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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

MANUALLY SIGNED

Form 10-K

WITH EXHIBITS

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

For the fiscal year ended May 31, 1989

Commission file no. ~~0-5751~~ 1-9927

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COMPREHENSIVE CARE CORPORATION
(Exact name of Registrant as specified in its charter)

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Delaware (State or other jurisdiction of incorporation or organization)	95-2594724 (I.R.S. Employer Identification No.)
18551 Von Karman Avenue Irvine, California (Address of principal executive offices)	92715 (Zip code)

Bechtel Information Services
Gaithersburg, Maryland

Registrant's telephone number, including area code (714) 851-2273

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, Par Value $.10 per share	New York Stock Exchange, Inc.
Common Share Purchase Rights	New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act:

7 1/2% Convertible Subordinated Debentures due 2010
(Title of Class)

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

Yes X No _

The aggregate market value of voting stock held by non-affiliates of the Registrant at August 7, 1989, was $81,616,846.

At August 7, 1989, the Registrant had 10,173,663 shares of Common Stock outstanding.

Documents Incorporated by Reference

Part III incorporates information by reference from the Registrant's definitive proxy statement for the Registrant's special meeting of stockholders to be held on September 13, 1989, which proxy statement has been filed.

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TOTAL NO. OF PAGES 323

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PART I

Item 1. BUSINESS.

The Registrant, Comprehensive Care Corporation, is a Delaware corporation which was organized in January 1969. The Registrant is primarily engaged in the development, marketing and management of programs for the treatment of chemical dependency, including alcohol and drugs, and psychiatric disorders. It is the largest private provider of hospital-based chemical dependency treatment programs in the United States. The programs are provided under contractual agreements with independent general hospitals or at freestanding facilities owned and/or operated by the Registrant. A wholly owned subsidiary, CareUnit, Inc., develops, markets and manages the Registrant's chemical dependency and psychiatric contract programs. During fiscal 1989, chemical dependency and psychiatric treatment programs accounted for approximately 85% of the Registrant's operating revenues. A wholly owned subsidiary of the Registrant, RehabCare Corporation ("RehabCare"), develops, markets and manages programs for the delivery of comprehensive medical rehabilitation services to functionally disabled persons. The following table sets forth for the five years ended May 31, 1989, the contribution to operating revenues of the Registrant's freestanding operations, CareUnit, Inc. contracts, RehabCare programs, and its other activities.

	Years Ended May 31,				
	1989	1988	1987	1986	1985
Freestanding operations..................	62%	58%	53%	56%	56%
CareUnit, Inc. contracts.................	21	28	35	38	40
RehabCare programs.......................	12	8	6	1	--
Other activities...........	5	6	6	5	4
	100%	100%	100%	100%	100%

REORGANIZATION

At a special meeting of stockholders of the Registrant to be held on September 13, 1989, the stockholders of the Registrant will act upon a proposal to adopt an Agreement and Plan of Reorganization, dated as of April 25, 1989, as amended (the "Reorganization Agreement"), by and among the Registrant, First Hospital Corporation, a Virginia corporation ("First Hospital"), and FHC-CompCare, Inc., a Delaware corporation formed for the purpose of effecting the transactions contemplated by the Reorganization Agreement ("FHC-CompCare"). The Reorganization Agreement contemplates the reorganization and consolidation (the "Reorganization") of the Registrant and First Hospital whereby FHC-CompCare will become the parent company of each of the Registrant and First Hospital.

If the Reorganization is approved and effected, each share of the Registrant's Common Stock outstanding immediately prior to the Reorganization (other than shares held by the Registrant or any of its subsidiaries and other than shares held by holders who have properly exercised their appraisal rights under Delaware law) will be converted into the right to receive $3.00 in cash, 0.78 of a share of Common Stock of FHC-CompCare and $2.75 principal amount of senior subordinated debentures of FHC-CompCare. In addition, each First Hospital Common Share will be converted into one and one-quarter shares of FHC-CompCare Common Stock.

The stockholders of the Registrant will receive in the aggregate approximately 7,935,457 shares of FHC-CompCare Common Stock, which represent approximately 39% of the voting power of the shares of FHC-CompCare Common Stock anticipated to be outstanding immediately after the Reorganization. The stockholders of First Hospital will receive in the aggregate approximately 12,631,474 shares of FHC-CompCare Common Stock, which represent approximately 61% of the voting power of the shares of FHC-CompCare Common Stock expected to be outstanding immediately after the Reorganization.

For a complete discussion of the proposed Reorganization, see the Registrant's definitive Proxy Statement for its special meeting of stockholders to be held on September 13, 1989, which Proxy Statement has been filed with the Securities and Exchange Commission.

FREESTANDING OPERATIONS

The Registrant currently operates or participates in the operation of 21 facilities representing 1,876 available beds. Since 1983, the Registrant has expanded its freestanding operations through the construction of eight freestanding chemical dependency facilities and the acquisition of six chemical dependency or psychiatric facilities, representing approximately 1,414 beds. In fiscal 1989, the Registrant sold a freestanding chemical dependency treatment facility, and a joint venture in which the Registrant participates sold a behavioral medicine facility. Freestanding facilities are either owned or leased by the Registrant or by joint ventures in which the Registrant and its partners share in the profits of losses. One psychiatric hospital (41 available beds) managed by the Registrant is owned or leased by such a joint venture, and one psychiatric hospital (100 available beds) is managed by the Registrant's partner in the joint venture. The Registrant has a 50% interest in this joint venture. In addition, one psychiatric hospital is owned by a joint venture between Behavioral Medical Care ("BMC") and Sutter Community Hospitals. BMC has a 49% interest in the joint venture. The Registrant has a 70% interest in BMC. For a discussion of current litigation involving BMC, see Item 3, "LEGAL PROCEEDINGS".

The following table sets forth selected operating data regarding the Registrant's freestanding facilities. Facilities are designated either psychiatric or chemical dependency based on the predominant treatment provided. For information concerning the nature of the Registrant's interest in the facilities, see Item 2, "PROPERTIES".

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	Year Acquired(1)	Licensed Beds	Patient Days 1989	1988	1987	1986	1985
Chemical Dependency Facilities							
CareUnit Hospital of Fort Worth......	1971	83	23,414	22,907	24,139	26,696	24,278
CareUnit Hospital of Orange..........	1976	104	29,579	32,652	29,697	33,763	33,677
CareUnit Hospital of Kirkland........	1981	[illegible]	17,136	19,574	18,640	24,336	27,099
CareUnit of Jacksonville Beach.......	1982	84	28,218	27,613	21,065	22,818	16,539
CareUnit Hospital of Cincinnati......	1982	128	30,778	29,446	25,955	29,065	29,181
CareUnit Hospital of St. Louis.......	1983	153	29,449	24,353	21,278	43,822	39,953
Starting Point, Oak Avenue...........	1983	136	28,345	27,048	21,593	22,705	21,136
Starting Point, Orange County........	1983	70	18,913	19,109	19,326	17,421	15,332
Starting Point, Grand Avenue.........	1983	25	7,694	6,834	7,249	7,264	6,158
CareUnit Hospital of Albuquerque.....	1984	70	15,543	17,187	16,730	16,080	9,597
CareUnit Hospital of Nevada..........	1984	50	13,626	13,738	11,615	8,748	7,640
CareUnit of Coral Springs............	1985	100	22,399	23,639	21,735	12,398	--
CareUnit of Grand Rapids.............	1985	76	15,212	13,483	8,595	3,386	--
CareUnit of Orlando..................	1987	100	18,115	15,844	106	--	--
CareUnit of San Diego................	1988	92	13,329	2,872	--	--	--
CareUnit of Colorado.................	1988	100	16,014	4,303	--	--	--
CareUnit of South Florida/Tampa......	1988	100	14,653	--	--	--	--
Psychiatric Facilities							
Brea Hospital Neuropsychiatric Center	1969	142	32,240	33,225	39,237	43,870	46,271
Crossroads Hospital..................	1972	41	10,942	12,281	14,148	13,657	14,503
Woodview-Calabasas Hospital..........	1970	117	15,513	19,143	22,473	23,104	25,531
Sutter Center for Psychiatry (2).....	1988	69	16,761	--	--	--	--
Closed/Sold Facilities (3)............			42,182	80,026	92,788	86,846	101,928
Patient days served during period......			459,955	445,277	416,369	435,979	418,823
Admissions............................			24,715	20,783	17,835	17,964	16,754
Available beds at end of period(4).....			1,876	2,067	1,927	1,687	1,609
Average occupancy rate for period(5)...			60%	61%	65%	73%	72%

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(1) Calendar year acquired or leased.

(2) Owned by a joint venture between BMC and Sutter Community Hospitals. BMC has a 49% interest in the joint venture. The Registrant has a 70% interest in BMC. For a discussion of current litigation involving BMC, see Item 3, "LEGAL PROCEEDINGS".

(3) In December 1988, Golden Valley Health Center, a 377-bed behavioral medicine facility in Minneapolis, Minnesota was sold to a group of investors led by facility management. The facility generated 31,249 patient days in fiscal 1989. In January 1989, a subsidiary of the Registrant sold CareUnit of DuPage, a 120-bed chemical dependency treatment facility in a suburb of Chicago, Illinois to Parkside Medical Services Corporation. The facility generated 10,833 patient days in fiscal 1989.

(4) A facility may have appropriate licensure for more beds than are in use for a number of reasons, including lack of demand, anticipation of future need, renovation and practical limitations in assigning patients to multiple-bed rooms. Available beds is defined as the number of beds which are available for use at any given time.

(5) Average occupancy rate is calculated by dividing total patient days by the number of available bed-days during the relevant period.

Freestanding Facility Programs

The Registrant's freestanding facilities offer a variety of behavioral medicine programs. The programs offered at a given freestanding facility are determined by the licensure of the facility, the extent and nature of competitive programs, the population base and demographics, and reimbursement considerations. A program within the facility represents a separately staffed unit dedicated to the treatment of individuals whose primary diagnosis suggests that their treatment needs will best be met within the unit. Patients whose diagnosis suggests the need for supplemental services are accommodated throughout their stay as the individual treatment plan developed for each patient requires.

Chemical Dependency. Chemical dependency programs are offered in all freestanding facilities except Woodview-Calabasas and Crossroads. These programs are delivered under the names CareUnit and Starting Point and include programs for adults and adolescents.

Each patient admitted to the facility is subject to a full medical and social history as well as a physical examination which includes those diagnostic studies ordered by the patient's attending physician. Patients are detoxified under close medical supervision for a period averaging four days prior to entry to the rehabilitation phase of treatment.

The rehabilitation phase of treatment begins as soon as detoxification is completed. This phase of treatment includes lectures; individual, family and group counseling sessions; and such medical, psychological, and other modalities that may be necessary to meet the individual patient's needs. The average length of stay for an adult patient is approximately 16 days, which includes detoxification. The average length of stay for an adolescent patient is approximately 29 days. After discharge from the facility, the patient's recovery is monitored for a 12-week period during which the patient and family members return to the facility once a week for outpatient counseling sessions. For individuals who do not require the structure and intensity of inpatient treatment, the Registrant has developed outpatient programs which generally operate in conjunction with existing inpatient programs. At May 31, 1989, 26 such outpatient programs were in operation.

Psychiatric. Psychiatric programs are offered in certain freestanding facilities. The type of program offered at a given freestanding facility is dependent upon the extent of community need, the competitive environment, and the licensure status of the facility. Admission to the programs offered by the Registrant is typically voluntary although certain facilities provide emergency psychiatric services and accept involuntary patients who are suffering an acute episodic psychiatric incident.

Each patient admitted to a psychiatric program undergoes a complete assessment including an initial evaluation by a psychiatrist, a medical history, physical examination, a laboratory work-up, a nursing assessment, a psychological evaluation, and social and family assessments. The assessments are utilized to develop an individualized treatment plan for each patient.

The treatment programs are undertaken by an inter-disciplinary team of professionals experienced in the treatment of psychiatric problems. The length of the treatment stay varies in accordance with the severity of the patient's condition. A comprehensive discharge plan is prepared for each patient which may include outpatient psychiatric or psychological treatment, or referral to an alternate treatment facility.

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Eating Disorders. The Registrant began providing eating disorders services in 1983. This program treats those individuals suffering from anorexia nervosa, bulimia and gross obesity. Each patient entering the program is subject to a physical examination and nutritional assessment. Additional diagnostic and psychiatric evaluations are undertaken when necessary. Each patient's treatment is directed by a physician experienced in the treatment of eating disorders. Eating disorders programs are offered by the Registrant only in certain freestanding facilities. Each facility offering said services is licensed as a psychiatric hospital. The eating disorders program includes: individual and group therapy, nutritional guidance and management of attendant medical or psychological problems.

Development of Freestanding Facilities

The Registrant presently has no active development projects with respect to freestanding facilities except for construction of a replacement of its psychiatric hospital in Brea, California. The development and operation of health care facilities is subject to compliance with various federal, state and local statutes and regulations. Health care facilities operated by the Registrant must comply with the licensing requirements of federal, state and local health agencies, with state mandated rate control initiatives and with the requirements of municipal building codes, health codes and local fire departments. State licensing of facilities is a prerequisite to participation in the Medicare and Medicaid programs.

Pursuant to the requirements of federal law, many states have enacted Certificate of Need ("CON") laws to curtail the proliferation of unnecessary health care services. Thus, prior to the construction of new facilities, the expansion of old facilities or the introduction of major new services in existing facilities, the Registrant must demonstrate to either state or local authorities, or both, that it is in compliance with the plan adopted by such agencies. The CON application process ordinarily takes from six to 18 months, and may in some instances take two years or more, depending upon the state involved and whether the application is contested by a competitor or the health agency. Certain states, including California and Texas, have enacted legislation repealing CON requirements for the construction of new health care facilities or the expansion of existing facilities. CON legislation is also being challenged as anti-competitive in certain states as it protects existing providers from new competition. The Registrant is unable to predict the outcome of these deliberations.

Factors to be considered in the development of freestanding facilities include population base and demographic characteristics, community pricing standards, state licensure and rate control issues, and CON requirements. During the past five years, the Registrant has focused its development efforts in states where the regulatory environment is relatively less restrictive so that the Registrant has been able to develop sub-acute facilities without obtaining a CON.

In general, sub-acute licensed facilities have lower operating costs than acute licensed facilities. State law governing the operation of health related facilities typically imposes a higher standard of construction, staffing and operating oversight on facilities licensed for acute treatment. The Registrant generally incurs the necessary construction cost to build its facilities to an acute psychiatric standard so that the facility may be converted to an alternative use if necessary. Although the sub-acute model facility has a lower level of operating cost, such facilities are not currently eligible for participation in the Medicare or Medicaid programs.

Sources of Revenues

During fiscal 1989, approximately 91% of the Registrant's operating revenues from freestanding operations were received from private sources (private health insurers or directly from patients) and the balance from Medicare, Medicaid and other governmental programs.

Private health insurers offer plans which typically include coverage for chemical dependency or psychiatric treatment. In some instances, the level of coverage for chemical dependency or psychiatric benefits is less than that provided for medical/surgical services. Lower coverage levels result in higher co-payments by the patient who is often unable to meet his or her commitment in its entirety or is unable to pay as rapidly as the insurance company. In freestanding facilities these factors tend to increase bad debts and days outstanding in receivables.

Private insurance plans vary significantly in their methods of payment, including: cost, cost plus, prospective rate, negotiated rate, percentage of charges, and billed charges. Blue Cross and other commercial insurance plans have adopted a number of payment mechanisms for the primary purpose of decreasing the amounts paid to hospitals (including the Registrant's) for services rendered. These mechanisms include various forms of utilization review, preferred provider arrangements where use of participating hospitals is encouraged in exchange for a discount, and payment limitations or negotiated rates which are based on community standards. The Registrant is unable to predict the impact of changing payment mechanisms in future years.

Health Maintenance Organizations ("HMOs") and Preferred Provider Organizations ("PPOs") attempt to control the cost of health care services by directing their enrollees to participating physicians and institutions. Aggressive utilization review and limitations on access to physician specialists are used to further limit the cost of service delivery. Such organizations have typically developed on a regional basis where an appropriate enrollee population and mix of participating physicians and institutions can be developed. To the extent that these organizations are successful in a given locale, the Registrant may be faced with a decreased population base (to the extent of the enrolled population) to support its programs. The Registrant believes participation in HMOs and PPOs is continuing to expand. The Registrant also believes that the development of these organizations has had a negative impact on utilization of its freestanding facilities in certain markets and is unable to predict the impact of future development of such organizations. In certain instances the Registrant has elected to participate with the HMO or PPO, in which case the Registrant may discount its charges for service.

Employers, union trusts and other major purchasers of health care services have become increasingly aggressive in pursuing cost containment. To the extent that the major purchasers are self-insured, they have begun actively to negotiate with hospitals, HMOs and PPOs for lower rates. Those major purchasers that are insured or use a third party administrator expect the insurer or administrator to control claims costs. In addition, many major purchasers of health care services are reconsidering the benefits that they provide and in many cases reducing the level of coverage, thereby shifting more of the burden to their employees or members. Such reductions in benefits have a negative impact on the Registrant's business.

The Medicare program provides hospitalization, physician, diagnostic and certain other services to eligible persons 65 years of age and over and others considered disabled. Providers of service are paid by the federal government in accordance with regulations promulgated by the United States Department of Health and Human Services ("HHS") and accept said payment, with nominal co-insurance amounts required of the service recipient, as payment in full.

Initially, Medicare provided for reimbursement of reasonable direct and indirect costs of the services furnished by hospitals to patients, plus a specified return on equity for proprietary hospitals. As a result of the Social Security Amendments Act of 1983, Congress adopted a prospective payment system ("PPS") to cover routine and ancillary operating costs of most Medicare inpatient hospital services. Under this system, the Secretary of HHS established fixed payment amounts per discharge based on diagnostic related groups ("DRG"). In general, a hospital's payment for Medicare inpatients is limited to the DRG rate and capital costs on the basis of reasonable cost, regardless of the amount of services provided to the patient or the length of the patient's hospital stay. Under PPS, a hospital may keep any difference between its prospective payment rate and its operating costs incurred in furnishing inpatient services, but is at risk for any operating costs that exceed its payment rate. Psychiatric hospitals, freestanding inpatient rehabilitation facilities and outpatient rehabilitation services are exempt from PPS. Inpatient psychiatric and rehabilitation units within acute care hospitals are eligible to obtain an exemption from PPS upon satisfaction of specified federal criteria. Qualified providers of alcohol and drug treatment services were excluded from PPS until October 1, 1987. Such providers are no longer eligible for exclusion from PPS effective with the beginning of their Medicare fiscal year on or after October 1, 1987 and are paid under PPS.

Exempt hospitals and exempt units within acute care hospitals are subject to limitations on the level of cost or the permissible increase in cost subject to reimbursement under the Medicare program, including those limitations imposed under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). No assurance can be given that psychiatric or rehabilitation services will continue to be eligible for exemption from PPS or that other regulatory or legislative changes will not adversely affect the Registrant's business.

Ten of the Registrant's facilities participate in the Medicare program. Of these, seven are currently excluded from PPS (TEFRA limits are applicable to these facilities). Medicare utilization at those facilities participating in the Medicare program averaged approximately 7% in fiscal 1989. The Registrant does not believe that the imposition of TEFRA limits or PPS have had a material adverse impact on its business at its freestanding facilities. Loss of exclusion at freestanding facilities would also not materially impact the Registrant's business.

Hospitals participating in the Medicare program are required to retain the services of a peer review organization ("PRO"). The PRO is responsible for determining the medical necessity, appropriateness and quality of care given Medicare program patients. In instances where the medical necessity of an admission or procedure is challenged by the PRO, payment may be delayed, reduced or denied in its entirety. Amounts denied because of medical review may not be charged to the service recipient, they are absorbed by the hospital. In non-emergency admissions (which encompass most of the Registrant's admissions) review is performed prior to the patient's arrival at the hospital. In the event that the PRO does not approve the admission, the patient is referred to an alternative treatment provider such as an outpatient program or sent home. The Registrant believes that the existence of PROs has had a negative impact on census growth in certain facilities but is unable to measure the magnitude because the primary impact is in lost admissions.

On October 1, 1987, CHAMPUS adopted a prospective payment system based on diagnosis related groups that is presently applicable to chemical dependency services rendered in certain settings. CHAMPUS is a program administered by the U.S. Department of Defense which provides hospital benefits to military retirees and dependents of active military duty personnel unable to obtain treatment in federal hospitals. On September 6, 1988, the Department of Defense issued a final rule adopting a per diem method of payment for mental health services rendered in certain settings under the CHAMPUS program. In addition, the Department of Defense has recently adopted a peer review system modeled after the Medicare peer review system and modified CHAMPUS regulations accordingly. Approximately 4% of the Registrant's total operating revenues in freestanding facilities was derived from the CHAMPUS program for the year ended May 31, 1989. Although not all of the changes made to the CHAMPUS program are presently applicable to certain facilities, there can be no assurance that these changes or similar changes in the future will not negatively impact the ability of the Registrant or its subsidiaries to render services profitably to CHAMPUS beneficiaries.

