convertible into or exchangeable for Common Stock (such rights, warrants or options being herein called "**Options**" and such convertible or exchangeable stock or securities being herein called "**Convertible Securities**"), whether or not such Options or the rights to convert or exchange any such Convertible Securities are immediately exercisable, then, for purposes of paragraph (i) above, the aggregate maximum number of shares of Common Stock issuable upon the exercise of such Options or upon conversion or exchange of such Convertible Securities and subsequent conversion or exchange thereof shall be deemed to have been issued as of the date of issuance of such Options, Convertible Securities or rights and thereafter shall be deemed to be outstanding; and the Company shall be deemed to have received as consideration the amount equal to the consideration, if any, received by the Company upon the issuance of such Options, Convertible Securities or rights plus the minimum additional consideration, if any, to be received by the Company upon the conversion or exchange of such Convertible Securities or the exercise of Options or rights (such consideration in each case to be determined in the manner provided in Sections 9(c)(ii)(A) and 9(c)(ii)(B));

(D) If the purchase price provided for in any Option, the additional consideration, if any, payable upon the conversion or exchange of any Convertible Securities, or the rate at which any Convertible Securities are convertible into or exchangeable for Common Stock shall change at any time (other than under or by reason of provisions designed to protect against, and having the effect of protecting against, dilution upon an event which results in a related adjustment pursuant to this Section 9), then, the Exercise Price then in effect shall forthwith be readjusted (effective only with respect to any exercise of this Warrant after such readjustment) to the Exercise Price which would then be in effect had the adjustment made upon the issue, sale, distribution or grant of such Options or Convertible Securities been made based upon such changed purchase price, additional consideration or conversion rate, as the case may be; provided, however, that such readjustment shall give effect to such change only with respect to such Options and Convertible Securities as then remain outstanding;

(E) In the case of the issuance, sale, distribution or granting of any Options as part of a unit consisting of Options and Common Stock and/or Convertible Securities, then for purposes of calculating any adjustment pursuant to this Section 9, no value shall be attributed to such Options in allocating the price paid for the unit among the securities comprising such unit; and

(F) Upon the expiration of any such Options or the termination of any rights, Convertible Securities or exchangeable securities, the applicable Exercise Price shall forthwith be readjusted to such Exercise Price as would have been in effect at the time of such expiration or termination had such Options, rights, Convertible Securities or exchangeable securities, to the extent outstanding immediately prior to such expiration or termination, never been issued.

(iii) For purposes of determining whether any adjustment is required pursuant to this Section 9(c), any security of the Company having rights substantially equivalent to the Common Stock as to dividends or upon liquidation, dissolution or winding up of the Company shall be treated as if such security were Common Stock. No further adjustment of the Exercise Price adjusted upon the issuance of any such options, rights, convertible securities or exchangeable securities shall be made as a result of the actual issuance of Common Stock on the exercise of any such rights or Options or any conversion or exchange of any such securities.

(iv) **"Excluded Stock"** shall mean (A) shares of Common Stock issued (or issuable upon exercise of rights, options or warrants outstanding from time to time) granted or issued to officers, directors or employees of, or consultants to, the Company pursuant to a stock grant, stock option plan, employee stock purchase plan, restricted stock plan or other similar plan or agreement or otherwise, in each case as approved by the Company's Board of Directors, (B) shares of Common Stock issued (or issuable upon exercise of rights, options or warrants outstanding from time to time) granted or issued to financial institutions, equipment lessors, brokers or similar persons in connection with commercial credit arrangements, equipment financings, commercial property lease transactions or similar transactions, (C) securities issued in connection with a strategic alliance, acquisition or similar transaction, (D) shares of Common Stock issued (or issuable upon exercise of rights, options or warrants outstanding from time to time) for bona fide services, (E) shares issued or issuable as a result of any stock split, combination, dividend, distribution, reclassification, exchange or substitution, (F) shares of Common Stock issuable upon exercise of rights, options, warrants, notes or other rights to acquire securities of the Company outstanding as of the date hereof, and (G) shares of Common Stock issued (or issuable upon exercise of rights, options or warrants outstanding from time to time) related to the transactions contemplated herein or in the Qualified Financing.

(d) Number of Warrant Shares. Simultaneously with any adjustment to the Exercise Price pursuant to paragraph (a) of this Section, the number of Warrant Shares that may be purchased upon exercise of this Warrant shall be increased or decreased proportionately, so that after such adjustment the aggregate Exercise Price payable hereunder for the adjusted number of Warrant Shares shall be the same as the aggregate Exercise Price in effect immediately prior to such adjustment.

(e) Calculations. All calculations under this Section 9 shall be made to the nearest cent or the nearest 1/100th of a share, as applicable. The number of shares of Common Stock outstanding at any given time shall not include shares owned or held by or for the account of the Company, and the disposition of any such shares shall be considered an issue or sale of Common Stock.

(f) Notice of Corporate Events. If the Company (i) declares a dividend or any other distribution of cash, securities or other property in respect of its Common Stock, including without limitation any granting of rights or warrants to subscribe for or purchase any capital stock of the Company or any subsidiary, (ii) authorizes or approves, enters into any agreement contemplating or solicits stockholder approval for any Fundamental Transaction or (iii) authorizes the voluntary dissolution, liquidation or winding up of the affairs of the Company, then the Company shall deliver to the Holder a notice describing the material terms and conditions of such transaction, at least 20 calendar days prior to the applicable record or effective date on which a Person would need to hold Common Stock in order to participate in or vote with respect to such transaction, and the Company will take all steps reasonably necessary in order to insure that the Holder is given the practical opportunity to exercise this Warrant prior to such time so as to participate in or vote with respect to such transaction; provided, however, that the failure to deliver such notice or any defect therein shall not affect the validity of the corporate action required to be described in such notice.

10. Payment of Exercise Price. The Holder may pay the Exercise Price in one of the following manners:

(a) Cash Exercise. The Holder may deliver immediately available funds; or

(b) Cashless Exercise. The Holder may notify the Company in an Exercise Notice of its election to utilize cashless exercise, in which event the Company shall issue to the Holder the number of Warrant Shares determined as follows:

$$X = Y [(A-B)/A]$$

where:

X = the number of Warrant Shares to be issued to the Holder.

Y = the number of Warrant Shares with respect to which this Warrant is being exercised.

A = the average of the closing prices for the five Trading Days immediately prior to (but not including) the Date of Exercise.

B = the Exercise Price.

For purposes of Rule 144 promulgated under the Securities Act, it is intended, understood and acknowledged that the Warrant Shares issued in a cashless exercise transaction shall be deemed to have been acquired by the Holder, and the holding period for the Warrant Shares shall be deemed to have commenced, on the date this Warrant was originally issued, subject to any change of law after the date hereof.

11. No Fractional Shares. No fractional shares of Warrant Shares will be issued in connection with any exercise of this Warrant. In lieu of any fractional shares which would, otherwise be issuable, the Company shall pay cash equal to the product of such fraction multiplied by the closing price of one Warrant Share as reported by the Trading Market on the Date of Exercise.

12. Notices. Any and all notices or other communications or deliveries hereunder (including, without limitation, any Exercise Notice) shall be in writing and shall be deemed given and effective on the earliest of (i) the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section, or via electronic mail, prior to 6:30 p.m. (New York City time) on a Trading Day and an electronic confirmation of delivery is received by the sender, (ii) the next Trading Day after the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section on a day that is not a Trading Day or later than 6:30 p.m. (New York City time) on any Trading Day, (iii) the Trading Day following the date of mailing, if sent by nationally recognized overnight courier service, or (iv) upon actual receipt by the party to whom such notice is required to be given.

13. Warrant Agent. The Company shall serve as warrant agent under this Warrant. Upon 30 days' notice to the Holder, the Company may appoint a new warrant agent. Any corporation into which the Company or any new warrant agent may be merged or any corporation resulting from any consolidation to which the Company or any new warrant agent shall be a party or any corporation to which the Company or any new warrant agent transfers substantially all of its corporate trust or shareholders services business shall be a successor warrant agent under this Warrant without any further act. Any such successor warrant agent shall promptly cause notice of its succession as warrant agent to be mailed (by first class mail, postage prepaid) to the Holder at the Holder's last address as shown on the Warrant Register.

