OPTICARE HEALTH SYSTEMS INC
Form 10-Q
November 14, 2002

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

FORM 10-Q

(MARK ONE)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2002

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

COMMISSION FILE NUMBER 1-15223

OPTICARE HEALTH SYSTEMS, INC.
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE	76-0453392
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

87 GRANDVIEW AVENUE, WATERBURY, CONNECTICUT	06708
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code:
(203) 596-2236

Indicate by check X 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.

[X]Yes [ ]No

The number of shares outstanding of the registrant's Common Stock, par value $.001 per share, at October 1, 2002 was 11,462,182 shares.

INDEX TO FORM 10-Q

	Page N
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
Condensed Consolidated Balance Sheets at September 30, 2002 and December 31, 2001 (unaudited)	3
Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2002 and 2001 (unaudited)	4
Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2002 and 2001 (unaudited)	5
Notes to Condensed Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	13
Item 3. Quantitative and Qualitative Disclosures About Market Risk	23
Item 4. Controls and Procedures	23
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	23
Item 2. Changes in Securities and Use of Proceeds	24
Item 6. Exhibits and Reports on Form 8-K	24
SIGNATURE	25
CERTIFICATIONS	26

OPTICARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	SEPTEMBER 30, 2002	DECE 2
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 2,440	$
Accounts receivable, net	6,977	
Inventories	2,128	
Deferred income taxes, current	2,600	
Assets held for sale	-	
Other current assets	1,699	
Total Current Assets	15,844	2
Property and equipment, net	3,261	
Intangible assets, net	1,400	
Goodwill, net	20,516	2
Deferred income taxes, non-current	1,800	
Assets held for sale, non-current	-	
Other assets	3,960	
TOTAL ASSETS	$ 46,781	$ 5
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 4,000	$
Accrued expenses	5,814	
Current portion of long-term debt	1,276	
Liabilities of held for sale business	-	
Other current liabilities	915	
Total Current Liabilities	12,005	1
Long-term debt, less current portion	20,551	3
Liabilities of held for sale business	-	
Other liabilities	1,061	
Total Non-Current Liabilities	21,612	3
Series B 12.5% voting, mandatorily redeemable , cumulative, convertible preferred stock, $0.001 par value, 3,500,000 shares authorized, 3,204,959 shares issued and outstanding	4,487	
STOCKHOLDERS' EQUITY:		
Series A Convertible Preferred Stock, $.001 par value, 550,000 shares authorized; no shares outstanding at September 30, 2002; 418,803 shares outstanding at December 31, 2001	-	
Common Stock, $0.001 par value; 75,000,000 shares authorized; 11,462,182 and 12,815,092 shares outstanding at September 30, 2002 and December 31, 2001, respectively	11	
Additional paid-in-capital	61,312	6
Accumulated deficit	(52,646)	(5
Total Stockholders' Equity	8,677	

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 46,781	$ 5

See notes to condensed consolidated financial statements.

3

OPTICARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2002	2001
NET REVENUES:		
Managed vision services	$ 7,217	$ 6,982
Product sales	9,940	10,681
Other services	5,182	5,471
Other income	671	-
Total net revenues	23,010	23,134
OPERATING EXPENSES:		
Medical claims expense	5,009	5,490
Cost of product sales	7,952	8,581
Cost of services	1,855	2,220
Selling, general and administrative	6,631	6,032
Depreciation	463	486
Amortization	45	258
Interest expense	769	763
Total operating expenses	22,724	23,830
Income (loss) from continuing operations before income taxes	286	(696)
Income tax expense (benefit)	182	41
Income (loss) from continuing operations	104	(737)
Income (loss) from discontinued operations, net of income taxes	130	(58)
Loss on disposal of discontinued operations	(153)	-
Income (loss) before extraordinary gain	81	(795)
Extraordinary gain on early extinguishment of debt, net of income taxes of $3,475	-	-

Net Income (loss)	$ 81	$ (795)
EARNINGS (LOSS) PER SHARE--BASIC AND DILUTED:		
Income (loss) from continuing operations available to Common stockholders	$ (0.01)	$ (0.06)
Income (loss) from discontinued operations	0.00	0.00
Extraordinary gain	-	-
Net income (loss) available to common stockholders	$ (0.01)	$ (0.06)

See notes to condensed consolidated financial statements.

4

OPTICARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(AMOUNTS IN THOUSANDS)
(UNAUDITED)

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,	
	2002	2001
OPERATING ACTIVITIES:		
Net income (loss)	$ 1,066	$ (1,951)
Extraordinary gain on early extinguishment of debt	(5,314)	-
(Income) loss on discontinued operations	3,779	(209)
Loss from continuing operations	(469)	(2,160)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization - discontinued operations	470	551
Depreciation - continuing operations	1,402	1,485
Amortization - continuing operations	134	849
Non-cash interest expense	1,461	417
Non-cash settlement income	(446)	-
Other non-cash	100	104
Changes in operating assets and liabilities		
Accounts receivable	(388)	678
Inventories	(341)	(191)
Other assets	(1,381)	124
Accounts payable and accrued expenses	(2,235)	459
Other liabilities	(495)	(167)
Cash used in discontinued operations	(505)	(401)
Net cash provided by (used in) operating activities	(2,693)	1,748

INVESTING ACTIVITIES:		
Purchase of notes receivable	(1,350)	-
Net proceeds from sale of discontinued operations	3,862	-
Purchases of equipment	(216)	(338)
Net cash provided by (used in) investing activities	2,296	(338)
FINANCING ACTIVITIES:		
Proceeds from long-term debt	23,474	500
Net increase (decrease) in revolving credit facility	(2,180)	-
Proceeds from issuance of preferred stock	4,000	-
Principal payments on long-term debt	(24,993)	(314)
Net cash provided by financing activities	301	186
Increase (decrease) in cash and cash equivalents	(96)	1,596
Cash and cash equivalents at beginning of period	2,536	1,445
Cash and cash equivalents at end of period	$ 2,440	$ 3,041
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 1,406	$ 130
Cash paid (received) for income taxes	33	(108)
Non-cash reduction of debt	1,011	-
Non-cash reduction of receivables	565	-

See notes to condensed consolidated financial statements.

5

OPTICARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands except share data)

1. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements of OptiCare Health Systems, Inc., a Delaware corporation, and subsidiaries (the "Company") for the three and nine months ended September 30, 2002 and 2001 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934 and are unaudited. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation of the consolidated financial statements have been included. The results of operations for the three and nine months ended September 30, 2002 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated balance sheet as of December 31, 2001 was derived from the Company's audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Certain prior period amounts have been reclassified to conform to the current period presentation.

2. DISCONTINUED OPERATIONS

In May 2002, the Company's Board of Directors approved management's plan to dispose of substantially all of the net assets relating to the retail optical business and professional optometry practice locations it operated in North Carolina ("NCOP"). Accordingly, during the quarter ended June 30, 2002 the Company recorded a $3,940 loss on disposal of discontinued operations based on the estimated fair value of the net assets held for sale. On August 12, 2002 the Company consummated the sale of the NCOP net assets to Optometric Eye Care Center, P.A. ("OECC"), an independent professional association owned by two former officers of the Company and recorded an additional loss on disposal of $153. In connection with the sale, the Company received $4,200 in cash and a $1,000 promissory note. Additional consideration included OECC's surrender of 1,321,010 shares of the Company's common stock (for retirement) with an estimated fair market value of $357 and OECC's assumption of $135 of certain other liabilities. The aggregate gross consideration from the sale of approximately $5,692 was offset by approximately $477 of closing and other direct costs associated with the sale. The Company paid $3,074 million to its bank from the proceeds it received from the sale, of which $500 was applied as a payment on the term loan and $2,674 was applied as a payment on the outstanding credit facility.

This sale was accounted for as a disposal group under Statement of Financial Accounting Standards ("SFAS") No. 144. Accordingly, amounts in the financial statements and related notes for all periods presented have been reclassified to reflect SFAS No. 144 treatment.

