

PRE PAID LEGAL SERVICES INC  
Form 10-Q  
July 24, 2007

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

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

For The Quarterly Period Ended June 30, 2007

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For The Transition Period From \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-09293

**PRE-PAID LEGAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

**Oklahoma**

(State or other jurisdiction of  
incorporation or organization)

**73-1016728**

(I.R.S. Employer  
Identification No.)

**One Pre-Paid Way, Ada, Oklahoma**

(Address of principal executive offices)

**74820-5813**

(Zip Code)

(Registrants' telephone number, including area code) **(580) 436-1234**

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of [accelerated filer and large accelerated filer] in Rule 12b-2 of the Exchange Act. Check one:

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Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)  
Yes  No

The number of shares outstanding of the registrant's common stock (excluding 4,852,179 shares held in treasury) as of July 20, 2007 was 13,237,405.

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**PRE-PAID LEGAL SERVICES, INC.**

**FORM 10-Q**

**For the Quarter Ended June 30, 2007**

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**ITEM 1. FINANCIAL STATEMENTS**

**PRE-PAID LEGAL SERVICES, INC.  
CONSOLIDATED BALANCE SHEETS  
(Amounts in 000's, except par values)**

**ASSETS**

|   | <b>June 30,<br/>2007<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2006</b> |
|---|--|----------------------------------|
| <b>Current assets:</b>                        |  |                                  |
| Cash and cash equivalents                     | \$ 18,195                                | \$ 12,031                        |
| Available-for-sale investments, at fair value | 40,592                                   | 42,275                           |
| Membership fees receivable                    | 5,666                                    | 5,518                            |
| Inventories                                   | 1,370                                    | 1,337                            |
| Refundable income taxes                       | 316                                      | 653                              |
| Deferred member and associate service costs   | 16,288                                   | 15,879                           |
| Deferred income taxes                         | 4,992                                    | 4,235                            |
| Other assets                                  | 6,561                                    | 6,404                            |
| <b>Total current assets</b>                   | <b>93,980</b>                            | <b>88,332</b>                    |
| Available-for-sale investments, at fair value | 21,491                                   | 27,461                           |
| Investments pledged                           | 4,246                                    | 4,145                            |
| Property and equipment, net                   | 57,550                                   | 59,643                           |
| Deferred member and associate service costs   | 2,485                                    | 2,636                            |
| Other assets                                  | 6,892                                    | 6,330                            |
| <b>Total assets</b>                           | <b>\$ 186,644</b>                        | <b>\$ 188,547</b>                |

**LIABILITIES AND STOCKHOLDERS' EQUITY**

|   |                |                |
|---|----------------|----------------|
| <b>Current liabilities:</b>               |                |                |
| Membership benefits                       | \$ 12,041      | \$ 11,995      |
| Deferred revenue and fees                 | 27,512         | 26,040         |
| Current portion of capital leases payable | 22             | 340            |
| Current portion of notes payable          | 18,437         | 18,437         |
| Accounts payable and accrued expenses     | 15,396         | 13,645         |
| <b>Total current liabilities</b>          | <b>73,408</b>  | <b>70,457</b>  |
| Capital leases payable                    | 945            | 957            |
| Notes payable                             | 64,314         | 73,533         |
| Deferred revenue and fees                 | 2,485          | 2,636          |
| Deferred income taxes                     | 4,769          | 4,897          |
| Other non-current liabilities             | 5,780          | 5,207          |
| <b>Total liabilities</b>                  | <b>151,701</b> | <b>157,687</b> |

## Stockholders' equity:

|   |                   |                   |
|---|-------------------|-------------------|
| Common stock, \$.01 par value; 100,000 shares authorized; 18,096 and 18,488 issued at June 30, 2007 and December 31, 2006, respectively | 181               | 185               |
| Retained earnings   | 132,995           | 129,413           |
| Accumulated other comprehensive income  | 795               | 290               |
| Treasury stock, at cost; 4,852 shares held at June 30, 2007 and December 31, 2006, respectively   | (99,028)          | (99,028)          |
| <b>Total stockholders' equity</b>   | <b>34,943</b>     | <b>30,860</b>     |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 186,644</b> | <b>\$ 188,547</b> |

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

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**PRE-PAID LEGAL SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(Amounts in 000's, except per share amounts)  
(Unaudited)

|   | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|---|--------------------------------|------------------|------------------------------|------------------|
|   | 2007                           | 2006             | 2007                         | 2006             |
| <b>Revenues:</b>                        |                                |                  |                              |                  |
| Membership fees                         | \$ 106,936                     | \$ 103,111       | \$ 210,817                   | \$ 204,851       |
| Associate services                      | 5,968                          | 6,820            | 13,032                       | 13,783           |
| Other                                   | 1,156                          | 1,267            | 2,295                        | 2,524            |
|   | 114,060                        | 111,198          | 226,144                      | 221,158          |
| <b>Costs and expenses:</b>              |                                |                  |                              |                  |
| Membership benefits                     | 36,927                         | 36,490           | 73,678                       | 72,118           |
| Commissions                             | 34,243                         | 32,745           | 64,775                       | 64,630           |
| Associate services and direct marketing | 6,682                          | 7,584            | 13,057                       | 14,886           |
| General and administrative              | 13,383                         | 13,020           | 26,130                       | 25,487           |
| Other, net                              | 3,293                          | 2,900            | 7,037                        | 5,623            |
|   | 94,528                         | 92,739           | 184,677                      | 182,744          |
| Income before income taxes              | 19,532                         | 18,459           | 41,467                       | 38,414           |
| Provision for income taxes              | 6,353                          | 6,369            | 13,560                       | 13,253           |
| <b>Net income</b>                       | <b>\$ 13,179</b>               | <b>\$ 12,090</b> | <b>\$ 27,907</b>             | <b>\$ 25,161</b> |
| Basic earnings per common share         | \$ .99                         | \$ .81           | \$ 2.08                      | \$ 1.66          |
| Diluted earnings per common share       | \$ .99                         | \$ .81           | \$ 2.07                      | \$ 1.65          |

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

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**PRE-PAID LEGAL SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(Amounts in 000's)

(Unaudited)