14. Non-Circumvention. The Company hereby covenants and agrees that the Company will not, by amendment of its Certificate of Incorporation, Bylaws or through any reorganization, transfer of assets, consolidation, merger, scheme of arrangement, dissolution, issue or sale of securities, or any other voluntary action, avoid or seek to avoid the observance or performance of any of the terms of this Warrant, and will at all times in good faith carry out all the provisions of this Warrant and take all action as may be required to protect the rights of the Holder. Without limiting the generality of the foregoing, the Company (i) shall not increase the par value of any shares of Common Stock receivable upon the exercise of this Warrant above the Exercise Price then in effect, (ii) shall take all such actions as may be necessary or appropriate in order that the Company may validly and legally issue fully paid and nonassessable shares of Common Stock upon the exercise of this Warrant, and (iii) shall, so long as any portion of this Warrant is outstanding, take all action necessary to reserve and keep available out of its authorized and unissued shares of Common Stock, solely for the purpose of effecting the exercise of the Warrant, 110% of the number of shares of Common Stock as shall from time to time be necessary to effect the exercise of the portion of the Warrant then outstanding (without regard to any limitations on exercise).

15. Reserved.

16. Miscellaneous.

(a) This Warrant shall be binding on and inure to the benefit of the parties hereto and their respective successors and assigns. Subject to the preceding sentence, nothing in this Warrant shall be construed to give to any Person other than the Company and the Holder any legal or equitable right, remedy or cause of action under this Warrant. This Warrant may be amended only in writing signed by the Company and the Holder and their successors and assigns.

(b) All questions concerning the construction, validity, enforcement and interpretation of this Warrant shall be governed by and construed and enforced in accordance with the internal laws of the State of New York, without regard to the principles of conflicts of law thereof.

(c) The headings herein are for convenience only, do not constitute a part of this Warrant and shall not be deemed to limit or affect any of the provisions hereof.

(d) In case any one or more of the provisions of this Warrant shall be invalid or unenforceable in any respect, the validity and enforceability of the remaining terms and provisions of this Warrant shall not in any way be affected or impaired thereby and the parties will attempt in good faith to agree upon a valid and enforceable provision which shall be a commercially reasonable substitute therefor, and upon so agreeing, shall incorporate such substitute provision in this Warrant.

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

CATASYS, INC.

By: /s/ Susan Etzel
Susan Etzel, Chief Financial Officer

CATASYS, INC.
WARRANT ORIGINALLY ISSUED OCTOBER 5, 2011
WARRANT NO. 100520111

EXERCISE NOTICE

To **Catasys, Inc.**:

The undersigned hereby irrevocably elects to purchase _____ shares of Common Stock pursuant to the attached Warrant.

The Holder intends that payment of the Exercise Price shall be made as:

_____ a Cash Exercise with respect to _____ Warrant Shares; and/or

_____ a Cashless Exercise with respect to _____ Warrant Shares.

If such Holder is not utilizing the Cashless Exercise provisions set forth in the Warrant, the Holder encloses herewith $_____ in cash, certified or official bank check or checks or other immediately available funds, which sum represents the aggregate Exercise Price (as defined in the Warrant) for such Warrant Shares, together with any applicable taxes payable by the undersigned pursuant to the Warrant.

The undersigned requests that certificates for the shares of Common Stock issuable upon this exercise be issued in the name of

PLEASE INSERT SOCIAL SECURITY OR
TAX IDENTIFICATION NUMBER

(Please print name and address)

Confirmed:

CATASYS, INC.

By: _____
Name:
Title:

Date: _____

CATASYS, INC.
WARRANT ORIGINALLY ISSUED OCTOBER 5, 2011
WARRANT NO. 100520111

FORM OF ASSIGNMENT

[To be completed and signed only upon transfer of Warrant]

FOR VALUE RECEIVED, the undersigned hereby sells, assigns and transfers unto _____ the right represented by the above-captioned Warrant to purchase _____ shares of Common Stock to which such Warrant relates and appoints _____ attorney to transfer said right on the books of the Company with full power of substitution in the premises.

Dated: _____, ____

_____
(Signature must conform in all respects to name of holder as specified on the face of the Warrant)

_____
Address of Transferee

_____
_____

In the presence of:

_____

Exhibit 10.1

SECURITIES PURCHASE AGREEMENT

This Securities Purchase Agreement (this **"Agreement"**) is dated as of October 5, 2011 (the **"Effective Date"**), between Catasys, Inc., a Delaware corporation (the **"Company"**), and **David E. Smith** (the **"Investor"**).

WHEREAS, the Company wishes to sell to the Investor, and the Investor wishes to purchase, on the terms and subject to the conditions set forth in this Agreement, (i) a Convertible Promissory Note in the form attached hereto as Exhibit A (the **"Note"**) and (ii) a Warrant in the form attached hereto as Exhibit B (the **"Warrant"**).

NOW, THEREFORE, in consideration of the mutual covenants contained in this Agreement, and for other good and valuable consideration the receipt and adequacy of which are hereby acknowledged, the Company and the Investor hereby agree as follows:

ARTICLE I.
DEFINITIONS

1.1 Definitions. In addition to the terms defined elsewhere in this Agreement, for all purposes of this Agreement, the following terms shall have the meanings indicated in this Section 1.1:

"Action" has the meaning set forth in Section 3.1(j).

"Affiliate" means any Person that, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with a Person, as such terms are used in and construed under Rule 144.

"Blackout Period" has the meaning set forth in Section 5.14(h).

"Business Day" means any day other than a Saturday, a Sunday or a day on which the New York Stock Exchange is closed or on which banks are authorized by law to close in New York, New York.

"Closing" has the meaning set forth in Section 2.2.

"Closing Date" has the meaning set forth in Section 2.2.

"Commission" means the U.S. Securities and Exchange Commission.

"Common Stock" means the common stock of the Company, $0.0001 par value per share, and any securities into which such common stock may hereafter be reclassified.

"Conversion Securities" means the securities into which the Note is convertible, and any securities issuable upon conversion or exercise thereof.

"Evaluation Date" has the meaning set forth in Section 3.1(r).

"Exchange Act" means the Securities Exchange Act of 1934, as amended.

"GAAP" means United States generally accepted accounting principles applied on a consistent basis during the periods involved.

"Intellectual Property Rights" has the meaning set forth in Section 3.1(o).

"Investment Company Act" means the Investment Company Act of 1940, as amended.

"Liens" means a lien, charge, security interest, encumbrance, right of first refusal, preemptive right or other restriction.

"Material Adverse Effect" means any material adverse effect on (i) the legality, validity or enforceability of any Transaction Document, (ii) the results of operations, assets, business, prospects or financial condition of the Company and the Subsidiaries, taken as a whole, or (iii) the Company's ability to perform in any material respect on a timely basis its obligations under any Transaction Document.

"Material Permits" has the meaning set forth in Section 3.1(m).

"Opinion" means an opinion from the Company's outside legal counsel, in the form agreed upon by the parties, to be delivered once upon Investor's request.

"Person" means an individual or corporation, partnership, trust, incorporated or unincorporated association, joint venture, limited liability company, joint stock company, government (or an agency or subdivision thereof) or other entity of any kind.

"Purchase Price" means $680,000.00.

"**Qualified Financing**" means the first round of equity financing (which shall include any convertible debt, convertible preferred stock or other equity-linked derivative security financing) in a single or series of related transactions, which raises gross proceeds to the Company of at least $2,000,000.00 in the aggregate.

"Regulation D" means Regulation D promulgated under the Securities Act.

"Rule 144" means Rule 144 promulgated by the Commission pursuant to the Securities Act, as such Rule may be amended from time to time, or any similar rule or regulation hereafter adopted by the Commission having substantially the same effect as such Rule.

"SEC Guidance" means (i) any publicly-available written or oral guidance, comments, requirements or requests of the Commission staff, (ii) the Securities Act, and (iii) the Exchange Act, as applicable.

"SEC Reports" includes all reports required to be filed by the Company under the Securities Act and/or the Exchange Act, including pursuant to Section 13(a) or 15(d) thereof, for the two years preceding the Effective Date (or such shorter period as the Company was required by law to file such material) and for the period in which this Agreement is in effect.

"Securities" means the Notes, the Conversion Securities, the Warrants and the Warrant Shares.

"Securities Act" means the Securities Act of 1933, as amended.

"Subsidiary" means any Person the Company owns or controls, or in which the Company, directly or indirectly, owns a majority of the capital stock or similar interest that would be disclosable pursuant to Regulation S-K, Item 601(b)(21).

"Trading Day" means (i) a day on which the Common Stock is traded on a Trading Market, or (ii) if the Common Stock is not listed on a Trading Market, a day on which the Common Stock if traded in the over-the-counter market is quoted in the over-the-counter market as reported by the National Quotation Bureau Incorporated (or any similar organization or agency succeeding to its functions of reporting prices); provided, that in the event that the Common Stock is not listed or quoted as set forth in (i) or (ii) hereof, then Trading Day shall mean a Business Day.