The unaudited carrying amounts of the assets and liabilities of the disposal group at December 31, 2001 were as follows:

Assets:	
Accounts receivable	$ 1,350
Inventory	1,259
Property and equipment, net	1,846
Intangible assets, net	6,605
Other assets	669
Total assets	$11,729
Liabilities:	
Accounts Payable	$ 963
Accrued Expenses	938
Other liabilities	334
Total liabilities	$ 2,235

6

Operating results of the discontinued operations are as follows:

THREE MONTHS ENDED
SEPTEMBER 30,

	2002	2001
External revenue	$ 2,366	$ 6,608
Intercompany revenue	$ 578	$ 2,281
Income (loss) from discontinued operations before taxes	$ 218	$ (99)
Income tax expense (benefit)	88	(41)
Income (loss) from discontinued operations	130	(58)
Loss on disposal of discontinued operations	(153)	-
Total income (loss) from discontinued operations	$ (23)	$ (58)
Income (loss) per share from discontinued operations	$ 0.00	$ 0.00

3. CAPITAL RESTRUCTURING

On January 25, 2002, the Company closed a series of transactions which resulted in a major restructuring of its debt, equity and voting capital stock (the "Capital Restructuring Transactions"). The Capital Restructuring Transactions included, among other things, the following:

Palisade Concentrated Equity Partnership, L.P. ("Palisade"), a fund manager and stockholder of the Company, purchased, for $3,600 in cash, 2,571,429 shares of the Company's Series B 12.5% Voting Cumulative Convertible Participating Preferred Stock, par value $.001 per share and Linda Yimoyines, wife of Dean J. Yimoyines, M.D., Chairman of the Board and Chief Executive Officer of the Company, purchased for a $400 cash payment 285,714 shares of Series B Preferred Stock. Each share of Series B Preferred Stock is immediately convertible into ten shares of common stock and has the voting power equivalent to ten shares of common stock; accrues cumulative dividends at an annual rate of 12.5%; must be redeemed in full by the Company on December 31, 2008; and with respect to dividends, redemption rights, and rights on liquidation, winding up, corporate reorganization and dissolution, ranks senior to the Company's common stock.

Bank Austria Creditanstalt Corporate Finance, Inc. ("Bank Austria"), which was, until January 25, 2002, the Company's senior secured lender, forgave approximately $10,000 of debt and accrued interest due to it and sold the loans and other obligations of the Company which Bank Austria then held, including security agreements, pledges of stock by certain of the Company's subsidiaries and guarantees of loans and other obligations, to CapitalSource Finance LLC ("CapitalSource"), an asset-based lender specializing in the health care industry.

CapitalSource, as lender, and the Company, as borrower, amended and restated the terms of the indebtedness acquired by CapitalSource from Bank Austria by entering into an Amended and Restated Revolving Credit, Term Loan and Security Agreement, referred to as the Loan and Security Agreement or Credit Facility.

Palisade made a subordinated loan to the Company of $13,900, and Linda Yimoyines made a subordinated loan to the Company of $100 which loans are

evidenced by senior subordinated secured notes. These notes are subordinate to the Company's indebtedness to its senior lender, CapitalSource, and are secured by second-priority security interests in substantially all of the Company's assets (the first-priority security interest is held by CapitalSource).

In connection with providing the $13,900 subordinated loan to the Company, Palisade received warrants to purchase up to 17,375,000 shares of common stock. In connection with providing the $100 subordinated loan to the Company, Ms. Yimoyines received warrants to purchase up to 125,000 shares of common stock. In conjunction with the amendment and restatement of the credit facility, CapitalSource received warrants to purchase 250,000 shares of common stock. The warrants were issued at an exercise price of $0.14 per share and are exercisable during a ten-year

period expiring January 24, 2012. The estimated fair value of the warrants of approximately $1,380 was recorded as a debt discount and is being amortized on the interest method over the term of the related debt.

The bridge loan from Alexander Enterprise Holdings Corp. ("Alexander Enterprise") was satisfied in full, as follows: (i) $2,534 in cash was paid to Alexander Enterprise in full satisfaction of the $2,300 of principal and $234 of accrued interest due to Alexander Enterprise under the Bridge Loan. Alexander Enterprise relinquished its security interest in the assets of the Company and has no further claims against the Company. The cash was provided by the $3,600 purchase by Palisade of Series B Preferred Stock; (ii) The Company issued 309,170.5 shares of Series B Preferred Stock to Palisade to satisfy the $400 of principal and $33 of accrued interest due to Palisade as a participant under the Bridge Loan; and (iii) the Company issued 38,646.3 shares of Series B Preferred Stock to Ms. Yimoyines to satisfy the $50 of principal and $4 of accrued interest due to Ms. Yimoyines as a participant under the bridge loan.

The Company reacquired from Bank Austria, for a cash payment of $1,350, certain notes and contractual rights originally issued or made to the company in connection with the Company's transfers of certain medical practice assets to physicians engaged in such practices.

Without further consideration, Bank Austria surrendered warrants previously issued to it to purchase 100,000 shares of the Company's common stock; surrendered to the Company (for retirement) 418,803 shares of Series A convertible preferred stock of the Company; and surrendered to the Company (for the Company to retire) 56,900 shares of common stock.

In connection with the Capital Restructuring Transactions, the number of shares of authorized common stock was increased from 50,000,000 to 75,000,000. The additional authorized shares provide, among other things, for the availability of common stock to be issued upon conversion of the Series B Preferred Stock and exercise of the warrants issued.

The following table sets forth the long-term debt of the Company at September 30, 2002:

Term note payable to CapitalSource in principal amounts of $50 per quarter. The final principal payment is payable for the outstanding principal balance and is due and payable on January 25, 2004. Principal and interest is due and payable monthly in arrears. The interest rate equals the Prime Rate plus 3.5%. The term note is collateralized

by substantially all assets of the Company.	$2,383
Revolving credit note to CapitalSource, due January 25, 2005, interest is due and payable monthly in arrears on the first of the month at an annual rate of Prime Rate plus 1.5% and is collateralized by substantially all assets of the Company. As of September 30, 2002, the Company had $1,153 of availability under its revolving credit note.	4,294
Senior subordinated secured notes payable due January 24, 2012. The interest rate is 11.50% payable on the last day of each calendar quarter. The notes are secured by second-priority security interests in substantially all the Company's assets (the first-priority security interest is held by CapitalSource). The outstanding loan balance at September 30, 2002 includes $1,143 of paid-in-kind interest.	15,143
Subordinated notes payable due at various dates through 2004. Principal and interest payments are due monthly or annually. Interest is payable at rates ranging from 7% to 11.4%.	1,295
Unamortized discounts	(1,288)
Total	$21,827
Less current portion	1,276
Long-term portion	$20,551

4. EXTRAORDINARY ITEM

On January 25, 2002, the Company recorded a gain on the early extinguishment of debt of $8,789 before income tax of $3,475 as a result of the Company's Capital Restructuring Transactions. The $8,789 gain was comprised principally of approximately $10,000 of debt and interest forgiveness by Bank Austria, the Company's former senior secured lender, which was partially offset by $1,200 of unamortized deferred financing fees and debt discount.

5. SEGMENT INFORMATION

During the third quarter of 2002, the Company sold its retail optometry division in North Carolina and modified the Company's strategic vision to reflect that of the Company's new President. Accordingly, the Company realigned its business into the following three reportable operating segments: (1) Managed Vision, (2) Consumer Vision, and (3) Distribution and Technology. These operating segments are managed separately, offer separate and distinct products and services, and serve different customers and markets. Discrete financial information is available for each of these segments and the Company's President assesses performance and allocates resources among these three operating segments.

The Managed Vision segment contracts with insurers, managed care plans and other third party payors to manage claims payment administration of eye health benefits for those contracting parties. The Consumer Vision segment sells

retail optical products to consumers and operates integrated eye health centers and surgical facilities where comprehensive eye care services are provided to patients. The Distribution and Technology segment provides products and services to eye care professionals (ophthalmologists, optometrists and opticians). This segment operates a buying group program for optical and ophthalmic goods and medical supplies, and develops and sells technology systems and software, to eye care professionals. In addition to its reportable operating segments, the Company's "All Other" category includes other non-core operations and transactions, including its health service organization operation, which do not meet the quantitative thresholds for a reportable segment.