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2007                           | 2006      | 2007                         | 2006      |
| Net income   | \$ 13,179                      | \$ 12,090 | \$ 27,907                    | \$ 25,161 |
| Other comprehensive income (loss), net of tax:   |                                |           |                              |           |
| Foreign currency translation adjustment  | 553                            | 232       | 604                          | 191       |
| Unrealized gains (losses) on investments:  |                                |           |                              |           |
| Unrealized holding gains (losses) arising during period  | (192)                          | (178)     | (167)                        | (382)     |
| Reclassification adjustment for realized (gains) losses included in net income   | (4)                            | 56        | 68                           | 29        |
|  | (196)                          | (122)     | (99)                         | (353)     |
| Other comprehensive income (loss), net of income taxes of \$(125) and \$(78) for the three months and \$(63) and \$(226) for the six months ended June 30, 2007 and 2006, respectively | 357                            | 110       | 505                          | (162)     |
| Comprehensive income   | \$ 13,536                      | \$ 12,200 | \$ 28,412                    | \$ 24,999 |

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

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**PRE-PAID LEGAL SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Amounts in 000's)**  
**(Unaudited)**

|   | Six Months Ended<br>June 30, |           |
|---|------------------------------|-----------|
|   | 2007                         | 2006      |
| Cash flows from operating activities:   |                              |           |
| Net income  | \$ 27,907                    | \$ 25,161 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |           |
| Benefit for deferred income taxes   | (754)                        | (620)     |
| Depreciation and amortization   | 4,297                        | 4,042     |
| (Increase) decrease in Membership income receivable                               | (148)                        | 375       |
| (Increase) decrease in inventories  | (33)                         | 438       |
| Decrease (increase) in income tax receivable                                      | 337                          | (175)     |
| Increase in deferred member and associate service costs                           | (258)                        | (15)      |
| Increase in other assets  | (719)                        | (2,219)   |
| Increase in accrued Membership benefits   | 46                           | 274       |
| Increase in deferred revenue and fees   | 1,321                        | 891       |
| Increase in other non-current liabilities   | 573                          | 294       |
| Decrease in income tax payable  | □                            | (1,738)   |
| Increase in accounts payable and accrued expenses and other                       | 2,355                        | 229       |
| Net cash provided by operating activities   | 34,924                       | 26,937    |

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|  |                          |           |
|--|--------------------------|-----------|
| Cash flows from investing activities:  |                          |           |
| Additions to property and equipment  | (2,204)                  | (5,910)   |
| Purchases of investments <input type="checkbox"/> available for sale               | (119,812)                | (8,559)   |
| Maturities and sales of investments <input type="checkbox"/> available for sale    | 127,134                  | 10,576    |
| Net cash provided by (used in) investing activities                                | 5,118                    | (3,893)   |
| Cash flows from financing activities:  |                          |           |
| (Use) proceeds from exercise of stock options and related tax withholding payments | (84)                     | 222       |
| Tax benefit on exercise of stock options   | 790                      | 636       |
| Proceeds from issuance of debt   | <input type="checkbox"/> | 85,000    |
| Decrease in capital lease obligations  | (330)                    | (310)     |
| Common stock dividends paid  | <input type="checkbox"/> | (4,643)   |
| Repayments of debt   | (9,219)                  | (23,532)  |
| Purchases of treasury stock  | (25,035)                 | (37,569)  |
| Net cash (used in) provided by financing activities                                | (33,878)                 | 19,804    |
| Net increase in cash and cash equivalents  | 6,164                    | 42,848    |
| Cash and cash equivalents at beginning of period                                   | 12,031                   | 33,957    |
| Cash and cash equivalents at end of period   | \$ 18,195                | \$ 76,805 |
| Supplemental disclosure of cash flow information:                                  |                          |           |
| Cash paid for interest   | \$ 3,732                 | \$ 1,317  |
| Cash paid for income taxes   | \$ 13,256                | \$ 14,998 |

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

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**PRE-PAID LEGAL SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Except for per share amounts, dollar amounts in tables are in thousands unless otherwise indicated)  
(Unaudited)

**Note 1 - Basis of Presentation**

The accompanying consolidated financial statements and notes thereto have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been omitted. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in our 2006 Annual Report on Form 10-K. Terms such as we, our and us are sometimes used as abbreviated references to Pre-Paid Legal Services, Inc.

In our opinion, the accompanying unaudited financial statements as of June 30, 2007, and for the three month and six month periods ended June 30, 2007 and 2006, reflect adjustments (which were normal and recurring) which, in our opinion, are necessary for a fair statement of our financial position and results of operations of the interim periods presented. Results for the three month and six month periods ended June 30, 2007 are not necessarily indicative of results expected for the full year.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Note 2 ☐ Contingencies**

Beginning in the second quarter of 2001 multiple lawsuits were filed against us, certain officers, employees, sales associates and other defendants in various Mississippi state courts by current or former members seeking actual and punitive damages for alleged breach of contract, fraud and various other claims in connection with the sale of Memberships. At one time, we were aware of 11 separate lawsuits involving approximately 400 plaintiffs in multiple counties in Mississippi. These cases seek varying amounts of actual and punitive damages. We tried three separate lawsuits in Mississippi. On September 11, 2006 we reached a settlement agreement with counsel for the more than 400 plaintiffs in numerous pending cases in Mississippi. For an amount significantly less than our then accrued reserves of \$2.5 million, all pending litigation against us is being resolved in Mississippi, including the Barbara Booth v. Pre-Paid Legal Services, Inc. case in which the \$9.9 million punitive damage verdict was entered. Settlement and dismissal of almost all pending litigation has been approved by the plaintiffs.

On March 27, 2006 we received a complaint filed by a former provider attorney law firm in Davidson County, Tennessee seeking compensatory and punitive damages on the basis of allegations of breach of contract. On May 15, 2006 the trial court dismissed plaintiff's complaint in its entirety. Plaintiff filed a notice of appeal on June 13, 2006. Oral argument was held on May 11, 2007. The ultimate outcome of this matter is not determinable.

On March 23, 2007 we received a Civil Investigative Demand from the Federal Trade Commission requesting information relating to our Identity Theft Shield and ADRS Program. We are working with the Federal Trade Commission to resolve the matter. The ultimate outcome of the matter is not determinable.

We are a defendant in various other legal proceedings that are routine and incidental to our business. We will vigorously defend our interests in all proceedings in which we are named as a defendant. We also receive periodic complaints or requests for information from various state and federal agencies relating to our business or the activities of our marketing force. We promptly respond to any such matters and provide any information requested.