"Trading Market" means whichever of the New York Stock Exchange, the NYSE Amex, The NASDAQ Global Market, The NASDAQ Global Select Market, The NASDAQ Capital Market or OTC Bulletin Board on which the Common Stock is listed or quoted for trading on the date in question, but does not include the Pink Sheets inter-dealer electronic quotation and trading system.

"Transaction Documents" means this Agreement, the Note, the Warrant and any other documents or agreements executed in connection with the transactions contemplated hereunder, documents referenced herein, and the exhibits and schedules hereto and thereto.

"Warrant Shares" means the shares of Common Stock into which the Warrant is exercisable.

ARTICLE II.
PURCHASE AND SALE

2.1 Purchase and Sale. Upon the terms and subject to the satisfaction or waiver of the conditions set forth herein, the Company agrees to sell to the Investor and the Investor agrees to purchase from the Company the Note and the Warrant.

2.2 Closing. The closing of the transactions contemplated herein (the "**Closing**") will take place on October 5, 2011, or at such other time as the Company and the Investor shall determine (the "**Closing Date**"). At the Closing, (A) this Agreement and the other Transaction Documents shall have been executed and delivered by the Company and the Investor, (B) each of the conditions to the Closing described in this Agreement shall have been satisfied or waived as specified herein and (C) full payment of the Purchase Price shall have been made by wire transfer of immediately available funds against physical delivery by the Company of duly executed certificates representing the Note and Warrant.

ARTICLE III.
REPRESENTATIONS AND WARRANTIES OF THE COMPANY

3.1 The Company hereby represents and warrants to, and as applicable covenants with, Investor as of the Closing Date, as follows:

(a) Subsidiaries. The Company owns, directly or indirectly, all of the capital stock or other equity interests of each Subsidiary, and all of such directly or indirectly owned capital stock or other equity interests are owned free and clear of any Liens. All the issued and outstanding shares of capital stock of each Subsidiary are duly authorized, validly issued, fully paid, non-assessable and free of preemptive and similar rights to subscribe for or purchase securities.

(b) Organization and Qualification. Each of the Company and each Subsidiary is an entity duly incorporated or otherwise organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation or organization, as applicable, with the requisite power and authority to own and use its properties and assets and to carry on its business as currently conducted. Neither the Company nor any Subsidiary is in violation or default of any of the provisions of its respective certificate or articles of incorporation, bylaws or other organizational or charter documents. Each of the Company and each Subsidiary is duly qualified to conduct business and is in good standing as a foreign corporation or other entity in each jurisdiction in which the nature of the business conducted or property owned by it makes such qualification necessary, except where the failure to be so qualified or in good standing, as the case may be, could not have or reasonably be expected to result in a Material Adverse Effect and no proceeding has been instituted in any such jurisdiction revoking, limiting or curtailing or seeking to revoke, limit or curtail such power and authority or qualification.

(c) Authorization; Enforcement. The Company has the requisite corporate power and authority to enter into and to consummate the transactions contemplated by each of the Transaction Documents and otherwise to carry out its obligations hereunder or thereunder. The execution and delivery of each of the Transaction Documents by the Company and the consummation by it of the transactions contemplated hereby or thereby have been duly authorized by all necessary action on the part of the Company and no further consent or action is required by the Company. Each of the Transaction Documents has been, or upon delivery will be, duly executed by the Company and, when delivered in accordance with the terms hereof, will constitute the valid and binding obligation of the Company, enforceable against the Company in accordance with its terms, except (i) as limited by general equitable principles and applicable bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting enforcement of creditors' rights generally, (ii) as limited by laws relating to the availability of specific performance, injunctive relief or other equitable remedies and (iii) insofar as indemnification and contribution provisions may be limited by applicable law. Neither the Company nor any Subsidiary is in violation of any of the provisions of its respective certificate or articles of incorporation, by-laws or other organizational or charter documents.

(d) No Conflicts. The execution, delivery and performance of the Transaction Documents by the Company, the issuance and sale of the Securities and the consummation by the Company of the other transactions contemplated thereby do not and will not (i) conflict with or violate any provision of the Company's or any Subsidiary's certificate or articles of incorporation, articles of association, bylaws, or other organizational or charter documents, or (ii) conflict with, or constitute a default (or an event that with notice or lapse of time or both would become a default) under, result in the creation of any Lien upon any of the properties or assets of the Company or any Subsidiary, or give to others any rights of termination, amendment, acceleration or cancellation (with or without notice, lapse of time or both) of, any agreement, credit facility, debt or other instrument (evidencing a Company or Subsidiary debt or otherwise) or other understanding to which the Company or any Subsidiary is a party or by which any property or asset of the Company or any Subsidiary is bound or affected, or (iii) conflict with or result in a violation of any law, rule, regulation, order, judgment, injunction, decree or other restriction of any court or governmental authority to which the Company or a Subsidiary is subject (including federal and state securities laws and regulations), or by which any property or asset of the Company or a Subsidiary is bound or affected, or (iv) conflict with or violate the terms of any agreement by which the Company or any Subsidiary is bound or to which any property or asset of the Company or any Subsidiary is bound or affected; except in the case of each of clauses (ii) and (iii), such as could not have or reasonably be expected to result in a Material Adverse Effect.

(e) Filings, Consents and Approvals. Neither the Company nor any Subsidiary is required to obtain any consent, waiver, authorization or order of, give any notice to, or make any filing or registration with, any court or other federal, state, local or other governmental authority or other Person in connection with the execution, delivery and performance by the Company of the Transaction Documents, other than any required federal and state securities filings and such filings and approvals as are required to be made or obtained under the applicable Trading Market rules in connection with the transactions contemplated hereby, each of which has been, or (if not yet required to be filed) shall be, timely filed.

(f) Issuance of the Securities. The Securities are duly authorized and, when issued and paid for in accordance with the applicable Transaction Documents, will be duly and validly issued, fully paid and nonassessable, free and clear of all Liens. The Company has reserved from its duly authorized capital stock a number of shares of Common Stock for issuance of the Securities at least equal to the number of Securities which could be issued pursuant to the terms of the Transaction Documents, based on the then-anticipated exercise prices of the Warrant.

(g) Capitalization. The capitalization of the Company is as described in the Company's most recently filed periodic SEC Report and pre-effective registration statement on Form S-1 currently on file with the SEC ("Form S-1"). No Person has any right of first refusal, preemptive right, right of participation, or any similar right to participate in the transactions contemplated by the Transaction Documents. Except as a result of the purchase and sale of the Securities or as set forth in the SEC Reports and Form S-1, there are no outstanding options, warrants, script rights to subscribe to, calls or commitments of any character whatsoever relating to, or securities, rights or obligations convertible into or exchangeable for, or giving any Person any right to subscribe for or acquire, any shares of Common Stock, or contracts, commitments, understandings or arrangements by which the Company or any Subsidiary is or may become bound to issue additional shares of Common Stock or securities convertible into or exercisable for shares of Common Stock. Except as set forth in the SEC Reports and Form S-1 the issuance and sale of the Securities will not obligate the Company to issue shares of Common Stock or other securities to any Person (other than Investor) and will not result in a right of any holder of Company securities to adjust the exercise, conversion, exchange, or reset price under such securities. All of the outstanding shares of capital stock of the Company are validly issued, fully paid and nonassessable, have been issued in compliance with all federal and state securities laws, and none of such outstanding shares was issued in violation of any preemptive rights or similar rights to subscribe for or purchase securities. No further approval or authorization of any stockholder, the Board of Directors of the Company or others is required for the issuance and sale of the Securities. There are no stockholders agreements, voting agreements or other similar agreements with respect to the Company's capital stock to which the Company is a party or, to the knowledge of the Company, between or among any of the Company's stockholders.

(h) SEC Reports; Financial Statements. The Company has filed all required SEC Reports for the two years preceding the Effective Date (or such shorter period as the Company was required by law to file such SEC Reports) on a timely basis. As of their respective dates, the SEC Reports complied in all material respects with the requirements of the Securities Act and the Exchange Act and the rules and regulations of the Commission promulgated thereunder, as applicable, and none of the SEC Reports, when filed, contained any untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading. The financial statements of the Company included in the SEC Reports comply in all material respects with applicable accounting requirements and the rules and regulations of the Commission with respect thereto as in effect at the time of filing. Such financial statements have been prepared in accordance with GAAP, except as may be otherwise specified in such financial statements or the notes thereto and except that unaudited financial statements may not contain all footnotes required by GAAP, and fairly present in all material respects the financial position of the Company and its consolidated subsidiaries as of and for the dates thereof and the results of operations and cash flows for the periods then ended, subject, in the case of unaudited statements, to normal, immaterial, year-end audit adjustments.