As a result of the changes discussed above, historical amounts previously reported in 2002 and 2001 have been restated to conform to the Company's current operating segment presentation.

Summarized financial information, by segment, for the three and nine months ended September 30, 2002 and 2001 is as follows:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE S
	2002	2001	2002
REVENUES:			
Managed vision	$ 7,217	$ 6,982	$ 21,9
Consumer vision	7,155	6,969	21,6
Distribution and technology	9,152	9,384	28,8
Reportable segment totals	23,524	23,335	72,4
All other	941	856	2,1
Elimination of inter-segment revenues	(1,455)	(1,057)	(4,2
Total net revenue	$ 23,010	$ 23,134	$ 70,3
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE TAX:			
Managed vision	$ 1,090(a)	$ 501	$ 1,9
Consumer vision	423	86	1,1
Distribution and technology	190	12	6
Reportable segment totals	1,703	599	3,7
All other	653	745	1,6
Depreciation	(463)	(486)	(1,4
Amortization	(45)	(258)	(1
Interest expense	(768)	(763)	(2,3
Corporate	(794)	(533)	(2,2
Income (loss) from continuing operations before income taxes	$ 286	$ (696)	$ (6

(a) Includes a $600 reduction in claims expense due to a favorable adjustment to the reserve.

6. EARNINGS (LOSS) PER SHARE

The following tables sets forth the computation of basic and diluted earnings (loss) per share:

	THREE MONTHS ENDED SEPTEMBER 30,	
	2002	2001
Income (loss) from continuing operations	$ 104	$ (737)
Preferred stock dividend	(143)	-
Loss from continuing operations available to Common stockholders	(39)	(737)
Discontinued operations	(23)	(58)
Extraordinary gain	-	-
Net income (loss) available to common stockholders	$ (62)	$ (795)
Weighted average common shares outstanding - Basic and diluted	12,065,252	12,815,092
Earnings (loss) per share - basic and diluted:		
Loss from continuing operations available to common stockholders	$ (0.01)	$ (0.06)
Discontinued operations	(0.00)	0.00
Extraordinary item	-	-
Net income (loss) per common share	$ (0.01)	$(0.06)

The following table reflects the potential common shares of the Company at September 30, 2002 and 2001. These potential shares have been excluded from the calculation of diluted earnings per share because the Company incurred a loss from continuing operations available to common stockholders in those periods and their effect would be anti-dilutive.

	2002	2001
Options	4,908,545	920,458
Warrants	21,196,198	3,501,198
Convertible Preferred Stock	32,049,598	418,803
	58,154,341	4,840,459

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7. CONTINGENCIES

The Company is both a plaintiff and defendant in lawsuits incidental to its current and former operations. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. Consequently, the ultimate aggregate amount of monetary liability or financial impact with respect to these matters at September 30, 2002 cannot be ascertained. Management is of the opinion that, after taking into account the merits of defenses and established reserves, the ultimate resolution of these matters will not have a material adverse impact on the Company's consolidated financial position or results of operations.

8. NEW ACCOUNTING PRONOUNCEMENTS

Effective January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets". The standard changes the accounting for goodwill and intangible assets with an indefinite life whereby such assets will no longer be amortized; however the standard does require evaluation for impairment, and a corresponding write-down, if appropriate. FAS No. 142 requires the Company to complete a transitional goodwill impairment test six months from the date of adoption. The Company completed its transitional impairment test during the quarter ended June 30, 2002 and no impairment write-down was required.

Comparative information as if goodwill had not been amortized is as follows:

	THREE MONTHS ENDED SEPTEMBER 30,		N
	2002	2001	20
Net income (loss) as reported	$ 81	$(795)	$1,06
Add back: goodwill amortization	-	213	-
Adjusted net income (loss)	81	(582)	1,06
Preferred stock dividend	(143)	-	(38
Adjusted net income (loss) available to common Stockholders	$ (62)	$(582)	$ 67
Earnings (loss) per common share - basic and diluted:			
Net income (loss) available to common stockholders	$0.00	$(0.06)	$ 0.0
Goodwill amortization	-	0.01	-
Adjusted net income (loss) per share	$0.00	$ 0.05	$ 0.0

Intangible assets subject to amortization are as follows:

	AT SEPTEMBER 30, 2002	AT DECEMBER 31, 2001
Gross Carrying Amount	$ 1,926	$ 1,926
Accumulated Amortization	(526)	(392)
Total	$ 1,400	$ 1,534

Amortization of intangibles was $45 for the three months ended September 30, 2002 and 2001, and $134 for the nine months ended September 30, 2002 and 2001. Estimated annual amortization expense is expected to be $178, $172, $111, $111 and $111 for the years 2002, 2003, 2004, 2005 and 2006, respectively.

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 143, "Accounting For Asset Retirement Obligations". This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Company is required to adopt the provisions of SFAS No. 143 at the beginning of fiscal 2003. The Company has determined that the adoption of this statement will not have a material impact on its financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". This statement requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. This statement also broadens the definition of discontinued operations to include more disposal transactions. The provisions of this statement were adopted by the Company on January 1, 2002. The Company applied SFAS No. 144 to the sale of assets used in its retail optical and optometry operations in North Carolina and reported a loss on disposal of $153 and $4,092 for the three and nine month periods ended September 30, 2002.

In April 2002, the FASB issued SFAS No. 145, "Recission of FASB Statements 4, 44 and 64, Amendment of FASB Statement 13, and Technical Corrections". SFAS No. 145 rescinds the provisions of SFAS No. 4 that requires companies to classify certain gains and losses from debt extinguishments as extraordinary items, eliminates the provisions of SFAS No. 44 regarding transition to the Motor Carrier Act of 1980 and amends the provisions of SFAS No. 13 to require that certain lease modifications be treated as sale leaseback transactions. The provisions of SFAS No. 145 related to classification of debt extinguishment are effective for fiscal years beginning after May 15, 2002. In future periods, the Company will classify debt extinguishment costs within income from operations and will reclassify previously reported debt extinguishments as such. The provisions of SFAS No. 145 related to lease modification are effective for transactions occurring after May 15, 2002. Upon

adoption, the Company will reclassify its previously reported gain from extinguishment of debt of $8,789 and related income tax expense of $3,475 from an extraordinary item to continuing operations.

In June 2002, the FASB issued Statement No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" and nullified EITF Issue No. 94-3. SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, whereas EITF No 94-3 had recognized the liability at the commitment date of an exit plan. The Company is required to adopt the provisions of SFAS No. 146 effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect the provisions of SFAS No. 146 to have a material impact on its financial position or results of operations.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion may be understood more fully by reference to the financial statements, notes to the financial statements, and management's discussion and analysis contained in the company's Annual Report on Form 10-K for the year ended December 31, 2001, as filed with the Securities and Exchange Commission.

Overview. OptiCare Health Systems, Inc. is an integrated eye care services company that delivers a range of services and systems for eye health professionals and consumers, including managed care and professional eye care services. During the third quarter of 2002, the Company sold its retail optometry division in North Carolina and modified the Company's strategic vision to reflect that of the Company's new President. Accordingly, the Company realigned its business into the following three reportable operating segments: (1) Managed Vision, (2) Consumer Vision, and (3) Distribution and Technology. These operating segments are managed separately, offer separate and distinct products and services, and serve different customers and markets. Discrete financial information is available for each of these segments and the Company's President assesses performance and allocates resources among these three operating segments. The Managed Vision segment contracts with insurers, managed care plans and other third party payors to manage claims payment administration of eye health benefits for those contracting parties. The Consumer Vision segment sells retail optical products to consumers and operates integrated eye health centers and surgical facilities where comprehensive eye care services are provided to patients. The Distribution and Technology segment provides products and services to eye care professionals (ophthalmologists, optometrists and opticians). This segment operates a buying group program for optical and ophthalmic goods and medical supplies, and develops and sells technology systems and software, to eye care professionals. In addition to its reportable operating segments, the company's "All Other" category includes other non-core operations and transactions, including its health service organization that do not meet the quantitative thresholds for a reportable segment.

