

QUADRAMED CORP  
Form S-1  
January 21, 2004  
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As filed with the Securities and Exchange Commission on January 21, 2004

Registration No. 333-####

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM S-1**  
**REGISTRATION STATEMENT**

*UNDER*  
*THE SECURITIES ACT OF 1933*

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**QUADRAMED CORPORATION**

(Exact Name of Registrant as Specified in its Charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**7371**  
(Primary Standard Industrial  
Classification Code Number)

**52-1992861**  
(I.R.S. Employer  
Identification Number)

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**12110 Sunset Hills Road**  
**Reston, Virginia 20190**  
**(703) 709-2300**

(Address, Including Zip Code, and Telephone Number, Including Area Code, of Registrant's Principal Executive Offices)

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**Lawrence P. English**

**Chief Executive Officer**

**12110 Sunset Hills Road**

**Reston, Virginia 20190**

**(703) 709-2300**

**(Name, Address, Including Zip Code, and Telephone Number, Including Area Code, of Agent for Service)**

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*Copy to:*

**Morris F. DeFeo, Jr.**

**Miles & Stockbridge, P.C.**

**1751 Pinnacle Drive, Suite 500**

**McLean, Virginia 22102**

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**Approximate Date of Commencement of Proposed Sale to the Public:** As soon as practicable on or after the effective date of this Registration Statement.

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If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. "

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective statement for the same offering. "

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities registration number of the earlier effective registration statement for the same offering. "

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. "

## CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities	Amount To	Proposed Maximum Offering Price	Proposed Maximum Aggregate	
To Be Registered	Be Registered	Per Share	Offering Price	Amount of Registration Fee
Common Stock, par value \$0.01 per share	11,586,438(1)	\$3.175(2)	\$36,786,940(2)	\$2,977
Senior Secured Notes due 2008			\$72,293,780(3)	\$5,849

- (1) This number comprises (i) 11,303,842 shares of Common Stock ( Shares ) underlying warrants and (ii) 282,596 Shares previously issued upon the exercise of warrants.
- (2) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457 (c) under the Securities Act of 1933, as amended, based upon the average of the high and low prices for a share of Common Stock reported on the Over-The-Counter Bulletin Board as of January 15, 2004.
- (3) Represents the aggregate principal amount at maturity of the 2008 notes, for the purpose of calculating the registration fee pursuant to Rule 457(o) under the Securities Act of 1933, as amended.

The registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(A) of the Securities Act of 1933, as amended, or until the Registration Statement shall become effective on such dates as the Securities and Exchange Commission, acting pursuant to said Section 8(A), may determine.

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**The information in this prospectus is not complete and may be changed. The selling security holders may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities, and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

**PRELIMINARY PROSPECTUS    SUBJECT TO COMPLETION, DATED JANUARY 21, 2004**

**[GRAPHIC APPEARS HERE]**

**11,586,438 Shares of Common Stock, par value \$0.01 per share**

**\$72,293,780 10% Senior Secured Notes due 2008**

## **QuadraMed Corporation**

Shares of our common stock and our 10% senior secured notes due 2008 are being offered for a forty-five day period after the effective date of this Registration Statement to the public market by those individuals named in the section of this prospectus entitled **Selling Holders** . We will not receive any proceeds from the sale of the common stock or the notes, but we will bear the costs relating to the registration of the common stock and notes.

The selling holders may sell the common stock and notes covered by this prospectus through various means, including directly to purchasers or through underwriters, broker-dealers, and agents. If the common stock or notes are sold through underwriters, broker-dealers, or agents, these parties may be compensated for their services in the form of discounts or commissions, which is deemed to be **underwriting compensation** . If required, the selling holders will disclose the names of any underwriter(s), applicable commissions or discounts, and any other required information with respect to any particular sales in an accompanying prospectus supplement. For additional information on the selling holders possible methods of sale, you should refer to the section in this prospectus entitled **Plan of Distribution** .

We issued \$71,000,000 of our senior secured notes due 2008 in a private placement in April 2003 ( **2008 notes** ). We sold the notes at the original principal amount and issue price of \$1,000 per note. The notes bear interest at the initial rate of 10%. The interest rate will be reduced to 9% upon the listing of our common stock on a U.S. national securities exchange or upon the relisting of our common stock on the Nasdaq National Market or Nasdaq SmallCap Market. On November 13, 2003, we filed an application to list our common stock on the American Stock Exchange. The terms of the notes provide that interest is initially payable 6% in cash and 4% in additional notes through and including April 1, 2004. Interest is payable semiannually on April 1 and October 1 of each year. On October 1, 2003, notes in the aggregate principal amount of \$1.3 million were issued as an interest payment on the 2008 notes. This additional amount of notes is reflected in the amount of notes registered by this registration statement. The notes are secured by substantially all of our intellectual property.

Along with the notes, we issued warrants to purchase 11,303,842 shares of our common stock. Additional warrants to purchase 2,047,978 shares of our common stock will be issued to holders of the 2008 notes if we do not file a registration statement within 90 days after receiving a request

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from the holders on or after the date that is 270 days after April 17, 2003, the date of issuance of the 2008 notes. Furthermore, we also issued warrants to purchase 282,596 shares of our common stock to Philadelphia Brokerage Corporation as consideration in connection with the transaction. As of December 31, 2003, a total of 282,596 of these warrants had been exercised. The warrants have a term of 5 years, have an exercise price of \$0.01 per share and are subject to certain anti-dilution provisions including dilution from any issuance of shares in settlement of existing litigation. The shares of common stock being registered in this registration statement constitute shares underlying, or issued upon the exercise of, these warrants.

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On October 23, 2003, pursuant to the registration rights agreement described in Description of Securities Registration Rights Agreement , we received a demand request from a holder of the 2008 notes requiring us to file a registration statement with the Securities and Exchange Commission ( SEC ) within 90 days of the demand request. On November 3, 2003, we mailed a request notice to all holders of the 2008 notes, notifying them of the demand request and informing them that they had fifteen (15) days within which to request that any or all of their notes or warrants be included in the registration statement to be filed. Those holders who elected to have their notes or warrants included in this registration statement are listed in this prospectus in the section entitled Selling Holders .

We may redeem for cash all or a portion of the notes at any time on or after April 17, 2006, at prices calculated as described in Description of Notes Redemption of Notes at Our Option .

We have not applied for listing of the notes on any securities exchange or for quotation through any automated quotation system. The notes were offered to qualified institutional buyers as defined in, and in reliance on, Rule 144A under the Securities Act, in transactions exempt from, or not subject to, the registration requirements of the Securities Act.

Our common stock is currently traded on the Over-The-Counter Bulletin Board (symbol: QMDC.OB). and on the Pink Sheets over-the-counter market (symbol: QMDC.PK). As of January 15, 2004, the high and low prices for our common stock were \$3.25 and \$3.10 per share on the Over-the-Counter Bulletin Board.

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**Investing in our common stock and the notes involves risks that are described in the Risk Factors section of this prospectus beginning on page 9.**

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**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.**

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The date of this prospectus is January \_\_, 2004.

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We have obtained trademark registrations in the United States for most of our corporate and product trademarks, including QuadraMed, Affinity, Quantim, and Complysource and We do technology. So you can do healthcare. This prospectus also contains product names, trade names and trademarks of ours as well as those of other organizations. All other brand names and trade names and trademarks appearing in this prospectus are the property of their respective holders.

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**PROSPECTUS SUMMARY**

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission to register the resale of the common stock and notes issued or issuable to the selling holders as explained in this prospectus. As permitted by the SEC's rules, this prospectus does not contain all of the information you can find in the registration statement or the exhibits to the registration statement. This prospectus summarizes some of the documents that are exhibits to the registration statement, and you should refer to the exhibits for more complete information as to the matters covered by these documents.

You should read this prospectus summary together with the more detailed information contained in this prospectus, including the risk factors, the financial statements and the notes to the financial statements. This prospectus contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that might cause such a difference include those discussed in the Risk Factors section and elsewhere in this prospectus. For more information, please refer to the section entitled Cautionary Note Regarding Forward-Looking Statements located in this prospectus.

Unless we state otherwise, we, us, our, the company, and QuadraMed refer to QuadraMed Corporation, including all of our subsidiaries. Unless otherwise indicated, industry data in this prospectus is derived from publicly available sources, which we have not independently verified.

You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with any information that is different from the information contained in this prospectus. The selling holders are offering to sell, and seeking offers to buy, common stock and notes only in jurisdictions where such offers and sales are permitted. The information contained in this prospectus is accurate only as of the date on the front cover of this prospectus, regardless of the time of the delivery of this prospectus or of any sale of the common stock or notes. Our business, financial condition, results of operation and prospects may have changed since that date.

**Our Company**

We provide healthcare information technology products and services that help healthcare providers to improve the quality of the care they deliver and the efficiency with which it is delivered. We accomplish our mission by developing and implementing sophisticated, user-friendly software applications designed and developed by the healthcare professionals and software specialists we employ.

Our products are designed to eliminate paper, improve processes, and decrease error through the efficient management of patient clinical and financial records. They are suitable for acute care hospitals, specialty hospitals, Veterans Health Administration facilities and associated/affiliated businesses such as outpatient clinics, long-term care facilities, and rehabilitation hospitals and are used by healthcare organizations of varying size from small single entity hospitals to large multi-facility care delivery organizations. Our products are sold as standalone, bundled, or fully integrated software packages. We also provide services to support the hospital's collection of receivables and its administration of contractual reimbursements from managed care companies. As of December 31, 2003, approximately 1,900 healthcare provider facilities were utilizing at least one QuadraMed product.

Our headquarters office is located at 12110 Sunset Hills Road, Reston, Virginia in the Washington, D.C. metropolitan area. The company was founded in 1993 and reincorporated in Delaware in 1996. Our telephone number is (703) 709-2300. Our website can be found at [www.quadramed.com](http://www.quadramed.com) where all of our current SEC filings can be accessed free of charge.





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### **The Offering**

Use of proceeds	We will not receive any of the proceeds from the sale of the shares of our common stock and the notes offered by the selling holders.
Risk Factors	An investment in our common stock and notes is subject to significant risks. You should carefully consider the information set forth in the Risk Factors section and the other sections of this prospectus, including our financial statements and related notes.

### **Common Stock**

Common Stock offered by the selling holders	Up to 11,586,438 shares, of which 282,596 shares are issued and outstanding and 11,303,842 shares which may be issued upon the exercise of warrants, held by the selling holders, including their transferees, pledgees, donees, or other successors.
Dividend Policy	We do not expect to pay dividends on our common stock in the foreseeable future. We anticipate that future earnings generated from operations, if any, will be retained to develop and expand our business.
Plan of Distribution	The shares of common stock offered for resale may be sold by the selling holders pursuant to this prospectus in the manner described under Plan of Distribution .
Trading and Symbol	Our common stock currently trades on the Over-the-Counter Bulletin Board market under the symbol QMDC.OB and on the Pink Sheets over-the-counter market under the symbol QMDC.PK .
Common Stock Outstanding	As of January 19, 2004, we had 27,727,924 shares of common stock outstanding.

### **Notes**

Notes offered by the selling holders	Up to \$72,293,780 aggregate principal amount of notes
Maturity Date	April 1, 2008
Interest	The notes bear interest at an initial interest rate of 10% per year. The interest rate will be automatically reduced to 9% immediately following the next interest payment date upon (1) the listing of our common stock for trading on a U.S. national securities exchange or (2) the approval for trading on Nasdaq, including the Nasdaq SmallCap market. The terms of the notes provide that interest is initially payable 6% in cash and 4% in additional notes through and including April 1, 2004. Interest is payable semiannually in arrears on April 1 and October 1 in each year, commencing on October 1, 2003, to holders of record at the close of business on the March 15 or September 15 immediately preceding such interest payment due.
Tax Original Issue Discount	Because a portion of the interest in the first year is payable in additional notes, the notes will be considered issued with original issue discount for United States federal income tax purposes, regardless of the timing of receipt of the related cash payments.

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Guarantees	Our obligations under the notes are not guaranteed.
Ranking	The notes are our senior secured obligations. They rank on a par with, or senior to, all of our existing and future debt and liabilities. The notes are secured by any and all of our right, title, and interest in and to all existing and future copyrights, patents, trademarks, and licenses to use copyrights, patents, and trademarks. Accordingly, the claims of the holders of the notes will rank ahead of unsecured claims of our creditors to the extent of the value, priority, and validity of the liens securing the notes. The indenture under which the notes were issued prohibits us and our subsidiaries from incurring any indebtedness for borrowed money that ranks senior to or equal with the notes in the right of repayment. The indenture also prohibits us and our subsidiaries from making any investments other than those specifically allowed as permitted investments as defined in the indenture, unless we have cash or cash equivalents greater than \$10 million.
Security	We assigned and pledged to the trustee on the indenture, under which the notes were issued, as security for the notes and for the benefit of the holders of the notes (and not for the benefit of our other creditors) any and all of our right, title, and interest in and to all existing and future copyrights, patents, trademarks, and licenses to use copyrights, patents, and trademarks.
Change of control	In the event of a change of control of QuadraMed as defined in the indenture, each holder will have the right, at the holder's option, subject to the terms and conditions of the indenture, to require us to purchase for cash all or any portion of the holder's notes. However, the original principal amount submitted for purchase by a holder must be \$1,000 or an integral multiple of \$1,000.
Sinking Fund	None
Redemption of notes at our option	<p>Prior to April 17, 2006, we cannot redeem the notes at our option. Beginning on April 17, 2006, we may redeem the notes for cash, as a whole at any time or from time to time in part. We are required to give at least thirty (30) days but not more than sixty (60) days notice of redemption by mail to the holders of the notes.</p> <p>If we redeem the notes at our option, we will redeem them at the following prices, plus accrued and unpaid cash interest, if any, as of the applicable redemption dates:</p> <p style="padding-left: 40px;">If redeemed between April 17, 2006 and March 31, 2007, the redemption price will be 101.50% of the original principal amount of such notes as of the applicable redemption date;</p> <p style="padding-left: 40px;">If redeemed between April 1, 2007 and March 31, 2008, the redemption price will be 100.75% of the original principal amount of such notes as of the applicable redemption date;</p> <p style="padding-left: 40px;">If redeemed on April 1, 2008 or thereafter, the redemption price will be 100% of the original principal amount of such notes as of the applicable redemption date.</p>

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	<p>If we redeem less than all of the outstanding notes, the trustee will select the notes to be redeemed in principal amounts at maturity of \$1,000 or integral multiples of \$1,000. In this case, the trustee may select the notes by lot, pro rata or by any other method the trustee considers fair and appropriate.</p>
Mandatory redemption with excess cash	<p>Within 10 days following the filing of our Form 10-K with the SEC, we are required to furnish the trustee with an officer's certificate setting forth (1) the amount of excess free cash, if any, for the immediately preceding year (plus any carryover excess free cash) and (2) an amount equal to 50% of the amount in clause (1). If this total excess cash is greater than \$500,000 and we have not already called all of the notes for redemption, we will be required within 15 days to mail a redemption notice to all holders of notes. If the total excess cash is sufficient to redeem all notes, we must redeem all notes within 30 days for cash equal to 100% of the principal amount plus accrued and unpaid interest. If the amount is insufficient to redeem all of the notes, we will redeem them on a pro rata basis. The purchase price of a note will be equal to the original principal amount and accrued and unpaid cash interest, if any, on such notes as of the applicable purchase date.</p>
Certain covenants	<p>The indenture governing the notes among other things restricts, with certain exceptions, our ability and the ability of our subsidiaries to merge, sell assets, incur indebtedness, and create or incur liens.</p>
Trading	<p>The notes do not trade on any national securities exchange, nor do we intend to list the notes on any such national securities exchange.</p>
Governing law	<p>New York</p>

## **Recent Events**

As of January 21, 2004, we have agreed in principal to acquire all of the issued and outstanding capital stock of Détente Systems Pty Limited, an Australian proprietary limited company ( "Détente" ) and all of the units of trust ownership of the Détente Systems Trust, an Australian business trust (the "Trust" ). Détente is engaged in the business of developing, selling and supporting clinical systems in Australia, New Zealand, and the United Kingdom. The Trust holds title to all of the intellectual property used or useful in Détente's business. The proposed purchase price for Détente's stock and the Trust's units is \$4 million in cash. Of this amount, it is expected that \$2.6 million will be paid on the closing date of the acquisition, and the balance will be deposited in an escrow account to be payable upon the satisfactory performance of certain technology and performance goals relating to the acquired Détente technology. There can be no assurance that we will consummate the acquisition.

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The following selected financial data for the fiscal years ended December 31, 2002, 2001, 2000, 1999, and 1998 included herein is derived from our audited consolidated Financial Statements and related notes thereto. The financial data for the nine months ended September 30, 2003 and 2002 are derived from the unaudited interim condensed consolidated Financial Statements included elsewhere in this prospectus, are prepared on the same basis as our audited consolidated Financial Statements, and include all adjustments, consisting of only normal recurring adjustments, that we consider necessary for a fair presentation of our financial position and results of operations at and for such periods. This selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, and the audited consolidated Financial Statements and related notes thereto and the unaudited interim condensed consolidated Financial Statements and related notes thereto included elsewhere in this prospectus. Historical results are not necessarily indicative of future results.

	Nine months ended September 30,		Year Ended December 31,				
	(unaudited)		(In thousands, except per share amounts)				
	2003	2002	2002	2001	2000	1999	1998 <sup>(1)(2)</sup>
<b>Consolidated Statement of Operations Data</b>							
Revenue	\$ 88,373	\$ 79,072	\$ 109,585	\$ 117,046	\$ 121,012	\$ 199,162	\$ 172,228
Restatement costs	6,500	3,300	7,463				
Extraordinary gain on redemption of debentures				12,907			
Income (loss) from continuing operations	(22,193)	(14,255)	(20,858)	11,952	(39,354)	(52,527)	(16,308)
Net income (loss)	(22,193)	(15,783)	(14,362)	9,413	(36,675)	(47,388)	(21,376)
Basic income (loss) per share from continuing operations	(0.81)	(0.53)	(0.77)	0.47	(1.53)	(2.20)	(0.85)
Basic net income (loss) per share	(0.81)	(0.59)	(0.53)	0.37	(1.43)	(1.99)	(0.91)
Diluted income (loss) per share from continuing operations	(0.81)	(0.53)	(0.77)	0.47	(1.53)	(2.20)	(0.85)
Diluted net income (loss) per share	(0.81)	(0.59)	(0.53)	0.37	(1.43)	(1.99)	(0.91)
<b>Other Data<sup>(3)</sup></b>							
Ratio of earnings to fixed charges and preferred dividends <sup>(4)</sup>							
Deficiency of earnings to cover combined fixed charges and preferred dividends	22,193	14,255	20,858	805	38,737	52,527	21,376
<b>Consolidated Balance Sheet Data:</b>							
Cash, cash equivalents and short term investments	\$ 35,580	\$ 24,175	\$ 26,191	\$ 32,213	\$ 39,664	\$ 29,732	\$ 89,574
Total assets	133,352	121,101	126,927	125,133	149,286	201,759	264,733
Deferred revenue	49,141	38,950	39,492	30,721	22,489	7,258	14,021
Working capital	11,091	10,480	18,137	32,509	46,107	61,030	94,963
Notes and debentures	71,226	73,719	73,719	73,719	115,000	115,000	115,000

(1) Revenue for 1998 does not reflect the adoption of EITF No. 01-14, *Income Statement Characterization of Reimbursements for Out-of-Pocket Expenses Incurred*. Accordingly, revenue has not been increased to reflect any billable out-of-pocket reimbursable expenses. All other periods presented reflect the adoption of this standard.

(2)

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Discontinued operations have not been segregated from the 1998 results as the company structure was significantly different at that time. All other periods presented reflect the classification of HIM Services Division as a discontinued operation.

- (3) For purposes of determining the ratio of earnings to combined fixed charges and preferred dividends and the deficiency of earnings to cover combined fixed charges and preferred dividends, earnings includes pre-tax income (loss) adjusted for fixed charges and preferred dividends. Fixed charges consist of interest expensed and capitalized, amortization of deferred financing charges, and that portion of operating lease rental expense (deemed to be 30% of rental expense) representative of interest.
- (4) The ratios of combined fixed charges and preferred dividends to earnings are not presented for the years ended 2002, 2001, 2000, 1999 and 1998 and for the nine months ended September 3, 2003 and 2002 because earnings were inadequate to cover combined fixed charges and preferred dividends.

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**RISK FACTORS**

An investment in the shares of our common stock and the notes involves a high degree of risk. In considering whether to purchase the notes and shares of our common stock, you should carefully consider the following factors and other information set forth in this prospectus, including our financial statements and the related notes. The risks set forth below are in addition to risks that apply to most businesses.

**Risks Related to the Notes and Our Common Stock**

**Our indebtedness could prevent us from fulfilling our obligations under the notes and may negatively affect our financial and operating flexibility.**

We have now and will continue to have for the foreseeable future a considerable amount of indebtedness. As of December 31, 2003, we had approximately \$84 million of outstanding indebtedness, which consists of the 2008 notes and the notes issued under a May 1, 1998 indenture agreement for \$115 million in debentures maturing on May 1, 2005 (the 2005 notes). Our outstanding indebtedness could have important consequences to you. It could:

Make it more difficult to satisfy our obligations with respect to the notes;

Limit our ability to obtain additional financing to operate or grow our business;

Limit our financial flexibility in planning for and reacting to industry changes;

Require us to dedicate a material portion of our operating cash flow to fund interest payments on our indebtedness, thereby reducing the availability of our cash flow for other purposes; and

Place us at a competitive disadvantage as compared to less leveraged companies.

**We have incurred losses from continuing operations for the past five years, except 2001, and we will incur a loss from continuing operations in 2003. If we continue to incur substantial losses from continuing operations in the future, our ability to honor the notes may be impaired. Our ability to meet our debt service obligations depends on our future performance.**

During the nine months ended September 30, 2003, we incurred a loss from continuing operations of \$22.2 million. We will incur a loss from continuing operations for the year ended December 31, 2003. Although we had income from continuing operations of \$9.4 million in 2001, we incurred losses from continuing operations of \$14.4 million and \$36.7 million for the years ended December 31, 2002 and 2000, respectively. If we are unable to achieve or sustain profitability, it may impair our ability to pay principal and interest on the notes and on our other indebtedness as it becomes due, to obtain future equity or debt financing, or to do so on economical terms and to sustain and expand our business.

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Our ability to make such payments depends on our future operating performance. Future operating performance is subject to market conditions and business factors, which are often outside of our control. Therefore, we are not able to assure you that we will have sufficient cash flow to pay the principal and interest on our notes and other indebtedness. If our cash flow and capital resources are not enough to allow us to make our scheduled payments on the notes and other indebtedness, we may have to reduce or delay capital expenditures, sell assets, seek additional capital, or restructure or refinance our indebtedness. We cannot assure you that the terms of our indebtedness will allow these alternative measures or that such measures would satisfy the scheduled debt service obligations. If we are unable to make the scheduled payments on the notes or other indebtedness, we will be in default, and our debt holders could declare all outstanding principal and interest to be due and payable.

**The notes are structurally subordinated. This may affect your ability to receive payments on the notes.**

The notes are obligations exclusively of QuadraMed Corporation. We conduct a substantial portion of our operations through our subsidiaries. As a result, our cash flow and our ability to service our debt, including the 2008 notes, depend upon the earnings of our subsidiaries. In addition, we depend on the distribution of earnings, loans or other payments by our subsidiaries to us. Payments to us by our subsidiaries will be contingent upon our subsidiaries' earnings and business considerations.



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Our subsidiaries are separate and distinct legal entities. Our subsidiaries have no obligation to pay any amounts due on the notes or to provide us with funds for our payment obligations, whether by dividends, distributions, loans or other payments. In addition, any payment of dividends, distributions, loans or advances by our subsidiaries to us could be subject to statutory or contractual restrictions. Payments to us by our subsidiaries will also be contingent upon our subsidiaries' earnings and business considerations.

Our right to receive any assets of any of our subsidiaries upon their liquidation or reorganization and, as a result, our ability to use those assets to discharge our obligations to the holders of the 2008 notes, are effectively subordinated to the claims of that subsidiary's creditors, including trade creditors. In addition, even if we were a creditor of any of our subsidiaries, our rights as a creditor would be subordinate to any security interest in the assets of our subsidiaries and any indebtedness of our subsidiaries senior to indebtedness held by us.

**We may not have the ability to raise the funds necessary to finance the change of control repurchase.**

Upon the occurrence of specific kinds of change of control events, holders of notes may require us to repurchase their notes. However, it is possible that we would not have sufficient funds at that time to make the required repurchase of notes.

**There is no public market for the notes, and the transfer of the notes is restricted.**

There is no trading market for the notes, no market for the notes may develop, and any market that develops may not last. We do not intend to apply for listing of the notes on any securities exchange or other inter-dealer quotation service. Accordingly, we cannot assure you that a holder of the notes will be able to sell these notes in the future or as to the price at which any sale of the notes may occur. The liquidity of the market for the notes and the prices at which the notes trade will depend upon the amount of notes outstanding, the number of holders of the notes, the interest of securities dealers in maintaining a market in the notes and other factors beyond our control. The liquidity of, and the trading market for, the notes may also be adversely affected by general declines in the market for high yield securities. Even after we have registered the notes and the shares of common stock underlying the warrants, we will have the right, pursuant to the registration rights agreement, to suspend the use of this registration statement in certain circumstances. In the event of such a suspension, you would not be able to sell any notes or shares of common stock issuable upon exercise of the warrants.

## **Risks Related to Our Business**

**We Are Currently the Target of Securities Litigation and May Be the Target of Further Actions, Which May Be Costly and Time Consuming to Defend.**

In October 2002, a series of securities law class action complaints were filed in the United States District Court, California Northern District, against us and certain of our officers and directors. The plaintiffs in these actions allege, among other things, violations of the Securities Exchange Act of 1934 due to issuing a series of allegedly false and misleading statements concerning our business and financial condition between May 11, 2000 and August 11, 2002. The complaints seek unspecified monetary damages and other relief.

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The ultimate outcome of these matters cannot presently be determined and may require significant commitment of our financial and management resources and time, which may seriously harm our business, financial condition and results of operations. We cannot assure you that any of the allegations discussed above can be resolved without costly and protracted litigation, and the outcome may have a materially adverse impact upon our financial position, results of operations and cash flows.

In addition, securities class action litigation has often been brought against a company following a decline in the market price of its securities. The uncertainty of the currently pending investigation and litigation could lead to more volatility in our stock price. We may in the future be the target of securities class action claims similar to those described above.

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### **We Are Subject to a Formal SEC Inquiry as a Result of the Restatement of Our Financial Statements.**

Following our August 12, 2002 announcement that we intended to restate prior period financial statements, the staff of the San Francisco District Office of the SEC requested certain information concerning the anticipated restatement as part of an informal, preliminary inquiry.

On February 28, 2003, we reported that the SEC had issued a formal non-public order of investigation concerning our accounting and financial reporting practices for the period beginning January 1, 1998. On October 10, 2003, we announced that the Staff of the San Francisco District Office of the Securities and Exchange Commission has informed us that the Staff intends to recommend to the SEC that it institute an enforcement action against us for violations of the antifraud, periodic filing and books and records provisions of the federal securities laws. The proposed recommendation concerns our accounting for transactions that we entered into with Health+Cast LLP in 1998 and 1999. The 1999 transactions were restated as part of our recent restatement of our 1999 financial statements. The Staff invited us to make a Wells submission with respect to the proposed recommendation. We plan to continue to discuss this matter with the Staff; however, we cannot predict when the SEC will conclude its inquiry, or the outcome and impact thereof. The Staff also indicated that it does not presently intend to recommend any action against QuadraMed's current officers, directors or employees.

### **Our Common Stock Has Been Delisted from the Nasdaq Stock Market.**

We received a notice from the Nasdaq Stock Market on March 4, 2003 that required us to file Forms 10-Q for the quarters ended June 30 and September 30, 2002 as well as restated financial statements for the years ended December 31, 2001, 2000, and 1999 on or before February 28, 2003. Because we were unable to meet these requirements in a timely manner, on March 4, 2003 our common stock was delisted from the Nasdaq Stock Market. The delisting of our stock triggered a repurchase event under the terms of a May 1, 1998 indenture agreement for our 2005 notes. This repurchase event required us to partially refinance our 2005 notes. On April 17, 2003, we repurchased \$61.8 million of our outstanding 2005 notes and issued \$71 million in 2008 notes and warrants to purchase 11,303,842 shares of our common stock. We also issued warrants to purchase 282,596 shares of our common stock to Philadelphia Brokerage Corporation as consideration for their assistance with the issuance of the 2008 notes.

Delisting from the Nasdaq National Market subjects us to numerous consequences that may adversely affect our business, including the loss of investors. We may no longer qualify for exemptions from state securities registration requirements. Without an exemption from registration, we may need to file time-consuming and costly registration statements for future securities transactions and issuances and to amend our stock option and stock option purchase plans. Furthermore, delisting may result in decreased coverage by securities analysts.

### **We Have a Limited Trading Market.**

There is currently a limited trading market for our common stock on the Over-the-Counter Bulletin Board and the Pink Sheets. The ability to trade our common stock on the over-the-counter market depends on the presence and investment decisions of willing buyers and sellers. Therefore, the market of investors who are willing to purchase our common stock is limited, the volume of our common stock traded on a daily basis is low, and the liquidity of our common stock is limited. All of these will affect your ability to sell and the price you may receive for our common stock. While we have applied for quotation of our common stock on the American Stock Exchange ( AMEX ), there can be no assurance that our common stock will be accepted for quotation by the AMEX or any other exchange.

**The Trading Price of Our Common Stock Has Been, and Is Expected to Continue to Be, Volatile.**

The Nasdaq National Market on which our common stock was listed, the Pink Sheets over-the-counter market and the Over-the-Counter Bulletin Board, where our stock currently trades, and stock markets in general,

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have historically experienced extreme price and volume fluctuations that have affected companies unrelated to their individual operating performance. The trading price of our common stock has been and is likely to continue to be volatile due to such factors as:

Variations in quarterly results of operations;

Announcements of new products or acquisitions by our competitors;

Government regulatory action;

Resolution of pending or unasserted litigation, including the existing stockholder lawsuits and SEC investigation;

Developments or disputes with respect to proprietary rights; and

General trends in our industry and overall market conditions.

Movements in prices of equity securities in general may also affect the market price of our common stock.

### **Our Quarterly Operating Results Are Subject to Fluctuations, which Could Adversely Affect Our Financial Results and the Market Price of Our Common Stock.**

Our quarterly operating results have varied significantly in the past and may fluctuate in the future as a result of a variety of factors, many of which are outside our control. Accordingly, quarter-to-quarter comparisons of our operating results may not be indicative of our future performance. Some of the factors causing these fluctuations include:

Variability in demand for products and services;

Introduction of product enhancements and new products by us and our competitors;

Timing and significance of announcements concerning present or prospective strategic alliances;

Discontinuation of, or reduction in, the products and services we offer;

Loss of customers due to consolidation in the healthcare industry;

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Delays in product delivery requested by our customers;

Customer budget cycle fluctuation;

Investment in marketing, sales, research and development, and administrative personnel necessary to support anticipated operations;

Costs incurred for marketing and sales promotional activities;

Software defects and other product quality factors;

General economic conditions and their impact on the healthcare industry;

Cooperation from competitors on interfaces and implementation when a customer chooses a QuadraMed software application to use with various vendors;

Delays in implementation due to product readiness, customer induced delays in training or installation, and third party interface development delays;

Final negotiated sales prices of systems;

Federal regulations (*i.e.*, OIG, HIPAA, ICD-10) that can increase demand for new, updated systems;

Federal regulations that directly affect reimbursements received, and therefore the amount of money available for purchasing information systems;

The fines and penalties a healthcare provider or system may incur due to fraudulent billing practices; and

Increases in third party royalty fees associated with embedded products in QuadraMed software applications.

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Our operating expense levels, which increase with the addition of acquired businesses, are relatively fixed. Accordingly, if future revenues are below expectations, we would experience a disproportionate adverse affect on our net income and financial results. In the event of a revenue shortfall, we will likely be unable to, or may elect not to, reduce spending quickly enough to offset any such shortfall. As a result, it is possible that our future revenues or operating results may fall below the expectations of securities analysts and investors. In such a case, the price of our publicly traded securities may be adversely affected.

### **Future Sales of Our Common Stock in the Public Market, Warrants or Option Exercises and Sales Could Lower Our Stock Price.**

A substantial number of shares of our common stock are subject to stock options and warrants, and our outstanding 2005 notes may be converted into shares of common stock. We cannot predict the effect, if any, that future sales of shares of common stock, or the availability of shares of common stock for future sale, will have on the market price of our common stock. Sales of substantial amounts of common stock, including shares registered under this registration statement or issued upon the exercise of stock options or the conversion of our outstanding 2005 notes, or the perception that such sales could occur, may adversely affect prevailing market prices for our common stock.

### **Provisions in Our Certificate of Incorporation and Bylaws and Delaware Law Could Delay or Discourage a Takeover which Could Adversely Affect the Price of Our Common Stock.**

Our Board of Directors has the authority to issue up to five million shares of preferred stock and to determine the price, rights, preferences, privileges, and restrictions, including voting rights, of those shares without any further vote or action by holders of our common stock. If preferred stock is issued, the voting and other rights of the holders of our common stock may be subject to, and may be adversely affected by, the rights of the holders of our preferred stock. The issuance of preferred stock may have the effect of delaying or preventing a change of control of QuadraMed that could have been at a premium price to our stockholders.

Certain provisions of our certificate of incorporation and bylaws could discourage potential takeover attempts and make attempts to change management by stockholders difficult. Our Board of Directors has the authority to impose various procedural and other requirements that could make it more difficult for our stockholders to effect certain corporate actions. In addition, our certificate of incorporation provides that directors may be removed only by the affirmative vote of the holders of two-thirds of the shares of our capital stock entitled to vote. Any vacancy on our Board of Directors may be filled only by a vote of the majority of directors then in office. Further, our certificate of incorporation provides that the affirmative vote of two-thirds of the shares entitled to vote, voting together as a single class, subject to certain exceptions, is required for certain business combination transactions. These provisions, and certain other provisions of our certificate of incorporation, could have the effect of delaying or preventing (i) a tender offer for our common stock or other changes of control of QuadraMed that could be at a premium price or (ii) changes in our management.

In addition, certain provisions of Delaware law could have the effect of delaying or preventing a change of control of QuadraMed. Section 203 of the Delaware General Corporation Law, for example, prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years from the date the person became an interested stockholder unless certain conditions are met.

### **We Do Not Expect to Pay Cash Dividends in the Foreseeable Future.**

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We have not declared or paid cash or other dividends on our common stock and do not expect to pay cash dividends for the foreseeable future. Also, under the terms of our 2008 notes, our excess cash must be used to redeem the notes. We currently intend to retain all future earnings for use in the operation of our business and to fund future growth. Any future cash dividends will depend upon our results of operations, financial conditions, cash requirements, the availability of a surplus and other factors.



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### **We May Be Liable for Violating the Intellectual Property Rights of Third Parties.**

We do not believe that the intellectual property important to the operation of our business, whether owned by us or licensed to us by a third party, infringes or violates the intellectual property rights of any other party. However, intellectual property litigation is increasingly common in the software industry. The risk of an infringement claim against us may increase over time as the number of competitors in our industry segment grows and the functionality of products overlaps. Third parties have, in the past, asserted infringement claims and could assert infringement claims against us in the future. Regardless of the merits, we could incur substantial litigation expenses in defending any such asserted claim. In the event of an unfavorable ruling on any such claim, a license or similar agreement may not be available to us on reasonable terms, if at all. Infringement may also result in significant monetary liabilities that could have a material adverse effect on our business, financial condition, and results of operations. We may not be successful in the defense of these or similar claims. We have taken steps to contractually limit our liability for the use of intellectual property licensed to us by third parties. However, there can be no guarantee that we have adequate protection.

### **Our Inability to Protect Our Intellectual Property Could Lead to Unauthorized Use of Our Products, which Could Have an Adverse Effect on Our Business.**

We rely on a combination of trade secret, copyright and trademark laws, nondisclosure, non-compete, and other contractual provisions to protect our proprietary rights. In 2001, we filed our first patent application covering our developed technology, the Affinity CPOE software application. This application lapsed, and we have no patents. Measures taken by us to protect our intellectual property may not be adequate, and our competitors could independently develop products and services that are substantially equivalent or superior to our products and services. Any infringement or misappropriation of our proprietary software and databases could put us at a competitive disadvantage in a highly competitive market and could cause us to lose revenues, incur substantial litigation expense, and divert management's attention from other operations.

We depend on licenses from a number of third-party vendors for certain technology used to develop and operate our products. Most of these licenses expire within three to five years. Such licenses can be renewed only by mutual consent and may be terminated if we breach the license terms and fail to cure the breach within a specified time period. If such licenses are terminated, we may not be able to continue using the technology on commercially reasonable terms or at all. As a result, we may have to discontinue, delay or reduce product shipments until equivalent technology is obtained, which could have a material adverse effect on our business, financial condition, and results of operations. Most of our third-party licenses are non-exclusive and competitors may obtain the same or similar technology. In addition, if vendors choose to discontinue support of the licensed technology, we may not be able to modify or adapt our products.

### **We Face Product Development Risks Associated with Rapid Technological Changes.**

The healthcare software market is highly fragmented and characterized by ongoing technological developments, evolving industry standards, and rapid changes in customer requirements. Our success depends on our ability to timely and effectively:

Offer a broad range of software products;

Enhance existing products and expand product offerings;

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Respond promptly to new customer requirements and industry standards;

Remain compatible with popular operating systems and develop products that are compatible with the new or otherwise emerging operating systems; and

Develop new interfaces with competing HIS vendors to fully integrate our Quantim product suite in order to maximize features and functionality of the new products.

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Our performance depends in large part upon our ability to provide the increasing functionality required by our customers through the timely development and successful introduction of new products and enhancements to our existing suite of products. We may not successfully, or in a timely manner, develop, acquire, integrate, introduce, or market new products or product enhancements. Product enhancements or new products developed by us also may not meet the requirements of hospitals or other healthcare providers and payers or achieve or sustain market acceptance. Our failure to either estimate accurately the resources and related expenses required for a project, or to complete our contractual obligations in a manner consistent with the project plan upon which a contract was based, could have a material adverse effect on our business, financial condition, and results of operations. In addition, our failure to meet a customer's expectations in the performance of our services could damage our reputation and adversely affect our ability to attract new business.

### **A Significant Amount of Our Assets Comprise Goodwill, Customer Lists and Other Intangible Items Subject to Impairment and Adjustment That Could Possibly Negatively Impact Our Results of Operations and Stockholders' Equity.**

A significant amount of our assets comprise intangible assets, such as the value of the installed customer base, core technology, capitalized software, goodwill, and other identifiable intangible assets acquired through our acquisitions, such as trademarks.

Pursuant to SFAS No. 142, we must test goodwill and other intangible assets for impairment at least annually and adjust them when impaired to the appropriate net realizable value. We engaged a valuation firm to perform an impairment test on the carrying value of our goodwill and intangibles as of December 31, 2002 and 2001. The valuation firm determined that there was no impairment as of these dates. We have engaged a valuation firm to perform the impairment test as of December 31, 2003, but we have not yet received that report. In addition, our internally-developed software has been capitalized assuming our earnings from these product developments exceeds the costs incurred to develop them. If it is determined that these assets have been impaired and our future operating results will not support the existing carrying value of our intangible assets, we will be required to adjust the carrying value of such assets to net realizable value.

We, however, cannot predict that all of our intangible assets will continue to remain unimpaired. Our future operating results and stockholders' equity could possibly decrease with any future impairment and write-down of goodwill, customer lists, or other such intangibles.

### **The Nature of Our Products Makes Us Particularly Vulnerable to Undetected Errors or Bugs that Could Reduce Revenues, Market Share or Demand for Our Products and Services.**

Products such as those we offer may contain errors or failures, especially when initially introduced or when new versions are released. Although we conduct extensive testing on our products, software errors have been discovered in certain enhancements and products after their introduction. Despite such testing by us and by our current and potential customers, products under development, enhancements, or shipped products may contain errors or performance failures, resulting in, among other things:

Loss of customers and revenue;

Delay in market acceptance;

Diversion of resources;

Damage to our reputation; or

Increased service and warranty costs.

Any of these consequences could have a material adverse effect on our business, financial condition, and results of operations.

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### **If Our Products Fail to Accurately Assess, Process, or Collect Healthcare Claims or Administer Managed Care Contracts, We Could Be Subject to Costly Litigation and Be Forced to Make Costly Changes to Our Products.**

Some of our products and services are used in the payment, collection, coding, and billing of healthcare claims and the administration of managed care contracts. If our employees or products fail to accurately assess, process, or collect these claims, customers could file claims against us. Our insurance coverage may not be adequate to cover such claims. A successful claim that is in excess of, or is not covered by, insurance coverage could adversely affect our business, financial condition, and results of operations. Even a claim without merit could result in significant legal defense costs and could consume management time and resources. In addition, claims could increase our premiums such that appropriate insurance could not be found at commercially reasonable rates. Furthermore, if we were found liable, we may have to significantly alter one or more of our products, possibly resulting in additional unanticipated research and development expenses.

### **Changes in Procurement Practices of Hospitals Have and May Continue to Have a Negative Impact on Our Revenues.**

A substantial portion of our revenues has been and is expected to continue to be derived from sales of software products and services to hospitals. Consolidation in the healthcare industry, particularly in the hospital and managed care markets, could decrease the number of existing or potential purchasers of products and services and could adversely affect our business. In addition, the decision to purchase our products often involves a committee approval. Consequently, it is difficult for us to predict the timing or outcome of the buying decisions of our customers or potential customers. In addition, many healthcare providers are consolidating to create integrated delivery networks with greater regional market power. These emerging systems could have greater bargaining power, which may lead to decreases in prices for our products, which could adversely affect our business, financial condition, and results of operations.

### **Changes in the Healthcare Financing and Reimbursement System Could Adversely Affect the Amount of and Manner in which Our Customers Purchase Our Products And Services.**

Changes in current healthcare financing and reimbursement systems could result in unplanned product enhancements, delays, or cancellations of product orders or shipments, or reduce the need for certain systems. We could also have the endorsement of products by hospital associations or other customers revoked. Any of these occurrences could have a material adverse effect on our business. Alternatively, the federal government recently mandated that all but small health care providers submit claims to Medicare in electronic format, which may positively affect our systems and product.

The healthcare industry in the United States is subject to changing political, economic, and regulatory influences that may affect the procurement practices and operations of healthcare organizations. The traditional hospital delivery system is evolving as more hospital services are being provided by niche, free standing practices and outpatient providers. The commercial value and appeal of our products may be adversely affected if the current healthcare financing and reimbursement system were to change. During the past several years, the healthcare industry has been subject to increasing levels of governmental regulation. Proposals to reform the healthcare system have been and are being considered by the United States Congress. These proposals, if enacted, could adversely affect the commercial value and appeal of our products or change the operating environment of our customers in ways that cannot be predicted. Healthcare organizations may react to these proposals by curtailing or deferring investments, including those for our products and services. In addition, the regulations promulgated under HIPAA could lead healthcare organizations to curtail or defer investments in non-HIPAA related features in the next several years.

### **The Variability and Length of Our Sales Cycle for Our Products May Exacerbate the Unpredictability and Volatility of Our Operating Results.**

We cannot accurately forecast the timing of customer purchases due to the complex procurement decision processes of most healthcare providers and payers. How and when to implement, replace, expand or substantially

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modify an information system are major decisions for hospitals, and such decisions require significant capital expenditures by them. As a result, we typically experience sales cycles that extend over several quarters. In particular, our Affinity enterprise software has a higher average selling price and longer sales cycle than many of our other products. As a result, we have only a limited ability to forecast the timing and size of specific sales, making the prediction of quarterly financial performance more difficult.

### **We Operate in a Highly Competitive Market.**

Competition for our products and services is intense and is expected to increase. Increased competition could result in reductions in our prices, gross margins, and market share and have a material adverse effect on our business, financial condition, and results of operations. We compete with other providers of healthcare information software and services, as well as healthcare consulting firms. Some competitors have formed business alliances with other competitors that may affect our ability to work with some potential customers. In addition, if some of our competitors merge, a stronger competitor may emerge. Some principal competitors include:

In the market for enterprise healthcare information systems: McKesson Corporation, Inc., Shared Medical Systems, Inc., a division of Siemens, MediTech Corporation, Eclipsys Corporation, Cerner, and IDX Corporation;

In the market for electronic document management products: McKesson Corporation, SoftMed Corporation Inc., FileNet, Lanvision, MedPlus, and Eclipsys Corporation;

In the market for MPI products and services: Madison Technologies, Inc., McKesson Corporation, Shared Medical Systems, Inc., a division of Siemens, and Medibase;

In the market for decision support products: Eclipsys Corporation, Healthcare Microsystems, Inc., a division of Health Management Systems Inc., McKesson Corporation, Shared Medical Systems, Inc., a division of Siemens, and MediQual Systems, Inc., a division of Cardinal Health, Inc.;

In the market for coding, compliance, data, and record management products in the Health Information Management Software Division: 3M Corporation, SoftMed Corporation, Inc., MetaHealth, Eclipsys Corporation and HSS, Inc.;

In the market for financial services: Advanced Receivables Strategy, Inc., a division of Perot Systems Corporation, NCO Group, Inc., Outsourcing Solutions, Inc., Health Management Systems, Inc., and Triage Consulting Group.

Current and prospective customers also evaluate our products' capabilities against the merits of their existing information systems and expertise. Major software information systems companies, including those specializing in the healthcare industry, that do not presently offer competing products may enter our markets. Many of our competitors and potential competitors have significantly greater financial, technical, product development, marketing and other resources, and market recognition than we have. Many of these competitors also have, or may develop or acquire, substantial installed customer bases in the healthcare industry. As a result of these factors, our competitors may be able to respond more quickly to new or emerging technologies, changes in customer requirements, and changes in the political, economic or regulatory environment in the healthcare industry.