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The Medicaid program is a combined federal and state program providing coverage for low income persons. The specific services offered and reimbursement methods vary from state to state. Less than 2% of the Registrant's freestanding facility revenue is derived from the Medicaid program. Accordingly, changes in Medicaid program reimbursement are not expected to have a material adverse impact on the Registrant's business.

Competition and Promotion

The Registrant competes first for the development and implementation of freestanding facilities and subsequently for patients who utilize those facilities. With respect to both of these areas of competition, the Registrant's primary competitors are hospital management companies (both not-for-profit and investor owned) which offer programs similar to that of the Registrant. The Registrant has faced generally increasing competition in the last few years as a result of the increasing development of competitive programs. Some of the hospitals which compete with the Registrant are either owned or supported by governmental agencies or are owned by not-for-profit corporations supported by endowments and charitable contributions which enable some of these hospitals to provide a wider range of services regardless of cost-effectiveness.

The Registrant and its competitors compete to attract patients to utilize their programs. In many instances the patient may be directed to a specific facility by his or her employer (or their agent), by a physician, by a social services agency, or by another health care provider. The Registrant markets its services by attracting these referral sources to its programs. The primary competitive factors in attracting referral sources, patients and physicians are marketing, reputation, success record, cost and quality of care, and location and scope of services offered by a facility. The Registrant has an active promotional program, described below, and believes it is competitive in reputation and other factors necessary for patient attraction. In addition, the Registrant and its competitors compete to attract qualified physicians and psychiatrists.

The Registrant has an active public relations program designed to increase public awareness of the programs offered by the Registrant. During fiscal 1989, the Registrant spent approximately $8.2 million for all forms of advertising in support of its freestanding operations. Media advertising (television, radio and print) was approximately $7.5 million in fiscal 1989. The Registrant's advertising program includes a series of television commercials advertising the Registrant's programs. The forms of media used are specifically tailored to the geographic area in which the marketing efforts are directed. The Registrant is in the process of reducing its media advertising and redirecting its expenditures to other forms of promotion.

Other aspects of the Registrant's public awareness program include a nationwide telephone hot line which is staffed by counselors who provide referral advice and help on a 24-hour basis and a Crisis Intervention Program which assists relatives of chemically dependent or emotionally disturbed individuals in motivating a potential patient to seek professional help through an appropriate program.

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CONTRACT OPERATIONS

Behavioral Medicine

As a result of the reorganization of the Registrant's operations in fiscal 1988, CareUnit, Inc. is engaged in the development, marketing, and management of programs for the delivery of behavioral medicine services to patients requiring such services in dedicated units of hospitals. The programs offered are similar to the behavioral medicine programs offered in the Registrant's freestanding facilities.

In June 1983, the Registrant entered into a joint venture with an affiliate of Voluntary Hospital of America, Inc. ("VHA"), one of the largest associations of not-for-profit hospitals in the United States. The Registrant has a 70% interest in the joint venture which is called Behavioral Medical Care ("BMC"). BMC markets programs to the VHA network of hospitals. As a part of its internal reorganization, the Registrant assigned its interest in BMC to CareUnit, Inc. which manages the BMC joint venture. As of May 31, 1989, BMC was operating 38 contracts consisting of 900 beds. Unless otherwise specified, the following discussion and tables relating to CareUnit, Inc. include BMC contracts. See Item 3, "LEGAL PROCEEDINGS" for a discussion of current litigation involving BMC.

Under a contract, the hospital furnishes patients with all hospital facilities and services necessary for their generalized medical care, including, nursing, dietary, and housekeeping services. CareUnit, Inc. typically provides support in the areas of program implementation and management, staff recruiting, continuing education, treatment team training, community education, advertising, public relations, insurance, and on-going program quality assurance. CareUnit, Inc. is obligated to provide a multi-disciplinary team generally consisting of a physician (who serves as medical director for the program), a program manager, a social worker, a therapist and other appropriate supporting personnel. As a result of reimbursement changes and competitive pressures, the contractual obligations of CareUnit, Inc. have been subject to more intense evaluation during the past year. In general, some prospective client hospitals are expressing a desire for more control over the services provided by CareUnit, Inc. and in response CareUnit, Inc. is providing a more flexible approach to contract management.

In response to changes in reimbursement and competitive environment, CareUnit, Inc. began offering franchises to hospitals and related health care providers in December 1987. At present, franchises are offered for adult and adolescent chemical dependency and adult psychiatric programs. Under a CareUnit, Inc. franchise, the franchisee receives a license to use the CareUnit name, certain program and promotional materials, and training necessary to operate a program in exchange for initial and on-going fees. The franchisee provides and compensates all members of the treatment team and is responsible for all costs of operating the treatment program. CareUnit, Inc. also provides on-going operational, promotional, and quality assurance support. As of May 31, 1989, one franchise has been sold and is in operation.

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During fiscal 1989, CareUnit, Inc. suffered a loss in the number of contracts and beds in operation. The Registrant believes that the decline in the number of contracts and beds under contract is a result of increased competitive pressure and changes in reimbursement patterns, which have had the effect of making CareUnit, Inc.'s contracts less profitable to hospitals. In addition, CareUnit, Inc. has terminated certain marginally profitable contracts during the fiscal year. The following table sets forth selected operating data regarding behavioral medicine programs managed under contract:

	Years Ended May 31,				
	1989	1988	1987	1986	1985
Number of contracts at end of period (1):					
Adult CareUnits (2)	68	82	86	95	84
Adolescent CareUnits (2)	12	22	28	28	20
Adult CarePsychCenters (2)	17	21	20	22	17
Adolescent CarePsychCenters (2)	5	6	9	8	5
Eating disorders units	5	4	8	11	7
Total	107(3)	135	151	164	133
Available beds at end of period	2,640	3,446	3,860	3,981	3,145
Patient days served during period	615,862	769,255	845,853	803,255	697,509
Admissions	38,225	45,171	48,100	44,136	38,443
Average occupied beds per contract	14.0	14.2	14.5	15.1	15.8
Average occupancy rate for period (4)	57%	57%	58%	62%	66%

(1) Excludes contracts which have been executed but are not operational as of the end of the period.

(2) CareUnit is the service mark under which the Registrant markets chemical dependency treatment programs. CarePsychCenter is the service mark under which the Registrant markets psychiatric treatment programs.

(3) During the fiscal year ended May 31, 1989, CareUnit, Inc. opened 18 new contracts and closed 46 contracts. B'K opened seven and closed 19 of these contracts. Of the 46 closed contracts, 16 contracts were terminated by CareUnit, Inc. and 28 were terminated by the contracting hospitals. Two contracts were closed and the patients transferred upon opening of the Sutter Center for Psychiatry. CareUnit, Inc. has recently received termination notices from client hospitals with respect to two of its most profitable contract programs. Both of these programs have been closed. The Registrant believes that one of these contracts was terminated by the client hospital in breach of the agreement and intends to pursue vigorously its remedies under the agreement. These two contracts generated unit level profits of approximately $903,000 in the year ended May 31, 1989. Thirty-one of the hospitals with closed contracts have continued treatment programs, by either operating their own independent program or associating with another contract provider.

(4) Average occupancy rate is calculated by dividing total patient days by the number of available bed-days during the relevant period.

Sources of Revenues

Patients are admitted to a behavioral medicine program under the contracting hospital's standard admission policies and procedures. The hospital submits to the patient, the patient's insurance company, or other responsible party, a bill which covers the services of the hospital. The hospital pays CareUnit, Inc. a fixed monthly management fee plus a fee for each patient day of service provided. Fees paid by the hospital are subject to annual adjustments to reflect changes in the Consumer Price Index. CareUnit, Inc. and the hospital share the risk of non-payment by patients based on a predetermined percentage participation by CareUnit, Inc. in bad debts. CareUnit, Inc. may also participate with a contracting hospital in charity care and certain contractual allowances and discounts. Hospitals contracting for programs generally suffer from the same reimbursement pressures as the Registrant's freestanding facilities. In some instances, contracting hospitals have instituted admissions policies which restrict the ability of CareUnit, Inc. to promote utilization of the programs. Such policies have a negative impact on contract revenues.

Generally, management contracts are entered into for a period of two to five years and thereafter are automatically renewed for successive one year periods unless either party gives notice of termination at least 90 days prior to the end of such periods. Contracts are also terminable for material defaults. A significant number of contracts are terminable by either party on their anniversary dates.

Development, Competition and Promotion

CareUnit, Inc. directs its development activities toward increasing the number of management contracts with hospitals. The primary competitors of CareUnit, Inc. are hospitals and hospital management companies which offer programs similar to those offered by CareUnit, Inc.

The significant factors in a hospital's decision to utilize a contract manager include the degree of sophistication of hospital management, financial resources of the hospital, and perceived value of the services to be rendered under contract. Individual contract managers are selected based on experience, reputation for quality programs, availability of program support services and price. While a number of competing companies offer contract programs at prices lower than CareUnit, Inc., it believes that its experience, reputation, and program support are superior to that of its competitors. CareUnit, Inc. also believes that its experience with CON issues and program implementation often results in a reduced start-up period. Risk to the hospital is also reduced because the fees paid by the hospital to CareUnit, Inc. are primarily based on bed occupancy.

Programs managed by CareUnit, Inc. must meet minimum occupancy levels to be profitable for both the hospital and CareUnit, Inc. The program manager of each unit is responsible for local promotion of the unit. The program manager is responsible for identifying and contacting referral sources, instituting promotional campaigns, obtaining local media coverage relating to behavioral medicine problems and otherwise promoting the unit. The program manager is supported by media advertising including television, radio, and print. CareUnit, Inc. spent approximately $5.9 million on media advertising for the year ended May 31, 1989. Most of these expenditures were for the promotion of chemical dependency services rather than psychiatric services which are driven more by professional referrals. CareUnit, Inc. has recently reduced its level of advertising expenditures.

Comprehensive Medical Rehabilitation

RehabCare is currently engaged in the development, marketing and management of programs for the delivery of comprehensive medical rehabilitation services to functionally disabled persons in dedicated units of acute care hospitals. Comprehensive medical rehabilitation is a health treatment program offered to disabled or impaired persons with the objective of making such persons as functionally independent and self sufficient as possible. Rehabilitation programs are used to treat disabilities or impairments resulting from medical problems such as traumatic brain injuries, strokes, spinal cord injuries, severe fractures, back disorders, arthritis, neurological disorders and amputations. Rehabilitative care emphasizes the treatment of functional limitations and disability in order to maximize the patient's ability to function independently. Although the transition from acute to rehabilitative care is not always precisely demarcated, patients do not enter a rehabilitation program until they no longer require acute medical care.

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RehabCare's responsibility under its contracts is to provide a multi-disciplinary team generally consisting of a physician (who serves as the medical director for the rehabilitation program), a program manager, a psychologist, physical and occupational therapists, a speech pathologist, a social worker and other appropriate supporting personnel. In addition, RehabCare provides program implementation and management, treatment team training, staff recruiting, continuing education, insurance, community education, promotion, therapy equipment, public relations and on-going quality assurance.

When a patient is referred to one of RehabCare's programs, he or she undergoes an initial evaluation and assessment process by the entire treatment team that results in the development of a rehabilitation care plan designed specifically for the short- and long-term objectives of that patient up to the date of discharge. Depending upon the patient's disability, this evaluation process may involve the services of at least two disciplines, such as physical therapy and occupational therapy for an injury to an extremity, or of all of the disciplines, as in the case of a severe stroke patient. The following services are typically made available to patients in the rehabilitation programs:

- Inpatient rehabilitation nursing services
- Physical therapy services
- Speech/language pathology services
- Audiological services
- Orthotic/prosthetic services
- Nutritional counseling services
- Psychological services
- Social work services
- Respiratory therapy services
- Occupational therapy services

In addition, educational and psychological services are provided to the families of patients as part of the program.

As of May 31, 1989, RehabCare programs were offered solely in acute care hospitals and skilled nursing facilities under contract. RehabCare opened its first contract program in February 1984. The following table sets forth selected operating data regarding RehabCare programs:

	Years Ended May 31,				
	1989	1988	1987	1986	1985
Number of contracts at end of period (1).....	47(2)	33	21	15	8
Available beds at end of period.............	980	682	405	310	201
Patient days served during period............	170,385	109,940	73,027	33,036	5,680
Admissions..................................	6,907	3,932	2,426	1,394	292
Average occupied beds per contract..........	10.7	11.1	11.9	7.6	5.4
Average occupancy rate for period (3)........	52%	54%	59%	33%	27%

(1) Excludes contracts which have been executed but are not operational as of the end of the period. Three contracts had been executed but were not operational at May 31, 1989.

(2) During the fiscal year ended May 31, 1989, RehabCare opened 20 new contracts and closed six contracts. Of the six closed contracts, two were terminated by RehabCare, three were terminated by mutual agreement and one was terminated by the contracting hospital. Three of these hospitals have continued operating treatment programs, by either operating their own independent program or associating with another contract provider.

(3) Average occupancy rate is calculated by dividing total patient days by the number of available bed-days during the relevant period.

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Sources of Revenues

RehabCare's contracts are similar to those of CareUnit, Inc. RehabCare receives a fixed monthly management fee plus a fee for each patient day of service rendered. Fees paid to RehabCare are subject to annual adjustments to reflect changes in the Consumer Price Index. RehabCare also participates with its hospital clients in the risk of non-payment by patients by sharing in bad debts, contractual adjustments and charity allowances.

Generally, RehabCare's contracts are entered into for a three year period and thereafter are automatically renewed for successive one year periods unless either party gives notice of termination at least 90 days prior to the end of such periods. Contracts are also terminable for material defaults.

Development, Competition and Promotion

RehabCare's development efforts are directed toward increasing the number of management contracts. Site selection for such contract units emphasizes communities where there is a demonstrated need for inpatient rehabilitation programs in quality community hospitals located in moderate to high growth population areas; community pricing standards; and state licensure and CON requirements. RehabCare intends to expand the scope of its activities in the field of rehabilitation services beyond its standard contractual relationship for inpatient programs. RehabCare intends to explore joint venture opportunities in selected markets with its acute care hospital clients to acquire or develop freestanding inpatient and outpatient rehabilitation facilities.

RehabCare competes with other health care management companies for contracts and RehabCare's programs compete for patients with the programs of other hospitals and rehabilitation facilities. The success of RehabCare is dependent on its ability to establish relationships with sources of patient referrals. RehabCare believes that the principal competitive factors in each case are reputation for quality of programs, the effectiveness of program support services and price.

RehabCare believes that hospital discharge planners, physicians, other health care professionals, insurance claims adjusters and case managers representing various other payors are its principal sources of patient referral. Accordingly, RehabCare directs its marketing efforts toward these sources rather than directly to prospective patients. RehabCare relies principally upon aggressive local public relations and marketing activities conducted by its program managers followed by direct mail campaigns to deliver brochures, newsletters and other promotional materials to referral sources. RehabCare also maintains active community relations programs designed to increase local community awareness of the availability of RehabCare's rehabilitation programs.

OTHER ACTIVITIES

LONG TERM CARE. The Registrant leases and operates a 99-bed intermediate care facility. This facility provides nursing, rehabilitative and sustaining care over extended periods of time to persons who do not require the extensive care provided in a general hospital. For the fiscal year ended May 31, 1989, the intermediate care facility accounted for less than 1% of the Registrant's operating revenues.

PUBLISHING ACTIVITIES. Since 1976, the Registrant (under the name CompCare Publishers) has been engaged in the publication, distribution and sale of books, pamphlets and brochures relating to the Registrant's health care activities. The primary purpose of these activities is to support the Registrant's treatment, training and marketing programs. Literature distributed by the Registrant is

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sold to patients participating in a program both by contracting hospitals and facilities operated by the Registrant. Such literature is also sold to the general public and educational institutions. The Registrant does not own or operate the printing facilities used in the publication of its literature. Publishing activities accounted for approximately 2% of the Registrant's operating revenues in fiscal 1989.

SMOKING CESSATION. In fiscal 1985, the Registrant entered into a license agreement with SmokEnders, Inc. The license agreement granted the Registrant the right to operate smoking cessation seminars using the name and materials of SmokEnders, Inc. The license agreement, which has an eight year life, requires the Registrant to pay a royalty to SmokEnders, Inc. based upon revenues derived from operation of the seminars. In fiscal 1986, the Registrant determined that there had been a permanent impairment in the value of the license agreement. Accordingly, the unamortized balance of license consideration of $1.4 million was charged to earnings in fiscal 1986. Smoking cessation programs accounted for approximately 1% of the Registrant's operating revenues in fiscal 1989 and were marginally profitable.

WEIGHT CONTROL. In fiscal 1986, the Registrant purchased the assets of a weight loss center and subsequently began operation of a weight control program under the name CareFast. The weight control clinic business has not grown to the extent originally envisioned and there are no current plans to further expand this aspect of the business. In conjunction with the acquisition of the weight control clinic, the Registrant also acquired the rights to market and distribute a protein supplement which contains vitamins and minerals necessary to maintain the health of individuals during the course of a weight reduction program. The Registrant has expanded its marketing of the supplement. Sales of the supplement are directed toward organizations operating weight control programs and not to individual users. Weight control activities accounted for less than 1% of the Registrant's operating revenues in fiscal 1989.

GOVERNMENTAL REGULATION

The development and operation of health care facilities is subject to compliance with various federal, state and local statutes and regulations. Health care facilities operated by the Registrant as well as hospitals under contract with CareUnit, Inc. or RehabCare must comply with the licensing requirements of federal, state and local health agencies, with state mandated rate control initiatives and with the requirements of municipal building codes, health codes and local fire departments. State licensing of facilities is a prerequisite to participation in the Medicare and Medicaid programs.

The laws of various states in which the Registrant operates generally prevent corporations from engaging in the practice of medicine or other professions. Although the Registrant believes that its operations do not violate these prohibitions, recent legal precedents in this area are unclear and there can be no assurance that state authorities or courts will not determine that the Registrant is engaged in unauthorized professional practice. In the event of an unfavorable determination, the Registrant could be required to modify its method of operation or could be restrained from the continuation of certain of its operations, the result of which could be materially adverse to the Registrant.

Under Section 1128A of the Social Security Act, the Department of Health and Human Services has the authority to impose civil monetary penalties against any participant in the Medicare program that makes claims for payment for services which were not rendered as claimed or were rendered by a person or entity not properly licensed under state law or other false billing practices. Under this law the Secretary of the Department of Health and Human Services has the authority to impose a penalty of not more than $2,000 for each improperly claimed service and an assessment equal to not more than twice the amount claimed for each service not rendered.

Section 1128B of the Social Security Act makes it a felony for a hospital to make false statements relating to claims for payments under the Medicare program, to engage in certain remuneration arrangements with physicians and other health care providers relating to referrals or the purchase of services, or to make false statements relating to compliance with the Medicare conditions of participation. In addition, the making of false claims for payment by providers participating in the Medicare program is subject to criminal penalty under Federal laws relating generally to claims for payment made to the Federal government or any agency. Courts have construed broadly the provisions of Section 1128B concerning illegal remuneration arrangements and in so doing have created uncertainty as to the legality of numerous types of common business and financial relationships between health care providers and practitioners. Such relationships often are created to respond to competitive pressures. Proposed regulations identifying business practices that do not constitute illegal remuneration do not eliminate this uncertainty, and, if adopted in final form, may cause providers and practitioners alike to abandon certain mutually beneficial relationships.

Pursuant to the Medicare Catastrophic Coverage Act of 1988 the Inspector General of the Department of Health and Human Services studied and reported to Congress on physician ownership of hospitals, or compensation from any entity providing items or services to hospitals, to which the physician makes referrals and for which payment may be made under the Medicare program; the ranges of such arrangements and the means by which they are marketed to physicians; the potential of such ownership or compensation to influence the decisions of the physician; and the practical difficulties involved in enforcement actions against such ownership and compensation arrangements that violate current anti-kickback laws. In April 1989, the Inspector General issued a report on financial arrangements between physicians and health care businesses. The report contained a number of recommendations, including a prohibition of physician referrals to any facility in which the physician has a financial interest. In addition, legislation has been introduced in Congress to prohibit or restrict such physician referrals. Should such legislation be enacted, certain of the Registrant's relationships with physicians and the Registrant's development of relationships with physicians could be adversely affected.

The Registrant and CareUnit, Inc. are subject to federal and state regulation governing the sale and operation of franchises. These regulations include the Federal Trade Commission's "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" and similar regulations adopted by certain states. Generally, these regulations require disclosure of specific information to a prospective franchisee and prohibit certain sales and operating activities. In addition, some states require registration. The Registrant believes that its franchise related activities comply with these regulations, as applicable.

Insurance codes of certain states specify the extent of coverage required in group insurance contracts with respect to chemical dependency and psychiatric services. The impact of these requirements varies from state to state. To the extent that coverage for chemical dependency or psychiatric services is expanded, the Registrant's business is positively impacted. Such requirements have a negative impact when coverage is reduced or restricted. The Registrant is unable to measure the impact of insurance industry regulation on its business.