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While the ultimate outcome of these proceedings is not determinable, we do not currently anticipate that these contingencies will result in any material adverse effect to our financial condition or results of operation, unless an unexpected result occurs in one of the cases. The costs of the defense of these various matters are reflected as a part of general and administrative expense, or Membership benefits if fees relate to Membership issues, in the consolidated statements of income. We have established an accrued liability, we believe will be sufficient to cover estimated damages in connection with various cases (exclusive of ongoing defense costs which are expensed as incurred), which at June 30, 2007 was \$75,000. We believe that we have meritorious defenses in all pending cases and will vigorously defend against the plaintiffs' claims. However, it is possible that an adverse outcome in certain cases or increased litigation costs could have an adverse effect upon our financial condition, operating results or cash flows in particular quarterly or annual periods.

Canadian taxing authorities are challenging portions of our commission and general and administrative deductions for tax years 1999 - 2002 and have tax assessments which aggregate \$5.7 million. The Canadian taxing authorities contend commission deductions should be matched with the membership revenue as received, we contend these commissions are deductible when paid. Under Canadian tax laws, our commission payments are treated as a prepaid expense. We base our deduction of commission on the fact that all the services (the sale of the membership) have been performed by the sales associate at the time of sale therefore this prepaid expense (the commission payments) is deductible when paid. Also, the commission payment is taxable to the sales associate when paid and each year we issue a T4 (Canadian 1099 equivalent) to sales associates for the total commission payments made during that year. In addition, Canadian taxing authorities have challenged our allocation of general and administrative expenses to Canadian operations. We contend the allocation of general and administrative expenses, based on the percentage of Canadian new memberships written and the Canadian percentage memberships in force, is reasonable. During July 2007 we received a settlement offer from the Canadian taxing authorities regarding the general and administrative deductions which if accepted would allow us to claim a deduction on the Canadian tax return for over 70% of these items. This settlement offer would allow us to deduct the remaining 30% of these items on our US federal tax returns. We have established an accrued liability we believe will be sufficient to cover the estimated tax assessment in connection with these items, which at June 30, 2007 was \$477,000. As stated above, we believe that we have reasonable basis for our tax position relative to these items, however, it is possible that an adverse outcome could have an adverse effect upon our financial condition, operating results or cash flows in particular quarterly or annual periods.

**Note 3 □ Treasury Stock Purchases**

We announced on April 6, 1999, a treasury stock purchase program authorizing management to acquire up to 500,000 shares of our common stock. The Board of Directors has increased such authorization from 500,000 shares to 13 million shares during subsequent board meetings. At June 30, 2007 we had purchased 11.9 million treasury shares under these authorizations for a total consideration of \$321.0 million, an average price of \$27.00 per share. We purchased and formally retired 185,815 shares of our common stock during the 2007 second quarter for \$11.0 million, or an average price of \$59.44 per share, reducing our common stock by \$1,858 and our retained earnings by \$11.0 million. See Note 6 below. Given the current interest rate environment, the nature of other investments available and our expected cash flows, we believe that purchasing treasury shares enhances shareholder value and may seek alternative sources of financing to continue or accelerate the program. Any additional treasury stock purchases will be made at prices that we consider attractive and at such times that we believe will not unduly impact our liquidity.

**Note 4 □ Earnings Per Share**

Basic earnings per common share are computed by dividing net income by the weighted average number of shares of common stock outstanding during the respective period. Diluted earnings per common share are computed by dividing net income by the weighted average number of shares of common stock and dilutive potential common shares outstanding during the respective period. The weighted average number of common shares is increased by the number of dilutive potential common shares issuable on the exercise of options less the number of common shares assumed to have been purchased with the proceeds from the exercise of the options pursuant to the treasury stock method; those purchases are assumed to have been made at the average price of the common stock during the respective period.

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|  | Three Months<br>Ended June 30, |           | Six Months<br>Ended June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2007                           | 2006      | 2007                         | 2006      |
| <b>Basic Earnings Per Share:</b>               |                                |           |                              |           |
| <u>Earnings:</u>                               |                                |           |                              |           |
| Net income                                     | \$ 13,179                      | \$ 12,090 | \$ 27,907                    | \$ 25,161 |
| <u>Shares:</u>                                 |                                |           |                              |           |
| Weighted average shares outstanding            | 13,278                         | 14,863    | 13,408                       | 15,125    |
| <b>Diluted Earnings Per Share:</b>             |                                |           |                              |           |
| <u>Earnings:</u>                               |                                |           |                              |           |
| Net income                                     | \$ 13,179                      | \$ 12,090 | \$ 27,907                    | \$ 25,161 |
| <u>Shares:</u>                                 |                                |           |                              |           |
| Weighted average shares outstanding            | 13,278                         | 14,863    | 13,408                       | 15,125    |
| Assumed exercise of options                    | 44                             | 94        | 66                           | 118       |
| Weighted average number of shares, as adjusted | 13,322                         | 14,957    | 13,474                       | 15,243    |
| Shares issued pursuant to option exercises     | 82                             | 89        | 122                          | 111       |

Options to purchase shares of common stock are excluded from the calculation of diluted earnings per share when their inclusion would have an anti-dilutive effect on the calculation. No options were excluded for the three month and six month periods ended June 30, 2007 and 2006.

**Note 5 □ Recently Issued Accounting Pronouncements**

We adopted FASB Interpretation 48, Accounting for Uncertainty in Income Taxes (□FIN 48□), on January 1, 2007. The adoption of FIN 48 did not have a material effect on our consolidated financial position or results of operations.

We and our subsidiaries are subject to U.S. federal income tax, Canadian income tax, as well as income tax of multiple state and local jurisdictions. Our 2003 □ 2006 U.S. federal income tax returns remain open to examination by the Internal Revenue Service (IRS). Our state and local income tax returns for years 1999 through 2006 remain open to examination by the state and local taxing authorities. Canadian income tax returns for 1999



through 2002 are currently under examination and years 1999 - 2006 are open to examination. The IRS examined our U.S. federal income tax return for 2004 resulting in no recommended adjustments to the tax return.