These competitors may be in a position to devote greater resources to the development, promotion, and sale of their products than we can. We may not be able to compete successfully against current and future competitors, and such competitive pressures could materially adversely affect

our business, financial condition, and operating results.



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### **We Have Encountered Significant Challenges Integrating Acquired Businesses, and Future Transactions May Adversely Affect Our Business, Operations, and Financial Condition.**

From 1993 to 1999, we completed 28 acquisitions, and we encountered significant challenges integrating the acquired businesses into our operations. From 2000 through 2003, we made significant progress toward that integration. However, we continue to support several different technology platforms. In the future, we plan to make investments in or acquire additional complementary businesses, products, services or technologies. These investments and acquisitions will create new integration challenges. Some of the challenges we have encountered, and may encounter with acquisitions in the future, in integrating acquired businesses have included:

Interruption, disruption or delay of our ongoing business;

Distraction of management's attention from other matters;

Additional operational and administrative expenses;

Difficulty managing geographically dispersed operations;

Failure of acquired businesses to achieve expected results, resulting in our failure to realize anticipated benefits;

Write-down or reclassification of acquired assets;

Failure to retain key acquired personnel and difficulty and expense of training those retained;

Increases in stock compensation expense and increased compensation expense resulting from newly hired employees;

Assumption of liabilities and potential for disputes with the sellers of acquired businesses;

Customer dissatisfaction or performance problems related to acquired businesses;

Failure to maintain good relations with customers or suppliers;

Exposure to the risks of entering markets in which we have no direct prior experience and to risks associated with market acceptance of acquired products and technologies; and

Platform and technical issues related to integrating systems from various acquired companies.

All of these factors have had an adverse effect on our business, financial condition, and results of operations in the past, and could have an adverse effect in the future.

**No Mirror Processing Site for Our Customer Data Processing Facilities Exists; Our Business, Financial Condition, and Results of Operations Could Be Adversely Affected if These Facilities Were Subject to a Closure from a Catastrophic Event or Otherwise.**

We currently process substantially all of our customer data at several of our facilities across the United States. Although we back up our data nightly and have safeguards for emergencies, such as power interruption or breakdown in temperature controls, we have no mirror processing site to which processing could be transferred in the case of a catastrophic event at any of these facilities. If a major catastrophic event occurs at these facilities possibly leading to an interruption of data processing, or any other interruption or closure, our business, financial condition, and results of operations could be adversely affected.

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### **We May Be Required to Make Substantial Changes to Our Products if They Become Subject to FDA Regulation, which Could Require a Significant Capital Investment.**

Computer products used or intended for use in the diagnosis, cure, mitigation, treatment, or prevention of diseases or other conditions or that affect the structure or function of the body are subject to regulation by the FDA under the Federal Food, Drug and Cosmetic Act. At present, none of our software products are so regulated. In the future, the FDA could determine that some of our products, because of their predictive aspects, are clinical decision tools and subject them to regulation. Compliance with FDA regulations could be burdensome, time consuming, and expensive. Other new laws and regulations affecting healthcare software development and marketing also could be enacted in the future. If so, it is possible that our costs and the length of time for product development and marketing could increase and that other unforeseeable consequences could arise.

### **Governmental Regulation of the Confidentiality of Patient Health Information Could Result in Our Customers Being Unable to Use Our Products Without Significant Modification, which Could Require Us to Expend Substantial Amounts.**

There is substantial state and federal regulation of the confidentiality of patient health information and the circumstances under which such information may be used by, disclosed to or processed by us as a consequence of our contacts with various health care providers. Although compliance with these laws and regulations is presently the principal responsibility of the hospital, physician, or other healthcare provider, regulations governing patient confidentiality rights are dynamic and rapidly evolving. Changes may be made which require us to change our systems and our methods which could require significant expenditure of capital and decrease future business prospects. Additional federal and state legislation governing the dissemination of individually identifiable information have been proposed and may be adopted, which may also significantly affect our business.

The Health Insurance Portability and Accountability Act of 1996 ( HIPAA ) is a federal law that affects the use, disclosure, transmission and storage of individually identifiable health information. As directed by HIPAA, the United States Department of Health and Human Services ( HHS ) must promulgate standards and implementation guidelines for certain electronic health transactions, code sets, data security, unique identification numbers, and privacy of individually identifiable health information. HHS has issued some of these regulations in final form while others remain in development. Moreover, HHS could, at any time in the future, modify any existing final regulations in a manner that could require us to change our systems or operations.

First, HHS published a final regulation governing transaction and code set standards that had an initial compliance date of October 16, 2002. If a covered entity (health care providers that transmit certain covered transactions in electronic form, health plans and health care clearinghouses) or its agent filed a timely extension, the covered entity would have received an additional year to comply with the HIPAA transaction and code sets requirements, until October 16, 2003. As a consequence, all covered entities must now comply with this regulation. As noted above, HHS may make further revisions to the transactions and code sets standards which could require us to change our products and systems to enable our covered entity customers to meet such obligations.

Second, HHS has published a final HIPAA privacy regulation which had a compliance date of April 14, 2003. The HIPAA privacy regulation is complex and far reaching. Similar to the HIPAA transaction and code sets regulation, the HIPAA privacy regulation applies to covered entities. Covered entities are, in most instances, required to execute a contract with any business associate that performs certain services on the covered entity's behalf involving protected health information. Under the regulations, QuadraMed's Financial Services and Electronic Data Interchange businesses are considered covered entities and are therefore governed by HIPAA regulations. QuadraMed's hospital customers are covered entities, and to the extent that QuadraMed customers use the software to manipulate protected health information and submit electronic transactions, QuadraMed is required by its customer contracts to ensure that the software complies with all relevant regulations. The HIPAA privacy regulation and state healthcare privacy regulations could materially restrict the ability of healthcare providers to disclose protected health

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information from patient records using our products and services or could require us to make additional capital expenditures to be in compliance. Accordingly, the HIPAA privacy regulation and state privacy laws may significantly impact our product's use in the health care delivery system and therefore, decrease our revenue, increase working capital requirements and decrease future business prospects.

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Third, HHS has published the final HIPAA security regulation with a compliance date of April 21, 2005. The HIPAA security regulation applies to the use, disclosure, transmission, storage and destruction of electronic protected health information by covered entities. Covered entities must implement stringent security measures to ensure the confidentiality of the electronic protected health information, and to protect against the unauthorized use of the electronic protected health information. Implementing such measures will require us to expend substantial capital due to required product, service, and procedure changes.

QuadraMed has completed modifications to its business practices and software offerings and is currently in full compliance with HIPAA regulations. However, HHS continues to publish change notices to existing rules and propose new rules. There is no certainty that QuadraMed will be able to respond to all such rules in a timely manner and our inability to do so could adversely affect our business.

### **Government Regulation to Adopt and Implement ICD-10-CM and ICD-10-PCS Medical Code Set Standards Could Require Substantial Modification of our Coding and Compliance Software.**

The American Health Information Management Association ( AHIMA ) and other prominent healthcare industry advocacy groups are calling on the Department of Health and Human Services (HHS) and the healthcare industry to take action to adopt and implement ICD-10-CM and ICD-10-PCS code sets, rules, and guidelines as a replacement for current ICD-9-CM guidelines used in our software products. Adoption of these new code sets would require us to change our systems and our methods which could require a significant expenditure of research and development capital and decrease future business prospects for our current product line.

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**CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This prospectus contains certain forward-looking statements that we believe are within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by such acts. For this purpose, any statements that are not statements of historical fact may be deemed to be forward-looking statements, including the statements made in the section of the prospectus under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" regarding our strategy, future operations, future expectations or future estimates, financial position and objectives of management. In some cases, you can identify forward-looking statements by terminology such as believes, anticipates, plans, should, expects, predicts, intends, estimates, may, will, could, would, pro forma, seek, continue, or the negative of those terms or comparable terminology. Not all forward-looking statements contain such identifying words. These forward-looking statements are based on our current expectations and are subject to a number of risks, uncertainties and assumptions relating to our operations, results of operations, competitive factors, shifts in market demand and other risks and uncertainties. These statements are only predictions and we can give no assurance that such expectations will prove to be correct.

We discuss risks, uncertainties, and assumptions that could cause our actual results to differ from these forward looking statements elsewhere in this prospectus, including in the section entitled "Risk Factors", and in our periodic reports filed with the SEC. These are factors that we believe could cause our actual results to differ materially from our expected and historical results.

Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of the assumptions could be inaccurate and actual results may differ from those indicated by the forward-looking

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statements included in this prospectus. You should not place undue reliance on these forward-looking statements. In light of the significant uncertainties inherent in the forward-looking statements included in this prospectus, you should not consider the inclusion of such information as a representation by us or anyone else that we will achieve such results. We undertake no obligation to publicly update any forward-looking statements, whether as the result of new information, future events, or otherwise. You are advised, however to consult any further disclosures we make in our subsequent current reports on Form 8-K, quarterly reports on Form 10-Q, annual reports on Form 10-K and other reports filed with the SEC.

## **WHERE YOU CAN FIND MORE INFORMATION**

We have filed with the Securities and Exchange Commission a registration statement on Form S-1, including exhibits under the Securities Act with respect to the shares and notes to be sold in this offering. This prospectus does not contain all of the information set forth in the registration statement. For further information regarding QuadraMed Corporation and the common stock and notes offered by this prospectus, we refer you to the registration statement, including the exhibits thereto, and the financial statements and notes filed as a part thereof. With respect to each such document filed with the SEC as an exhibit to the registration statement, reference is made to the exhibit for a more complete description of the matter involved.

We file quarterly and annual reports, proxy statements and other information with the SEC. You may read and copy any document that we file at the public reference facilities of the SEC in Washington, D.C. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. Our SEC filings are also available to the public from the SEC's web site at <http://www.sec.gov> and on our website, <http://www.quadramed.com>, where all of our current SEC filings can be accessed free of charge.

## **USE OF PROCEEDS**

The selling holders will receive all of the proceeds from the resale of the shares of common stock and notes that may be sold using this prospectus. We will not receive any of the proceeds from the resale of these shares of common stock and notes.

**Table of Contents****PRICE RANGE OF OUR COMMON STOCK**

Our common stock currently trades on the Over-the-Counter Bulletin Board market under the symbol QMDC.OB and on the Pink Sheets over-the-counter market under the symbol QMDC.PK .

The following table shows the trading history of our common stock:

<u>Start Date</u>	<u>End Date</u>	<u>Market</u>	<u>Symbol</u>
October 9, 1996	August 29, 2000	Nasdaq National Market	QMDC
August 30, 2000	May 22, 2002	Nasdaq SmallCap Market	QMDC
May 23, 2002	August 22, 2002	Nasdaq National Market	QMDC
August 23, 2002	March 3, 2003	Nasdaq National Market	QMDCE
March 4, 2003*	Present (January 21, 2004)	Pink Sheets	QMDC.PK
December 10, 2003	Present (January 21, 2004)	Over the Counter Bulletin Board	QMDC.OB

\* On March 4, our common stock was delisted from the Nasdaq National Market.

On January 15, 2004, the high and low prices for our common stock on the Over-the-Counter Bulletin Board were \$3.25 and \$3.10 per share respectively. On January 8, 2004, there were 284 holders of record and approximately 4,600 beneficial holders of our common stock. This approximation is based on the number of the holders of record in addition to the number of proxy reports distributed to our beneficial holders as of the record date for our 2003 Annual Meeting held in October 2003.

The following table sets forth the high and low prices for our common stock traded on the Over-the-Counter Bulletin Board for the periods indicated.

<u>Fiscal Year Ended December 31, 2003</u>	<u>High</u>	<u>Low</u>
Quarter ended December 31 (December 10 - December 30)	\$ 2.650	\$ 2.250
<u>Fiscal Year Ending December 31, 2004</u>	<u>High</u>	<u>Low</u>
Quarter ending March 31 (through January 15)	\$ 3.180	\$ 2.650

The following table sets forth the high and low bid and asked prices for our common stock traded on the Pink Sheets for the periods indicated.

<u>Fiscal Year Ended December 31, 2003</u>	<u>High</u>	<u>Low</u>
Quarter ended March 31 (March 4 - March 31)	\$ 1.160	\$ 0.349
Quarter ended June 30	\$ 1.950	\$ 0.950



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Quarter ended September 30	\$ 2.700	\$ 1.740
Quarter ended December 31 (through December 16)	\$ 2.870	\$ 2.250

The following table sets forth the range of our common stock with high and low closing sales prices as reported on the applicable Nasdaq Market for the periods indicated.

Fiscal Year Ended December 31, 2002 <sup>(1)</sup>	High	Low
Quarter ended March 31	\$ 11.550	\$ 8.110
Quarter ended June 30	\$ 9.640	\$ 5.570
Quarter ended September 30	\$ 6.980	\$ 1.470
Quarter ended December 31	\$ 3.000	\$ 1.160
Fiscal Year Ended December 31, 2003 <sup>(2)</sup>	High	Low
Quarter ended March 3 (January 1 March 4)	\$ 2.670	\$ 0.349

(1) Stock traded on Nasdaq SmallCap Market until May 22, 2002. Stock traded on the Nasdaq National Market starting May 23, 2002.

(2) Stock traded on the Nasdaq National Market.

We have authorized 150,000,000 shares of common stock, par value \$0.01 per share. We have authorized 5,000,000 shares of preferred stock, par value \$0.01 per share. Our Board of Directors has authority to provide for the issuance of our shares of preferred stock in series, to establish from time to time the number of shares to be included in each such series and to fix the designation, powers, preferences and rights of the shares of each such

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series and the qualifications, limitations or restrictions thereof, without any further vote or action by the stockholders. As of January 19, 2004, we had 27,727,924 shares of common stock outstanding and no outstanding preferred stock.

**DIVIDEND POLICY**

We have never declared or paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. We anticipate that we will retain earnings, if any, to finance the growth and development of our business. Additionally, the terms of our 2008 notes require us to use excess cash to buy back 2008 notes. Therefore, we do not expect to pay cash dividends on our common stock for the foreseeable future. Any future determination to pay cash dividends will be at the discretion of our Board of Directors and will depend upon our financial condition, operating results, capital requirements, plans for expansion, restrictions imposed by any financing arrangements and whatever other factors that our Board of Directors determines are relevant.

**Table of Contents****SELECTED FINANCIAL DATA**

The following selected financial data for the fiscal years ended December 31, 2002, 2001, 2000, 1999, and 1998 included herein is derived from our audited consolidated Financial Statements and related notes thereto. The financial data for the nine months ended September 30, 2003 and 2002 are derived from the unaudited interim condensed consolidated Financial Statements included elsewhere in this prospectus, are prepared on the same basis as our audited consolidated Financial Statements, and include all adjustments, consisting of only normal recurring adjustments, that we consider necessary for a fair presentation of our financial position and results of operations at and for such periods. This selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, and the audited consolidated Financial Statements and related notes thereto and the unaudited interim condensed consolidated Financial Statements and related notes thereto included in this prospectus. Historical results are not necessarily indicative of future results.

	Nine months ended September 30,		Year Ended December 31,				
	(unaudited)		(In thousands, except per share amounts)				
	2003	2002	2002	2001	2000	1999	1998 <sup>(1)(2)</sup>
<b>Consolidated Statement of Operations Data</b>							
Revenue	\$ 88,373	\$ 79,072	\$ 109,585	\$ 117,046	\$ 121,012	\$ 199,162	\$ 172,228
Restatement costs	6,550	3,300	7,463				
Extraordinary gain on redemption of debentures				12,907			
Income (loss) from continuing operations	(22,193)	(14,255)	(20,858)	11,952	(39,354)	(52,527)	(16,308)
Net income (loss)	(22,193)	(15,783)	(14,362)	9,413	(36,675)	(47,388)	(21,376)
Basic income (loss) per share from continuing operations	(0.81)	(0.53)	(0.77)	0.47	(1.53)	(2.20)	(0.85)
Basic net income (loss) per share	(0.81)	(0.59)	(0.53)	0.37	(1.43)	(1.99)	(0.91)
Diluted income (loss) per share from continuing operations	(0.81)	(0.53)	(0.77)	0.47	(1.53)	(2.20)	(0.85)
Diluted net income (loss) per share	(0.81)	(0.59)	(0.53)	0.37	(1.43)	(1.99)	(0.91)
<b>Other Data<sup>(3)</sup></b>							
Ratio of earnings to fixed charges and preferred dividends <sup>(4)</sup>							
Deficiency of earnings to cover combined fixed charges and preferred dividends	22,193	14,255	20,858	805	38,737	52,527	21,376
<b>Consolidated Balance Sheet Data:</b>							
Cash, cash equivalents and short term investments	\$ 35,580	\$ 24,175	\$ 26,191	\$ 32,213	\$ 39,664	\$ 29,732	\$ 89,574
Total assets	133,352	121,101	126,927	125,133	149,286	201,759	264,733
Deferred revenue	49,141	38,950	39,492	30,721	22,489	7,258	14,021
Working capital	11,091	10,480	18,137	32,509	46,107	61,030	94,963
Notes and debentures	71,226	73,719	73,719	73,719	115,000	115,000	115,000

- (1) Revenue for 1998 does not reflect the adoption of EITF No. 01-14, *Income Statement Characterization of Reimbursements for Out-of-Pocket Expenses Incurred*. Accordingly, revenue has not been increased to reflect any billable out-of-pocket reimbursable expenses. All other periods presented reflect the adoption of this standard.
- (2) Discontinued operations have not been segregated from the 1998 results as the company structure was significantly different at that time. All other periods presented reflect the classification of HIMS Services Division as a discontinued operation.

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- (3) For purposes of determining the ratio of earnings to combined fixed charges and preferred dividends and the deficiency of earnings to cover combined fixed charges and preferred dividends, earnings includes pre-tax income (loss) adjusted for fixed charges and preferred dividends. Fixed charges consist of interest expensed and capitalized, amortization of deferred financing charges, and that portion of operating lease rental expense (deemed to be 30% of rental expense) representative of interest.
- (4) The ratios of combined fixed charges and preferred dividends to earnings are not presented for the years ended 2002, 2001, 2000, 1999 and 1998 and for the nine months ended September 3, 2003 and 2002 because earnings were inadequate to cover combined fixed charges and preferred dividends.

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### **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis should be read in conjunction with our consolidated Financial Statements appearing elsewhere in this prospectus.

#### **Critical Accounting Policies and Estimates**

Our critical accounting policies have a considerable impact on Management's Discussion and Analysis.

#### **Principles of Consolidation**

Our consolidated financial statements, which include our accounts and all our significant business divisions and subsidiaries, have been prepared in conformity with (i) generally accepted accounting principles in the United States ( "GAAP" ); and (ii) the rules and regulations of the SEC. All significant intercompany accounts and transactions between us and our subsidiaries have been eliminated in the consolidated financial statements.

#### **Use of Estimates**

Management's discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements included herein, which have been prepared in accordance with GAAP. In preparing these financial statements, we make estimates, assumptions, and judgments that affect the reported amounts of assets and liabilities, contingent assets and liabilities, revenues, and expenses. Significant estimates and assumptions have been made regarding revenue recognition, the allowance for doubtful accounts, capitalized software, income taxes, pensions and other benefits, contingencies and litigation and intangibles, primarily goodwill and customer lists, resulting from our purchase business combinations. We base our estimates, assumptions, and judgments on historical experience and on various other assumptions which management believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Uncertainties inherent in these estimates include projections of future operating results and the discount rates used to determine the net present values of these future results and useful lives of the acquired assets as well as technological advances. In addition, for our fixed-price contracts, we make significant estimates within percentage-of-completion accounting, including estimating total costs to be incurred as calculated on a labor hour basis. We annually review and test our estimates, specifically those related to the valuations of intangibles including acquired software, goodwill, customer lists, trademarks and other intangibles, and capitalized software. Actual results may differ materially from these estimates.

#### **Revenue Recognition**

Our revenue in the ordinary course of business is principally generated from two sources: (i) licensing arrangements, and (ii) services and other.

Our license revenue consists of fees for licenses of proprietary and third-party software. Cost of license revenue primarily includes third-party software and royalties and amortization of capitalized software. Our service revenue consists of maintenance, customer training, and consulting services and fees for providing management services, such as accounts receivable and payment collection outsourcing, specialized staffing, analytical services, seminars and hardware. Cost of services consists primarily of salaries, benefits, and allocated costs related to providing such services, labor costs for engineers performing implementation services, technical support, training personnel and hardware.

We license our products through our direct sales force. Our license agreements for such products do not provide for a right of return and historically, product returns have not been significant.

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We recognize revenue on our software products in accordance with Statement of Position ( SOP ) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*; SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; and Staff Accounting Bulletin ( SAB ) 101, *Revenue Recognition in Financial Statements*.

We recognize revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery of the product has occurred; no significant obligations by us with regard to implementation remain; the fee is fixed and determinable, and collectibility is probable. Delivery is considered to have occurred when title and risk of loss have been transferred to the customer, which generally occurs when media containing the licensed programs is provided to a common carrier. We consider all arrangements with payment terms extending beyond 180 days to be not fixed and determinable, and revenue is recognized as payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

SOP 97-2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Revenue recognized from multiple-element arrangements is allocated to undelivered elements of the arrangement, such as maintenance, support and professional services, based on the relative fair values of the elements specific to us. Our determination of fair value of each element in multi-element arrangements is based on vendor-specific objective evidence ( VSOE ). We limit our assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

If evidence of fair value of all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue from hosted applications is recognized ratably over the term of the arrangement. The proportion of revenue recognized upon delivery may vary from quarter to quarter depending upon the relative mix of licensing arrangements and the availability of VSOE of fair value for undelivered elements.

Certain of our perpetual and time-based licenses include unspecified additional products and/or payment terms that extend beyond 12 months. We recognize revenue from perpetual and time-based licenses that include unspecified additional software products ratably over the term of the arrangement.

Contract accounting is utilized for service revenue from fixed-price contracts and those requiring significant software modification, development or customization. In such instances, the arrangement fee is accounted for in accordance with SOP 81-1, whereby the arrangement fee is recognized, generally using the percentage-of-completion method measured on labor input costs. If increases in projected costs-to-complete are sufficient to create a loss contract, the entire estimated loss is charged to operations in the period the loss first becomes known. The complexity of the estimation process and judgment related to the assumptions, risks and uncertainties inherent with the application of the percentage-of-completion method of accounting affect the amounts of revenue and related expenses reported in our consolidated financial statements. A number of internal and external factors can affect our estimates, including labor rates, utilization, changes to specification and testing requirements and collectibility of unbilled receivables.

Service revenues from software maintenance and support are recognized ratably over the maintenance term, which in most cases is one year. Service revenues from training, consulting and other service elements are recognized as the services are performed.

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Service revenues from providing management services such as accounts receivable and payment collection outsourcing are recognized in accordance with SAB 101. When all criteria for revenue recognition, as noted above, have been met, revenue is recognized upon invoicing. If collectibility is not considered probable, revenue is recognized when the fee is collected.



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### **Accounts Receivable and Allowance for Doubtful Accounts**

Accounts receivable consist primarily of amounts due us from our normal business activities. We maintain an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified within our portfolio. If the financial condition of our customers were to deteriorate resulting in an impairment of their ability to make payments, or if payments from customers are significantly delayed, additional allowances might be required.

### **Intangible Assets**

*Goodwill.* In June 2001, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001. Under SFAS No. 142, goodwill and intangible assets deemed to have indefinite lives are to be separately disclosed on the balance sheet, and no longer amortized but subject to annual impairment tests. With the adoption of SFAS No. 142, we ceased amortization of goodwill as of January 1, 2002. Prior to this point, goodwill was amortized using the straight-line method over its estimated useful life.

SFAS No. 142 requires that goodwill be tested for impairment at the reporting unit level (i.e., business segments) upon adoption and at least annually thereafter using a two-step impairment analysis. In accordance with SFAS No. 142, we performed the first of the required two-step impairment tests of goodwill and indefinite-lived assets as of January 1, 2002 utilizing an independent appraiser. The test results showed no indicators of impairment as of January 1, 2002.

As of January 1, 2003, we re-engaged the independent appraiser to review the goodwill as of this date for impairment. Once again, the test showed no indicators of impairment. We will continue to perform the tests of impairment for goodwill required by SFAS No. 142 on an annual basis or more often, as deemed necessary.

*Capitalized Software.* Software development costs are capitalized upon the establishment of technological feasibility. In accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, we establish technological feasibility upon completion of a detailed program design determined on a project-by-project basis, which substantiates that the computer software product can be produced in accordance with its design specifications. Software development costs are capitalized based upon an assessment of their recoverability. This assessment requires considerable judgment by management with respect to various factors, including, but not limited to, anticipated future gross margins, estimated economic lives, and changes in software and hardware technology. Amortization is based on the greater of the ratio that current revenues bear to total and anticipated future revenues for the applicable product, or the straight-line method over the remaining estimated economic life of the product, generally five years, and is charged to cost of licenses.

*Other Intangible Assets.* Other intangible assets primarily relate to acquired software, trademarks and customer lists acquired in our purchase business combinations. On January 1, 2002, we adopted the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which generally requires impairment losses to be recorded on long-lived assets (excluding goodwill) used in operations, such as property, equipment and improvements, and intangible assets, when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of the assets. The provisions of this statement did not have a significant impact on our financial condition or operating results.

**New Accounting Standards**

In November 2002, the Emerging Issues Task Force ( EITF ) reached consensus on issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables* on a model to be used to determine when a revenue arrangement with multiple deliverables should be divided into separate units of accounting and, if separation is appropriate, how the arrangement consideration should be allocated to the identified accounting units. The EITF also reached a consensus that this guidance should be effective for all revenue arrangements entered into for fiscal periods beginning after June 15, 2003, which for QuadraMed would be the quarter ending September 30, 2003. The company does not expect the adoption of EITF No. 00-21 to have a material impact on the company's consolidated financial position, results of operations or cash flows.

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In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, as amended in December 2003 by No. 46-R, which addresses the consolidation of variable interest entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. FIN No. 46 was effective upon issuance for certain disclosure requirements and for variable interest entities created after January 1, 2003, and in the first fiscal year or interim period beginning after June 15, 2003 for all other variable interest entities. Adoption of the standard is not expected to have a material impact on the company's consolidated financial position, results of operations or cash flows.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial reporting for certain derivative instruments and for hedging activities accounted for under SFAS No. 133 and is effective for contracts entered into or modified, and for hedges designated, after June 30, 2003. Adoption of the standard is not expected to have a material impact on the company's consolidated financial position, results of operations or cash flows.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with characteristics of both Liabilities and Equity*. SFAS No. 150 requires that certain financial instruments issued in the form of shares that are mandatorily redeemable as well as certain other financial instruments be classified as liabilities in the financial statements. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. The provisions of this statement are not expected to have a material impact on the company's consolidated financial position, results of operations or cash flows.

**Results of Operations for the Nine Months ended September 30, 2003 and 2002**

The following table sets forth selected data for the indicated periods. Percentages are expressed as a percentage of total revenues, except for cost of revenue, which is expressed as a percentage of the related revenue classification.

	Nine months ended September 30,			
	2003		2002	
	(unaudited)		(unaudited)	
<b>Revenue</b>				
Services and other	\$ 58,294	66.0%	\$ 57,419	72.6%
Licenses	30,079	34.0	21,653	27.4
<b>Total revenue</b>	<b>88,373</b>	<b>100.0</b>	<b>79,072</b>	<b>100.0</b>
<b>Cost of revenue</b>				
Cost of services and other	31,190	53.5	26,508	46.2
Cost of licenses	5,363	17.8	6,193	28.6
<b>Total cost of revenue</b>	<b>36,553</b>	<b>41.4</b>	<b>32,701</b>	<b>41.4</b>
<b>Gross margin</b>	<b>51,820</b>	<b>58.6</b>	<b>46,371</b>	<b>58.6</b>
<b>Operating expenses</b>				
Sales and marketing	16,858	19.1	16,030	20.3

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Research and development	17,080	19.3	12,535	15.9
General and administration	32,747	37.1	26,572	33.6
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Amortization and other operating charges	1,756	2.0	2,401	3.0
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total operating expenses</b>	<b>68,441</b>	<b>77.5</b>	<b>57,538</b>	<b>72.8</b>
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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### **Revenue**

*Total Revenue.* Total revenue for the nine months ended September 30, 2003, was \$88.4 million, an increase of \$9.3 million or 11.8% from \$79.1 million for the nine months ended September 30, 2002.

As of September 30, 2003, deferred revenue was \$49.1 million, an increase of \$9.6 million or 24.4% from \$39.5 million as of December 31, 2002. Deferred revenue increased by \$9.6 million during the same period primarily due to \$5.4 million related to HIM government sales, \$2.7 million in other HIM software division and \$1.5 million in Enterprise division sales.

*Services and Other.* Services and other revenue consists of professional services such as implementation services and training, maintenance, which consists of technical support and product upgrades, hardware, reimbursable expenses and other service revenue. Professional services are typically provided over a period of three months to six months for the Health Information Management (HIM) Software division and up to two years for the Enterprise division. These services are provided subsequent to the signing of a software license arrangement and depend in large part on our software license revenues. Financial Services revenue is recognized as services are performed. Our maintenance revenues depend on both licenses of our software products and renewals of maintenance agreements by our existing customer base. For the nine months ended September 30, 2003, services and other revenue was \$58.3 million, an increase of \$875,000 or 1.5% from \$57.4 million in the first nine months of 2002.

For the nine months ended September 30, 2003, the Enterprise division's service and other revenue increased primarily due to a significant hardware sale and overall increased installations.

Service and other revenue for the HIM Software division improved slightly for the nine months ended September 30, 2003 primarily due to the increase in coding software and record management products revenue resulting from customer installations and maintenance renewals.

Revenue for the Financial Services division has decreased by approximately \$2.4 million for the nine months in 2003 compared to 2002 due to a decrease in the quality of assignments and average lower contract fees.

*Licenses.* License revenue consists of fees for licenses of proprietary and third-party software. We market our products through our direct sales force. For the nine months ended September 30, 2003, license revenue was \$30.1 million, an increase of \$8.4 million or 38.9% compared to \$21.7 million in the first nine months of 2002.

The increase in absolute dollar amount of license revenue for the nine months of 2003 was due to growth in the HIM software division. The HIM division growth was due primarily to migration sales and recognition of deferred revenue from coding software products and, to a lesser extent, government sales. The increase in absolute dollar amount of license revenue for the nine months ended September 30, 2003, was primarily due to the increase in software license revenue from the recognition of Coding products and an increase in government revenue due to growth in sales.

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The Enterprise Division grew close to 26% for the nine month period of 2003 compared to 2002. The increase was directly related to the Affinity suite of products, Performance Measurement products and purchase of Pharmacy Data Systems, Inc. (PDS) in June 2002.

### **Cost of Revenue**

*Cost of Services and Other.* Cost of services and other consists of salaries and related expenses associated with services performed for customer support, consulting services as well as third-party hardware costs. Cost of services and other for the nine months ended September 30, 2003 was \$31.2 million, an increase of \$4.7 million or 17.7% compared to the \$26.5 million recorded in the corresponding period of 2002. As a percentage of services and other revenue, cost of services and other was 53.5% and 46.2% for the nine months ended September 30, 2003 and 2002, respectively.

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The Enterprise division cost of services and other increased substantially for the nine month period in 2003 compared to 2002 due to increased salary and bonus expense and hardware cost due to the related hardware revenue.

The HIM software division cost of services and other increased slightly for the nine months in 2003 compared to 2002, due to salary and related expenses.

The Financial Services division cost of services and other increased slightly for the nine months in 2003 compared to 2002, due to salary and related expenses. The gross margin decreased for the nine months ended September 30, 2003 compared to 2002 due to the decline in service revenue while no change to cost of services.

*Cost of Licenses.* Cost of license consists primarily of third party software and royalties and amortization of capitalized software. For the nine months ended September 30, 2003, cost of license was \$5.4 million, a decrease of \$830,000 or 13.4% from \$6.2 million from the same period of 2002. As a percentage of license revenues, cost of license was 17.8% and 28.6% for the nine months ended September 30, 2003 and 2002, respectively.

The decrease for the nine months ended September 30, 2003 was primarily due to a decrease in the cost of third party software license in the Enterprise division as a result of lower third party software license revenue. The gross margin in license revenue for the HIM software division improved in 2003 due to the mix of license revenue in comparison to the cost of licenses.

## **Operating Expenses**

*Sales and Marketing.* Sales and marketing expense includes costs associated with our sales and marketing personnel and product marketing personnel and consists primarily of compensation and benefits, commissions and bonuses, promotional and advertising expenses. For the nine months ended September 30, 2003, sales and marketing expense was \$16.9 million, an increase of \$828,000 or 5.2% compared to \$16.0 million in the first nine months of 2002. As a percentage of total revenue, sales and marketing expense was 19.1% for the nine months ended September 30, 2003 as compared to 20.3% in the same quarter of 2002.

In absolute dollars, the increase in sales and marketing expense for the nine months ended September 30, 2003 was primarily due to an increase in salaries and bonus expense reduced by marketing expenses.

*Research and Development.* Research and development expense includes costs associated with the development of new products, enhancements of existing products for which technological feasibility has not been achieved, and quality assurance activities and primarily includes compensation and benefits costs. For the nine months ended September 30, 2003, research and development costs were \$17.1 million, an increase of \$4.5 million or 36.3% from \$12.5 million in the first nine months of 2002. The increase in research and development expense was primarily due to product development efforts for the continued development of both the Affinity and HIM software suite of products. The level of research and development investments increased in the first nine months of 2003 with the primary funding of Affinity development.

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During the nine months ended September 30, 2003, there were no capitalized costs from software development compared to approximately \$1.7 million in the first nine months of 2002.

*General and Administration.* General and administration expense consists of compensation and benefit costs for executive, finance, legal, information technology, and administrative personnel. For the nine months ended September 30, 2003, general and administration expense was \$32.7 million, an increase of \$6.2 million or 23.2% from \$26.6 million in the comparable period in 2002. As a percentage of total revenue, general and administration expense increased to 37.1% for the nine months ended September 30, 2003 from 33.6% in the nine months ended September 30, 2002.

The increase in general and administration expense for the nine months ended September 30, 2003, was due to an increase in accountants, consultants and attorneys' fees and retention bonuses as part of the restatement process of \$3.5 million, and an increase in employee benefits and contractual services.



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*Amortization and Other Operating Charges.* Amortization and other operating charges represented amortization of identifiable intangible assets and in process research and development. Expense for the nine months in 2002 also includes a \$400,000 write-off of in-process research and development expense associated with the acquisition of PDS.

**Other Income (Expense)**

*Other Income (Expense), Net.* For the nine months ended September 30, 2003 and 2002, net other income (expense) was \$5.6 million and \$3.1 million, respectively. The increase for the nine months ended was due to the additional interest expense on the new debentures entered into April 2003, which have a current interest rate of 10%, and \$1.2 million of year-to-date amortization of the associated warrants, offset by \$565,000 income from a short swing profit from an investor.

**Income Taxes**

*Provision for Income Taxes.* There was no provision for income taxes for the nine months ended September 30, 2003 and 2002. For financial reporting purposes, a 100% valuation allowance has been recorded against our deferred tax assets under SFAS No. 109, *Accounting for Income Taxes*.

**Results of Operations for the Years ended December 31, 2002, 2001, and 2000**

The following table sets forth certain items from our consolidated statement of operations, expressed as percentage of total revenue.

	Year ended December 31,		
	2002	2001	2000
<b>Revenue</b>			
Services	70.1%	70.5%	76.4%
Licenses	29.9	29.5	23.6
<b>Total revenue</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Cost of revenue</b>			
Cost of services	32.9	29.1	45.3
Cost of licenses	8.3	7.4	5.9
<b>Total cost of revenue</b>	<b>41.2</b>	<b>36.5</b>	<b>51.2</b>
<b>Gross margin</b>	<b>58.8</b>	<b>63.5</b>	<b>48.8</b>

<b>Operating expenses</b>			
General and administration	37.5	30.5	47.1
Sales and marketing	19.7	17.7	19.6
Research and Development	15.7	12.3	20.3
Amortization, impairment and other operating charges	2.8	7.7	9.2
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total operating expenses</b>	<b>75.7</b>	<b>68.2</b>	<b>96.2</b>
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Loss from operations</b>	<b>(16.9)</b>	<b>(4.7)</b>	<b>(47.4)</b>
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Other income (expense)</b>			
Interest expense	(3.2)	(4.1)	(5.4)
Interest income	0.6	1.7	1.8
Gain on sale of assets	1.4	6.1	22.5
Other income (expense), net	(0.9)	0.3	(3.4)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Other income (expense), net</b>	<b>(2.1)</b>	<b>4.0</b>	<b>15.5</b>
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Loss from continuing operations before income taxes and extraordinary item</b>	<b>(19.0)</b>	<b>(0.7)</b>	<b>(31.9)</b>
Provision for income taxes		(0.1)	(0.5)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Loss from continuing operations before extraordinary item</b>	<b>(19.0)</b>	<b>(0.8)</b>	<b>(32.4)</b>
Gain on redemption of debentures		11.0	
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Net income (loss) from continuing operations</b>	<b>(19.0)</b>	<b>10.2</b>	<b>(32.4)</b>
Income (loss) from discontinued operations (net of income taxes)	(2.1)	(2.2)	2.2
Gain on disposal of discontinued operations	8.0		
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Net income (loss)</b>	<b>(13.1)%</b>	<b>8.0%</b>	<b>(30.2)%</b>
	<u>          </u>	<u>          </u>	<u>          </u>

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### **Revenue**

*Services.* Service revenue consists of consulting, maintenance, installation, hardware, reimbursable expenses and other service revenue. Service revenue was \$76.8 million in 2002, a decrease of \$5.7 million or 6.9% from \$82.5 million in 2001. The decrease was primarily due to decrease in services associated with the sale of the EZ-CAP Division in August 2001 and reduction in Financial Services Division.

Service revenue of \$82.5 million in 2001 represented a decrease of \$9.9 million or 10.7% from the \$92.4 million reported 2000. The decrease was primarily due to a substantial decrease of \$23.8 million due to the sale of the ROI Division in 2000, a decrease in Health Management Services Division, slight decrease due to the sale of EZ-CAP Service Division in August 2001, offset by an increase in the Enterprise Division installation and services and increase in Health Management Software Division maintenance revenue and Financial Services Division revenue.

*Licenses.* License revenue consists of license and third-party software sales. License revenue in 2002 was \$32.8 million, a decrease of \$1.8 million or 5.2% from \$34.6 million in 2001. The decrease in license revenue was primarily attributable to the decrease in license associated with the sale of EZ-CAP Division revenue offset by an increase in Health Management Software government licenses.

License revenue of \$34.6 million in 2001 showed an increase of \$6.0 million or 20.8% from the \$28.6 million in 2000. The increase was primarily attributable to an increase in the Enterprise Division and Health Management Software Division.

### **Cost of Revenue**

*Cost of Services.* Cost of services consists of salaries and related expenses associated with services performed for customer support and consulting services as well as third-party hardware costs. Cost of services in 2002 was \$36.1 million, an increase of \$2.0 million or 5.8% from \$34.1 million in 2001. The increase was primarily due to an increase in salaries and benefits offset by a slight decrease in third-party hardware costs. The gross margin earned on services revenue in 2002 was 53.0%, which was 5.7 percentage points less than the 2001 level of 58.7%.

Cost of services in 2001 of \$34.1 million was \$20.7 million or 37.8% below the 2000 cost of \$54.8 million. Cost of services decreased primarily due to salary and benefits expense reduction in the consulting organization.

*Cost of Licenses.* Cost of licenses consists of third party royalties, amortization of capitalized software and documentation and production costs of our software. Cost of licenses in 2002 was \$9.1 million, 5.3% above the corresponding 2001 level of \$8.7 million. Gross margin on license revenue was 72.1%, a deterioration of 2.8 percentage points from the 2001 level of 74.9%. The absolute dollars were consistent from period to period.

Cost of licenses in 2001 of \$8.7 million was up \$1.6 million or 21.8% from \$7.1 million in 2000. Gross margin was consistent from period to period.



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Amortization of capitalized software development costs totaled \$2.4 million, \$2.0 million, and \$1.7 million in 2002, 2001, and 2000, respectively.

### **Operating Expenses**

*General and Administration.* General and administration expense consists of compensation and benefit costs for executive, finance, legal, information technology, and administrative personnel. General and administrative expenses were \$41.1 million in 2002, an increase of \$5.4 million or 15.2% compared to \$35.7 million in 2001. As a percentage of total revenue, general and administration expense increased to 37.5% in 2002 from 30.5% in 2001. The increase was primarily due to an increase in accountants, consultants and attorneys fees, as part of the restatement process in the year of approximately \$7.5 million, offset by other operating costs. We anticipate that general and administration expenses will be lower in absolute dollars in 2003 than in 2002.

General and administration expense of \$35.7 million in 2001 reflected a decrease of \$21.3 million or 37.4% compared to \$57.0 million in 2000. The decrease was primarily due to severance costs and provision for bad debt expense in the prior period. As a percentage of total revenue, general and administration expense decreased to 30.5% in 2001, compared to 47.1% in 2000.

*Sales and Marketing.* Sales and marketing expense includes costs associated with our sales and marketing personnel and product marketing personnel and consists primarily of compensation and benefits, commissions and bonuses, promotional and advertising expenses. Sales and marketing expense increased by only \$841,000 in 2002 to \$21.6 million from \$20.7 million in 2001. Sales and marketing expenses were consistent from period to period. We anticipate that sales and marketing expense will be slightly higher in absolute dollars and as a percentage of revenue in 2003 than in 2002 due to increased promotional expenditures.

Sales and marketing expense of \$20.7 million in 2001 was \$3.1 million less than the \$23.8 million recorded in 2000 reflecting a decrease as a percentage of revenue to 17.7% from 19.6% in the prior year. The decline in sales and marketing expense was primarily due to a decrease in commission expense.

*Research and Development.* Research and development expense includes costs associated with the development of new products, enhancements of existing products for which technological feasibility has not been achieved, and quality assurance activities, and primarily includes compensation and benefits expense. Research and development expense for 2002 was \$17.2 million, a 19.4% increase from 2001. As a percentage of revenue, the increase was 3.4 percentage points to 15.7% in 2002 from 12.3% in 2001. The increase in research and development expense was due to increased product development efforts on the Computerized Physician Order Entry product. In addition to these expenses, we capitalized \$1.8 million in development costs representing 10% of research and development expenditures in 2002, compared to \$1.8 million or 11.0% of expenditures in 2001, on products qualifying for capitalization under the definition of technological feasibility. We anticipate that research and development expenses will increase in absolute dollars in 2003 due to increased development of products.

Research and development expense in 2001 was \$10.2 million less than in 2000, a decline of 41.5%. As a percentage of revenue, the decrease was 8.0 percentage points to 12.3% in 2001 from 20.3% in 2000. The decline in research and development expense was due to the elimination of corporate research and development projects to shift our focus to specific product line development, elimination of support costs for divested products, and the termination of several product development efforts that were not critical to our core strategies. In addition to these expenses, we capitalized \$1.8 million in development costs compared to \$527,000 or 2.1% of expenditures in 2000.

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*Amortization, Impairment and Other Operating Charges.* Amortization, impairment and other operating charges were \$3.1 million, \$9.1 million and \$11.1 million in 2002, 2001 and 2000, respectively, which primarily consists of the following items:

Amortization of goodwill and other intangible assets, excluding capitalized software development costs, declined to \$2.5 million in 2002 from \$6.2 million in 2001 and \$7.8 million in 2000 as certain assets reached the end of their amortized lives and goodwill was not amortized in 2002.

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During 2000, we recorded \$1.2 million in charges to write-down certain software assets primarily related to our 1998 acquisition of IMN.

Charges of \$4.7 million were incurred during the year ended December 31, 2000. The charges consisted of \$3.4 million associated with separation agreements for officers and \$1.3 million for employee severance and closure of facilities. As of December 31, 2002, there is no remaining liability for restructuring costs.

## **Other Income (Expense)**

*Interest Income (Expense).* Interest expense, net of interest income, was \$2.8 million, \$2.7 million and \$4.4 million for 2002, 2001 and 2000, respectively. Interest expense was principally due to our Debentures, offset by interest earned on our cash and investments. The change from 2001 to 2002 was not significant as expected, while the decrease in 2001 of \$1.1 million compared to 2000 is attributable to the retirement of \$41.3 million of our Debentures during 2001.

On April 16, 2003, we announced that we had executed an agreement with certain of our bondholders to refinance \$61.8 million of our 2005 Debt and issue new 2008 Debt with an interest rate of 10% and 11.3 million detachable warrants. As a result, we will incur higher interest charges in 2003 through 2008.

*Gain on Sale of Assets.* In 2002, we recorded a gain of \$8.8 million on the sale of the HIM Services Division and received \$1.5 million related to an earn-out provision on the 2001 sale of EZ-CAP. We recorded a \$7.1 million initial gain on the sale of our EZ-CAP business in 2001. Our gain of \$27.2 million in 2000 resulted primarily from the sale of the ROI division to ChartOne.

## **Extraordinary Item**

*Gain on Redemption of Bonds.* During 2001, we repurchased approximately \$41.3 million of our Debentures on the open market for a total of \$28.4 million in cash, resulting in a gain of \$12.9 million.

## **Discontinued Operations**

On December 31, 2002, we announced the sale of certain assets of our HIM Services Division to Precyse Solutions, LLC. We received \$14 million in cash (of which \$1.5 million is to be held in escrow for 18 months) and a \$300,000 promissory note with a two-year term. We recorded a gain of \$8.8 million in connection with the sale.

The results of operation have been presented as a discontinued operation for all periods presented. The operating results were as follows (in thousands):

	Year ended December 31,		
	2002	2001	2000
Revenue	\$ 17,313	\$ 19,735	\$ 29,968
Income (loss) from operations of discontinued operation	\$ (2,270)	\$ (2,539)	\$ 2,679
Gain on disposal	8,776		
Total income (loss) on discontinued operations	\$ 6,506	\$ (2,539)	\$ 2,679

*Provision for Income Taxes.* There was no provision for income taxes in 2002 due to a current book and tax loss. There was a \$150,000 provision for income taxes in 2001 due to state tax liabilities on certain of our legal entities. For financial reporting purposes, a 100% valuation allowance has been recorded against our deferred tax assets under SFAS No. 109, *Accounting for Income Taxes*, as our history of losses makes realization of the asset uncertain. We had federal net operating loss carryforwards of approximately \$76.1 million and state net operating loss carryforwards of approximately \$2.0 million as of December 31, 2002. In addition, we had gross federal and California research and development credit carryforwards of approximately \$4.2 million and \$1.8 million respectively.