Both Medicare and Medicaid programs contain specific physical plant, safety, patient care and other requirements which must be satisfied by health care facilities in order to qualify under said programs. The Registrant believes that the facilities it owns or leases are in substantial compliance with the various Medicare and Medicaid regulatory requirements applicable to them.

ACCREDITATION

The Joint Commission on Accreditation of Healthcare Organizations ("JCAHO") is an independent commission which conducts voluntary accreditation programs with the goal of improving the quality of care provided in health care facilities. Generally, hospitals including dedicated units, long-term care facilities and certain other health care facilities may apply for JCAHO accreditation. If a hospital under contract with CareUnit, Inc. requests a JCAHO survey of its entire facility, the contract program, if a chemical dependency program, will be separately surveyed. After conducting on-site surveys, JCAHO awards accreditation for up to three years to facilities found to be in substantial compliance with JCAHO standards. Accredited facilities are periodically resurveyed. Loss of JCAHO accreditation could adversely affect the hospital's reputation and its ability to obtain third party reimbursement. The Registrant believes that all of its freestanding facilities and the hospitals under contract with CareUnit, Inc. have received or, in the case of new facilities, have applied for such accreditation.

RehabCare's programs are or will be reviewed by the Commission on Accreditation of Rehabilitation Facilities ("CARF"), an independent commission which surveys and accredits rehabilitation programs. RehabCare voluntarily seeks accreditation of each of its programs by CARF as soon as feasible (generally after two to three years of operation). As of May 31, 1989, three of RehabCare's programs had received CARF accreditation.

ADMINISTRATION AND EMPLOYEES

The Registrant's executive and administrative offices are located in Irvine, California, where management controls operations, business development, legal and accounting, medical insurance claims, governmental and statistical reporting, advertising and public relations, research and treatment program evaluation. The administrative offices of CareUnit, Inc., and RehabCare are presently located in Chesterfield, Missouri.

At July 31, 1989, the Registrant employed approximately 140 persons in its corporate and administrative offices, 2,970 persons in the freestanding and long-term health care facilities operated by it, 660 persons assigned to CareUnit, Inc., 530 persons assigned to RehabCare and 60 persons in other operations. The physicians and psychiatrists who are the medical directors of the Registrant's contract units, the psychologists serving on treatment teams, and the physicians utilizing the facilities operated by the Registrant are not employed by the Registrant.

The Registrant has not encountered any work stoppages due to labor disputes with its employees.

Item 2. PROPERTIES.

The following table sets forth certain information regarding the properties owned or leased by the Registrant at May 31, 1989:

Name and Location	Owned or Leased	Lease Expires (1)	Monthly Rental (2)
Chemical Dependency Treatment Facilities			
CareUnit Hospital.......................... Fort Worth, Texas	Owned (3)	--	--
CareUnit Hospital.......... . ... Orange, California	Owned (3)	--	--
CareUnit Hospital. .... Kirkland. Washington	Leased	2035	$15,300 (4)
CareUnit Facility.......................... Jacksonville Beach, Florida	Owned (3)	--	--
CareUnit Hospital.......................... Cincinnati, Ohio	Owned (3)	--	--
CareUnit Hospital.......................... St. Louis, Missouri	Owned	--	--
Starting Point, Oak Avenue................. Orangevale, California	Owned (3)	--	--

(Table continued on following page)

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Item 2. PROPERTIES (continued)

Name and Location	Owned or Leased	Lease Expires (1)	Monthly Rental (2)
Starting Point, Orange County.............. Costa Mesa, California	Owned (3)	--	--
Starting Point, Grand Avenue............... Sacramento, California	Owned (3)	--	--
CareUnit Hospital.......................... Albuquerque, New Mexico	Leased	2012	12,965
CareUnit Hospital.......................... Las Vegas, Nevada	Owned (3)	--	--
CareUnit Facility.......................... Coral Springs, Florida	Owned (3)	--	--
CareUnit Facility.......................... Grand Rapids, Michigan	Leased	1990	12,417
CareUnit Facility.......................... Orlando, Florida	Owned (3)	--	--
CareUnit Facility.......................... Aurora, Colorado	Owned (3)	--	--
CareUnit Facility.......................... San Diego, California	Owned (3)	--	--
CareUnit Facility.......................... Tampa, Florida	Owned	--	--
Psychiatric Treatment Facilities			
Brea Hospital Neuropsychiatric Center...... Brea, California	Owned	--	--
Crossroads Hospital(5)..................... Van Nuys, California	Leased	1997	5,577
Woodview-Calabasas Hospital (6)............ Calabasas, California	Leased	1996	21,401 (7)
Sutter Center for Psychiatry (8)........... Sacramento, California	Owned	--	--
Other Operating Facilities			
Tustin Manor............................... Tustin, California (Intermediate Care Facility)	Leased	1995	16,093 (7)
CompCare Publishers........................ Minneapolis, Minnesota	Leased	1990	7,347
Administrative Facilities			
Corporate Headquarters..................... Irvine, California	Owned (3)	--	--
Regional Headquarters...................... Chesterfield, Missouri	Leased	1994	15,948
Regional Headquarters (9).................. Tampa, Florida	Leased	1989	5,241

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(1) Assumes all options to renew will be exercised.

(2) All leases, other than those relating to the Registrant's administrative facilities, are triple net leases under which the Registrant bears all costs of operations, including insurance, taxes and utilities. The Registrant is responsible for specified increases in taxes, assessments and operating costs relating to its administrative facilities.

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(3) Subject to encumbrances. For information concerning the Registrant's long-term debt, see Note 7 to the Registrant's consolidated financial statements contained in this report.

(4) Subject to increase every three years based upon increases in the Consumer Price Index, not to exceed 10%.

(5) Leased by a joint venture and managed by the Registrant.

(6) Leased by the Registrant and managed by the Registrant's partner in a joint venture.

(7) Subject to increase every five years based upon increases in the Consumer Price Index.

(8) BMC owns a 49% interest in the property. Commenced operations on June 28, 1988.

(9) Closed in August 1989. The Registrant intends to sublease the office space.

Item 3. LEGAL PROCEEDINGS.

On July 6, 1989, VHA Behavioral Medical Care, Inc. ("VHA-BMC") the Registrant's joint venture partner in BMC and Parkside Medical Services Corporation ("Parkside") filed a lawsuit in the Superior Court, County of Orange, California, against the Registrant, CareUnit, Inc. and First Hospital seeking, among other things, the dissolution of the joint venture, the appointment of VHA-BMC to manage BMC during its dissolution, and compensatory and punitive damages of $4 million for alleged breaches of the joint venture agreement by CareUnit, Inc. The Registrant and First Hospital believe that the allegations in the lawsuit are unfounded and materially false and intend to vigorously defend the lawsuit. The Registrant has filed an answer to the lawsuit and intends to file a counterclaim against the plaintiffs for, among other things, trade libel, tortious interference with contractual relations, and compensatory and punitive damages. However, the parties are currently engaged in settlement negotiations. For fiscal 1989, BMC generated revenues of approximately $14.7 million and earnings before taxes on income of approximately $3.3 million, of which the Registrant's share is 70%. At May 31, 1989, BMC operated 38 contracts totalling 900 available beds. The dissolution of the joint venture would have a material adverse impact on the Registrant's financial condition and results of operations if the hospitals at which BMC has contract operations choose not to enter into new contractual relationships with CareUnit, Inc. The Registrant is unable to predict the ultimate impact on the Registrant of the dissolution of BMC or the impact of the lawsuit.

The Registrant is routinely engaged in the defense of lawsuits arising out of the ordinary course and conduct of its business and has insurance policies covering such potential insurable losses where such coverage is cost effective. Management believes that the outcome of such lawsuits will not have a material adverse impact on the Registrant's business.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

Inapplicable.

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PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

(a) The Registrant's Common Stock was traded on the over-the-counter market and quoted on the NASDAQ National Market System under the symbol CMPH until July 18, 1988 when trading commenced on the New York Stock Exchange under the symbol CMP. The following table sets forth the range of high and low bid prices for the Common Stock for the fiscal quarters indicated through July 17, 1988 and the high and low sale prices for the fiscal quarters indicated thereafter. Over-the-counter prices represent inter-dealer prices, without retail markup, markdown or commission and do not necessarily represent actual transactions.

Fiscal Year	Prices High	Prices Low
1989:		
First Quarter (through July 17, 1988)................	$12-1/4	$ 8-7/8
First Quarter (July 18, 1988, through August 31, 1988)	10-3/8	8-1/4
Second Quarter....................................	9-3/8	7-1/2
Third Quarter.....................................	12-5/8	7-7/8
Fourth Quarter....................................	13	9
1988:		
First Quarter.....................................	$15-5/8	$12-1/2
Second Quarter....................................	14-1/2	6-3/8
Third Quarter.....................................	9-1/4	5-1/2
Fourth Quarter....................................	9-3/4	8-3/8

(b) As of August 7, 1989, the Registrant had 2,348 stockholders of record.

(c) The Registrant paid $.10 per share cash dividends on a quarterly basis during the fiscal year ended May 31, 1988 and the first two quarters of fiscal 1989, or an aggregate of $.40 and $.20 per share for those periods. As a result of the Registrant's declining earnings and restrictions contained in the Registrant's loan agreements, no cash dividend was declared for either the third or fourth quarters of fiscal 1989. The Registrant does not expect to resume payment of cash dividends in the foreseeable future. See Item 7, "**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**" and Note 7 to the consolidated financial statements contained in this report for a description of restrictions on the payment of dividends contained in the Registrant's loan agreements.

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Item 6. SELECTED FINANCIAL DATA.

The following tables summarize selected consolidated financial data and should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this report. Prior year amounts have been reclassified to reflect the accounting for certain joint venture partnerships on the equity method instead of the proportionate consolidation method. The financial data presented herein is not necessarily indicative of the Registrant's future financial condition or results of operations. See Item 7, "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS" for a discussion of the proposed Reorganization, recent results of operations and liquidity.

	Years Ended May 31,				
	1989	1988	1987	1986	1985
	(Amounts in thousands, except per share data)				
Statement of Earnings Data					
Operating revenues	$209,911	$193,573	$173,245	$164,717	$128,665
Costs and expenses:					
Operating, general and administrative	190,484	165,126	144,635	134,571	99,518
Depreciation and amortization	8,694	7,757	6,527	5,032	3,399
Loss on write-down of assets	--	--	--	5,701	--
	199,178	172,883	151,162	145,304	102,917
Operating earnings	10,733	20,690	22,083	19,413	25,748
Net gain on sale/write-down of assets	1,363	--	--	--	--
Equity in earnings of unconsolidated joint ventures	25	2,137	4,340	5,518	5,770
Minority interest in earnings of joint ventures	(989)	(1,382)	(770)	(404)	(185)
Interest income (expense), net	(9,371)	(6,545)	(2,975)	892	3,548
Earnings before taxes on income	$ 1,761	$ 14,900	$ 22,678	$ 25,419	$ 34,881
Net earnings	$ 502	$ 8,970	$ 12,088	$ 13,102	$ 17,226
Earnings per common and common equivalent share:					
Primary and fully diluted	$ .05	$ .88	$ .90	$ .87	$ 1.13
Cash dividends per share	$ .20	$ .40	$ .36	$ .32	$ .30
Weighted average common and common equivalent shares outstanding	10,186	12,522	15,360	16,987	15,315

	May 31,				
	1989	1988	1987	1986	1985
	(Dollars in thousands)				
Balance Sheet Data					
Working capital	$ 36,916	$ 30,047	$ 34,730	$ 73,855	$ 86,698
Total assets	209,520	228,093	214,611	218,770	207,288
Long-term obligations	83,007	111,205	100,828	59,377	57,403
Stockholders' equity	79,194	81,470	85,369	132,180	123,745

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

The following table sets forth for the periods indicated (i) percentages which certain items reflected in the financial data bear to operating revenues, and (ii) the percentage change of such items as compared to the indicated prior period:

	Relationships to Operating Revenues Years Ended May 31,			Period-to-Period Change Years Ended	
	1989	1988	1987	1988-89	1987-88
Operating revenues	100.0%	100.0%	100.0%	8.4%	11.7%
Costs and expenses:					
Operating, general and administrative	90.7	85.3	83.5	15.4	14.2
Depreciation and amortization	4.1	4.0	3.8	12.1	18.8
Operating earnings	5.2	10.7	12.7	(48.1)	(6.3)
Net gain on sale/write-down of assets.	.6	--	--	100.0	--
Equity in earnings of unconsolidated joint ventures	--	1.1	2.5	(98.8)	(50.8)
Minority interest in earnings of joint ventures	.5	.7	.4	(28.4)	79.5
Interest expense, net	4.5	3.4	1.7	43.2	120.0
Earnings before taxes on income	.8	7.7	13.1	(88.2)	(34.3)
Taxes on income	.6	3.1	6.1	(78.8)	(44.0)
Net earnings	.2%	4.6%	7.0%	(94.4)%	(25.8)%

Results of Operations

The Registrant reported earnings of $502,000, or $.05 per share, for the fiscal year ended May 31, 1989, including a fourth quarter loss of $5.1 million, or $.50 per share. Results for the quarter were primarily impacted by poor utilization of the Registrant's freestanding facilities and behavioral medicine contracts, by costs of approximately $1.3 million associated with the Reorganization and by asset write-downs of approximately $2.4 million (pre-tax). The Registrant is incurring operating losses which are expected to continue until utilization of its freestanding facilities and behavioral medicine contracts improves. Utilization has continued to decline during the first quarter of fiscal 1990. Management attributes some of the decline in utilization to the emphasis on stricter admission policies at certain facilities and increased pressure by third-party payors on length of stay and reimbursement. Management also believes that community and employee uncertainty regarding the Reorganization further contributed to the decline. A transition team of both the Registrant and First Hospital officers has been formed to identify and address ongoing operational issues during the transition, and management believes that the transition team will assist in alleviating such anxiety with respect to the Reorganization. However the impact of the transition team has yet to be fully realized.

At a special meeting of stockholders of the Registrant to be held on September 13, 1989, the stockholders of the Registrant will act upon a proposal to adopt the Reorganization Agreement. The Reorganization Agreement contemplates the Reorganization of the Registrant and First Hospital whereby FHC-CompCare will become the parent company of each of the Registrant and First Hospital. If the proposed Reorganization is effected, the business and operations of the Registrant and First Hospital will be combined (so far as practicable and consistent with outstanding debt and other obligations of each of the Registrant and First Hospital) into a reorganized and consolidated business enterprise. For a complete discussion of the proposed Reorganization, see the Registrant's definitive Proxy Statement for the Registrant's special meeting of stockholders to be held on September 13, 1989, which has been filed with the Securities and Exchange Commission and is incorporated herein by this reference.

Fiscal 1989

Operating revenues increased approximately 8% over fiscal 1988. Overall utilization of the Registrant's freestanding facilities increased by 3% while utilization of behavioral medicine contracts declined by approximately 20%. Patient days of service rendered by RehabCare increased by approximately 55%. Utilization of the Registrant's freestanding facilities and behavioral medicine contracts was particularly disappointing during the fourth quarter of fiscal 1989. Management believes that the decline is partially attributable to its February 9, 1989 public announcement that the Registrant had engaged Prudential Bache Capital Funding as its financial advisor and formed a Special Committee to evaluate the Registrant's strategic financial alternatives and the subsequent announcement on April 26, 1989 of the Reorganization. Patient days of service rendered in mature freestanding facilities (excluding closed units) were comparable to those in fiscal 1988. Three new chemical dependency facilities and one new psychiatric facility, all opened since February 1988, accounted for approximately 54,000 patient days of service in fiscal 1989, leading to the overall increase in freestanding patient days of service.

Utilization of Brea Hospital Neuropsychiatric Center has declined substantially since an article was published in the Los Angeles Times on March 24, 1989, alleging poor patient care at the facility. Much of the information contained in the article had been taken from the complaints of two former Brea employees who have sued the Registrant for wrongful termination. The Registrant denies all allegations contained in the complaints. Management believes that the decline in utilization is probably partially attributable to the article but also believes that uncertainty regarding the ownership of the Registrant may have negatively affected Brea's referral sources. Historically, Brea has been the Registrant's most profitable facility. CareUnit Hospital of St. Louis incurred operating losses in fiscal 1989 and is expected to suffer significant operating losses in fiscal 1990.

Operating revenues from freestanding facilities increased by approximately 15% in fiscal 1989. Revenues from three new chemical dependency facilities opened since February 1988, net of the loss in revenues from closed facilities, accounted for approximately 40% of this increase. Rate increases and changes in payor mix accounted for the remainder. Revenues of freestanding facilities were adversely affected by continuing increases in deductions from revenues, which, as a percentage of gross revenues, increased by approximately 6% in fiscal 1989. Management expects that deductions from revenues, as a percentage of gross revenues, will continue to increase as a result of continuing pressure from third party payors. As a result of the factors above, the majority of the Registrant's freestanding facilities recorded lower profits in fiscal 1989 when compared to fiscal 1988.

In September 1988, the Registrant sold the property where it had previously operated CareUnit Hospital of Los Angeles and in December 1988, the Registrant sold CareUnit of DuPage, a 120-bed chemical dependency treatment facility located in a suburb of Chicago, Illinois. During fiscal 1989, CareUnit of DuPage generated 10,833 patient days of service, operating revenues of approximately $3.5 million and incurred a nominal loss. During fiscal 1988, CareUnit of DuPage generated 11,969 patient days of service, operating revenues of approximately $3.4 million, and incurred a loss of approximately $1.1 million. In addition, in December 1988, a joint venture in which the Registrant has a 50% interest sold Golden Valley Health Center, a 377-bed behavioral medicine facility located in a suburb of Minneapolis, Minnesota. Golden Valley Health Center generated 31,249 patient days of service in fiscal 1989 and the Registrant recorded its equity interest in the earnings on operations of Golden Valley Health Center in the amount of approximately $100,000. In fiscal 1988, Golden Valley Health Center generated 48,877 patient days of service and the Registrant recorded its equity interest in the earnings of Golden Valley Health Center in the amount of approximately $128,000.

During the fourth quarter of fiscal 1989, the Registrant recorded a write-down of approximately $2 million (pre-tax) to adjust the book value to the estimated amount realizable from the intended sale of its corporate headquarters building in Irvine, California and a write-down of approximately

$400,000 (pre-tax) of its book value to the estimated market value of its unimproved land in Miami, Florida, which it also presently intends to sell.

Behavioral medicine contract revenues decreased by approximately 17% as a result of the decrease in the number of patient days of service rendered in managed units. The number of units in operation and number of beds under contract also declined in fiscal 1989 by approximately 21% and 23%, respectively. Management believes that the decline in the number of contracts and beds under contract is a result of increased competitive pressure and changes in reimbursement, which have had the effect of making the Registrant's contracts less profitable to hospitals. The Registrant expects the number of contracts and the number of beds under contract will decrease further in fiscal 1990, and as a result contract earnings will continue to decline. On July 6, 1989, the Registrant's partner in the BMC joint venture and Parkside Medical Services Corporation filed suit against the Registrant, CareUnit, Inc. and First Hospital seeking, among other things, the dissolution of the joint venture, the appointment of VHA-BMC to manage the joint venture during its dissolution, and compensatory and punitive damages of $4 million for alleged breaches of the joint venture contract by CareUnit, Inc. The Registrant and First Hospital believe that the allegations in the lawsuit are unfounded and materially false and intend to vigorously defend the lawsuit. The Registrant has filed its answer to the complaint and intends to file a counterclaim against the plaintiffs for, among other things, trade libel, tortious interference with contractual relations, and compensatory and punitive damages. However, the parties are currently engaged in settlement negotiations. For fiscal 1989, BMC generated revenues of $14.7 million and earnings before taxes on income of approximately $3.3 million, of which the Registrant's share is 70%. At May 31, 1989, BMC operated 38 contracts totalling 900 available beds. The dissolution of the joint venture would have a material adverse impact on the Registrant's results of operations if the hospitals at which BMC has contract operations choose not to enter into new contractual relationships with CareUnit, Inc. The Registrant is unable to predict the ultimate impact of the dissolution of BMC or the impact of the lawsuit.

Revenues from RehabCare increased by approximately 50% as a result of an increase in the number of units in operation from 33 to 47 and an increase in the number of patient days of service of approximately 55%. Earnings from RehabCare increased significantly as a number of units opened in the past two years reached maturity. RehabCare units typically incur significant start-up losses during the first few months of operation principally as a result of low utilization.

Operating, general and administrative expenses increased approximately 15% in fiscal 1989. The opening of two new freestanding facilities in February 1988 and one in June 1988, the expansion of RehabCare's business and increased costs in mature freestanding facilities were the principal factors in the increase. During the fourth quarter of fiscal 1989, the Registrant recorded costs of approximately $1.3 million associated with the proposed Reorganization.

Depreciation and amortization increased by approximately 12% principally as a result of the opening of freestanding chemical dependency facilities. Interest expense increased by 43% principally as a result of an increase in the average outstanding indebtedness during the year and an increase in interest rates. Capitalized interest on construction projects, which offsets interest expense, decreased from approximately $1.2 million to $158,000 due to decreased construction activities. The Registrant's total borrowings were $96.4 million at May 31, 1989 compared to $110.8 million at May 31, 1988. During the year, the Registrant utilized the proceeds from the sale of certain freestanding facilities to reduce its outstanding indebtedness.