Canadian taxing authorities are challenging portions of our commission and general and administrative deductions for tax years 1999 - 2002 and have tax assessments which aggregate \$5.7 million. The Canadian taxing authorities contend commission deductions should be matched with the membership revenue as received, we contend these commissions are deductible when paid. Under Canadian tax laws, our commission payments are treated as a prepaid expense. We base our deduction of commission on the fact that all the services (the sale of the membership) have been performed by the sales associate at the time of sale therefore this prepaid expense (the commission payments) is deductible when paid. Also, the commission payment is taxable to the sales associate when paid and each year we issue a T4 (Canadian 1099 equivalent) to sales associates for the total commission payments made during that year. In addition, Canadian taxing authorities have challenged our allocation of general and administrative expenses to Canadian operations. We contend the allocation of general and administrative expenses, based on the percentage of Canadian new memberships written and the Canadian percentage memberships in force, is reasonable. During July 2007 we received a settlement offer from the Canadian taxing authorities regarding the general and administrative deductions which if accepted would allow us to claim a deduction on the Canadian tax return for over 70% of these items. This settlement offer would allow us to deduct the remaining 30% of these items on our US federal tax returns. We have established an accrued liability we believe will be sufficient to cover the estimated tax assessment in connection with these items, which at June 30, 2007 was \$477,000. As stated above, we believe that we have reasonable basis for our tax position relative to these items, however, it is possible that an adverse outcome could have an adverse effect upon our financial condition, operating results or cash flows in particular quarterly or annual periods.

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We are continuing our practice of recognizing interest and/or penalties related to income tax matters in general and administrative expenses.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This statement clarifies how to measure fair value as permitted under other accounting pronouncements but does not require any new fair value measurements. However, for some entities, the application of this statement will change current practice. We will be required to adopt SFAS No. 157 as of January 1, 2008 and are currently evaluating the impact of SFAS No. 157 and have not yet determined the effect on our earnings or financial position.

In March 2006, the FASB Emerging Issues Task Force issued Issue 06-3, How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (EITF 06-3). A tentative consensus was reached that a company should disclose its accounting policy (i.e., gross or net presentation) regarding presentation of taxes within the scope of EITF 06-3. If taxes are significant, a company should disclose the amount of such taxes for each period for which an income statement is presented. Sales taxes are not significant and our accounting policy is to present them on a net basis (excluded from revenues).

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for us January 1, 2008. We are evaluating the impact that the adoption of SFAS No. 159 will have on our consolidated financial statements.

#### **Note 6 - Notes Payable**

On June 23, 2006, we received \$80 million of senior, secured financing (the "Senior Loan") from Wells Fargo Foothill, Inc. (Wells Fargo) consisting of a \$75 million five year term loan facility (the "Term Facility") and a \$5 million five year revolving credit facility (the "Revolving Facility"). At June 30, 2007, we have the full Revolving Facility available to us. After payment of an origination fee of 1%, lender costs and retirement of \$15.3 million of existing bank indebtedness, the net proceeds of the Term Facility we received were \$58.8 million. Since receiving the net proceeds, we used them to purchase 1.4 million shares of treasury stock at an average price of \$42.95 per share.

The Term Facility was fully funded on June 23, 2006 and provides for a five-year maturity and amortizes in monthly installments of \$1.25 million commencing August 1, 2006, with interest on the outstanding balances under the Term Facility and the Revolving Facility payable, at our option, at a rate equal to Wells Fargo base rate plus 150 basis points or at the LIBOR plus 250 basis points. The interest rate at June 30, 2007 was 7.82%. We are also obligated to make additional quarterly payments equal to 50% of our "excess cash flow" (as defined in the Senior Loan agreement) if our Leverage Ratio is greater than or equal to 1 to 1 at the end of a quarter. We expect to be able to repay the facilities with cash flow from operations. We have the right to prepay the Term Facility in whole or in part, subject to a prepayment premium of 1% in the first year, 0.5% in the second year and none thereafter, with a reduction of 50% of the prepayment premium if the prepayment is from the proceeds of another loan provided by Wells Fargo.

The Senior Loan is guaranteed by our non-regulated subsidiaries and is secured by all of our tangible and intangible personal property (other than aircraft), including stock in all of our direct subsidiaries, and a mortgage on a building we recently acquired in Duncan, Oklahoma and remodeled to relocate and expand our existing customer service facility in Duncan.

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In addition to customary covenants for loans of a similar type, the principal covenants for the Senior Loan are:

- a limitation on incurring any indebtedness in excess of the remaining existing bank indebtedness outstanding and \$2.3 million in permitted capitalized leases or purchase money debt;
- a limitation on our ability to pay dividends or make stock purchases, other than with the net proceeds of the Term Loan, unless we meet certain cash flow tests;
- a prohibition on prepayment of other debt;
- a requirement to maintain consolidated EBITDA for the twelve month period ending December 31, 2006 and each quarter thereafter of at least \$80 million (\$75 million for us and our top tier direct subsidiaries);
- a requirement to maintain a quarterly fixed charge coverage ratio (EBITDA (with certain adjustments) divided by the sum of interest expense, income taxes and scheduled principal payments) of at least 1.1 to 1;
- a requirement to maintain at least 1.3 million members; and
- a requirement to maintain a Leverage Ratio (funded indebtedness as of the end of each quarter divided by EBITDA for the trailing twelve months) of no more than 1.5 to 1.

We were in compliance with these covenants at June 30, 2007.

In addition to customary events of default, it is an event of default if Harland Stonecipher ceases to be our Chairman and Chief Executive Officer for a period of 120 days unless replaced with a person approved by Wells Fargo.

We used the proceeds of the Term Facility to repay in full the \$5.3 remaining balance of our existing stock loan with Bank of Oklahoma, N.A., First United Bank and Trust and Comerica Bank, which was originated in 2003 and the \$10 million we borrowed from Bank of Oklahoma, N. A. earlier in June 2006. The related loan agreements were thereby terminated and the associated collateral was released. As a part of the transaction, we also amended our existing \$20 million real estate loan which we incurred in 2002 to finance our new headquarters building in Ada, Oklahoma to extend the final maturity from September 2008 to August 2011. This loan, with interest at the 30 day LIBOR rate plus 2.25%, adjusted monthly, remains secured by a mortgage on our headquarters, but the additional security interest in our membership contracts was released. The interest rate at June 30, 2007 was 7.57%. We will continue to be required to make the same monthly payments on this loan of \$191,000 plus interest with the balance of approximately \$2.3 million due at maturity. The real estate loan was also amended to conform the financial covenants to those under the new Senior Loan.