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### **Liquidity and Capital Resources for the Period ending September 30, 2003**

#### **Balance Sheet and Cash Flows**

Cash, and cash equivalents and short-term investments were \$35.6 million as of September 30, 2003 and \$26.2 million as of December 31, 2002, an increase of \$9.4 million or 35.6% during the period. Cash flows used by operating activities were \$1.3 million for the nine months ended September 30, 2003. These amounts primarily resulted from a net loss of \$22.2 million for the nine months ended September 30, 2003, offset by depreciation and amortization of \$8.7 million and a decrease of working capital of \$7.1 million. Cash flows from investing activities of \$2.0 million resulted from a \$2.7 million payment received for the HIM Services sale and \$1.5 million earn-out payment associated with the EZ-CAP sale offset by \$2.5 million in fixed asset purchases. In addition, \$8.6 million was provided from the restructuring of the long term debt.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, specifically the timing of our accounts receivable collections, and the timing of other payments. For the nine months ended September 30, 2003 we paid \$6.5 million related to the restatement and other non-recurring events. These expenses will be significantly reduced in future quarters. For the nine months ended September 30, 2003 we invested \$17.1 million in research and development of our software products. We expect to continue to invest in research and development in the future.

Prepaid expenses and other accrued liabilities increased by \$1.5 million and \$2.2 million, respectively from December 31, 2002 to September 30, 2003 due to third-party royalties owed on HIM government sales. An additional \$2.9 million of other accrued liabilities resulted from accrued interest on the 2008 Debt. Deferred revenue increased by \$9.6 million during the same period primarily due to \$5.4 million related to HIM government sales, \$2.7 million in other HIM software division and \$1.5 million in Enterprise division sales.

On March 4, 2003, our common stock was delisted from the Nasdaq National Market. The delisting constituted a Repurchase Event under the provisions of our 5.25% Convertible Subordinated Debentures Agreements due 2005 (the 2005 Debt). Upon such an event, the 2005 Debt Agreement grants to each debenture holder the right, at the holder's option, to require us to repurchase all or any of the holder's debentures. On April 17, 2003, we issued \$71.0 million of our Senior Secured Notes due 2008 (the 2008 Debt). The proceeds from the issuance of the 2008 Debt were used to repurchase \$61.8 million (plus \$1.5 million in accrued interest) of the 2005 Debt required to be repurchased. Accordingly, the net proceeds as a result of the issuance of the 2008 Debt, less the costs (including fees) associated with the repurchase of the 2005 Debt, were \$8.5 million, with \$11.9 million of the 2005 Debt remaining outstanding. Additionally, the repurchase right on the 2005 Debt remaining outstanding expired on April 17, 2003.

The 2008 Debt bears interest at an initial rate of 10%, of which 6% is due in semi-annual cash coupon payments in the first year with the remainder added to the outstanding principal balance of the notes. The interest rate on the 2008 Debt will be reduced to 9% upon relisting of our common stock on the Nasdaq, including Nasdaq Small Cap or any U.S. National Market, and is secured by substantially all of our intellectual property. The 2008 Debt contains certain events of default. These events include: failure to timely repay principal or interest owed on the debentures, default under any other borrowing, and bankruptcy. As part of the transaction, we also issued warrants to purchase 11.6 million shares of common stock, of which warrants for 11.3 million shares were issued to purchasers of the 2008 Debt and 283,000 shares were issued as compensation for services provided with the offering. The warrants have a term of five years, an exercise price of \$.01 per share, and are subject to certain anti-dilution provisions, including dilution from the issuance of shares in settlement of any existing litigation. We valued the warrants using the Black-Scholes valuation model using a volatility of 142%, expected life of 5 years, 2.74% risk-free interest rate and no dividend yield. The result was a fair value of \$12.9 million for the warrants issued to debt holders. This amount was recorded as a discount to the debt and will be amortized to interest expense ratably over the 5-year term of the debt. In addition, costs associated with the debt offering, including the warrants for 283,000 shares, totaled \$1.0 million, which will be amortized to interest expense ratably over the same term. In June 2003, 283,000 warrants were exercised.



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At September 30, 2003, long-term debt consisted of a principal balance of \$11.9 million for the 2005 debt, \$71.0 million for the 2008 debt and unamortized warrants of \$11.7 million at September 30, 2003.

**Commitments**

The following table summarizes financial data for our contractual obligations and other commercial commitments, including interest obligations, as of September 30, 2003 (in thousands):

	Payments Due by Period				
		Less Than	1-3	3-5	After 5
	Total	1 year	years	years	years
<b>Contractual Obligations</b>					
Principal on long-term debt	\$ 85,671	\$	\$ 11,931	\$ 73,740	\$
Interest on long term debt	34,858	4,736	15,374	14,748	
Operating leases	26,739	4,660	7,663	7,077	7,339
Other long-term obligations	966	483	483		
<b>Total contractual cash obligations</b>	<b>\$ 148,234</b>	<b>\$ 9,879</b>	<b>\$ 35,451</b>	<b>\$ 95,565</b>	<b>\$ 7,339</b>
<b>Other Commercial Commitments</b>					
Standby letters of credit <sup>(1)</sup>	\$ 4,076	\$ 1,100	\$	\$ 2,620	\$ 356
<b>Total commercial commitments</b>	<b>\$ 4,076</b>	<b>\$ 1,100</b>	<b>\$</b>	<b>\$ 2,620</b>	<b>\$ 356</b>

(1) The 3-5 years amount of \$2.6 million is for an existing surety bond requirement on September 30, 2003. Actual requirements may be less as work is completed towards the underlying contract.

In addition, as of September 30, 2003, we had approximately \$26.7 million in minimum operating lease commitments that will be repaid through 2011. Finally, we have a Supplemental Executive Retirement Plan ( SERP ) that will require total payments from 2008 through 2027 estimated at \$7.8 million. We owe annual premiums of \$483,000 on the SERP through 2005 to fund our obligations.

We believe that we will have sufficient liquidity and capital resources to fund our scheduled debt and other obligations through the next twelve months.

**Quantitative and Qualitative Disclosures About Market Risk****Interest Rate Risk**

Our exposure to market risk for changes in interest rates primarily relates to our investment portfolio. It is our intent to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk, and reinvestment risk. We invest in high-quality issuers, including money market funds, and United States government corporate debt securities. We have a policy of investing in securities with maturities of two years or less. We do not invest in derivative financial or foreign investments.

The table below presents fair values of principal amounts and weighted average interest rates for our investment portfolio as of September 30, 2003 (in thousands, except average interest rates):

	<u>Aggregate Fair Value</u>	<u>Weighted Average Interest Rate</u>
Cash and cash equivalents:		
Cash	\$ 10,689	
Money Market funds	22,511	0.83%
	<u>          </u>	
Total cash and cash equivalents	\$ 33,200	
	<u>          </u>	
Short-term investments:		
Corporate debt securities	\$ 2,380	1.70%
	<u>          </u>	
Total short-term investments	\$ 2,380	
	<u>          </u>	
Long-term investments:		
Corporate debt securities	\$ 472	5.17%
Debt issued by the U.S. government	876	5.02%
	<u>          </u>	
Total long-term investments	\$ 1,348	
	<u>          </u>	

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### **Performance of Equity Markets**

The performance of equity markets can have an effect on our operations, and recent declines in equity markets, if sustained, will have an adverse effect on us related to certain variable life insurance policies in which we have an investment interest.

### **Foreign Currency Risk**

Although we sell our products internationally from time to time, all such transactions are denominated in U.S. Dollars and there is no foreign currency fluctuation risk associated with such sales.

## **CHANGES IN REGISTRANT'S CERTIFYING ACCOUNTANTS**

On April 5, 2002, QuadraMed, upon the approval of our Audit Committee and our Board of Directors, appointed PricewaterhouseCoopers, LLP ( PwC ) as our independent public accountant and dismissed Pisenti & Brinker, LLP ( P&B ), which had been appointed our independent public accountants on May 8, 2000, and had served in such capacity for the fiscal years ending December 31, 2000 and 2001, and subsequent interim periods.

P&B's reports on our financial statements for the fiscal years 2000 and 2001 and any subsequent interim period did not contain an adverse opinion or a disclaimer of opinion, and were not qualified or modified as to uncertainty, audit scope, or accounting principles. There were no disagreements between QuadraMed and P&B on any matters of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements, if not resolved to the satisfaction of P&B, would have caused them to make reference to the subject matter of such disagreements in connection with their reports during our fiscal years 2000 and 2001, and any subsequent interim period.

Furthermore, during QuadraMed's fiscal years 2000 and 2001, and any subsequent interim period, P&B never advised QuadraMed that it had concerns with our internal controls, management's representations, financial statements prepared by management, scope of their audit, or previously issued financial statements and Reports of Independent Auditors.

We asked P&B to provide us with a letter addressed to the SEC stating whether it agreed with QuadraMed's disclosures and, if not, to specify in which respects it did not agree. A copy of such letter, dated May 15, 2002, is filed as an exhibit to the registration statement of which this prospectus is a part.

On April 28, 2003, QuadraMed dismissed PwC as our independent accountants. Our Audit Committee made the decision to change independent accountants.

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PwC did not report on our consolidated financial statements for any fiscal year. During their retention as our independent accountants from April 5, 2002 through April 28, 2003, there were no disagreements with PwC on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of PwC, would have caused them to make reference thereto in their report on the consolidated financial statements.

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PwC did, however, inform both management and our Audit Committee of its concerns regarding material weaknesses in the company's system of internal controls, policies and procedures, including the adequacy and reliability of certain financial information, and certain financial personnel. Specifically, PwC reported material weaknesses in 1) the accounting for software revenue and related expense recognition, 2) the reporting of discontinued operations, 3) the accounting for the company's investment in certain non-consolidated subsidiaries, 4) the accounting for certain life insurance contracts and the Supplemental Executive Retirement Plan ( SERP ), 5) the accounting and reporting of non-recurring charges, 6) the accounting for stock-based compensation, 7) the accounting and reporting of capitalized software development costs, 8) the accounting for income taxes, 9) the documentation supporting the accounting for certain business combinations, and 10) timely analysis and reconciliation of general ledger accounts. PwC further stated that these material weaknesses would require PwC to expand the scope of its uncompleted audit of fiscal year 2002, and that its findings to date may materially impact the fairness and reliability of our previously issued financial statements as previously filed with the SEC and the report of the prior independent public accountants on those financial statements. We requested that PwC furnish us with a letter addressed to the SEC stating whether or not it agrees with the above statements. A copy of such letter, dated May 5, 2003, was filed on our Current Report on Form 8-K with the SEC on May 5, 2003 and is filed as an exhibit to the registration statement of which this prospectus is a part.

We engaged BDO Seidman, LLP ( BDO ) as our new independent accountants as of May 5, 2003.

As a result of the matters discussed above, as well as management's discovery and analysis of accounting and financial reporting errors, the Audit Committee concluded at a meeting on August 9, 2002 that the restatement of the company's consolidated financial statements for the years ended December 31, 2001 and 2000 and the unaudited condensed consolidated financial statements for the quarter ended March 31, 2002, was required. Deloitte & Touche LLP ( Deloitte ) was engaged to perform forensic accounting and other services in connection with accounting, disclosure and other issues that resulted in the restatements and rendered an extensive report to the Audit Committee and the company. The Audit Committee re-engaged Pisenti & Brinker, LLP ( P&B ), the company's independent public accountants who immediately preceded PwC, to reaudit the years ended December 31, 2000 and 2001.

In October 2002, the Audit Committee further concluded after additional meetings that the year ended December 31, 1999, a year previously audited by Arthur Andersen LLP, required restatement as well, for the same reasons as mentioned above. Upon the completion of the audit of the restated years by P&B, we filed an amended Form 10-K/A for the year ended December 31, 2001 on June 6, 2003, and an amended Form 10-Q/A for the period ended March 31, 2002 on August 15, 2003.

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### **BUSINESS**

#### **Overview**

We provide healthcare information technology products and services that help healthcare providers to improve the quality of the care they deliver and the efficiency with which it is delivered. We accomplish our mission by developing and implementing sophisticated, user-friendly software applications designed and developed by the healthcare professionals and software specialists we employ.

Our products are designed to eliminate paper, improve processes, and decrease error through the efficient management of patient clinical and financial records. They are suitable for acute care hospitals, specialty hospitals, Veterans Health Administration facilities and associated/affiliated businesses such as outpatient clinics, long-term care facilities, and rehabilitation hospitals and are used by healthcare organizations of varying size from small single entity hospitals to large multi-facility care delivery organizations. Our products are sold as standalone, bundled, or fully integrated software packages. We also provide services to support the hospital's collection of receivables and its administration of contractual reimbursements from managed care companies. As of December 31, 2003, approximately 1,900 healthcare provider facilities were utilizing at least one QuadraMed product.

Our headquarters office is located at 12110 Sunset Hills Road, Reston, Virginia in the Washington, D.C. metropolitan area. The company was founded in 1993 and reincorporated in Delaware in 1996. Our telephone number is (703) 709-2300. Our website can be found at [www.quadramed.com](http://www.quadramed.com) where all of our current SEC filings can be accessed free of charge.

#### **Healthcare Market**

The healthcare industry is under increasing pressure from government, consumers, employers, and third party payors to increase the use of technology to improve efficiency, eliminate errors, and to enhance the quality of care. This fact is demonstrated by the number of government, private industry and consumer-driven initiatives that are acting as catalysts and driving the business decisions made by healthcare executives.

The need to increase the use of technology to improve patient safety became evident in 1999 when the Institute of Medicine of the National Academy of Science ( IOM ) published a report entitled "To Err is Human". This report detailed the extent of preventable medical errors in today's hospitals errors which were estimated to cause between 44,000 and 98,000 deaths each year. In their most current report (November 2003), the IOM advises health care organizations to adopt information technology systems that collect and share health information on patients and their care in order to significantly reduce deaths and injuries caused by medical errors. The report goes on to recommend that the systems that health care organizations implement should operate as part of a national network of health information accessible by all healthcare organizations.

In addition to the IOM report, private industry has identified healthcare and the associated cost attributed to medical errors as an area requiring significant change. More than 145 public and private organizations formed a coalition called the Leapfrog Group. These organizations have significant healthcare purchasing power which has brought their initiative to the forefront in the public arena. They are demanding changes designed to improve the quality of care, reduce errors and to lower the associated cost. One of Leapfrog's recommendations is that hospitals implement a Computerized Physician Order Entry ( CPOE ) system to reduce or eliminate adverse drug events, one of the most common medical errors.



The federal government is another key player driving the need for information technology. The Centers for Medicare and Medicaid Services ( CMS ) is encouraging the use of Electronic Health Record Systems ( EHR-S ) to improve care quality based on better clinical data. The focus of the EHR-S is the centralization of and access to electronic health information on a patient level. CMS will be initiating a demonstration project in which hospitals are rewarded financially for providing higher levels of quality care. The need to capture, store, access and communicate patient information electronically will further drive the need for healthcare organizations to implement sophisticated information technology solutions based on industry recognized data standards.

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In May 2003, the Department of Health and Human Services ( DHHS ) issued a report entitled Toward a National Health Information Infrastructure: A Key Strategy for Improving Quality in Long-Term Care. This report establishes the path for the future development of healthcare information technology based on a national infrastructure. The report states:

Demands for readily available health care information have increased dramatically in recent years. Demographic changes such as an aging population with increased chronic illness and a more mobile population have created needs for larger volumes of health information and more easily transferable information. The delivery of cost-effective, high quality health care in order to meet national goals for healthy people and healthy populations is now clearly linked to the availability of information.

This report cites a number of examples of how a national infrastructure can improve the quality of healthcare. These include the ability for consumers to manage their own health care needs and decision-making by having access to their information, providing healthcare providers access to more accurate and complete real-time patient data and use of systems with knowledge and content for better decision-making, and the ability for public health officials to access aggregate data to identify health problems and trends. The federal government is strongly advocating the implementation of an electronic medical record based on data and technology standards that allow systems to communicate and share information across all care settings.

The Health Insurance Portability and Accountability Act of 1996 ( HIPAA ) legislation has had a significant impact on healthcare organizations and their need for technology to help them comply with the resulting regulations. For example, prior to HIPAA legislation, the Health Information Department had sole responsibility for facilitating disclosure of patient information. Under HIPAA's privacy requirements, disclosures must be tracked and aggregated from all departments in the organization, not just the Health Information Department. The complexity of tracking disclosures throughout the organization, as well as providing the patient with a record of what has been disclosed for a minimum of six years, places both a burden and a risk on the organization. In addition, the legislation requires electronic transmission of standards and includes requirements for maintenance and transmission of health information that identifies individual patients.

These standards are designed to:

Improve the efficiency and effectiveness of the healthcare infrastructure by standardizing the interchange of electronic data for specified administrative and financial transactions; and

Protect the security and confidentiality of a patient's health information.

The requirements outlined by the law and the regulations promulgated by DHHS are far-reaching ***all healthcare organizations that maintain or transmit electronic health information must comply***. Healthcare information technology companies, particularly Healthcare Information System ( HIS ) vendors, must partner with healthcare organizations in meeting the significant regulatory requirements mandated by the HIPAA legislation.

## **QuadraMed's Strategy**

QuadraMed's strategy focuses on its core software business. We plan to achieve the status of industry leader by:

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Continually enhancing the functionality of our existing product solutions and their underlying technology to meet the emerging needs of health care providers;

Developing or acquiring additional software applications to complement our product line;

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Focusing on selling new and enhanced applications to our existing customer base;

Acquiring new customers through expanded professional sales and marketing activities;

Maintenance of expense discipline; and

Divestiture of non-strategic assets.

Our goal is to increase market share by offering affordable and user-friendly clinical, administrative, financial and medical records software products to meet the growing demand among hospitals and other healthcare providers for better patient safety, fewer medical errors and improved efficiencies. To achieve this goal, we have combined the considerable healthcare expertise of our product managers with the technological skill of our development engineers in an effort to assure that our products are designed by people who understand healthcare providers and are built using modern technology.

## **QuadraMed's Products and Solutions**

QuadraMed provides comprehensive software and service solutions that help our customers achieve clinical and financial efficiency across the full continuum of patient care. **Affinity** integrated enterprise information systems enable the customer to manage patient registration, clinical, and financial information, and **Quantim** health information management software provides acute care hospitals, VA facilities and physicians with the tools to manage coding, compliance, abstracting and record management processes. In addition, we have standalone solutions that fulfill niche needs including Electronic Document Management, Identity Manager ( MPI ), Decision Support, EDI and Pharmacy. Furthermore, our Financial Services Solutions identify and collect accounts receivable, recover underpayments from managed care contracts, and provide educational services for hospitals and medical groups.

### ***Software Solutions***

The following table provides a list of our major software products and associated services:

#### ***Affinity Patient Access Management***

Patient Scheduling

Patient Registration

Master Population Index

#### ***Affinity Care Management***

Computerized Physician Order Entry ( CPOE )

Clinician Access

Order Management

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Community Master Population Index ( CMPI )

Ancillary Department Management

Medical Records Abstracting

Patient Charting

Medical Records Control

Medication Charting

DRG/Case Mix

Plan of Care

Account Workflow

Acuity/Staff Requirements

Electronic Data Interchange

Health Notes

Quality Management

Utilization Management

Medication Management

Pharmacy Management

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*Affinity Healthcare Information Management*

Abstracting

Coding

Compliance

*Affinity Financial - General Office*

General Ledger

Accounts Payable

Payroll Personnel

InSight Executive Decision Support

Performance Measurement

*Affinity Financial - Patient Financial Management*

Patient Accounting

Central Business Office

Account Workflow

*Electronic Document Management*

HIM

Clinical

File Manager

Workflow

*MPI Integrity Management*

MPISpy

SmartMerge

PreciseID Patient Search Algorithm

MPI Clean Up Services

*Decision Support*

Contract Management

Performance Measurement

Clinical Outcome Practice Evaluator ( COPE )

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Contract Management	<i>EDI</i>
Electronic Data Interchange	EDI Transaction Services
<i>Affinity Professional Services</i>	<i>Other Compliance Management Products</i>
Consulting Services	VHA ProFee Compliance Suite
Interface and Conversion Services	<i>Other Coding and Reimbursement Products</i>
Systems Operations Management Services	Physician Coding - nCoder+MD
Query Services	Facility Coding - nCoder+, Cascade Encoder, WinCoder Interactive
Customer Training Courses	VA Coding - nCoder+/PTF
Professional Services	<i>Other Abstracting Products</i>
<i>Quantim Health Information Management</i>	WinCoder + CS, Cascade Master System
Abstracting	<i>Record Management</i>
Coding    Physician and Facility	MEDREC Millennium Record Management
Compliance    Inpatient and Outpatient	Chart Completion
Correspondence Management	Chart Locator

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eSignature

Correspondence Management

*Pharmacy Management*

Enterprise Search and Reporting

Inpatient

Electronic Signature

Outpatient/Clinic

Long-Term Care

pcMAR



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**Affinity.** Affinity is our brand name for the product family that includes integrated enterprise wide solutions. The core product is a standards-based, integrated, healthcare information system ( HIS ). It is highly scaleable and flexible and supports the business application needs of hospitals of varying sizes, from small community facilities to large multi-entity integrated delivery networks. It can be implemented on both Microsoft NT and UNIX operating systems and supports a number of hardware platforms, including Hewlett Packard/Compaq, Sun Microsystems, IBM, and EMC. Affinity applications are designed to:

Streamline workflow processes;

Reduce administrative expenses;

Improve the speed and accuracy of billing processes; and

Improve patient safety and care by supporting clinical decision-making and documentation.

The Affinity system provides a fully integrated healthcare information system from patient access and identification to care management, health information management and financial management. The system can be installed fully integrated and bundled in best-of-suite configurations.

*Affinity Patient Access Management* solutions are designed to ensure that accurate patient information is accessible across an organization, improving workflow, compliance and patient safety. By centralizing all patient information in an integrated, scalable system, our access management solutions enable healthcare professionals to quickly and accurately track patients from registration through billing.

*Affinity Care Management* provides improved integration, streamlined workflow, better documentation and better decision support for patient safety. The system supports order control/results reporting, acuity/staff requirements, plan of care, vital signs and intake/output, charting and assessment, pharmacy/medical management, department management, physician access, and computerized physician order entry. The Affinity CPOE, Pharmacy and Patient Charting applications provide a comprehensive, advanced clinical solution focused on patient safety. The Affinity Pharmacy Management component provides a comprehensive solution to help healthcare organizations manage the daily operations of their pharmacy departments and is fundamental in addressing patient safety concerns that are driving clinical decisions.

Additionally, we offer a standalone solution for pharmacy management for the inpatient, ambulatory, and long-term care settings. Our pharmacy solution also provides a point of care electronic medication charting tool.

*Affinity Health Information Management* includes our proprietary coding, compliance and record management systems and automates the management of the patient revenue cycle.

*Affinity Financial Management* solutions provide acute care hospitals with comprehensive revenue cycle management capabilities. Affinity helps hospitals capture and manage revenue throughout the patient revenue cycle. By combining clinical, financial and patient information within a single patient-centered database, Affinity helps organizations reduce accounts receivable days, improve cash flow, increase productivity and improve operational and strategic decision-making.

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**Quantim.** Quantim is our brand name for our product family of standalone Health Information Management solutions. When sold as standalone products, these solutions are frequently integrated with other vendors' HIS systems. Quantim is an integrated health information management system that provides acute care hospitals and physician practices with the tools to manage coding, compliance, abstracting and record management processes. This combination of integrated solutions is designed to significantly improve the business of healthcare. Quantim software solutions are designed to generate operational efficiencies, improve cash flow and measure the cost and quality of care. Quantim provides a single, fully integrated, web-native platform for our health information management product suite. Quantim represents a significant improvement over the functionality of traditional health information management product offerings in the areas of coding, compliance, abstracting, and medical records management.

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*Quantim Abstracting* captures, structures, and analyzes clinical and financial data using standard and customizable fields, rules and screen design. The Application Builder tool provides users the ability to customize workflow by creating fields and rules and designing screen navigation. Quantim Abstracting provides an integrated solution that enables the user to access both the Coding and Compliance tools within a patient encounter and provides timely and accurate data for clinical and business decisions.

*Quantim Coding* provides advanced search functionality while maintaining a solid knowledge-based approach to coding. It includes a sophisticated search engine to facilitate the encoding process and improve coding accuracy. Coding accuracy is enhanced through Quantim Coding's powerful simultaneous encoding and grouping system, designed to maximize productivity and minimize duplication.

*Quantim Compliance* is a transaction based software solution that facilitates accurate ICD-9-CM, CPT/HCPCS, DRG and APC assignment. Quantim Compliance automates the selection process and assists the user in monitoring appropriate and accurate coding for both inpatient and outpatient encounters. Quantim Compliance improves the quality of data and acts as an early warning system to identify potential areas of noncompliance.

*Quantim Correspondence Management* provides complete functionality to facilitate a healthcare organization's compliance with the disclosure management aspect of the HIPAA privacy mandate. In addition, it provides the tools needed by HIM to automate the entire release of information workflow process, including robust accounts receivable management.

Quantim Correspondence Management generates disclosure accounting and audit reports, retains an on-line history of the disclosure accounting process and permits tracking of the specific disclosure type all within a secure environment. In addition, it tracks and monitors suspensions by health oversight and law enforcement agencies. The release of information features provide for tracking and monitoring of requests made by individuals or entities outside of the healthcare organization.

*Quantim Electronic Document Management* captures, indexes, routes, stores and retrieves health information documents and images. It transforms paper documents into a secure, electronic format and creates a central repository for patient documents allowing access through a web browser.

**Other Solutions.** In addition to Affinity and Quantim, we also market standalone solutions that fulfill specific needs, including QuadraMed EDM – an electronic document imaging and management system, QuadraMed MPI, a suite of Master Person Index (MPI) Software and Services (MPIspy®, SmartID®, SmartMerge®, MPI Cleanup), which enable the identification, correction, and elimination of duplicate patient records in a facility's master population index; Decision Support tools, including: Contract Management, a managed care contract management system; Performance Measurement, a clinical and financial outcome analysis and decision support system; and, Clinical Outcome Practice Evaluator (COPE), which electronically captures, abstracts, and enters data required for Core Measures of the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). We also market an electronic transaction service (EDI).

### ***Financial Services Solutions***

We provide two services that identify and collect accounts receivable for hospitals and medical groups: (i) Accounts Receivable Management; and (ii) Managed Care Payment Review.

Our Accounts Receivable Management services provide a variety of third-party collection services, including:

Complete outsourcing that initially bills and collects accounts from time of service;

Early out programs that collect accounts of pre-designated age or amount;

Aged accounts placement that collects aged accounts on a one-time basis;

Resolution of accounts unable to be transferred as part of conversion to a provider's new health information system;

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Operational assessments of hospital revenue cycles; and

Training and education on business office operations and compliance issues related to collection.

We also offer customization of accounts receivable services and detailed reconciliation reports on our work.

Our Managed Care Payment Review Service audits managed care patient accounts for appropriate payment pursuant to managed care contracts. In providing this service, we use our own proprietary software that automates many audit functions and permits greater reporting options.

## **Product Development Strategy**

The key drivers for our technology development are portability of information, flexibility of deployment, access anywhere and anytime, and data standardization. Our technology strategy is guided by the following technology trends:

The Internet and distributed computing have had and will likely continue to have a significant impact on the way software is developed and delivered;

Web-native applications with a modern Internet architecture will likely have a significant role in the future; and

Computing power, storage capacity, and network bandwidth have in the past doubled, and may continue to double, every 18, 12, and 6 months, respectively.

The principles upon which our core products are developed will enhance their ability to be easily accessed, scaled, extended, and integrated with the customer's legacy systems: These principles include:

**Standards Based:** Our products support industry standards, such as Health Level 7 (HL7), X12 EDI and XML. This enables QuadraMed customers to preserve their investments in previously installed departmental systems and to support a corporate-wide integration strategy. Increasingly, our products will make it possible to integrate information from different environments into a single, patient-centered database.

**Platform Independent:** We intend to isolate the application business logic and user interface from the underlying hardware and operating system through an adaptive technology framework and core services. A QuadraMed customer will be able to pursue the most advantageous hardware route generally without affecting data portability.

**Scalable and Reliable:** Our architecture is based upon the communications and networking facilities of UNIX and Windows. The adaptive architecture offers total scalability and reliability from small to large enterprise systems.

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**Flexible and Customizable:** Our architecture includes powerful tools that allow users to adapt the system to their specific needs. At the institution level, customers can design custom data entry screens, reports, and workflow all without programming. At the user level, the framework supports end user authoring which allows physicians and clinicians to easily configure the system to provide the information that they need, in a format that they are comfortable with, organized to support the way they work.

**Ease of Installation and Implementation:** Our emerging architecture makes it easy to install and implement. The use of web based thin clients eliminates the need for manual software installation and configuration on individual workstations. QuadraMed has a record in successful installations and customer satisfaction. Our products are designed to support incremental installation and we specialize in interfacing with legacy systems, thereby providing the customer with a rapid return on investment.

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**Web Accessible:** Our newer applications are fully web accessible, including a web-native and Java (J2EE)-based framework that is fully integrated with core enterprise-wide registration, clinical and financial systems. This architecture also allows integration with existing web portals to make enterprise wide information web-accessible.

## **Technical Architecture**

To eliminate the disparity of technical architectures that resulted from our many acquisitions, we have established a technical architecture which guides the development and integration of our products. We have focused on integrating the functionality of our products through the development of web-native applications (designed to run in a web browser) built on n-tiered architecture (developed in discrete layers separating the user interface from the business rules and data storage to provide maximum platform independence). The layers of this architecture are as follows:

**Platform** the platform layer is the computer hardware and operating system. Our software is designed to be system independent, which means it can run on a variety of hardware and operating systems from a number of vendors. Our systems can run on computers from any manufacturer that supports Microsoft Windows® or commercial Unix operating systems.

**Database** the database layer consists of a commercial relational database management system such as Oracle®, Microsoft SQL Server, or InterSystems Cache. Our software is designed to be database independent and is capable of being deployed on a variety of database management systems.

**EDR** the Enterprise Data Repository ( EDR ) is the developed implementation of a healthcare specific data model. The design of the EDR has been heavily influenced by the HL7 Reference Information Model ( RIM ). HL7 is the recognized governing standards body for healthcare information technology. The RIM includes definitions for all objects and acts specific to healthcare, including complete conceptual definitions of terms like patient, provider, procedure, and diagnosis, and the potential relationships among the terms.

**Framework** the Framework layer is a developed layer that implements a set of core services which are reusable across our applications. By developing a set of core services one time in a common framework we are able to support our product families and leverage the vast amount of healthcare domain knowledge that is embedded in products like Quantum Coding or Affinity CPOE.

**Application Logic** the Application Logic layer is a developed layer that implements specific applications such as Quantum Coding or Affinity Pharmacy. Application layers use combinations of Framework layer services and application specific business logic. The differentiating code that makes one product distinct from another is developed in this layer.

**Thin Client** the Thin Client or presentation layer is responsible for the presentation of the software to the end user what the user sees on the screen. By designing our systems to run in a web browser we build in a great deal of flexibility in the deployment of our applications. By separating the presentation layer from the application layer, we greatly simplify the task of supporting new end-user devices as they become available.

**Product Families** the architecture supports our product strategy. QuadraMed's two major product families, Affinity and Quantum, are being developed in the QuadraMed architecture which is an integrated, standards-based software platform which simplifies and automates workflow across the continuum of patient care. It is this core technology that supports all QuadraMed products and enables their integration into a new or existing system.

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### **Customers**

We primarily market to acute care hospitals and multi-facility care delivery organizations or integrated delivery networks. We also sell products to Veterans Health Administration facilities, specialty hospitals, hospital associations, and physicians. We have customers located in all 50 states, the District of Columbia, Puerto Rico, and Canada. In 2002, 2001, and 2000, no single customer accounted for 10% or more of our total revenue. In all, our products are used in approximately 1,900 healthcare provider facilities.

### **Highly Competitive Market**

Competition for our products and services is intense and is expected to increase. We compete with other providers of healthcare information software and services, as well as healthcare consulting firms. Our principal competitors include McKesson Corporation, Inc., Siemens Medical Services Health Services Corp. (formerly Shared Medical Systems or SMS), Meditech Corporation, Eclipsys Corporation, Cerner, GE Medical Systems, IDX Corporation, 3M, and Softmed. Other competitors include niche providers of electronic document management software, MPI products and services, decision support products, and financial services consulting and outsourcing.

Some of our competitors may be in a position to devote greater resources to the development, marketing and sales of their products. The trend towards merger and consolidation could further increase the level of competition providing other companies with greater ability to develop products on more aggressive schedules. Some of the main considerations of our customers that impact competition are customer service and support, ability to install systems in a reasonable timeframe, use of open standards as well as industry standards that allow disparate systems to work together, product functionality, company reputation and stability, and price.

### **Government Regulation and Healthcare Reform**

Computer products used or intended for use in the diagnosis, cure, mitigation, treatment, or prevention of disease or other conditions or that affect the structure or function of the body are subject to regulation by the U.S. Food and Drug Administration ( FDA ) under the Federal Food, Drug and Cosmetic Act. At present, none of our software products are so regulated by the FDA.

There is substantial state and federal regulation of the confidentiality of patient medical records and the circumstances under which such records may be used by, disclosed to or processed by us as a consequence of our contacts with various health providers. Although compliance with these laws and regulations is presently the principal responsibility of covered entities including hospitals, physicians, or other healthcare providers, regulations governing patient confidentiality rights are rapidly evolving. Additional federal and state legislation governing the dissemination of medical record information may be adopted which may have a material affect on our business. Those laws, including HIPAA and ICD 10 implementation, may significantly affect our future business and materially impact our product development, revenue and working capital. During the past several years, the healthcare industry also has been subject to increasing levels of governmental regulation of, among other things, reimbursement rates and certain capital expenditures. We are unable to predict what, if any, changes will occur as a result of such regulation.

### **Intellectual Property**



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We rely on a combination of copyright, trademark and trade secret law, and nondisclosure and non-compete agreements to protect our proprietary methodologies, computer software, and databases. We maintain the confidentiality of proprietary technology through a policy of obtaining agreements with our employees that (i) prohibit employees from disclosing or using our confidential information, and (ii) require the disclosure and assignment to us of new ideas, developments, discoveries or inventions related to our business. We also initiated a new branding strategy in 2001 that included the adoption of a new trademark, We do technology. So you can do healthcare. We also enter into non-disclosure agreements with business partners and customers in the ordinary course of business. We have obtained trademark registrations in the United States for most of our corporate and product trademarks, including QuadraMed, Affinity, Quantim, and Complysource. We had not filed for or obtained any patents for our proprietary technology until 2001, when we sought a patent on our Affinity CPOE software application. This patent application has lapsed. We may in the future seek patents for new products if, in our business judgment, their importance warrants such steps and is susceptible to protection under the patent laws. We also depend on licenses for certain technology used to develop our products from third-party vendors.

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### **Employees**

QuadraMed's staff numbers includes a product management and development team with healthcare experience, software engineers trained in 21st century technology, sales and marketing, and corporate support/administrative. We believe that we have a satisfactory relationship with our employees, none of whom are represented by a union or other collective bargaining group. As of December 31, 2003, we had approximately 900 employees: 96 in general and administration, 87 in sales and marketing, and the remaining employees in technical, consulting, research and development, and support services.

### **Properties**

We lease all our facilities and do not own any real property. As of December 31, 2003, our executive and corporate offices were located in Reston, Virginia, in approximately 49,000 square feet of leased office space under a lease that expires in 2011. We also lease approximately 41,000 and 34,000 square feet of office space in San Marcos, California and San Rafael, California, respectively. These leases both expire in 2009. We believe that our facilities provide sufficient space for our present needs, and that additional suitable space, if needed, would be available on reasonable terms. In connection with the relocation of our corporate headquarters to Reston, Virginia, the company intends to vacate the San Rafael, California facility effective March 31, 2004 and expects to record a loss on this lease in the first quarter of 2004.

### **Legal Proceedings**

In October 2002, a series of securities law class action complaints were filed in the United States District Court, California Northern District, against QuadraMed and certain of its officers and directors. The plaintiffs in these actions allege, among other things, violations of the Securities Exchange Act of 1934 due to issuing a series of allegedly false and misleading statements concerning its business and financial condition between May 11, 2000 and August 11, 2002. The complaints seek unspecified monetary damages and other relief. These matters are at an early stage and no discovery has taken place. QuadraMed intends to defend itself vigorously against these allegations. However, the ultimate outcome of these matters cannot presently be determined.

On February 28, 2003, QuadraMed reported that the SEC issued a formal non-public order of investigation concerning QuadraMed's accounting and financial reporting practices for the period beginning January 1, 1998. On October 10, 2003, QuadraMed announced that the Staff of the San Francisco District Office of the Securities and Exchange Commission (the Staff) has informed QuadraMed that the Staff intends to recommend to the SEC that it institute an enforcement action against QuadraMed for violations of the antifraud, periodic filing and books and records provisions of the federal securities laws. The proposed recommendation concerns QuadraMed's accounting for transactions that it entered into with Health+Cast LLP in 1998 and 1999. The 1999 transactions were restated as part of the recent restatement of our 1999 financial statements. The Staff invited QuadraMed to make a Wells submission with respect to the proposed recommendation. QuadraMed plans to continue to discuss this matter with the Staff; however, QuadraMed cannot predict when the SEC will conclude its inquiry, or the outcome and impact thereof. The Staff also indicated that it does not presently intend to recommend any action against QuadraMed's current officers, directors or employees.

In June 2000, QuadraMed entered into a Separation Agreement with James Durham upon his resignation as the company's chief executive officer. This agreement was amended in July 2001 when Mr. Durham resigned from our Board of Directors. Pursuant to the agreement as amended, upon these resignations, Mr. Durham received approximately \$3.2 million as of the dates of the agreements, a \$250,000 per year salary through January 1, 2001, a \$2,000 per month salary until December 31, 2003, the vesting of approximately 100,000 unvested options, the vesting of interest in the company's Supplemental Employee Retirement Plan (the SERP), and payments of approximately \$500,000 per year by

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the company into his account in the SERP Trust, all subject to the terms and conditions of the agreement, as amended. Among other terms, the Separation Agreement contained a provision for non-disparagement, requiring Mr. Durham to refrain from directly or indirectly disparaging the company or its stockholders, directors, officers, employees, or agents for the term in which Mr. Durham was receiving payments

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under the Separation Agreement and for a period of one year thereafter. In a November 2002 article published in the *Marin Independent Journal* for which he was interviewed, Mr. Durham made repeated disparaging remarks about the company and our management. When notified that his published remarks were in breach of his Separation Agreement, Mr. Durham requested a lump sum election for his SERP benefits. The amount of payment called for in the SERP is described in note 16 Employee Benefit Plans Supplemental Executive Retirement Plan to our audited consolidated Financial Statements beginning on page F-25 of this prospectus.

In light of Mr. Durham's breach of his Separation Agreement, QuadraMed has notified Mr. Durham and his counsel that it is not obligated to fund additional SERP payments on behalf of Mr. Durham and that it will not pay him a lump sum for his SERP benefits. In January 2004, Mr. Durham filed an amended complaint against the company in the Superior Court of the State of California, Marin County, alleging a breach of his SERP contract and a breach of good faith and fair dealing under this contract. This amended complaint seeks payment of his lump sum SERP benefits, interest, attorneys' fees, and other relief. These matters are at an early stage and no discovery has taken place. QuadraMed intends to defend itself vigorously against these allegations and feels that it is in the best interests of the company and its stockholders to defend this action, due to Mr. Durham's disparaging comments after his resignation and his breach of the Separation Agreement, as amended. The ultimate outcome of these matters cannot presently be determined. For additional information concerning the calculation and amount of this obligation, please see note 16 Employee Benefit Plans Supplemental Executive Retirement Plan to our audited consolidated Financial Statements beginning on page F-25 of this prospectus.

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Our directors and executive officers as of January 21, 2004 are as follows:

<b><u>Name</u></b>	<b><u>Age</u></b>	<b><u>Position</u></b>
Lawrence P. English	63	Chairman of the Board and Chief Executive Officer
F. Scott Gross	57	Director
William K. Jurika	63	Director
Robert L. Pevenstein	57	Director
Michael J. King	64	Director
Cornelius T. Ryan	72	Director
Joseph L. Feshbach	49	Director
Robert W. Miller	62	Director
Michael S. Wilstead	46	President and Chief Operating Officer
Charles J. Stahl	57	Executive Vice President and Chief Financial Officer
Dean A. Soules	43	Executive Vice President and Chief Technology Officer
John C. Wright	55	Executive Vice President and Corporate Secretary
Frank J. Pecaitis	40	Senior Vice President, Client Development

*Mr. English* has been our Chairman of the Board since December 2000, and our Chief Executive Officer since June 2000. He was the Founder and Chief Executive Officer of Lawrence P. English, Inc., a private turn-around management firm, from January 1999 to June 2000. He has served as Director of Curative Healthcare Corporation since May 2000. He was the Chairman of the Board and Chief Executive Officer of Aesthetics Medical Management, Inc., a physician practice management company for plastic surgeons, from July 1997 to January 1999. He was the President of CIGNA Healthcare, one of the largest HMO providers in the United States, from March 1992 until August 1996. Until he resigned in September 2002, he served as Director of Clarent Hospital Corporation, formerly Paracelsus Healthcare Corporation, since May 1999 and as the Non-Executive Chairman of the Board since February 2000. Mr. English possesses a Bachelor of Arts degree from Rutgers University and a Masters of Business Administration from George Washington University, and is a graduate of Harvard Business School's Advanced Management Program.

*Mr. Gross* has been a Director since 2000, and a private investor since January 2002. He was the founder, President, and Chief Executive Officer of Primus Management, Inc., a health services management company (formerly known as Alpha Hospital Management Inc.) from 1989 to December 2001. He has been a Director of Fountain View, Inc., a nursing home chain, since 1999. Mr. Gross earned a Bachelor of Science degree in Biology from California State University at Northridge, and a Masters degree in Public Administration (Healthcare Management Option) from the University of Southern California.

*Mr. Jurika* has been a Director since July 2003. He has been a private investor since 2001. He co-founded JMK Investment Partners LLC, an investment company, and founded Jurika & Voyles, Inc., an investment management firm, in 1976, where he served as the Chief Executive Officer and then Chairman of the Board until 2001. He received a Bachelor of Science degree in Marketing from the University of Denver.

*Mr. Pevenstein* has been a Director since September 2003. He has been a Director of the University of Maryland Medical System, which includes six community hospitals, and a Regent of the University System of Maryland, which includes thirteen higher education institutions, since 2003. In 1998 he became the President of Princeville Partners LLC, a mergers and acquisitions and business consulting group. He was the Senior Vice President and Chief Financial Officer of UNC Incorporated, an aviation services and manufacturing company, from 1987 to 1997. Mr. Pevenstein is a Certified Public Accountant, with a Masters of Business Administration from Pepperdine University and Bachelor of

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Science degrees in Business Administration and Accounting from the University of Maryland.

*Mr. King* has been a Director since 1999. He has served as the Chairman and Chief Executive Officer of HealthScribe, Inc., a computerized medical transcription company, since May 1999. He was the Chairman of the Board of Directors and Chief Executive Officer of The Compucare Company, a healthcare information systems

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company acquired by QuadraMed in March 1999, from 1996 to 1999. Since 1999 he has served as the Director of Osprey Systems, an e-business consulting services firm. He has a degree in Mechanical Engineering from the University of Sheffield and a Masters of Business Administration equivalent in Management Studies from the University of Hatfield.

*Mr. Ryan* has been a Director since 2000, and previously served as a Director from 1995 to 1999. He is the Founding General Partner of Oxford Partners, LP, a Delaware limited partnership, since 1981 and of Oxford Bioscience Partners LP, since 1991. Oxford is a venture capital firm specializing in life sciences currently managing over \$850 million in committed capital. He possesses a Bachelor of Commerce from the University of Ottawa and a Master of Business Administration from the Wharton School of Business at the University of Pennsylvania.

*Mr. Feshbach* has been a Director since 2001. He has served as Chairman of the Board and Chief Executive Officer of Curative Health Services, Inc., a disease management company focused on chronic wound care and specialty pharmacy, since October 2000. He joined Curative's Board in February 2000. He has been a private investor in QuadraMed since 1998. From 1985 to 1998, he was the General Partner of Feshbach Brothers, a money management and stock brokerage firm.

*Mr. Miller* has been a Director since May 2003. Currently, he is an Adjunct Professor of Law, Emory University School of Law. He served as Director of Magellan Health Services, Inc from 1998-2004 and was a non-executive Chairman from 1998-2001. He was a Partner in the law firm of King & Spalding from 1985 until his retirement in 1997. He has a Bachelor of Arts degree in History from the University of Georgia, and earned an LL.B. from Yale Law School.

*Mr. Wilstead* has been President of QuadraMed since March 2003 and Chief Operating Officer since December 2001. He previously served as President of the Health Information Management Service and Software Divisions and the former EZ-CAP Division. He joined QuadraMed in July 1998 as Vice President of Sales. He was the Group President at STERIS Corporation, an infection control and surgical support products company, from 1995 to 1998. He held various positions at AMSCO International, a medical equipment company that was purchased by STERIS in 1995, from 1990 to 1995. Mr. Wilstead earned a Bachelor of Science degree in Business Administration from the University of Phoenix.

*Mr. Stahl* has been Chief Financial Officer and Executive Vice President since April 2003. He is a Certified Public Account, and was a Partner with Deloitte and Touche LLP from 1978 to 2001, with various roles and responsibilities including Managing Partner of the Valuation and Realty Consulting Group, National Director of Financial Consulting, and audit partner in the technology industry. He is currently a member of Financial Executives International, a professional association of senior-level corporate financial executives, which is dedicated to advancing ethical, responsible financial management, and a member of the American Institute of Certified Public Accountants.. Mr. Stahl earned his Bachelor of Science degree in Business and Accounting from Indiana University.