Operating earnings and earnings before taxes on income decreased by approximately $10.0 million and $13.1 million, respectively. The Registrant's effective tax rate increased from approximately 40% in fiscal 1988 to 71% in fiscal 1989 principally as a result of non-deductible costs associated with the Reorganization. In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes" ("SFAS 96"). This accounting standard significantly changes the methodology used to calculate and report income taxes for financial statement purposes. The Registrant is required to adopt SFAS 96 by no later than fiscal 1991, although earlier adoption is optional.

The Registrant expects to implement SFAS 96 in fiscal 1991. If the Registrant had adopted SFAS 96 in fiscal 1989, the impact would not have been material to its consolidated financial statements.

Fiscal 1988

Operating revenues increased approximately 12% over fiscal 1987. Overall utilization of the Registrant's freestanding facilities increased by approximately 7% while utilization of behavioral medicine contract units declined by 9%. Patient days of service rendered by RehabCare increased by approximately 51%.

Patient days of service rendered in mature freestanding facilities (excluding closed facilities) increased by approximately 5% in fiscal 1988 as a result of an increase in the number of admissions. The Registrant's freestanding psychiatric facilities suffered a decline in patient days of service rendered of approximately 13%. Two chemical dependency facilities were expanded during fiscal 1988 (CareUnit Hospital of Cincinnati and Starting Point, Oak Avenue) and each of these facilities recorded significantly higher census levels. Patient days of service rendered in facilities opened in fiscal 1988 and late fiscal 1987 contributed substantially to the overall 7% increase in freestanding facility census.

Operating revenues from freestanding facilities increased by approximately 20% in fiscal 1988. Approximately 35% of the increase is attributable to new freestanding units, 20% to improved census in mature units, and the balance to rate increases and changes in patient mix. Revenues of freestanding facilities were adversely affected by an increase in deductions from revenues, which, as a percentage of gross revenues, increased by approximately 2% in fiscal 1988. A majority of the Registrant's freestanding facilities achieved increased earnings in fiscal 1988 over the prior year.

The Registrant incurred significant losses in the operation and subsequent closure of two freestanding facilities. In July 1987, the Registrant closed CareUnit Hospital of Portland which had not been profitable since it opened in April 1986. In May 1988, the Registrant closed CareUnit Behavioral Center of Los Angeles, a 104-bed psychiatric and chemical dependency treatment facility, because it had sustained operating losses in each of the last two fiscal years and was in need of substantial renovation. The Registrant's losses on facilities closed during fiscal 1988 totalled approximately $2.4 million.

The performance of CareUnit Hospital of St. Louis improved gradually throughout fiscal 1988 and the facility posted a modest profit in the fourth quarter. CareUnit of DuPage operated at a loss in fiscal 1988.

Behavioral medicine contract revenues decreased by approximately 11% as a result of a decline in the number of patient days of service rendered in managed units. The number of units and number of beds under contract also declined in fiscal 1988 by 11%. Management believes that the decline in the number of contracts and beds under contract is a result of increased competitive pressure and changes in reimbursement, which have had the effect of making the Registrant's contracts less profitable to hospitals. As a result, the Registrant adopted a more flexible approach to contract development and shifted its focus from chemical dependency to psychiatric treatment programs. The Registrant also reorganized its internal structure to compete more effectively on price and service.

Revenues from RehabCare increased by approximately 61% as a result of an increase in the number of units in operation at year end from 21 to 33 and an increase in the number of patient days of service of approximately 51%. Earnings from RehabCare decreased substantially due to the start-up costs of the large number of units opened in fiscal 1988.

Operating, general and administrative expenses increased by approximately 14%. The opening of freestanding facilities and increase in the number of operating RehabCare units were the principal factors for the increase. Corporate overhead expenses increased slightly as a result of general inflationary pressures.

Depreciation and amortization increased approximately 19% or $1.2 million principally as a result of the opening of new freestanding facilities in fiscal 1987 and fiscal 1988.

Interest income declined from approximately $2.5 million in fiscal 1987 to $.7 million in fiscal 1988 as balances of cash on hand decreased. Interest expense increased by approximately 33% principally as a result of increased borrowings. Capitalized interest on construction projects, which offsets interest expense, increased from $.5 million to $1.2 million. The Registrant's total borrowings were $110.8 million at May 31, 1988 compared to $96.7 million at May 31, 1987.

Operating earnings and earnings before taxes on income declined by $1.4 million and $7.8 million, respectively.

The Registrant's effective tax rate declined from approximately 47% in fiscal 1987 to 40% in fiscal 1988, principally as a result of the changes in rates under the Tax Reform Act of 1986.

Liquidity and Capital Commitments

The Registrant's current ratio declined from approximately 1.9:1 at May 31, 1988 to 1.8:1 at May 31, 1989. The decline is principally due to the reclassification of certain indebtedness to current liabilities and operating losses incurred in the fourth quarter of fiscal 1989. The decline was partially offset by the reclassification of property and equipment held for sale at May 31, 1989. Accounts receivable days increased from 84 days outstanding at May 31, 1988 to 90 days outstanding at May 31, 1989. Management believes that the increase in days outstanding is a result of continuing slow down in payments by third party payors and does not expect days outstanding to improve significantly in the foreseeable future. The increase in days outstanding has had a negative impact on the Registrant's cash flow in fiscal 1989. The Registrant has committed approximately $12 million for replacement of the Brea facility and expects to incur approximately $4 million for improvements to other facilities.

At May 31, 1989, the Registrant had a term loan and two revolving loans outstanding with banks. The revolving loans provide for borrowings of $10 million and $5 million. Outstanding on the revolving loans at May 31, 1989 were $10 million and $3 million, respectively, and $10 million was outstanding on the term loan. The Registrant has reached agreements pursuant to which the banks have agreed to extend the Registrant's two revolving loans until, and have agreed to modify the term loan to become due upon, the earlier of (i) September 15, 1989, and (ii) the closing date of the Reorganization. In the event of the abandonment or termination of the Reorganization Agreement prior to September 15, 1989, the Registrant has agreed to repay all bank borrowings within 90 days thereof. The Registrant paid the banks $200,000 upon execution of the extension agreement and has agreed to pay a rate of interest of prime plus 1% on its bank borrowings. The Registrant has further agreed to collateralize the loans promptly in the event of, among other things, the abandonment or termination of the Reorganization Agreement.

The Registrant has negotiated a waiver of certain financial covenants related to the Registrant's $20 million of senior secured notes. Such waiver requires that the Registrant maintain consolidated current assets at an amount equal to 150% of consolidated current liabilities at all times prior to June 1, 1990. In addition, the Registrant must maintain for the fiscal quarters ending August 31, 1989, November 30, 1989, February 29, 1990, and May 31, 1990 ratios of total income available for fixed charges to total fixed charges for the twelve month periods greater than .42:1, (.124:1), (.229:1), and .254:1, respectively. Consolidated current assets, consolidated current liabilities, total income available for fixed charges, and total fixed charges are determined in accordance with the trust indenture related to such senior secured notes. On the granting of such waiver, the Registrant is required to pay an accommodation fee of $100,000 and the note holders have agreed to credit one-half of such fee against any prepayment premium required to be paid under the trust indenture. In addition, the Registrant has agreed to increase the interest rate on the senior secured notes for the period September 1, 1989 through May 31, 1990 to 11.4%. The waiver has been granted through June 1, 1990, accordingly the senior secured notes have been classified as long-term liabilities. If the Registrant defaults under the terms of the senior secured notes, substantially all of Registrant's debt, including its term and revolving bank loans and its industrial revenue bonds, could be accelerated, resulting in the banks' and the note and bond holders' ability to proceed against the Registrant's properties which secure such indebtedness. In addition, as long as the Registrant is in default under its senior indebtedness, the Registrant will be precluded from paying interest to the holders of its Convertible Subordinated Debentures. If such a payment default occurs and is not cured within the 30 day period provided in the trust indenture, the holders of the Convertible Subordinated Debentures may declare a default and the $46 million in principal amount of Debentures could also be accelerated.

In accordance with the terms of the Reorganization Agreement, the Registrant has executed an initial subordinated promissory note, pursuant to which First Hospital advanced the Registrant $5 million in June 1989. If First Hospital elects to extend the date by which the Effective Time (as defined in the Reorganization Agreement) must occur under the Reorganization Agreement, First Hospital has agreed to advance to the Registrant up to an additional $5 million under the terms of a second subordinated promissory note. The Registrant has agreed to use the proceeds of the notes only in the ordinary course of its business.

Subsequent to the filing of the lawsuit by VHA-BMC and Parkside relating to the BMC joint venture (see Item 3, "Legal Proceedings"), the Board of Directors of BMC has not approved any cash distributions. There can be no assurance that the Registrant will have available, if needed, its share of the undistributed cash balance in BMC of approximately $3.2 million at May 31, 1989.

If the Reorganization Agreement is terminated, the Registrant will be required to restructure its debt to avoid a short term liquidity problem. The Registrant will require approximately $25 million to repay its outstanding bank indebtedness which will come due on September 15, 1989, or 90 days after the termination of the Reorganization Agreement, if terminated prior to September 15, 1989. Approximately $24.4 million of other senior secured debt and industrial revenue bonds could also become due through acceleration if the Registrant's financial condition were to continue to decline. The Registrant will also need to fund the construction of its new facility in Brea and its working capital needs, which have increased as a result of operating losses. To obtain the funds necessary for its short term cash needs, the Registrant currently plans to make further borrowings, if available, and liquidate certain assets. Among the possible sources of available funds are a sale or pledge of certain accounts or notes receivable. The Registrant also plans to sell unimproved land it owns in Miami, Florida and shares of stock of a company in which the Registrant has an investment although it is unlikely that such sales could be accomplished in less than three to six months. In addition, the Registrant intended to sell its corporate headquarters building in Irvine, California, and utilize the sale proceeds to reduce the Registrant's outstanding bank indebtedness. However, the expected purchaser of this building has recently refused to complete escrow and the Registrant has not yet entered into any other sales agreement but still intends to do so. The Registrant has retained a firm to act as its agent to refinance its debt and obtain necessary working capital; however, it is anticipated to take at least six weeks to obtain financing commitments and four to six weeks thereafter to close any transaction. The Registrant expects that any financing which it is able to obtain would be at rates and on terms less favorable than it had been able to obtain in the past. In addition, the Registrant would recruit experienced senior executives to strengthen its

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management capabilities, and evaluate the retention or disposition of certain assets including RehabCare, certain of its freestanding facilities and its CareFast and SmokEnders operations. There can be no assurance that the Registrant will be able to obtain the necessary funds from the foregoing sources.

If the Reorganization is not completed, the continuation of the Registrant in its current form will be dependent upon its ability to arrange adequate financing and return to profitable operations. The Registrant expects to sustain losses through the third quarter of fiscal 1990, and return to profitability thereafter. However, the business of the Registrant is highly competitive and subject to substantial rate pressure by purchasers of health care services, accordingly there can be no assurance that the Registrant will achieve its goals.

The Registrant is currently undergoing a payroll tax audit by the Internal Revenue Service ("IRS") for calendar years 1983 and 1984. The IRS agent conducting the audit has verbally asserted that certain physicians and psychologists engaged as independent contractors by the Registrant should have been treated as employees for payroll tax purposes. The Registrant has not received an assessment related to this assertion. Management believes that its treatment of the independent contractors is consistent with IRS guidelines and established industry practice. Management intends to defend vigorously any claims made by the IRS related to this issue. Management is unable to predict the ultimate impact of the IRS audit.

Impact of Inflation

Although inflation has become a less significant factor in the nation's economy, to cope with its effect of increasing expenses, the Registrant regularly raises prices charged at its freestanding facilities. The Registrant's contracts provide for annual price increases to reflect increases in the Consumer Price Index. To date, these price increases have been adequate to offset the Registrant's increases in costs due to inflation.

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Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

Index to Consolidated Financial Statements

Years Ended May 31, 1989, 1988 and 1987

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Stockholders and Board of Directors
Comprehensive Care Corporation:

We have audited the accompanying consolidated balance sheets of Comprehensive Care Corporation and subsidiaries (the "Company") as of May 31, 1989 and 1988, and the related consolidated statements of earnings, stockholders' equity and cash flows for each of the years in the three-year period ended May 31, 1989. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Comprehensive Care Corporation and subsidiaries at May 31, 1989 and 1988, and the results of their operations and their cash flows for each of the years in the three-year period ended May 31, 1989, in conformity with generally accepted accounting principles.

As discussed in Note 14 to the financial statements, the Company is a defendant in a lawsuit filed by its partner in a joint venture. The complaint asks for, among other things, dissolution of the joint venture and compensatory and punitive damages. The Company has filed its answer to the complaint and intends to file a counterclaim. In addition, the Company is currently undergoing a payroll tax audit by the Internal Revenue Service for calendar years 1983 and 1984. The IRS agent conducting the audit has verbally asserted that certain physicians and psychologists engaged as independent contractors by the Company should have been treated as employees for payroll tax purposes. The ultimate outcome of these matters cannot presently be determined. Accordingly, no provision for any liability that may result upon resolution of these matters has been recognized in the accompanying financial statements.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 16 to the financial statements, the Company has a substantial portion of its debt due upon the earlier of September 15, 1989 or the closing date of a proposed reorganization, or 90 days after abandonment or termination of the reorganization agreement if terminated prior to September 15, 1989, and expects to incur negative cash flow from operations for fiscal 1990. The need for additional financing to repay debt as it comes due and finance the Company's anticipated negative cash flow from operations for fiscal 1990 raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regards to these matters are also described in Note 16. The financial statements do not include any adjustments relating to the recoverability and classification of reported asset amounts or the amounts and classification of liabilities that might result from the outcome of this uncertainty.

Peat Marwick Main & Co.

Orange County, California
August 28, 1989

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

ASSETS	May 31, 1989	May 31, 1988
	(Dollars in thousands)	
Current assets:		
Cash (partially restricted, see Note 14)	$ 7,641	$ 7,667
Accounts and notes receivable, less allowance for doubtful accounts of $16,355 and $14,416 (Note 4)	55,403	51,357
Prepaid and deferred income taxes (Note 8)	2,458	--
Property and equipment held for sale (Note 5)	12,969	--
Other current assets	5,766	6,431
Total current assets	84,237	65,465
Property and equipment, at cost (Notes 5, 7 and 9)	124,154	146,606
Less accumulated depreciation and amortization	(27,081)	(24,951)
Net property and equipment	97,073	121,655
Equity in unconsolidated joint ventures (Note 3)	5,586	14,984
Other assets:		
Intangible assets	7,569	7,426
Notes receivable	1,300	857
Investments	6,404	6,221
Deferred contract costs	2,846	2,721
Other	4,505	8,764
Total other assets	22,624	25,989
	$209,520	$228,093

LIABILITIES AND STOCKHOLDERS' EQUITY

	1989	1988
Current liabilities:		
Accounts payable and accrued liabilities (Note 6)	$ 23,132	$ 20,434
Notes payable (Note 7)	23,047	6,000
Long-term debt payable within one year (Note 7)	1,140	2,401
Deferred income taxes (Note 8)	--	4,424
Income taxes payable (Note 8)	--	2,159
Total current liabilities	47,319	35,418
Long-term debt due after one year (Note 7)	72,232	102,408
Other liabilities (Note 10)	6,314	5,547
Deferred income taxes (Note 8)	1,122	--
Minority interest in joint venture (Note 14)	3,339	3,250
Commitments and contingencies (Notes 9, 14 and 16)		
Stockholders' equity (Notes 7, 11 and 12):		
Common stock, $.10 par value; authorized 30,000,000 shares; issued 15,213,467 and 15,182,295 shares	1,521	1,518
Additional paid-in capital	76,135	75,885
Retained earnings	64,374	66,903
Less treasury stock; at cost, 5,080,000 shares	(62,836)	(62,836)
Total stockholders' equity	79,194	81,470
	$209,520	$228,093

See notes to consolidated financial statements.

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

	Years Ended May 31,		
	1989	1988	1987
	(Dollars in thousands, except per share amounts)		
Operating revenues (Note 4)	$209,911	$193,573	$173,245
Costs and expenses:			
Operating	128,352	117,089	102,166
General and administrative	62,132	48,037	42,469
Depreciation and amortization	8,694	7,757	6,527
	199,178	172,883	151,162
Operating earnings	10,733	20,690	22,083
Net gain on sale/write-down of assets (Notes 5 and 13)	1,363	--	--
Equity in earnings of unconsolidated joint ventures (Notes 3 and 13)	25	2,137	4,340
Minority interest in earnings of joint ventures (Note 14)	(989)	(1,382)	(770)
Interest income	747	657	2,458
Interest expense	(10,118)	(7,202)	(5,433)
Earnings before taxes on income	1,761	14,900	22,678
Taxes on income (Note 8)	1,259	5,930	10,590
Net earnings	$ 502	$ 8,970	$ 12,088
Earnings per common and common equivalent share (Note 1):			
Primary and fully diluted	$ .05	$ .88	$ .90
Dividends per common share	$ .20	$ .40	$ .36

See notes to consolidated financial statements.

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional Paid-In Capital	Retained Earnings	Treasury Stock		Total Stockholders' Equity
	Shares	Amount			Shares	Amount	
	(Amounts in thousands)						
Balances, May 31, 1986	15,179	$1,518	$75,830	$54,832	--	$ --	$132,180
Net earnings	--	--	--	12,088	--	--	12,088
Exercise of stock options (Note 11)	3	--	55	--	--	--	55
Cash dividends	--	--	--	(4,730)	--	--	(4,730)
Purchase of treasury stock (Note 12)	--	--	--	--	(4,080)	(54,224)	(54,224)
Balances, May 31, 1987	15,182	1,518	75,885	62,190	(4,080)	(54,224)	85,369
Net earnings	--	--	--	8,970	--	--	8,970
Cash dividends	--	--	--	(4,257)	--	--	(4,257)
Purchase of treasury stock (Note 12)	--	--	--	--	(1,000)	(8,612)	(8,612)
Balances, May 31, 1988	15,182	1,518	75,885	66,903	(5,080)	(62,836)	81,470
Net earnings	--	--	--	502	--	--	502
Exercise of stock options (Note 11)	31	3	250	--	--	--	253
Cash dividends	--	--	--	(3,031)	--	--	(3,031)
Balances, May 31, 1989	15,213	$1,521	$76,135	$64,374	(5,080)	$(62,836)	$ 79,194

See notes to consolidated financial statements.

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended May 31,		
	1989	1988	1987
	(Dollars in thousands)		
Cash flows from operating activities:			
Cash received from services rendered	$207,767	$189,462	$172,542
Cash paid to suppliers and employees	(191,543)	(165,766)	(139,841)
Interest received	643	682	2,010
Interest paid	(9,658)	(7,756)	(5,482)
Income taxes paid	(9,259)	(4,053)	(10,473)
Other, net	(543)	(31)	32
	(2,593)	12,538	18,788
Cash flows from investing activities:			
Proceeds from sales of assets	23,661	256	65
Capital expenditures	(5,351)	(18,017)	(38,449)
Sale of annuity and insurance policies	3,706	3,521	--
Proceeds from notes receivable	808	1,668	7,921
Long term loans made	(953)	(371)	(339)
Distribution from joint ventures	1,100	2,800	3,925
Other, net	(3,235)	(4,009)	(5,068)
	19,736	(14,152)	(31,945)
Cash flows from financing activities:			
Bank and other borrowings	27,000	20,000	41,000
Dividends paid	(3,031)	(4,257)	(4,730)
Purchase of treasury stock	--	(8,612)	(54,224)
Repayment of debt	(41,280)	(5,842)	(962)
Principal payments under lease obligations	(111)	(95)	(119)
Other, net	253	--	50
	(17,169)	1,194	(18,985)
Net decrease in cash and cash equivalents	(26)	(420)	(32,142)
Cash and cash equivalents, beginning of year	7,667	8,087	40,229
Cash and cash equivalents, end of year	$ 7,641	$ 7,667	$ 8,087

(Continued)

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

	Years Ended May 31,		
	1989	1988	1987
	(Dollars in thousands)		
Reconciliation of net earnings to net cash provided (used) by operating activities:			
Net earnings	$ 502	$ 8,970	$12,088
Adjustments for items not requiring (providing) cash:			
Depreciation and amortization	8,694	7,757	6,527
Net gain on sale/write-down of assets	(1,363)	--	--
Undistributed earnings in unconsolidated joint ventures	(25)	(2,137)	(4,340)
Minority interest in earnings of joint ventures	989	1,382	770
Change in accounts receivable	(4,317)	(6,259)	(1,550)
Change in income taxes	(10,163)	1,701	(1,159)
Change in other assets	665	1,155	(675)
Change in accounts payable and accrued liabilities	2,698	852	2,487
Other changes	(273)	(883)	4,640
Total adjustments	(3,095)	3,568	6,700
Net cash provided (used) by operating activities	$(2,593)	$12,538	$18,788

See notes to consolidated financial statements.