Our \$11.5 million aircraft loan was fully funded in November 2005 with interest payable monthly at the 30 day LIBOR rate plus 1.75%, adjusted monthly, and requires monthly principal installments of \$96,000 which began December 31, 2005 with the remaining balance payable in a final installment due November 30, 2012. The interest rate at June 30, 2007 was 7.07%. The loan is collateralized by the aircraft purchased. In addition to customary events of default, if Harland C. Stonecipher ceases to be our Chief Executive Officer for a period of 90 consecutive days an event of default will occur.

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A schedule of outstanding balances as of June 30, 2007 is as follows:

|  |           |
|--|-----------|
| Senior loan                            | \$ 61,250 |
| Real estate loan                       | 11,809    |
| Aircraft loan                          | 9,692     |
| Total notes payable                    | 82,751    |
| Less: Current portion of notes payable | (18,437)  |
| Long term portion                      | \$ 64,314 |

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A schedule of future maturities as of June 30, 2007 is as follows:

|  |           |
|--|-----------|
| Repayment Schedule commencing July 2007: |           |
| Year 1                                   | \$ 18,437 |
| Year 2                                   | 18,437    |
| Year 3                                   | 18,437    |
| Year 4                                   | 19,687    |
| Year 5                                   | 3,818     |
| Thereafter                               | 3,935     |
| Total notes payable                      | \$ 82,751 |

**Note 7 - Share-based Compensation**

During the six months ended June 30, 2007, the stock option activity under our stock option plans was as follows:

|   | Weighted<br>Average<br>Price | Number of<br>Shares | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(In Years) | Aggregate<br>Intrinsic<br>Value |
|---|------------------------------|---------------------|---|---------------------------------|
| Outstanding, January 1, 2007            | \$ 23.26                     | 273,040             |   |                                 |
| Granted                                 | □                            | □                   |   |                                 |
| Cancelled                               | 22.87                        | (5,597)             |   |                                 |
| Exercised                               | 24.17                        | (208,943)           |   |                                 |
| Outstanding, June 30, 2007              | \$ 20.08                     | 58,500              | 2.92  | \$ 6,821                        |
| Options exercisable as of June 30, 2007 | \$ 20.08                     | 58,500              | 2.92  | \$ 6,821                        |

Other information pertaining to option activity during the six months ended June 30, 2007 and 2006 was as follows:

|   |                |                |
|---|----------------|----------------|
|   | June 30, 2007  | June 30, 2006  |
| Weighted average grant-date fair value of stock options granted | Not applicable | Not applicable |
| Total fair value of stock options vested                        | Not applicable | Not applicable |
| Total intrinsic value of stock options exercised                | \$ 2,587       | \$ 3,604       |

Under our stock option plan, 1,346,252 shares of our Common Stock are available for issuance. Options outstanding and exercisable were granted at a stock option price which was not less than the fair market value of our Common Stock on the date the option was granted and no option has a term in excess of ten years. Additionally, options vested and became exercisable either on the grant date or up to five years from the option grant date.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, Share-Based Payment (□SFAS No. 123R□ or the □Statement□). This Statement is a revision of SFAS No. 123, Accounting for Stock-Based Compensation (□SFAS 123□), and supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (□APB No. 25□) and its related implementation guidance. On January 1, 2006, we adopted the provisions of SFAS No. 123R using the modified prospective method. SFAS No. 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. The Statement requires entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as financing cash flows, rather than as an operating cash flow as prescribed under the prior accounting rules. This requirement reduces net operating cash flows and increases net financing cash flows in periods after adoption. Total cash flow remains unchanged from what would have been reported under prior accounting rules.

Prior to the adoption of SFAS No. 123R, we followed the intrinsic value method in accordance with APB No. 25 to account for our employee stock options. Accordingly, no compensation expense was recognized in connection with the issuance of stock options under any of our stock option plans for periods ended prior to January 1, 2006. The adoption of SFAS No. 123R primarily resulted in a change in our method of recognizing the fair value of share-based compensation. Our adoption of SFAS No. 123R did not result in our recording compensation expense for employee stock options, since all options had vested, no modifications were made to existing options and no new options were granted.

We do not expect to grant any additional employee options or modify any existing options and therefore recognize any share-based payments' expense from the issuance of employee stock options in 2007. The options outstanding at December 31, 2005 did not and will not impact 2006 or 2007 consolidated results of operations and financial position since all option-holders were fully vested in such options at December 31, 2005.

**ITEM 1A. RISK FACTORS**

There are a number of risk factors that could affect our financial condition or results of operations. See Note 2 in Part 1, Item 1 - Contingencies and Part II, Item 1 - Legal Proceedings. Please refer to page 14 and 15 of our 2006 Annual Report on Form 10-K for a description of other risk factors. There have not been any material changes in the risk factors disclosed in the Annual Report.

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

The following discussion should be read in conjunction with the Management's Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the year ended December 31, 2006, which describes, among other things, our basic business model, critical accounting policies, measures of Membership retention, and basic cash flow characteristics of our business. The following tables set forth changes in the principal categories of revenues and expenses and Membership and recruiting activity for the second quarter of 2007 compared to the second quarter of 2006 and the first quarter of 2007 (Table amounts in 000□s). The sum of the percentages in the tables may not total due to rounding.

|                                   |          |         |        |          |           |
|-----------------------------------|----------|---------|--------|----------|-----------|
| Three Months Ended June 30, 2007  | Three    | %       | %      | Three    | Three     |
| compared to                       | Months   | Change  | Change | Months   | Months    |
| Three Months Ended June 30, 2006  | Ended    | % of    | from   | Ended    | % of      |
| and compared to                   | June 30, | Total   | Prior  | June 30, | Total     |
| Three Months Ended March 31, 2007 | 2007     | Revenue | Year   | 2006     | Revenue   |
|                                   |          |         | Period |          | March 31, |
|                                   |          |         |        |          | 2007      |