In May 2002, the company's Board of Directors approved management's plan to dispose of substantially all of the net assets used in retail optical and professional optometry practice locations that it owned or operated in the State of North Carolina. On August 12, 2002, the company consummated the sale of those net assets to Optometric Eye Care Center, P.A., an independent professional association owned by two former officers of the company. The sale

was accounted for as a disposal group under Statement of Financial Accounting Standards ("SFAS") No. 144. Accordingly, amounts in the financial statements (and described below) for all periods presented have been reclassified to reflect SFAS No. 144 treatment.

RESULTS OF OPERATIONS

Three Months Ended September 30, 2002 Compared to the Three Months Ended September 30, 2001

Managed vision services revenue. Managed vision services revenue increased to $7.2 million for the three months ended September 30, 2002 from $7.0 million for the three months ended September 30, 2001, an increase of $0.2 million. This increase was primarily due to revenue on new contracts and growth in existing contracts, which were partially offset by decreases in revenue associated with contracts that are no longer being serviced by the company.

Product sales revenue. Product sales revenue decreased to $9.9 million for the three months ended September 30, 2002 compared to $10.7 million for the three months ended September 30, 2001, a decrease of $0.8 million. Of this decrease $0.7 million represents a decrease in buying group revenue and $0.1 million represents a decrease in retail optical revenue resulting from a decrease in purchasing volume. The decrease in buying group volume is primarily due to consolidation in the eye care industry whereby smaller independent eye care businesses are being replaced by larger eye care chains that purchase directly from vendors. The company expects this shift to continue and potentially further reduce the buying group's market share and revenue, however the company does not expect this trend to have a material impact on its overall profitability.

Other services revenue. Other services revenue decreased to $5.2 million for the three months ended September 30, 2002 compared to $5.5 million for the three months ended September 30, 2001, a decrease of $0.3 million. This decrease was due to a $0.6 million decrease in health service organization revenue, which was partially offset by a $0.3 million increase in consumer vision services attributed to improved productivity of service providers. The company's revenue stream from fees collected under its health service organization agreements has been decreasing due to disputes with certain physician practices who are parties to these agreements. The company is in litigation with several of these practices and intends to continue to pursue settlement of these matters in the future. While a continued decrease in these contractual fees could negatively impact our cash flows, the company is currently focusing on resolving the disputes with these practices and believes the company will receive cash payments and/or other consideration in settlement of these disputes.

13

Other income. Other income for the three months ended September 30, 2002 of $0.7 million represents non-recurring settlements on contracts.

Medical claims expense. Medical claims expense was $5.0 million for the three months ended September 30, 2002 compared to $5.5 million for the three months ended September 30, 2001. This decrease was due to a $0.6 million favorable adjustment to the reserve in the current quarter. The medical claims expense loss ratio (MLR), representing medical claims expense as a percentage of managed vision revenue decreased to 69.4% for the three months ended September

30, 2002 compared to 78.6% for the same period in 2001, due to the favorable adjustment of $0.6 million in the current quarter. Excluding this adjustment, MLR for the three months ended September 30, 2002 would have been 77.7% compared to 78.6% for the same period in 2001.

Cost of product sales. Cost of product sales decreased to $8.0 million for the three months ended September 30, 2002 from $8.6 million for the three months ended September 30, 2001, a decrease of $0.6 million. This decrease primarily represents a reduction in cost of sales related to the buying group program as a result of the decrease in sales volume.

Cost of services. Cost of services decreased to $1.9 million for the three months ended September 30, 2002 from $2.2 million for the three months ended September 30, 2001, a decrease of $0.3 million. This decrease was largely due to a decrease in cost of services associated with consumer vision services as a result of cost containment initiatives.

Selling, general and administrative. Selling, general and administrative expenses increased to $6.6 million for the three months ended September 30, 2002 from $6.0 million for the three months ended September 30, 2001, an increase of $0.6 million. This change primarily represents an increase in compensation due to staff expansion, and an increase in legal and other professional fees.

Amortization expense. Amortization expense decreased to less than $0.1 million for the three months ended September 30, 2002 from $0.3 million for the three months ended September 30, 2001 due to the discontinuation of the amortization of goodwill effective January 1, 2002 in accordance with Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets".

Income tax expense. The income tax expense of $182 for the three months ended September 30, 2002 represents tax expense on income from continuing operations for the quarter as well as an adjustment for minimum state tax expense. For the three months ended September 30, 2001, the $41 tax expense on the loss from continuing operations was offset by a $41 tax benefit on the loss from discontinued operations. There was no aggregate income tax benefit on the net loss for the three months ended September 30, 2001 due to the uncertainty regarding the company's ability to utilize its net operating loss carryforwards at that time.

Discontinued operations. In May 2002, the company's Board of Directors approved management's plan to dispose of the company's net assets used in the retail optical and optometry practice locations it owned or operated in North Carolina and on August 12, 2002 consummated the sale of those assets. During the quarter ended September 30, 2002 the company recorded an additional loss on disposal of discontinued operations of $0.2 million, primarily due to changes in estimated closing costs and increases in the carrying value of the net assets held for sale as a result of operations from June 30, 2002 through the sale date. The company reported $0.1 million of income from discontinued operations, net of tax, for the three months ended September 30, 2002 compared to a $0.1 million loss from discontinued operations, net of tax, for the three months ended September 30, 2001.

Net income (loss). The company reported net income of $0.1 million for the three months ended September 30, 2002 compared to a net loss of $0.8 million for the three months ended September 30, 2001, representing an improvement of $0.9 million. This improvement was primarily due to a net decrease in operating expenses, as more fully described above.

Nine Months Ended September 30, 2002 Compared to the Nine Months Ended September

30, 2001

Managed vision services revenue. Managed vision services revenue increased to $22.0 million for the nine months ended September 30, 2002 compared to $21.8 million for the nine months ended September 30, 2001, an increase of $0.2 million. Managed vision revenue increased due to new contracts and growth on existing contracts, which were partially offset by a decrease in revenue primarily on three contracts that were not renewed.

Product sales revenue. Product sales revenue decreased to $31.6 million for the nine months ended September 30, 2002 compared to $34.8 million for the nine months ended September 30, 2001, a decrease of $3.2 million. Of this

decrease, $2.8 million represents a decrease in buying group revenue and $0.4 million represents a decrease in retail optical product revenue resulting from decreases in purchasing volume. The decrease in buying group volume is due to consolidation in the eye care industry and an accompanying trend toward direct purchase from vendors. The company expects this shift to continue and potentially further reduce the buying group's market share and revenue, however, the company does not expect this trend to have a material impact on its overall profitability.

Other services revenue. Other services revenue decreased to $15.5 million for the nine months ended September 30, 2002 compared to $15.6 million for the nine months ended September 30, 2001, a decrease of $0.1 million. This decrease includes a $1.3 million decrease in health service organization revenue, which was offset by a $0.7 million increase in consumer vision services and a $0.5 million increase in software services. The company's revenue stream from fees collected under its health service organization agreements has been decreasing due to disputes with certain physician practices which are parties to these agreements. The company is in litigation with several of these practices and intends to continue to pursue settlement of these matters in the future. While a continued decrease in these contractual fees could negatively impact our cash flows, the company is currently focusing on resolving the disputes with these practices and believes the company will receive cash payments and/or other consideration in settlement of these disputes. The $0.7 million increase in consumer vision services was due to improved productivity in the optometry and ophthalmology service areas and the $0.5 million increase in software sales was primarily due to an increase in sales volume.

Other income. Other income for the nine months ended September 30, 2002 was $1.3 million, which represented non-recurring settlements on contracts.

Medical claims expense. Medical claims expense decreased to $16.8 million for the nine months ended September 30, 2002 compared to $17.3 million for the nine months ended September 30, 2001, a decrease of $0.5 million. This decrease is primarily due to a $0.6 million favorable adjustment to the claims reserve in 2002. The medical claims expense loss ratio (MLR), representing medical claims expense as a percentage of managed vision revenue, decreased to 76.5% in 2002 compared to 79.5 % in 2001, due primarily to the aforementioned $0.6 million adjustment. Excluding this adjustment, MLR would have remained relatively unchanged at 79.2% in 2002 compared to 79.5% in 2001.