(i) Material Changes. Except as described in the Form S-1, since the date of the latest audited financial statements included within the SEC Reports (i) there has been no event, occurrence or development that has had, or that could reasonably be expected to result in, a Material Adverse Effect, (ii) the Company has not incurred any liabilities (contingent or otherwise) other than (A) trade payables and accrued expenses incurred in the ordinary course of business consistent with past practice, and (B) liabilities not required to be reflected in the Company's financial statements pursuant to GAAP or required to be disclosed in filings made with the Commission, (iii) the Company has not altered its method of accounting, (iv) the Company has not declared or made any dividend or distribution of cash or other property to its stockholders or purchased, redeemed or made any agreements to purchase or redeem any shares of its capital stock (other than as contemplated and permitted by the Transaction Documents), and (v) the Company has not issued any equity securities to any officer, director or Affiliate, except pursuant to existing Company equity incentive plans as disclosed in the SEC Reports. The Company does not have pending before the Commission any request for confidential treatment of information.

(j) Litigation. Except as set forth in the SEC Reports, there is no action, suit, inquiry, notice of violation, proceeding or investigation pending or, to the knowledge of the Company, threatened against or affecting the Company, any Subsidiary or any of their respective properties before or by any court, arbitrator, governmental or administrative agency or regulatory authority (federal, state, county, local or foreign) (collectively, an "Action"), which (i) adversely affects or challenges the legality, validity or enforceability of any of the Transaction Documents or the Securities, or (ii) could, if there were an unfavorable decision, have or reasonably be expected to result in a Material Adverse Effect. Except as set forth in the SEC Reports, neither the Company nor any Subsidiary, nor to the knowledge of the Company any director or officer thereof, is or has been the subject of any Action involving a claim of violation of or liability under federal or state securities laws or a claim of breach of fiduciary duty. There has not been, and to the knowledge of the Company, there is not pending or contemplated, any investigation by the Commission involving the Company or any current or former director or officer of the Company. The Commission has not issued any stop order or other order suspending the effectiveness of any registration statement filed by the Company or any Subsidiary under the Exchange Act or the Securities Act.

(k) Labor Relations. No material labor dispute exists or, to the knowledge of the Company, is imminent with respect to any of the employees of the Company, which could reasonably be expected to result in a Material Adverse Effect.

(l) Compliance. Neither the Company nor any Subsidiary (i) is in default under or in violation of (and no event has occurred that has not been waived that, with notice or lapse of time or both, would result in a default by the Company or any Subsidiary under), nor has the Company or any Subsidiary received notice of a claim that it is in default under or that it is in violation of, any indenture, loan or credit agreement or any other similar agreement or instrument to which it is a party or by which it or any of its properties is bound (whether or not such default or violation has been waived), (ii) is in violation of any order of any court, arbitrator or governmental body, or (iii) is or has been in violation of any statute, rule or regulation of any governmental authority, including without limitation all foreign, federal, state and local laws applicable to its business, except in each case under clauses (i)-(iii) above as could not have a Material Adverse Effect.

(m) Regulatory Permits. The Company and each Subsidiary possess all certificates, authorizations and permits issued by the appropriate federal, state, local or foreign regulatory authorities necessary to conduct their respective businesses as described in the SEC Reports, except where the failure to possess such permits could not, individually or in the aggregate, have or reasonably be expected to result in a Material Adverse Effect ("Material Permits"), and neither the Company nor any Subsidiary has received any notice of proceedings relating to the revocation or modification of any Material Permit.

(n) Title to Assets. The Company and each Subsidiary have good and marketable title in fee simple to all real property owned by them that is material to the business of the Company and each Subsidiary and good and marketable title in all personal property owned by them that is material to the business of the Company and each Subsidiary, in each case free and clear of all Liens, except for Liens that do not materially affect the value of such property and do not materially interfere with the use made and proposed to be made of such property by the Company and each Subsidiary and Liens for the payment of federal, state or other taxes, the payment of which is neither delinquent nor subject to penalties. Any real property and facilities held under lease by the Company and each Subsidiary are held by them under valid, subsisting and enforceable leases of which the Company and each Subsidiary are in compliance.

(o) Patents and Trademarks. The Company and each Subsidiary have, or have rights to use, all patents, patent applications, trademarks, trademark applications, service marks, trade names, copyrights, licenses and other similar rights that are necessary or material for use in connection with their respective businesses as described in the SEC Reports and which the failure to so have could have a Material Adverse Effect (collectively, the "Intellectual Property Rights"). Neither the Company nor any Subsidiary has received a written notice that the Intellectual Property Rights used by the Company or any Subsidiary violates or infringes upon the rights of any Person. To the knowledge of the Company, all such Intellectual Property Rights are enforceable and there is no existing infringement by another Person of any of the Intellectual Property Rights of the Company or each Subsidiary.

(p) Insurance. The Company and each Subsidiary are insured by insurers of recognized financial responsibility against such losses and risks and in such amounts as are prudent and customary in the businesses in which the Company and each Subsidiary are engaged, including but not limited to directors and officers insurance coverage at least equal to an amount, and with policy coverage terms, that would cover any claims the Company could reasonably be required to pay pursuant to its breach of any of the Transaction Documents. To the best of Company's knowledge, such insurance contracts and policies are accurate and complete. Neither the Company nor any Subsidiary has any reason to believe that it will not be able to renew its existing insurance coverage as and when such coverage expires or to obtain similar coverage from similar insurers as may be necessary to continue its business without a significant increase in cost.

(q) Transactions With Affiliates and Employees. Except as set forth in the SEC Reports and Form S-1, none of the officers or directors of the Company and, to the knowledge of the Company, none of the employees of the Company is presently a party to any transaction with the Company or any Subsidiary (other than for services as employees, officers and directors), including any contract, agreement or other arrangement providing for the furnishing of services to or by, providing for rental of real or personal property to or from, or otherwise requiring payments to or from any officer, director or such employee or, to the knowledge of the Company, any entity in which any officer, director, or any such employee has a substantial interest or is an officer, director, trustee or partner, in each case in excess of $120,000 other than (i) for payment of salary or consulting fees for services rendered, (ii) reimbursement for expenses incurred on behalf of the Company and (iii) for other employee benefits, including stock option agreements under any equity incentive plan of the Company.

(r) Sarbanes-Oxley; Internal Accounting Controls. The Company is in material compliance with all provisions of the Sarbanes-Oxley Act of 2002, which are applicable to it as of the Effective Date and the Closing Date. The Company and each Subsidiary maintain a system of internal accounting controls sufficient to provide reasonable assurance that (i) transactions are executed in accordance with management's general or specific authorizations, (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain asset accountability, (iii) access to assets is permitted only in accordance with management's general or specific authorization, and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences. The Company has established disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Company and designed such disclosure controls and procedures to ensure that material information relating to the Company, including its Subsidiaries, is made known to the certifying officers by others within those entities, particularly during the period in which the Company's most recently filed periodic report under the Exchange Act, as the case may be, is being prepared. The Company's certifying officers have evaluated the effectiveness of the Company's disclosure controls and procedures as of the date prior to the filing date of the most recently filed periodic report under the Exchange Act (such date, the "Evaluation Date"). The Company presented in its most recently filed periodic report under the Exchange Act the conclusions of the certifying officers about the effectiveness of the Company's disclosure controls and procedures based on their evaluations as of the Evaluation Date. Since the Evaluation Date, there have been no significant changes in the Company's internal accounting controls or its disclosure controls and procedures or, to the Company's knowledge, in other factors that could materially affect the Company's internal accounting controls or its disclosure controls and procedures.

(s) Certain Fees. No brokerage or finder's fees or commissions are or will be payable by the Company to any broker, financial advisor or consultant, finder, placement agent, investment banker, bank or other Person with respect to the transactions contemplated by this Agreement.

(t) Private Placement. Assuming the accuracy of the Investor's representations and warranties as set forth herein with respect to private placement requirements to meet the safe harbor of Regulation D or otherwise qualify as a non-public offering pursuant to the applicable provisions of Section 4 of the Securities Act, no registration under the Securities Act is required for the offer and sale of the Securities by the Company to Investor as contemplated hereby. The issuance and sale of the Securities hereunder does not contravene the rules and regulations of any Trading Market.

(u) Investment Company. The Company is not, and is not an Affiliate of, and immediately after receipt of payment for the Securities, will not be or be an Affiliate of, an "investment company" within the meaning of the Investment Company Act. The Company shall conduct its business in a manner so that it will not become subject to the Investment Company Act.