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|   |            |       |       |       |            |       |            |
|---|------------|-------|-------|-------|------------|-------|------------|
| <b>Revenues:</b>                        |            |       |       |       |            |       |            |
| Membership fees                         | \$ 106,936 | 93.8  | 3.7   | 2.9   | \$ 103,111 | 92.7  | \$ 103,881 |
| Associate services                      | 5,968      | 5.2   | -12.5 | -15.5 | 6,820      | 6.1   | 7,064      |
| Other                                   | 1,156      | 1.0   | -8.8  | 1.5   | 1,267      | 1.1   | 1,139      |
|   | 114,060    | 100.0 | 2.6   | 1.8   | 111,198    | 100.0 | 112,084    |
| <b>Costs and expenses:</b>              |            |       |       |       |            |       |            |
| Membership benefits                     | 36,927     | 32.4  | 1.2   | 0.5   | 36,490     | 32.8  | 36,751     |
| Commissions                             | 34,243     | 30.0  | 4.6   | 12.2  | 32,745     | 29.5  | 30,532     |
| Associate services and direct marketing | 6,682      | 5.9   | -11.9 | 4.8   | 7,584      | 6.8   | 6,375      |
| General and administrative              | 13,383     | 11.7  | 2.8   | 5.0   | 13,020     | 11.7  | 12,747     |
| Other, net                              | 3,293      | 2.9   | 13.6  | -12.1 | 2,900      | 2.6   | 3,744      |
|   | 94,528     | 82.9  | 1.9   | 4.9   | 92,739     | 83.4  | 90,149     |
| Income before income taxes              | 19,532     | 17.1  | 5.8   | -11.0 | 18,459     | 16.6  | 21,935     |
| Provision for income taxes              | 6,353      | 5.6   | -0.3  | -11.9 | 6,369      | 5.7   | 7,207      |
| Net income                              | \$ 13,179  | 11.6  | 9.0   | -10.5 | \$ 12,090  | 10.9  | \$ 14,728  |

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|  | <b>Three Months Ended</b> |                  |                  |
|--|---------------------------|------------------|------------------|
|  | <b>6/30/2007</b>          | <b>3/31/2007</b> | <b>6/30/2006</b> |
| <b><u>New Memberships:</u></b>   |                           |                  |                  |
| New legal service membership sales                                     | 138,083                   | 147,742          | 146,043          |
| New [stand-alone] IDT membership sales                                 | 8,082                     | 13,788           | 6,461            |
| Total new membership sales   | 146,165                   | 161,530          | 152,504          |
| New [add-on] IDT membership sales                                      | 92,382                    | 93,204           | 98,156           |
| Average Annual Membership fee  | \$326.04                  | \$309.86         | \$327.34         |
| <b><u>Active Memberships:</u></b>                                      |                           |                  |                  |
| Active legal service memberships at end of period                      | 1,484,414                 | 1,477,604        | 1,484,498        |
| Active [stand-alone] IDT memberships at end of period (see note below) | 75,156                    | 73,525           | 57,167           |
| Total active memberships at end of period                              | 1,559,570                 | 1,551,129        | 1,541,665        |
| Active [add-on] IDT memberships at end of period (see note below)      | 587,550                   | 562,075          | 507,049          |
| <b><u>New Sales Associates:</u></b>                                    |                           |                  |                  |
| New sales associates recruited   | 38,175                    | 31,043           | 45,517           |
| Average enrollment fee paid by new sales associates                    | \$44.65                   | \$103.13         | \$49.70          |
| <b><u>Average Membership fee in force:</u></b>                         |                           |                  |                  |
| Average Annual Membership fee  | \$295.98                  | \$294.17         | \$291.22         |

**Note** [ ] reflects 5,328 net transfers from [add-on] status to [stand-alone] status during the quarter

Identity Theft Shield ([IDT]) memberships sold in conjunction with new legal plan memberships or [added-on] to existing legal plan memberships sell for \$9.95 per month and are not counted as [new] memberships but do increase the average premium and related direct expenses (membership benefits and commissions) of our membership base, while [stand alone] Identity Theft Shield memberships are not attached to a legal plan membership and sell for \$12.95 per month.

*Recently Issued Accounting Pronouncements*

See Note 5 [ ] Recently Issued Accounting Pronouncements in Item 1 above.

**Results of Operations [ ] Second Quarter of 2007 compared to Second Quarter of 2006**

Net income increased 9% for the second quarter of 2007 to \$13.2 million from \$12.1 million for the prior year[ ]s second quarter primarily due to an increase in membership fees of \$3.8 million partially offset by an increase in commissions of \$1.5 million, an increase in Membership benefits of \$437,000, and increase in general and

administrative expenses of \$363,000 and an increase in other, net expenses of \$393,000. Diluted earnings per share increased 22% to 99 cents per share from 81 cents per share for the prior year's comparable quarter due to the 9% increase in net income and an approximate 11% decrease in the weighted average number of diluted shares outstanding.

Membership fees totaled \$106.9 million during the 2007 second quarter compared to \$103.1 million for 2006, an increase of 4%. Membership fees and their impact on total revenues in any period are determined directly by the number of active Memberships in force during any such period and the monthly amount of such Memberships. The active Memberships in force are determined by both the number of new Memberships sold in any period together with the renewal rate of existing Memberships. New Membership sales decreased 4% during the three months ended June 30, 2007 to 146,165 from 152,504 during the comparable period of 2006. At June 30, 2007, there were 1,559,570 active Memberships in force compared to 1,541,665 at June 30, 2006, an increase of 1%. Additionally, the average annual fee per Membership has increased from \$291 for all Memberships in force at June 30, 2006 to \$296 for all Memberships in force at June 30, 2007, primarily as a result of a larger number of Identity Theft Shield memberships.

Associate services revenue decreased by approximately \$852,000 to \$6 million, primarily due to decreases in associate enrollment fees and eService fees during the second quarter of 2007 when compared to the 2006 quarter. New associates enrolled were 38,175 during the 2007 period compared to 45,517 for the same period of 2006, and average enrollment fees paid by new sales associates decreased from \$50 during the 2006 period to \$45 during the 2007 quarter due to a lower enrollment fee in place for most of the 2007 second quarter. We expect to continue some form of reduced enrollment programs for the remainder of the year. The eService fees decreased to \$3.1 million during the second quarter of 2007 compared to \$3.3 million for the comparable period of 2006. Future revenues from associate services will depend primarily on the number of new associates enrolled, the price charged for the *Certified Field Trainer* program and the number who choose to participate in our eService program, but we expect that such revenues will continue to be offset by the direct and indirect cost to us of training, providing associate services and other direct marketing expenses.