*Mr. Souleles* became Chief Technology Officer in August 2000. From September 2002 until November 2003, he served as the Executive Vice President of the Enterprise Software Division. He joined QuadraMed in February 2000 as Vice President of Development. He served as the Chief Technology Officer and Director of Research and Development for Chase Systems, Inc., a software and technical services firm serving the mortgage credit reporting industry, from March 1997 to February 2000. He was Chief Technology Officer of SureNet Corporation, an Internet service provider, from October 1995 to December 1996. He was also a consultant to NASA's Jet Propulsion Laboratory as principal engineer and system architect on various space, civil, and defense programs from March 1986 to October 1995. A recipient of the Department of Transportation, Federal Aviation Administration Weather and Flight Service Systems Director's Award, Mr. Souleles was educated in Computer Science at California State University, Northridge.

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*Mr. Wright* has been the Executive Vice President and Corporate Secretary since September 2003. He is a Certified Public Accountant, and acted as an advisor to our Audit Committee from January 2003 to July 2003. He served as the Chief Financial Officer of Teligent, Inc. from September 2000 to March 2001. Prior thereto, he was a partner with Ernst & Young from 1982. Mr. Wright earned his Bachelor of Science Degree in Accounting from the University of North Carolina at Chapel Hill, and is a veteran of the U.S. Army Reserve.



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*Mr. Pecaitis* is the Senior Vice President of Client Development. He joined QuadraMed as a result of the company's acquisition of Compucare in 1999 where he served as a sales executive and expert in Hospital Information Systems. Before assuming his present position in October 2003, Mr. Pecaitis served as Senior Vice President of Sales and Client Management for our Enterprise Division, Chief Marketing Officer, West Area Vice President of Sales, and as Senior Vice President of Sales and Marketing for the Enterprise Division. Previously, he worked as a Vice President of Western Field Sales after several years as a top sales performer with Compucare. In 1985, Mr. Pecaitis began his career as an Administrative Resident at the Hospital of the University of Pennsylvania and later held several client services and sales positions with Professional Healthcare Systems prior to joining Compucare in 1992. Mr. Pecaitis graduated from The Pennsylvania State University with a Bachelor of Science degree in Health Planning and Administration.

**Table of Contents****Committees of the Board**

The table below shows the current membership of the standing Board committees:

<u>Name</u>	<u>Audit</u>	<u>Compensation</u>	<u>Nominating and Governance</u>	<u>Strategic Planning</u>
Lawrence P. English				
F. Scott Gross	X	X	X*	X
William K. Jurika		X	X	
Robert L. Pevenstein	X*			
Michael J. King				X
Cornelius T. Ryan		X*	X	
Joseph L. Feshbach				X*
Robert W. Miller	X		X	

\* Chairman

The principal responsibilities and functions of the standing Board committees are as follows:

***Audit Committee***

Acts under a written charter that was amended, restated, adopted, and approved by our Board of Directors on September 24, 2003.

Reviews the integrity and accuracy of our auditing, accounting, and reporting processes and consideration and approval of appropriate changes.

Reviews our financial reports and other financial information provided to the public and filed with the SEC.

Reviews our internal controls regarding finance, accounting, legal compliance, and ethics.

Recommends our independent accountants and annually reviews their performance.

Performs other functions that the Board may assign to the Committee regarding QuadraMed's accounting and financial reporting processes, and the audits of the financial statements of QuadraMed.

Note: All members of the Audit Committee are independent as required by the Sarbanes-Oxley Act of 2002 and Nasdaq listing requirements.

***Compensation Committee***

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Acts under a written charter that was adopted and approved by our Board of Directors on December 23, 2003.

Oversees the administration of our employee stock incentive plans, employee stock purchase plan, and disinterested administration of employee benefit plans in which executive officers may participate.

Determines senior management compensation and collaborates with senior management on benefit and compensation programs for our employees.

### *Nominating and Governance Committee*

Acts under a written charter that was adopted and approved by our Board of Directors on December 11, 2003.

Recommends candidates for election to the Board.

Reviews candidates for election to the Board submitted by stockholders before the deadline for stockholder proposals.

Develops and makes recommendations to the Board regarding the size and composition of the Board and its committees.

Develops and makes recommendations to the Board with respect to corporate governance principles.

Responsible for overseeing corporate governance.

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### ***Strategic Planning Committee***

Provides supervision and guidance on our growth strategies, including mergers, acquisitions, divestitures, and organic growth initiatives.

The Board of Directors held 13 meetings in 2003, either in person or by telephone. Each director attended at least 75% of all Board and applicable committee meetings during 2003. The standing Board Committees and the number of meetings they held in 2003 were as follows:

Audit Committee 13

Compensation Committee 10

Nominating and Governance Committee 2

Strategic Planning Committee 1

### **Compensation Committee Interlocks And Insider Participation**

Directors Ryan, Jurika and Gross were members of the Compensation Committee during 2003. None of the members of the Compensation Committee has ever been an officer or employee of QuadraMed Corporation or any of its subsidiaries.

In 2003, none of QuadraMed's executive officers:

Served as a member of the compensation committee (or committee performing a similar function, or in the absence of such committee, the Board of Directors) of another entity, one of whose executive officers served on QuadraMed's Compensation Committee;

Served as a director of another entity, one of whose executive officers served on QuadraMed's Compensation Committee; or

Served as a member of the compensation committee (or committee performing a similar function, or in the absence of such committee, the Board of Directors) of another entity, one of whose executive officers served on QuadraMed's Board of Directors.

### **Director Compensation**

QuadraMed executive officers do not receive additional compensation for service as a director. Compensation for non-employee directors in 2003 is shown in the following table:

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<u>COMPENSATION</u>	<u>2003</u>
Annual Retainer Fee <sup>(1)</sup>	\$15,000
Option Grant <sup>(2)</sup>	34,500 shares to ongoing directors <sup>(3)</sup>
Board Meeting Attendance	\$1,500 in person or by telephone
Committee Meeting Attendance	\$1,500 in person or by telephone
	\$2,000 in person or by telephone for Audit Committee Meeting <sup>(4)</sup>
Expenses	Reasonable
Option Grant Upon First Election	46,000 shares to new directors <sup>(5)</sup>
Option Grant Upon Election as Committee Chairman	None

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- (1) Non-employee directors may elect to participate in the Director Fee Option Grant Program under QuadraMed's 1996 Stock Incentive Plan. This program allows non-employee directors to apply all or a percentage of their annual retainer fee otherwise payable in cash to a special option grant. The terms of the special option grant are:

Exercise Price:	One-third (1/3) of the fair market value of QuadraMed common stock, as determined by the closing price reported on a nationally recognized stock exchange or market, on the first trading day of January (FMV).
No. of Option Shares:	Equal to the amount of annual retainer fee elected divided by two-thirds (2/3) of the FMV, rounded down to the next whole share.
Vesting:	Fifty percent (50%) on completion of six (6) months of Board service Remaining fifty-percent (50%) in six (6) equal monthly installments thereafter Immediate vesting upon director's death or disability Immediate vesting upon the occurrence of a Corporate Transaction or Change of Control (each as defined in QuadraMed's 1996 Stock Incentive Plan) while the director is a Board member.
Term:	Ten (10) years.

- (2) The terms of the stock option are:

Exercise Price:	Equal to the fair market value of QuadraMed common stock, as determined by the closing price reported on a nationally recognized stock exchange or market, on the date of election.
Vesting:	Death or disability.  Change of Control.
Term:	Ten (10) years.

- (3) These 34,500 shares are the annual option grants for fiscal years 2003, 2004, and 2005. These shares vest 33% on grant, 33% on the one-year anniversary, and 33% on the two-year anniversary of the date of grant.
- (4) Mr. Gross received a total of \$105,000 for services on the company's Audit Committee from March 2003 through September 2003 and a total of \$30,000 for services on a Special Committee of the Board evaluating strategic opportunities for the company for March and April 2003.
- (5) These 46,000 shares are the annual option grants for new directors for fiscal years 2003, 2004 and 2005. These shares vest 50% on the one-year anniversary and 50% on the two-year anniversary of the date of grant.

## **Executive Compensation**

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The following tables show, for the last three completed fiscal years, compensation information for QuadraMed's Chief Executive Officer and the next four most highly compensated executives. Other tables that follow provide more detail about the specific type of compensation. Each of these officers is referred to as a named executive officer.

### Summary Compensation Table:

Name and Principal Position	Fiscal Year	Annual Compensation			Long Term Compensation		
		Salary (\$) <sup>(1)</sup>	Bonus (\$) <sup>(2)</sup>	Other Compensation (\$) <sup>(3)</sup>	Restricted Stock Awards (\$) <sup>(4)</sup>	Securities Underlying Options (#)	All Other Compensation (\$) <sup>(5)</sup>
<b>Lawrence P. English</b> <sup>(6)</sup>	2003	410,000	123,000	308,000	1,687,500	925,000	4,000
Chairman of the Board and	2002	407,500	200,000			110,000	4,000
Chief Executive Officer	2001	400,000			360,000		46,886 <sup>(7)</sup>
<b>Michael S. Wilstead</b> <sup>(8)</sup>	2003	296,250	71,250	225,000	843,750	492,500	4,000
President and Chief	2002	285,000	113,125		62,090	40,000	4,000
Operating Officer	2001	237,083	111,625		367,000	100,000	3,400
<b>Charles J. Stahl</b> <sup>(9)</sup>	2003	202,971		115,388 <sup>(10)</sup>	86,250	300,000	
Chief Financial Officer	2002	N/A	N/A	N/A	N/A	N/A	N/A
	2001	N/A	N/A	N/A	N/A	N/A	N/A
<b>Dean A. Souleles</b> <sup>(11)</sup>	2003	224,257	55,000	154,899 <sup>(12)</sup>		142,900	4,000
Executive Vice President and	2002	202,500	87,500	111,045 <sup>(13)</sup>		55,000	3,400
Chief Technology Officer	2001	180,000	63,250		180,000		1,650
<b>Frank J. Pecaitis</b> <sup>(13)</sup>	2003	184,050	224,273	102,700 <sup>(14)</sup>		417,900	
Senior Vice President	2002	180,000		662,889 <sup>(15)</sup>		17,900	
	2001	180,000	68,828				

- (1) If approved by the Compensation Committee, selected executive officers may elect to apply from \$10,000 to \$50,000 of their annual base salary to a special option grant under the Salary Investment Option Grant Program of the 1996 Stock Incentive Plan (1996 Plan). There were no executive officers selected for the program by the Compensation Committee in 2003.
- (2) Bonus payments in each year were made pursuant to the preceding year's Incentive Plan.
- (3) Unless otherwise noted, the amounts shown for 2003 are payments made under Key Employee Retention agreements with these officers. See Management Key Employee Retention Agreements.

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- (4) The amounts shown represent the dollar value of QuadraMed common stock on the date the restricted stock was granted. All grants of restricted stock ( Restricted Shares ) were made under the 1996 Stock Incentive Plan. The Restricted Shares cliff vest on the third anniversary of the grant, except for the 2003 grants to Mr. English and Mr. Wilstead, which cliff vest on April 15, 2007. The Restricted Shares are subject to forfeiture if employment terminates before becoming fully vested and non-forfeitable.

The following is a summary of all outstanding grants of restricted shares to the named executive officers:

On June 8, 2001, Mr. English received a grant of 150,000 Restricted Shares; and Messrs. Wilstead and Souleles each received grants of 75,000 Restricted Shares.

On December 13, 2001, Mr. Wilstead received a grant of 25,000 Restricted Shares.

On February 19, 2002, Mr. Wilstead received a grant of 7,000 Restricted Shares.

On April 15, 2003, Mr. Stahl received a grant of 75,000 Restricted Shares.

On December 30, 2003, Mr. English received a grant of 675,000 Restricted Shares, and Mr. Wilstead received a grant of 337,500 Restricted Shares.

As of December 31, 2003, the aggregate number of all Restricted Shares held by each named executive officer and the dollar values of the Restricted Shares (equal to the product of the number of Restricted Shares multiplied by \$2.65, the closing price reported by the Over-the-Counter Bulletin Board on December 31, 2003) were as follows: Mr. English, 825,000 shares (\$2,186,250); Mr. Wilstead, 444,500 shares (\$1,177,925); Mr. Stahl, 75,000 shares (\$198,750); and Mr. Souleles 75,000 shares (\$198,750).

- (5) Unless otherwise noted, amount shown is QuadraMed's annual contribution on behalf of the named executive officer to the QuadraMed 401(k) Plan.
- (6) Mr. English was appointed QuadraMed's Chief Executive Officer effective June 12, 2000 and elected Chairman of the Board effective December 31, 2000.
- (7) Includes QuadraMed's annual contribution of \$6,410 on behalf of Mr. English to QuadraMed's 401(k) Plan, \$35,801 attributable to the net increase in Mr. English's state income tax solely related to pre-employment gross adjusted income, and payment of professional fees of \$4,675 associated with preparation of Mr. English's personal tax returns. Although provided in his employment agreement, Mr. English did not lease an automobile.
- (8) Mr. Wilstead joined QuadraMed in July 1998 and was appointed Chief Operating Officer in December 2001 and President in March 2003.
- (9) On April 15, 2003, QuadraMed appointed Mr. Stahl as Chief Financial Officer and Executive Vice President. From December 23, 2002 to April 15, 2003, Mr. Stahl served as a consultant and, for his services, he received \$192,000 in compensation. This compensation is not reflected in this table.
- (10) Mr. Stahl is not a party to a Key Employee Retention agreement and did not receive a payment from such an agreement. Mr. Stahl received a signing bonus of \$100,000 upon the commencement of his employment with QuadraMed. Mr. Stahl also receives an allowance for an automobile and medical insurance.
- (11) Mr. Souleles joined QuadraMed in February 2000 and was appointed Chief Technology Officer in November 2003. From September 2002 to November 2003, he was Executive Vice President of the Enterprise software division. From August 2000 to September 2002, he was Chief Technology Officer.
- (12) This represents \$71,104 in relocation expenses and a \$83,795 payment under his Key Employee Retention agreement.
- (13) Represents amount of gain from exercise of options by Mr. Souleles.
- (14) Mr. Pecaitis joined QuadraMed in February 1999 and was appointed Senior Vice President in February 2001.
- (15) In addition to a \$92,700 payment under his Key Employee Retention agreement, Mr. Pecaitis received a \$10,000 merit bonus.
- (16) This represents commissions in the amount of \$263,027 and an amount of gain on stock options of \$399,861.

**Option Grants In Last Fiscal Year**

This table shows stock options granted to the named executive officers during the 2003 fiscal year. All stock options listed below were granted to executive officers under the 1996 Stock Incentive Plan.

Name	Individual Grants <sup>(1)</sup>	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation For Option Term (\$) <sup>(4)</sup>	
		5%	10%



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	Number of Securities Underlying Options Granted <sup>(2)</sup>	% Of Total Options Granted to Employees In  Fiscal 2003	Exercise of Base Price  (\$/Sh) <sup>(3)</sup>	Expiration Date		
Lawrence P. English	825,000 <sub>(5)</sub>	14.94%	\$ 2.50	12/30/13	\$ 1,297,095	\$ 3,287,094
	100,000	1.81%	\$ 0.98	03/14/13	72,323	183,280
Michael S. Wilstead	50,000	0.91%	\$ 1.45	01/14/13	45,595	115,546
	30,000	0.54%	\$ 1.14	02/20/13	21,508	54,506
	412,500 <sub>(5)</sub>	7.47%	\$ 2.50	12/30/13	648,548	1,643,547
Charles J. Stahl	300,000	5.43%	\$ 1.15	04/15/13	216,969	549,841
Dean A. Souleles	25,000	0.45%	\$ 1.45	01/14/13	22,797	57,773
	17,900	0.32%	\$ 1.14	02/20/13	12,833	32,522
	100,000	1.81%	\$ 1.15	04/15/13	72,323	183,280
Frank J. Pecaitis	25,000	0.45%	\$ 1.45	01/14/13	22,797	57,773
	17,900	0.32%	\$ 1.14	02/20/13	12,833	32,522
	375,000	6.79%	\$ 1.15	04/15/13	271,211	687,301

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- (1) This table does not include the 1,500,000 and 750,000 options of Mr. English and Mr. Wilstead, respectively, granted by the Board of Directors and later surrendered to the company by Mr. English and Mr. Wilstead due to an insufficient number of shares being available under the 1996 Stock Incentive Plan. Mr. English and Mr. Wilstead received options later in 2003 when the number of shares available in the 1996 Stock Incentive Plan had been increased.
- (2) The option has a maximum term of ten years, subject to earlier cancellation upon termination of the named executive officer's service with QuadraMed. In the event of an acquisition of QuadraMed by merger or asset sale, the vesting will accelerate and the option shares will become fully exercisable unless assumed by the successor corporation. If terminated other than for cause, a recipient's option shares shall vest. However, if the recipient ceases to remain employed with us for any reason (other than death, permanent disability, misconduct, or termination for cause) while his option is outstanding, then he shall have a period of twenty-four (24) months (commencing with the date of such termination of employment) during which to exercise this option, but in no event shall this option be exercisable at any time after the expiration date.
- (3) The exercise price is equal to the fair market value of QuadraMed common stock, as determined by the closing price reported on The Nasdaq Stock Market, the Pink Sheets, or the Over-the-Counter Bulletin Board on the date of grant.
- (4) There can be no assurance provided to the named executive officer or any other holder of QuadraMed's securities that the actual stock price appreciation over the 10-year option term will be at the assumed 5% and 10% compounded annual rates or at any other defined level. Unless the market price of QuadraMed common stock appreciates over the option term, no value will be realized from the option granted to the named executive officer.
- (5) Twenty-five percent (25%) of the option shares vest on April 15, 2004, and the balance vests in equal monthly installments over the next three years of service.

**Aggregated Option Exercises In 2003 and Year-End Option Values**

This table shows the value of unexercised stock options held by each named executive officer as of December 31, 2003. None of the named executive officers exercised any options in 2003.

Name	Number of Securities Underlying Unexercised Options at Fiscal Year End (#)		Value of Unexercised In the Money Options At Fiscal Year End (\$) <sup>(1)</sup>	
	Exercisable	Unexercisable	Exercisable	Unexercisable
Lawrence P. English	925,417	1,109,583	\$ 131,250	\$ 309,500
Michael S. Wilstead	308,749	585,751	72,325	182,300
Charles J. Stahl	100,000	275,000	150,000	412,500
Dean A. Souleles	80,105	192,795	33,741	115,868
Frank J. Pecaitis	102,634	453,117	69,383	650,212

- (1) Calculated by subtracting the option exercise price from the closing price of QuadraMed common stock on December 31, 2003, as reported on Over-the-Counter Bulletin Board, and multiplying the difference by the applicable number of exercisable or unexercisable option shares.

**Employment Agreements and Termination and Change of Control Provisions**

QuadraMed has employment agreements with its Chairman and CEO, Lawrence P. English, and the other named executive officers, Michael S. Wilstead, Dean A. Souleles, and Frank J. Pecaitis. All of these agreements are at will and have similar terms and conditions as set forth in the following table. The employment agreement with Charles J. Stahl does not have terms similar to the following table since his agreement

contemplates his employment terminating on or about March 31, 2004.

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Term	Two years, automatically renewed unless three months prior notice for Mr. English and Mr. Winstead. One year, automatically renewed for terms of one year unless one month's prior notice for the other named executive officers.
CEO English's Compensation	Annual base rate of salary determined by the Compensation Committee. Discretionary bonus target of 60% of annual base rate of salary determined by the Compensation Committee. Enhanced cash bonus of 50% of target annual bonus to be paid on December 31, 2003 if QuadraMed exceeds the cash flow goals determined by the Board for 2001, 2002, and 2003 or the three year aggregate total, only if the executive remains employed by QuadraMed. Additional discretionary bonuses determined by the Compensation Committee based on achievement of specified goals established by the Board.
Other Executive Officer Compensation	Annual base rate of salary approved by the Compensation Committee.  Discretionary bonus target of 50% of annual base rate of salary determined by the Compensation Committee. Enhanced cash bonus of 50% of target annual bonus to be paid on December 31, 2003, if QuadraMed exceeds the cash flow goals determined by the Board for 2001, 2002, and 2003 or the three year aggregate total, only if the executive remains employed by QuadraMed. Additional discretionary bonuses determined by the Compensation Committee based on achievement of specified goals established by the Board.
Benefits	Participation in group life, medical, and dental insurance. Accidental death and dismemberment plan. Other employee benefits, including 401(k) plan, profit sharing, stock purchase and option plans.
Vacation	Four weeks.
Options	Issued pursuant to QuadraMed's 1996 Stock Incentive Plan.
Expenses	Customary, ordinary, and necessary business expenses. Relocation. Preparation of personal tax returns for Mr. English only. Automobile lease for Mr. English only.
Termination for Cause or Nonperformance	Acts of fraud, embezzlement, or misappropriation of proprietary information, trade secrets, or confidential information. Failure to adhere to QuadraMed policies. Failure to devote full working time and effort to performance of duties.(1)
Change of Control	Merger or acquisition in which QuadraMed is not the surviving entity. Stockholder approved sale, transfer, or disposition of all or substantially all of QuadraMed's assets. Transfer of substantially all of QuadraMed's assets pursuant to a partnership or joint venture in which QuadraMed's interest is less than 50%. Reverse merger in which QuadraMed is the surviving entity but in which more than 50% of QuadraMed's shares are transferred. Change in ownership such that one person or entity becomes beneficial owner of more than 50% of QuadraMed's shares. Majority of the Board is replaced in a 12-month period by Directors not endorsed by the majority of the existing Board.

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Involuntary Termination	Termination not for cause. Involuntary discharge or dismissal. Failure to renew employment agreement. Material reduction in responsibilities.
CEO English's Severance on Involuntary Termination Other Than in Connection with a Change of Control	Two times then current annual base salary. Acceleration of unvested options so that at least 250,000 shares will be vested and exercisable as of the date of termination. Gross up payment if any severance payment is subject to excise tax under Section 4999 of Internal Revenue Code. Severance conditioned on complete and unconditional release.
CEO English's Severance on Change of Control or Involuntary Termination Within 24 Months of a Change of Control	Two times then current annual base salary and annual target bonus. Two years of life, health, and disability plan coverage. Gross up payment if any severance payment is subject to excise tax under Section 4999 of Internal Revenue Code. To extent not assumed by the acquiring company, acceleration of all unvested options, which terminate pursuant to the terms of the grant. Acceleration of unvested options and restricted stock. In lieu of other severance, Mr. English may voluntarily terminate his employment, contingent on continued employment for a minimum of 60 days, whereupon one-half of unvested options shall accelerate and, together with all vested options, remain exercisable for the full term of the option.
Other Executive Officer Severance On Involuntary Termination Other Than in Connection With a Change of Control	One times then current annual base salary. One year of life, health, and disability plan coverage. Acceleration of unvested options, restricted stock, and phantom stock. Gross up payment if any severance payment is subject to excise tax under Section 4999 of Internal Revenue Code. Severance conditioned on complete and unconditional release.
Other Executive Officer Severance On Change of Control or Involuntary Termination within 24 months of a Change of Control	One times then current annual base salary and annual target bonus. Two years of life, health, and disability plan coverage. To extent not assumed by the acquiring company, acceleration of all unvested options. Gross up payment if any severance payment is subject to excise tax under Section 4999 of Internal Revenue Code.

- (1) Mr. English, pursuant to his agreement, is permitted to serve as a member of up to three outside boards of directors.

## **Key Employee Retention Agreements**

In March 2003, at a time in which the company was preparing the restatement of its financial statements and anticipated being delisted from the Nasdaq Stock Market, QuadraMed's Board of Directors approved its Special Committee's recommendation that the company enter into retention agreements with a total of fifteen key employees, including its Chairman and CEO, Lawrence P. English, and three other named executive officers, Michael S. Wilstead, Dean A. Souleles, and Frank J. Pecaitis. The purpose of such agreements was to provide additional incentives to these employees to continue their employment with the company through the successful achievement of one of certain strategic objectives. Each of the key employee retention agreements requires that in exchange for the employee's continued employment with the company (unless terminated earlier by the company for cause),

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commitment to use his or her best efforts to achieve the selected strategic objective, and agreement not to disclose any of the company's confidential or proprietary information, the company will pay the applicable employee an amount as follows: (i) 25% of such amount on the date the company's common stock is delisted from the Nasdaq Stock Market; (ii) 25% of such amount upon the earlier of three months from the delisting or the announcement of a filing of a plan of reorganization in bankruptcy; and (iii) 50% of such amount upon the earliest of (A) the listing of our common stock on a U.S. national securities exchange or upon the relisting of our common stock on the Nasdaq National Market or Nasdaq SmallCap Market, (B) the closing date of the sale of the company and/or its assets, (C) the closing date of the sale of the division of the company in which the employee is employed, or (D) the emergence of the company and/or its assets from a plan of reorganization. The total retention benefit payable to the company's named executive officers is as follows: Lawrence P. English, \$615,000; Michael S. Wilstead, \$450,000; Dean A. Souleles, \$167,590; and Frank J. Pecaitis, \$185,400, of which 50% has been paid to each key employee in accordance with the terms of their agreement.

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**SECURITY OWNERSHIP OF  
CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The following table and the accompanying notes set forth certain information, as of January 19, 2004, concerning the beneficial ownership of our common stock by: (1) each person who is known by us to beneficially own more than five percent of our common stock, (2) each director of our company, (3) each named executive officer, and (4) all directors and named executive officers as a group. The beneficial ownership percentages have been calculated based on 27,727,924 shares of common stock outstanding on January 19, 2004.

Under the SEC's rules, a person is deemed to be the beneficial owner of a security if such person has or shares the power to vote or direct the voting of such security or the power to dispose or direct the disposition of such security. A person is also deemed to be a beneficial owner of a security if that person has the right to acquire beneficial ownership within 60 days. Accordingly, more than one person may be deemed to be a beneficial owner of the same security. Unless otherwise indicated by footnote, the named entities or individuals have sole voting and investment power with respect to the shares of common stock which they beneficially own. All persons listed have an address in care of QuadraMed's principal executive offices, except as otherwise noted. All information with respect to beneficial ownership has been furnished to us by our respective stockholders, unless otherwise noted.

<b>Name of Beneficial Owner</b>	<b>Number of Shares Owned</b>	<b>Right to Acquire</b>	<b>Total</b>	<b>Percentage</b>
David M. Knott <sup>(1)(2)</sup>	1,511,800		1,511,800	5.5%
Zazove Associates, LLC <sup>(3)(4)</sup>	1,219,088	2,069,718 <sup>(5)</sup>	3,288,806	11.0%
Lawrence P. English <sup>(6)(7)</sup>	100,000	1,019,792	1,119,792	3.9%
F. Scott Gross <sup>(6)</sup>		74,223	74,223	*
William K. Jurika <sup>(6)</sup>	3,806,040	6,198	3,812,238	13.7%
Robert L. Pevenstein <sup>(6)</sup>	10,000		10,000	*
Michael J. King <sup>(6)</sup>		206,597	206,597	*
Cornelius T. Ryan <sup>(6)</sup>	5,000	78,014	83,014	*
Joseph L. Feshbach <sup>(6)</sup>	20,000	60,845	80,845	*
Robert W. Miller <sup>(6)</sup>				*
Michael S. Wilstead <sup>(7)</sup>	2,500	343,854	346,354	1.2%
Charles J. Stahl <sup>(7)</sup>		137,500	137,500	*
Dean A. Soules <sup>(7)</sup>		101,515	101,515	*
Frank Pecaitis <sup>(7)</sup>	7,027	123,498	130,525	*
All directors and executive officers as a group (13 people)	3,950,567	2,152,036	6,102,603	20.4%

\* Less than 1% of our outstanding shares of common stock.

(1) Address: 485 Underhill Boulevard, Suite 205, Syosset, New York 11791

(2) This information was obtained from the Schedule 13G filed with the SEC by Mr. Knott on December 5, 2003.

(3) Address: 940 Southwood Boulevard, Suite 200, Incline Village, NV 89451

(4) This information was obtained from the Schedule 13G filed with the SEC by Zazove Associates on January 9, 2004.

(5) Represents the number shares issuable upon the exercise of warrants to purchase common stock owned by Zazove Associates, LLC, as reflected in its Schedule 13G filed on January 9, 2004.

(6) Director

(7) Executive Officer

**CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Lawrence P. English, QuadraMed's Chairman and Chief Executive Officer, is a director of Curative Health Services, Inc. and serves as Chairman of its Executive Committee and as a member of its Audit Committee. Joseph L. Feshbach, a QuadraMed director, is the Chairman of the Board of Curative Health Services, Inc.



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**OTHER INDEBTEDNESS**

On May 1, 1998, we issued \$115,000,000 aggregate principal amount of our 5.25% Convertible Subordinated Debentures Agreements due 2005 and 3,458,647 shares of our common stock, par value \$.01 per share, which were initially issuable upon conversion of the notes, plus such additional indeterminate number of shares of common stock as became issuable upon conversion of the notes as a result of adjustments to the conversion price thereunder. The 2005 notes were convertible into our common stock at any time at or before maturity, unless previously redeemed, at a conversion price of \$33.25 per share, subject to adjustment in certain events. The 2005 notes are our unsecured obligations and are subordinate to all of our present and future senior indebtedness. The indenture did not restrict the incurrence of any other indebtedness or liabilities by the company or our subsidiaries.

The 2005 notes did not provide for a sinking fund. After May 4, 2001, the 2005 notes were redeemable at our option, in whole or in part, at redemption prices varying from 103% to 100%, together with accrued interest. Upon a repurchase event, each holder of the 2005 notes had the right, at the holder's option, to require us to repurchase such holder's 2005 notes at a purchase price equal to 100% of the principal amount thereof, plus accrued interest.

The delisting of our common stock from a U.S. national securities exchange constituted a repurchase event under the 2005 notes indenture. On April 17, 2003, we issued \$71.0 million of our Senior Secured Notes due 2008. We used proceeds from the issuance of the 2008 notes to repurchase \$61.8 million (plus \$1.5 million in accrued interest) of the 2005 notes required to be repurchased. Accordingly, the net proceeds as a result of the issuance of the 2008 notes, less the costs (including fees) associated with the repurchase of the 2005 notes, were \$8.5 million, with \$11.9 million of the 2005 notes remaining outstanding. The repurchase right on the 2005 notes remaining outstanding expired on April 17, 2003.

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### **DESCRIPTION OF SECURITIES**

As used in this description of securities, the words “we,” “us,” “our” or “QuadraMed” refer only to QuadraMed Corporation and do not include any current or future subsidiary of QuadraMed Corporation.

#### **Description of Capital Stock**

The following summary is a description of the material terms of our capital stock. This summary is not intended to be a complete description of our capital stock, and it is subject in all respects to the applicable provisions of Delaware law and of our constituent documents and of the constituent documents of our subsidiaries. For more information, please review our amended and restated certificate of incorporation and bylaws.

#### **General**

Our authorized capital stock consists of 150,000,000 shares of common stock, par value \$.01 per share, and 5,000,000 shares of preferred stock, par value \$.01 per share. As of January 19, 2004, 27,727,924 shares of common stock and no shares of preferred stock were outstanding.

#### **Common Stock**

Holders of common stock are entitled to one vote for each share held of record on all matters submitted to a vote of stockholders. Subject to preferences that may be applicable to any outstanding preferred stock, the holders of common stock are entitled to receive ratably the dividends, if any, that may be declared from time to time by the Board of Directors out of funds legally available for such dividends. We have never declared a dividend and do not anticipate doing so in the foreseeable future. In the event of a liquidation, dissolution or winding up of QuadraMed, subject to the prior rights of the preferred stock, the holders of common stock are entitled to share ratably in any remaining assets after payment of liabilities. The common stock has no preemptive or other subscription rights and is not subject to any future calls or assessments. There are no conversion rights or redemption or sinking fund provisions applicable to shares of common stock. All of the outstanding shares of common stock are validly issued, fully paid and nonassessable.

#### **Preferred Stock**

The Board may issue preferred stock from time to time as shares of one or more classes or series. Subject to the provisions of our amended and restated certificate of incorporation and limitations prescribed by law, the Board is expressly authorized to issue the shares, fix the number of shares, change the number of shares constituting any series, and provide for or change the voting powers, designations, preferences and relative, participating, optional or other special rights, qualifications, limitations or restrictions thereof, including dividend rights (including whether dividends are cumulative), dividend rates, terms of redemption (including sinking fund provisions), redemption prices, conversion rights, and liquidation preferences of the shares constituting any class or series of the preferred stock, in each case without any further action or vote by the stockholders.

One of the effects of undesignated preferred stock may be to enable the Board to render more difficult or to discourage an attempt to obtain control of QuadraMed by means of a tender offer, proxy contest, merger or otherwise, and thereby to protect the continuity of our management. The issuance of shares of the preferred stock pursuant to the Board's authority described above may adversely affect the rights of the holders of common stock. For example, preferred stock issued by us may rank prior to common stock as to dividend rights, liquidation preference or both, may have full or limited voting rights and may be convertible into shares of common stock. Accordingly, the issuance of shares of preferred stock may discourage bids for common stock or may otherwise adversely affect the market price of common stock.

## **Warrants**

In connection with the issuance of the 2008 notes, on April 17, 2003, we issued warrants to purchase 11,586,438 shares of our common stock. For more information on these warrants, please refer to the section entitled "Description of Securities Description of Notes Warrants" in this prospectus.

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### **Statutory Business Combination Provision**

We are subject to the provisions of Section 203 of the Delaware General Corporation Law. Section 203 provides, with certain exceptions, that a Delaware corporation may not engage in any of a broad range of business combinations with a person or an affiliate or associate of such person, who is an interested stockholder for a period of three years from the date that such person became an interested stockholder unless:

The transaction resulting in a person becoming an interested stockholder, or the business combination, is approved by the Board of Directors of the corporation before the person becomes an interested stockholder.

Upon consummation of the transaction which resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction in commenced, excluding for purposes of determining the number of shares outstanding those shares owned (1) by persons who are directors and officers and (2) by employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer; or

On or after the date the person becomes an interested stockholder, the business combination is approved by the corporation's Board of Directors and by the holders of at least 66 2/3% of the corporation's outstanding voting stock at an annual or special meeting, excluding shares owned by the interested stockholder.

Under Section 203, an interested stockholder is defined as any person who is:

The owner of 15% or more of the outstanding voting stock of the corporation; or

An affiliate or associate of the corporation and who was the owner of 15% or more of the outstanding voting stock of the corporation at any time within the three-year period immediately prior to the date on which it is sought to be determined whether such person is an interested stockholder.

The provisions of Section 203 could delay or frustrate a change of control of QuadraMed, deny stockholders the receipt of a premium on their common stock and have an adverse effect on the common stock. The provisions also could discourage, impede or prevent a merger or tender offer, even if such event would be favorable to the interests of stockholders. Our stockholders, by adopting an amendment to the certificate of incorporation, could elect not to be governed by Section 203, which election would be effective 12 months after adoption. However, they have not made such an election.

### **Limitations on Directors' Liability**

Delaware law authorizes corporations to limit or eliminate the personal liability of directors to corporations and their stockholders for monetary damages for breach of directors' fiduciary duty of care. This duty of care requires that, when acting on behalf of the corporation, directors must exercise an informed business judgment based on all material information reasonably available to them. Absent the limitations authorized by Delaware law, directors could be accountable to corporations and their stockholders for monetary damages for conduct that does not satisfy their duty of care. Although Delaware law does not change directors' duty of care, it enables corporations to limit available relief to equitable remedies such as injunction or rescission. Our amended and restated certificate of incorporation limits the liability of our directors to QuadraMed and its

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stockholders to the fullest extent permitted by Delaware law. Specifically, directors of QuadraMed will not be personally liable for monetary damages for breach of a director's fiduciary duty as a director, except for liability for:

Any breach of the director's duty of loyalty to QuadraMed or its stockholders;

Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

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Unlawful payments of dividends or unlawful stock repurchases or redemptions as provided in Delaware General Corporation Law section 174; or

Any transaction from which the director derived an improper personal benefit.

The inclusion of this provision in our amended and restated certificate of incorporation may have the effect of reducing the likelihood of derivative litigation against directors and may discourage or deter stockholders or management from bringing a lawsuit against directors for breach of their duty of care, even though such an action, if successful, might otherwise have benefited QuadraMed and its stockholders.

## **Potential Anti-takeover Effect of Certain Provisions of the Amended and Restated Certificate of Incorporation and By-Laws**

Our amended and restated certificate of incorporation and by-laws contain other provisions that could have an anti-takeover effect. The provisions are intended to enhance the likelihood of continuity and stability in the composition of the Board and in the policies formulated by the Board. These provisions also are intended to help ensure that the Board, if confronted by an unsolicited proposal from a third party which has acquired a block of our stock, will have sufficient time to review the proposal and appropriate alternatives to the proposal and to act in what it believes to be the best interest of the stockholders. The following is a summary of such provisions included in our certificate of incorporation and by-laws.

Our amended and restated certificate of incorporation provides that stockholder action can be taken only at an annual or special meeting of stockholders and cannot be taken by written consent in lieu of a meeting. The certificate of incorporation and the by-laws also provide that, except as otherwise required by law, special meetings of the stockholders can be called only by (1) the Chairman of the Board of Directors, (2) the Chairman or the Secretary at the written request of a majority of the total number of directors which the company would have if there were no vacancies upon not fewer than 10 nor more than 60 days' written notice, or (3) the holders of shares entitled to cast not less than 10 percent of the votes at such special meeting upon not fewer than 10 nor more than 60 days' written notice.

The by-laws establish an advance notice procedure for stockholder proposals to be brought before an annual meeting of stockholders of QuadraMed, including proposed nominations of persons for election to the Board. Stockholders at an annual meeting may only consider proposals or nominations specified in the notice of a meeting or brought before the meeting by or at the direction of the Board or by a stockholder who was a stockholder of record on the record date for the meeting who is entitled to vote at the meeting and who has given our Secretary timely written notice, in proper form, of the stockholder's intention to bring that business before the meeting. Although the by-laws do not give the Board the power to approve or disapprove stockholder nominations of candidates or proposals regarding other business to be conducted at an annual meeting, these procedures may have the effect of prohibiting stockholders from raising proposals at annual meetings if the proper procedures are not followed or may discourage or deter a potential acquirer from conducting a solicitation of proxies to elect its own slate of directors or otherwise attempting to obtain control of QuadraMed.

Our certificate of incorporation also contains a provision requiring the affirmative vote of at least 66 <sup>2</sup>/<sub>3</sub>% of our outstanding voting stock to approve any of a broad range of business combinations with a person or an affiliate or associate of such person, which is (or as a result of the transaction would be) an interested stockholder. Under this provision, an interested stockholder is defined as a any person who:

was the owner of 15% or more of our outstanding voting stock at any time within the two-year period immediately prior to the consummation of the proposed business combination;

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is an affiliate or associate of QuadraMed and at any time during such two-year period owned 15% or more of our outstanding stock; or

succeeds to any shares of our voting stock which at any time during such two year period were owned by an interested stockholder, in a transaction not involving a public offering.

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This 66 <sup>2</sup>/<sub>3</sub>% vote is not required if the business combination has been approved by two-thirds of our Board.

Our certificate of incorporation and by-laws provide that the affirmative vote of holders of at least 66 <sup>2</sup>/<sub>3</sub>% of the total votes, eligible to be cast in the election of directors, is required to amend, alter, change or repeal certain of their provisions. This requirement of a super-majority vote to approve amendments to the certificate of incorporation and by-laws could enable a minority of QuadraMed stockholders to exercise veto power over any such amendments. The Board has no current plans to formulate or effect additional measures that could have an anti-takeover effect.

## **Transfer Agent and Registrar**

The Transfer Agent and Registrar for the common stock is EquiServe, Inc.

## **Description of Notes**

The Senior Secured Notes due 2008, or the notes, were issued under an indenture, dated as of April 17, 2003, between us, as issuer, and The Bank of New York, as trustee. The following summarizes the material provisions of the notes. The following description does not purport to be complete and is subject to, and qualified by reference to, all of the provisions of the indenture and the notes, including the definitions of certain terms used in the indenture or the notes. Wherever particular provisions or defined terms of the indenture or form of note are referred to, these provisions or defined terms are incorporated herein by reference. A copy of the indenture is available as set forth in the section of this prospectus entitled Where You Can Find More Information.

## **General**

We issued \$71,000,000 aggregate principal amount of the notes in a private placement in April 2003. The notes mature on April 1, 2008. The original amount, and the issue price, of each note is \$1,000. The notes will be payable at the principal corporate trust office of the paying agent, which is an office or agency of the trustee, or an office or agency maintained by us for such purpose, in the Borough of Manhattan, The City of New York.

The notes bear interest at an initial interest rate of 10% per year on the original principal amount from the issue date, or from the most recent date to which interest has been paid or provided for, until April 1, 2008. The interest rate will be automatically reduced to 9% immediately following the next interest payment date upon the (1) listing of our common stock for trading on a U.S. national securities exchange or (2) approval for trading on Nasdaq, including the Nasdaq SmallCap market. Interest is payable semiannually in arrears on April 1 and October 1 in each year, commencing on October 1, 2003, to holders of record at the close of business on the March 15 or September 15 immediately preceding such interest payment date. Each payment of cash interest on the notes includes interest accrued through the day before the applicable interest payment date (or purchase or redemption date, as the case may be). Any payment required to be made on any day that is not a business day is made on the next succeeding business day, provided that if such date is a maturity date no additional interest will accrue.



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On the October 1, 2003 and April 1, 2004 interest payment dates, interest is payable in a combination of cash and additional notes as follows: (1) in cash equivalent to 6% per annum of the principal amount and (2) in additional notes having a principal amount equal to the remainder of the cash interest that would otherwise have been payable. On October 1, 2003, we issued notes in the aggregate principal amount of \$1.3 million as an interest payment on the 2008 notes. This additional amount of notes is reflected in the amount of notes registered under this registration statement.

Because a portion of the interest in the first year is payable in additional notes, the notes will be considered issued with original issue discount for United States federal income tax purposes. Accordingly, U.S. holders (as defined herein) generally are required to include such original issue discount in their gross income for United States federal income tax purposes, regardless of the timing of receipt of the related cash payments. For a more detailed discussion of original issue discount and other tax issues, please refer to the section of this prospectus entitled "Certain United States Federal Income Tax Considerations - Interest and Yield on Notes".

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Purchase by us at the option of a holder or redemption of a note at our option will cause the cash interest, if any, to cease to accrue on such note. We may not reissue or replace a note that has matured or been exchanged.

Notes may be presented for exchange or registration of transfer at the office of the registrar. The registrar shall initially be the trustee. No service charge will be made for any registration of transfer or exchange of notes. However, we may require the holder to pay any tax, assessment or other governmental charge payable as a result of such transfer or exchange.

The indenture does not limit the amount of other indebtedness or securities that may be issued by us or any of our subsidiaries. However, the indenture does prohibit us and our subsidiaries from incurring any indebtedness for borrowed money that ranks senior to or equally with the notes in right of repayment. The indenture does not contain any financial covenants or restrictions on the payment of dividends, or the repurchase of our securities (other than the notes). The indenture contains no covenants or other provisions to afford protection to holders of notes in the event of a highly leveraged transaction or a change of control except to the extent described under **Description of Notes** **Change of Control** below.

## **Methods of Receiving Payments on the Notes**

Each installment of semiannual interest on any note is paid in same-day funds by transfer to an account maintained by the payee located inside the United States, if the trustee shall have received proper wire transfer instructions from such payee not later than the related regular record date. If the trustee has not received such instructions, a check drawn on a bank located in New York City is mailed to the payee at its address set forth on the registrar's books.

## **Paying Agent and Registrar for the Notes**

The trustee is the paying agent and registrar. We may change the paying agent or registrar without prior notice to the holders of the notes, and we or any of our subsidiaries may act as paying agent or registrar.

## **Ranking of the Notes**

The notes are senior secured obligations, which rank senior in right of payment to all of our current and future unsecured and unsubordinated indebtedness, and are effectively subordinated to our current and future secured indebtedness to the extent of the security on such other indebtedness. As of December 31, 2003, we have \$84 million of indebtedness outstanding, consisting of the 2005 notes and 2008 notes.

We and our subsidiaries may not incur any indebtedness for borrowed money which ranks senior or equal to the right of repayment for the notes. Furthermore, we and our subsidiaries may not make any investment, other than a **permitted investment**, unless we have cash or cash equivalents of at least \$10 million. As defined in the indenture, **permitted investments** include:

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investments by QuadraMed in QuadraMed or in our existing subsidiaries;

investments in cash equivalents;

an investment that is made by us or one of our existing subsidiaries in the form of any capital stock, bonds, notes, debentures or other securities that are issued by a third party to us or our subsidiary solely as partial consideration for the consummation of an asset sale;

stock, obligations or securities received either in the satisfaction of judgments or in connection with the sale or disposition of a person or entity, assets or business;

investments in prepaid expenses, negotiable instruments held for collection and lease, utility and worker's compensation, performance and other similar deposits;

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investments if we have determined that collection is not likely or as a result of bankruptcy or insolvency proceedings or upon the foreclosure, perfection or enforcement of any lien in favor of us or any subsidiary, in each case as to debt owing to us or any subsidiary that arose in the ordinary course of business of the company or our subsidiary; and

investments in existence on the date of the indenture.

## **Security**

We assigned and pledged to the trustee (as collateral agent) as security for the notes and for the benefit of the holders of the notes (and not for the benefit of our other creditors) any and all of our right, title and interest in and to all existing and future copyrights, patents, trademarks and licenses to use copyrights, patents and trademarks.

## **Guarantees**

Our obligations under the notes were not guaranteed at the time of issuance of the notes. In addition, the indenture does not preclude any of our subsidiaries from guaranteeing or pledging any assets to secure the payment of any indebtedness of such subsidiary or any other subsidiary.