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

May 31, 1989, 1988 and 1987

Note 1--Summary of Significant Accounting Policies

The consolidated financial statements include the accounts of Comprehensive Care Corporation (the "Registrant"), its subsidiaries, and its 70% owned joint venture partnership, Behavioral Medical Care ("BMC"). All intercompany accounts and transactions have been eliminated in consolidation. In fiscal 1989, the Registrant adopted the equity method of accounting for its 50% owned joint venture partnerships. In prior years the Registrant had used the proportionate consolidation method for these joint ventures. Certain reclassifications of prior year amounts have been made to conform with current year classifications.

The Registrant's financial statements are presented on the basis that it is a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The continuation of the Registrant's business is dependent upon either the completion of a reorganization whereby the Registrant will be reorganizing and consolidating with First Hospital Corporation ("First Hospital"), (see Note 2, "Proposed Reorganization") or resolution of short term operating and liquidity problems (see Note 16, "Operating Losses and Liquidity Concerns"). The Registrant is also a defendant in a lawsuit filed by its partner in a joint venture. An adverse result with respect to the lawsuit could have a material adverse impact on the Registrant's financial condition and results of operations. See Note 14, "Litigation and Contingencies", for a description of the lawsuit and other contingencies which may have an adverse impact on the Registrant.

Revenue Recognition

Approximately 91% of the Registrant's operating revenues are received from private sources; the remainder from Medicare, Medicaid and other governmental programs. The latter are programs which provide for payments at rates generally less than the established billing rates. Payments are subject to audit by intermediaries administering these programs. Revenues from these programs are recorded under reimbursement principles applicable under the circumstances. Although management believes estimated provisions currently recorded properly reflect these revenues, any differences between final settlement and these estimated provisions are reflected in operating revenues in the year finalized.

Property and Equipment

Depreciation and amortization of property and equipment are computed on the straight-line method over the estimated useful lives of the related assets, principally: buildings and improvements -- 5 to 40 years; furniture and equipment -- 3 to 12 years; leasehold improvements -- life of lease or life of asset, whichever is less.

Intangible Assets

Intangible assets include costs in excess of fair value of net assets of businesses purchased (goodwill), licenses, and similar rights. Costs in excess of net assets purchased are amortized over 25 to 40 years. The costs of other intangible assets are amortized over the period of benefit. The amounts on the consolidated balance sheets are net of accumulated amortization of $2,646,000 and $2,224,000 at May 31, 1989 and 1988, respectively.

Capitalized Interest

Interest incurred during the construction of freestanding facilities is capitalized and subsequently charged to depreciation expense over the life of the related asset. The interest rate utilized is either the rate of the specific borrowing associated with the project or the Registrant's

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

May 31, 1989, 1988 and 1987

Note 1-- Summary of Significant Accounting Policies (continued)

average interest rate on borrowings where there is no specific borrowing associated with the project. The amount of interest capitalized was $158,000, $1,202,000 and $474,000 in fiscal 1989, 1988 and 1987, respectively.

Deferred Contract Costs

The Registrant has entered into a limited number of contracts with independent general hospitals whereby it will provide services over a period in excess of the standard agreement. In recognition of the hospital's long-term commitment, the Registrant has paid certain amounts to them. These amounts may be used by the hospital for capital improvements or as otherwise determined by the hospital. The Registrant is entitled to a pro rata refund in the event that the hospital terminates the contract before its scheduled termination date; accordingly, these amounts are charged to expense over the life of the contract.

Statements of Cash Flows

In November 1987, the Financial Accounting Standards Board issued Statement No. 95 requiring a statement of cash flows in place of a statement of changes in financial position. The Registrant has adopted the statement for its 1989 financial statements and has replaced the 1988 and 1987 consolidated statements of changes in financial position with consolidated statements of cash flows.

Cash and Cash Equivalents

Cash in excess of daily requirements is invested in short term investments with maturities of three months or less. Such investments are deemed to be cash equivalents for purposes of the consolidated statements of cash flows. Included in cash are short-term investments of $4,200,000 and $1,549,000 at May 31, 1989 and 1988, respectively.

Income Taxes

Deferred income taxes are recognized for differences in the recognition of revenues and expense items that are reported in different years for financial reporting purposes and income tax purposes using the tax rate applicable to the year of calculation. Under the deferred method, deferred taxes are not adjusted for subsequent changes in tax rates.

In December 1987, the Financial Accounting Standards Board issued Statement No. 96, "Accounting for Income Taxes" ("SFAS 96"). This statement requires the use of the asset and liability method, whereby deferred income taxes are recognized for the tax consequences of "temporary differences" by applying the enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Under SFAS 96, the effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. SFAS 96 may be implemented prospectively or retroactively. The Financial Accounting Standards Board has delayed the required implementation of SFAS 96 until not earlier than fiscal 1991 to consider additional comments with respect to the standard.

The Registrant expects to implement SFAS 96 in fiscal 1991. If the Registrant had adopted SFAS 96 in fiscal 1989, the impact would not have been material to its consolidated financial statements.

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Note 1--Summary of Significant Accounting Policies (continued)

Investment tax credits are accounted for under the "flow through" method.

Earnings Per Share

Primary and fully diluted earnings per common and common equivalent share have been computed by dividing net earnings, after giving effect to the elimination of interest expense applicable to the convertible debentures less income tax effect, by the weighted average number of common and common equivalent shares outstanding during the period. The convertible debentures issued in April 1985 are considered to be common stock equivalents from the time of issuance. The weighted average of the number of shares issuable on conversion of the convertible debentures and exercise of stock options was added to the weighted average number of common shares outstanding. During fiscal 1989, the convertible debentures had an anti-dilutive impact on earnings per share and accordingly were excluded from the computation.

The weighted average number of shares used to calculate earnings per share was 10,186,000, 12,522,000 and 15,360,000 in 1989, 1988 and 1987, respectively.

Note 2--Proposed Reorganization

At a special meeting of stockholders of the Registrant to be held on September 13, 1989, the stockholders of the Registrant will act upon a proposal to adopt a proposed reorganization (the "Reorganization Agreement"). The Reorganization Agreement contemplates the reorganization of the Registrant and First Hospital whereby FHC-CompCare will become the parent company of each of the Registrant and First Hospital. If the proposed Reorganization is effected, the business and operations of the Registrant and First Hospital will be combined (so far as practicable and consistent with outstanding debt and other obligations of each of the Registrant and First Hospital) into a reorganized and consolidated business enterprise. In exchange for each share of the Registrant's common stock, each stockholder will receive $3.00 cash, $2.75 merger debentures and 0.78 shares of FHC-CompCare common stock. The Registrant's stockholders will own 39% of the stock of FHC-CompCare.

In accordance with the terms of the Reorganization Agreement, the Registrant has executed an inital subordinated promissory note, pursuant to which First Hospital advanced the Registrant $5 million in June 1989. If First Hospital elects to extend the date by which the Effective Time (as defined in the Reorganization Agreement) must occur under the Reorganization Agreement, First Hospital has agreed to advance to the Registrant up to an additional $5 million under the terms of a second subordinated promissory note. The Registrant has agreed to use the proceeds of these notes only in the ordinary course of its business.

Note 3--Joint Venture Partnerships

In 1972, the Registrant entered into a joint venture partnership with another corporation for the purpose of operating two hospitals. Under the terms of the joint venture agreement, the Registrant manages one of the hospitals and its partner manages the other. Each of the partners in the joint venture receives a management fee for the hospital it manages. The Registrant has a 50% interest in the joint venture.

In 1984, the Registrant entered into a joint venture agreement with a subsidiary of HealthOne Corp. (formerly The Health Central System). The joint venture owned and operated Golden Valley Health Center, a behavioral medicine hospital located in a suburb of Minneapolis, Minnesota which was sold in fiscal 1989. The Registrant serves as managing partner of the joint venture for which it earns a fee based on profitability. The Registrant has a 50% interest in the joint venture.

Note 3--Joint Venture Partnerships (continued)

The Registrant reports its interest in these joint ventures on the equity method. The combined assets and liabilities of these joint ventures are set forth in the following table:

	May 31, 1989	May 31, 1988
	(Dollars in thousands)	
Assets		
Current assets	$ 7,240	$13,092
Property and equipment, net	2,734	20,366
Other assets	2,506	110
	$12,480	$33,568
Liabilities and partners' equity		
Total liabilities	$ 1,308	$ 3,600
Partners' equity	11,172	29,968
	$12,480	$33,568

Combined operating results of these joint venture partnerships are as follows:

	Years Ended May 31, 1989	1988	1987
	(Dollars in thousands)		
Revenues	$26,776	$35,622	$38,374
Costs and expenses:			
Operating, general and administrative	25,738	30,052	28,524
Depreciation and amortization	988	1,296	1,170
	26,726	31,348	29,694
Earnings before taxes on income	$ 50	$ 4,274	$ 8,680

Note 4--Accounts and Notes Receivable

Accounts and notes receivable include current notes receivable of $291,000 and $572,000 at May 31, 1989 and 1988, respectively.

The following table summarizes changes in the Registrant's allowance for doubtful accounts for the fiscal years ended May 31, 1989, 1988 and 1987:

	Balance at Beginning of Period	Additions: Charged to Revenues	Additions: Recoveries	Deductions: Write-off of Accounts	Balance at End of Period
	(Dollars in thousands)				
Year ended May 31, 1989	$14,416	$37,627	$3,620	$39,308	$16,355
Year ended May 31, 1988	9,842	22,701	3,802	21,929	14,416
Year ended May 31, 1987	6,931	15,918	3,652	16,659	9,842

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Note 5--Property and Equipment

Property and equipment consists of the following:

	May 31, 1989	May 31, 1988
	(Dollars in thousands)	
Land and improvements	$ 14,841	$ 24,071
Buildings and improvements	82,435	95,187
Furniture and equipment	22,409	24,470
Leasehold improvements	1,765	174
Capitalized leases	2,704	2,704
	$124,154	$146,606

The Registrant intends to sell its corporate headquarters building in Irvine, California and certain unimproved land in Miami, Florida. As a result, an aggregate loss of approximately $2.4 million was recorded to reflect the properties at their estimated net realizable value of approximately $13 million, which amount has been reclassified to property and equipment held for sale at May 31, 1989.

Note 6--Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities consist of the following:

	May 31, 1989	May 31, 1988
	(Dollars in thousands)	
Accounts payable and accrued liabilities	$14,665	$14,263
Accrued salaries and wages	3,589	1,922
Accrued vacation	3,461	3,154
Payable to third party intermediaries	1,417	1,095
	$23,132	$20,434

Note 7--Notes Payable and Long-Term Debt

Notes payable and long-term debt consists of the following:

	May 31, 1989	May 31, 1988
	(Dollars in thousands)	
7-1/2% convertible subordinated debentures due 2010 (a)	$46,000	$46,000
Term loan, converted from a revolving loan during fiscal 1988, maturing in 1989 (b)	10,047	50,000
Line of credit, bearing interest at variable rates (b)	13,000	6,000
7% to 10% notes, payable in monthly installments with maturity dates through 1995; collateralized by real and personal property having a net book value of $5,968	953	1,565
Note payable bearing interest at 65% of prime, payable monthly, maturing in 1994; collateralized by real property having a net book value of $2,390	1,202	1,364

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Note 7-- Notes Payable and Long-Term Debt (continued)

	May 31, 1989	May 31, 1988
	(Dollars in thousands)	
Senior secured notes bearing interest at 10.5%, payable semi-annually, maturing in 1995, collateralized by real and personal property having a net book value of $23,087 (c)	$20,000	$ --
Note payable bearing interest at 88% of prime, payable quarterly, maturing in 1995; collateralized by real and personal property having a net book value of $6,209 (d)	3,375	3,875
Capital lease obligations (Note 9)	1,583	1,684
Other	259	321
	96,419	110,809
Less current notes payable	23,047	6,000
Less long-term debt due within one year	1,140	2,401
	$72,232	$102,408

As of May 31, 1989, the annual maturities of notes payable and long-term debt for the next five years amounted to $24,187 in 1990, $5,142 in 1991, $4,977 in 1992, $5,047 in 1993, and $5,057 in 1994.

The maximum amount outstanding of short-term borrowings from banks was $13 million and $6 million during the years ended May 31, 1989 and 1988, respectively. The average amount outstanding of such borrowings, based upon an average of month end balances for periods when the Registrant had such debt outstanding, was $11.6 million and $[illegible] million during the years ended May 31, 1989 and 1988, respectively. The weighted average interest rate, based upon a weighted average of monthly amounts, was 11% and 9% during the years ended May 31, 1989 and 1988, respectively. There were no short-term bank borrowings during the year ended May 31, 1987.

(a) In April 1985, the Registrant issued $46 million in convertible subordinated debentures. These debentures require that the Registrant make semi-annual interest payments in April and October at an interest rate of 7-1/2%. The debentures are due in 2010 but may be converted to Common Stock of the Registrant at the option of the holder at a conversion price of $25.97 per share, subject to adjustment in certain events. The debentures are also redeemable, at the option of the Registrant, in certain circumstances. Mandatory annual sinking fund payments sufficient to retire 5% of the aggregate principal amount of the debentures are required to be made on each April 15 commencing in April 1996 to and including April 15, 2009.

(b) At May 31, 1989, the Registrant had a term loan and two revolving loans outstanding with banks. The revolving loans provide for borrowings of $10 million and $5 million. Outstanding on the revolving loans at May 31, 1989 were $10 million and $3 million, respectively, and $10 million was outstanding on the term loan. The Registrant has reached agreements pursuant to which the banks have agreed to extend the Registrant's two revolving loans until, and have agreed to modify the term loan to become due upon, the earlier of (i) September 15, 1989, and (ii) the closing date of the Reorganization. In the event of the abandonment or termination of the Reorganization Agreement prior to September 15, 1989, the Registrant has agreed to repay all bank borrowings within 90 days thereof. The Registrant paid the banks $200,000 upon execution of the extension agreement and has agreed to

Note 7-- Notes Payable and Long-Term Debt (continued)

pay a rate of interest of prime plus 1% on its bank borrowings. The prime rate at May 31, 1989 was 11.5%. The Registrant has further agreed to collateralize the loans promptly in the event of, among other things, the abandonment or termination of the Reorganization Agreement.

Under the Registrant's term and revolving loan agreements the Registrant is required to maintain cash flow equal to at least 170% of debt service; maintain a minimum tangible net worth equal to the prior year's minimum tangible net worth plus the sum of (i) 25% of net after tax profits and (ii) 50% of any equity infusion; limit dividends to not more than 50% of net earnings; and limit capital expenditures to an amount not to exceed certain planned expenditures plus $2 million. At May 31, 1987, the Registrant was required to maintain a minimum tangible net worth of at least $58,828,000. Interest is payable on the outstanding principal amount of the loan on a quarterly basis. The Registrant was in compliance with these loan covenants at May 31, 1989.

(c) In July 1988, the Registrant and two subsidiaries of the Registrant issued $20 million in senior secured notes to a group of insurance companies. The notes are secured by three of the Registrant's freestanding facilities. Performance of the subsidiaries' obligations under the notes is guaranteed by the Registrant. The notes provide for the payment of interest at a fixed rate of 10.5% per annum. The notes require principal payment in five equal annual installments beginning on August 1, 1991. Interest on the unpaid balance is payable semi-annually commencing February 1, 1989.

The Registrant has negotiated a waiver of certain financial covenants related to the senior secured notes. Such waiver requires that the Registrant maintain consolidated current assets at an amount equal to 150% of consolidated current liabilities at all times prior to June 1, 1990. In addition, the Registrant must maintain for the fiscal quarters ending August 31, 1989 November 30, 1989, February 29, 1990, and May 31, 1990 ratios of total income available for fixed charges to total fixed charges for the twelve month periods greater than .42:1, (.124:1), (.229:1), and .254:1, respectively. Consolidated current assets, consolidated current liabilities, total income available for fixed charges, and total fixed charges are determined in accordance with the trust indenture related to such senior secured notes. On the granting of such waiver, the Registrant is required to pay an accommodation fee of $100,000 and the note holders have agreed to credit one-half of such fee against any prepayment premium required to be paid under the trust indenture. In addition, the Registrant has agreed to increase the interest rate on the senior secured notes for the period September 1, 1989 through May 31, 1990 to 11.4%. The waiver has been granted through June 1, 1990, accordingly, the senior secured notes have been classified as long-term liabilities. If the Registrant defaults under the terms of the senior secured notes, substantially all of Registrant's debt, including its term and revolving bank loans and its industrial revenue bonds, could be accelerated resulting in the banks' and the note and bond holders' ability to proceed against the Registrant's properties which secure such indebtedness. In addition, as long as the Registrant is in default under its senior indebtedness, the Registrant will be precluded from paying interest to the holders of its Convertible Subordinated Debentures. If such a payment default occurs and is not cured within the 30 day period provided in the trust indenture, the holders of the Convertible Subordinated Debentures may declare a default and the $46 million in principal amount of Debentures could also be accelerated.

Note 7-- Notes Payable and Long-Term Debt (continued)

(d) The Registrant has guaranteed the performance of a wholly owned subsidiary under terms of a trust indenture pursuant to which the subsidiary has borrowed $6,000,000. The Registrant's guarantee requires that it maintain a ratio of consolidated total debt to consolidated tangible net worth at not more than 1.5:1; a ratio of consolidated current assets to consolidated current liabilities at not less than 1.5:1; and consolidated tangible net worth at not less than $45 million. Consolidated total debt, consolidated tangible net worth, consolidated current assets and consolidated current liabilities are determined in accordance with the agreements related to the indenture. The Registrant was in compliance with these covenants at May 31, 1989.

Substantially all of the Registrant's senior debt has been issued pursuant to agreements which include cross-default provisions. Accordingly, a default under terms of any senior debt instrument may result in default under agreements governing substantially all of the Registrant's senior debt.

Note 8--Taxes on Income

Taxes on income consist of the following:

	Years Ended May 31,		
	1989	1988	1987
	(Dollars in thousands)		
Currently payable:			
Federal income taxes	$4,928	$ 8,512	$ 9,108
State income taxes	1,363	1,980	1,839
	6,291	10,492	10,947
Deferred:			
Federal income taxes	(3,924)	(3,625)	(186)
State income taxes	(1,108)	(937)	(171)
	(5,032)	(4,562)	(357)
	$1,259	$ 5,930	$10,590

A reconciliation between taxes on income and the amount computed by applying the statutory federal income tax rate (34% in 1989, 35% in 1988, and 46% in 1987) to earnings before taxes on income is as follows:

	Years Ended May 31,		
	1989	1988	1987
	(Dollars in thousands)		
Income taxes at the statutory tax rate	$ 599	$5,215	$10,432
State income taxes net of federal tax benefit	168	678	895
Investment tax credit	28	8	(900)
Reorganization expenses	410	--	--
Amortization of intangible assets	112	95	124
Other	(58)	(66)	39
	$1,259	$5,930	$10,590

(Continued)

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Note 8--Taxes on Income (continued)

Total taxes on income differ from taxes currently payable as a result of differences in the recognition of revenues and expenses for tax and financial statement purposes. The sources of these differences and the tax effect of each are as follows:

	Years Ended May 31,		
	1989	1988	1987
	(Dollars in thousands)		
Excess tax over book depreciation	$ 400	$ 1,251	$ 1,268
Cash basis accounting and different reporting period by joint ventures	(1,606)	(1,337)	1,219
State income taxes	353	304	236
Deferred compensation expense deductible on a cash basis	104	(578)	(612)
Cash basis accounting by subsidiaries	(732)	(401)	(335)
Employee benefit expenses not currently deductible	(235)	(1,069)	(1,373)
Write-down of assets held for sale not currently deductible	(840)	--	--
Bad debt expense not currently deductible	(1,634)	(2,516)	(685)
Other	(842)	(216)	(75)
	$(5,032)	$(4,562)	$ (357)

Note 9--Lease Commitments

The Registrant leases certain facilities, furniture and equipment. The facility leases contain escalation clauses based on the Consumer Price Index and provisions for payment of real estate taxes, insurance, maintenance and repair expenses.

Total rental expenses for all operating leases are as follows:

	Years Ended May 31,		
	1989	1988	1987
	(Dollars in thousands)		
Minimum rentals	$1,865	$1,830	$1,611
Contingent rentals	186	338	144
Total rentals	$2,051	$2,168	$1,755

Assets under capital leases are capitalized using interest rates appropriate at the inception of each lease; contingent rents associated with capital leases in fiscal 1989, 1988 and 1987 were $203,000, $188,000 and $148,000, respectively. The net book value of capital leases at May 31, 1989 and 1988 was $978,000 and $1,084,000, respectively.

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

May 31, 1989, 1988 and 1987

Note 9--Lease Commitments (continued)

Future minimum payments, by year and in the aggregate, under capital leases and non-cancellable operating leases with initial or remaining terms of one year or more consist of the following at May 31, 1989:

	Capital Leases	Operating Leases
	(Dollars in thousands)	
1990	$ 293	$1,376
1991	293	886
1992	293	567
1993	293	361
1994	293	190
Later years	1,842	--
Total minimum lease payments	$3,307	$3,380
Less amounts representing interest	1,724	
Present value of net minimum lease payments	$1,583	

Note 10--Deferred Compensation Plans

The Registrant has a deferred compensation agreement for its Chairman and President. The vested unfunded benefits at May 31, 1989 and 1988 of $1,524,000 and $1,446,000, respectively, have been accrued by the Registrant. The Registrant utilized an 8% discount rate in determining the present value of vested unfunded past service cost.