(v) Registration Rights. No Person (other than Investor pursuant to the Transaction Documents) has any right to cause the Company to effect the registration under the Securities Act of any securities of the Company.

(w) Listing and Maintenance Requirements. The Common Stock is registered pursuant to Section 12 of the Exchange Act, and the Company has taken no action designed to, or which to its knowledge is likely to have the effect of, terminating the registration of the Common Stock under the Exchange Act, nor has the Company received any notification that the Commission is contemplating terminating such registration. The Company has not, in the 12 months preceding the Effective Date, received notice from any Trading Market on which the Common Stock is or has been listed or quoted to the effect that the Company is not in compliance with the listing or maintenance requirements of such Trading Market. The Company is, and has no reason to believe that it will not in the foreseeable future continue to be, in compliance with all such listing and maintenance requirements.

(x) Application of Takeover Protections. The Company and its Board of Directors have taken all necessary action, if any, in order to render inapplicable any control share acquisition, business combination, poison pill (including any distribution under a rights agreement) or other similar anti-takeover provision under the Company's Certificate of Incorporation (or similar charter documents) or the laws of its state of incorporation that is or could become applicable to Investor as a result of Investor and the Company fulfilling their obligations or exercising their rights under the Transaction Documents, including without limitation the Company's issuance of the Securities and Investor's ownership of the Securities.

(y) Disclosure; Non-Public Information. Except with respect to the information that will be, and to the extent that it actually is timely publicly disclosed by the Company pursuant to Section 6.1(c), and notwithstanding any other provision in this Agreement or the other Transaction Documents, neither the Company nor any other Person acting on its behalf has provided Investor or its agents or counsel with any information that constitutes or might constitute material, non-public information, including without limitation this Agreement and the exhibits and schedules hereto, unless prior thereto Investor shall have executed a written agreement regarding the confidentiality and use of such information. The Company understands and confirms that neither Investor nor any Affiliate of Investor shall have any duty of trust or confidence that is owed directly, indirectly, or derivatively to the Company or the shareholders of the Company or to any other Person who is the source of material non-public information regarding the Company. No information provided to Investor in connection with the Transaction Documents constitutes material non-public information. There is no adverse material information regarding the Company that has not been publicly disclosed prior to the Effective Date. The Company understands and confirms that Investor will rely on the foregoing representations and covenants in effecting transactions in securities of the Company. All disclosures provided to Investor regarding the Company, its business and the transactions contemplated hereby furnished by or on behalf of the Company with respect to the representations and warranties made herein are true and correct in all material respects and do not contain any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made therein, in light of the circumstances under which they were made, not misleading.

(z) No Integrated Offering. Neither the Company, nor any of its Affiliates, nor any Person acting on its or their behalf has, directly or indirectly, made any offers or sales of any security or solicited any offers to buy any security, under circumstances that would cause this offering of the Securities to be integrated with prior offerings by the Company for purposes of the Securities Act or which could violate any applicable stockholder approval provisions, including, without limitation, under the rules and regulations of the Trading Market.

(aa) Reserved.

(bb) Tax Status. The Company and each of its Subsidiaries has made or filed all federal, state and foreign income and all other tax returns, reports and declarations required by any jurisdiction to which it is subject (unless and only to the extent that the Company and each of its Subsidiaries has set aside on its books provisions reasonably adequate for the payment of all unpaid and unreported taxes) and has paid all taxes and other governmental assessments and charges that are material in amount, shown or determined to be due on such returns, reports and declarations, except those being contested in good faith and has set aside on its books provisions reasonably adequate for the payment of all taxes for periods subsequent to the periods to which such returns, reports or declarations apply. There are no unpaid taxes in any material amount claimed to be due by the taxing authority of any jurisdiction, and the officers of the Company know of no basis for any such claim. The Company has not executed a waiver with respect to the statute of limitations relating to the assessment or collection of any foreign, federal, statue or local tax. None of the Company's tax returns is presently being audited by any taxing authority.

(cc) No General Solicitation or Advertising. Neither the Company nor, to the knowledge of the Company, any of its directors or officers (i) has conducted or will conduct any general solicitation (as that term is used in Rule 502(c) of Regulation D) or general advertising with respect to the sale of the Securities, or (ii) made any offers or sales of any security or solicited any offers to buy any security under any circumstances that would require registration of the Securities under the Securities Act or made any "directed selling efforts" as defined in Rule 902 of Regulation S.

(dd) Foreign Corrupt Practices. Neither the Company, nor to the knowledge of the Company, any agent or other person acting on behalf of the Company, has (i) directly or indirectly, used any corrupt funds for unlawful contributions, gifts, entertainment or other unlawful expenses related to foreign or domestic political activity, (ii) made any unlawful payment to foreign or domestic government officials or employees or to any foreign or domestic political parties or campaigns from corporate funds, (iii) failed to disclose fully any contribution made by the Company (or made by any person acting on its behalf of which the Company is aware) which is in violation of law, or (iv) violated in any material respect any provision of the Foreign Corrupt Practices Act of 1977, as amended.

(ee) Acknowledgment Regarding Investor's Purchase of Securities. The Company acknowledges and agrees that Investor is acting solely in the capacity of an arm's length purchaser with respect to this Agreement and the transactions contemplated hereby. The Company further acknowledges that Investor is not acting as a financial advisor or fiduciary of the Company (or in any similar capacity) with respect to this Agreement and the transactions contemplated hereby and any statement made by Investor or any of its representatives or agents in connection with this Agreement and the transactions contemplated hereby is not advice or a recommendation and is merely incidental to Investor's purchase of the Securities. The Company further represents to Investor that the Company's decision to enter into this Agreement has been based solely on the independent evaluation of the Company and its representatives.

(ff) Accountants. The Company's accountants are set forth in the SEC Reports and such accountants are an independent registered public accounting firm as required by the SEC Guidance.

(gg) No Disagreements with Accountants and Lawyers. There are no disagreements of any kind presently existing, or reasonably anticipated by the Company to arise, between the accountants and lawyers formerly or presently employed by the Company, and the Company is current with respect to any fees owed to its accountants and lawyers, except for any past-due amounts of less than one year that may be owed in the ordinary course of business.

(hh) Section 5 Compliance. No representation or warranty or other statement made by Company in the Transaction Documents contains any untrue statement or omits to state a material fact necessary to make any of them, in light of the circumstances in which it was made, not misleading. The Company is not aware of any facts or circumstances that would cause the transactions contemplated by the Transaction Documents, when consummated, to violate Section 5 of the Securities Act or other federal or state securities laws or regulations.

ARTICLE IV.
REPRESENTATIONS AND WARRANTIES OF THE INVESTOR

4.1 The Investor hereby represents and warrants to the Company as follows:

(a) Organization. The Investor is duly organized, validly existing and in good standing under the laws of the jurisdiction of its organization with the requisite power and authority to enter into and consummate the transactions contemplated by the applicable Transaction Documents and otherwise to carry out its obligations thereunder.

(b) No Registration. The Investor understands that the Securities have not been, and will not be, registered under the Securities Act by reason of a specific exemption from the registration provisions of the Securities Act, the availability of which depends upon, among other things, the accuracy of the Investor's representations as expressed herein or otherwise made pursuant hereto.

(c) Investment Intent. The Investor is acquiring the Securities for its own account. The Investor does not have any contract, undertaking, agreement or arrangement with any person or entity to sell, transfer or grant participation to such person or entity or to any third person or entity with respect to any of the Securities.

(d) Investment Experience. The Investor has substantial experience in evaluating and investing in securities of companies similar to the Company and acknowledges that the Investor can protect its own interests. The Investor has such knowledge and experience in financial and business matters so that the Investor is capable of evaluating the merits and risks of its investment in the Company.

(e) Speculative Nature of Investment. The Investor understands and acknowledges that an investment in the Company is highly speculative and involves substantial risks. The Investor can bear the economic risk of the Investor's investment and is able, without impairing the Investor's financial condition, to hold the Securities for an indefinite period of time and to suffer a complete loss of the Investor's investment.

(f) Access to Data. The Investor has had an opportunity to ask questions of, and receive answers from, the officers of the Company concerning the Securities, this Agreement, the exhibits and schedules attached hereto and the transactions contemplated by this Agreement, as well as the Company's business, management and financial affairs, which questions were answered to its satisfaction. The Investor believes that it has received all the information the Investor considers necessary or appropriate for deciding whether to purchase the Securities. The Investor also acknowledges that it is relying solely on its own counsel and not on any statements or representations of the Company or its agents for legal advice with respect to this investment or the transactions contemplated by this Agreement.