## **Redemption of Notes at Our Option**

No sinking fund is provided for the notes. Prior to April 17, 2006, we cannot redeem the notes at our option. Beginning on April 17, 2006, we may redeem the notes for cash, as a whole at any time or from time to time in part. We will give not less than 30 days or more than 60 days notice of redemption by mail to holders of notes.

If redeemed at our option, the notes will be redeemed at the following prices, plus accrued and unpaid cash interest, if any, on such notes as of the applicable redemption dates:

If redeemed between April 17, 2006 and March 31, 2007, at a price equal to 101.50% of the original principal amount of such notes as of the applicable redemption date;

If redeemed between April 1, 2007 and March 31, 2008, at a price equal to 100.75% of the original principal amount of such notes as of the applicable redemption date; and

If redeemed on April 1, 2008 or thereafter, at a price equal to 100% of the original principal amount of such notes as of the applicable redemption date.

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If less than all of the outstanding notes are to be redeemed, the trustee will select the notes to be redeemed in principal amounts at maturity of \$1,000 or integral multiples of \$1,000. In this case, the trustee may select the notes by lot, pro rata or by any other method the trustee considers fair and appropriate.

### **Mandatory Redemption with Excess Cash**

Within 10 days following the filing of our Form 10-K with the SEC, we are required to furnish to the trustee an officer's certificate setting forth (1) the amount of excess free cash, if any, for the immediately preceding year (plus any carryover excess free cash, as described below) and (2) an amount equal to 50% of the amount in clause (1). If the total of the amounts in clauses (1) and (2) is less than \$500,000, we will retain the amount and add it to the next year's calculation.

If the total excess cash payment is greater than \$500,000 and we have not already called for a redemption of all of the notes, we will be required within 15 days to mail a redemption notice to all holders of notes. The purchase price of a note will be equal to the original principal amount and accrued and unpaid cash interest, if any, on such notes as of the applicable purchase date. If the total excess cash payment is sufficient to redeem all notes, we must redeem all of the notes within 30 days for cash equal to 100% of the principal amount plus accrued but unpaid interest. If the amount is insufficient to redeem all of the notes, we will redeem them on a pro rata basis.

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Excess free cash means, for any fiscal year, EBITDA minus:

taxes based on income or profits for that year (to the extent that taxes were included in computing our consolidated net income );

consolidated interest expense for that year, whether paid or accrued and whether or not capitalized (including, without limitation, amortization of debt issuance costs and original issue discount, non-cash interest payments, the interest component of any deferred payment obligations, the interest component of all payments associated with capital lease obligations, commissions, discounts and other fees and charges incurred in respect of letter of credit or bankers acceptance financings, and net payments (if any) pursuant to hedging obligations), to the extent that any such expense was deducted in computing the consolidated net income; and

the amount of our capital expenditures for the immediately preceding fiscal year.

EBITDA means, for any period, our consolidated net income for the period plus:

provision for taxes based on income or profits for the period, to the extent that taxes were included in computing the consolidated net income;

consolidated interest expense for such period, whether paid or accrued and whether or not capitalized (including, without limitation, amortization of debt issuance costs and original issue discount, non-cash interest payments, the interest component of any deferred payment obligations, commissions, discounts and other fees and charges incurred in respect of letter of credit or bankers acceptance financings, and net payments (if any) pursuant to hedging obligations), to the extent that any such expense was deducted in computing the consolidated net income;

depreciation, amortization (including amortization of goodwill and other intangibles but excluding amortization of prepaid cash expenses that were paid in a prior period) and other non-cash expenses (excluding any non-cash expense to the extent that it represents an accrual of or reserve for cash expenses in any future period or amortization of a prepaid cash expense that was paid in a prior period) for the period to the extent that the depreciation, amortization and other non-cash expenses were deducted in computing our consolidated net income; and

non-recurring financing, advisory and other expenses incurred in connection with the issuance of the notes,

and minus non-cash items increasing the consolidated net income for the period (other than items accrued in the ordinary course of business), in each case, on a consolidated basis and determined in accordance with generally accepted accounting principles ( GAAP ). However, if any subsidiary is not a wholly owned subsidiary, EBITDA shall be reduced (to the extent not otherwise reduced in accordance with GAAP) by an amount equal to (A) the amount of EBITDA attributable to the subsidiary multiplied by (B) the percentage ownership interest in the subsidiary not owned on the last day of the period by us or any of our subsidiaries. Regardless of the preceding statements, the provision for taxes on the income or profits of, and the depreciation and amortization and other non-cash expenses of, a subsidiary of the company shall be added to consolidated net income to compute EBITDA only to the extent that a corresponding amount would be permitted at the date of determination to be dividended to the company by the subsidiary without prior governmental approval (that has not been obtained), and without direct or indirect restriction pursuant to the terms of its charter and all agreements, instruments, judgments, decrees, orders, statutes, rules and governmental regulations applicable to that subsidiary or its stockholders.

Consolidated net income means, for any period, the aggregate of the net income of QuadraMed and our restricted subsidiaries for the period, on a consolidated basis, determined in accordance with GAAP; provided that:

the net income of any person or entity, other than a subsidiary of QuadraMed, shall be excluded, except to the extent of the amount of cash dividends or distributions actually received by QuadraMed;

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the net income of any subsidiary of QuadraMed that is subject to any restriction or limitation on the payment of dividends or the making of other distributions (other than pursuant to the notes or the indenture) shall be excluded to the extent of the restriction or limitation;

(i) the net income of any person or entity acquired in a pooling of interests transaction for any period prior to the date of such acquisition shall be excluded and (ii) any net gain (but not loss) resulting from an asset sale by QuadraMed or any of our subsidiaries other than in the ordinary course of business shall be excluded;

extraordinary gains and losses and any foreign exchange gains and losses shall be excluded;

income or loss attributable to discontinued operations (including, without limitation, operations disposed of during the period whether or not such operations were classified as discontinued) shall be excluded;

any restoration to income or any contingency reserve of an extraordinary, non-recurring or unusual nature shall be excluded, except to the extent that provision for such reserve was made out of consolidated net income accrued at any time; and

in the case of a successor to QuadraMed by consolidation or merger or as a transferee of our assets, any earnings of the successor corporation prior to such consolidation, merger or transfer of assets shall be excluded.

Net income means, for any period, our net income or loss determined in accordance with GAAP.

Capitalized lease obligations means indebtedness represented by obligations under a lease that is required to be capitalized for financial reporting purposes in accordance with GAAP, and the amount of such indebtedness shall be the capitalized amount of such obligations determined in accordance with GAAP.

The required notice must be sent to all holders at their address shown in the register of the registrar, and to beneficial owners as required by applicable law, stating among other things:

the amount of the purchase price;

the procedures that holders must follow to require us to redeem their notes.

Payment of the purchase price for a note for which a purchase notice has been delivered and not validly withdrawn is conditioned upon delivery of the note, together with the necessary endorsements, to the paying agent at any time after delivery of the purchase notice. Payment of the purchase price for the note will be made as soon as practicable following the later of the purchase date or the time of delivery of the note.

If the paying agent holds money or securities sufficient to pay the purchase price of the note on the business day following the purchase date in accordance with the terms of the indenture, then, immediately after the purchase date, the note will cease to be outstanding and cash interest on such note will cease to accrue whether or not the note is delivered to the paying agent. Thereafter, all other rights of the holder shall terminate, other than the right to receive the purchase price upon delivery of the note.



## **Change of Control**

In the event of a change of control of QuadraMed, each holder will have the right, at the holder's option, subject to the terms and conditions of the indenture, to require us to repurchase for cash all or any portion of the holder's notes. However, the original principal amount submitted for repurchase by a holder must be \$1,000 or an integral multiple of \$1,000.

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We will be required to repurchase the notes as of a date no later than 30 business days after we give notice of the occurrence of a change of control at a cash price equal to the sum of the original principal amount and accrued and unpaid cash interest, if any, on such note as of the date of repurchase.

Within 15 days after the occurrence of a change of control, we are obligated to mail to the trustee, to all holders of notes at their addresses shown in the register of the registrar, and to beneficial owners as required by applicable law a notice regarding the change of control. This notice shall state, among other things:

the events causing a change of control;

the date of such change of control;

the last date on which the repurchase right may be exercised;

the change of control repurchase price;

the name and address of the paying agent and the conversion agent; and

the procedures that holders must follow to exercise these rights.

To exercise this right, the holder must deliver a written notice to the paying agent prior to the close of business on the change of control repurchase date. The required repurchase notice upon a change of control shall state:

the name of the holder;

the certificate numbers of the notes to be delivered by the holder;

the portion of the original principal amount of notes to be repurchased, which portion must be \$1,000 or an integral multiple of \$1,000; and

that we are to repurchase such notes pursuant to the applicable provisions of the notes.

Any such change of control repurchase notice may not be withdrawn by the holder.

Payment of the change of control repurchase price for a note for which a change of control repurchase notice has been delivered is conditioned upon delivery of the note, together with the necessary endorsements, to the paying agent at any time after the delivery of such change of control repurchase notice. Payment of this change of control repurchase price for such note will be made promptly following the later of the change of control repurchase date or the time of delivery of such note.

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If the paying agent holds money sufficient to pay the change of control repurchase price of the note on the business day following the change of control repurchase date in accordance with the terms of the indenture, then, immediately after the change of control repurchase date, the note will cease to be outstanding and cash interest will cease to accrue whether or not the note is delivered to the paying agent. Thereafter, all other rights of the holder shall terminate, other than the right to receive the change of control repurchase price upon delivery of the note.

Under the indenture, a change of control of QuadraMed is deemed to have occurred upon the occurrence of any of the following:

all or substantially all of our assets are sold as an entirety to any person or entity or related group of persons or entities;

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the consummation of any consolidation or merger of the company:

- in which the company is not the continuing or surviving corporation (other than a consolidation or merger with one of our wholly owned subsidiaries in which all of our outstanding shares of common stock immediately prior to the effectiveness of the consolidation or merger are changed into or exchanged for the same consideration), or
- in which our common stock would be converted into cash, securities or other property,

in each case other than a consolidation or merger of the company in which the holders of the common stock immediately prior to the consolidation or merger have, directly or indirectly, at least a majority of the total voting power of all classes of capital stock entitled to vote generally in the election of directors of the continuing or surviving corporation immediately after such consolidation or merger in substantially the same proportion as their ownership of common stock immediately before such transaction;

any person or entity, or any persons or entities acting together which would constitute a group for purposes of Section 13(d) of the Securities Exchange Act of 1934, together with any affiliates thereof, shall beneficially own (as defined in Rule 13d-3 under the Exchange Act) at least 50% of the total voting power of all classes of our capital stock entitled to vote generally in the election of the company's directors;

at any time during any consecutive two-year period, individuals who, at the beginning of such period, constituted our Board of Directors (together with any new directors whose election by such Board of Directors or whose nomination for election by our stockholders was approved by a vote of 66 2/3% of the directors then still in office who were either directors at the beginning of such period or whose election or nomination for election was previously so approved) cease for any reason to constitute a majority of our Board of Directors then in office; or

the company is liquidated or dissolved or adopts a plan of liquidation or dissolution.

The change of control repurchase feature of the notes may, in certain circumstances, make more difficult or discourage a takeover of QuadraMed. The change of control repurchase feature, however, is not the result of our knowledge of any plan by management to adopt a series of anti-takeover provisions or any specific effort of any entity to accumulate shares of common stock or to obtain control of us by means of a merger, tender offer, solicitation or otherwise.

Instead, the change of control repurchase feature is a standard term contained in other offerings of securities similar to the notes that have been marketed by the initial purchasers of the 2008 notes. The terms of the change of control repurchase feature resulted by negotiations between the initial purchasers and us.

We could, in the future, enter into certain transactions, including certain recapitalizations, that would not constitute a change of control with respect to the change of control repurchase feature of the notes but that would increase the amount of our or our subsidiaries' outstanding indebtedness. In addition, we could, in the future, enter into certain agreements that limit our ability to pay the change of control repurchase price. Any failure to pay the change of control repurchase price could result in an event of default under the indenture. The indenture does not contain any covenants or provisions that may afford holders of the notes protection in the event of a highly leveraged transaction or that prevent us from entering into such agreements.

The definition of change of control includes a phrase relating to the sale, lease, transfer, conveyance or other disposition of all or substantially all of the properties or assets of our and our subsidiaries' assets, taken as a whole. Although there is a limited body of case law interpreting the phrase substantially all, there is no precise established definition of the phrase under applicable law. Accordingly, the ability of a holder of notes

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to require us to repurchase its notes as a result of a sale, lease, transfer, conveyance or other disposition of less than all of our and our subsidiaries' assets, taken as a whole, to another person or group may be uncertain.

No notes may be repurchased at the option of holders upon a change of control if there has occurred and is continuing an event of default with respect to the notes, other than a default in the payment of the change of control repurchase price with respect to the notes.

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### **Events of Default and Acceleration**

The following are events of default under the indenture:

default in the payment of all or any part of the original principal amount, or any premium, redemption price, purchase price, or change of control repurchase price due with respect to the notes, when the same become due and payable;

default in payment of any interest upon the notes, which default continues for 30 days;

our failure to comply with any of our other agreements in the notes or the indenture upon our receipt of notice of such default from the trustee or from holders of not less than 25% in aggregate original principal amount of the notes, and our failure to cure (or obtain a waiver of ) such default within 60 days after we receive such notice;

default in the payment of indebtedness when due by us or any subsidiary constituting failure to pay principal in excess of \$5 million or any such default resulting in acceleration of other indebtedness of ours or indebtedness of our subsidiaries for borrowed money where the aggregate principal amount with respect to which the default and acceleration has occurred exceeds \$5 million, and such acceleration has not been rescinded or annulled within a period of 10 days after written notice to us by the trustee or to us and the trustee by the holders of at least 25% in original principal amount of the notes;

any liens or collateral securing the notes cease to constitute a valid, perfected lien free and clear of all other liens (other than permitted liens) or, except as permitted by the indenture, any collateral arrangements are terminated or cease to be in full force effect, and the default continues for 15 days or we contest the enforceability of the liens;

any failure to pledge or assign collateral for the notes when required, and such condition shall have continued for a period of three business days after written notice of such failure requiring us to remedy the same shall have been given to us by the trustee or to us and the trustee by the holders of 25% in aggregate original principal amount of the notes outstanding;

failure to provide timely notice of a change of control; or

certain events of bankruptcy, insolvency or reorganization affecting us or certain of our subsidiaries.

If an event of default shall have happened and be continuing, either the trustee or the holders of not less than 25% in aggregate original principal amount of the notes then outstanding may declare the principal amount of the notes, any premium thereon, through the date of such declaration, to be immediately due and payable. In the case of certain events of bankruptcy or insolvency, the principal amount of the notes, together with any accrued cash interest through the occurrence of such event shall automatically become and be immediately due and payable.

### **Mergers and Sales of Assets**

The indenture provides that we may not consolidate with or merge into any person or convey, transfer or lease all or substantially all of our properties and assets to another person unless:

either (1) we are the surviving corporation, or (2) the resulting, surviving or transferee person is a corporation organized and existing under the laws of the United States, any state thereof or the District of Columbia, and such corporation (if other than us) assumes all our obligations under the notes and the indenture;

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after giving effect to the transaction no event of default, and not event that, after notice or passage of time, would become an event of default, has occurred and is continuing; and

other conditions described in the indenture are met.

Upon the assumption of our obligations by such corporation in such circumstances, subject to the consent of the holders of two-thirds in aggregate principal amount of the notes outstanding, we shall be discharged from all obligations under the notes and the indenture. Although such transactions are permitted under the indenture, certain of the foregoing transactions occurring could constitute a change of control of QuadraMed Corporation, permitting each holder to require us to purchase the notes of such holder as described above.

## **Modification and Amendment**

The trustee and we may modify or amend the indenture or the notes with the consent of the holders of not less than a majority in aggregate original principal amount of the notes then outstanding. However, the consent of the holders of each outstanding note would be required to:

make any note payable in money other than that stated in the note;

change the stated maturity of any note;

reduce the original principal amount, interest rate, redemption price, purchase price or change of control repurchase price with respect to any note;

make any change that adversely affects the right to require us to purchase a note;

amend or modify the indenture, the notes or any collateral documents in any manner adverse to the holder;

subordinate in right of payment the notes to any other indebtedness;

impair the right to institute suit for the enforcement of any payment with respect to the notes; and

change the provisions in the indenture that relate to modifying, waiving or amending the indenture.

Without the consent of any holder of notes, the trustee and we may enter into supplemental indentures for any of the following purposes:

to evidence a successor to us and the assumption by that successor of our obligations under the indenture and the notes;

to add to our covenants for the benefit of the holders of the notes or to surrender any right or power conferred upon us;



to secure our obligations in respect of the notes;

to make any change to comply with the Trust Indenture Act of 1939, or any amendment thereto, or to comply with any requirement of the SEC in connection with the qualification of the indenture under the Trust Indenture Act, or as necessary in connection with the registration of the notes under the Securities Act;

to cure any ambiguity or inconsistency in the indenture or in the collateral documents; or

to make any change that does not adversely affect the rights of any holder of the notes.

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The holders of a majority in original principal amount of the outstanding notes may, on behalf of all the holders of all notes:

waive compliance by us with restrictive provisions of the indenture, as detailed in the indenture; and

waive any past default under the indenture and its consequences, except a default in the payment of the principal amount, accrued and unpaid interest, redemption price, purchase price or change of control repurchase price.

## **Discharge of the Indenture**

We may satisfy and discharge our obligations under the indenture by:

delivering to the trustee for cancellation all outstanding notes, or

depositing with the trustee, the paying agent or the conversion agent, if applicable, cash sufficient to pay all of the outstanding notes and paying all other sums payable under the indenture, after the notes have become due and payable, whether at stated maturity or any redemption date, or any purchase date, or a change of control repurchase date, or otherwise.

## **Governing Law**

The indenture and the notes are governed by, and construed in accordance with, the law of the State of New York.

## **Information Concerning the Trustee**

The Bank of New York is the trustee, registrar and paying agent under the indenture for the notes. The Bank of New York is also the collateral agent under the security agreement.

## **Book-Entry System**

The majority of the notes are issued in the form of global securities held in fully-registered book-entry form. The remainder of the notes are held in certificated form. Depository Trust Company ( DTC ) or its nominee is the registered holder of this majority of the notes for all purposes under the indenture (the DTC notes ). For these DTC notes, owners of beneficial interests in the DTC notes represented by the global securities will hold their interests pursuant to the procedures and practices of DTC. As a result, beneficial interests in any such securities will be shown on, and may only be transferred through, records maintained by DTC and its direct and indirect participants and any such interest may not be exchanged for certificated securities, except in limited circumstances. Owners of beneficial interests must exercise any rights in respect of their interests, including any right to convert or require purchase of their interests in the notes, in accordance with the procedures and practices of DTC.

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Beneficial owners will not be holders and will not be entitled to any rights under the global securities or the indenture. QuadraMed and the trustee, and any of their respective agents, may treat DTC as the sole holder of these DTC notes and registered owner of these global securities.

### **Exchange of Global Securities**

DTC notes represented by global securities will be exchangeable for certificated securities with the same terms only if:

DTC has notified us that it is unwilling or unable to continue as depositary or if DTC ceases to be a clearing agency registered under the Exchange Act and a successor depositary is not appointed by us within 90 days;

We decide to discontinue use of the system of book-entry transfer through DTC (or any successor depositary); or

A default under the indenture occurs and is continuing.

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DTC has advised us as follows: DTC is a limited-purpose trust company organized under the New York Banking Law, a banking organization within the meaning of the New York Uniform Commercial Code, and a clearing agency registered pursuant to the provisions of Section 17A of the Exchange Act. DTC facilitates the settlement of transactions among its participants through electronic computerized book-entry changes in participants' accounts, eliminating the need for physical movement of securities certificates. DTC's participants include securities brokers and dealers, including the initial purchasers, banks, trust companies, clearing corporations and other organizations, some of whom and/or their representatives, own DTC. Access to DTC's book-entry system is also available to others, such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a participant, either directly or indirectly.

## **Warrants**

In connection with the issuance of the 2008 notes, on April 17, 2003, we issued warrants to purchase 11,586,438 shares of our common stock. Additional warrants to purchase 2,047,978 shares of common stock will be issued to holders of our 2008 notes if we do not file a registration statement within 90 days after receiving a request to do so from the holders on or after January 12, 2004. In connection with the warrants, holders received both demand and piggyback registration rights and are entitled to anti-dilution protection, including dilution from any issuance of shares in settlement of existing litigation. The warrants have an exercise price of \$0.01 per share and a term of five years.

On October 23, 2003, pursuant to the registration rights agreement described below, we received a demand request from a holder of the 2008 notes requiring us to file a registration statement with the SEC within 90 days of the demand request. On November 3, 2003, we mailed a request notice to all holders of the 2008 notes, notifying them of the demand request and informing them that they had fifteen (15) days within which to request that any or all of their notes or warrants be included in the registration statement to be filed. Those holders who elected to have their notes or warrants included in this registration statement are listed in this prospectus in the section entitled "Selling Holders".

## **Registration Rights**

We have entered into a registration rights agreement with the initial purchasers of the notes and warrants in which we agreed to provide them with registration rights for the notes and shares underlying warrants at our expense. There are three types of registrations covered by the registration rights agreement: demand registration, piggyback registration and Form S-3 shelf registration. This summary of the registration rights agreement is not intended to be exhaustive, and we recommend that you review the registration rights agreement available as set forth in the section of this prospectus entitled "Where You Can Find More Information".

The holders under the registration rights agreement may request a demand registration. A demand registration commences when the holders of at least ten percent (10%) of the notes or warrant shares provide written notice (a demand request) to the company that they demand we register their notes or shares underlying their warrants. A demand request must contain information about the type of number of securities the holders are requesting us to register, the method by which the holders intend to sell or dispose of their securities, and the expected price range acceptable to the holders to be received for the securities. Within ten (10) days of the demand request from the holders, we must provide written notice (a request notice) to the other holders under the registration rights agreement notifying them of a demand request and informing them that they have fifteen (15) days in which to request that any or all of their notes or warrants be included in the registration statement.

We are required to file a registration statement covering the securities which we have been requested to register with the SEC within ninety (90) days of our receipt of the demand request. We agree to use our commercially best efforts to have the registration statement be declared effective by the SEC. A demand registration statement shall not be deemed to have been effected (1) unless a registration statement has become effective and remained effective in compliance with the provisions of the Securities Act for a period not to exceed forty-five (45) days or (2) if, after it has

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become effective, the registration is interfered with by a stop order, injunction, or other order or requirement of the SEC, other governmental agency, or court that is not attributable to the participating holders and has not thereafter become effective.

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If the proposed public offering under the registration is an underwritten public offering, the managing underwriter may determine and advise the participating holders and the company in writing that the inclusion of all securities to be included in the underwritten public offering would adversely interfere with the successful marketing of the securities of those holders who initially requested the filing of the registration statement. In this situation, the company and the participating holders are prohibited from including any securities in excess of the amount that the managing underwriter reasonably and in good faith agrees to include in the public offering in addition to the amount of securities to be registered for the holders who initially requested the registration.

We may delay the filing of any registration statement or any action connected therewith for up to one hundred twenty (120) days upon the provision of a written certificate of the President and CEO to the holders stating that our Board of Directors has determined in good faith that the filing of the registration statement would be seriously detrimental to the company or would otherwise materially adversely affect a material business transaction and should therefore be deferred. We may not delay a demand request more than twice in any twelve (12) month period, and we may only delay as long as the reason for the delay exists. During any such delay, we may not file a registration statement for our own account or for anyone other than the holders.

We are only required to effect five (5) demand requests, and the holders are prohibited from making a demand request until six (6) months after the effective date of a registration statement relating to a demand request. We are not required to comply with a demand request unless the reasonably anticipated aggregate gross proceeds to be raised (before any underwriting discounts or commissions) would equal or exceed 10% of the aggregate principal amount of the notes originally issued or 10% of the aggregate number of warrants originally issued.

Each time that we propose for any reason to register any of the company's common stock under the Securities Act of 1933, either for our own account or for the account of stockholder(s) exercising demand registration rights other than demand requests under this registration rights agreement, we shall provide prompt notice of this proposed registration to all holders of the warrant shares, offering these holders the right to request that any or all of their warrant shares be included in the proposed registration. This piggyback registration does not affect our obligations to register securities pursuant to a demand request. Holders have ten (10) days from receipt of our notice of the proposed registration within which to request to participate in the registration and to notify us of the number of warrant shares they intend to sell and their intended method of sale or disposition.

If the proposed public offering under the registration is an underwritten public offering, the managing underwriter may determine and advise the participating holders and the company in writing that the inclusion of all securities to be included in the underwritten public offering would adversely interfere with the successful marketing of the company's securities. In this situation, the holders of the warrant shares are prohibited from including any shares in excess of the amount that the managing underwriter reasonably and in good faith agrees to include in the public offering in addition to the amount of securities to be registered for the company and those holders who were initially included in the registration.

As soon as practicable after the date on which we are eligible to register securities on Form S-3 (or a successor form) under the Securities Act of 1933, we shall use commercially reasonable efforts to deliver a shelf registration statement with respect to all the securities outstanding under this registration rights agreement. The holders shall not have demand or piggyback registration rights during the period in which the shelf registration is effective or during any period the company has a registration statement on Form S-1 declared effective and during the time such registration statement remains effective.

We agree to use our efforts to have the shelf registration declared effective as soon as reasonably practicable after filing and to keep it continuously effective through the term of the registration rights agreement. However, the effectiveness of the shelf registration may be terminated earlier if none of the securities under the registration rights agreement are outstanding. We agree to supplement or amend the shelf registration as necessary.

After a demand request or filing of a shelf registration, if our Board of Directors determines in good faith that the filing of a registration statement or sale of securities under a registration statement would require the

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disclosure of material non-public information, which would have a material adverse affect on our company, they shall notify the holders or S-3 holders in writing. The company may institute a blackout period : delay the filing of any unfiled registration statement, cease taking steps to cause any as yet ineffective registration statement to be declared effective, or suspend the holders sales of securities under an effective registration statement until the information is disclosed to the public or is no longer material or the company decides to end the blackout period.

The holders rights to demand registrations, piggyback registrations, and Form S-3 registrations terminate at the earlier of (i) five (5) years from the effective date of our first registration statement for a public offering of securities by the company or (ii) with respect to an individual holder, in the opinion of our counsel, all the securities proposed to be sold by such holder may be sold in a three (3) month period without registration under the Securities Act of 1933 pursuant to Rule 144 and such securities represent less than one percent (1%) of all outstanding shares of our common stock.

The remedy available for breaches of the provisions of the registration rights agreement is specific performance only; no monetary damages are available.



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**CERTAIN UNITED STATES FEDERAL INCOME TAX CONSIDERATIONS**

The following summary discusses certain material U.S. federal income tax (and, if you are a non-U.S. holder, as defined below, certain U.S. federal estate tax) consequences relating to your purchase, ownership, and disposition of notes and/or shares of common stock. Except where noted, this summary deals only with notes and shares of which you are the beneficial owner and which you hold as capital assets and is applicable only if you are the initial holder and purchased notes and/or shares for an amount of cash equal to their initial offering price. Additionally, this summary does not deal with special situations, such as tax consequences:

if you are a dealer in securities or currencies, a bank, a financial institution, an insurance company, a tax-exempt entity or a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings;

if you hold notes and/or shares as part of a hedging, integrated, constructive sale or conversion transaction or a straddle;

if your functional currency is not the U.S. dollar;

under the alternative minimum tax regime, if applicable; or

under any state, local or foreign laws.

The discussion below is based upon the provisions of the Internal Revenue Code of 1986, as amended (the Code), and U.S. Treasury regulations, rulings and judicial decisions as of the date hereof. Those authorities may be changed, perhaps retroactively, so as to result in U.S. federal income tax consequences different from those discussed below. There can be no assurance that the Internal Revenue Service (the IRS) will not challenge one or more of the tax consequences discussed herein. If a partnership holds our notes or shares, the tax treatment of a partner in the partnership will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding our notes or shares, you should consult your tax adviser. Whether a note is treated as debt (and not equity) for U.S. federal income tax purposes is an inherently factual question and no single factor is determinative. We will treat the notes as indebtedness for U.S. federal income tax purposes and the following discussion assumes that such treatment will be respected.

For purposes of this summary, you are a U.S. holder if you are the beneficial owner of a note and/or shares and you are:

a citizen or resident of the United States;

a corporation or partnership created or organized in or under the laws of the United States or any political subdivision of the United States;

an estate the income of which is subject to U.S. federal income taxation regardless of its source; or

a trust (1) subject to the primary supervision of a court within the United States and one or more U.S. persons have authority to control all of your substantial decisions or (2) with a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

If you are the beneficial owner of a note and/or shares and you are not a U.S. holder, you are referred to herein as a non-U.S. holder .

#### **Interest and Yield on Notes**

In general, subject to a *de minimis* rule, a debt obligation will be treated as being issued with original issue discount ( OID ) if the stated redemption price at maturity of the instrument exceeds that instrument's issue price .

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The stated redemption price at maturity of a debt obligation is the aggregate of all payments due to the holder under such debt obligation at or prior to its maturity date, other than interest that is actually and unconditionally payable in cash or property (other than debt instruments of the issuer) at a single fixed rate at least annually ( *QSIPs* ). During the first year of the notes, interest on the notes is payable 6% in cash and 4% in additional notes. Because interest on the notes will be paid through the issuance of additional notes in the first year, all interest payments above 6% will not qualify as *QSIPs*, so the stated redemption price at maturity of the notes will include all payments of principal and interest on the notes above 6%. Furthermore, under the regulations issued pursuant to the OID provisions of the Code (the *OID Regulations* ), a payment-in-kind note (or also commonly known as a *PIK Note* ) and any notes that are issued with respect thereto are treated as part of the same debt instrument. Accordingly, the adjusted issue price of the combined note and any notes issued with respect thereto will not be reduced upon the issuance of the additional notes, and the stated redemption price at maturity of the combined note will not change upon the issuance of the additional notes and will include the interest payable under the additional notes.

Assuming that neither the notes nor the additional notes are traded on an established securities market within the meaning of the OID provisions of the Code and the regulations thereunder, the company believes that the issue price of each note equals its stated principal amount. Because the stated redemption price at maturity exceeds the stated principal amount of the notes, the notes were issued with OID.

The holder of an OID instrument must include in income the sum of the daily portion of the OID accretion during the taxable year for each year it holds the instrument even in the absence of payments during such year. The daily portion of the OID accretion on an instrument is determined by allocating to each day in the period the ratable portion of the increase in the adjusted issue price of the instrument during that period. A U.S. holder's tax basis in a note will be increased by the amount of OID included in the U.S. holder's income and reduced by the portion of all interest payments not qualifying as *QSIPs* (other than payments in the form of additional notes) received on the notes. Therefore, the holder of a note will not have to pay income tax on amounts previously taxed as OID when the associated cash payment is received.

In addition, the amount of OID will be recalculated under the *OID Regulations* if the interest rate changes upon the listing of our common stock on a U.S. national securities exchange or upon the relisting of our common stock on the Nasdaq National Market or Nasdaq SmallCap Market.

## **Sale, Exchange, Redemption and Other Disposition of Notes and/or Shares**

You will generally recognize gain or loss upon the sale, exchange, redemption or other disposition of a note equal to the difference between the amount realized upon the sale, exchange, redemption or other disposition and your adjusted tax basis in the note, which will be equal to the amount paid for the note, increased by the amount of OID previously included in income and decreased by the amount of payments of interest and principal. You will generally recognize gain or loss upon the sale, exchange, redemption, or other disposition of a share equal to the difference between the proceeds received and your adjusted basis in the share.

Any gain or loss recognized on a disposition of the note and/or stock will be capital gain or loss. If you are a noncorporate U.S. holder and have held the note and/or stock for more than one year, such capital gain will be subject to tax at a maximum rate of 15%. Your ability to deduct capital losses may be limited.

## **Rules Generally Relating to Distributions With Respect To Stock**

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When a corporation makes a distribution with respect to its capital stock, the amount of the distribution received by the stockholder will be treated as a dividend, which will be taxed to the stockholder as ordinary income, to the extent that it is paid from the current or accumulated earnings and profits of the corporation. The amount of a distribution made in property other than cash is the fair market value of that property at the time of the distribution. If you are a corporation, you are entitled to a dividends-received deduction subject to certain limitations. Earnings and profits for this purpose consists of an amount based on the taxable income of the corporation as adjusted by the application of detailed rules set forth in Treasury Regulations. A distribution will be treated as a dividend even though we have an overall deficit in our earnings and profits to the extent we have positive earnings and profits in the year in which we make the distribution (i.e., current earnings and profits). If the amount of a distribution

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exceeds the current and accumulated earnings and profits of the corporation, the excess will be treated first as a tax-free return of investment up to the basis of the stock, and this amount will reduce your tax basis in the stock. If the distribution exceeds the current and accumulated earnings and profits, and your tax basis in the stock, this excess amount will be treated as capital gain to you. If you are a U.S. corporation, you would generally be able to claim a deduction equal to a portion of the amount of the distribution treated as a dividend, subject to certain requirements under the Code, in accordance with the foregoing rules.

## **Exercise of the Optional Redemption or Purchase Right**

If you require us to purchase a note on a purchase date, then, in general:

you should recognize gain (but not loss) to the extent that the cash exceeds your adjusted tax basis in the note, but in no event should the amount of recognized gain exceed the amount of cash you receive;

to the extent not previously included in gross income, you will be required to include in gross income as ordinary income the OID accrued on your notes through the date of purchase; and

your holding period for the shares received in the exchange should include the holding period for the note that was purchased.

If we elect to exercise our option to purchase a note or if a U.S. holder requires us to purchase a note on a purchase date and if, in either event, we deliver to a holder cash in full satisfaction of the purchase price, the purchase will be treated the same as a sale of the note, as described above under **Sale, Exchange, Redemption and other Disposition of the Notes**.

## **New Tax Legislation**

As part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the **Act**), signed into law on May 28, 2003, the maximum tax rate on dividends was generally reduced to 15% for tax years through 2008. In general, a dividend would not be eligible for the 15% rate if the stock was held for 60 days or less. In addition, the Act established a maximum tax rate of 15% on net long-term capital gains of individuals, trusts and estates effective for gains properly taken into account after May 5, 2003. The Act also had the effect of reducing the backup withholding rate. Investors are encouraged to consult with their own tax advisors regarding the application to them of the provisions of the Act.

## **Non-U.S. Holders**

The following is a summary of certain material U.S. federal tax consequences that will apply to you if you are a non-U.S. holder of notes and/or shares. Special rules may apply to you if you are a controlled foreign corporation, passive foreign investment company, or foreign personal holding company for U.S. federal income tax purposes, or a U.S. expatriate. Those special rules are not discussed in this summary. You should consult your own tax adviser to determine the U.S. federal, state, local and other tax consequences that may be relevant to you.

***Payment of Interest to Non-U.S. Holders***

Payments of principal of and interest (including OID) on a note to you will not be subject to U.S. federal income or withholding tax if:

the payments are not effectively connected with your conduct of a trade or business in the United States;

you do not actually or constructively own 10% or more of the total combined voting power of all classes of our stock entitled to vote;

you are not a controlled foreign corporation related to us;

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you are not a bank, a foreign tax exempt organization or a foreign private foundation for United States federal income tax purposes;  
and

prior to payment, we or our agent receive a statement (generally made on a properly completed and duly executed IRS Form W-8BEN) certifying that you are the beneficial owner of the note and not a United States person.

Special certification rules may apply if you hold your note through certain intermediaries or through pass-through entities.

If you cannot satisfy the requirements described above, payments of interest and OID) on a note to you will generally be subject to U.S. federal income and withholding tax at a rate of 30% unless:

you are entitled to the benefits of an applicable income tax treaty and claim an exemption from or reduction in such tax (generally by providing a properly completed and duly executed IRS Form W-8BEN on which you will claim the benefits of such treaty); or

the interest or OID is effectively connected with your conduct of a trade or business in the United States and we or our agent receive a statement certifying to that effect (generally on a properly completed and duly executed IRS Form W-8ECI).

If the interest or OID on a note is effectively connected with your conduct of a trade or business in the United States (and, if you are entitled to the benefits of an applicable income tax treaty, such interest or OID is attributable to your U.S. permanent establishment), you will be subject to U.S. federal income tax on such interest or OID on a net income basis, generally under the same rules that would apply if you were a U.S. holder. In addition, if you are a foreign corporation, you could be subject to a branch profits tax equal to 30% (or lower applicable treaty rate) of your adjusted effectively connected earnings and profits for the taxable year.

### ***Sale, Exchange or Redemption of Notes and/or Shares by Non-U.S. Holders***

The gain you may realize upon a sale, exchange, redemption or other disposition of a note and/or share generally will not be subject to U.S. federal income or withholding tax unless:

the gain is effectively connected with your conduct of a trade or business in the United States (and, if you are entitled to the benefits of an applicable income tax treaty, the gain is attributable to your U.S. permanent establishment);

you are an individual who is present in the United States for 183 days or more in the taxable year of that disposition and certain other conditions are met, or

we are or have been a U.S. real property holding corporation for U.S. federal income tax purposes.

If the gain you realize is described in the first bullet point above, you will be subject to U.S. federal income tax on such gain on a net income basis, generally under the same rules that would apply if you were a U.S. holder. In addition, if you are a foreign corporation, you could be subject to a branch profits tax equal to 30% (or lower applicable treaty rate) of your adjusted effectively connected earnings and profits for the

taxable year.

If the gain you realize is described in the second bullet point above, subject to any provision to the contrary under an applicable tax treaty, you will generally be subject to a flat 30% U.S. federal income tax on such gain.

We believe we are not and do not anticipate becoming a U.S. real property holding corporation for U.S. federal income tax purposes. However, there can be no assurances that we will not become a U.S. real property holding corporation in the future.



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### **U.S. Federal Estate Tax**

If you are a non-U.S. holder other than an individual, you will not be subject to the United States federal estate tax. If you are a non-U.S. holder and an individual, your notes will not be included in your gross estate for United States federal estate tax purposes unless at the time of death (i) you were a citizen or resident of the United States (as defined for United States federal estate tax purposes) and (ii) either (a) payments of interest or OID on the notes would have been effectively connected with your conduct of a trade or business in the United States or (b) you actually or constructively owned 10 percent or more of the total combined voting power of all classes of our stock entitled to vote.

By contrast, common stock held by you at the time of your death will be included in your gross estate for U.S. estate tax purposes unless an applicable estate tax treaty provides otherwise.

You should consult with your own tax adviser regarding the potential application of the U.S. federal estate tax rules to you and your estate before considering an investment in the notes.

### **Information Reporting and Backup Withholding**

If you are a U.S. holder, in general, information reporting requirements will apply to certain payments of principal and interest on the notes, dividends paid on the common stock, and the proceeds of a sale of notes or shares of our common stock unless you are an exempt recipient (such as a corporation). A 28% backup withholding tax will apply to such payments if you fail to provide your taxpayer identification number or a certification of foreign status or to report in full dividend and interest income, or if you fail to otherwise establish an exemption.

If you are a non-U.S. holder and you have provided a certification of non-U.S. status (e.g., on a properly executed and duly executed IRS Form W-8BEN), in general, you will not be subject to information reporting or backup withholding with respect to payments that we make to you provided that we do not have actual knowledge or reason to know that you are a United States person. In addition, you will not be subject to information reporting or backup withholding with respect to the proceeds of a sale of a note or share of common stock, even if such sale is effected within the United States or conducted through a U.S.-related financial intermediary, as long as the payor does not have actual knowledge or reason to know that you are a United States person.

We are required to and will report annually to the IRS and to you the amount of, and the tax withheld, if any, with respect to, any interest or dividends paid to you. Copies of these information returns may be made available to the tax authorities of the country in which you are a resident under the provisions of a specific treaty or agreement.

Any amounts withheld under the backup withholding rules will be allowed as a refund or a credit against your U.S. federal income tax liability provided the required information is furnished timely to the IRS.

**Table of Contents****SELLING HOLDERS**

Information about the selling holders may change over time. Any changed information will be set forth in a prospectus supplement to the extent we are advised of such changes. From time to time, additional information concerning ownership of the notes may rest with certain holders thereof not named in the table below and of whom we are unaware.

The following table and accompanying notes set forth certain information, as of January 19, 2004, regarding the selling holders. Under this prospectus, the selling holders and any of their respective transferees, assignees, donees, distributees, pledgees, or other successors-in-interest may offer and sell from time to time an aggregate of 11,586,438 (including 11,303,842 shares subject to issuance upon the exercise of our warrants) shares of our common stock and an aggregate of \$72,293,780 in principal amount of the 2008 notes. The securities listed below are being registered to permit public sales of these securities by the selling holders, and the selling holders may offer all, some or none of their securities.

The number of shares of common stock that may be actually purchased by certain selling holders under the warrants and the number of shares of common stock and our notes that may be actually sold by each selling holder will be determined by such selling holder. Because certain selling holders may purchase all, some or none of the shares of common stock which can be purchased under the warrants and each selling holder may sell all, some or none of the shares of common stock or our notes which each holds, and because the offering contemplated by this prospectus is not currently being underwritten, no estimate can be given as to the number of shares of common stock or our notes that will be held by the selling holders upon termination of the offering. In addition, the selling holders listed below may have acquired, sold or transferred, in transactions exempt from the registration requirements of the Securities Act, some or all of their shares of common stock or notes since the date as of which the information in the tables is presented.

**Common Stock**

The following table sets forth information regarding the beneficial ownership of shares of common stock by the selling holders as of the date of this prospectus, and the number of shares of common stock covered by this prospectus. Except as otherwise noted below, none of the selling holders has held any position or office, or has had any other material relationship with us or any of our affiliates within the past three years. Except as otherwise indicated, each person listed in the table below has informed us that it has (1) voting and investment power with respect to its shares of our common stock and (2) record and beneficial ownership with respect to its shares of our common stock.

The information set forth in the following table regarding the beneficial ownership after resale of shares is based on the assumption that each selling holder will purchase the maximum number of shares of common stock provided for by the warrants owned by the selling holder and each selling holder will sell all of the shares of common stock owned by the selling holder and covered by the prospectus. If all of the shares of our common stock listed below are sold pursuant to this prospectus, then the selling holders will sell 11,586,438 shares of our common stock, or 29.5% of the total number of shares of our common stock outstanding.

Name and Address of Beneficial Owner	Number of	Beneficial Ownership		Beneficial Ownership	
		Prior to the Offering		After the Offering	
		Percent	Number of Shares of Common Stock Offered by	Number of Shares of	Percent

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	<u>Shares of Common Stock</u>	<u>_____</u>	<u>this Prospectus <sup>(1)</sup></u>	<u>Common Stock</u>	<u>_____</u>
Mackay Shields	6,669,637	19.8%	5,930,537	739,100	2.2%
9 W. 57 <sup>th</sup> Street					
New York, NY 10019					
Century National Insurance Company	361,405	1.3%	361,405	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					

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National Union Fire Insurance Company of Pittsburgh, PA	1,042,819	3.6%	1,042,819	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					
Gene T. Pretti	7,960	*	7,960	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					
Qwest Occupational Health Trust	36,618	*	36,618	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					
Qwest Pension Trust	206,972	*	206,972	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					
San Diego County Employees Retirement Association	87,565	*	87,565	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					
StarVest Convertible Securities Fund, Ltd.	31,842	*	31,842	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					
Zazove Aggressive Growth Fund, L.P.	189,209	*	189,209	0	0%
c/o Zazove Associates, LLC					
1 Maritime Plaza					
San Francisco, CA 94111					
Zazove High Yield Convertible Securities Fund, L.P.	195,328	*	195,328	0	0%
c/o Zazove Associates, LLC					

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1 Maritime Plaza

San Francisco, CA 94111

Allianz Insurance Company	72,440	*	72,440	0	0%
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c/o Allianz of America, Inc.

55 Greens Farms Road

P.O. Box 5160

Westport, CT 06881-5160

Allianz Life Insurance Company	949,682	3.3%	949,682	0	0%
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c/o Allianz of America, Inc.

55 Greens Farms Road

P.O. Box 5160

Westport, CT 06881-5160

Allianz Underwriters Insurance Company	18,309	*	18,309	0	0%
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c/o Allianz of America, Inc.

55 Greens Farms Road

P.O. Box 5160

Westport, CT 06881-5160

Fireman s Fund Insurance Company	833,459	2.9%	833,459	0	0%
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c/o Allianz of America, Inc.

55 Greens Farms Road

P.O. Box 5160

Westport, CT 06881-5160

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Jefferson Insurance Company of New York	29,454	*	29,454	0	0%
c/o Allianz of America, Inc.					
55 Greens Farms Road					
P.O. Box 5160					
Westport, CT 06881-5160					
Monticello Insurance Company	7,165	*	7,165	0	0%
c/o Allianz of America, Inc.					
55 Greens Farms Road					
P.O. Box 5160					
Westport, CT 06881-5160					
Mellon HBV Master Multi-Strategy Fund	144,407	*	144,407	0	0%
c/o Mellon HBV Alternative Strategies					
200 Park Avenue					
Suite 3300					
New York, NY 10166-3399					
Mellon HBV Special Situations Fund	104,604	*	104,604	0	0%
c/o Mellon HBV Alternative Strategies					
200 Park Avenue					
Suite 3300					
New York, NY 10166-3399					
Lampe Conway & Co. LLC	517,429	1.8%	517,429	0	0%
730 Fifth Avenue					
Suite 2102					
New York, NY 10019					
Triage Capital Management, LP	247,067	*	125,377	121,690	*
c/o Triage Management LLC					
401 City Avenue, Suite 526					
Bala Cynwyd, PA 19004					
Triage Offshore Fund Ltd.	439,770	1.6%	179,110	260,660	*
c/o Triage Management LLC					

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401 City Avenue, Suite 526					
Bala Cynwyd, PA 19004					
OTA, LLC	94,383	*	53,733	40,650	*
One Manhattanville Rd.					
Purchase, NY 10577					
Lonestar Partners, L.P.	318,418	1.1%	318,418	0	0%
8 Greenway Plaza, Suite 800					
Houston, TX 77046					
Philadelphia Brokerage Corporation	682	*	682	0	0%
992 Old Eagle School Road, Ste. 915					
Wayne, PA 19087					
Robert Jacobs	45,922	*	45,922	0	0%
c/o Philadelphia Brokerage Corporation					
992 Old Eagle School Road, Ste. 915					
Wayne, PA 19087					
Mark Zimmer	45,992	*	45,992	0	0%
c/o Philadelphia Brokerage Corporation					
992 Old Eagle School Road, Ste. 915					
Wayne, PA 19087					
Robert Fisk	50,000	*	50,000	0	0%
c/o Philadelphia Brokerage Corporation					
992 Old Eagle School Road, Ste. 915					
Wayne, PA 19087					
<b>TOTAL</b>	12,748,538	32.4%	11,586,438	1,162,100	3.0%

\* Less than 1%

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- (1) Other than 282,596 total shares of unregistered common stock resulting from the exercise of warrants, this number of shares represents warrants to purchase shares of our common stock. The unregistered common stock is owned as follows: Zazove Aggressive Growth Fund 30,000; Zazove High Yield Convertible Securities 60,000; Mellon HBV Master Multi-Strategy Fund 25,000; Mellon HBV Special Situations Fund 25,000; Philadelphia Brokerage Corporation 682; Robert Jacobs 45,922; Mark Zimmer 45,992; Robert Fisk 50,000. Messrs. Jacobs, Zimmer and Fisk are employees of Philadelphia Brokerage Corp.