The Registrant has deferred compensation plans (the Financial Security Plan) for its key executives and medical directors. Under provisions of these plans, participants have elected to defer receipt of a portion of their compensation to future periods. Effective January 1, 1989, participants were not offered the opportunity to defer compensation to future periods.

Note 11--Stock Option and Rights Plans

In 1983, the Registrant adopted a stock option plan which is intended to qualify as an incentive stock option plan under Section 422A of the Internal Revenue Code of 1986, as amended ("IRC").

In fiscal 1988, the Registrant's Board of Directors adopted a 1988 Incentive Stock Option Plan and 1988 Nonstatutory Stock Option Plan to replace the plan adopted in 1983. During the fiscal year ended May 31, 1989, an option to purchase 2,176 shares under the 1983 plan was cancelled. All other options outstanding under the 1983 plan were cancelled during fiscal 1988.

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Note 11--Stock Option and Rights Plans (continued)

Options granted under the 1988 Incentive Stock Option Plan are intended to qualify as incentive stock options ("ISOs") under Section 422A of the IRC. Options granted under the 1988 Nonstatutory Stock Option Plan do not qualify as ISOs. The maximum number of shares subject to option are 750,000 and 200,000 for the ISOs and nonstatutory options, respectively.

The following table sets forth the incentive stock options granted under the 1988 plan:

	Number of Shares	Option Price Per Share	Option Price Aggregate
	(Dollars in thousands, except share amounts)		
Options granted in fiscal 1988...........	654,728	$8.125	$ 5,320
Balances, May 31, 1988...............	654,728	$8.125	5,320
Options forfeited in fiscal 1989..........	(167,367)	8.125	(1,360)
Options exercised in fiscal 1989..........	(31,172)	8.125	(253)
Balances, May 31, 1989...............	456,189	$8.125	$ 3,707

The per share exercise price of shares to be issued under the plans shall be determined by the Board of Directors, but in no event shall the option exercise price be less than the Fair Market Value (as defined in the plans) of the shares. In the case of an incentive stock option, if on the date of the grant of such option the optionee is a Restricted Stockholder (as defined in the plans), the option exercise price shall not be less than 110% of the Fair Market Value of the shares on the date of the grant.

Options shall vest and become exercisable at such times and in such installments as the Board of Directors shall provide in the individual option agreement, except that an option granted to a director may not be exercised until the expiration of one year from the date such option is granted. Subject to the limitation with respect to the vesting of options granted to directors, the Board may in its sole discretion accelerate the time at which an option or installment thereof may be exercised.

In fiscal 1987, the Registrant granted nonstatutory options for 30,908 common shares at an exercise price of $12.94 per share. During fiscal 1988, the Registrant granted nonstatutory options for 28,316 common shares at an exercise price of $14.13 per share. All outstanding nonstatutory options were cancelled during fiscal 1988. During fiscal 1988, nonstatutory options for 92,557 shares were granted under the 1988 plan at exercise prices ranging from $8.125 to $14.13 per share in replacement of the cancelled options. The nonstatutory options became exercisable one year after the date of grant. In fiscal 1989, options for 14,806 shares were cancelled. At May 31, 1989, options for 77,751 shares were outstanding at exercise prices ranging from $8.125 to $14.13.

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Note 11--Stock Option and Rights Plans (continued)

On April 19, 1988, the Registrant declared a dividend of one Common Share Purchase Right ("Right") for each share of Common Stock outstanding at May 6, 1988. Each Right entitles the holder to purchase one share of Common Stock at a price of $30 per share, subject to certain antidilution adjustments. The Rights are not exercisable and are transferable only with the Common Stock until the earlier of ten days following a public announcement that a person has acquired ownership of 25% or more of the Registrant's Common Stock or the commencement or announcement of a tender or exchange offer, the consummation of which would result in the ownership by a person of 30% or more of the Registrant's Common Stock. In the event that a person acquires 25% or more of the Registrant's Common Stock or if the Registrant is the surviving corporation in a merger and its Common Stock is not changed or exchanged, each holder of a Right, other than the 25% stockholder (whose Rights will be void), will thereafter have the right to receive on exercise that number of shares of Common Stock having a market value of two times the exercise price of the Right. If the Registrant is acquired in a merger or more than 50% of its assets are sold, proper provision shall be made so that each Right holder shall have the right to receive or exercise, at the then-current exercise price of the Right, that number of shares of common stock of the acquiring company that at the time of the transaction would have a market value of two times the exercise price of the Right. The Rights are redeemable at a price of $.02 per Right at any time prior to ten days after a person has acquired 25% or more of the Registrant's Common Stock.

Note 12--Purchase of Treasury Stock

In fiscal 1987, the Registrant announced an offer to purchase up to four million shares of its Common Stock at $13 net per share in cash. Approximately 4,587,166 shares were tendered and the Registrant accepted for payment 4,080,000 validly tendered shares including 80,000 additional shares permitted to be purchased under the terms of the offer. The Registrant utilized existing cash balances of approximately $26 million and borrowed $28 million to provide funding for the repurchase of shares and related costs.

In fiscal 1988, the Registrant repurchased one million shares of its Common Stock at an aggregate cost of approximately $8.6 million pursuant to an open market stock repurchase program.

Note 13--Acquisitions and Dispositions

In June 1988, the Sutter Center for Psychiatry, a 69-bed psychiatric hospital, opened in Sacramento, California. The facility is owned by a joint venture between BMC and Sutter Community Hospitals. BMC has a 49% interest in the joint venture. The Registrant has a 70% interest in BMC.

In September 1988, the Registrant sold its CareUnit Behavioral Center of Los Angeles facility which it had closed in May 1988. In December 1988, Golden Valley Health Center, a behavioral medicine facility located in Minneapolis, Minnesota was sold to a group of investors led by facility management. This facility was owned by a joint venture in which the Registrant has a 50% interest. In January 1989, a subsidiary of the Registrant sold CareUnit of DuPage, a chemical dependency treatment facility located in a suburb of Chicago. The Registrant utilized the net proceeds of sale of these facilities to reduce its long-term debt.

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Note 14--Litigation and Contingencies

On July 6, 1989, VHA Behavioral Medical Care, Inc. ("VHA-BMC") the Registrant's joint venture partner in BMC and Parkside Medical Services Corporation ("Parkside") filed a lawsuit in the Superior Court, County of Orange, California, against the Registrant, its wholly owned subsidiary, CareUnit, Inc. and First Hospital seeking, among other things, the dissolution of the joint venture, the appointment of VHA-BMC to manage BMC during its dissolution, and compensatory and punitive damages of $4 million for alleged breaches of the joint venture agreement by CareUnit, Inc. The Registrant and First Hospital believe that the allegations in the lawsuit are unfounded and materially false and intend to vigorously defend the lawsuit. The Registrant has filed its answer to the lawsuit and intends to file a counterclaim against the plaintiffs for, among other things, trade libel, tortious interference with contractual relations, and compensatory and punitive damages. However, the parties are currently engaged in settlement negotiations. For fiscal 1989, BMC generated revenues of $14.7 million and earnings before taxes on income of $3.3 million, of which the Registrant's share is 70%. At May 31, 1989, BMC operated 38 contracts totalling 900 available beds. The dissolution of the joint venture would have a material adverse impact on the Registrant's financial condition and results of operations if the hospitals at which BMC has contract operations choose not to enter into new contractual relationships with CareUnit, Inc. Distributions of cash from the joint venture require approval of the joint venture's Board of Directors. The Board of Directors has not approved any cash distribution subsequent to the filing of the lawsuit. There can be no assurance that the Registrant will have available, if needed, its share of the undistributed cash balance in BMC of approximately $3.2 million at May 31, 1989. The Registrant is unable to predict the ultimate impact on the Registrant of the dissolution of BMC or the lawsuit.

The Registrant is currently undergoing a payroll tax audit by the Internal Revenue Service ("IRS") for calendar years 1983 and 1984. The IRS agent conducting the audit has verbally asserted that certain physicians and psychologists engaged as independent contractors by the Registrant should have been treated as employees for payroll tax purposes. The Registrant has not received an assessment related to this assertion. Management believes that its treatment of the independent contractors is consistent with IRS guidelines and established industry practice. Management intends to defend vigorously any claims made by the IRS related to this issue; however, management is unable to predict the ultimate impact of the IRS audit.

The Registrant is routinely engaged in the defense of lawsuits arising out of the ordinary course and conduct of its business and has insurance policies covering such potential insurable losses where such coverage is cost effective. The Registrant maintains professional liability insurance coverage on a modified occurrence basis with $10 million limits. Management believes that the outcome of such lawsuits will not have a material adverse effect on the Registrant's consolidated financial statements.

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

May 31, 1989, 1988 and 1987

Note 15--Unaudited Quarterly Results (1)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(Dollars in thousands, except per share amounts)			
1989				
Operating revenues	$53,227	$54,745	$51,837	$50,102
Costs and expenses	48,460	48,382	48,713	53,623
Operating earnings (loss)	4,767	6,363	3,124	(3,521)
Net gain (loss) on sale/write-down of assets	--	2,553	1,170	(2,360)
Interest expense, net of interest income	(2,473)	(2,603)	(2,360)	(1,935)
Equity in earnings (loss) of unconsolidated joint venture	685	(791)	(212)	343
Minority interest in earnings of joint venture	(299)	(237)	(261)	(192)
Earnings (loss) before taxes on income	2,680	5,285	1,461	(7,665)
Taxes on income (benefit)	1,072	2,192	601	(2,606)
Net earnings (loss)	$ 1,608	$ 3,093	$ 860	$(5,059)
Per share:				
Earnings (loss)--primary and fully diluted	$ .18	$ .30	$ .08	$ (.50)
Dividend declared	$ .10	$ .10	$ --	$ --
1988				
Operating revenues	$44,758	$46,938	$48,222	$53,655
Costs and expenses	39,142	41,735	42,592	49,414 (2)
Operating earnings	5,616	5,203	5,630	4,241
Interest expense, net of interest income	(1,955)	(1,633)	(1,919)	(1,038)(2)
Equity in earnings of unconsolidated joint venture	599	162	191	1,185
Minority interest in earnings of joint venture	(47)	(31)	(550)	(754)
Earnings before taxes on income	4,213	3,701	3,352	3,634
Taxes on income	1,706	1,562	1,407	1,255
Net earnings	$ 2,507	$ 2,139	$ 1,945	$ 2,379
Per share:				
Earnings--primary and fully diluted	$ .23	$ .21	$ .20	$ .24
Dividend declared	$ .10	$ .10	$ .10	$ .10

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(1) Amounts have been reclassified from those previously reported to reflect accounting for certain joint venture partnerships on the equity method instead of the proportionate consolidation method.

(2) An adjustment of $610,000 was recorded during the fourth quarter to reduce interest expense and increase capitalized interest on the Registrant's new facilities. The impact of this adjustment was offset by additional fourth quarter adjustments which increased operating costs and depreciation.

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Note 16--Operating Losses and Liquidity Concerns

The Registrant lost approximately $7.7 million before taxes on income in its fourth quarter ended May 31, 1989. Of the losses, approximately $3.7 million represents non-recurring charges including $1.3 million in costs related to legal, investment banking and other expenses associated with the Registrant's pending Reorganization with First Hospital. The Registrant also recorded write-downs due to the planned sale of certain unimproved land and its corporate headquarters building of $2.4 million (pre-tax). The Registrant's loss on operations was principally a result of poor utilization of its freestanding facilities and behavioral medicine contracts. Utilization of freestanding facilities and behavioral medicine contracts continued at levels inadequate to generate profits through August 1989. Unless the utilization of freestanding facilities and behavioral medicine contracts improves or the Registrant is able to reduce costs, the Registrant will continue to incur losses on operations.

The Registrant's bank debt is due upon the earlier of September 15, 1989 or the closing date of the Reorganization. In the event of the abandonment or termination of the Reorganization Agreement prior to September 15, 1989, the Registrant has agreed to repay all bank borrowings within 90 days thereof. Accordingly, the Registrant will be required in such event to restructure its debt to avoid a short term liquidity problem.

Cash on hand and expected cash to be generated from operations will not be adequate to finance anticipated operating losses, working capital, and other cash requirements for the next several months. At July 31, 1989, Registrant had fully utilized its current bank lines of credit. The Registrant has not utilized the $5 million advance from First Hospital (see Note 2, "Proposed Reorganization"). It is anticipated that cash required to meet the Registrant's needs will be provided in conjunction with the Reorganization financing, however, there can be no assurance that the Reorganization will be completed or if completed that such financing will be available when required by the Registrant. If the Reorganization is terminated, the Registrant intends to arrange alternate financing, sell or close certain unprofitable freestanding facilities, and sell certain other assets. The Registrant believes that it can implement such actions but there can be no assurance that it will be successful. In the event that the Registrant is successful in arranging alternate financing, it expects to be subject to additional restrictive covenants and to incur higher interest charges.

If the Reorganization is not completed, the continuation of the Registrant in its current form will be dependent upon its ability to arrange adequate financing and return to profitable operations. The Registrant expects to sustain losses through the third quarter of fiscal 1990, and return to profitability thereafter. However, the business of the Registrant is highly competitive and subject to substantial rate pressure by purchasers of health care services, accordingly there can be no assurance that the Registrant will achieve its goals.

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

None.

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

DIRECTORS OF THE REGISTRANT

WARREN G. ELLIOTT, age 62. Mr. Elliott is an attorney practicing law in Washington, D.C. Since 1986 he has been a partner of Epstein, Becker & Green, P.C., a law firm that specializes in health care law. Mr. Elliott was a partner of Elliott & Zweben, P.C. from 1984 to 1986 and was a partner of Nossaman, Guthner, Knox & Elliott from 1979 to 1984. Mr. Elliott is currently counsel to that firm. Mr. Elliott was General Counsel to Aetna Life & Casualty Co. from 1968 to 1978 and was Associate General Counsel of the Life Insurance Association of America from 1961 to 1968. Mr. Elliott has served as a director of the Registrant since February 1988.

ROBERT B. HUNTER, M.D., age 70. Dr. Hunter is a retired family medicine practitioner residing in Sedro-Woolley, Washington. He was President of the American Medical Association ("AMA") during its fiscal year ended June 30, 1981. He has been a trustee of the AMA since 1971 and was the Chairman of its Board of Directors from 1977 to 1979. Dr. Hunter has served as a director of the Registrant since 1981.

B. LEE KARNS, age 59. Mr. Karns served as President of the Registrant from 1972 until 1985. Mr. Karns presently serves as Chairman of the Board and Chief Executive Officer and in 1986 he was reappointed President of the Registrant. He is a director of Medical Care International, Inc. Mr. Karns has served as a director of the Registrant since 1972.

ROBERT L. KASSELMANN, age 53. Mr. Kasselmann has been employed by the Registrant since 1974. He was a Vice President of the Registrant from 1974 to 1984. From 1985 to 1986 he was its Executive Vice President--Special Services. He was President of RehabCare from 1984 to 1987. He was Executive Vice President--Operations of the Registrant from 1986 to 1987 when he became Executive Vice President--Contract Operations and President of CareUnit, Inc. In July 1988, he became Executive Vice President--Corporate Administrative Services. Mr. Kasselmann resigned as an executive officer of the Registrant effective June 30, 1989. Mr. Kasselmann has served as a director of the Registrant since 1987.

STANLEY R. NELSON, age 62. Mr. Nelson is Executive in Residence for the Health Services Administration Program at the University of Minnesota, Minneapolis, Minnesota. He was the President of the Henry Ford Health Care Corporation from 1984 to June 1988 and was the Executive Vice President and Chief Executive Officer of the Henry Ford Hospital from 1971 to 1984. Mr. Nelson was a member of the Board of Trustees of the American Hospital Association from 1977 to 1983 and was its Chairman in 1982. From 1977 to 1981, Mr. Nelson was the President of the Voluntary Hospitals of America. Mr. Nelson has served as a director of the Registrant since February 1988.

TOM E. NESBITT, SR., M.D., age 66. Dr. Nesbitt is a urologist and has been in the private practice of medicine in Nashville, Tennessee for over 30 years. Dr. Nesbitt was the President of the AMA in 1978/79; he was the President of the Tennessee Medical Association of Clinical Urologists in 1971/72; and he was the President of the Tennessee Medical Association in 1970/71. Dr. Nesbitt was also a member of the Board of Trustees of the American Hospital Association from 1980 to 1985 and is currently a member of the Board of Directors of the AHA Health Providers Insurance Company. Dr. Nesbitt has served as a director of the Registrant since February 1988.

W. JAMES NICOL, age 45. Mr. Nicol has been employed by the Registrant since 1973. Mr. Nicol was the Registrant's Corporate Secretary from 1973 to 1987; he was a Vice President and the Treasurer from 1974 through 1983; he was a Senior or Executive Vice President from 1983 to 1985; and in 1985 he became the Vice Chairman and was elected to the Registrant's Board of Directors. Mr. Nicol resigned as an officer and director of the Registrant in 1987, to become President and Chief Executive Officer of RehabCare. In February 1988, Mr. Nicol was reelected to the Registrant's Board of Directors and effective July 1988, Mr. Nicol became Executive Vice President--Contract Operations of the Registrant and President and Chief Executive Officer of CareUnit, Inc. Mr. Nicol resigned as an executive officer of the Registrant effective June 30, 1989. Mr. Nicol also served as a director of the Registrant from 1985 to 1987.

EXECUTIVE OFFICERS OF THE REGISTRANT

Executive

B. LEE KARNS, age 59. Mr. Karns has been a director of the Registrant since 1972 and served as President of the Registrant from 1972 until 1985. Mr. Karns presently serves as Chairman of the Board and Chief Executive Officer of the Registrant and in 1986 he was reappointed President.

Operations

MARY LEE POTTER, age 63. Ms. Potter has been employed by the Registrant since 1977. She was Director, Human Resources from 1979 until 1984. She was Vice President--Professional Services from 1984 until 1985 when she became Vice President--Operations. She was Vice President--Operations from 1985 until 1986 when she was reappointed Vice President--Professional Services. She became Senior Vice President--Professional Services in 1987. In July 1988, she became Senior Vice President--Quality Assurance.

LAURENCE J. STEUDLE, age 42. Mr. Steudle has been employed by the Registrant since 1970. He was Vice President--BMC Operations of the Registrant from 1984 until 1985 when he became Senior Vice President--Operations. In 1987, he became Senior Vice President--Contract Operations.

STEPHEN J. TOTH, age 40. Mr. Toth has been employed by the Registrant since 1974. He was Vice President--Employee Services from 1984 until 1986 when he became Vice President--Outpatient Services. In November 1987, he became Senior Vice President--Quality Assurance. In July 1988, he became Senior Vice President--Professional Services.

Finance

STEPHEN R. MUNROE, age 45. Mr. Munroe has been employed by the Registrant since 1977 and was a Vice President from 1983 until 1984 when he became Chief Financial Officer. He became a Senior Vice President in 1985.

MARK A. EDWARDS, age 35. Mr. Edwards has been employed by the Registrant since 1977. He has been Corporate Controller of the Registrant since 1983. He was a Vice President of the Registrant from 1985 until 1987, when he became a Senior Vice President.

BRUCE K. NELSON, age 35. Mr. Nelson has been employed by the Registrant since 1985. He was Finance Manager from 1985 until 1986 when he became Assistant Treasurer. He was appointed Treasurer of the Registrant in 1987. Prior to his employment with the Registrant, Mr. Nelson was a Corporate Banking Officer with California First Bank from 1982 to 1985.

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Law

MARILYN U. MacNIVEN-YOUNG, age 38. Ms. MacNiven-Young was employed by the Registrant in 1985 as Vice President, General Counsel and Assistant Secretary. She was appointed Corporate Secretary of the Registrant in 1987. Prior to her employment with the Registrant, Ms. MacNiven-Young was Senior Counsel for Fluor Corporation, an engineering and construction and natural resources company from 1978 through 1985.

All executive officers serve at the discretion of the Board of Directors of the Registrant.

Item 11. EXECUTIVE COMPENSATION.

The following table sets forth all cash compensation paid, accrued or deferred to the following persons during or with respect to the 1989 fiscal year for services rendered in all capacities to the Registrant and its subsidiaries by (i) each of the five most highly compensated executive officers of the Registrant whose aggregate cash compensation exceeded $60,000 and (ii) all executive officers of the Registrant as a group.

Name of individual or group	Principal capacities in which served	Cash compensation(2)
B. Lee Karns...............	Chairman of the Board and President	$ 507,292
W. James Nicol.............	Executive Vice President--Contract Operations	250,032
Robert L. Kasselmann.......	Executive Vice President--Corporate Administrative Service	219,000
James P. Carmany...........	Executive Vice President--Hospital Operations	139,097
Stephen R. Munroe..........	Senior Vice President--Chief Financial Officer	131,152
All executive officers (16 persons) as a group (1)..................................		$2,294,501

(1) Includes individuals who were elected or resigned during the year. Amounts are included only for periods during which executive officers served as such.