Cost of product sales. Cost of product sales decreased to $25.1 million for the nine months ended September 30, 2002 from $28.0 million for the nine months ended September 30, 2001, a decrease of $2.9 million. This decrease

primarily represents a reduction in cost of sales related to the buying group program as a result of the decrease in sales volume.

Cost of services. Cost of services decreased to $6.1 million for the nine months ended September 30, 2002 from $6.4 million for the nine months ended September 30, 2001, a decrease of $0.3 million. This decrease was comprised of a $0.4 million decrease in consumer services due to the implementation of cost containment initiatives. This decrease was offset by a $0.1 million increase in technology services due to an increase in sales.

Selling, general and administrative. Selling, general and administrative expenses increased to $19.1 million for the nine months ended September 30, 2002 from $18.2 million for the nine months ended September 30, 2001, an increase of $0.9 million. This increase is primarily due to increases in compensation, legal and professional fees.

Amortization expense. Amortization expense decreased to $0.1 million for the nine months ended September 30, 2002 from $0.8 million for the nine months ended September 30, 2001 due to the discontinuation of the amortization of goodwill effective January 1, 2002 in accordance with Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets".

Income tax benefit. The income tax benefit on continuing operations for the nine months ended September 30, 2002 was $200, which represents a tax benefit at the statutory rate on the loss from continuing operations, offset by anticipated minimum taxes. For the nine months ended September 30, 2001, the $139 tax benefit on the loss from continuing operations was offset by $139 of tax expense on income from discontinued operations. There was no aggregate income tax benefit on the company's net loss for the nine months ended September 30, 2001 due to the uncertainty regarding the company's ability to utilize its net operating loss carryforwards.

Discontinued operations. In May 2002, the company's Board of Directors approved management's plan to dispose of the company's net assets of the retail optical and optometry practices it owned or operated in North Carolina and on August 12, 2002 the company consummated the sale. For the nine months ended September 30, 2002, the company recorded a $4.1 million loss on the disposal of discontinued operations. Income from discontinued operations, net of

tax, was $0.3 million for the nine months ended September 30, 2002 compared to $0.2 million for the nine months ended September 30, 2001.

Extraordinary item. The company reported a $5.3 million net gain on early extinguishment of debt for the nine months ended September 30, 2002. The gain was reported in the first quarter of 2002 and was comprised of approximately $10.0 million of forgiveness of principal and interest by Bank Austria, the company's former senior secured lender, and was partially offset by the write-off of $1.2 million of related unamortized deferred financing fees and debt discount, and $3.5 million of income taxes.

Net income (loss). The company reported net income of $1.1 million for the nine months ended September 30, 2002 compared to a net loss of $1.9 million for the nine months ended September 30, 2001, an increase in net income of $3.0 million. The improvement was primarily due to the $5.3 million gain on the extinguishment of debt and a $1.7 million improvement in continuing operations which was partially offset by a $4.0 million loss on discontinued operations, as more fully described above.

LIQUIDITY AND CAPITAL RESOURCES

The company's primary sources of liquidity are cash flows generated from operations and borrowings under its credit facility. The company's principal uses of liquidity are to provide working capital, meet debt service requirements and finance capital expenditures. We believe that our cash flow from operations, borrowings under our credit facility, and operating and capital lease financing will provide us with sufficient funds to finance our operations for the next 12 months.

As of September 30, 2002, we had approximately $2.4 million of cash and cash equivalents, $2.4 million of borrowings outstanding under a term loan, and $4.3 million outstanding under our revolving credit agreement. Although we have a $10 million revolving credit facility, the amount available to be borrowed at any time is based on the value of the collateral underlying the facility and on the amount outstanding under the facility at such time. As of September 30, 2002, we had $1.2 million of available credit under our revolving credit facility.

Net cash used in operating activities of $2.7 million for the nine months ended September 30, 2002 was primarily driven by a $2.7 million reduction in accounts payable and other liabilities as a result of the company's improved liquidity after the capital and debt restructuring in January 2002 and a $1.7 million increase in other assets from escrow deposits. Other uses of cash for the period included increases in accounts receivable and inventory of $0.7 million. These changes were offset by $2.5 million of net income from continuing operations after adding back non-cash charges for depreciation, amortization and interest of continuing operations. Net cash provided by operating activities for the nine months ended September 30, 2001 of $1.7 million included $0.6 million of income from continuing operations after adding back non-cash charges for depreciation, amortization and interest of continuing operations, a $0.7 million decrease in accounts receivable and a $0.5 million increase in accounts payable and accrued expenses.

Net cash provided by investing activities was $2.3 million for the nine months ended September 30, 2002 compared to $0.3 million used in investing activities for the nine months ended September 30, 2001. Net cash provided by investing activities in 2002 consisted principally of $3.9 million in net cash received from the sale of discontinued operations, which was offset by $1.4 million paid to reacquire certain notes receivable and contractual rights as part of the Capital Restructuring Transactions and $0.2 million for the purchase of fixed assets. Net cash used in investing activities for the nine months ended September 30, 2001 was $0.3 million for the purchase of fixed assets.

Net cash provided by financing activities was $0.3 million for the nine months ended September 30, 2002 compared to $0.2 million for the nine months ended September 30, 2001. Net cash provided by financing activities in 2002 consisted of approximately $27.5 million from the issuance of debt and preferred stock, which was partially offset by approximately $25.0 million of principal payments on long-term debt, primarily related to the company's debt restructuring in January 2002, and a $2.2 million net decrease in the revolving credit facility. The primary sources of net cash from financing activities for the nine months ended September 30, 2001 was $0.5 million of net proceeds from funds borrowed under the company's amended bridge loan which was partially offset by approximately $0.3 million of principal payments on notes payable.

Under an agreement with the Texas Department of Insurance, the company is required to maintain a restricted investment of $250,000. The company does not believe the requirements of the Texas Department of Insurance will have a material impact on the company's liquidity.

16

The Capital Restructuring Transactions

On January 25, 2002, the company completed a series of transactions that resulted in a major reduction in, and restructuring of, the debt described above as well as our issuance of voting capital stock. The transactions included, among other things, the following:

1. Palisade Concentrated Equity Partnership, L.P., a fund manager and stockholder of the company, purchased, for $3.6 million in cash, 2,571,429 shares of the company's Series B 12.5% Voting Cumulative Convertible Participating Preferred Stock, par value $.001 per share, referred to as the Series B Preferred Stock, convertible into 25,714,290 shares of common stock. Linda Yimoyines, wife of Dr. Yimoyines, purchased for a cash payment of $0.4 million, 285,714 shares of Series B Preferred Stock. The Series B Preferred Stock is described in more detail below.

2. Bank Austria forgave the portion of our indebtedness to it in excess of $21.8 million and sold the loans and other obligations of the company which Bank Austria then held, including security agreements, pledges of stock by certain of our subsidiaries and guarantees of loans and other obligations, to CapitalSource Finance LLC, a Delaware limited liability company.

3. CapitalSource, as lender, and the company, as borrower, amended and restated the terms of the indebtedness acquired by CapitalSource from Bank Austria by entering into an Amended and Restated Revolving Credit, Term Loan and Security Agreement, referred to as the Loan and Security Agreement or the Credit Facility.

4. Palisade made a subordinated loan to us of $13.9 million, and Linda Yimoyines, wife of Dean J. Yimoyines, made a subordinated loan to us of $100,000, which loans are evidenced by senior subordinated secured notes, the terms of which are described in more detail below.

5. In connection with providing its $13.9 million subordinated loan to the company, Palisade received warrants entitling Palisade to purchase up to 17,375,000 shares of common stock at an exercise price of $0.14 per share (subject to anti-dilution provisions). In connection with her providing a $100,000 subordinated loan to the company, Ms. Yimoyines received warrants entitling her to purchase up to 125,000 shares of common stock at an exercise price of $0.14 per share (subject to anti-dilution provisions). The warrants issued to Palisade and to Ms. Yimoyines are exercisable during a ten-year period expiring January 24, 2012.