**The Notes**

The selling holders may from time to time offer and sell pursuant to this prospectus any and all of the 2008 notes listed below. When we refer to the selling holders in this prospectus, we mean those persons listed in the table below, as well as the permitted assignees, pledges, donees, transferees, successors and others who later hold any of the selling holders' notes.

The table below sets forth the name and address of each selling holder and the principal amount at maturity of notes as of January 19, 2004 that each selling holder may offer pursuant to this prospectus. Unless set forth below, none of the selling holders has or, within the past three years has had, any material relationship with us or any of our affiliates. The information set forth in the table below regarding the beneficial ownership after resale of 2008 notes is based on the assumption that each selling holder will sell all of the 2008 notes owned by the selling holder and covered by the prospectus.

Name and Address of Beneficial Owner	Beneficial Ownership		Beneficial Ownership	
	Prior to the Offering		After the Offering	
	Aggregate Principal Amount of Notes	Aggregate Principal Amount of Notes Offered by this Prospectus	Aggregate Principal Amount of Notes	Percent
Mackay Shields	\$ 38,417,522	\$ 38,417,522	\$ 0	0%
9 W. 57 <sup>th</sup> Street				
New York, NY 10019				
Century National Insurance Company	\$ 2,311,364	\$ 2,311,364	\$ 0	0%
c/o Zazove Associates, LLC				
1 Maritime Plaza				
San Francisco, CA 94111				
National Union Fire Insurance Company of Pittsburgh, PA	\$ 6,669,356	\$ 6,669,356	\$ 0	0%
c/o Zazove Associates, LLC				
1 Maritime Plaza				
San Francisco, CA 94111				
Gene T. Pretti	\$ 50,911	\$ 50,911	\$ 0	0%



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c/o Zazove Associates, LLC

1 Maritime Plaza

San Francisco, CA 94111

Qwest Occupational Health Trust	\$	234,191	\$	234,191	\$ 0	0%
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c/o Zazove Associates, LLC

1 Maritime Plaza

San Francisco, CA 94111

Qwest Pension Trust	\$	1,323,688	\$	1,323,688	\$ 0	0%
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c/o Zazove Associates, LLC

1 Maritime Plaza

San Francisco, CA 94111

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San Diego County Employees Retirement Association	\$ 2,107,720	\$ 2,107,720	\$ 0	0%
c/o Zazove Associates, LLC				
1 Maritime Plaza				
San Francisco, CA 94111				
StarVest Convertible Securities Fund, Ltd.	\$ 203,644	\$ 203,644	\$ 0	0%
c/o Zazove Associates, LLC				
1 Maritime Plaza				
San Francisco, CA 94111				
Zazove Aggressive Growth Fund, L.P.	\$ 1,018,222	\$ 1,018,222	\$ 0	0%
c/o Zazove Associates, LLC				
1 Maritime Plaza				
San Francisco, CA 94111				
Zazove High Yield Convertible Securities Fund, L.P.	\$ 865,488	\$ 865,488	\$ 0	0%
c/o Zazove Associates, LLC				
1 Maritime Plaza				
San Francisco, CA 94111				
Allianz Insurance Company	\$ 463,291	\$ 463,291	\$ 0	0%
c/o Allianz of America, Inc.				
55 Greens Farms Road				
P.O. Box 5160				
Westport, CT 06881-5160				
Allianz Life Insurance Company	\$ 6,119,516	\$ 6,119,516	\$ 0	0%
c/o Allianz of America, Inc.				
55 Greens Farms Road				
P.O. Box 5160				
Westport, CT 06881-5160				
Allianz Underwriters Insurance Company	\$ 117,096	\$ 117,096	\$ 0	0%
c/o Allianz of America, Inc.				
55 Greens Farms Road				
P.O. Box 5160				

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Westport, CT 06881-5160				
Fireman's Fund Insurance Company	\$ 5,330,393	\$ 5,330,393	\$ 0	0%

c/o Allianz of America, Inc.

55 Greens Farms Road

P.O. Box 5160

Westport, CT 06881-5160				
Jefferson Insurance Company of New York	\$ 188,371	\$ 188,371	\$ 0	0%

c/o Allianz of America, Inc.

55 Greens Farms Road

P.O. Box 5160

Westport, CT 06881-5160				
Mellon HBV Alternative Strategies	\$ 1,272,777	\$ 1,272,777	\$ 0	0%

200 Park Avenue

Suite 3300

New York, NY 10166-3399

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Lampe Conway & Co. LLC	\$ 3,309,222	\$ 3,309,222	\$ 0	0%
730 Fifth Avenue				
Suite 2102				
New York, NY 10019				
Triage Capital Management, LP	\$ 801,850	\$ 801,850	\$ 0	0%
C/o Triage Management LLC				
401 City Avenue, Suite 526				
Bala Cynwyd, PA 19004				
Triage Offshore Fund Ltd.	\$ 1,145,499	\$ 1,145,499	\$ 0	0%
C/o Triage Management LLC				
401 City Avenue, Suite 526				
Bala Cynwyd, PA 19004				
OTA, LLC	\$ 343,650	\$ 343,650	\$ 0	0%
One Manhattanville Rd.				
Purchase, NY 10577				

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**PLAN OF DISTRIBUTION**

We are registering a total of (1) 11,586,438 shares of our common stock, of which 282,596 shares are issued and outstanding and 11,303,842 shares are issuable upon the exercise of warrants, and (2) the 2008 notes for resale by the selling holders. We will not receive any of the proceeds from the sale by the selling holders of the shares of common stock or the notes, although we may receive up to approximately \$116,000 upon exercise of all of the warrants by the selling holders. A selling holder is a person named in the section of this prospectus entitled "Selling Holders" and also includes any donee, pledgee, transferee, or other successor-in-interest selling shares of our common stock or notes received after the date of this prospectus from a selling holder as a gift, pledge, partnership distribution, or other non-sale related transfer.

We will bear all costs, fees and expenses in connection to our obligation to register the shares of common stock and 2008 notes offered by this prospectus. If the shares of common stock or notes are sold through broker-dealers or agents, the selling holders will be responsible for any compensation to such broker-dealers or agents.

The selling holders may pledge or grant a security interest in some or all of the shares of common stock or notes owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock or notes from time to time pursuant to this prospectus. The selling holders also may transfer and donate the shares of common stock or notes in other circumstances in which case the transferees, donees, pledgees or other successors-in-interest will be the selling beneficial owners for purpose of this prospectus.

The selling holders will sell their shares of common stock and 2008 notes subject to the following:

all or a portion of the shares of common stock or notes beneficially owned by selling holders or their respective pledgees, donees, transferees or successors-in-interest, may be sold on the OTC Bulletin Board, any national securities exchange or quotation service on which the shares of common stock may be listed or quoted at the time of sale, in the over-the counter market, in privately negotiated transactions, through the writing of options, whether such options are listed on an options exchange or otherwise, short sales or in combination of such transactions;

each sale may be made at market prices prevailing at the time of such sale, at negotiated prices, at fixed prices, or at varying prices determined at the time of sale; and

some or all of the shares of common stock or notes may be sold through one or more broker-dealers or agents and may involve crosses, block transactions in which the broker-dealer will attempt to sell shares and notes as agent but may position and resell a portion of the block as principal to facilitate the transaction, or hedging transactions. The selling holders may enter into hedging transactions with broker-dealers or agents, which may in turn engage in short sales of common stock in the course of hedging in positions they assume. The selling holders may also sell shares of common stock short and deliver shares of common stock to close out short positions, or loan pledge shares of common stock to broker-dealers or agents that in turn may sell such shares.

In connection with such sales through one or more broker-dealers or agents, such broker-dealers or agents may receive compensation in the form of discounts, concessions or commissions from the selling holders and receive commissions from the purchasers of the shares of common stock or notes for whom they act as broker-agent or to whom they sell as principal (which discounts, concessions or commissions as to particular broker-dealers or agents may be excess of those customary in the types of transactions involved). Any broker-dealer or agent participating in any such sale may be deemed to be an "underwriter" within the meaning of the Securities Act of 1933, as amended, and will be required to deliver a copy of this prospectus to any person who purchases any shares of common stock or notes from or through such broker-dealer or agent. We

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know of no existing arrangements between stockholders and any other stockholder, broker, dealer, underwriter or agent relating to the sale or distribution of the shares of common stock.

The selling holders and any broker-dealer participating in the distribution of the shares of common stock or notes may be deemed to be underwriters within the meaning of the Securities Act of 1933, as amended, and any profits realized by the selling holder, and commissions paid, or any discounts or concessions allowed to any broker-

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dealer may be deemed to be underwriting commissions or discounts under the Securities Act of 1933. In addition, any shares of common stock or notes covered by this prospectus which qualify for sale pursuant to Rule 144 may be sold under Rule 144 rather than pursuant to this prospectus.

If required at the time a particular offering of the shares of common stock or notes is made, a prospectus supplement or, if appropriate, a post-effective amendment to the registration statement of which this prospectus is a part, will be distributed which will set forth the aggregate amount of shares of common stock and notes being offered and the terms of the offering, including the name or names of any broker-dealers or agents, any discounts, commissions and other terms constituting compensation from the selling holder and any discounts, commissions or concessions allowed or reallocated or paid to broker-dealers.

Under the securities laws of some states, the shares of common stock or notes may be sold in such states only through registered or licensed brokers or dealers. In addition, in some states the shares of common stock or notes may not be sold unless such shares have been registered or qualified for sale in such state or an exemption from registration or qualification is available and is complied with. There can be no assurance that any selling holder will sell any or all of the shares of common stock or notes registered pursuant to the registration statement of which this prospectus forms a part.

The selling holders and any other person participating in such distribution will be subject to applicable provisions of the Securities Exchange Act of 1934, as amended, and the rules and regulations thereunder, including, without limitation, Regulation M of the Exchange Act, which may limit the timing of purchases and sales of any of the shares of common stock by the selling holders and participating person. Regulation M may also restrict the ability of any person engaged in the distribution of the shares of common stock to engage in market-making activities with respect to the shares of common stock. All of the foregoing may affect the marketability of the shares of common stock and the ability of any person or entity to engage in market-making activities with respect to the shares of common stock.

We will bear all expenses of the registration of the shares of common stock and notes, pursuant to the terms of the registration rights agreement entered into with the selling holders, including, without limitation, Securities and Exchange Commission and selling commissions and expenses of compliance with state securities or blue sky laws.

The selling holders will pay all underwriting discounts and selling commissions and expenses, brokerage fees and transfer taxes. We will indemnify the selling holders against liabilities, including some liabilities under the Securities Act of 1933, in accordance with the registration rights agreement or the selling holders will be entitled to contribution. We will be indemnified by the selling holders against civil liabilities, including liabilities under the Securities Act of 1933, that may arise from any written information furnished to us by the selling holders for use in this prospectus, in accordance with the registration rights agreement or will be entitled to contribution. Once sold under this registration statement, of which this prospectus forms a part, the shares of common stock and notes will be freely tradable in the hands of persons other than affiliates.

## **LEGAL MATTERS**

The validity of the shares of our common stock and the notes that may be sold using this prospectus will be passed upon for us by Miles & Stockbridge P.C., McLean, Virginia.

**EXPERTS**

The consolidated financial statements of QuadraMed Corporation included in this prospectus and the related financial statement schedule included elsewhere in this registration statement have been audited by BDO Seidman, LLP to the extent and for the year indicated in their reports thereon. Such consolidated financial statements, and the related financial statement schedule, have been included in this prospectus and registration statement in reliance upon the reports of BDO Seidman, LLP and upon the authority of such firm as experts in auditing and accounting.



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The consolidated financial statements of QuadraMed Corporation included in this prospectus and the related financial statement schedule included elsewhere in this registration statement have been audited by Pimenti & Brinker LLP to the extent and for the year indicated in their report thereon. Such consolidated financial statements, and the related financial statement schedule, have been included in this prospectus and registration statement in reliance upon the report of Pimenti & Brinker LLP and upon the authority of such firm as experts in auditing and accounting.

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**REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

To the Board of Directors and Stockholders of QuadraMed Corporation:

We have audited the accompanying consolidated balance sheet of QuadraMed Corporation (a Delaware corporation) and its subsidiaries as of December 31, 2002, and the related consolidated statements of operations, changes in stockholders' equity (deficit) and comprehensive income (loss), and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides 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 QuadraMed Corporation and its subsidiaries as of December 31, 2002, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 2 to the consolidated financial statements, in fiscal 2002 the Company changed its method for accounting for reimbursable out of pocket expenses to conform with Emerging Issues Task Force Issue No. 01-14, *Income Statement Characterization of Reimbursements Received for Out of Pocket Expenses Incurred*.

As discussed in note 3 to the consolidated financial statements, in fiscal 2002 the Company changed its method for accounting for goodwill and other intangible assets to conform to Statement of Financial Standards No. 142, *Goodwill and Other Intangible Assets*.

/s/ BDO Seidman, LLP

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BDO Seidman, LLP

San Jose, California

August 1, 2003

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**REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS**

To the Board of Directors and Stockholders of QuadraMed Corporation:

We have audited the accompanying consolidated balance sheets of QuadraMed Corporation and its subsidiaries (the Company) as of December 31, 2001, and the related consolidated statements of operations, changes in stockholders' equity (deficit) and comprehensive income (loss), and cash flows for each of the years in the two-year period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 Company's financial position as of December 31, 2001, and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedule listed in Item 15(a)2 is presented for purposes of complying with the Securities and Exchange Commission's rules and is not part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in our audits of the basic financial statements and, in our opinion, fairly states in all material respects the financial data required to be set forth therein in relation to the basic financial statements taken as a whole.

/s/ Pisenti & Brinker LLP

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PISENTI & BRINKER LLP

Petaluma, California

March 28, 2003 (May 15, 2003 as to the first paragraph of note 25)

**Table of Contents****QUADRAMED CORPORATION****CONSOLIDATED BALANCE SHEETS**

(in thousands)

	December 31,	
	2002	2001
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 23,663	\$ 29,799
Short-term investments	2,528	2,414
Accounts receivable, net of allowance for doubtful accounts of \$4,346 and \$4,239, respectively	31,612	33,165
Unbilled receivables	3,475	3,825
Notes and other receivables	4,416	282
Prepaid expenses and other current assets	8,972	7,285
<b>Total current assets</b>	<b>74,666</b>	<b>76,770</b>
Restricted cash	5,849	4,356
Property and equipment, net of accumulated depreciation and amortization of \$16,170 and \$12,634, respectively	6,019	7,323
Capitalized software development costs, net of accumulated amortization of \$7,776 and \$6,511 respectively	5,670	6,214
Goodwill	18,445	14,721
Other intangible assets, net of accumulated amortization of \$13,316 and \$10,784, respectively	9,275	8,634
Other long-term assets	7,003	7,115
<b>Total assets</b>	<b>\$ 126,927</b>	<b>\$ 125,133</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
<b>Current liabilities</b>		
Accounts payable and accrued expenses	\$ 3,586	\$ 893
Accrued payroll and related	6,942	6,402
Other accrued liabilities	6,509	6,245
Deferred revenue	39,492	30,721
<b>Total current liabilities</b>	<b>56,529</b>	<b>44,261</b>
Convertible subordinated debentures	73,719	73,719
Other long-term liabilities	3,914	2,932
<b>Total liabilities</b>	<b>134,162</b>	<b>120,912</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' equity (deficit)</b>		
Preferred stock, \$0.01 par, 5,000 shares authorized, no shares issued and outstanding		
Common stock, \$0.01 par, 50,000 shares authorized, 26,965 and 26,493 shares issued and outstanding, respectively	205	201

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Additional paid-in-capital	275,631	273,384
Deferred compensation	(588)	(1,085)
Accumulated other comprehensive loss	(310)	(468)
Accumulated deficit	(282,173)	(267,811)
	<u>          </u>	<u>          </u>
<b>Total stockholders' equity (deficit)</b>	<b>(7,235)</b>	<b>4,221</b>
	<u>          </u>	<u>          </u>
<b>Total liabilities and stockholders' equity (deficit)</b>	<b>\$ 126,927</b>	<b>\$ 125,133</b>
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these consolidated financial statements.

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**Table of Contents****QUADRAMED CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

	Year ended December 31,		
	2002	2001	2000
<b>Revenue</b>			
Services	\$ 76,804	\$ 82,477	\$ 92,399
Licenses	32,781	34,569	28,613
<b>Total revenue</b>	<b>109,585</b>	<b>117,046</b>	<b>121,012</b>
<b>Cost of revenue</b>			
Cost of services	36,098	34,104	54,846
Cost of licenses	9,130	8,673	7,118
<b>Total cost of revenue</b>	<b>45,228</b>	<b>42,777</b>	<b>61,964</b>
<b>Gross margin</b>	<b>64,357</b>	<b>74,269</b>	<b>59,048</b>
<b>Operating expenses</b>			
General and administration	41,149	35,707	57,036
Sales and marketing	21,551	20,710	23,767
Research and development	17,154	14,371	24,573
Amortization, impairment and other operating charges	3,108	9,069	11,137
<b>Total operating expenses</b>	<b>82,962</b>	<b>79,857</b>	<b>116,513</b>
<b>Loss from operations</b>	<b>(18,605)</b>	<b>(5,588)</b>	<b>(57,465)</b>
<b>Other income (expense)</b>			
Interest expense	(3,461)	(4,741)	(6,504)
Interest income	696	2,034	2,139
Gain on sale of assets	1,500	7,088	27,196
Other income (expense), net	(988)	402	(4,103)
<b>Other income (expense)</b>	<b>(2,253)</b>	<b>4,783</b>	<b>18,728</b>
<b>Loss from continuing operations before income taxes and extraordinary item</b>	<b>(20,858)</b>	<b>(805)</b>	<b>(38,737)</b>
Provision for income taxes		(150)	(617)
<b>Loss from continuing operations before extraordinary item</b>	<b>(20,858)</b>	<b>(955)</b>	<b>(39,354)</b>
Gain on redemption of debentures		12,907	
<b>Income (loss) from continuing operations</b>	<b>(20,858)</b>	<b>11,952</b>	<b>(39,354)</b>

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Income (loss) from discontinued operations (net of income taxes)	(2,280)	(2,539)	2,679
Gain on disposal of discontinued operations	8,776		
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Net income (loss)</b>	<b>\$ (14,362)</b>	<b>\$ 9,413</b>	<b>\$ (36,675)</b>
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Income (loss) per share</b>			
<b>Basic</b>			
Continuing before extraordinary item and discontinued operations	\$ (0.77)	\$ (0.03)	\$ (1.53)
Extraordinary item		0.50	
	<u>          </u>	<u>          </u>	<u>          </u>
Continuing operations	(0.77)	0.47	(1.53)
Discontinued operations	0.24	(0.10)	0.10
	<u>          </u>	<u>          </u>	<u>          </u>
Net	\$ (0.53)	\$ 0.37	\$ (1.43)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Diluted</b>			
Continuing before extraordinary item and discontinued operations	\$ (0.77)	\$ (0.03)	\$ (1.53)
Extraordinary item		0.50	
	<u>          </u>	<u>          </u>	<u>          </u>
Continuing operations	(0.77)	0.47	(1.53)
Discontinued operations	0.24	(0.10)	0.10
	<u>          </u>	<u>          </u>	<u>          </u>
Net	\$ (0.53)	\$ 0.37	\$ (1.43)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Weighted average shares outstanding</b>			
Basic	26,915	25,566	25,623
	<u>          </u>	<u>          </u>	<u>          </u>
Diluted	26,915	25,566	25,623
	<u>          </u>	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these consolidated financial statements



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## QUADRAMED CORPORATION

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)  
AND COMPREHENSIVE INCOME (LOSS)**

(in thousands)

	<u>Common Stock</u>		<u>Additional</u>		<u>Accumulated</u>		<u>Total</u>	<u>Other</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in Capital</u>	<u>Deferred Compensation</u>	<u>Other Comprehensive Income (Loss)</u>	<u>Accumulated Deficit</u>	<u>Stockholders Equity (Deficit)</u>	<u>Comprehensive Income (Loss)</u>
<b>December 31, 1999</b>	<b>25,319</b>	<b>\$ 187</b>	<b>\$ 270,691</b>	<b>\$ (2,530)</b>	<b>\$ (287)</b>	<b>\$ (240,549)</b>	<b>\$ 27,512</b>	<b>\$ (47,518)</b>
Issuance of common stock through Employee Stock Purchase Plan	58		488				488	
Amortization of restricted shares of common stock				154			154	
Accelerated vesting of restricted shares				1,878			1,878	
Cancellation of restricted shares			(498)	498				
Issuance of common stock for legal expenses	79	1	78				79	
Exercise of common stock options	299	3	438				441	
Unrecognized pension costs					(1,364)		(1,364)	(1,364)
Net unrealized gain on available-for-sale securities					321		321	321
Net loss						(36,675)	(36,675)	(36,675)
<b>December 31, 2000</b>	<b>25,755</b>	<b>191</b>	<b>271,197</b>		<b>(1,330)</b>	<b>(277,224)</b>	<b>(7,166)</b>	<b>(37,718)</b>
Issuance of restricted shares of common stock	475	5	1,262	(1,267)				
Amortization of restricted shares of common stock				205			205	
Issuance of common stock options to non-employees and consultants			64	(64)				
Amortization of common stock options of non-employees and consultants				41			41	
	60	1	105				106	

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Exercise of common stock of non-employees and consultants								
Compensation related to issuance of common stock	187	2	887				889	
Exercise of common stock options	216	2	691				693	
Purchase of treasury stock	(200)		(822)				(822)	
Unrecognized pension costs				834			834	834
Net unrealized gain on available-for-sale securities				28			28	28
Net income						9,413	9,413	9,413
<b>December 31, 2001</b>	<b>26,493</b>	<b>201</b>	<b>273,384</b>	<b>(1,085)</b>	<b>(468)</b>	<b>(267,811)</b>	<b>4,221</b>	<b>10,275</b>
Issuance of restricted shares of common stock	39		348	(348)				
Amortization of restricted shares of common stock				812			812	
Amortization of common stock options of non-employees and consultants				33			33	
Exercise of common stock options	433	4	1,899				1,903	
Unrecognized pension costs					137		137	137
Net unrealized gain on available-for-sale securities					21		21	21
Net loss						(14,362)	(14,362)	(14,362)
<b>December 31, 2002</b>	<b>26,965</b>	<b>\$ 205</b>	<b>\$ 275,631</b>	<b>\$ (588)</b>	<b>\$ (310)</b>	<b>\$ (282,173)</b>	<b>\$ (7,235)</b>	<b>\$ (14,204)</b>

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****QUADRAMED CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

	Year ended December 31,		
	2002	2001	2000
<b>Cash flows from operating activities</b>			
Net income (loss) from continuing operations	\$ (20,858)	\$ 11,952	\$ (39,354)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	9,890	11,580	14,783
Provisions for bad debts	1,403	2,090	7,234
Write-off of assets	939	3,813	5,522
Impairments of intangible assets			1,308
Gain on redemption debentures		(12,907)	
Gain on sale of assets	(1,500)	(7,088)	(27,196)
Non-cash settlement of litigation			79
Other	28	771	776
Changes in assets and liabilities:			
Accounts receivable	1,002	(3,753)	11,134
Prepaid expenses and other	(1,434)	1,105	7,624
Accounts payable and accrued liabilities	3,784	(820)	(12,858)
Deferred revenue	8,039	8,808	(2,715)
Cash provided by (used in) continuing operations	1,293	15,551	(33,663)
Cash (used in) provided by discontinued operations	(2,275)	(1,707)	3,388
Cash (used in) provided by operating activities	(982)	13,844	(30,275)
<b>Cash flows from investing activities</b>			
Increase (decrease) in restricted cash	(38)	1,259	(6,959)
Sales of available-for-sale securities, net	10	12,219	18,278
Sale of assets	9,800	8,124	38,449
Acquisitions of businesses, net of cash acquired	(11,930)		
Purchases of equipment	(2,607)	(2,743)	(3,109)
Capitalized software development costs	(1,837)	(1,762)	(527)
Cash (used in) provided by investing activities	(6,602)	17,097	46,132
<b>Cash flows from financing activities</b>			
Repayments of debt	(455)	(28,489)	(945)
Purchase of treasury shares		(821)	
Proceeds from issuance of common stock	1,903	800	927
Cash provided by (used in) financing activities	1,448	(28,510)	(18)
Net (decrease) increase in cash and cash equivalents	(6,136)	2,431	15,839

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<b>Cash and cash equivalents</b> , beginning of period	29,799	27,368	11,529
<b>Cash and cash equivalents</b> , end of period	<u>\$ 23,663</u>	<u>\$ 29,799</u>	<u>\$ 27,368</u>
<b>Supplemental disclosure of cash flow information</b>			
Cash paid for interest	\$ 3,874	\$ 5,690	\$ 6,072
Cash paid for taxes	207	394	418
<b>Supplemental disclosure of non-cash investing and financing transactions</b>			
Issuances (cancellations) of restricted common stock	\$ 348	\$	\$ (498)
Issuances of common stock options to non-employees and consultants		1,267	
Release of restricted cash into short-term investments		2,380	

The accompanying notes are an integral part of these consolidated financial statements.

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2002**

**1. NATURE OF OPERATIONS**

QuadraMed Corporation along with all significant business divisions and subsidiaries, (the Company or QuadraMed ) is dedicated to improving healthcare delivery by providing innovative healthcare information technology and services. From clinical to patient information management and revenue cycle to health information management, QuadraMed delivers real-world solutions that help healthcare professionals deliver outstanding patient care with optimum efficiency. QuadraMed was reincorporated in Delaware in 1996, having been originally incorporated in California in 1993. QuadraMed is managed in three distinct business segments which are as follows: Enterprise Division, Health Information Management Software Division and Financial Services Division.

**2. QUADRAMED CORPORATION AND BASIS OF PRESENTATION**

**Principles of Consolidation**

These consolidated financial statements, which include the accounts of QuadraMed and all significant business divisions and subsidiaries, have been prepared in conformity with (i) accounting principles generally accepted ( GAAP ) in the United States; and (ii) the rules and regulations of the U.S. Securities and Exchange Commission ( SEC ). All significant intercompany accounts and transactions between QuadraMed and its subsidiaries are eliminated in consolidation.

**Use of Estimates in Preparation of Financial Statements**

We make estimates, assumptions, and judgments that affect the reported amounts of assets and liabilities, contingent assets and liabilities, revenues, and expenses. Significant estimates and assumptions have been made regarding revenue recognition, the allowance for doubtful account, investments, capitalized software, income taxes, restructuring, pensions and other benefits, and contingencies and litigation and intangibles, primarily goodwill and customer lists, resulting from our purchase business combinations. We base our estimates, assumptions, and judgments on historical experience and on various other assumptions believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Uncertainties inherent in these estimates include projections of future operating results and the discount rates used to determine the net present values of these future results and useful lives of the acquired assets as well as technological advances. In addition, for our fixed-price contracts, we make significant estimates within percentage-of-completion accounting, including estimating total costs to be incurred as calculated on a labor hour basis. We periodically review and test our estimates, specifically those related to the valuations of intangibles including acquired software, goodwill, customer lists, trademarks and other intangibles, and capitalized software. Actual results may differ materially from these estimates.



**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002****Reclassifications***Adoption of EITF No. 01-14*

Certain reclassifications have been made to the 2001 and 2000 consolidated financial statements to conform to the 2002 presentation. Specifically, the 2001 and 2000 financial statements have been reclassified to comply with Financial Accounting Standards Board ( FASB ) Emerging Issues Task Force ( EITF ) No. 01-14, *Income Statement Characterization of Reimbursements for Out-of-Pocket Expenses Incurred*. As such, QuadraMed has reclassified prior year amounts to include billable out-of-pocket reimbursable expenses in both license and service revenues and cost of licenses and services, respectively. The adoption of EITF No. 01-14 does not impact either income (loss) from operations or net income (loss) but does increase revenue and cost of revenues and reduces gross margin percentages as shown in the following tables:

	Year ended			Year ended		
	December 31, 2001			December 31, 2000		
	Services	Licenses	Total	Services	Licenses	Total
<b>Revenue</b>						
Reported revenue	\$ 82,477	\$ 34,569	\$ 117,046	\$ 92,399	\$ 28,613	\$ 121,012
Less impact of EITF No. 01-14	3,454	933	4,387	3,144	993	4,137
<b>Pro-forma revenue</b>	<b>\$ 79,023</b>	<b>\$ 33,636</b>	<b>\$ 112,659</b>	<b>\$ 89,255</b>	<b>\$ 27,620</b>	<b>\$ 116,875</b>
<b>Cost of revenue</b>						
Reported cost of revenue	\$ 34,104	\$ 8,673	\$ 42,777	\$ 54,846	\$ 7,118	\$ 61,964
Less impact of EITF No. 01-14	3,454	933	4,387	3,144	993	4,137
<b>Pro-forma cost of revenue</b>	<b>\$ 30,650</b>	<b>\$ 7,740</b>	<b>\$ 38,390</b>	<b>\$ 51,702</b>	<b>\$ 6,125</b>	<b>\$ 57,827</b>
<b>Gross margin percentage</b>						
Reported gross margin percentage	58.7%	74.9%	63.5%	40.6%	75.1%	48.8%
Impact of EITF No. 01-14	2.5	2.1	2.4	1.5	2.7	1.7
<b>Pro-forma gross margin percentage</b>	<b>61.2%</b>	<b>77.0%</b>	<b>65.9%</b>	<b>42.1%</b>	<b>77.8%</b>	<b>50.5%</b>

*Change in Classification of Certain Service and License Revenue and Related Costs*

In previously reported periods, the Company's license revenue and associated cost of license revenue included in the Statement of Operations consisted of fees for the licensing of the Company's software products, hardware, maintenance, hosted services, customer training and consulting services. In the accompanying Consolidated Statements of Operations, license revenue and cost of license revenue for both 2001 and 2000 have been reclassified to include only fees and costs, respectively associated with the licensing of the Company's software products. The table below presents the impact of the reclassification of licenses and services for the years ended December 31, 2001 and 2000 (in thousands):

	Year ended		Year ended	
	December 31,		December 31,	
	2001	2001	2000	2000
		(Reclassified)		(Reclassified)
<b>Revenue</b>				
Services	\$ 26,772	\$ 82,477	\$ 49,665	\$ 92,399
Licenses	90,274	34,569	71,347	28,613
	<u>\$ 117,046</u>	<u>\$ 117,046</u>	<u>\$ 121,012</u>	<u>\$ 121,012</u>
<b>Cost of revenue</b>				
Services	\$ 19,295	\$ 34,104	\$ 34,943	\$ 54,846
Licenses	23,482	8,673	27,021	7,118
	<u>\$ 42,777</u>	<u>\$ 42,777</u>	<u>\$ 61,964</u>	<u>\$ 61,964</u>

#### Restatement

In 2002, management of QuadraMed discovered accounting and reporting errors within its Quarterly Report on Form 10-Q as filed for the three months ended March 31, 2002 and its Annual Report on Form 10-K as filed for the years ended December 31, 2001, 2000 and 1999. These errors resulted in management determining that the reports for these years needed to be restated. In June 2003, QuadraMed amended and restated its 2001 Annual Report on Form 10-K/A. This report is also being filed simultaneously with the restatement of our Quarterly Report on Form 10-Q/A for the three months ended March 31, 2002.



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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Revenue Recognition** - QuadraMed's revenue in the ordinary course of business is principally generated from two sources: (i) licensing arrangements and (ii) services.

The Company's license revenue consists of fees for licenses of the Company's software and hosted services. Cost of license revenue primarily includes product, delivery and royalty costs and facilities costs. The Company's services revenue consists of maintenance, customer training and consulting services and fees for providing management services such as accounts receivable and payment collection outsourcing, specialized staffing, analytical services and seminars. Cost of services consists primarily of salaries, benefits, and allocated costs related to providing such services, labor costs for engineers performing implementation services and technical support and training personnel.

QuadraMed licenses its products through its direct sales force. The Company's license agreements for such products do not provide for a right of return, and historically product returns have not been significant.

QuadraMed recognizes revenue on its software products in accordance with Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*; SOP 81-1, *Accounting for Performance of Construction-Type and Certain production-Type Contracts*; and Staff Accounting Bulletin (SAB) 101, *Revenue Recognition in Financial Statements*.

QuadraMed recognizes revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery of the product has occurred; no significant obligations by the Company with regard to implementation remain; the fee is fixed and determinable; and, collectibility is probable. Delivery is considered to have occurred when title and risk of loss have been transferred to the customer, which generally occurs when media containing the licensed programs is provided to a common carrier. The Company considers all arrangements with payment terms extending beyond 180 days to be not fixed and determinable, and revenue is recognized as payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

SOP 97-2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Revenue recognized from multiple-element arrangements is allocated to undelivered elements of the arrangement, such as maintenance, support and professional services, based on the relative fair values of the elements specific to the Company. QuadraMed's determination of fair value of each element in multi-element arrangements is based on vendor-specific objective evidence (VSOE). The Company limits its assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

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If evidence of fair value of all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue from hosted applications is recognized ratably over the term of the arrangement. The proportion of revenue recognized upon delivery may vary from quarter to quarter depending upon the relative mix of licensing arrangements and the availability of VSOE of fair value for undelivered elements.

Certain of the Company's perpetual and time-based licenses include unspecified additional products. QuadraMed recognizes revenue from perpetual and time-based licenses that include unspecified additional software products ratably over the term of the arrangement.

Contract accounting is utilized for services revenues from fixed-price contracts and those requiring significant software modification, development or customization. In such instances, the arrangement fee is accounted for in accordance with SOP 81-1, whereby the arrangement fee is recognized, generally using the percentage-of-completion method measured on labor input costs. If increases in projected costs-to-complete are sufficient to create a loss contract,

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

the entire estimated loss is charged to operations in the period the loss first becomes known. The complexity of the estimation process and judgment related to the assumptions, risks and uncertainties inherent with the application of the percentage-of-completion method of accounting affect the amounts of revenue and related expenses reported in its consolidated financial statements. A number of internal and external factors can affect its estimates, including labor rates, utilization, changes to specification and testing requirements and collectibility of unbilled receivables.

Service revenues from software maintenance and support are recognized ratably over the maintenance term, which in most cases is one year. Service revenues from training, consulting and other service elements are recognized as the services are performed.

Service revenues from providing management services such as accounts receivable and payment collection outsourcing are recognized in accordance with SAB 101. When all criteria for revenue recognition, as noted above, have been met, revenue is recognized upon invoicing. If collectibility is not considered probable, revenue is recognized when the fee is collected.

**Cash and Cash Equivalents** - Cash and cash equivalents consist of highly liquid investments that are comprised principally of taxable, short-term certificates of deposit, money market instruments and commercial paper with original maturities of three months or less at the time of purchase and demand deposits with financial institutions. These instruments carry insignificant interest rate risk because of their short-term maturities. Cash equivalents are stated at amounts that approximate fair value based on quoted market prices.

**Investments** - QuadraMed considers its holdings of short-term and long-term securities, consisting primarily of fixed income securities, to be available-for-sale securities. The difference between cost or amortized cost (cost adjusted for amortization of premiums and accretion of discounts that are recognized as adjustments to interest income) and fair value, representing unrealized holdings gains or losses, net of the related tax effect, if any, is recorded, until realized, as a separate component of stockholders' equity. Gains and losses on the sale of debt securities are determined on a specific identification basis. Realized gains and losses are included in other income (expense) in the accompanying consolidated statements of operations.

**Accounts Receivable and Allowance for Doubtful Accounts** - Accounts receivable consist primarily of amounts due to the Company from its normal business activities. The Company maintains an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified within the portfolio. If the financial condition of QuadraMed's customers were to deteriorate resulting in an impairment of their ability to make payments, or if payments from customers are significantly delayed, additional allowances might be required.

**Concentration of Credit Risk** - Accounts receivable subject QuadraMed to its highest potential concentration of credit risk. QuadraMed reserves for credit losses and does not require collateral on its trade accounts receivable. In addition, QuadraMed maintains cash, cash equivalent and investment balances in accounts at various domestic banks and one brokerage firm. QuadraMed is insured by the Federal Deposit Insurance Corporation for up to \$100,000 at each bank. Balances maintained at the brokerage firm are not insured.

**Goodwill** - In June 2001, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001. Under SFAS 142, goodwill and intangible assets deemed to have indefinite lives are to be separately disclosed on the balance sheet, and no longer amortized but subject to annual impairment tests. With the adoption of SFAS 142, QuadraMed ceased amortization of goodwill as of January 1, 2002. Prior to this point, goodwill was amortized using the straight-line method over its estimated useful life.

SFAS 142 requires that goodwill be tested for impairment at the reporting unit level (i.e., business segments) upon adoption and at least annually thereafter using a two-step impairment analysis. In accordance with SFAS 142, QuadraMed performed the first of the required two-step impairment tests of goodwill and indefinite-lived assets as of January 1, 2002. In performing the first step of this analysis, QuadraMed first assigned its assets and liabilities, including existing goodwill and other intangible assets, to its identified reporting units to determine their carrying value. For this purpose, QuadraMed's reporting units equated to its five business segments then in place. QuadraMed's reporting units equate to its business segments since this is the lowest level of QuadraMed at which operating plans are prepared and

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002**

operating profitability is measured for assessing management performance. See note 18 for more information regarding QuadraMed's business segments. Based on an analysis by an independent third party appraiser, QuadraMed then estimated the fair value of each reporting unit with significant goodwill utilizing various valuation techniques including the Income Approach and the Market Approach. The Income Approach provides an estimation of the fair value of a reporting unit based on the discounted cash flows derived from the reporting unit's estimated remaining life plus the present value of any residual value. The Market Approach indicates the fair value of a reporting unit based upon a comparison to publicly-traded companies in similar lines of business. Step one of this analysis was then completed by comparing the carrying value of each the-analyzed reporting units to its fair value. This comparison resulted in the fair values of the analyzed reporting units exceeding the carrying values of the net assets. Accordingly, no indicators of impairment existed. As a result, QuadraMed did not perform step two as described by SFAS 142.

As of January 1, 2003, QuadraMed re-engaged the same independent appraiser to review the goodwill as of this date for impairment. The result of performing step one of this analysis resulted in the fair values of the analyzed reporting units exceeding the carrying values of the net assets once again. Accordingly, step two was not performed.

The following schedule shows the Company's reported net income (loss) for periods prior to the adoption of SFAS No. 142 as adjusted to add back goodwill amortization as if SFAS No. 142 had been adopted during the periods (in thousands, except per share data):

	<b>Year ended December 31,</b>	
	<b>2001</b>	<b>2000</b>
Loss before extraordinary item	\$ (955)	\$ (39,354)
Add back: goodwill amortization	3,415	3,851
Adjusted income (loss) before extraordinary item	\$ 2,460	\$ (35,503)
Reported net income (loss)	\$ 9,413	\$ (36,675)
Add back: goodwill amortization	3,415	3,851
Adjusted net income (loss)	\$ 12,828	\$ (32,824)
Basic and diluted income (loss) per share before extraordinary item:		
Reported income (loss) before extraordinary item	\$ (0.03)	\$ (1.53)
Goodwill	0.13	0.15
Adjusted basic and diluted income (loss) per share before extraordinary item	\$ 0.10	\$ (1.38)
Basic and diluted net income (loss) per share:		
Reported net income (loss)	\$ 0.37	\$ (1.43)

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Goodwill	0.13	0.15
	<hr/>	<hr/>
Adjusted basic and diluted net income (loss) per share	\$ 0.50	\$ (1.28)
	<hr/>	<hr/>

**Capitalized Software** - Software development costs are capitalized upon the establishment of technological feasibility. In accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, QuadraMed establishes technological feasibility upon completion of a detailed program design as specified by SFAS 86 and determined on a project-by-project basis, which substantiates that the computer software product can be produced in accordance with its design specifications. Software development costs are capitalized based upon an assessment of their recoverability. This assessment requires considerable judgment by management with respect to various factors, including, but not limited to, anticipated future gross margins, estimated economic lives, and changes in software and hardware technology. Upon the general release of the product to customers, development costs for that

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**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002**

product are amortized over the greater of the ratio that current revenues bear to total and anticipated future revenues for the applicable product or the straight-line method, generally five years. These amounts are charged to cost of licenses.

**Other Intangible Assets** - Other intangible assets primarily relate to acquired software, trademarks and customer lists acquired in QuadraMed's purchase business combinations. On January 1, 2002, QuadraMed adopted the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which generally requires impairment losses to be recorded on long-lived assets (excluding goodwill) used in operations, such as property, equipment and improvements, and intangible assets, when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of the assets. The provisions of this statement did not have a significant impact on QuadraMed's financial condition or operating results.

On an annual basis, QuadraMed reviews its intangible assets for impairment based on estimated future undiscounted cash flows attributable to the assets in accordance with the recently-adopted provisions of SFAS No. 144. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their net realizable values. Amortization of other intangible assets totaled \$2.5 million, \$2.7 million and \$2.8 million for the years ended December 31, 2002, 2001 and 2000, respectively.

Other intangible assets consist of the following (in thousands):

	<b>December 31, 2002</b>		
	<b>Accumulated</b>		
	<b>Gross</b>	<b>Amortization</b>	<b>Net</b>
Customer lists	\$ 13,602	\$ (7,223)	\$ 6,379
Acquired software	6,621	(5,059)	1,562
Other <sup>(1)</sup>	2,368	(1,034)	1,334
<b>Total</b>	<b>\$ 22,591</b>	<b>\$ (13,316)</b>	<b>\$ 9,275</b>

(1) Other consists primarily of trade names and existing and core technology.

**Segments** - In 2000, QuadraMed's operations were realigned into five distinct business segments. With the sale of the EZ-CAP managed care software business in August 2001, and the sale of the Health Information Management Services Division in December 2002, QuadraMed is now managed in three distinct business segments. The segment results reflected in the consolidated financial statements have been restated to reflect the 2002 reorganization for both current and prior year data.

The 2000 realignment was undertaken to more closely arrange products targeted at shared markets, more accurately measure financial performance by product/division, and establish greater management accountability. To this end, QuadraMed further refined its operating segments during the first half of 2001 and again in the third quarter of 2001 to reflect the sale of the material components previously included in the Physician Services segment.

**Property and Equipment, net** - Property and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives, which are generally three years for computer equipment and purchased software and five years for office furnishings and equipment. Leasehold improvements are amortized over the shorter of the term of the lease or the useful life (generally 10 years). Maintenance and repair costs are expensed as incurred. QuadraMed reviews property and equipment for potential impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

**Stock Based Compensation** - SFAS 123, *Accounting for Stock Based Compensation*, encourages, but does not require, companies to record compensation cost for stock based employee compensation plans at fair value. QuadraMed has chosen to continue to account for stock based employee compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees, and Related Interpretations*. Accordingly, compensation cost for stock options granted to employees is measured as the excess, if any, of the quoted market price of QuadraMed's stock at the date of the grant over the amount an employee must pay to acquire the stock.



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## QUADRAMED CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

December 31, 2002

QuadraMed has determined pro-forma information regarding net income and earnings per share as if we had accounted for employee stock options under the fair value method as required by SFAS No. 123. The fair value of these stock-based awards to employees was estimated using the Black-Scholes option pricing model. Please see below for assumptions used in the Black-Scholes option pricing model. Had compensation cost for the Company's stock option plan and employee stock purchase plan been determined consistent with SFAS No. 123, the Company's reported net income (loss) and net earnings (loss) per share would have been changed to the amounts indicated below (in thousands except per share data):

	Year ended December 31,		
	2002	2001	2000
Net loss as reported	\$ (14,362)	\$ 9,413	\$ (36,675)
Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects	812	205	2,032
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(5,936)	(2,986)	(2,661)
Pro forma net loss	\$ (19,486)	\$ 6,632	\$ (37,304)
Earnings per share:			
Basic as reported	\$ (0.53)	\$ 0.37	\$ (1.43)
Basic pro forma	\$ (0.72)	\$ 0.26	\$ (1.46)
Diluted as reported	\$ (0.53)	\$ 0.37	\$ (1.43)
Diluted pro forma	\$ (0.72)	\$ 0.26	\$ (1.46)

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following assumptions:

	Year ended December 31,		
	2002	2001	2000
Expected dividend yield			
Expected stock price volatility	112.04%	109.60%	107.10%
Risk-free interest rate	2.74%	4.12%	6.51%
Expected life of options	5 years	5 years	5 years

**Net Loss Per Share** - Basic loss per share is determined using the weighted average number of common shares outstanding during the period. Diluted loss per share is determined using the weighted average number of common shares and common equivalent shares outstanding during the period. Common equivalent shares consist of shares issuable upon the exercise of stock options and warrants (using the treasury stock

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method) and conversion of the subordinated debentures (using the as-converted method). Common equivalent shares are excluded from the diluted computation only if their effect is anti-dilutive.