(g) Accredited Investor. The Investor is an "accredited investor" within the meaning of Regulation D and shall submit to the Company such further assurances of such status as may be reasonably requested by the Company, including without limitation, the residency or principal place of business of the Investor.

(h) Rule 144**.** The Investor acknowledges that the Securities must be held indefinitely unless subsequently registered under the Securities Act or an exemption from such registration is available. The Investor is aware of the provisions of Rule 144 promulgated under the Securities Act which permit resale of shares purchased in a private placement subject to the satisfaction of certain conditions.

(i) Authorization. The Investor has all requisite power and authority to execute and deliver this Agreement, to receive the Securities hereunder as contemplated herein and to carry out and perform its obligations under the terms of this Agreement. All action on the part of the Investor necessary for the authorization, execution, delivery and performance of this Agreement, and the performance of all of the Investor's obligations under this Agreement, has been taken or will be taken prior to the Closing Date. This Agreement, when executed and delivered by the Investor, will constitute valid and legally binding obligations of the Investor, enforceable in accordance with its terms except: (i) to the extent that the indemnification provisions contained in this Agreement may be limited by applicable law and principles of public policy, (ii) as limited by applicable bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting enforcement of creditors' rights generally, and (iii) as limited by laws relating to the availability of specific performance, injunctive relief or other equitable remedies or by general principles of equity. No consent, approval, authorization, order, filing, registration or qualification of or with any court, governmental authority or third person is required to be obtained by the Investor in connection with the execution and delivery of this Agreement by the Investor or the performance of the Investor's obligations hereunder.

(j) Brokers or Finders. The Investor has not engaged any brokers, finders or agents, and the Company has not and will not incur, directly or indirectly, as a result of any action taken by the Investor, any liability for brokerage or finders' fees or agents' commissions or any similar charges in connection with this Agreement.

The Company acknowledges and agrees that Investor does not make, and has not made, any representations or warranties with respect to the transactions contemplated hereby other than those specifically set forth in this Section 4.1.

ARTICLE V.
OTHER AGREEMENTS OF THE PARTIES

5.1 Transfer Restrictions.

5.2 The Securities may only be disposed of in compliance with state and federal securities laws. In connection with any transfer of Securities other than (i) pursuant to an effective Registration Statement or Rule 144, (ii) to the Company, (iii) to an Affiliate of Investor, or (iv) in connection with a pledge as contemplated in Section 5.1(b), the Company may require the transferor thereof to provide to the Company an opinion of Luce Forward Hamilton & Scripps LLP ("Luce Forward"), or other counsel reasonably acceptable to Company, to the effect that such transfer does not require registration of such transferred Securities under the Securities Act.

(b) Certificates evidencing the Conversion Securities and the Warrant Shares will contain a legend in substantially the following form, until such time as not required under applicable state and federal securities laws in the opinion of counsel to Company or Investor:

> NEITHER THESE SECURITIES NOR THE SECURITIES INTO WHICH THESE SECURITIES ARE EXERCISABLE HAVE BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR THE SECURITIES COMMISSION OF ANY STATE IN RELIANCE UPON AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OR PURSUANT TO AN AVAILABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND IN ACCORDANCE WITH APPLICABLE STATE SECURITIES LAWS. THESE SECURITIES AND THE SECURITIES ISSUABLE UPON EXERCISE OF THESE SECURITIES MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT OR OTHER LOAN SECURED BY SUCH SECURITIES.

The Company agrees to cause such legend to be removed immediately upon effectiveness of a Registration Statement, or when any Warrant Shares are eligible for sale under Rule 144 and, if requested by Investor or the transfer agent, to promptly provide at the Company's expense a legal opinion of counsel to the Company confirming that such legend may be removed. Company further acknowledges and agrees that Investor may from time to time pledge pursuant to a bona fide margin agreement with a registered broker-dealer or grant a security interest in some or all of the Securities to a financial institution that is an "accredited investor" as defined in Rule 501(a) under the Securities Act and who agrees to be bound by the provisions of this Agreement and, if required under the terms of such arrangement, Investor may transfer pledged or secured Securities to the pledgees or secured parties. Such a pledge or transfer would not be subject to approval of the Company and no legal opinion of legal counsel of the pledgee, secured party or pledgor shall be required in connection therewith. Further, no notice shall be required of such pledge. At Investor's reasonable expense, the Company will execute and deliver such documentation as a pledgee or secured party of Securities may reasonably request in connection with a pledge or transfer of the Securities.

5.3 Furnishing of Information. As long as Investor owns Securities, the Company covenants to timely file (or obtain extensions in respect thereof and file within the applicable grace period) all reports required to be filed by the Company after the Effective Date pursuant to the Exchange Act. Upon the request of Investor, the Company shall deliver to Investor a written certification of a duly authorized officer as to whether it has complied with the preceding sentence. As long as Investor owns Securities, if the Company is not required to file reports pursuant to such laws, it will prepare and furnish to Investor and make publicly available in accordance with Rule 144(c) such information as is required for Investor to sell the Securities under Rule 144. The Company further covenants that it will take such further action as any holder of Securities may reasonably request, all to the extent required from time to time to enable such Person to sell such Securities without registration under the Securities Act within the limitation of the exemptions provided by Rule 144.

5.4 Integration. The Company shall not sell, offer for sale or solicit offers to buy or otherwise negotiate in respect of any security (as defined in Section 2 of the Securities Act) that would be integrated with the offer or sale of the Securities in a manner that would require the registration under the Securities Act of the sale of the Securities to Investor or that would be integrated with the offer or sale of the Securities for purposes of the rules and regulations of any Trading Market such that it would require stockholder approval prior to the closing of such other transaction unless stockholder approval is obtained before the closing of such subsequent transaction.

5.5 Securities Laws Disclosure; Publicity. The Company shall timely file a Current Report on Form 8-K as required by this Agreement, and in the Company's discretion shall file a press release, in each case reasonably acceptable to Investor, disclosing the material terms of the transactions contemplated hereby. The Company and Investor shall consult with each other in issuing any press releases with respect to the transactions contemplated hereby, and neither the Company nor Investor shall issue any such press release or otherwise make any such public statement without the prior consent of the Company, with respect to any such press release of Investor, or without the prior consent of Investor, with respect to any such press release of the Company, which consent shall not unreasonably be withheld or delayed, except if such disclosure is required by law or Trading Market regulations, in which case the disclosing party shall promptly provide the other party with prior notice of such public statement or communication. Notwithstanding the foregoing, the Company shall not publicly disclose the name of Investor, or include the name of Investor in any filing with the Commission or any regulatory agency or Trading Market, without the prior written consent of Investor, except (i) as contained in the Current Report on Form 8-K and press release described above, (ii) as required by federal securities law in connection with any registration statement under which the Warrant Shares are registered, (iii) to the extent such disclosure is required by law or Trading Market regulations, in which case the Company shall provide Investor with prior notice of such disclosure, or (iv) to the extent such disclosure is required in any SEC Report filed by the Company.

5.6 Shareholders Rights Plan. No claim will be made or enforced by the Company or, to the knowledge of the Company, any other Person that Investor is an "Acquiring Person" under any shareholders rights plan or similar plan or arrangement in effect or hereafter adopted by the Company, or that Investor could be deemed to trigger the provisions of any such plan or arrangement, by virtue of receiving Securities under the Transaction Documents or under any other agreement between the Company and Investor. The Company shall conduct its business in a manner so that it will not become subject to the Investment Company Act.

5.7 Reimbursement. If Investor becomes involved in any capacity in any proceeding by or against any Person who is a stockholder of the Company (except as a result of sales, pledges, margin sales and similar transactions by Investor to or with any current stockholder), solely as a result of Investor's acquisition of the Securities under this Agreement, the Company will reimburse Investor for its reasonable legal and other reasonable expenses (including the reasonable cost of any investigation preparation and travel in connection therewith) incurred in connection therewith, as such expenses are incurred, or will assume the defense of Investor in such matter. The reimbursement obligations of the Company under this Section 5.7 shall be in addition to any liability which the Company may otherwise have, shall extend upon the same terms and conditions to any Affiliates of Investor who are actually named in such action, proceeding or investigation, and partners, directors, agents, employees and controlling persons (if any), as the case may be, of Investor and any such Affiliate, and shall be binding upon and inure to the benefit of any successors, assigns, heirs and personal representatives of the Company, Investor and any such Affiliate and any such Person. The Company also agrees that neither Investor nor any such Affiliates, partners, directors, agents, employees or controlling persons shall have any liability to the Company or any Person asserting claims on behalf of or in right of the Company solely as a result of acquiring the Securities under this Agreement.