(2) Includes amounts deferred or accrued under the Registrant's Financial Security and Employee Savings Plans described below.

Deferred Compensation and Other Agreements

The Registrant has a deferred compensation agreement with Mr. Karns which provides that the Registrant will pay $16,666 monthly to him or his spouse or children for a period of 120 months commencing at the time of his death, or other termination of employment. The annual amount payable to Mr. Karns is subject to adjustment based upon changes in the Consumer Price Index. During the term of the agreement, Mr. Karns is required to provide minimal consulting services to the Registrant and is prohibited from competing with it. Although the Registrant had fully accrued the anticipated benefits due Mr. Karns, during the fiscal year ended May 31, 1989, $78,000 was expensed by the Registrant with respect to such deferred compensation agreement to provide for changes in the Consumer Price Index.

In 1984, the Registrant adopted a new deferred compensation plan (the "Financial Security Plan") which permits employees selected by the Registrant to defer receipt of all or a portion of their annual compensation and bonus. However, the amounts deferred must be no less than $4,000 per annum. Under the Financial Security Plan, the Registrant has established and maintains a separate deferral account on its books of account for each benefit unit enrolled in the plan by a participating employee. Such deferral accounts are deemed to bear interest at specified rates depending upon whether: (a) the participating employee attains normal retirement (as defined in such plan); (b) the participating employee's employment with the Registrant is terminated other than by normal retirement; or (c) the participating employee experiences an adverse change of employment conditions (as defined in such plan) within 18 months following a change in control of the Registrant (as defined in such plan). The periods over which benefits are paid by the Registrant vary depending upon whether the payment is made by reason of normal retirement, early retirement, disability, termination of employment, or death. Insurance contracts have been purchased by the Registrant to meet anticipated obligations under the Financial Security Plan. Consummation of the Reorganization will constitute a change in control for purposes of the Financial Security Plan. The Registrant does not anticipate, however, that any participant will suffer an adverse change in employment conditions entitling them to an increase in deemed interest rates. Effective January 1, 1989, participants were not offered the opportunity to defer compensation to future periods.

The Registrant has individual death benefit agreements with four current executive officers which provide for the posthumous payment to their designees of 120 monthly installments of $4,167 commencing at their respective deaths. The Registrant is carrying insurance policies (payable to itself) on the lives of such officers in amounts equal to twice the aggregate amounts to be paid to them under such death benefit agreements. The total amount expensed during the fiscal year ended May 31, 1989 with respect to such insurance policies was approximately $16,879.

The Registrant has entered into a termination agreement with Mr. Nicol, who resigned as an executive officer of the Registrant as of June 30, 1989, but agreed to remain as a director through the Effective Time of the Reorganization. The agreement provides for the payment of his current salary through May 15, 1990 at $17,500 per month. Under the termination agreement, the Registrant has also agreed to forgive the principal amount owing under a relocation loan of $133,337. Mr. Nicol has agreed not to compete with the Registrant through May 15, 1990.

The Registrant has also entered into a termination agreement with Mr. Kasselmann, who resigned as an executive officer of the Registrant as of June 30, 1989, but agreed to remain as a director through the Effective Time of the Reorganization. The agreement provides for the payment of his current salary through April 30, 1990 at $14,000 per month. Under the termination agreement, the Registrant has also agreed to forgive the principal amount owing under a relocation loan of $67,096. Mr. Kasselmann has agreed not to compete with the Registrant through April 30, 1990.

During fiscal 1989, the Registrant entered into agreements with two of its executive officers, Marilyn U. MacNiven-Young and Stephen R. Munroe, providing for the payment to each of them of (i) a cash bonus equal to $35,000 payable upon the closing of any transaction involving a change of control of the Registrant and (ii) an amount equal to one year's salary in the event of their termination of employment, voluntarily or otherwise, following a change of control of the Registrant. Consummation of the Reorganization will constitute a change of control under the agreements.

In July 1985, Dr. Hunter entered into a consulting agreement with the Registrant pursuant to which Dr. Hunter received a $50,000 annual retainer plus an additional $1,000 per day for each day worked in excess of 50 days. In the fiscal year ended May 31, 1989 the Registrant paid $12,500 in consulting fees to Dr. Hunter. Effective August 1, 1988, Dr. Hunter's consulting agreement was terminated.

On April 17, 1989, Mr. Karns exercised an option to purchase from the Registrant a membership in a country club located in Orange County, California for $1,000. The Registrant estimates that the current market value of Mr. Karns' membership is approximately $130,000, subject to a transfer fee of the greater of $25,000 or 25% of the last quarter's average membership sales price.

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Bonus Plans

The Registrant has a bonus plan for officers and other management employees. Amounts awarded under the bonus plan are based upon growth in the Registrant's earnings before state and federal income tax and depend upon individual salary levels. The Registrant also has incentive compensation plans for certain of its operational and business development employees. Amounts awarded under these plans are based upon varying individual performance levels.

Indebtedness of Officers

In 1985, the Registrant loaned $100,000 to James E. Parkhurst, former Senior Vice President--Business Development, to assist him in the purchase of a home in the Orange County area. The Registrant considered this loan necessary as it required Mr. Parkhurst to relocate from Texas to California. The loan is evidenced by a promissory note bearing interest at 11.5% per annum and due on May 1, 1990. The largest aggregate amount of such indebtedness outstanding during the fiscal year ended May 31, 1989 was $46,952.

In 1985, the Registrant loaned $100,000 to Ms. Potter to assist her in the purchase of a home in the Orange County area. The Registrant considered this loan necessary as it required Ms. Potter to relocate from Florida to California. The loan is evidenced by a promissory note bearing interest at 10% per annum and due on December 1, 1990. The largest aggregate amount of such indebtedness outstanding during the fiscal year ended May 31, 1989 was $56,192.

In 1985, the Registrant loaned $200,000 to Mr. Kasselmann to assist him in the purchase of a home in the Orange County area. The Registrant considered this loan necessary as it required Mr. Kasselmann to relocate from Missouri to California. The loan is evidenced by a promissory note bearing interest at 10% per annum. The largest aggregate amount of such indebtedness outstanding during the fiscal year ended May 31, 1989 was $121,038. The loan was forgiven under the terms of Mr. Kasselmann's termination agreement.

In 1986, the Registrant loaned $140,000 to Mr. Carmany to assist him in the purchase of a home in the Orange County area. The loan was considered necessary by the Registrant as it required Mr. Carmany to relocate from Florida to California. The loan is evidenced by a promissory note bearing interest at 10% per annum and due on February 1, 1991. The largest aggregate amount of such indebtedness outstanding during the fiscal year ended May 31, 1989 was $98,517. On May 3, 1989, Mr. Carmany's employment terminated, although the loan remains outstanding.

In 1987, RehabCare loaned $200,000 to Mr. Nicol to assist him in the purchase of a home in the Chesterfield, Missouri area. The Registrant considered this loan necessary as it required Mr. Nicol to relocate from California to Missouri. The loan is evidenced by a promissory note bearing interest at 8% per annum. The largest aggregate amount of such indebtedness outstanding during the fiscal year ended May 31, 1989 was $173,333. The loan was forgiven under terms of Mr. Nicol's termination agreement.

All promissory notes are secured by deeds of trust on such homes. At July 31, 1989, the total amount of indebtedness of Messrs. Parkhurst and Carmany and Ms. Potter was $21,787, $68,177, and $37,193, respectively.

Stock Options

The Registrant's 1988 Incentive Stock Option Plan (the "Incentive Plan") and 1988 Nonstatutory Stock Option Plan (the "Nonstatutory Plan") were originally adopted by the Board of Directors on February 3, 1988 (collectively, the "Plans") and approved by the Registrant's stockholders at its 1988 annual meeting of stockholders. The Incentive Plan is intended to qualify as an Incentive Stock Option Plan under Section 422A of the Internal Revenue Code of 1986, as amended (the "Code"). The persons eligible for participating in the 1988 Plan as recipients of options and appreciation rights are the officers and key employees of the Registrant or any of its subsidiaries.

The maximum aggregate number of shares of the Registrant's Common Stock that may be optioned and sold under the Plans in the aggregate is 950,000, plus the number of shares issued on exercise of options which are reacquired by the Registrant upon the exercise of options. The maximum number of shares which may be optioned and sold to directors of the Registrant under the Plans in the aggregate is 250,000 plus the number of shares issued upon exercise of options that are reacquired from directors by the Registrant upon the exercise of options. The number of shares which may be optioned and sold under the Incentive Plan and Nonstatutory Plan are 750,000 and 200,000, respectively. In the event that options granted under the Plans shall for any reason terminate, lapse, be forfeited, or expire without being exercised, the shares of Common Stock subject to such unexercised options shall again be available for granting under the Plans, and if such options had been granted to a director, under the limitation on grants to directors described above.

The number or kind of shares, and the per-share option price thereof, that may be issued in the aggregate and to individual optionees under the Plans is subject to proportionate adjustment by the Registrant's Board of Directors in the event the outstanding shares of the Registrant's Common Stock are increased, decreased, changed into or exchanged for a different number or kind of shares through reorganization, recapitalization, reclassification, stock dividend, stock split or reverse stock split.

The Plans are administered by the Registrant's Board. The Board has full power and authority in its sole discretion to determine (a) which eligible persons shall receive options; (b) when the options shall be granted; (c) the terms and conditions, not inconsistent with the provisions of the Plans, of any options granted; and (d) the number of shares which may be issued on exercise of the options. Under the Plans, the Board has full power and authority to interpret the provisions of the Plans and any option granted under the Plans. The Board may adopt rules and regulations relating to the Plans. The Board also has the authority to delegate some or all of its powers, authority and discretion under the Plans to a committee of not less than two members of the Board.

All installments of an option shall expire and terminate on such date as the Board shall determine, unless earlier terminated as described below, but in no event will an option terminate later than ten years from the date such option was granted and, in the case of an option granted pursuant to the Incentive Plan granted to a Restricted Stockholder (as defined in the Plans), the option by its terms shall not be exercisable after the expiration of five years from the date the option was granted.

Installments under options which have not yet become exercisable expire and become unexercisable when an optionee's employment or directorship (as the case may be) with a Participating Company (as defined in the Plans) is terminated. If such termination is for any reason other than the death or total disability of the optionee, in the Board's discretion the optionee may exercise installments under the option until the earlier of three months after such termination or the applicable option termination date, but only to the extent such installments were exercisable on the date of such termination. However, in the event that an optionee's employment or directorship with the Registrant is terminated "for cause," then all options, whether vested or not, shall expire and become

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unexercisable as of the effective date of such termination. "For cause" under the Plans means gross negligence, willful misconduct or habitual neglect by an optionee in carrying out his or her duties. If the optionee dies or becomes totally disabled while employed or while serving as a director, installments under options may be exercised at any time until the earlier of the first anniversary of the date of termination or the applicable option termination date by the optionee's heirs or legal representatives to whom the option passes, but only to the extent that such installments were exercisable by the optionee on the date of termination by reason of the optionee's death or total disability. In the case of any optionee who is an employee or director of a Participating Company which ceases to be a Participating Company (an "Affiliation Termination"), such Affiliation Termination will be deemed for purposes of the Plans to be a termination of such optionee's employment or directorship for reasons other than death or total disability.

Under the terms of the Plans, all outstanding options, as well as the Plans themselves, may be affected by the occurrence of a "Terminating Transaction." As used in the Plans, the phrase "Terminating Transaction" means any of the following events: (a) the dissolution or liquidation of the Registrant; (b) a reorganization, merger or consolidation of the Registrant with one or more other corporations as a result of which the Registrant goes out of existence or becomes a subsidiary or another corporation; (c) a sale of substantially all of the Registrant's property; or (d) a sale of more than 80% of the Registrant's then outstanding capital stock to another corporation. Consummation of the Reorganization will constitute a Terminating Transaction under the Plans.

Upon a Terminating Transaction the Plans and any options theretofore granted will terminate unless specific written provision is made in connection with such Terminating Transaction for the continuance of the Plans and the assumption of options theretofore granted, or for the substitution for such options of new options covering securities of a successor employer corporation, or an affiliate thereof, with appropriate adjustments, in which case the Plans and options shall continue or be replaced, as the case may be. If the Plans and the options terminate pursuant to a Terminating Transaction without such provision, all persons holding options then outstanding under the Plans will have the right to exercise their options to the full extent not theretofore exercised, including any installments which have not yet become vested installments. In the event options continue or are replaced after a Terminating Transaction, the options shall become fully vested and become exercisable as to all installments thereof to and including the termination date thereof, in the event the optionee's employment with the Registrant and its successor and all affiliates of the Registrant and such successor terminates for any reason other than for good cause at any time within two years after the Terminating Transaction has been completed.

The Plans provide that the Board of Directors may at any time amend, alter, and/or terminate the Plans, provided, however, that unless required by applicable law, the Board shall not amend the Plans without stockholder approval if the amendment would (i) increase the maximum number of shares available for grant under the Plans; (ii) provide for the administration of the Plans other than by the Board or a committee thereof; (iii) change the manner of determining the option exercise price; (iv) change the classes of persons eligible to receive options or Participating Companies; or (v) extend the maximum option exercise period or term of the Plans. Unless sooner terminated by the Board, the Plans will terminate on February 3, 1998.

During fiscal 1989, no options were granted under the Registrant's 1988 Incentive Stock Option Plan and 1988 Nonstatutory Stock Option Plan; no executive officer exercised any option under such Plan; all optionees, as a group, exercised options for 31,172 shares at an average exercise price of $8.125 per share. The net value realized on such exercises (market value of the shares on the exercise date less the exercise price) was $79,622.

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Employee Savings Plan

The Registrant has an Employee Savings Plan in which all eligible employees of the Registrant are permitted to participate. The Employee Savings Plan is intended to qualify under Section 401(a) of the Code as a profit sharing plan and with respect to its cash or deferred arrangement, under Section 401(k) of the Code. Employees are eligible to participate on each January 1 or July 1 commencing with or next following (i) the completion of a six consecutive month period in which he or she completes two hundred fifty hours of service, such period to be the period beginning on the date the employee commences service or in a succeeding six month period or (ii) the completion of the twelve month period beginning on the date the employee commences service in which he or she performs one thousand hours of service. Participation is voluntary. A participant may defer from 2% to 12% of his or her compensation. The Registrant makes matching contributions equal to three-fourths of each participant's contribution up to a maximum of 6% of each participant's compensation. Forfeitures occurring in a calendar quarter are used to reduce the Registrant's matching contributions. Participants are 100% vested in their own contributions and effective July 1, 1988 the Registrant's matching contributions vest over three years

Participants may elect to invest their contributions in one or more of four investment options, i.e. the Registrant's Common Stock, a guaranteed income fund, a diversified equity fund or an insurance fund.

Distributions are only made upon termination of employment, death or total and permanent disability; however, the Employee Savings Plan provides for withdrawals once a plan year of a participant's own contribution prior to termination of employment on account of financial hardship which is determined in accordance with regulations under the Code.

Participants do not have the right to vote directly the shares of the Registrant's Common Stock allocated to his or her account, but each participant has the right to instruct the Committee (as defined in such Plan) how to vote those shares. To the extent the participant fails to direct the Committee as to the exercise of voting rights, the trustee has sole discretion in voting those shares.

Summary of Certain Other Compensation

With respect to the Registrant's Financial Security and Employee Savings Plans, the following table sets forth amounts paid, accrued or distributed during the fiscal year ended May 31, 1989 for each of the five most highly compensated executive officers of the Registrant and for all executive officers as a group.

Name of individual or group	Financial Security Plan	Employee Savings Plan
B. Lee Karns..................................	$242,083	$ 16,392
W. James Nicol..................................	--	14,123
Robert L. Kasselman..................................	20,457	1,879
James P. Carmany..................................	7,040	7,251
Stephen R. Munroe..................................	--	376
All executive officers (16 persons) as a group (1)..................................	$298,900	$106,007

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(1) Amounts are included for periods during which th[illegible]tive officers served as such.

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Members of the Registrant's Board of Directors who are not full-time employees of the Registrant each received a $5,000 retainer for their services as directors during the fiscal year ended May 31, 1989 and $5,000 for each regular Board meeting attended. Directors are not compensated for attendance at Board committee meetings or for participation in telephonic board meetings. Messrs. Karns, Kasselmann and Nicol did not receive any compensation for serving as directors.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

As of August 7, 1989, 10,173,663 shares of the Registrant's Common Stock were issued and outstanding. The following table sets forth, as of the above date, information with respect to beneficial ownership of the Registrant's Common Stock by each stockholder known to be a beneficial owner of more than 5% of the outstanding Common Stock of the Registrant, by each director who owns shares and by all officers and directors as a group.

	Amount and Nature of Beneficial Ownership	
Name of individual or group	No. of Shares	Percent of Class
Invista Capital Management, Inc. (formerly Value Investors, Inc.) 601 Locust, Suite 1150, Des Moines, Iowa	670,595(1)	6.6%
Nicholas Company, Inc. 700 North Water Street, Milwaukee, Wisconsin	631,000(1)	6.2
Wellington Management Company/Thorndike, Doran, Paine & Lewis 28 State Street, Boston, Massachusetts	803,488(1)	7.9
Warren G. Elliott, Esq.	500	*
Robert B. Hunter, M.D.	15,266(2)	*
B. Lee Karns	298,[illegible]00(2)(3)	2.9
Robert L. Kasselmann	29,758(2)(3)	*
Stanley R. Nelson	1,000	*
Tom E. Nesbitt, Sr., M.D.	1,000	*
W. James Nicol	7,280(2)(3)	*
All directors and officers (21 persons) as a group	428,368(2)(3)	4.2

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* less than 1%.

(1) The number of shares in the table is taken from filings made by Invista Capital Management, Inc. ("Invista") as of December 31, 1988, Nicholas Company, Inc. ("Nicholas") as of February 12, 1989, and Wellington Management Company/Thorndike, Doran, Paine & Lewis ("Wellington") as of February 9, 1989, with the Securities and Exchange Commission reporting beneficial ownership. Such filings indicate that Invista in its capacity as investment advisor has shared voting power and sole investment power with respect to all such shares, that Nicholas in its capacity as investment advisor has sole voting and investment power with respect to all such shares, and that Wellington in its capacity as investment advisor has shared voting power with respect to 340,577 shares and shared investment power with respect to all such shares.

(2) Includes currently exercisable options granted under the Registrant's Plans for the following number of shares and at the following average exercise prices: Dr. Hunter 11,266 shares at $13.31; Mr. Karns 32,034 shares at $9.95; Mr. Kasselmann 15,368 shares at $11.93; Mr. Nicol 4,102 shares at $8.13; and all directors and officers as a group 106,659 shares at $9.77.

(Footnotes continued on following page)

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IMAGE EVALUATION
TEST TARGET (MT-3)

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(3) Includes shares held by the independent trustee of the Registrant's Employee Savings Plan and allocated to the accounts of directors and officers as of March 31, 1989, as follows: 22,273 shares allocated to Mr. Karns; 926 shares allocated to Mr. Kasselmann; 2,614 shares allocated to Mr. Nicol; and 49,266 shares allocated to all directors and officers as a group. Unless otherwise indicated, the persons named in the table possess sole voting and investment power with respect to the shares listed (except to the extent such authority is shared with the trustee of Registrant's Employee Savings Plan or with spouses under applicable law).

At a special meeting of the stockholders of the Registrant to be held on September 13, 1989, the stockholders of the Registrant will act upon a proposal to adopt the Reorganization Agreement. The Reorganization Agreement contemplates the Reorganization of the Registrant and First Hospital whereby FHC-CompCare will become the parent company of each of the Registrant and First Hospital.

If the Reorganization is approved and effected, each share of the Registrant's Common Stock outstanding immediately prior to the Reorganization (other than shares held by the Registrant or any of its subsidiaries and other than shares held by holders who have properly exercised their appraisal rights under Delaware law) will be converted into the right to receive $3.00 in cash, 0.78 of a share of Common Stock of FHC-CompCare and $2.75 principal amount of senior subordinated debentures of FHC-CompCare. In addition, each First Hospital Common Share will be converted into one and one-quarter shares of FHC-CompCare Common Stock.

The stockholders of the Registrant will receive in the aggregate approximately 7,935,457 shares of FHC-CompCare Common Stock, which represent approximately 39% of the voting power of the shares of FHC-CompCare Common Stock anticipated to be outstanding immediately after the Reorganization. The stockholders of First Hospital will receive in the aggregate approximately 12,631,474 shares of FHC-CompCare Common Stock, which represent approximately 61% of the voting power of the shares of FHC-CompCare Common Stock expected to be outstanding immediately after the Reorganization.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

There is hereby incorporated by reference the information appearing in Item 11 of Part III "Executive Compensation - Deferred Compensation and Other Agreements" and "Indebtedness of Officers."

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PART IV

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.