Other revenue declined 9% from \$1.3 million for the 2006 period to \$1.2 million for the 2007 period.

Total revenues increased 3% to \$114.1 million for the three months ended June 30, 2007 from \$111.2 million during the comparable period of 2006 due to a \$3.8 million increase in Membership fees partially offset by an \$852,000 decline in associate services revenue.

Membership benefits totaled \$36.9 million for the three months ended June 30, 2007 compared to \$36.5 million for the comparable period of 2006, and represented 35% of Membership fees for both periods. This Membership benefit ratio (Membership benefits as a percentage of Membership fees) should be reduced going forward as substantially all active Memberships provide for a capitated cost and we have reduced the capitated cost of the Identity Theft plan benefits effective April 1, 2007.

Commissions to associates increased 5% to \$34.2 million for the three months ended June 30, 2007 compared to \$32.7 million for the comparable period of 2006, and represented 32% of Membership fees for both periods. Commissions to associates are primarily dependent on the number of new memberships sold, including add-on membership sales, during a period. Commissions to associates per new membership sold were \$234 per membership for the three months ended June 30, 2007 compared to \$215 for the comparable period of 2006. The average commission per new membership sold varies depending on the compensation structure that is in place at the time a new membership is sold, the amount of the Membership fee and the amount of any charge-backs (recoupment of previous commission advances) that are deducted from amounts that would otherwise be paid to the various sales associates that are compensated for the membership sale. Should we add additional commissions to our compensation plan or reduce the amount of chargebacks collected from our associates as we have from time to time, the commission cost per new Membership will increase accordingly.

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Associate services and direct marketing expenses decreased to \$6.7 million for the three months ended June 30, 2007 from \$7.6 million for the comparable period of 2006. The decrease was primarily a result of decreased costs for incentive trips and bonuses and decreased costs for materials sent to new associates due to the reduction in the number of new associates enrolled during the quarter. We offer the *Player's Club* incentive program to provide additional incentives to our associates as a reward for consistent, quality business. Associates can earn the right to receive additional monthly bonuses by meeting monthly qualification requirements for a 12 month period and maintaining certain personal retention rates for the Memberships sold during the 12 month period. These expenses also include the costs of providing associate services and marketing expenses.

General and administrative expenses during the three months ended June 30, 2007 and 2006 were \$13.4 million and \$13.0 million, respectively, and represented 13% of Membership fees for both periods.

Other expenses, net, which include depreciation and amortization, litigation accruals, interest expense and premium taxes reduced by interest income, were \$3.3 million for the three months ended June 30, 2007 compared to \$2.9 million for the 2006 comparable period. Depreciation increased to \$2.2 million for the second quarter of 2007 from \$2.0 million for the comparable period of 2006. Interest expense increased to \$1.8 million during the 2007 period from \$867,000 during the comparable period of 2006 as a result of additional debt. Premium taxes decreased from \$484,000 for the three months ended June 30, 2006 to \$476,000 for the comparable period of 2007. Interest income increased \$712,000 to \$1.6 million for the three months ended June 30, 2007 from \$450,000 for the comparable period of 2006, due to an increase in cash and investment balances.

We have recorded a provision for income taxes of \$6.4 million (32.5% of pretax income) and \$6.4 million (34.5% of pretax income) for the three months ended June 30, 2007 and 2006, respectively. The decrease in the tax rate is primarily due to an increase in non taxable interest income and tax credits.

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### **Results of Operations - Second Quarter of 2007 compared to First Quarter of 2007**

Second quarter 2007 membership fees increased 3% to \$106.9 million from \$103.9 million for the first quarter of 2007. Associate services revenues decreased during the 2007 second quarter by approximately \$1.1 million to \$6.0 million from \$7.1 million for the 2007 first quarter and associate services and direct marketing expenses increased by \$300,000 during the same period. Membership benefits totaled \$36.9 million in the second quarter of 2007 compared to \$36.8 million for the 2007 first quarter and represented 35% of membership fees for both periods. Commissions to associates totaled \$34.2 million in the 2007 second quarter compared to \$30.5 million for the 2007 first quarter and represented 32% and 29%, respectively, of membership fees for the two periods. General and administrative expenses increased during the 2007 second quarter to \$13.4 million compared to \$12.7 million for the 2007 first quarter and represented 13% and 12%, respectively, of membership fees for the two periods.

### **Results of Operations - First Six Months of 2007 compared to First Six Months of 2006**

Membership revenues increased 3% the first six months of 2007 to a record \$210.8 million compared to \$204.9 million for the first six months of 2006. Net income increased 11% for the first six months of 2007 to \$27.9 million from \$25.2 million for the prior year's comparable period primarily due to the increase of \$6 million in membership fees partially offset by an increase in Membership benefits expense of \$1.6 million, general and administrative expenses of \$643,000 and the provision for income taxes of \$307,000. Diluted earnings per share increased 26% to \$2.07 per share from \$1.65 per share for the prior year's comparable six month period due to the 11% increase in net income and an approximate 12% decrease in the weighted average number of diluted shares outstanding.

Membership fees and their impact on total revenues in any period are determined directly by the number of active Memberships in force during any such period. The active Memberships in force are determined by both the number of new Memberships sold in any period together with the renewal rate of existing Memberships. New Membership sales decreased 3% during the six months ended June 30, 2007 to 307,695 from 317,730 during the comparable period of 2006. At June 30, 2007, there were 1,559,570 active Memberships in force compared to 1,541,665 at June 30, 2006, an increase of 1.2%. Additionally, the average annual fee per Membership has increased from \$291 for all Memberships in force at June 30, 2006 to \$296 for all Memberships in force at June 30, 2007, primarily as a result of a larger number of Identity Theft Shield memberships.