5.8 Indemnification of Investor.

(a) Company Indemnification Obligation. Subject to the provisions of this Section 5.8, the Company will indemnify and hold Investor and any Warrant holder, their Affiliates and attorneys, and each of their directors, officers, shareholders, partners, employees, agents, and any person who controls Investor within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act (collectively, the "Investor Parties" and each an "Investor Party"), harmless from any and all losses, liabilities, obligations, claims, contingencies, damages, reasonable costs and expenses, including all judgments, amounts paid in settlements, court costs and reasonable attorneys' fees and costs of investigation (collectively, "Losses") that any Investor Party may suffer or incur as a result of or relating to (i) any breach of any of the representations, warranties, covenants or agreements made by the Company in this Agreement or in the other Transaction Documents, (ii) any action instituted against any Investor Party, or any of them or their respective Affiliates, by any stockholder of the Company who is not an Affiliate of an Investor Party, with respect to any of the transactions contemplated by the Transaction Documents (unless such action is based upon a breach of Investor's representations, warranties or covenants under the Transaction Documents or any agreements or understandings Investor may have with any such stockholder or any violations by Investor of state or federal securities laws or any conduct by Investor which constitutes fraud, gross negligence, willful misconduct or malfeasance), (iii) any untrue statement or alleged untrue statement of a material fact contained in a Registration Statement (or in a Registration Statement as amended by any post-effective amendment thereof by the Company), or arising out of or based upon any omission or alleged omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and/or (iv) any untrue statement or alleged untrue statement of a material fact included in any Prospectus (or any amendments or supplements to any Prospectus), in any free writing prospectus, in any "issuer information" (as defined in Rule 433 under the Securities Act) of the Company, or in any Prospectus together with any combination of one or more of the free writing prospectuses, if any, or arising out of or based upon any omission or alleged omission to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading.

(b) Indemnification Procedures. If any action shall be brought against an Investor Party in respect of which indemnity may be sought pursuant to this Agreement, such Investor Party shall promptly notify the Company in writing, and the Company shall have the right to assume the defense thereof with counsel of its own choosing. The Investor Parties shall have the right to employ separate counsel in any such action and participate in the defense thereof, but the fees and expenses of such counsel shall be at the expense of the Investor Parties except to the extent that (i) the employment thereof has been specifically authorized by the Company in writing, (ii) the Company has failed after a reasonable period of time to assume such defense and to employ counsel or (iii) in such action there is, in the reasonable opinion of such separate counsel, a material conflict with respect to the dispute in question on any material issue between the position of the Company and the position of the Investor Parties such that it would be inappropriate for one counsel to represent the Company and the Investor Parties. The Company will not be liable to the Investor Parties under this Agreement (i) for any settlement by an Investor Party effected without the Company's prior written consent, which shall not be unreasonably withheld or delayed; or (ii) to the extent, but only to the extent that a loss, claim, damage or liability is either attributable to Investor's breach of any of the representations, warranties, covenants or agreements made by Investor in this Agreement or in the other Transaction Documents.

5.9 Legal Fees. The Company shall be responsible for payment of all reasonable legal fees incurred by Investor in relation to the legal services incurred in drafting and negotiating the definitive agreements.

5.10 Company's Fees. The Company shall pay all fees and expenses that it incurs in connection with the transactions contemplated hereunder, including the fees and expenses of its advisers, counsel, accountants and other experts, if any, and all other expenses incurred by the Company incident to the negotiation, preparation, execution, delivery and performance of the Transaction Documents. The Company shall pay all stamp and other taxes and duties levied in connection with the sale of the Securities, if any.

5.11 Registration Rights. Upon the consummation of the Qualified Financing, the Company shall provide the Investor with any and all registration rights with respect to the Conversion Securities and the Warrant Shares that are provided to any investors in the Qualified Financing.

5.12 Reservation of Shares. The Company shall reserve and keep available, solely for the purpose of enabling it to issue Warrant Shares upon exercise of the Warrant as therein provided, the number of Warrant Shares which are then issuable and deliverable upon the exercise of the entire Warrant. In any event, the Company shall maintain a reserve from its duly authorized shares of Common Stock for issuance pursuant to the Transaction Documents in such amount as may be required to fulfill its obligations in full under the Transaction Documents.

ARTICLE VI.
CONDITIONS PRECEDENT TO CLOSING

6.1 The obligation of the Company to sell the Note and Warrant to the Investor at the Closing, and the Investor's obligation to make such purchase, is subject to the fulfillment, on or before the Closing, of each of the following conditions, unless otherwise waived in advance in writing:

(a) Representations and Warranties. The representations and warranties of the Company contained in this Agreement shall have been true and correct when made and shall be true and correct in all respects as of the Closing, with the same force and effect as if made as of the Closing Date, and the Company shall have delivered an Officer's Closing Certificate to such effect to Investor, signed by a duly appointed and authorized officer of the Company.

(b) Performance. The Company shall have performed and complied with all covenants, agreements, obligations and conditions contained in this Agreement that are required to be performed or complied with by the Investor on or before the Closing.

(c) Delivery of Documents. The following documents shall have been delivered to Investor: (A) this Agreement, executed by the Company; (B) a Secretary's Certificate as to (x) the resolutions of the Company's Board of Directors authorizing this Agreement and the Transaction Documents, and the transactions contemplated hereby and thereby, and (y) a copy of the Company's current Certificate of Incorporation, Bylaws, and other governing documents; (D) a copy of the Company's press release (if any) announcing the transactions contemplated by this Agreement; (E) a copy of the Company's Current Report on Form 8-K, as filed with the SEC, describing the transaction contemplated by, and attaching a complete copy of, the Transaction Documents; and (F) the final executed Warrant.

(d) No Material Adverse Effect. Other than for losses incurred in the ordinary course of business, there has not been any Material Adverse Effect on the Company since the date of the last SEC Report filed by the Company.

ARTICLE VII.
MISCELLANEOUS

7.1 Entire Agreement. The Transaction Documents, together with the exhibits and schedules thereto, contain the entire understanding of the parties with respect to the subject matter hereof and supersede all prior agreements and understandings, oral or written, with respect to such matters, which the parties acknowledge have been merged into such documents, exhibits and schedules.

7.2 Notices. Unless a different time of day or method of delivery is set forth in any applicable Transaction Document, any and all notices or other communications or deliveries required or permitted to be provided hereunder shall be in writing and shall be deemed given and effective on the earliest of (i) the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section, or via electronic mail, prior to 6:30 p.m. (New York City time) on a Trading Day and an electronic confirmation of delivery is received by the sender, (ii) the next Trading Day after the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section on a day that is not a Trading Day or later than 6:30 p.m. (New York City time) on any Trading Day, (iii) the Trading Day following the date of mailing, if sent by nationally recognized overnight courier service, or (iv) upon actual receipt by the party to whom such notice is required to be given by personal delivery.

7.3 Amendments; Waivers. No provision of this Agreement may be waived or amended except in a written instrument signed, in the case of an amendment, by the Company and Investor or, in the case of a waiver, by the party against whom enforcement of any such waiver is sought. No waiver of any default with respect to any provision, condition or requirement of this Agreement shall be deemed to be a continuing waiver in the future or a waiver of any subsequent default or a waiver of any other provision, condition or requirement hereof, nor shall any delay or omission of either party to exercise any right hereunder in any manner impair the exercise of any such right.

7.4 Headings. The headings herein are for convenience only, do not constitute a part of this Agreement and shall not be deemed to limit or affect any of the provisions hereof. The language used in this Agreement will be deemed to be the language chosen by the parties to express their mutual intent, and no rules of strict construction will be applied against any party. This Agreement shall be construed as if drafted jointly by the parties, and no presumption or burden of proof shall arise favoring or disfavoring any party by virtue of the authorship of any provisions of this Agreement or any of the other Transaction Documents.

7.5 Successors and Assigns. The terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective successors and permitted assigns of the parties. Nothing in this Agreement, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and permitted assigns any rights, remedies, obligations or liabilities under or by reason of this Agreement, except as expressly provided in this Agreement.

7.6 Governing Law; Dispute Resolution. All questions concerning the construction, validity, enforcement and interpretation of the Transaction Documents shall be governed by and construed and enforced in accordance with the laws of the State of New York, without regard to the principles of conflicts of law that would require or permit the application of the laws of any other jurisdiction. If either party shall commence an action or proceeding to enforce any provisions of the Transaction Documents, then the prevailing party in such action or proceeding shall be reimbursed by the other party for its reasonable attorneys' fees and other costs and expenses reasonably incurred in connection with the investigation, preparation and prosecution of such action or proceeding.