6. In conjunction with the amendment and restatement of the credit facility, we issued 10-year warrants to CapitalSource to purchase 250,000 shares of our common stock at an exercise price of $0.14 per share (subject to anti-dilution provisions).

7. The company applied a portion of the proceeds of the Palisade loan to pay down the indebtedness under our credit facility now held by

CapitalSource.

8. Our bridge loan from Alexander Enterprise was satisfied in full, as follows:

   a. $2.5 million in cash was paid to Alexander Enterprise in full satisfaction of the principal and interest owed to Alexander Enterprise under the bridge loan. Alexander Enterprise relinquished its security interest in the assets of the company and has no further claims against us. The cash was provided by the $3.6 million purchase by Palisade of Series B Preferred Stock.

   b. We satisfied our obligations to Palisade as a participant under the bridge loan by issuing to Palisade 309,170.5 shares of Series B Preferred Stock. The amount of such participation, including accrued but unpaid interest, was $432,839.

   c. We satisfied our obligations to Ms. Yimoyines as a participant under the bridge loan by issuing to Ms. Yimoyines 38,646.3 shares of Series B Preferred Stock. The amount of such participation, including accrued but unpaid interest, was $54,104.

9. We reacquired from Bank Austria, for a cash payment of $1.35 million, certain notes and contractual rights originally issued or made to the company in connection with the company's transfers of certain medical practice assets to physicians engaged in such practices.

17

10. Without further consideration, Bank Austria surrendered to the company warrants previously issued to it to purchase 100,000 shares of the company's common stock; surrendered to the company (for retirement) 418,803 shares of Series A convertible preferred stock of the company; and surrendered to the company (for retirement) 56,900 shares of common stock.

11. As of the closing of the Capital Restructuring Transactions on January 25, 2002, Palisade held (i) 2,000,000 shares of our common stock which were previously acquired, (ii) 2,880,599.5 shares of Series B Preferred Stock, immediately convertible into 28,805,995 shares of common stock, and (iii) immediately exercisable warrants to purchase up to an additional 17,775,000 shares of common stock, of which warrants to purchase 400,000 shares at $0.40 per share were previously acquired. Thus, 44,864,690 shares of our common stock (including 12,815,092 shares of common stock outstanding as of January 25, 2002 (i.e., prior to the Capital Restructuring Transactions), and 32,049,598 shares of common stock issuable upon conversion of the Series B Preferred Stock held by Palisade and Ms. Yimoyines) would be outstanding in the event that all of the shares of Series B Preferred Stock are converted. Without giving effect to any warrants, Palisade may be deemed to beneficially own 74.0% of our common stock. Giving effect to the warrants held by Palisade, Palisade may be deemed to beneficially own 81.8% of our common stock.

In connection with the Capital Restructuring Transactions, we agreed that, so long as Palisade owns more than 50% of the voting power of the company,

Palisade shall have the right to designate a majority of our board of directors. Pursuant to this provision, three nominees of Palisade were elected to the company's board of directors effective January 25, 2002.

In connection with the Capital Restructuring Transactions, our stockholders approved various equity-related proposals by written consent in a solicitation process, which commenced on January 4, 2002. Among those was a proposal to increase the number of shares of authorized common stock from 50,000,000 to 75,000,000. The additional authorized shares provide the availability of common stock to be issued upon conversion of the Series B Preferred Stock and exercise of the warrants, which were issued to Palisade, Ms. Yimoyines and CapitalSource.

Subject to the reservation shares of common stock for such conversion and exercise of warrants, the additional shares will be available for issuance from time to time by the company at the discretion of the board of directors, normally without further stockholder action or notification (except as may be required for a particular transaction by applicable law, requirements of regulatory agencies or by stock exchange rules) to provide for future equity and convertible debt financings, acquisitions of property or securities of other corporations, debt conversions and exchanges, exercise of current and future options and warrants, and for issuance under our current or future employee benefit plans, stock dividends and stock splits.

In conjunction with the Capital Restructuring Transactions the company adopted a by-law amendment which provides that, for so long as Palisade holds more than 50% of our voting power, the approval of the majority of the company's independent directors (as that term is defined by the American Stock Exchange) is required to, among other things, redeem the Series B Preferred Stock; issue any new class or series of preferred stock to Palisade; issue a security convertible into preferred stock to Palisade; declare or pay any dividend in cash, property or securities of the company; or amend the special voting provision of the company's by-laws.

The CapitalSource Credit Facility

The amended and restated credit facility with CapitalSource is comprised of a $3 million term loan and up to a $10 million revolving credit facility.

The principal terms of the term loan with CapitalSource are:

- The maximum amount of the term loan is 40% of the value of our capital equipment, as determined by CapitalSource in its absolute discretion; the current balance drawn down on the term loan is $3 million.

- The interest rate is 3.5 percentage points over the announced prime rate of Citibank, N.A., but not less than 9%.

- Principal and interest are payable monthly, on the basis of a 15-year amortization, with payment in full of the balance due on January 25, 2004, two years from the closing of the Loan and Security Agreement.

The principal terms of the revolving credit facility with CapitalSource are:

- The maximum amount which may be advanced under the revolving credit facility is the lesser of (i) $10 million or (ii) 80% of eligible accounts receivable and inventory of the company, plus up to an additional $750,000.

  - Eligible accounts receivable are accounts receivable not more than 120 days old, subject to certain cross-aging requirements, and subject to determination by CapitalSource.

  - Eligible inventory is inventory meeting a number of detailed requirements of CapitalSource and valued at the company's cost less all discounts.

- The interest rate on the revolving credit facility is 1.5 percentage points above the announced prime rate of Citibank, N.A., but not less than 7% per year. Interest is payable monthly in arrears.

- All accounts receivable of the company shall be paid into lockbox accounts and immediately transferred from such lockbox accounts into a depository account maintained by CapitalSource on a daily basis.

- The revolving credit facility expires and the outstanding balance of the revolving credit facility, together with accrued but unpaid interest, comes due in full on January 25, 2005, three years from the closing of the amended and restated Loan and Security Agreement.

With respect to both the term loan and the revolving credit facility, we must also pay a monthly "unused line fee" that equals the excess, if any, of $3,000 over all interest accrued for such month.

The Loan and Security Agreement contains certain restrictions on the conduct of our business, including, among other things, restrictions on incurring debt, purchasing or investing in the securities of, or acquiring any other interest in, all or substantially all of the assets of any person or joint venture, declaring or paying any cash dividends or making any other payment or distribution on our capital stock, and creating or suffering liens on our assets. We are required to maintain certain financial covenants, including a minimum fixed charge ratio and a minimum net worth.

The company's subsidiaries have guaranteed payments and other obligations under the credit facility and the company (including certain subsidiaries) has granted a security interest in substantially all its assets in favor of CapitalSource. The company also pledged the capital stock of certain of its subsidiaries to CapitalSource.

The occurrence of certain events or conditions described in the Loan and Security Agreement (subject to grace periods in certain cases) constitutes an "event of default." If an event of default occurs, the entire outstanding balance of principal and interest would become immediately due and payable. Events of default include:

- Our failure to pay any principal or interest when due;

- Our failure to pay any indebtedness to persons other than CapitalSource in excess of $250,000 (including amounts payable to Palisade under the note issued to Palisade);

- Our failure to observe any covenant under the credit facility (including, e.g., the financial covenants);

- Bankruptcy, insolvency or receivership proceedings with respect to the company;

- Certain changes of control of the company (as defined in the Loan and Security Agreement);

- Our inability to pay our debts generally as they come due; and

- The occurrence or expectation of any material adverse change with respect to the company.

In August 2002, the company paid $3,074,105 to CapitalSource from the proceeds it received from the sale of its net assets used in its retail optical and optometry operations in North Carolina. Of the $3,074,105 paid, $500,000 was applied as a payment on the term loan and $2,674,105 was applied as a payment on the outstanding credit facility. An additional $400,000 was paid to CapitalSource in October 2002 from proceeds released from escrow on the aforementioned sale, which was applied to the outstanding credit facility.