As QuadraMed recorded a net loss for each of the years ended December 31, 2002, 2001 and 2000, before extraordinary items, no common equivalent shares are included in the diluted weighted average common shares for those periods.

If the Company had reported net income, the calculation of diluted earnings per share would have included an additional 1,255,000, 957,000 and 23,000 common stock equivalent shares not included for basic earnings per share for the years ended December 31, 2002, 2001 and 2000, respectively.

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## QUADRAMED CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

December 31, 2002

**Comprehensive Income (Loss)** - Comprehensive income (loss) includes net earnings (loss) and other changes to stockholders' equity not reflected in net income (loss). The components of comprehensive income (loss) are as follows (in thousands):

	Year Ended December 31,		
	2002	2001	2000
Net Income (Loss)	\$ (14,362)	\$ 9,413	\$ (36,675)
Other Comprehensive Income (Loss)			
Unrealized gain (loss) on available-for-sale securities, net of tax effect	21	28	321
Change in unrecognized pension costs, net of tax effect	137	834	(1,364)
Other comprehensive income (loss)	158	862	(1,043)
Comprehensive income (loss)	\$ (14,204)	\$ 10,275	\$ (37,718)

Accumulated other comprehensive loss at December 31, 2002, 2001 and 2000, consists primarily of \$137,000, \$834,000 and \$1.4 million of unrecognized pension costs, respectively.

**Income Taxes** - QuadraMed accounts for income taxes using the liability method pursuant to SFAS No. 109, *Accounting for Income Taxes*. Under this method, deferred tax assets and liabilities are determined based on the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities for financial and income tax reporting purposes.

**Recent Accounting Standards** - In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. The statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The provisions of SFAS No. 143 are required to be applied starting with fiscal years beginning after June 15, 2002. QuadraMed expects that implementation of the new standard will not have a significant impact on its financial condition, results of operations, and cash flows.

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements Nos. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. This statement updates and clarifies existing pronouncements relating to the classification and reporting of gains and losses from the extinguishment of debt, the treatment of sale-leaseback transactions and also makes technical corrections to existing pronouncements. The provisions of SFAS No. 145 are required to be applied starting with fiscal years beginning after May 15, 2002. QuadraMed anticipates that implementation of this new standard will not have a significant impact on its financial condition, results of operations and cash flows however in connection with adopting this standard the Company will reclassify in the 2001 financial statements the

extraordinary gain on the redemption of the debentures to other income.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, effective for exit or disposal activities initiated after December 31, 2002. Under SFAS 146 a liability for the cost associated with an exit or disposal activity is recognized when the liability is incurred. Under prior guidance, a liability for such costs could be recognized at the date of commitment to an exit plan. SFAS 146 also requires that the liability be measured and recorded at fair value. Accordingly, the adoption of this standard may affect the timing of recognizing future restructuring costs as well as the amounts recognized. QuadraMed will adopt the provisions of SFAS 146 prospectively for all restructuring activities initiated after December 31, 2002.

In November 2002, the FASB reached a consensus on EITF No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. The guidance in EITF 00-21 is effective for revenue arrangements entered into in fiscal years beginning after June 15, 2003. This issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. Specifically, EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one earnings process and, if it does, how to divide the arrangement into separate units of accounting consistent with the identified earning processes for revenue recognition purposes. EITF 00-21 also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. The Company is evaluating the effect of this issue on its financial statements.

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

In November 2002, the FASB issued Interpretation ( FIN ) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including indirect Guarantees of Indebtedness of Others*. FIN 45 requires that QuadraMed recognizes the fair value for guarantee and indemnification arrangements issued or modified by QuadraMed after December 31, 2002, if these arrangements are within the scope of the interpretation. In addition, QuadraMed must continue to monitor the conditions that are subject to the guarantees and indemnifications, as required under previously existing generally accepted accounting principles, in order to identify if a loss has occurred. If QuadraMed determines it is probable that a loss has occurred then any such estimable loss would be recognized under those guarantees and indemnifications. Some of the software licenses granted by QuadraMed contain provisions that indemnify licensees of QuadraMed's software from damages and costs resulting from claims alleging that QuadraMed's software infringes the intellectual property rights of a third party. QuadraMed has historically received only a limited number of requests for indemnification under these provisions and has not been required to make material payments pursuant to these provisions. Accordingly, QuadraMed has not recorded a liability related to these indemnification provisions. QuadraMed will be required to implement the provisions of FIN 45 as of January 1, 2003 and does not believe that FIN 45 will have a material impact on its financial position, results of operations or cash flows.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*., SFAS 148 amends SFAS 123, to provide alternative methods of transition to the voluntary fair value method of accounting for stock-based employee compensation. SFAS 148 also amends the disclosure provisions of SFAS 123 to require that disclosure of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed in tabular format within a Company's summary of significant accounting policies. The disclosure provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002 and have been incorporated into these financial statements and accompanying footnotes.

**4. ACQUISITIONS AND DIVESTITURES**

**Acquisitions**

*Acquisition of Outstanding Shares of Pharmacy Data Systems, Inc.*

On June 11, 2002, QuadraMed acquired all of the outstanding shares of Pharmacy Data Systems, Inc. ( PDS ), a leader in advanced pharmacy, nursing, and physician information systems, for \$10.7 million, assumed liabilities of \$1,237,000 and acquisition costs of \$262,000. The consolidated financial statements include the results of operations of PDS since June 11, 2002. In connection with this acquisition, QuadraMed recorded an in-process research and development charge of \$400,000.

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002**

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition (in thousands):

<b>Assets:</b>	
Current assets	\$ 856
Property and equipment	100
Goodwill	7,893
Other intangible assets (including in-process research and development)	3,350
	<hr/>
	12,199
<b>Liabilities:</b>	
Current liabilities (including acquisition costs)	1,499
	<hr/>
Net purchase price	\$ 10,700
	<hr/>

Other intangible assets of \$3.4 million include in-process research and development, acquired technology, maintenance and other agreements and trademarks. Capitalized intangible assets are subject to amortization periods of one to five years. PDS is included within the Enterprise Segment of QuadraMed.

*Acquisition of the Assets of Cascade Health Information Software, Inc.*

On May 31, 2002, QuadraMed acquired the assets of Cascade Health Information Software, Inc., ( Cascade ) a leading provider of software for the coding and abstracting of patient medical records, which was a subsidiary of Transcend Services, Inc., for \$935,000, assumed liabilities of \$346,000 and acquisition costs of \$33,000. The purchase price was allocated \$882,000 to goodwill, \$222,000 to intangible assets (including maintenance agreements and existing technology), and \$210,000 to tangible net assets. Cascade is included within the HMS Software Segment of QuadraMed.

Pro forma results of operations for these business acquisitions have not been presented because the effects were not material to the consolidated financial statements on either an individual or aggregate basis.

**Divestitures***Sale of the Assets of HMS Services Division*

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On December 9, 2002, QuadraMed entered into an asset purchase agreement for the sale of certain assets used to conduct the HIMS Services division. On December 31, 2002, QuadraMed announced the closing of the sale of its HIM Services Division to Precyse Solutions, LLC. QuadraMed received \$14 million in cash (\$2.8 million of which was outstanding as of December 31, 2002 and paid in January 2003) and a \$300,000 promissory note with a two-year term. (\$1.5 million of the total sale price is to be held in escrow for 18 months.) QuadraMed recorded a gain of \$8.8 million in connection with the sale. Total assets sold as part of the sale included net fixed assets of approximately \$163,000 and net goodwill of approximately \$5.1 million.

The results of operation have been presented as a discontinued operation for all periods presented. The operating results were as follows (in thousands):

	Year ended December 31,		
	2002	2001	2000
Revenue	\$ 17,313	\$ 19,735	\$ 32,857
Income (loss) from operations of discontinued operation	\$ (2,280)	\$ (2,539)	\$ 2,679
Gain (loss) on disposal	8,776		
Total income (loss) on discontinued operations	\$ 6,496	\$ (2,539)	\$ 2,679

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

*Sale of EZ-CAP Assets*

On August 16, 2001, QuadraMed and its wholly-owned subsidiary, QuadraMed Operating Corporation, entered into an asset purchase agreement for the sale of certain assets and related products used to conduct the EZ-CAP managed care software business to OAO Transition, LLC, a Delaware limited liability company ( OAO Transition ), and OAO Technology Solutions, Inc., a Delaware corporation (individually and collectively OAO ). The transaction closed on August 31, 2001. QuadraMed received net proceeds from the sale of \$8.1 million and recorded a gain of \$7.1 million during 2001. In addition, as part of the agreement, QuadraMed received \$1.5 million in payments based on EZ-CAP s revenue growth and customer retention following the close of the transaction which was recorded as an additional gain on sale in October 2002. Income associated with the EZ-CAP operations for 2001 was \$1.6 million.

*Sale of Electronic Remittance Advice Product Line*

On March 31, 2001, QuadraMed sold its Electronic Remittance Advice product line. The Company recorded proceeds from the sale of \$24,000, and a loss after applicable taxes of \$57,000.

*Sale of the Assets and Liabilities of ROI Division*

Pursuant to an Asset Contribution Agreement, dated May 3, 2000, QuadraMed transferred and assigned the assets and liabilities of its ROI Division to ChartOne. Under this agreement, QuadraMed transferred \$13.9 million of assets (including \$2.7 million of cash) and the guarantee of Health+Cast s \$12.5 million line of credit to ChartOne and received \$3.0 million in cash from sales of software licenses, which has been classified as a gain on the sale of ChartOne. Subsequently, pursuant to the terms of a Securities Purchase Agreement dated May 5, 2000, on June 7, 2000, ChartOne sold 2.52 million shares of its Series A Preferred Stock, representing a 43% equity interest to the Warburg Group for \$25.2 million in cash (\$12.7 million in cash and \$12.5 million of other consideration). On October 19, 2000, QuadraMed sold its remaining 57% interest in ChartOne, represented by 2.13 million shares of series B Preferred Stock, 1.2 million shares of Series C Preferred Stock and 1 share of Common Stock, to the Warburg Group for \$26.6 million in cash, pursuant to a Securities Purchase Agreement dated September 28, 2000. QuadraMed recorded a gain of \$27.2 million for the year ended December 31, 2000 related to the ROI sale.

**5. CASH AND INVESTMENTS**

**Cash** - QuadraMed maintains cash balances in accounts at various domestic banks and one brokerage firm. QuadraMed is insured by the Federal Deposit Insurance Corporation for up to \$100,000 at each bank. Balances maintained at the brokerage firm are not insured. Cash and cash equivalents in excess of insured limits were approximately \$22.9 million as of December 31, 2002.



**Marketable Investments in Other Companies** - From 1997 to 1999, QuadraMed made a series of investments, totaling \$4.7 million, in VantageMed Corporation ( VantageMed ), a company that develops and sells software to physician groups. As of December 31, 2000, the fair market value of this investment (based upon its publicly-traded stock) was \$637,000 and, accordingly, QuadraMed recorded an other-than-temporary impairment of \$4.1 million (in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*) in the year 2000. As of December 31, 2002 and 2001, the fair value of the VantageMed investment was zero and \$575,000, respectively. QuadraMed recorded impairment charges of \$551,000 and \$86,000 during 2002 and 2001, respectively to adjust the investment to its fair value.

**Restricted Cash** - Restricted cash reflects amounts to be restricted greater than 12 months and accordingly is included in non-current assets. Restricted cash consists primarily of funds deposited in connection with lease agreements, contract guarantees and funds escrowed in connection with the sale of HIM Services. These balances were \$518,000, \$3.9 million and \$1.5 million, respectively, at December 31, 2002, and \$737,000, \$3.6 million and zero at December 31, 2001.

**Non-Marketable Investments in Other Companies** - In January 1999, QuadraMed loaned \$3.6 million to Purkinje, Inc. ( Purkinje ), a company that develops and sells software to physician groups, pursuant to the terms and conditions of a convertible secured promissory note ( Purkinje Note ), which was amended on June 7, 2001. In Third Quarter 2001, Purkinje was unable to meet its obligations under the Purkinje Note and suspended interest payments. At

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## QUADRAMED CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

December 31, 2002

that time and at Purkinje's request as full and final payment of all principal, interest, and related sums payable under the Purkinje Note, QuadraMed converted the amounts evidenced by the Purkinje Note to 5,677,560 shares of Purkinje Class A preferred shares. QuadraMed determined that the estimated fair value of the Purkinje Class A preferred stock was zero and recorded an impairment charge of \$3.6 million in Third Quarter 2001. There have been no material changes in QuadraMed's opinion of the valuation of Purkinje Class A preferred stock and it remains at a recorded value of zero as of December 31, 2002.

**Unrealized Gains (Losses) on Available-for-Sale Securities** - Cost or amortized cost, aggregate fair value, and unrealized gains (losses) by major security type are as shown in the following tables:

	Cost or Amortized Cost	Aggregate Fair Value	Unrealized Gain (Loss) on Available- for-Sale Securities
<b>As of December 31, 2002 (in thousands):</b>			
Short-term investments:			
Other short-term investments	\$ 2,528	\$ 2,528	\$
Long-term investments:			
Debt securities issued by the United States Government	\$ 706	\$ 768	\$ 62
Corporate debt securities	508	529	21
	\$ 1,214	\$ 1,297	\$ 83
VantageMed Corporation, marketable equity security	\$	\$	\$
Total unrealized gain			\$ 83
<b>As of December 31, 2001 (in thousands):</b>			
Short-term investments:			
Debt securities issued by the United States Government	\$ 34	\$ 34	
Other short-term investments	2,380	2,380	\$
	\$ 2,414	\$ 2,414	\$
Long-term investments:			
Debt securities issued by the United States Government	\$ 531	\$ 562	\$ 31
Corporate debt securities	568	575	7

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	\$ 1,099	\$ 1,137	\$ 38
VantageMed Corporation, marketable equity security	\$ 551	\$ 575	\$ 24
Total unrealized gain			\$ 62

Proceeds from the sale of available-for-sale securities were \$376,000, \$12.2 million and \$18.3 million during the years ended December 31, 2002, 2001 and 2000, respectively. Net realized gains (losses) were \$14,000, \$(14,000), and \$(61,000) during the years ended December 31, 2002, 2001 and 2000, respectively.

**Variable Life Insurance Policies** - QuadraMed has an investment interest in 3 variable life insurance policies. Each of the variable life insurance policies provides for the investment of the cash value portion into various sub-accounts that are similar in nature to mutual funds. 2 policies are issued pursuant to split-dollar agreements with the former executives, and trusts established for their benefit make the investment decisions on these policies. The third policy is a corporate-owned policy that QuadraMed contributed to a grantor or rabbi trust established to make contributions to satisfy its obligations under the Supplemental Executive Retirement Plan (SERP) and 2 other subsequently terminated benefit plans (see note 16, *Employee Benefit Plans*, for further explanation of these plans). QuadraMed makes the investment decisions on this policy only. The performance of the variable life insurance policies

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for cash value and premium amounts will vary depending on the performance of the selected underlying sub-accounts. Pursuant to FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, QuadraMed reports the amounts that could be realized under these variable life insurance contracts as an asset valued as of the statement of financial position date and treats the change in cash surrender value during the reported period as an adjustment of premiums paid in determining the expense or income to be recognized.

A reduction in the cash surrender value of the variable life insurance policies, future adverse changes in the condition of equity markets or poor operating results of the underlying policy sub-accounts could have an effect on QuadraMed's results of operations. The cash surrender values of the Split-dollar Life policies and the SERP Policy as of December 31, 2002 were each \$1.8 million and \$1.6 million, respectively, and at December 31, 2001, were each \$1.7 million.

**6. PROPERTY AND EQUIPMENT, NET**

Property and Equipment, net consisted of the following (in thousands):

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Computer equipment	\$ 10,507	\$ 9,273
Office furnishings and equipment	3,806	4,957
Purchased software	4,922	4,654
Leasehold improvements	2,954	1,073
<b>Total cost</b>	<b>22,189</b>	<b>19,957</b>
Less: Accumulated depreciation and amortization	(16,170)	(12,634)
<b>Net book value</b>	<b>\$ 6,019</b>	<b>\$ 7,323</b>

Depreciation expense was \$3.9 million, \$3.5 million, and \$4.6 million for the years ended December 31, 2002, 2001 and 2000, respectively.

**7. CAPITALIZED SOFTWARE DEVELOPMENT COSTS**

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Capitalized Software Development Costs - For the years ended December 31, 2002, 2001 and 2000, QuadraMed capitalized software development costs of \$1.8 million, \$1.8 million and \$527,000, respectively. Operating costs for research activities prior to the establishment of technological feasibility and for product upgrades to improve product performance or to respond to updated regulations and business requirements are charged to research and development expense as incurred. Such expenditures, excluding capitalized amounts were \$17.1 million, \$14.4 million and \$24.6 million in the years ended December 31, 2002, 2001 and 2000, respectively.

During 2000, QuadraMed recorded a \$1.2 million charge to write-down certain capitalized software assets primarily related to its 1998 acquisition of Integrated Medical Networks, Inc. Amortization of capitalized software development costs charged to cost of licenses was \$2.4 million, \$2.0 million and \$1.7 million for the years ended December 31, 2002, 2001 and 2000, respectively.

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**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002****8. LEASE OBLIGATIONS**

QuadraMed leases its headquarters and all other facilities and certain equipment under operating leases, some of which contain renewal and purchase options, and a nominal portion of its equipment under capital lease arrangements. Future minimum payments under operating leases with an initial term of more than one year at December 31, 2002 are as follows (in thousands):

	<b>Operating Leases</b>
2003	\$ 4,981
2004	4,392
2005	3,942
2006	3,616
2007	3,629
Thereafter	9,880
<b>Total minimum lease payments</b>	<b>\$ 30,440</b>

Rental expense was \$6.6 million, \$6.0 million, and \$7.6 million for the years ended December 31, 2002, 2001 and 2000, respectively.

**9. CONVERTIBLE SUBORDINATED DEBENTURES**

On May 1, 1998, QuadraMed issued convertible subordinated debentures through a public offering in the principal amount of \$115 million, including the underwriters' over-allotment option (the "Debentures"). QuadraMed's net proceeds from the offering were \$110.8 million. The Debentures mature on May 1, 2005 and bear interest at 5.25% per annum. The Debentures are convertible into common stock at any time prior to the redemption or final maturity, initially at the conversion price of \$33.25 per share (resulting in an initial conversion ratio of 30.075 shares per \$1,000 principal amount).

Under the terms of the indenture and related documents, QuadraMed is obligated to redeem the Debentures earlier than the May 1, 2005 maturity date upon defined Events of Default, including failure to timely repay principal or interest under the Debentures, default under any other borrowing, and bankruptcy. Further, QuadraMed is obligated to provide holders of the Debentures with notice and the holders have the individual option to redeem the Debentures should QuadraMed (i) cease to be traded on a U.S. national securities exchange or cease to be approved for trading on a U.S. automated over-the-counter securities market or (ii) experience defined Changes of Control, including a merger in which QuadraMed is not the surviving entity or its shareholders do not control at least 50% of the new entity, the sale of substantially all of QuadraMed's assets, a liquidation, or a substantial change in the board of directors over a two-year period.

In the year ended December 31, 2001, QuadraMed redeemed and cancelled \$41.3 million in principal amount of the Debentures at prices ranging between \$530.00 and \$697.50 per \$1,000 of principal amount resulting in an extraordinary gain of \$12.9 million after applicable taxes. As of December 31, 2002 and 2001, the outstanding principal amount of the Debentures was \$73.7 million with a fair value of \$63.3 million and \$59.2 million at December 31, 2002 and 2001, respectively. Additionally, as of December 31, 2002, the unamortized debt issuance costs were approximately \$900,000.

On April 16, 2003, QuadraMed announced that it had executed an agreement with certain of its bondholders to refinance \$61.8 million of its 2005 Debt. See Footnote 22, *Subsequent Events* for further details.

#### **10. STAND-BY LETTERS OF CREDIT**

During the year ended December 31, 2001 QuadraMed opened \$500,000 of stand-by letters of credit under bank financing agreements. No stand-by letters of credit were opened in 2002. QuadraMed paid a 1% annual fee to renew its existing stand-by letters of credit and secured all of the stand-by letters of credit with certificates of deposit totaling \$4.4 million recorded in the balance sheet as restricted cash at December 31, 2002 and 2001.

#### **11. STOCK REPURCHASE PROGRAM**

In June 2001, QuadraMed's board of directors approved a stock repurchase program under which QuadraMed was authorized to repurchase up to 6,000,000 shares of its common stock. QuadraMed intends to buy back its common stock at times when its market value presents opportunities to do so. The repurchase program is intended as a means to partially mitigate the dilutive impact of stock options and to provide an alternative investment for QuadraMed's excess

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

cash. The extent to which QuadraMed repurchases shares and the timing of such purchases will depend upon market conditions and other corporate considerations. As of December 31, 2001, 200,000 shares of QuadraMed common stock had been repurchased under the program. The shares were repurchased at an average price of \$4.05 and a total purchase price, including acquisition costs, of \$822,000 and were recorded as treasury stock. There were no stock repurchases in 2002.

**12. WARRANTS**

In connection with the acquisition of Linksoft Technologies, Inc. ( Linksoft ) in June 1999, QuadraMed assumed warrants for the purchase of 6,424 shares of the Company's common stock at an exercise price of \$0.03 per share. In 1999, the warrants were partially exercised and 5,396 shares of common stock were issued. At December 31, 2002, warrants that expire in March 2008 remain outstanding for 1,028 shares of common stock.

In connection with the acquisition of Compucare in March 1999, QuadraMed assumed warrants for the purchase of 24,563 shares of the Company's common stock. Warrants for 3,941 shares at an exercise price of \$61.73 expired in December 2000. At December 31, 2002, warrants for a total of 20,622 shares of common stock remain outstanding with at an exercise price of \$111.54 expiring January 2003; 2,690 at an exercise price of \$223.09 expiring October 2005; and 6,724 at an exercise price of \$0.15 expiring February 2006.

In December 1995, QuadraMed issued a warrant expiring in December 2005 to Trigon Resources Corporation ( Trigon ) for the purchase of up to 134,574 shares of the Company's common stock at \$3.75 per share pursuant to an Employment Agreement dated March 1, 1994 with James D. Durham, then QuadraMed's Chairman and Chief Executive Officer. Trigon is a Nevada corporation controlled by Mr. Durham. In October 2001, QuadraMed repurchased the warrant for \$193,000 at which time the warrant was cancelled. The repurchase price was based on the sum of the difference between \$3.75 and the 5-day trading average close price for QuadraMed's common stock for the week beginning October 29, 2001.

**13. RESTRICTED STOCK GRANTS**

During the years ended December 31, 2002 and 2001, QuadraMed issued an aggregate of 39,000 and 475,000 shares, respectively of its common stock as restricted stock under QuadraMed's 1996 Stock Plan. The grants were made to certain senior executives for no consideration. All of the restricted shares fully vest after a three-year period. QuadraMed has recorded the difference between fair market value of the restricted shares on the date the restricted stock purchase rights were granted, and the exercise price of such shares of the shares on that date as deferred compensation within the Stockholders' Equity (Deficit) section of the Consolidated Balance Sheet. In accordance with the provisions of SFAS 123, QuadraMed amortizes this amount, pro rata over the related vesting term as it expects the shares to vest. Any changes in the expected or actual outcome of the grants are considered to be changes in estimate and are accordingly, recognized in the period the change becomes known. In 2000, 30,000 restricted shares were cancelled upon the termination of a senior executive and a \$498,000 adjustment to deferred compensation was recorded. In December 2002, a senior executive of QuadraMed was terminated with an effective date of January 1, 2003. In accordance with the provisions of his employment agreement, 57,000 unvested shares immediately vested upon his termination. Accordingly, QuadraMed recognized the remaining \$277,000 associated with the accelerated vesting in 2002 as the vesting was a known event. Compensation expense



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associated with the grants of restricted stock totaling \$812,000, \$205,000, and \$154,000 was recognized during the years ended December 31, 2002, 2001 and 2000, respectively. As of December 31, 2002, 514,000 restricted shares remained subject to vesting.

### **14. STOCK INCENTIVE AND PURCHASE PLANS**

#### **Stock Incentive Plans**

QuadraMed has two main stock option plans: the 1996 Stock Incentive Plan and the 1999 Supplemental Stock Option Plan. In addition, QuadraMed adopted and amended the Compucare 1997 Stock Compensation Plan (the "Compucare Plan") and the Pyramid Heath Group, Inc. 1997 Employee and Consultant Stock Option Plan (the "Pyramid Plan") in connection with its acquisition of these entities. QuadraMed has made limited grants under the adopted plans. The terms and conditions of the options granted under the amended Compucare and Pyramid Plans are substantially similar to the terms and conditions of options granted under the 1996 Stock Incentive Plan.

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

**1996 Stock Incentive Plan**

Under QuadraMed's 1996 Stock Incentive Plan, (the "Incentive Plan"), the board of directors may grant incentive and nonqualified stock options to employees, directors, and consultants. The Incentive Plan is divided into the following 5 separate equity programs: (i) the discretionary option grant program under which eligible persons may, at the discretion of the plan administrator, be granted options to purchase share of common stock; (ii) the salary investment option grant program under which eligible employees may elect to have a portion of their base salary invested each year in special option grants; (iii) the stock issuance program under which eligible persons may, at the discretion of the plan administrator, be issued shares of common stock directly, either through the immediate purchase of such shares or as a bonus for services rendered to QuadraMed; (iv) the automatic option grant program under which eligible non-employee board members shall automatically receive option grants at periodic intervals to purchase shares of common stock; and, (v) the director fee option program under which non-employee board members may elect to have all or any portion of their annual retainer fee otherwise payable in cash applied to a special option grant.

The exercise price per share for an incentive stock option cannot be less than the fair market value on the date of grant. The exercise price per share for a nonqualified stock option cannot be less than 85% of the fair market value on the date of grant. Option grants under the Incentive Plan generally expire 10 years from the date of grant and generally vest over a four-year period. Options granted under the Incentive Plan are exercisable subject to the vesting schedule. As of December 31, 2002, QuadraMed's stockholders had authorized a total of 7,022,687 shares of common stock for grant under the Incentive Plan. The Incentive Plan provides that the share reserve automatically increases each year by an amount equal to 1.5% of the outstanding shares on the last trading day of the immediately preceding calendar year.

**1999 Supplemental Stock Option Plan**

In 1999, QuadraMed's board of directors approved QuadraMed's 1999 Supplemental Stock Option Plan (the "1999 Supplemental Plan"). The 1999 Supplemental Plan permits non-statutory option grants to be made to employees, independent consultants, and advisors who are not QuadraMed officers, directors, or Section 16 insiders. The 1999 Supplemental Plan is administered by the board of directors or its Compensation Committee and terminates in March 2009. The exercise price of all options granted under the 1999 Supplemental Plan may not be less than 100% of fair market value on the date of the grant. Options vest on a schedule determined by the board of directors or the Compensation Committee with a maximum option term of 10 years. As of December 31, 2001, QuadraMed's stockholders had authorized a total of 4,000,000 shares of common stock, respectively, for grant under the 1999 Supplemental Plan.

For non-employee stock-based awards, QuadraMed uses SFAS No. 123, *Accounting for Stock-Based Compensation*, and recognized compensation expense of \$33,000, \$41,000 and zero in the years ended December 31, 2002, 2001 and 2000, respectively.

In accordance with SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models. These models require subjective assumptions, including future stock price volatility and expected time to exercise. QuadraMed's calculations are based on a multiple option valuation approach and forfeitures are recognized as they occur.



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## QUADRAMED CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

December 31, 2002

The weighted average fair value of options and restricted shares granted during 2002, 2001 and 2000 were \$6.97, \$1.17 and \$1.44 per share, respectively. Option activity under the option plans is as follows (in thousands, except per share amounts):

	Options Outstanding	
	Number of Shares	Weighted Average Exercise Price
Balance, December 31, 1999	5,389	\$ 12.23
Granted	3,447	2.11
Exercised	(299)	4.41
Cancelled	(2,823)	13.11
Balance, December 31, 2000	5,714	\$ 5.62
Granted	986	3.50
Exercised	(276)	3.56
Cancelled	(677)	8.69
Balance, December 31, 2001	5,747	\$ 5.28
Granted	1,462	7.91
Exercised	(433)	4.39
Cancelled	(753)	5.74
Balance, December 31, 2002	6,023	\$ 5.36

The following table summarizes information about stock options and restricted shares outstanding as of December 31, 2002:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding as of 12/31/02	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable as of 12/31/02	Weighted Average Exercise Price
\$ 0.81 - \$ 2.50	2,666,492	7.16	\$ 2.04	1,713,763	\$ 2.04
\$ 2.59 - \$ 6.99	670,412	6.59	4.72	401,552	4.65
\$ 7.00 - \$ 9.13	2,079,577	7.58	8.46	981,007	8.29

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\$ 9.63 - \$11.50	320,275	4.10	11.39	315,275	11.41
\$ 12.00 - \$16.63	187,244	2.40	15.90	187,244	15.90
\$ 17.97 - \$21.04	25,341	3.19	19.58	25,341	19.58
\$ 22.38 - \$24.38	53,291	5.26	23.23	53,291	23.23
\$ 27.00 - \$30.13	20,000	5.56	28.56	20,000	28.58
\$ 0.81 - \$30.13	6,022,632	6.89	\$ 5.36	3,697,473	\$ 6.05

## Employee Stock Purchase Plan

QuadraMed's 2002 Employee Stock Purchase Plan (the "2002 Purchase Plan") was adopted by the Board of Directors in January 2002. A total of 333,450 shares of common stock are reserved for issuance under the 2002 Purchase Plan, pursuant to which eligible employees are able to contribute up to 10% of their compensation for the purchase of QuadraMed common stock at a purchase price of 85% of the lower of the fair market value of the shares on the first or last day of the six-month purchase period.

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

**15. RELATED PARTY TRANSACTIONS**

Lawrence P. English, QuadraMed's Chairman and Chief Executive Officer, is a director of Curative Health Services, Inc., and serves as Chairman of its Executive Committee and as a member of its Audit Committee. Joseph L. Feshbach, a QuadraMed director, is the Chairman of the Board of Curative Health Services, Inc.

Joseph L. Feshbach, elected to QuadraMed's Board in August 2001, provided consulting and advisory services to QuadraMed related to the development of financial and merger and acquisition strategies from April to August 2001. For these services, Mr. Feshbach was paid \$25,000 and received an option to purchase 20,000 shares of the Company's common stock at an exercise price of \$2.42, which vested fully on July 31, 2001. Mr. Feshbach exercised this option on December 6, 2001 at a trade price of \$8.30 and was attributed with \$117,600 in income as a result of the exercise.

Michael J. King, a QuadraMed director, is a former officer of QuadraMed and was President of Compucare, acquired by QuadraMed in 1999. He is the Chief Executive Officer of Healthscribe, Inc. (Healthscribe), a provider of transcription services. Prior to Mr. King's appointment as Healthscribe's CEO, QuadraMed entered into a subcontract with Healthscribe for transcription services at a healthcare facility managed by QuadraMed. At the end of March 2001, this subcontract was terminated and the healthcare facility managed by QuadraMed contracted directly with Healthscribe for services. In the years ended December 31, 2001, 2000 and 1999, QuadraMed paid Healthscribe a total of \$300,000, \$1.3 million and \$400,000, respectively.

**16. EMPLOYEE BENEFIT PLANS**

**401(k) Savings Plan**

QuadraMed maintains a 401(k) Savings Plan (the Plan). All eligible QuadraMed employees may participate in the Plan and elect to contribute up to 15% of pre-tax compensation to the Plan. Employee contributions are 100% vested at all times. At its discretion, QuadraMed may match employee contributions to the Plan. Presently, QuadraMed matches up to 50% of the first 4% of employee contributions. The vesting of such contributions is based on the employee's years of service, becoming 100% vested after 4 years. For the years ended December 31, 2002, 2001 and 2000, QuadraMed made discretionary contributions of approximately \$800,000, \$900,000 and \$1.0 million, respectively.

**Deferred Compensation Plan**

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In January 2000, QuadraMed adopted a deferred compensation plan (the DCP) to provide specified benefits to, and help retain, a select group of management and highly compensated employees and directors who contribute materially to QuadraMed's continued growth, development and future business success. The DCP was unfunded for tax purposes and for purposes of Title I of ERISA. The Compensation Committee was responsible, at its sole discretion, for the selection of employees and directors to participate in the DCP, and several employees were so selected. In February 2001, QuadraMed terminated the DCP pursuant to its terms effective January 1, 2001, returned any deferrals made for 2001, and made payments pursuant to the DCP for any deferrals made in 2000 from cash. For the years ended December 31, 2002, 2001 and 2000, QuadraMed made no discretionary contributions to the DCP.

### **Stock Exchange Deferred Compensation Plan**

In January 2000, QuadraMed adopted a Stock Exchange Deferred Compensation Plan (the SEDCP) to provide specified benefits to, and help retain, a select group of management and highly compensated employees who contribute materially to QuadraMed's continued growth, development and future business. The SEDCP was unfunded for tax purposes and for purposes of Title I of ERISA. The Compensation Committee was responsible, at its sole discretion, to select the employees to participate in the SEDCP. QuadraMed terminated the SEDCP pursuant to its terms in July 2001. For the year ended December 31, 2000, QuadraMed recorded compensation expense related to the SEDCP in the amount of \$2.4 million. There were no expenses related to the SEDCP in 2001.

### **Supplemental Executive Retirement Plan (the SERP)**

QuadraMed adopted a Supplemental Executive Retirement Plan (the SERP) effective January 1, 2000. The SERP is unfunded for purposes of the Internal Revenue Code and Title I of ERISA. In January 2000, the Compensation Committee selected James D. Durham, then QuadraMed's Chairman and Chief Executive Officer, and John A. Cracchiolo, then QuadraMed's Chief Operating Officer, for participation in the SERP.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

December 31, 2002

The SERP provides a 20-year retirement benefit that commences at age 60 and is paid in monthly installments equal to the product of 0.05 multiplied by the participant's highest annual compensation in their last 10 years of employment with QuadraMed multiplied by the number of full years of service that a participant has had with QuadraMed (not to exceed 13) divided by 12. The SERP benefit is cliff-vested at 7 years required of plan participation with QuadraMed. In the event of a change in control, a participant's death, disability, retirement or involuntary termination of employment, other than a termination of employment for cause, a participant becomes immediately vested in their SERP benefit. If the participant is involuntarily terminated, the SERP benefit is a lump sum equal to the actuarial equivalent of the SERP benefit using 13 years of service.

On June 12, 2000, QuadraMed executed separation agreements with Mr. Durham and Mr. Cracchiolo, thereby terminating their full-time employment. As part of his agreement, Durham remained a Director and a part-time employee, which ensured that he would continue to vest in the SERP. Pursuant to his separation agreement, Mr. Cracchiolo agreed to forfeit all of his rights under the SERP. As a result, Mr. Durham is the only participant in the SERP.

On July 31, 2001, QuadraMed and Mr. Durham amended his separation agreement (Durham Separation Amendment). Pursuant to the Durham Separation Amendment, QuadraMed and Durham agreed to (i) Durham's resignation as a Director, (ii) Durham's continued part-time employment through December 31, 2003, (iii) Durham's full vesting in the SERP benefit. Under SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, this amendment is a curtailment of the SERP requiring recognition of half of the remaining unamortized prior service costs, a charge of \$616,000.

In accordance with SFAS No. 87, *Employers' Accounting for Pensions*, SFAS No. 88 and SFAS No. 130, QuadraMed recognized the following expenses for the SERP using an assumed discount rate of 6.75% and 7.0% for 2002 and 2001, respectively (in thousands):

	Year ended December 31,	
	2002	2001
<b>Net Periodic Benefit Cost</b>		
Service cost	\$ 325	\$ 310
Interest cost	170	146
Amortization of prior service cost	205	218
	<u>700</u>	<u>674</u>
<b>Curtailment of SERP</b>		616
<b>Other Comprehensive Income</b>	69	
	<u>\$ 769</u>	<u>\$ 1,290</u>





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## QUADRAMED CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

December 31, 2002

As of the measurement date, December 31, the status of the SERP using an assumed discount rate of 6.75% and 7.0% for 2002 and 2001, respectively, was as follows (in thousands):

	December 31,	
	2002	2001
<b>Change in benefit obligation</b>		
Benefit obligation at beginning of year	\$ 2,443	\$ 1,987
Service cost	325	310
Interest cost	170	146
Actuarial losses	69	
Benefit obligation at end of year	3,007	2,443
<b>Change in plan assets</b> <sup>(1)</sup>		
<b>Funded status</b>	(3,007)	(2,443)
Unrecognized prior service cost	325	530
Unrecognized net actuarial loss	69	
<b>Accrued benefit obligation</b>	(2,613)	\$ (1,913)
Unfunded accumulated benefit obligation	(3,007)	(2,443)
<b>Additional liability</b> <sup>(2)</sup>	(394)	(530)
<b>Intangible asset</b> <sup>(3)</sup>	325	530
<b>Impact on accumulated deficit</b>	69	
<b>Benefit liability</b> <sup>(4)</sup>	\$ (3,007)	\$ (2,443)

- (1) Pursuant to the Durham Separation Agreement of July 12, 2000 between QuadraMed and Mr. Durham, QuadraMed was not obligated to a specific contribution schedule, but agreed in good faith to fund the SERP when it had the ability to do so.
- (2) Represents the unfunded accumulated benefit obligation less accrued benefit cost.
- (3) Represents the lesser of the additional liability and the unrecognized prior service.
- (4) Represents accrued benefit cost plus the additional liability.

As of December 31, 2001, Mr. Durham had 8 years of service for purposes of calculating the SERP benefit. At the termination of Mr. Durham's part-time employment pursuant to the Separation Agreement and the Separation Amendment on December 31, 2003, Mr. Durham will have 10 years of service. Mr. Durham's highest annual compensation was and is expected to remain \$777,492. Accordingly, the estimated annual SERP benefit for Mr. Durham totals \$388,746 (.05 x \$777,492 x 10). Mr. Durham will turn 60 in 2008 and will receive benefits under the SERP until 2027. The total payout of Mr. Durham's SERP benefit over the 20-year period is estimated to be \$7.8 million.

**QuadraMed Grantor or Rabbi Trust**

In January 2000, contemporaneously with the establishment of the DCP, SEDCP, and the SERP (collectively, Plans ), QuadraMed entered into a Grantor Trust Agreement with Wachovia Bank, NA ( Wachovia ), as trustee, establishing a grantor or rabbi trust ( Rabbi Trust ) into which QuadraMed could make contributions to satisfy its obligations under the Plans ( Rabbi Trust Agreement ).

Pursuant to the Rabbi Trust Agreement, QuadraMed is required to make contributions to the Rabbi Trust in an amount equal to not less than 100%, but not more than 120%, of the amount necessary to pay all benefits due under the Plans on the date that a threatened change in control occurs. In the event a change in control does not occur within six months of the threatened change in control, QuadraMed has the right to recover such funds. Upon a change in control, QuadraMed is obligated to make an irrevocable contribution to the trust in an amount equal to not less than 100%, but not more than 120%, of the amount necessary to pay all benefits due under the Plans on the date the change in control occurs. QuadraMed is also obligated to fund a \$125,000 expense reserve for the trustee upon a threatened change in control or a change in control. A threatened change in control is defined to include any pending offer for QuadraMed's outstanding shares of common stock, any pending offer to acquire QuadraMed by merger, or any pending action or plan to effect a change in control.

In conjunction with the establishment of the Plans in January 2000, QuadraMed purchased a corporate variable life insurance policy from the Travelers Insurance Company ( Travelers Policy ) insuring the lives of 73 employees. Although the Company intended to use the Travelers Policy to fund the obligations under the Plans, it was not

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

immediately assigned to the Rabbi Trust. The face amount of the Travelers Policy is \$44.6 million and its maximum annual premiums are \$2.0 million. At the time the Travelers Policy was issued, a calculation was performed that indicated the cash surrender value of Travelers Policy would be sufficient to satisfy the DCP and SEDCP benefits assuming QuadraMed mirrored its investment allocations with those of the participants. QuadraMed accounted for the DCP and SEDCP as defined benefit pension plans pursuant to SFAS No. 87, *Employers' Accounting for Pensions*. When QuadraMed terminated the DCP and SEDCP pursuant to their terms in February and July 2000, respectively, QuadraMed did not surrender the Travelers Policy. At the time, QuadraMed considered it more capital efficient to pay the benefits under the terminated DCP and SEDCP from cash rather than to surrender the tax-advantaged Travelers Policy. In July 2001, as part of the Durham Separation Amendment, QuadraMed agreed to contribute 5 annual payments of approximately \$483,000 during the period from 2001 to 2005 ( *Payments* ) to the Rabbi Trust. In addition, QuadraMed assigned the Travelers Policy to the Rabbi Trust as a funding mechanism for Mr. Durham's SERP benefit. At the time the Travelers Policy was contributed to the Rabbi Trust, a calculation was performed that indicated that the cash surrender value of the Travelers Policy plus the Payments would be sufficient to satisfy Mr. Durham's SERP benefits, assuming a 7% investment return.

**Split-Dollar Life Insurance Policies**

In November of 1998, QuadraMed entered into split-dollar insurance agreements with:

Mr. Durham and E.A. Roskovensky<sup>1</sup>, Trustee, for the James Dean Durham Irrevocable Trust ( *Durham Trust* ) dated October 24, 1996 ( *Durham Split-Dollar Agreement* ); and,

Mr. Cracchiolo, Mr. Cracchiolo's spouse, and Vincent Cracchiolo, Trustee for the Cracchiolo Irrevocable Family Trust ( *Cracchiolo Trust* ) dated September 14, 1998 ( *Cracchiolo Split-Dollar Agreement* ).

The Durham Split-Dollar Agreement and the Cracchiolo Split-Dollar Agreement are referred to collectively as the *Split-Dollar Agreements*.

The purpose of the Split-Dollar Agreements was to assist Mr. Durham and Mr. Cracchiolo with their personal life insurance programs and ensure that their estates would have sufficient liquidity upon their deaths to avoid an estate tax induced liquidation of their QuadraMed holdings that could potentially destabilize the market for QuadraMed common shares. For the three months prior to the execution of the Split-Dollar Agreements, the average closing price of QuadraMed's common shares was \$23.04.

Pursuant to the Durham Split-Dollar Agreement, (i) the Durham Trust purchased a variable life insurance policy from the John Hancock Variable Life Insurance Company ( *John Hancock* ) in the amount of \$10.0 million that covered Mr. Durham's life ( *Durham Policy* ); (ii) QuadraMed agreed to make to 5 annual premium payments of \$519,066 from 1998 to 2002 to John Hancock, subject to repayment from the Durham Policy upon Mr. Durham's death or pursuant to the expected return of the policy in policy years 11 to 15; (iii) the Durham Trust

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collaterally assigned the Durham Policy to QuadraMed as security for the premiums to be paid by QuadraMed; (iv) Mr. Durham agreed to reimburse QuadraMed for the economic benefit attributable to the life insurance provided to the Durham Trust under the Durham Split-Dollar Agreement, which defined it to be the product of (a) the lower of (i) the P.S. 58 term life rates published by the government of the United States or (ii) John Hancock's one-year term insurance rate available for all standard risks; and (b) the excess of (i) the total death benefit then payable under the Durham Policy over (ii) the aggregate premiums paid by QuadraMed.

The terms and arrangements under the Cracchiolo Split-Dollar Agreement are the same as under the Durham Split-Dollar Agreement except that the amount of the death benefit under the John Hancock variable life insurance policy covering Mr. Cracchiolo and Mr. Cracchiolo's spouse is \$2.5 million ( Cracchiolo Policy ) and the amount of each of the 5 annual premium payments agreed to be advanced by QuadraMed from 1998 to 2002 is \$33,244.

In 2002, QuadraMed made the final premium payment for both policies and is not obligated to fund any additional amounts.

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<sup>1</sup> Mr. Roskovensky was subsequently elected to the QuadraMed Board of Directors on April 26, 1999.

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002**

As the owners of the John Hancock policies, the Durham Trust and the Cracchiolo Trust each direct the investment of the cash value portion of their respective John Hancock policies into various sub-accounts that are similar in nature to mutual funds. QuadraMed has no ability to direct the selection of sub-accounts. Thus, the performance of the Durham Policy and the Cracchiolo Policy for cash value and premium amounts will each vary depending on the performance of the underlying sub-accounts respectively selected by the Durham Trust and the Cracchiolo Trust.

**17. MAJOR CUSTOMERS**

In the years ended December 31, 2002, 2001 and 2000, no single customer accounted for more than 10% of total revenues however, in 2002 sales to the U. S. government accounted for 21% of HIM Software Division revenues.

**18. SEGMENT REPORTING**

QuadraMed aligns its operations into three business segments for management reporting purposes. These segments are based on product functionality and shared target markets. This alignment allows management to more accurately measure financial performance by product/division and to establish greater management accountability. QuadraMed's business segments are (i) the Enterprise Division, (ii) the Health Information Management Software Division, and (iii) the Financial Services Division. The operations and assets of these segments are primarily located in the United States. QuadraMed reports the Enterprise Division, the Health Information Management Software Division, and the Financial Services Division as reportable segments in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies described in footnotes 2 and 3. The financial results for these operating segments for prior periods have been reclassified to conform to the current period presentation.

Results of operations for these business segments are provided to QuadraMed's Chief Operating Decision Maker (CODM), which is the Chairman of the Board and Chief Executive Officer.