(a) 1. Financial Statements

Included in Part II of this report:

Report of Independent Certified Public Accountants
Consolidated Balance Sheets at May 31, 1989 and 1988
Consolidated Statements of Earnings for years ended May 31, 1989, 1988 and 1987
Consolidated Statements of Stockholders' Equity for years ended May 31, 1989, 1988 and 1987
Consolidated Statements of Cash Flows for years ended May 31, 1989, 1988 and 1987
Notes to Consolidated Financial Statements

2. Financial Statement Schedules

V. Property and Equipment
VI. Accumulated Depreciation and Amortization of Property and Equipment
X. Supplementary Statements of Earnings Information

Other schedules are omitted, as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.

3. Exhibits

Exhibit Number	Description and Reference
2.1	Agreement and Plan of Reorganization, dated as of April 25, 1989, as amended, among the Registrant, FHC-CompCare, Inc. and First Hospital Corporation(11)
3.1	Restated Certificate of Incorporation(5)
3.2	Restated Bylaws as amended July 14, 1986(4)
4.1	Indenture dated April 25, 1985 between the Registrant and Bank of America, NT&SA relating to Convertible Subordinated Debentures(2)
4.2	Amended and Restated Loan Agreement dated as of July 20, 1987 among the Registrant, Union Bank, Centerre Bank, National Association, and Southeast Bank, N.A.(6)
4.3	First Amendment to Amended and Restated Loan Agreement dated as of January 25, 1988 among the Registrant, Union Bank, Centerre Bank, N.A., and Southeast Bank, N.A.(7)
4.4	Second Amendment to Amended and Restated Loan Agreement dated as of March 17, 1988 among the Registrant, Union Bank, Centerre Bank, N.A., and Southeast Bank, N.A.(7)
4.5	Third Amendment to Amended and Restated Loan Agreement dated as of July 7, 1989 among the Registrant, Union Bank, The Boatmen's National Bank of St Louis, and Southeast Bank, N.A. (filed herewith)
4.6	Letter Agreement dated as of March 17, 1988, as amended, between the Registrant and Union Bank(10)
4.7	Letter Agreement dated as of September 20, 1988, as amended, between the Registrant and Union Bank (filed herewith)

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4.8	Amendment to letter agreements dated as of July 7, 1989 between the Registrant and Union Bank (filed herewith)
4.9	Trust Indenture dated as of July 1, 1988 among the Registrant, Starting Point Incorporated, CareUnit Hospital of Ohio, Inc., and Security Pacific National Bank, relating to Senior Secured Notes (10)
4.10	Rights Agreement dated as of April 19, 1988 between the Registrant and Security Pacific National Bank(8)
10.1	Standard form of CareUnit Contract (10)
10.2	Standard form of CarePsychCenter Contract (10)
10.3	The Registrant's Employee Savings Plan, as amended and restated(9)
10.4	Deferred Compensation Agreement dated April 6, 1982 between the Registrant and B. Lee Karns (10)
10.5	Amendment No. 1 to Deferred Compensation Agreement dated September 20, 1983 between the Registrant and B. Lee Karns(1)
10.6	Amendment No. 2 to Deferred Compensation Agreement dated April 21, 1986 between the Registrant and B. Lee Karns(4)
10.7	Form of Individual Death Benefit Agreement(1)
10.8	Financial Security Plan for executive management(3)
10.9	The Registrant's 1988 Incentive Stock Option and 1988 Nonstatutory Stock Option Plans(9)
10.10	Form of Stock Option Agreement (10)
10.11	Form of Indemnity Agreement (10)
10.12	Description of Executive Bonus Plan(3)
10.13	Guaranty Agreement dated June 1, 1982 among CareManor of Northeast Florida, the Registrant, Womlar, Inc., Burch Williams, Arthur Lucas, Fred Ahern, Sr., and Algie Outlaw and Southeast Bank, N.A. (10)
10.14	Joint Venture Agreement dated June 17, 1983 between the Registrant and Voluntary Health Enterprises, Inc.(1)
10.15	Agreements between the Registrant and SmokEnders, Inc.(3)
10.16	City of Coral Springs, Florida Industrial Development Revenue Bonds (CareUnit of Coral Springs Project) dated September 19, 1983 in the amount of $6,000,000(1)
10.17	Executive Employment Agreement, dated as of March 22, 1989, between the Registrant and Marilyn U. MacNiven-Young (filed herewith)
10.18	Executive Employment Agreement, dated as of March 22, 1989, between the Registrant and Stephen R. Munroe (filed herewith)
10.19	Separation and Release Agreement, dated June 30, 1989, between the Registrant and W. James Nicol (filed herewith)
10.20	Separation and Release Agreement, dated June 30, 1989, between the Registrant and Robert L. Kasselmann (filed herewith)
11	Computation of Earnings per Share (filed herewith)
22	List of the Registrant's subsidiaries (filed herewith)
24.1	Report and consent of Peat Marwick Main & Co. (filed herewith)
28.1	The Registrant's definitive Proxy Statement for the Registrant's special meeting of stockholders to be held September 13, 1989 (filed herewith)

---

(1) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1984.

(2) Filed as an exhibit to the Registrant's Form S-3 Registration Statement No. 2-97160.

(3) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1985.

(4) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1986.

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(5) Filed as an exhibit to the Registrant's Form 10-Q for the quarter ended August 31, 1986.

(6) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1987.

(7) Filed as an exhibit to the Registrant's Form 10-Q for the quarter ended February 29, 1988.

(8) Filed as an exhibit to the Registrant's Form 8-K dated May 4, 1988.

(9) Filed as an exhibit to the Registrant's Post-Effective Amendment No. 1 to Form S-8 Registration Statement No. 33-6520.

(10) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended May 31, 1988.

(11) Filed as an annex to the Registrant's definitive proxy statement for the special meeting of stockholders to be held September 13, 1989.

(b) Reports on Form 8-K

During the quarter ended May 31, 1989, no reports on Form 8-K were filed.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, August 16, 1989.

COMPREHENSIVE CARE CORPORATION

By ____________________
B. LEE KARNS
Chairman of the Board and President

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

Signature	Title	Date
B. LEE KARNS	Director, Chairman of the Board, and President (Chief Executive Officer)	August 25, 1989
STEPHEN R. MUNROE	Senior Vice President and Chief Financial Officer (Principal Financial Officer)	August 29, 1989
MARK A. EDWARDS	Senior Vice President and Corporate Controller (Principal Accounting Officer)	August 29, 1989
WARREN G. ELLIOTT, ESQ.	Director	August __, 1989
ROBERT B. HUNTER, M.D.	Director	August __, 1989
ROBERT L. KASSELMANN	Director	August __, 1989

SIGNATURES

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________________ STEPHEN R. MUNROE	Senior Vice President and Chief Financial Officer (Principal Financial Officer)	August __, 1989
________________ MARK A. EDWARDS	Senior Vice President and Corporate Controller (Principal Accounting Officer)	August __, 1989
Warren Elliott WARREN G. ELLIOTT, ESQ.	Director	August 24, 1989
________________ ROBERT B. HUNTER, M.D.	Director	August __, 1989
________________ ROBERT L. KASSELMANN	Director	August __, 1989

SIGNATURES

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MARK A. EDWARDS	Senior Vice President and Corporate Controller (Principal Accounting Officer)	August __, 1989
WARREN G. ELLIOTT, ESQ.	Director	August __, 1989
ROBERT B. HUNTER, M.D.	Director	August 25, 1989
ROBERT L. KASSELMANN	Director	August __, 1989

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STEPHEN R. MUNROE	Senior Vice President and Chief Financial Officer (Principal Financial Officer)	August __, 1989
MARK A. EDWARDS	Senior Vice President and Corporate Controller (Principal Accounting Officer)	August __, 1989
WARREN G. ELLIOTT, ESQ.	Director	August __, 1989
ROBERT B. HUNTER, M.D.	Director	August __, 1989
R L Kasselmann ROBERT L. KASSELMANN	Director	August 25 1989

SIGNATURES (continued)

Signature	Title	Date
Stanley R. Nelson STANLEY R. NELSON	Director	August 29, 1989
TOM E. NESBITT, SR., M.D.	Director	August __, 1989
W. JAMES NICOL	Director	August __, 1989

SIGNATURES (continued)

Signature	Title	Date
STANLEY R. NELSON	Director	August __, 1989
Tom E. Nesbitt TOM E. NESBITT, SR., M.D.	Director	August 29, 1989
W. JAMES NICOL	Director	August __, 1989

SCHEDULE V

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

Schedule V--Property and Equipment

For the Years Ended May 31, 1989, 1988 and 1987

	Balance at Beginning of Period	Additions at Cost	Sales and Retirements	Reclassifications(1)	Balance at End of Period
	(Dollars in thousands)				
Year ended May 31, 1989					
Land and improvements.........	$ 24,071	$ --	$ 1,334	$ (7,896)	$ 14,841
Buildings and improvements....	95,187	5,526	8,709	(9,569)	82,435
Furniture and equipment.......	24,470	2,989	4,374	(676)	22,409
Leasehold improvements........	174	238	198	1,551	1,765
Capitalized building leases...	2,704	--	--	--	2,704
	$146,606	$8,753	$14,615	$(16,590)	$124,154
Year ended May 31, 1988					
Land and improvement	$ 27,065	$ 41	$ --	$(3,035)	$ 24,071
Buildings and improvements....	77,346	14,851	45	3,035	95,187
Furniture and equipment.......	20,893	4,263	686	--	24,470
Leasehold improvements........	213	19	58	--	174
Capitalized building leases...	2,704	--	--	--	2,704
	$128,221	$19,174	$ 789	$ --	$146,606
Year ended May 31, 1987					
Land and improvements.........	$ 14,666	$12,399	$ --	$ --	$ 27,065
Buildings and improvements....	54,417	22,974	18	(27)	77,346
Furniture and equipment.......	17,287	3,686	107	27	20,893
Leasehold improvements........	204	9	--	--	213
Capitalized building leases...	2,704	--	--	--	2,704
	$ 89,278	$39,068	125	$ --	$128,221

(1) Includes amounts which have been reclassified in 1989 to property and equipment held for sale.

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BECHTEL

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(301) 738-1500

New York Office - (212) 425-5210
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EXHIBITS FOLLOW

COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

Schedule VI--Accumulated Depreciation and Amortization of Property and Equipment

For the Years Ended May 31, 1989, 1988 and 1987

	Balance at Beginning of Period	Additions Charged to Expense	Sales and Retirements	Reclass-ifications(1)	Balance at End of Period
			(Dollars in thousands)		
Year ended May 31, 1989					
Buildings and improvements .	$12,406	$3,682	$1,328	$(1,401)	$ 13,359
Furniture and equipment......	10,832	2,955	2,139	(390)	11,258
Leasehold improvements.......	93	159	6	492	738
Capitalized building leases..	1,620	106	--	--	1,726
	$24,951	$6,902	$3,473	$(1,299)	$ 27,081
Year ended May 31, 1988					
Buildings and improvements...	$ 8,893	$3,530	$ 17	$ --	$12,406
Furniture and equipment......	8,434	2,961	563	--	10,832
Leasehold improvements.......	99	21	27	--	93
Capitalized building leases..	1,523	97	--	--	1,620
	$18,949	$6,609	$607	$ --	$24,951
Year ended May 31, 1987					
Buildings and improvements...	$ 6,595	$2,570	$ --	$ (272)	$ 8,893
Furniture and equipment......	5,926	2,277	41	272	8,434
Leasehold improvements.......	69	30	--	--	99
Capitalized building leases..	1,404	119	--	--	1,523
	$13,994	$4,996	$ 41	$ --	$18,949

(1) Includes amounts which have been reclassified in 1989 to property and equipment held for sale.

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

Schedule X--Supplementary Statements of Earnings Information

For the Years Ended May 31, 1989, 1988 and 1987

	May 31,		
	1989	1988	1987
	(Dollars in thousands)		
Advertising costs..................	$14,994	$15,472	$16,107

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COMPREHENSIVE CARE CORPORATION AND SUBSIDIARIES

EXHIBIT INDEX

FISCAL YEAR ENDED MAY 31, 1989

Exhibit No.	Description	Sequentially Numbered Page
4.5	Third Amendment to Amended and Restated Loan Agreement dated as of July 7, 1989 among the Registrant, Union Bank, The Boatmen's National Bank of St. Louis, and Southeast Bank, N.A.	000074
4.7	Letter Agreement dated as of September 20, 1988, as amended, between the Registrant and Union Bank	000116
4.8	Amendment to letter agreements dated as of July 7, 1989 between the Registrant and Union Bank	000122
10.17	Executive Employment Agreement, dated as of March 22, 1989, between the Registrant and Marilyn U. MacNiven-Young	000160
10.18	Executive Employment Agreement, dated as of March 22, 1989, between the Registrant and Stephen R. Munroe	000169
10.19	Separation and Release Agreement, dated June 30, 1989, between the Registrant and W. James Nicol	000178
10.20	Separation and Release Agreement, dated June 30, 1989, between the Registrant and Robert L. Kasselmann	000184
11	Computation of Earnings per Share	000190
22	List of the Registrant's subsidiaries	000191
24.1	Report and consent of Peat Marwick Main & Co.	000192
28.1	The Registrant's definitive Proxy Statement for the Registrant's special meeting of stockholders to be held September 13, 1989	000193

COMPREHENSIVE CARE CORPORATION
SCHEDULE OF SUBSIDIARIES

SUBSIDIARY NAME	STATE OF INCORPORATION
NPHS, INC.	California
CAREMANOR HOSPITAL OF WASHINGTON, INC.	Washington
TRINITY OAKS HOSPITAL, INC.	Texas
CAREMANOR HOSPITAL OF VIRGINIA, INC.	California
TERRACINA CONVALESCENT HOSPITAL & HOME, INC.	California
CAREUNIT, INC.	California
CAREUNIT HOSPITAL OF ST. LOUIS, INC.	Missouri
STARTING POINT INCORPORATED	California
CAREUNIT HOSPITAL OF ALBUQUERQUE, INC.	New Mexico
COMPREHENSIVE CARE CORPORATION	Nevada
CAREUNIT HOSPITAL OF NEVADA, INC.	Nevada
CAREUNIT CLINIC OF WASHINGTON, INC.	Washington
CAREUNIT REDEVELOPMENT CORPORATION	Missouri
CAREUNIT HOSPITAL OF OHIO, INC.	Ohio
CAREUNIT OF FLORIDA, INC.	Florida
COMPREHENSIVE CARE CORPORATION (CANADA) LTD.	Canada
REHABCARE CORPORATION	Delaware
TWELVE POINT RIDGE, INC.	Oklahoma
CAREUNIT OF CHICAGO, INC.	Illinois
VIDEOHEALTH, INC.	California
CAREUNIT, INC.	Delaware
CAREFAST, INC.	Delaware

EXHIBIT 22

INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS'

REPORT ON SCHEDULES AND CONSENT

To the Stockholders and Board of Directors
Comprehensive Care Corporation:

The audits referred to in our report dated August 28, 1989 included the related financial statement schedules as of May 31, 1989 and for each of the years in the three-year period ended May 31, 1989 included in Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules, based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

Our report dated August 28, 1989 contains two separate explanatory paragraphs which state:

As discussed in Note 14 to the financial statements, the Company is a defendant in a lawsuit filed by its partner in a joint venture. The complaint asks for, among other things, dissolution of the joint venture and compensatory and punitive damages. The Company has filed its answer to the complaint and intends to file a counterclaim. In addition, the Company is currently undergoing a payroll tax audit by the Internal Revenue Service for calendar years 1983 and 1984. The IRS agent conducting the audit has verbally asserted that certain physicians and psychologists engaged as independent contractors by the Company should have been treated as employees for payroll tax purposes. The ultimate outcome of these matters cannot presently be determined.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 16 to the financial statements, the Company has a substantial portion of its debt due upon the earlier of September 15, 1989 or the closing date of a proposed reorganization, or 90 days after abandonment or termination of the reorganization agreement if terminated prior to September 15, 1989, and expects to incur negative cash flow from operations for fiscal 1990. The need for additional financing to repay debt as it comes due and finance the Company's anticipated negative cash flow from operations for fiscal 1990 raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regards to these matters are also described in Note 16.

The consolidated financial statements and financial statement schedules do not include any adjustments relating to the recoverability and classification of reported asset amounts or the amounts and classification of liabilities that might result from the outcome of these uncertainties.

We consent to the incorporation by reference in the Registration Statements (Nos. 33-6520 and 33-3091) on Form S-8 of Comprehensive Care Corporation and in the Registration Statement (No. 33-30406) on Form S-4 of FHC-CompCare, Inc. of our report dated August 28, 1989 relating to the consolidated balance sheets of Comprehensive Care Corporation and subsidiaries as of May 31, 1989 and 1988 and the related consolidated statements of earnings, stockholders' equity and cash flows for the years then ended which report appears in the May 31, 1989 annual report on Form 10-K of Comprehensive Care Corporation.

Peat Marwick Main & Co.

Orange County, California
August 28, 1989

EXHIBIT 24.1

COMPREHENSIVE CARE CORPORATION

18551 Von Karman Avenue
Irvine, California 92715

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS
TO BE HELD SEPTEMBER 13, 1989

NOTICE is hereby given that a special meeting of stockholders of Comprehensive Care Corporation, a Delaware corporation ("CompCare"), will be held at CompCare's corporate headquarters, 18551 Von Karman Avenue, Irvine, California, on Wednesday, September 13, 1989, at 9:00 a.m., California time, for the following purposes:

1. To consider and vote upon a proposal to adopt an Agreement and Plan of Reorganization, dated as of April 25, 1989, as amended (the "Reorganization Agreement"), by and among FHC-CompCare, Inc., a Delaware corporation formed for the purpose of effecting the transactions contemplated by the Reorganization Agreement (the "Company"), CompCare and First Hospital Corporation, a Virginia corporation ("First Hospital"), all as described in the accompanying Proxy Statement-Prospectus. The Reorganization Agreement provides, among other things, for the following transactions and the transactions described in the Proxy Statement-Prospectus (sometimes collectively referred to herein as the "Reorganization"):

(a) the merger of Comprehensive Care Acquisition Corp., a Delaware corporation and a wholly owned subsidiary of the Company ("SubI"), with and into CompCare pursuant to the Comprehensive Care Corporation Agreement and Plan of Merger, dated as of April 25, 1989, as amended, by and among the Company, CompCare and SubI, in which merger each share of Common Stock of CompCare, par value $.10 per share ("CompCare Common Stock"), outstanding immediately prior to the Reorganization (other than shares held by CompCare or any of its subsidiaries and other than shares held by holders who have properly exercised their appraisal rights under Delaware law) will be converted into the right to receive $3.00 in cash, 0.78 of a share of Common Stock of the Company, par value $.01 per share ("Company Common Stock"), and $2.75 principal amount of senior subordinated debentures of the Company (the "Merger Debentures"), which will result in the stockholders of CompCare receiving in the aggregate approximately 7,935,457 shares of Company Common Stock in the Reorganization, which represents approximately 39% of the shares of Company Common Stock anticipated to be issued and outstanding immediately after the Reorganization;

(b) an exchange pursuant to agreements among the Company, First Hospital and participating First Hospital stockholders (the "Exchange") whereby the Company will receive from 85% to 100% of the outstanding Common Shares of First Hospital, $.03-⅓ par value ("First Hospital Common Stock"), held by such stockholders, in exchange for up to 12,631,474 shares of Company Common Stock (which represents approximately 61% of the shares of Company Common Stock anticipated to be issued and outstanding immediately after the Reorganization) at a rate of one and one-quarter shares of Company Common Stock for each share of First Hospital Common Stock, which Exchange will be immediately followed, in the event the Company receives less than 100% of the outstanding shares of First Hospital Common Stock in the Exchange, by a merger of First Hospital Acquisition Corp., a Virginia corporation and a wholly owned subsidiary of the Company ("SubII"), with and into First Hospital pursuant to the First Hospital Corporation Agreement and Plan of Merger, dated as of April 25, 1989, by and among the Company, First Hospital and SubII, in which merger each share of First Hospital Common Stock outstanding immediately prior to the Reorganization held by holders who have not participated in the Exchange (other than shares held by the Company, or First Hospital or any of its subsidiaries and other than shares held by holders who have properly exercised their dissenters' rights under Virginia law) will be converted into the right to receive one and one-quarter shares of Company Common Stock.

2. To transact such other business as may properly come before the meeting or any adjournment or postponement thereof.

The Board of Directors has fixed the close of business on Monday, August 7, 1989, as the record date for the determination of stockholders entitled to receive notice of and to vote at the meeting.

By Order of the Board of Directors

MARILYN U. MACNIVEN-YOUNG,
Secretary

Irvine, California
August 14, 1989

YOUR VOTE IS IMPORTANT
WHETHER OR NOT YOU EXPECT TO ATTEND THE SPECIAL MEETING IN PERSON, PLEASE COMPLETE, DATE AND SIGN THE ENCLOSED PROXY CARD AND RETURN IT PROMPTLY IN THE ENCLOSED POSTAGE PREPAID ENVELOPE. THE PROXY IS REVOCABLE AND WILL NOT AFFECT YOUR RIGHT TO VOTE IN PERSON IF YOU ATTEND THE MEETING. YOUR ATTENDANCE IS WELCOMED.