The Palisade and Yimoyines Senior Subordinated Secured Loans

Palisade made a subordinated loan to us of $13.9 million, and Ms. Yimoyines made a subordinated loan to us of $100,000, which loans are evidenced by senior subordinated secured notes. The senior subordinated secured notes issued to Palisade and to Ms. Yimoyines rank pari passu with each other. The notes are subordinate to our indebtedness to CapitalSource and are secured by second-priority security interests in substantially all the company's assets (the first-priority security interest is held by CapitalSource).

Principal is due to be paid in 10 years (i.e., on January 25, 2012) and interest is payable quarterly at the rate of 11.5%. In the first and second years, the company has the right to defer 100% and 50%, respectively, of interest to maturity by increasing the principal amount of the note by the amount of interest so deferred. In the third through tenth years, the holder of the note has the right to require the company to defer interest to maturity by increasing the principal amount of the note by the amount of interest so deferred. As of September 30, 2002, the Company deferred the payment of interest on these senior notes to maturity by increasing the principal balance of these notes by $1,143,000.

The notes contain certain restrictions on the conduct of our business, including, among other things, restrictions on incurring debt, becoming a party to a merger, selling or transferring substantially all of the assets of the company, declaring or paying any cash dividends or making any other payment or distribution on the company's capital stock or purchasing or redeeming such stock, entering into any agreements inconsistent with the company's obligations under the notes, making any redemption or prepayment of any subordinated debt, creating or suffering liens on the company's assets, or materially changing the nature of the company's business.

The occurrence of certain events or conditions described in the Notes (subject to grace periods in certain cases) constitutes a "default." If a default occurs, the entire outstanding balance of principal and interest would become immediately due and payable. Such defaults include, but are not limited

to, failure to pay any principal or interest under the notes when due; failure to pay any principal or interest when due with respect to the CapitalSource credit facility; failure to perform or comply with any obligation under the notes; entry of a final judgment against the company, which, together with all other final judgments, exceeds in the aggregate $250,000, and which judgment is not stayed, paid or discharged; and bankruptcy, insolvency or receivership proceedings with respect to the company.

The Series B Preferred Stock

The company issued 3,204,959 shares of Series B 12.5% Voting Cumulative Convertible Participating Preferred Stock. The Series B Preferred Stock accrues cumulative dividends at an annual rate of 12.5%. As of September 30, 2002, accrued and unpaid dividends on the Preferred Stock were approximately $388,000.

Each share of Series B Preferred Stock is immediately convertible into ten shares of common stock and has the voting power equivalent to ten shares of common stock, subject to certain anti-dilution adjustments. The Preferred Stock is redeemable at any time by the company on 30 days' notice and must be redeemed in full by the company on December 31, 2008, at a price equal to the greater of the aggregate adjusted redemption value of the Series B Preferred Stock plus accrued but unpaid dividends or the amount the preferred stockholders would be entitled to receive if the Series B Preferred Stock plus accrued dividends were converted at that time into common stock and the company were to liquidate and distribute all of its assets to its common stockholders.

RECENT ACCOUNTING CHANGES

Effective January 1, 2002, the company adopted Statement of Financial Accounting Standard ("SFAS") No. 142, "Goodwill and Other Intangible Assets". The standard changes the accounting for goodwill and intangible assets with an indefinite life whereby such assets will no longer be amortized; however the standard does require evaluation for impairment, and a corresponding write-down, if appropriate. SFAS No. 142 requires a transitional goodwill impairment test six months from the date of adoption. The company completed its transitional impairment test during the quarter ended June 30, 2002 and no impairment write-down was required.

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 143, "Accounting For Asset Retirement Obligations". This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The company is required to adopt

the provisions of SFAS No. 143 at the beginning of fiscal 2003. The company has determined that the adoption of this statement will not have a material impact on its financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". This statement requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. This statement also broadens the definition of discontinued operations to include more disposal transactions. The provisions of this statement were adopted by the company on January 1, 2002. The Company applied SFAS No. 144 to the sale of its North Carolina retail optical and optometry assets and reported a loss on disposal of $153 and $4,092

for the three and nine months ended September 30, 2002, respectively.

In April 2002, the FASB issued SFAS No. 145, "Recission of FASB Statements 4, 44 and 64, Amendment of FASB Statement 13, and Technical Corrections". SFAS No. 145 rescinds the provisions of SFAS No. 4 that requires companies to classify certain gains and losses from debt extinguishments as extraordinary items, eliminates the provisions of SFAS No. 44 regarding transition to the Motor Carrier Act of 1980 and amends the provisions of SFAS No.13 to require that certain lease modifications be treated as sale leaseback transactions. The provisions of SFAS No.145 related to classification of debt extinguishment are effective for fiscal years beginning after May 15, 2002. In future periods, the company will classify debt extinguishment costs within income from operations and will reclassify previously reported debt extinguishments as such. The provisions of SFAS No.145 related to lease modification are effective for transactions occurring after May 15, 2002. Upon adoption, the company will reclassify its previously reported gain from extinguishment of debt of $8,789 and related income tax expense of $3,475 from an extraordinary item to continuing operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" and nullified EITF Issue No. 94-3. SFAS No.146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, whereas EITF No 94-3 had recognized the liability at the commitment date of an exit plan. The company is required to adopt the provisions of SFAS No. 146 effective for exit or disposal activities initiated after December 31, 2002. The company does not expect the provisions of SFAS No. 146 to have a material impact on its financial position or results of operations.

IMPACT OF INFLATION AND CHANGING PRICES

The company is subject to pre-determined Medicare reimbursement rates which, for certain products and services, have decreased over the past three years. A decrease in Medicare reimbursement rates could have an adverse effect on the company's results of operations if it cannot manage these reductions through increases in revenues or decreases in operating costs. To some degree, prices for health care are driven by Medicare reimbursement rates, so that the company's non-Medicare business is also affected by changes in Medicare reimbursement rates.

Management believes that inflation has not had a material effect on the company's revenues for the three and nine-month periods ended September 30, 2002 and 2001.

FORWARD-LOOKING INFORMATION AND RISK FACTORS

The statements in this Form 10-Q and elsewhere (such as in other filings by the company with the Securities and Exchange Commission, press releases, presentations by the company or its management and oral statements) that relate to matters that are not historical facts are "forward-looking statements" within the meaning of Section 27A of the Securities Exchange Act of 1934. When used in this document and elsewhere, words such as "anticipate," "believe," "expect," "plan," "intend," "estimate," "project," "will," "could," "may," "predict" and similar expressions are intended to identify forward-looking statements. Such forward-looking statements include those relating to:

- Future opportunities;
- The outlook of customers;

- The reception of new services, technologies and pricing methods;
- Existing and potential strategic alliances;
- The likelihood of incremental revenues offsetting expense related to new initiatives; and
- Expected improvements in the company's financial condition as a result of the new capital structure.

In addition, such forward-looking statements involve known and unknown risks, uncertainties, and other factors which may cause the actual results, performance or achievements of the company to be materially different from any future results expressed or implied by such forward-looking statements. Also, our business could be materially adversely affected and the trading price of our common stock could decline if any of the following risks and uncertainties develop into actual events. Such risk factors, uncertainties and the other factors include:

- Changes in the regulatory environment applicable to the company's business, including health-care cost containment efforts by Medicare, Medicaid and other third-party payers;
- Demand and competition for the company's products and services;
- General economic conditions;
- Risks related to the eye care industry, including the cost and availability of medical malpractice insurance, and adverse long-term experience with laser and other surgical vision correction;
- Risks related to the managed care and insurance industries, including risks relating to class action litigation seeking to broaden the scope of covered services;
- Our ability to successfully integrate and profitably manage our operations;
- Loss of the services of key management personnel;
- Our ability to execute our growth strategy, without which we may not become profitable or sustain our profitability;
- Our ability to obtain additional capital, without which our growth could be limited;
- The fact that we have a history of losses and may incur further losses in the future;
- The fact that if we default on our debt, our creditors could foreclose on our assets;
- The possibility that we may not compete effectively with other eye care services companies which have more resources and experience than us;

- Failure to negotiate profitable capitated fee arrangements;
- The possibility that we may have potential conflicts of interests with respect to related party transactions which could result in certain of our officers, directors and key employees having interests that differ from us and our stockholders;
- Health care regulations or health care reform initiatives, which could materially adversely affect our business, financial condition and results of operations;
- The fact that the nature of our business could subject us to potential malpractice, product liability and other claims;
- The fact that managed care companies face increasing threats of private-party litigation, including class actions, over the scope of care that the managed care companies must pay for;
- The fact that the company is dependent upon letters of credit or other forms of third party security in connection with certain of its contractual arrangements and, thus, would be adversely affected in the event it was unable to obtain such credit as needed;
- The fact that certain parties are challenging the validity of and/or the company's compliance with Health Services Organization contracts and have ceased or may cease making payments under such contracts, jeopardizing the company's cash flow; and
- Other risks and uncertainties discussed in this Form 10-Q and detailed from time to time in the company's periodic earnings releases and reports filed with the Securities and Exchange Commission.