Summary financial data by business segment as reported to the CODM is presented below for the years ended December 31, 2002, 2001 and 2000 (in thousands):

<u>Description</u>	<b>Year ended December 31, 2002</b>				<b>Consolidated Total</b>
	<u>Enterprise</u>	<b>HIM Software</b>	<b>Financial Services</b>	<u>Other<sup>(1)</sup></u>	

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Total revenue	\$ 63,313	\$ 30,988	\$ 10,857	\$ 4,427	\$ 109,585
Gross margin <sup>(2)</sup>	\$ 40,798	\$ 18,474	\$ 4,662	\$ 423	\$ 64,357
Interest expense, net	\$ 1,528	\$ 725	\$ 504	\$ 8	\$ 2,765
Segment assets	\$ 41,834	\$ 38,099	\$ 5,332	\$ 41,662	\$ 126,927
Total depreciation and amortization expense <sup>(3)</sup>	\$ 2,105	\$ 3,715	\$ 600	\$ 3,408	\$ 9,828

- (1) Other includes specialty products, non-allocated expenses for bad debt, legal costs and divested product lines, as well as the assets associated with the discontinued Health Information Management Services Division.
- (2) Gross margin represents segment results before interest, amortization of goodwill, taxes, and corporate overhead allocations.
- (3) Total depreciation and amortization is comprised of equipment depreciation and capitalized software amortization reflected in gross margin, debt-offering costs as reflected in interest expense, and amortization of other intangibles, excluding capitalized software development costs, which are reflected separately in the above schedule.

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**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002**

Description	Year ended December 31, 2001				Consolidated Total
	Enterprise	HIM Software	Financial Services	Other <sup>(1)</sup>	
Total revenue	\$ 61,780	\$ 27,677	\$ 15,459	\$ 12,130	\$ 117,046
Gross margin <sup>(2)</sup>	\$ 36,953	\$ 19,209	\$ 10,618	\$ 7,489	\$ 74,269
Interest expense, net	\$ 1,395	\$ 710	\$ 508	\$ 94	\$ 2,707
Segment assets	\$ 30,758	\$ 36,919	\$ 6,103	\$ 51,353	\$ 125,133
Total depreciation and amortization expense <sup>(3)</sup>	\$ 1,904	\$ 5,839	\$ 523	\$ 3,520	\$ 11,786

- (1) Other includes specialty products, non-allocated expenses for bad debt, legal costs, restructuring charges and divested product lines including \$6.4 million in revenue and \$1.6 million in net income for EZ Cap, as well as the assets associated with the discontinued Health Information Management Services Division.
- (2) Gross margin represents segment results before interest, amortization of goodwill, taxes and corporate overhead allocations.
- (3) Total depreciation and amortization is comprised of equipment depreciation and capitalized software amortization reflected in gross margin, debt-offering costs as reflected in interest expense, and goodwill and amortization of other intangibles, excluding capitalized software development costs, which are reflected separately in the above schedule.

Description	Year ended December 31, 2000				Consolidated Total
	Enterprise	HIM Software	Financial Services	Other <sup>(1)</sup>	
Total revenue	\$ 46,565	\$ 20,779	\$ 11,813	\$ 41,855	\$ 121,012
Gross margin <sup>(2)</sup>	\$ 31,462	\$ 14,709	\$ 4,026	\$ 8,851	\$ 59,048
Interest expense, net	\$ 2,270	\$ 1,165	\$ 844	\$ 86	\$ 4,365
Segment assets	\$ 29,336	\$ 36,000	\$ 7,393	\$ 76,557	\$ 149,286
Total depreciation and amortization expense <sup>(3)</sup>	\$ 1,235	\$ 5,340	\$ 1,065	\$ 6,103	\$ 13,743

- (1) Other includes specialty products, non-allocated expenses for bad debt, legal costs, restructuring charges and divested product lines including \$32.7 million in revenue and \$5.8 million in net income for EZ Cap and ROI, as well as the assets associated with the discontinued Health Information Management Services Division.
- (2) Gross margin represents segment results before interest, amortization of goodwill, taxes and corporate overhead allocations.
- (3) Total depreciation and amortization is comprised of equipment depreciation and capitalized software amortization reflected in gross margin, debt-offering costs as reflected in interest expense, and goodwill and amortization of other intangibles, excluding capitalized software development costs, which are reflected separately in the above schedule.



**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002****19. OTHER OPERATING CHARGES**

Restructuring charges of \$7.1 million were incurred during the year ended December 31, 2000. The charges consisted of \$5.8 million associated with separation agreements for officers and \$1.3 million for employee severance and closure of facilities. As of December 31, 2002, there is no remaining liability for restructuring costs.

**20. INCOME TAXES**

QuadraMed accounts for income taxes pursuant to SFAS No. 109, *Accounting for Income Taxes*, which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities versus the tax bases of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The impact of tax rate changes on deferred tax assets and liabilities is recognized in the year that the change is enacted.

The provision for income taxes consists of the following (in thousands):

	Year ended December 31,		
	2002	2001	2000
<b>Current:</b>			
Federal	\$	\$	\$ 617
State		150	
<b>Total current</b>		150	617
<b>Deferred:</b>			
Federal	2,518	(2,004)	9,881
State	2,315	187	1,183
<b>Total deferred</b>	4,833	(1,817)	11,064
<b>Change in valuation allowance, net of the effect of acquisitions</b>	(4,833)	1,817	(11,064)

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Provision for income taxes	\$	\$ 150	\$ 617
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**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002**

The tax effects of the temporary differences that give rise to significant portions of deferred tax assets and liabilities are as follows (in thousands):

	<b>December 31,</b>		
	<b>2002</b>	<b>2001</b>	<b>2000</b>
<b>Deferred tax assets:</b>			
Research and development credits	\$ 5,988	\$ 5,109	\$ 4,104
Net operating loss carryforwards	26,073	25,294	30,622
Deferred revenue	9,934	6,611	4,235
Intangible assets	9,707	9,683	10,070
Other	6,574	7,101	5,782
	<u>58,276</u>	<u>53,798</u>	<u>54,813</u>
<b>Deferred tax liabilities:</b>			
Other intangible assets	(2,468)	(2,785)	(2,785)
Depreciation	(880)	(1,218)	(116)
	<u>(3,348)</u>	<u>(3,703)</u>	<u>(2,901)</u>
Net deferred tax asset before allowance	54,928	50,095	51,912
Valuation allowance	(54,928)	(50,095)	(51,912)
Net deferred tax assets	<u>\$</u>	<u>\$</u>	<u>\$</u>

Realization of deferred tax assets is primarily dependent on future taxable income, the amount and timing of which is uncertain given QuadraMed's history of losses. Therefore a valuation allowance has been recorded for the entire deferred tax asset. The valuation allowance is adjusted on a periodic basis to reflect management's estimate of the realizable value of the net deferred assets.

The reconciliation of the tax provision (benefit) computed at the statutory rate to the effective tax rate is as follows:

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2001</b>	<b>2000</b>

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Federal income tax rate	(34.0)%	34.0%	(34.0)%
Change in valuation allowance	25.7	(23.6)	28.0
Permanent tax differences	8.3	(10.5)	6.0
Other		1.7	1.7
	<u>          </u>	<u>          </u>	<u>          </u>
Effective tax rate	0.0%	1.6%	1.7%
	<u>          </u>	<u>          </u>	<u>          </u>

As of December 31, 2002, the Company had federal net operating loss carryforwards of approximately \$76.1 million and state net operating loss carryforwards of approximately \$2.0 million. In addition, the Company has gross federal and California research and development credit carryforwards of approximately \$4.2 million and \$1.8 million respectively. The federal net operating loss carryforwards and research and development credits will expire from 2011 through 2020.

The Tax Reform Act of 1986 contains provisions that may limit the amount of NOL and research and development credit carryforwards that may be used in any given year if certain events, including a significant change in ownership, occur. If there should be a subsequent ownership change of the Company, as defined, the ability to utilize its carryforwards could be restricted.

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**December 31, 2002**

**21. LITIGATION**

In October 2002, a series of securities law class action complaints were filed in the United States District Court, California Northern District, against QuadraMed and certain of its officers and directors. The plaintiffs in these actions allege, among other things, violations of the Securities Exchange Act of 1934 due to issuing a series of allegedly false and misleading statements concerning its business and financial condition between May 11, 2000 and August 11, 2002. The complaints seek unspecified monetary damages and other relief. These matters are at an early stage. No responses to the complaints have yet been filed, and no discovery has taken place. QuadraMed intends to defend itself vigorously against these allegations. However, the ultimate outcome of these matters cannot presently be determined.

**22. SUBSEQUENT EVENTS**

On February 28, 2003, QuadraMed reported that the SEC has issued a formal non-public order of investigation concerning QuadraMed's accounting and financial reporting practices for the period beginning January 1, 1998. QuadraMed intends to continue to cooperate with the SEC and has complied with the SEC's requests for information. QuadraMed cannot predict when the SEC will conclude its inquiry, or the outcome and impact thereof.

On March 4, 2003, QuadraMed's common stock was delisted from the Nasdaq National Market. The delisting constitutes a Repurchase Event under the provisions of the QuadraMed's Convertible Subordinated Debentures. Upon such an event, the Subordinated Indenture grants to each debenture holder the right, at the holder's option, to require QuadraMed to repurchase all or any of the holder's debentures. On April 16, 2003, QuadraMed announced that it had executed an agreement with certain of its bondholders to refinance its outstanding 5.25% Convertible Subordinated Debentures due 2005 (the 2005 Debt). On April 17, 2003, under the terms of the refinance agreement, QuadraMed issued \$71.0 million of its Senior Secured Notes due 2008 (the 2008 Debt). The proceeds from the issuance of the 2008 Debt were used to repurchase \$61.8 million (plus \$1.5 million in accrued interest) of the 2005 Debt which became subject to repurchase by the Company as a result of its delisting from the NASDAQ National Market on March 4, 2003. Accordingly, the net proceeds to QuadraMed as a result of the issuance of the 2008 Debt less the costs (including fees) associated with the repurchase of the 2005 Debt was \$7.6 million, with \$11.9 million of the 2005 Debt remaining outstanding. Additionally, the repurchase right on the 2005 Debt remaining outstanding expired on April 17, 2003. The 2008 Debt bears interest at an initial rate of 10% which will be reduced to 9% upon the relisting of QuadraMed's common stock on the Nasdaq, including Nasdaq SmallCap or U.S. National Market and is secured by certain intellectual property of QuadraMed. As part of the transaction, QuadraMed also issued 11,303,842 detachable warrants with the 2008 Debt. The warrants have a term of five years, have an exercise price of \$.01 per share and are subject to certain anti-dilution provisions including dilution from the issuance of shares in settlement of existing litigation. The 2008 Debt contains certain events of default. These events include: failure to timely repay principal or interest owed on the debentures, default under any other borrowing, and bankruptcy.

**UNAUDITED QUARTERLY/SUPPLEMENTARY FINANCIAL INFORMATION**

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Unaudited Quarterly Results of Operations/Supplementary Financial Information for 2002  
Unaudited Quarterly Results of Operations/Supplementary Financial Information for 2001

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**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002****QuadraMed Corporation****Unaudited Quarterly Consolidated****Financial Data**

(thousands of dollars, except per share amounts)	Quarter				Total
	First	Second	Third	Fourth	
<b>2002</b>					
Revenue	\$ 27,180	\$ 26,301	\$ 25,591	\$ 30,513	\$ 109,585
Gross margin	\$ 17,320	\$ 15,831	\$ 13,220	\$ 17,986	\$ 64,357
Loss from continuing operations	\$ (624)	\$ (2,415)	\$ (11,216)	\$ (6,603)	\$ (20,858)
Net income (loss)	\$ (1,328)	\$ (2,999)	\$ (11,456)	\$ 1,421	\$ (14,362)
<b>Earnings (loss) per share</b>					
<b>Basic</b>					
Continuing operations	\$ (0.02)	\$ (0.09)	\$ (0.42)	\$ (0.25)	\$ (0.77)
Total	\$ (0.05)	\$ (0.11)	\$ (0.43)	\$ 0.05	\$ (0.53)
<b>Diluted</b>					
Continuing operations	\$ (0.02)	\$ (0.09)	\$ (0.42)	\$ (0.24)	\$ (0.77)
Total	\$ (0.05)	\$ (0.11)	\$ (0.43)	\$ 0.05	\$ (0.53)
<b>Weighted average shares outstanding</b>					
Basic	26,809	26,941	26,950	26,960	26,915
Diluted	26,809	26,941	26,950	27,259	26,915

1. QuadraMed's gross margin in the above table, for all quarters presented, has been conformed to the presentation for the year ended December 31, 2002. Specifically, the Company's gross margin reflects the reclassification of certain expenses related to its customer support from operating expenses to cost of services. In addition, QuadraMed has adopted EITF 01-14, which requires reimbursable expenses to be included within revenues and cost of revenues, but has no gross margin effect. In addition, QuadraMed reclassified certain items that had previously been included within licenses and costs of licenses to services and cost of services, respectively. These reclassifications did not impact previously reported operating income, net income or earnings per share data.
2. For the quarter ended September 30, 2002, income (loss) from continuing operations before extraordinary item includes restatement fees of QuadraMed's 2001 financial statements and reduced gross margin resulting from lower sales volume.
3. For the quarter ended December 31, 2002, net income (loss) reflects an \$8.8 million gain from the sale of the HIM Services Division and an earn-out provision on the EZ-CAP sale.





**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****December 31, 2002****QuadraMed Corporation****Unaudited Quarterly Consolidated****Financial Data**

(thousands of dollars, except per share amounts)	Quarter				
	First	Second	Third	Fourth	Total
<b>2001</b>					
Revenue	\$ 25,921	\$ 29,207	\$ 29,755	\$ 32,163	\$ 117,046
Gross margin	\$ 15,872	\$ 17,421	\$ 19,928	\$ 21,048	\$ 74,269
Loss from continuing operations	\$ (4,434)	\$ (991)	\$ 2,748	\$ 1,722	\$ (955)
Extraordinary gain on redemption of debentures	\$	\$ 2,402	\$ 10,505	\$	\$ 12,907
Net income (loss)	\$ (4,829)	\$ 1,214	\$ 12,311	\$ 717	\$ 9,413
<b>Earnings (loss) per share</b>					
<b>Basic</b>					
Continuing operations	\$ (0.17)	\$ (0.03)	\$ 0.11	\$ 0.07	\$ (0.04)
Total	\$ (0.19)	\$ 0.05	\$ 0.48	\$ 0.03	\$ 0.37
<b>Diluted</b>					
Continuing operations	\$ (0.17)	\$ (0.03)	\$ 0.10	\$ 0.06	\$ (0.04)
Total	\$ (0.19)	\$ 0.05	\$ 0.46	\$ 0.03	\$ 0.37
<b>Weighted average shares outstanding</b>					
Basic	25,734	25,543	25,403	25,584	25,566
Diluted	25,734	25,543	27,057	27,408	25,566

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**QUADRAMED CORPORATION**  
**INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share amounts)

	September 30, 2003	December 31, 2002
	(unaudited)	
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 33,200	\$ 23,663
Short-term investments	2,380	2,528
Accounts receivable, net of allowance for doubtful accounts of \$3,016 and \$4,346, respectively	32,749	31,612
Unbilled receivables	4,920	3,475
Notes and other receivables	650	4,416
Prepaid expenses and other current assets	10,431	8,972
<b>Total current assets</b>	84,330	74,666
Restricted cash	5,534	5,849
Property and equipment, net of accumulated depreciation and amortization of \$18,820 and \$16,170, respectively	5,861	6,019
Capitalized software development costs, net of accumulated amortization of \$9,655 and \$7,776, respectively	3,791	5,670
Goodwill	18,445	18,445
Other intangible assets, net of accumulated amortization of \$15,040 and \$13,316, respectively	7,551	9,275
Other long-term assets	7,840	7,003
<b>Total assets</b>	\$ 133,352	\$ 126,927
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
<b>Current liabilities</b>		
Accounts payable and accrued expenses	\$ 4,561	\$ 3,586
Accrued payroll and related	8,150	6,942
Other accrued liabilities	11,387	6,509
Deferred revenue	49,141	39,492
<b>Total current liabilities</b>	73,239	56,529
5.25% Convertible subordinated debt due 2005	11,931	73,719
10% Senior secured debt due 2008, net of unamortized discount of \$11,705 and none, respectively	59,295	
Other long-term liabilities	4,394	3,914
<b>Total liabilities</b>	148,859	134,162
Commitments and contingencies		
<b>Stockholders' deficit</b>		
Preferred stock		
Common stock	278	205
Additional paid-in-capital	289,271	275,631

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Deferred compensation	(470)	(588)
Accumulated other comprehensive loss	(220)	(310)
Accumulated deficit	(304,366)	(282,173)
	<u>          </u>	<u>          </u>
<b>Total stockholders' deficit</b>	<b>(15,507)</b>	<b>(7,235)</b>
	<u>          </u>	<u>          </u>
<b>Total liabilities and stockholders' deficit</b>	<b>\$ 133,352</b>	<b>\$ 126,927</b>
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these interim condensed consolidated financial statements.

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## QUADRAMED CORPORATION

## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Nine months ended September 30,	
	2003	2002
<b>Revenue</b>		
Services and other	\$ 58,294	\$ 57,419
Licenses	30,079	21,653
<b>Total revenue</b>	<b>88,373</b>	<b>79,072</b>
<b>Cost of revenue</b>		
Cost of services and other	31,190	26,508
Cost of licenses	5,363	6,193
<b>Total cost of revenue</b>	<b>36,553</b>	<b>32,701</b>
<b>Gross margin</b>	<b>51,820</b>	<b>46,371</b>
<b>Operating expenses</b>		
Sales and marketing	16,858	16,030
Research and development	17,080	12,535
General and administrative	32,747	26,572
Amortization and other operating charges	1,756	2,401
<b>Total operating expenses</b>	<b>68,441</b>	<b>57,538</b>
<b>Loss from operations</b>	<b>(16,621)</b>	<b>(11,167)</b>
<b>Other income (expense)</b>		
Interest expense	(6,766)	(2,596)
Interest income	438	453
Other income (expense), net	756	(945)
<b>Other income (expense)</b>	<b>(5,572)</b>	<b>(3,088)</b>
<b>Loss from continuing operations</b>	<b>(22,193)</b>	<b>(14,255)</b>
Loss from discontinued operations		(1,528)
<b>Net loss</b>	<b>\$ (22,193)</b>	<b>\$ (15,783)</b>
<b>Loss per share</b>		
Basic and diluted		

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Continuing operations	\$ (0.81)	\$ (0.53)
Discontinued operations		(0.06)
	<u>          </u>	<u>          </u>
Net	\$ (0.81)	\$ (0.59)
	<u>          </u>	<u>          </u>
<b>Weighted average shares outstanding</b>		
Basic and diluted	27,263	26,900
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these interim condensed consolidated financial statements.

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**Table of Contents****QUADRAMED CORPORATION****INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Nine months ended September 30,</b>	
	<b>2003</b>	<b>2002</b>
<b>Cash flows from operating activities</b>		
Net loss from continuing operations	\$ (22,193)	\$ (14,255)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	8,701	6,496
Provision for bad debts	487	915
Write-off of marketable investments		444
In-process research and development		400
Other	151	219
Changes in assets and liabilities:		
Accounts receivable	(1,624)	5,136
Prepaid expenses and other	(4,041)	(89)
Accounts payable and accrued liabilities	7,559	630
Deferred revenue	9,649	7,497
Cash (used in) provided by continuing operations	(1,311)	7,393
Cash used in discontinued operations		(1,563)
Cash (used in) provided by operating activities	(1,311)	5,830
<b>Cash flows from investing activities</b>		
Decrease (increase) in restricted cash	314	(92)
Purchases of available-for-sale securities	(620)	(367)
Proceeds from sale of available-for-sale securities	656	316
Acquisitions of businesses		(11,930)
Purchases of property and equipment	(2,491)	(1,508)
Proceeds from sale of assets	4,190	
Capitalized software development costs		(1,700)
Cash provided by (used in) investing activities	2,049	(15,281)
<b>Cash flows from financing activities</b>		
Issuances (repayments) of debt	8,561	(438)
Proceeds from issuance of common stock	238	1,885
Cash provided by financing activities	8,799	1,447
Net increase (decrease) in cash and cash equivalents	9,537	(8,004)
<b>Cash and cash equivalents</b> , beginning of period	23,663	29,799

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<b>Cash and cash equivalents, end of period</b>	<b>\$ 33,200</b>	<b>\$ 21,795</b>
	<b>_____</b>	<b>_____</b>
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for interest	\$ 1,854	\$ 1,935
	<b>_____</b>	<b>_____</b>
Net cash (refunded) paid for taxes	\$ (1)	\$ 418
	<b>_____</b>	<b>_____</b>
<b>Supplemental disclosure of non-cash investing and financing transactions</b>		
Issuances of restricted common stock	\$ 268	\$ 348
	<b>_____</b>	<b>_____</b>
Issuance of warrants in connection with debt offering	\$ 13,209	\$
	<b>_____</b>	<b>_____</b>

The accompanying notes are an integral part of these interim condensed consolidated financial statements.

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**QUADRAMED CORPORATION**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2003**

**1. NATURE OF OPERATIONS**

QuadraMed Corporation, along with all significant business divisions and subsidiaries (collectively, the Company or QuadraMed), is dedicated to improving healthcare delivery by providing innovative healthcare information technology and services. From clinical to patient information management and revenue cycle to health information management, QuadraMed delivers real-world solutions that help healthcare professionals deliver outstanding patient care with optimum efficiency. QuadraMed was reincorporated in Delaware in 1996, having been originally incorporated in California in 1993. QuadraMed is managed in three distinct business segments: Enterprise Division, Health Information Management Software Division, and Financial Services Division. In December 2002, QuadraMed sold its Health Information Management Services Division. Results of operations for this division are reflected as discontinued operations in the Statement of Operations.

**2. BASIS OF PRESENTATION**

**Unaudited Interim Results**

The condensed consolidated financial statements at September 30, 2003 and December 31, 2002 and for the nine months ended September 30, 2003 and 2002 have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The interim financial information is unaudited but reflects all adjustments that are, in the opinion of management, necessary for a fair presentation of QuadraMed's condensed consolidated financial position, operating results, and cash flows for the interim periods. The preparation of condensed consolidated financial statements, in conformity with GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods.

These condensed consolidated financial statements have been prepared in accordance with the instructions for a report on Form 10-Q as required by the SEC and, therefore, do not include all information and notes normally provided in annual financial statements. As a result, these condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management's discussion and analysis of financial condition and results of operations, contained in QuadraMed's annual report on Form 10-K for the fiscal year ended December 31, 2002. The results of operations for the nine months ended September 30, 2003 are not necessarily indicative of the results for the fiscal year ending December 31, 2003 or any other future periods.

**3. LONG-TERM DEBT**

On March 4, 2003, QuadraMed's common stock was delisted from the Nasdaq National Market. The delisting constituted a Repurchase Event under the provisions of QuadraMed's 5.25% Convertible Subordinated Debentures Agreements due 2005 (the 2005 Debt). Upon such an event,



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the 2005 Debt Agreement grants to each debenture holder the right, at the holder's option, to require QuadraMed to repurchase all or any of the holder's debentures. On April 17, 2003, QuadraMed issued \$71.0 million of its Senior Secured Notes due 2008 (the "2008 Debt"). The proceeds from the issuance of the 2008 Debt were used to repurchase \$61.8 million (plus \$1.5 million in accrued interest) of the 2005 Debt required to be repurchased. Accordingly, the net proceeds as a result of the issuance of the 2008 Debt, less the costs (including fees) associated with the repurchase of the 2005 Debt, were \$8.5 million, with \$11.9 million of the 2005 Debt remaining outstanding. Additionally, the repurchase right on the 2005 Debt remaining outstanding expired on April 17, 2003.

The 2008 Debt bears interest at an initial rate of 10%, of which 6% is due in semi-annual cash coupon payments in the first year with the remainder added to the outstanding principal balance of the notes. The interest rate on the 2008 Debt will be reduced to 9% upon relisting of QuadraMed's common stock on the Nasdaq, including Nasdaq SmallCap or any U.S. National Market, and is secured by substantially all of QuadraMed's intellectual property. The 2008 Debt contains certain events of default. These events include: failure to timely repay principal or interest owed on the debentures, default under any other borrowing, and bankruptcy. As part of the transaction,

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Table of Contents**QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (continued)**

QuadraMed also issued warrants to purchase 11.6 million shares of common stock, of which warrants for 11.3 million shares were issued to purchasers of the 2008 Debt and 283,000 shares were issued as compensation for services provided with the offering. The warrants have a term of five years, an exercise price of \$.01 per share, and are subject to certain anti-dilution provisions, including dilution from the issuance of shares in settlement of any existing litigation. QuadraMed valued the warrants using the Black-Scholes valuation model using a volatility of 142%, expected life of 5 years, 2.74% risk-free interest rate and no dividend yield. The result was a fair value of \$12.9 million for the warrants issued to debt holders. This amount was recorded as a discount to the debt and will be amortized to interest expense ratably over the 5-year term of the debt. In addition, costs associated with the debt offering, including the warrants for 283,000 shares, totaled \$1.0 million, which will be amortized to interest expense ratably over the same term. In June 2003, 283,000 warrants were exercised.

At September 30, 2003, long-term debt consisted of a principal balance of \$11.9 million for the 2005 debt, \$71.0 million for the 2008 debt and unamortized warrants of \$11.7 million.

**4. STOCK-BASED COMPENSATION**

SFAS No. 123, *Accounting for Stock Based Compensation*, encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. QuadraMed has chosen to continue to account for stock-based employee compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees, and Related Interpretations*. Accordingly, compensation cost for stock options granted to employees is measured as the excess, if any, of the quoted market price of QuadraMed's stock at the date of the grant over the amount an employee must pay to acquire the stock.

QuadraMed has determined pro-forma information regarding net income and earnings per share as if QuadraMed had accounted for employee stock options under the fair value method as required by SFAS No. 123. The fair value of these stock-based awards to employees was estimated using the Black-Scholes option-pricing model. Had compensation cost for QuadraMed's stock option plan and employee stock purchase plan been determined consistent with SFAS No. 123, QuadraMed's reported net income (loss) and net earnings (loss) per share would have been changed to the amounts indicated below (in thousands except per share data):

	<b>Nine months ended September 30,</b>	
	<b>2003</b>	<b>2002</b>
Net loss as reported	\$ (22,193)	\$ (15,783)
Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects	385	417
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,402)	(4,842)
Pro forma net loss	\$ (25,210)	\$ (20,208)

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Earnings per share:		
Basic and diluted	as reported	\$ (0.81) \$ (0.59)
Basic and diluted	pro forma	\$ (0.92) \$ (0.75)

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**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (continued)**

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following assumptions:

	<u>2003</u>	<u>2002</u>
Expected dividend yield		
Expected stock price volatility	138.91%	135.55%
Risk-free interest rate	2.74%	2.26%
Expected life of options	5 years	5 years

**5. NET LOSS PER SHARE AND COMPREHENSIVE INCOME (LOSS)**

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the period less restricted shares of common stock. Diluted net loss per share is computed by dividing income by the sum of the weighted average number of common shares, as adjusted for restricted shares, and common equivalent shares outstanding during the period. Common equivalent shares consist of shares issuable upon the exercise of stock options and warrants (using the treasury stock method) and convertible subordinated debentures (using the as-converted method). Common equivalent shares are excluded from the diluted computation only if their effect is anti-dilutive. As QuadraMed recorded net losses for the nine months ended September 30, 2003 and 2002, no common equivalent shares were included in the net loss per share calculation because they were anti-dilutive.

The components of QuadraMed's comprehensive income (loss) include the unrealized gain (loss) on available-for-sale securities which is not significant for any period presented.

**6. SEGMENT REPORTING**

QuadraMed aligns its operations into three business segments for management reporting purposes. These segments are based on product functionality and shared target markets. This alignment allows management to more accurately measure financial performance by product/division and to establish greater management accountability. QuadraMed's business segments are (i) the Enterprise Division, (ii) the Health Information Management Software Division, and (iii) the Financial Services Division. The operations and assets of these segments are primarily located in the United States. QuadraMed reports the Enterprise Division, the Health Information Management Software Division, and the Financial Services Division as reportable segments in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies described in notes to the financial statements in its Annual Report on Form 10-K for the year ended December 31, 2002. The financial results for these operating segments for prior periods have been reclassified to conform to the current period presentation.

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Selected results of operations for these business segments are provided to QuadraMed's Chief Operating Decision Maker ( CODM ), who is the Chairman of the Board and Chief Executive Officer.

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**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (continued)**

Summary financial data by business segment as reported to the CODM is presented below for the nine months ended September 30, 2003 and 2002 (in thousands):

Description	Nine months ended September 30, 2003				
	HIM		Financial		Consolidated
	Enterprise	Software	Services	Other <sup>(1)</sup>	Total
Total revenues	\$ 54,629	\$ 26,327	\$ 7,417	\$	\$ 88,373
Gross margin	\$ 32,502	\$ 17,773	\$ 1,545	\$	\$ 51,820
Interest income (expense), net	\$ (3,826)	\$ (1,446)	\$ (1,191)	\$ 135	\$ (6,328)
Segment assets	\$ 40,747	\$ 41,274	\$ 4,137	\$ 47,194	\$ 133,352
Total depreciation and amortization <sup>(2)</sup>	\$ 3,870	\$ 3,115	\$ 760	\$ 956	\$ 8,701

- (1) Other includes non-allocable assets such as cash and cash equivalents and restricted cash, investments and certain enterprise-wide intangible assets.
- (2) Total depreciation and amortization is comprised of capitalized and acquired software amortization reflected in gross margin, equipment depreciation, amortization of debt-offering costs reflected in interest expense, amortization of deferred compensation and amortization of other intangibles.

Description	Nine months ended September 30, 2002				
	HIM		Financial		Consolidated
	Enterprise	Software	Services	Other <sup>(1)</sup>	Total
Total revenues	\$ 49,400	\$ 19,859	\$ 9,813	\$	\$ 79,072
Gross margin	\$ 30,610	\$ 11,508	\$ 4,253	\$	\$ 46,371
Interest income (expense), net	\$ (1,316)	\$ (529)	\$ (418)	\$ 120	\$ (2,143)
Segment assets	\$ 40,374	\$ 44,512	\$ 4,959	\$ 31,256	\$ 121,101
Total depreciation and amortization <sup>(2)</sup>	\$ 1,647	\$ 2,814	\$ 426	\$ 1,609	\$ 6,496

- (1) Other includes non-allocable assets such as cash and cash equivalents and restricted cash, investments and certain enterprise-wide intangible assets.
- (2) Total depreciation and amortization is comprised of capitalized and acquired software amortization reflected in gross margin, equipment depreciation, amortization of debt-offering costs reflected in interest expense, amortization of deferred compensation and amortization of other intangibles.

**7. MAJOR CUSTOMERS**

For the nine month period ended September 30, 2003 and 2002, no single customer accounted for more than 10% of total revenues. However, for the nine months ended September 30, 2003 and 2002, U.S. government revenue accounted for 22.0% and 23.9%, respectively, of HIM

Software Division revenues.

## **8. LITIGATION AND OTHER MATTERS**

In October 2002, a series of securities law class action complaints were filed in the United States District Court, California Northern District, against QuadraMed and certain of its officers and directors. The plaintiffs in these actions allege, among other things, violations of the Securities Exchange Act of 1934 due to issuing a series of allegedly false and misleading statements concerning its business and financial condition between May 11, 2000 and August 11, 2002. The complaints seek unspecified monetary damages and other relief. These matters are at an early stage and no discovery has taken place. QuadraMed intends to defend itself vigorously against these allegations. However, the ultimate outcome of these matters cannot presently be determined.

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**QUADRAMED CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (continued)**

On February 28, 2003, QuadraMed reported that the SEC issued a formal non-public order of investigation concerning QuadraMed's accounting and financial reporting practices for the period beginning January 1, 1998. On October 10, 2003, QuadraMed announced that the Staff of the San Francisco District Office of the Securities and Exchange Commission (the Staff) has informed QuadraMed that the Staff intends to recommend to the SEC that it institute an enforcement action against QuadraMed for violations of the antifraud, periodic filing and books and records provisions of the federal securities laws. The proposed recommendation concerns QuadraMed's accounting for transactions that it entered into with Health+Cast LLP in 1998 and 1999. The 1999 transactions were restated as part of QuadraMed's recent restatement of its 1999 financial statements. The Staff invited QuadraMed to make a Wells submission with respect to the proposed recommendation. QuadraMed plans to continue to discuss this matter with the Staff; however, QuadraMed cannot predict when the SEC will conclude its inquiry, or the outcome and impact thereof. The staff also indicated that it does not presently intend to recommend any action against QuadraMed's current officers, directors or employees.

**9. SUBSEQUENT EVENTS**

On October 23, 2003, QuadraMed received a written Demand Request from a Holder of Registrable Securities, pursuant to Section 2 of the Registration Rights Agreement (the Agreement), dated as of April 17, 2003. QuadraMed mailed a Request Notice to all Holders under the Agreement on November 3, 2003. QuadraMed is required to file for registration of the warrants within 90 days of receiving the Demand Request and is preparing such filing.

On November 5, 2003 QuadraMed consolidated the organization of the HIM Software Division and Enterprise Division into a single functional software organization. This reorganization is designed to use existing resources more efficiently and to facilitate the integration of products and technologies. The change does not affect the Financial Services Division.



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**REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS  
ON FINANCIAL STATEMENT SCHEDULE**

To the Board of Directors and Stockholders of QuadraMed Corporation:

The audit referred to in our report dated August 1, 2003, relating to the consolidated financial statements of QuadraMed Corporation, which is contained in Item 15 of this Form 10-K, included the audit of the financial statement schedule listed in the index at Item 15.(a)2. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audit.

In our opinion, the financial statement schedule as of and for the year ended December 31, 2002, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ BDO Seidman, LLP

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BDO Seidman, LLP

San Jose, California

August 1, 2003

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**QUADRAMED CORPORATION**

**SCHEDULE II**

**VALUATION AND QUALIFYING ACCOUNTS**

(in thousands)

Description	Additions				
	Balance at	Charged to	Additions		Balance at End of
	Beginning of	Costs and	Charged to Other		
	Year	Expenses	Accounts	Deductions	
Year ended December 31, 2000:					
Allowance for doubtful accounts	\$ 2,669	\$ 7,234		\$ (6,437)	\$ 3,466
Year ended December 31, 2001:					
Allowance for doubtful accounts	\$ 3,466	\$ 2,090		\$ (1,317)	\$ 4,239
Year ended December 31, 2002:					
Allowance for doubtful accounts	\$ 4,239	\$ 1,403		\$ (1,296)	\$ 4,346

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**PRELIMINARY PROSPECTUS   SUBJECT TO COMPLETION, DATED JANUARY\_\_ , 2004**

**[GRAPHIC APPEARS HERE]**

**11,586,438 Shares of Common Stock, par value \$0.01 per share**

**\$72,293,780 10% Senior Secured Notes due 2008**

**QuadraMed Corporation**

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**PROSPECTUS**

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**Table of Contents****PART II: INFORMATION NOT REQUIRED IN PROSPECTUS****Item 13. Other Expenses of Issuance and Distribution**

The following table provides the fees and expenses, payable by our company in connection with the issuance and distribution of the securities being registered hereunder. Except for the SEC registration fees, all amounts are estimates.

SEC registration fee	\$ 8,826
Other fees	\$ *
Printing and filing expenses	\$ *
Legal fees and expenses	\$ 100,000
Accounting fees and expenses	\$ *
Blue sky fees and expenses	\$ *
Transfer agent fees	\$ *
<hr/>	
Total	\$ 108,826
<hr/>	

\* To be filed by amendment.

**Item 14. Indemnification of Directors and Officers**

Under Section 145 of the Delaware General Corporation Law (the "DGCL"), a corporation may indemnify its directors, officers, employees and agents and its former directors, officers, employees and agents and those who serve, at the corporation's request, in such capacities with another enterprise, against expenses (including attorney's fees), as well as judgments, fines and settlements in nonderivative lawsuits, actually and reasonably incurred in connection with the defense of any action, suit or proceeding in which they or any of them were or are made parties or are threatened to be made parties by reason of their serving or having served in such capacity. The DGCL provides, however, that such person must have acted in good faith and in a manner such person reasonably believed to be in (or not opposed to) the best interests of the corporation and, in the case of a criminal action, such person must have had no reasonable cause to believe his or her conduct was unlawful. In addition, the DGCL does not permit indemnification in an action or suit by or in the right of the corporation, where such person has been adjudged liable to the corporation, unless, and only to the extent that, a court determines that such person fairly and reasonably is entitled to indemnity for costs the court deems proper in light of liability adjudication. Indemnity for costs the court deems proper in light of liability adjudication. Indemnity is mandatory to the extent a claim, issue or matter has been successfully defended.

Our Certificate of Incorporation and By-Laws provide that, to the extent permitted by law, the company shall fully indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending, or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that such person is or was or has agreed to become a director, officer, employee, or agent of the company, or is or was serving at the request of the company as director, officer, employee, or agent of another corporation, partnership, joint venture, trust, employee benefit, plan or enterprise, or by reason of any action alleged to have been taken or omitted in such capacity, and may indemnify any person who was or is a party or is threatened to be made a party to such an action, suit or proceeding by reason of that fact that the person is or was or has agreed to become an employee or agent of the company, or is or was serving or has agreed to serve at the request of the company as an employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding and any appeal therefrom, if the person acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the company, and, with respect to any criminal action or proceeding had not reasonable cause to believe the person's conduct

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was unlawful; except that in the case of an action or suit by or in the right of the company to procure a judgment in its favor (1) such indemnification shall be limited to expenses (including attorneys' fees) actually and reasonably incurred by such person in the defense or settlement of such proceeding, and (2) no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the company unless and only

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to the extent that the Delaware Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnify for such expenses which the Delaware Court of Chancery or such other court shall deem proper.

The Certificate of Incorporation and By-Laws further provide that the company shall advance expenses incurred by a director or officer in defending any such action if the director or officer undertakes to repay such amount if it is determined that the director or officer is not entitled to indemnification. The company also shall purchase and maintain insurance to protect itself and any such director, officer, or other person against any liability asserted against him and incurred by him in respect of such service whether or not the company would have the power to indemnify him against such liability by law or under the provisions of the Certificate of Incorporation or By-Laws.

Further, the company has entered into indemnification agreements with its directors and certain of its senior executive officers. Pursuant to the terms of the indemnification agreements, each of the senior executive officers and directors of the company will be indemnified by the company to the fullest extent permitted by Delaware law in the event such officer is made or threatened to be made a party to a claim arising out of such person acting in his capacity as an officer or director of the company.

The registration rights agreement associated with the 2008 notes provides that the holders of the 2008 notes and warrants shall indemnify the company and its directors and officers from and against any and all losses, claims, damages, expenses (including reasonable costs of investigation and fees, disbursements, and other charges of counsel and any amounts paid in settlement) or other liabilities to which the company or its directors and officers may become subject under the securities laws, any other federal law, any state or common law rule or regulation which results from, arises out of, or is based upon any untrue, or alleged untrue, statement or omission, or alleged omission, of material fact by the holders contained in any registration statement, prospectus, or preliminary prospectus (as amended or supplemented) or any document incorporated by reference in any of the foregoing, if such information was furnished in writing by the holder to the company for use in such document.

## **Item 15. Recent Sales of Unregistered Securities**

On April 17, 2003, we issued warrants to purchase 282,596 shares of common stock to Philadelphia Brokerage Corporation in connection with the 2008 notes transaction. On June 10, 2003, Philadelphia Brokerage exercised all of these warrants and was issued 282,596 shares of unregistered common stock. Philadelphia Brokerage Corporation is an accredited investor that is unaffiliated with QuadraMed. Upon the exercise of warrants with an exercise price of \$0.01 per share, our total gross proceeds were \$ 2,825.96.

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### Item 16. Exhibits and Financial Statement Schedules

- (a) The following exhibits are filed as part of this registration statement. Certain of the following exhibits have been previously filed with the SEC and are incorporated herein by reference from the document described in parentheses. Certain others are filed herewith.

Exhibit Number	Exhibit Description
1.1	Purchase Agreement, dated as of April 27, 1998, by and among QuadraMed Corporation and the Initial Purchasers named therein. (Exhibit 1.1 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
2.1	Asset Purchase Agreement, by and among, QuadraMed Corporation, QuadraMed Operating Corporation, OAO Technology Solutions, Inc., and OAO Transaction, LLP, dated as of August 16, 2001. (Exhibit 2.3 to our Current Report on Form 8-K, as filed with the SEC on August 21, 2001.)
3.1**	Amended and Restated Bylaws of QuadraMed.
3.2	Third Amended and Restated Certificate of Incorporation of QuadraMed. (Exhibit 3.5 to our Annual Report Amended on Form 10-K/A, as filed with the SEC on August 24, 1998.)
3.3**	Amendment to the Third Amended and Restated Certificate of Incorporation of QuadraMed.
4.1	Reference is made to Exhibits 3.1, 3.2 and 3.3.
4.2	Form of Common Stock certificate. (Exhibit 4.2 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
4.3	Securities Purchase Agreement, dated as of April 17, 2003, among QuadraMed Corporation and certain investors listed on the signature pages attached thereto. (Exhibit 4.1 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.4	Form of Note. (Exhibit 4.2 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.5	Warrant Agreement dated as of April 17, 2003, by and between QuadraMed Corporation and The Bank of New York, as warrant agent. (Exhibit 4.3 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.6	Indenture, dated as of April 17, 2003, between QuadraMed Corporation and the Bank of New York, as trustee. (Exhibit 4.4 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.7	Registration Rights Agreement, dated as of April 17, 2003, among QuadraMed, the investors listed on the signature pages thereto, and Philadelphia Brokerage Corporation. (Exhibit 4.5 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.8	Security Agreement, dated as of April 17, 2003, made by QuadraMed Corporation in favor of The Bank of New York, as collateral agent. (Exhibit 4.6 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.9	Form of Warrant to Purchase Common Stock. (Exhibit 4.11 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
4.10	Subordinated Indenture, dated as of May 1, 1998, between QuadraMed and The Bank of New York. (Exhibit 4.6 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
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Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)

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4.13	Form of Global Debenture. (Exhibit 4.9 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
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10.3	Summary Plan Description, QuadraMed Corporation 401(k) Plan. (Exhibit 10.3 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
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12.1**	Statement of Computation of Ratio of Earnings to Fixed Charges.
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21.1**	QuadraMed Corporation subsidiaries.
23.1**	Consent of BDO Seidman, LLP, Independent Public Accountants.
23.2**	Consent of Pisenti & Brinker, LLP, Independent Public Accountants.
23.3**	Consent of Miles & Stockbridge, P.C. (included in Exhibit 5.1).
24.1**	Power of Attorney (set forth in the signature page hereto).
25.1**	Statement of Eligibility of Trustee.

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\*\* Filed herewith.

(b) Financial Statement Schedules

Reference is made to Schedule II Valuation and Qualifying Accounts on page S-1 of this registration statement.

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**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, the registrant certifies that it has reasonable grounds to believe that it meets all of the requirements for filing on Form S-1 and has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the County of Fairfax, Commonwealth of Virginia, on this 21st day of January, 2004.

QUADRAMED CORPORATION

By: /s/ Lawrence P. English

Lawrence P. English

Chairman, Chief Executive Officer

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Each individual whose signature appears below constitutes and appoints Lawrence P. English as his attorney-in-fact, for him in any and all capacities, to sign any amendments to this registration statement, and to file the same, with exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting to said attorney-in-fact, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming the said attorney-in-fact or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the dates indicated.

/s/ Lawrence P. English	Chairman, Chief Executive Officer	January 21, 2004
_____ Lawrence P. English	(Principal Executive Officer)	
/s/ Charles J. Stahl	Executive Vice President, Chief Financial Officer	January 21, 2004
_____ Charles J. Stahl	(Principal Financial and Accounting Officer)	
/s/ F. Scott Gross	Director	January 21, 2004
_____ F. Scott Gross		
/s/ William K. Jurika	Director	January 21, 2004
_____ William K. Jurika		
/s/ Robert L. Pevenstein	Director	January 21, 2004
_____ Robert L. Pevenstein		
/s/ Michael J. King	Director	January 21, 2004
_____ Michael J. King		
/s/ Cornelius T. Ryan	Director	January 21, 2004
_____ Cornelius T. Ryan		
/s/ Joseph A. Feshbach	Director	January 21, 2004
_____ Joseph A. Feshbach		
/s/ Robert W. Miller	Director	January 21, 2004
_____ Robert W. Miller		



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**EXHIBIT INDEX**

Certain of the following exhibits have been previously filed with the SEC and are incorporated herein by reference from the document described in parentheses. Certain others are filed herewith.

<b>Exhibit Number</b>	<b>Exhibit Description</b>
1.1	Purchase Agreement, dated as of April 27, 1998, by and among QuadraMed Corporation and the Initial Purchasers named therein. (Exhibit 1.1 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
2.1	Asset Purchase Agreement, by and among, QuadraMed Corporation, QuadraMed Operating Corporation, OAO Technology Solutions, Inc., and OAO Transaction, LLP, dated as of August 16, 2001. (Exhibit 2.3 to our Current Report on Form 8-K, as filed with the SEC on August 21, 2001.)
3.1**	Amended and Restated Bylaws of QuadraMed.
3.2	Third Amended and Restated Certificate of Incorporation of QuadraMed. (Exhibit 3.5 to our Annual Report Amended on Form 10-K/A, as filed with the SEC on August 24, 1998.)
3.3**	Amendment to the Third Amended and Restated Certificate of Incorporation of QuadraMed.
4.1	Reference is made to Exhibits 3.1, 3.2 and 3.3.
4.2	Form of Common Stock certificate. (Exhibit 4.2 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
4.3	Securities Purchase Agreement, dated as of April 17, 2003, among QuadraMed Corporation and certain investors listed on the signature pages attached thereto. (Exhibit 4.1 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.4	Form of Note. (Exhibit 4.2 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.5	Warrant Agreement dated as of April 17, 2003, by and between QuadraMed Corporation and The Bank of New York, as warrant agent. (Exhibit 4.3 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.6	Indenture, dated as of April 17, 2003, between QuadraMed Corporation and the Bank of New York, as trustee. (Exhibit 4.4 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.7	Registration Rights Agreement, dated as of April 17, 2003, among QuadraMed, the investors listed on the signature pages thereto, and Philadelphia Brokerage Corporation. (Exhibit 4.5 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.8	Security Agreement, dated as of April 17, 2003, made by QuadraMed Corporation in favor of The Bank of New York, as collateral agent. (Exhibit 4.6 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
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