7.7 Survival. The representations and warranties contained herein shall survive the Closing and the delivery and exercise of the Securities.

7.8 Execution. This Agreement may be executed in two or more counterparts, all of which when taken together shall be considered one and the same agreement and shall become effective when counterparts have been signed by each party and delivered to the other party, it being understood that both parties need not sign the same counterpart. In the event that any signature is delivered by facsimile transmission or in a PDF by e-mail transmission, such signature shall create a valid and binding obligation of the party executing (or on whose behalf such signature is executed) with the same force and effect as if such facsimile signature page were an original thereof.

7.9 Severability. If any provision of this Agreement is held to be invalid or unenforceable in any respect, the validity and enforceability of the remaining terms and provisions of this Agreement shall not in any way be affected or impaired thereby and the parties will attempt to agree upon a valid and enforceable provision that is a reasonable substitute therefor, and upon so agreeing, shall incorporate such substitute provision in this Agreement.

7.10 Replacement of Securities. If any certificate or instrument evidencing any Securities is mutilated, lost, stolen or destroyed, the Company shall issue or cause to be issued in exchange and substitution for and upon cancellation thereof, or in lieu of and substitution therefor, a new certificate or instrument, but only upon receipt of evidence reasonably satisfactory to the Company of such loss, theft or destruction and customary and reasonable indemnity, if requested. The applicants for a new certificate or instrument under such circumstances shall also pay any reasonable third-party costs associated with the issuance of such replacement Securities.

7.11 Remedies. In addition to being entitled to exercise all rights provided herein or granted by law, including recovery of damages, Investor shall be entitled to specific performance under the Transaction Documents. The parties agree that monetary damages may not be adequate compensation for any loss incurred by Investor by reason of any breach of the obligations of the Company described herein, and the Company hereby agrees to waive, in any action for specific performance, the defense that a remedy at law would be adequate. Investor shall not be liable for special, indirect, consequential or punitive damages suffered or alleged to be suffered by the Company or any third party, whether arising from or related to the Transaction Documents or otherwise.

7.12 Payment Set Aside. To the extent that the Company makes a payment or payments to Investor pursuant to any Transaction Document or Investor enforces or exercises its rights thereunder, and such payment or payments or the proceeds of such enforcement or exercise or any part thereof are subsequently invalidated, declared to be fraudulent or preferential, set aside, recovered from, disgorged by or are required to be refunded, repaid or otherwise restored to the Company, a trustee, receiver or any other person under any law (including, without limitation, any bankruptcy law, state or federal law, common law or equitable cause of action), then to the extent of any such restoration the obligation or part thereof originally intended to be satisfied shall be revived and continued in full force and effect as if such payment had not been made or such enforcement or setoff had not occurred.

7.13 Liquidated Damages. The Company's obligations to pay any liquidated damages or other amounts owing under the Transaction Documents is a continuing obligation of the Company and shall not terminate until all unpaid liquidated damages and other amounts have been paid notwithstanding the fact that the instrument or security pursuant to which such liquidated damages or other amounts are due and payable shall have been cancelled.

7.14 Time of the Essence. Time is of the essence with respect to all provisions of this Agreement that specify a time for performance.

7.15 Construction. The parties agree that each of them and/or their respective counsel has reviewed and had an opportunity to revise the Transaction Documents and, therefore, the normal rule of construction to the effect that any ambiguities are to be resolved against the drafting party shall not be employed in the interpretation of the Transaction Documents or any amendments hereto. The language used in this Agreement will be deemed to be the language chosen by the parties to express their mutual intent, and no rules of strict construction will be applied against any party.

7.16 Entire Agreement. This Agreement, together with the exhibits and schedules hereto, contains the entire agreement and understanding of the parties, and supersedes all prior and contemporaneous agreements, term sheets, letters, discussions, communications and understandings, both oral and written, which the parties acknowledge have been merged into this Agreement. No party, representative, attorney or agent has relied upon any collateral contract, agreement, assurance, promise, understanding or representation not expressly set forth hereinabove. The parties hereby expressly waive all rights and remedies, at law and in equity, directly or indirectly arising out of or relating to, or which may arise as a result of, any Person's reliance on any such assurance.

IN WITNESS WHEREOF, the parties hereto have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first written above.

COMPANY:

CATASYS, INC.

By: /s/ Susan Etzel
Susan Etzel, Chief Financial Officer

INVESTOR:

/s/ David E. Smith

By: David E. Smith
Title:_____

EXHIBIT A

Form of Note

(see attached)

EXHIBIT B

Form of Warrant

(see attached)

CONSENT

This Consent (this **"Agreement"**) is dated as of October 5, 2011 (the **"Effective Date"**), among Catasys, Inc., a Delaware corporation (the **"Company"**), Socius Capital Group, LLC, a Delaware limited liability company (the **"Investor"**), and David E. Smith (the **"New Lender"**).

WHEREAS, the Investor is the Holder of a Company issued Secured Convertible Promissory Note in the amount of $650,000 dated August 17, 2011 (the **"Original Note"**), which provides for a first priority security interest in all of the assets of the Company (the "**Collateral**");

WHEREAS, the Company wishes to issue to the New Lender a Secured Convertible Promissory Note in the amount of $680,000 (**"Additional Note"** and, together with the Original Note, the "**Notes**") and provide the New Lender with a security interest in all of the assets of the Company on a pari passu basis with the Investor;

WHEREAS, the Investor wishes to consent to the Company's issuance of such Additional Note in the amount of $680,000 to the New Lender.

NOW, THEREFORE, in consideration of the mutual covenants contained in this Agreement, and for other good and valuable consideration the receipt and adequacy of which are hereby acknowledged, the parties hereby agree as follows:

1. Definitions. Unless otherwise stated in this Agreement defined terms shall have the meaning set forth in the Original Note.

2. Consent.

   a. The Investor hereby consents to the Company issuing the Additional Note and related agreements.

   b. The Investor hereby consents to the holder of the Additional Note having the same first priority security interest as the Investor in all of the Company's assets (as defined in Section 8 of the Original Note) on a pari passu basis with Investor.

   c. The Investor hereby further consents and agrees that at any time and from time to time the Investor will execute and deliver all further instruments and documents that the Company or the Additional Noteholder may request in order to perfect and protect the security interest granted to the Additional Noteholder or to enable the Additional Noteholder to exercise and enforce its rights and remedies with respect to the Collateral.

   d. It is the intent of the parties hereto that all recoveries with respect to the security interests granted under either Note (including as a result of any foreclosure of any Collateral) be for the ratable benefit (in proportion to the respective original principal amounts under the Notes (i.e., 48.87% to the Investor and 51.13% to the New Lender)) of both the Investor and the New Lender. Each party hereto shall take such

actions as may be reasonably requested by any other party hereto (including by transferring any excess recovery to the appropriate other party hereto) to carry out the intent of this Section 2(c).

e. The Company shall not take any action that disproportionately favors the Original Note over the Additional Note or disproportionately impacts adversely the Additional Note when compared with the Original Note, in each case, without the consent of the New Lender. The Company shall not take any action that disproportionately favors the Additional Note over the Original Note or disproportionately impacts adversely the Original Note when compared with the Additional Note, in each case, without the consent of the Investor.

f. The Original Note is hereby amended such that the Maturity Date thereunder shall be the maturity date of the Additional Note.

g. The Investor represents and warrants to the New Lender that, other than the indebtedness represented by the Original Note, there is no secured indebtedness owed by the Company or any of its subsidiaries to any of the Investor, Terren Peizer, or their respective affiliates or associated persons. The Investor hereby subordinates any such indebtedness (if any) to the indebtedness represented by the Original Note and the Additional Note such that no amount shall be payable with respect to any such indebtedness until such time as all amounts owed under the Original Note and the Additional Note have been irrevocably paid in full.

3. Amendment. No provision of this Agreement shall be waived, amended or modified except pursuant a written instrument executed by all parties hereto.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed by their respective authorized signatories as of the date first written above.

COMPANY:

CATASYS, INC.

By:_____
Susan Etzel, Chief Financial Officer

INVESTOR:

SOCIUS CAPITAL PARTNERS, LLC

By:_____
Terren Peizer, Managing Director

NEW LENDER:

DAVID E. SMITH

By:_____
David E. Smith

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed by their respective authorized signatories as of the date first written above.

COMPANY:

CATASYS, INC.

By:_____
Susan Etzel, Chief Financial Officer

INVESTOR:

SOCIUS CAPITAL PARTNERS, LLC

By:_____
Terren Peizer, Managing Director

NEW LENDER:

DAVID E. SMITH

By:_____
David E. Smith