We undertake no obligation to publicly update or revise forward-looking statements to reflect events or circumstances after the date of this Form 10-Q or to reflect the occurrence of unanticipated events.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The company is subject to market risk from exposure to changes in interest rates based on its financing activities under its credit facility with CapitalSource, due to its variable interest rate. The nature and amount of the company's indebtedness may vary as a result of future business requirements, market conditions and other factors. The extent of the company's interest rate risk is not quantifiable or predictable due to the variability of future interest rates and financing needs. The company does not expect changes in interest rates to have a material effect on income or cash flows in the year 2002, although there can be no assurances that interest rates will not significantly change. A 10% change in the interest rate payable by the company on its variable rate debt would have increased or decreased the nine month interest expense by approximately $81,000 assuming that the company's borrowing

level is unchanged. The company did not use derivative instruments to adjust the company's interest rate risk profile during the nine months ended September 30, 2002.

ITEM 4: CONTROLS AND PROCEDURES

During the 90-day period prior to the filing date of this report, management, including the company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the company's disclosure controls and procedures. Based upon, and as of the date of, that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective, in all material respects, to ensure that information required to be disclosed in the reports the company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required. There have been no significant changes in the company's internal controls or in other factors which could significantly affect internal controls subsequent to the date the company carried out its evaluation. There were no significant deficiencies or material weaknesses identified in the evaluation and, therefore, no corrective actions were taken.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The company and/or its subsidiaries filed lawsuits described below against eleven (11) medical practices and their shareholders. Each suit involves a medical practice which was unwound from the former PrimeVision Health network and which remained affiliated with the company through a Health Service Organization ("HSO") agreement. These suits were filed in response to the medical practices' failure to pay the agreed upon HSO services fees. With one exception involving a state court filing, each of the suits was filed in the Federal District Court for the district in which a defendant practice is located. The company intends to move to transfer each matter to the multi-district litigation currently pending in the Federal District Court for the Western District of Kentucky in Louisville, KY. The various defendant practices have not yet filed responsive pleadings. The company continues to discuss settlement of the HSO matters with some of the defendant practices. The suits are in the early stages of litigation, and there can be no assurance of a favorable outcome.

The company has filed suit against Delaware Eye Care Center, Dover DE, in Delaware Superior Court, New Castle, DE; Downing-McPeak Vision Centers, P.S.C., Bowling Green, KY, in the United States District Court for the Western District of Kentucky; Surgical Care Center, Inc., Indianapolis, IN, in the United States District Court for the District of Indiana; Eye Surgeons of Indiana, P.C., Indianapolis, IN, in the United States District Court for the District of Indiana; Jeffrey P. Wasserstrom, M.D., a Medical Corporation, La Mesa, CA, in the United States District Court for the Southern District of California; Midwest Eye Institute, Kansas City, MO, in the United States District Court for the Western District of Missouri (Western Division); The Milne Eye Medical Center, Inc., Silver Spring, MD, in the United States District Court for the District of Maryland (Southern Division); Robert M. Thomas, Jr., M.D., a Medical Corporation, San Diego, CA, in the United States District Court for the Southern District of California; The Brinkenhoff Eye Medical Center, Inc., Ventura, CA, in the United States District Court for the Central District of California; and Tri-County Eye Institute, a Medical Corporation, Corona, CA, in the United States District Court for the Central District of California.

In each lawsuit listed above, the company maintains that the defendant practice has breached its HSO agreement by failing to pay the agreed upon HSO

services fees. The company seeks payment of past due HSO services fees, payment of the Buy-Out Fee as stated in the HSO agreement, attorneys' fees and interest as permissible in the HSO agreement and interest. The company's complaints filed in the above referenced litigation review in detail the history of the relationship with the defendant practices.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

On July 16, 2002, options to purchase 262,500 shares of common stock at an exercise price of $0.25 were granted under the 2002 Stock Incentive Plan.

On August 12, 2002, in connection with the sale of the net assets of the company's retail optical and optometry operations in North Carolina, the company received back 1,321,010 shares of its common stock for retirement. Those shares of common stock had an aggregate fair market value of approximately $357,000 on August 12, 2002.

The above transactions were private transactions not involving a public offering and were exempt from the registration provisions of the Securities Act pursuant to Section 4(2) thereof. No underwriter was engaged in connection with the foregoing sales of securities. The company has reason to believe that (i) all of the foregoing purchasers were familiar with or had access to information concerning the operations and financial conditions of the company, (ii) all of those individuals purchasing securities represented that they acquired the shares for investment and not with a view to the distribution thereof, and (iii) other than with respect to the options, the foregoing purchasers are accredited investors within the meaning of Regulation D promulgated under the Securities Act. At the time of issuance, all of the foregoing securities were deemed to be restricted securities for purposes of the Securities Act and the certificates representing such securities bore or will bear legends to that effect.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

a. Exhibits

The following Exhibits are filed as part of this Quarterly Report on Form 10-Q:

EXHIBIT	DESCRIPTION
2	Asset Purchase Agreement dated as of August 1, 2002 by and among OptiCare Health Systems, Inc., PrimeVision Health, Inc. and Optometric Eye Care Center, P.A. incorporated herein by reference to the Registrant's Current Report on Form 8-K filed on August 27, 2002, Exhibit 2.

b. Reports on Form 8-K filed in the period covered by this report:

The Company filed a Current Report on Form 8-K with the Securities and Exchange Commission on August 27, 2002 relating to the Company's sale of the net assets of the retail optical business and professional optometry practices that it operated in North Carolina.

SIGNATURE

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

Date: November 14, 2002 OPTICARE HEALTH SYSTEMS, INC.

By: /s/ William A. Blaskiewicz

William A. Blaskiewicz
Vice President and Chief Financial Officer
(Principal Financial and Accounting
Officer and duly authorized officer)

OPTICARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CERTIFICATION

I, Dean J. Yimoyines, certify that:

1. I have reviewed this quarterly report on Form 10-Q of OptiCare Health Systems, Inc;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this

quarterly report is being prepared;

b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ Dean J. Yimoyines, M.D.

Dean J. Yimoyines
Chairman and Chief Executive Officer

Date: November 14, 2002

OPTICARE HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CERTIFICATION

I, William A. Blaskiewicz, certify that:

1. I have reviewed this quarterly report on Form 10-Q of OptiCare Health Systems, Inc;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

   a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

By: /s/ William A. Blaskiewicz

William A. Blaskiewicz
Vice President and Chief Financial Officer

Date: November 14, 2002

CERTIFICATION

Each of the undersigned hereby certifies in his capacity as an officer of OptiCare Health Systems, Inc. (the "Company") that the Quarterly Report of the Company on Form 10-Q for the period ended September 30, 2002 fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that the information contained in such report fairly presents, in all material respects, the financial condition of the Company at the end of such period and the results of operations of the Company for such period.

Date: November 14, 2002

/s/ Dean J. Yimoyines, M.D.

Dean J. Yimoyines
Chairman and Chief Executive Officer

/s/ William A. Blaskiewicz

William A. Blaskiewicz
Vice President and Chief Financial Officer