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Associate services revenue decreased 5% from \$13.8 million for the first six months of 2006 to \$13 million during the comparable period of 2007 due to a decrease in associate enrollment fees and eServices fees. Total new associates enrolled during the first six months of 2007 were 69,218 compared to 95,293 for the same period of 2006 and average enrollment fees paid by new sales associates increased from \$50 during the 2006 period to \$71 during the 2007 six months due to a higher enrollment fee in place for most of the 2007 first quarter. We expect to continue some form of reduced enrollment programs for the remainder of the year. The eService fees decreased to \$6.0 million during the first six months of 2007 compared to \$6.4 million for the comparable period of 2006. Future revenues from associate services will depend primarily on the number of new associates enrolled, the price charged for the *Certified Field Trainer* program and the number who choose to participate in the Company's eService program, but the Company expects that such revenues will continue to be offset by the direct and indirect cost to the Company of training (including training bonuses paid), providing associate services and other direct marketing expenses

Other revenue decreased \$229,000 from \$2.5 million for the six month period ending June 2006 to \$2.3 million for the same period of 2007.

Primarily as a result of the increase in Membership fees, total revenues increased to \$226.1 million for the six months ended June 30, 2007 from \$221.2 million during the comparable period of 2006 an increase of 2%.

Membership benefits totaled \$73.7 million for the six months ended June 30, 2007 compared to \$72.1 million for the comparable period of 2006, and represented 35% of Membership fees for both periods. This Membership benefit ratio (Membership benefits as a percentage of Membership fees) should be reduced going forward as substantially all active Memberships provide for a capitated cost and we have reduced the capitated cost of the Identity Theft plan benefits effective April 1, 2007.

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Commissions to associates increased less than one percent to \$64.8 million for the six months ended June 30, 2007 compared to \$64.6 million for the comparable period of 2006, and represented 31% and 32% of Membership fees for such periods. Commissions to associates are primarily dependent on the number of new memberships sold during a period. Commissions to associates per new membership sold were \$211 per membership for the six months ended June 30, 2007 compared to \$203 for the comparable period of 2006. The average commission per new membership sold varies depending on the compensation structure that is in place at the time a new membership is sold and the amount of any charge-backs (recoupment of previous commission advances) that are deducted from amounts that would otherwise be paid to the various sales associates that are compensated for the membership sale. Should we add additional commissions to our compensation plan or reduce the amount of chargebacks collected from its associates as it has from time to time, the commission cost per new Membership will increase accordingly.

Associate services and direct marketing expenses decreased to \$13.1 million for the six months ended June 30, 2007 from \$14.9 million for the comparable period of 2006. The decrease was primarily a result of fewer new associates enrolled during the six month period and decreased cost for incentive trips and bonuses. We offer the *Player's Club* incentive program to provide additional incentives to our associates as a reward for consistent, quality business. Associates can earn the right to receive additional monthly bonuses by meeting monthly qualification requirements for the entire calendar year and maintaining certain personal retention rates for the Memberships sold during the calendar year. These expenses also include the costs of providing associate services and marketing expenses.

General and administrative expenses during the six months ended June 30, 2007 and 2006 were \$26.1 million and \$25.5 million, respectively, and represented 12% of Membership fees for both periods. The increases in general and administrative expense were primarily due to increased employee costs and property and other taxes.

Other expenses, net, which include depreciation and amortization, litigation accruals, interest expense and premium taxes reduced by interest income, was \$7 million for the six months ended June 30, 2007 compared to \$5.6 million for the 2006 comparable period. Depreciation increased to \$4.3 million for the first six months of 2007 from \$4 million for the comparable period of 2006. Interest expense increased to \$3.6 million during the 2007 period from \$1.5 million during the comparable period of 2006 primarily as a result of higher indebtedness.



Premium taxes increased from \$873,000 for the six months ended June 30, 2006 to \$982,000 for the comparable period of 2007. Interest income increased \$1.1 million to \$1.9 million for the six months ended June 30, 2007 from \$837,000 for the comparable period of 2006, primarily due to increased cash and investment balances.

We have recorded a provision for income taxes of \$13.6 million (32.7% of pretax income) for the first six months of 2007 compared to \$13.3 million (34.5% of pretax income) for the same period of 2006. The decrease in the tax rate is primarily due to an increase in non taxable interest income and tax credits.

### **Liquidity and Capital Resources**

#### *General*

Consolidated net cash provided from operating activities for the first six months of 2007 increased \$8.0 million to \$34.9 million from \$26.9 million for the 2006 period. The increase of \$8.0 million resulted primarily from the increase in net income of \$2.7 million, the \$1.5 million change in the increase in other assets, the change in the decrease of income taxes payable of \$1.7 million and the \$2.1 million change in the increase in accounts payable and accrued expenses and other.

Consolidated net cash provided by investing activities was \$5.1 million for the first six months of 2007 compared to net cash used of \$3.9 million for the comparable period of 2006. This \$9.0 million change in investing activities resulted from a \$3.7 million decrease in additions to property and equipment and a \$116.6 million increase in the maturities and sales of investments partially offset by a \$111.3 million increase in investment purchases.

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Net cash used in financing activities during the first six months of 2007 was \$33.9 million compared to net cash provided of \$19.8 million for the comparable period of 2006. This \$53.7 million change was primarily comprised of the \$85 million decrease in debt proceeds partially offset by the \$4.6 million decrease in common stock dividends paid, the \$14.3 million decreases in debt repayments and the \$12.5 million decrease in purchases of treasury stock.

We purchased and formally retired 514,638 shares of our common stock during the first half of 2007 for \$25.0 million, or an average price of \$48.65 per share, reducing our common stock by \$5,146 and our retained earnings by \$25.0 million. We had positive working capital of \$20.6 million at June 30, 2007, an increase of \$2.7 million compared to working capital of \$17.9 million at December 31, 2006. The increase was primarily due to a \$6.2 million increase in cash and cash equivalents partially offset by a decrease in the current portion of available-for-sale investments of \$1.7 million, an increase of \$1.5 million in deferred revenue and fees and a \$1.8 million increase in accounts payable and accrued expenses. The \$20.6 million positive working capital at June 30, 2007 would have been a \$31.8 million positive working capital excluding the current portion of deferred revenue and fees in excess of the current portion of deferred member and associate service costs. These amounts will be eliminated by the passage of time without the utilization of other current assets or us incurring other current liabilities. We do not expect any difficulty in meeting our financial obligations in the next 12 months.

At June 30, 2007 we reported \$80.3 million in cash and cash equivalents and unpledged investments compared to \$81.8 million at December 31, 2006. Our investments consist of common stocks, investment grade (rated Baa or higher) bonds primarily issued by corporations, the United States Treasury, federal agencies, federally sponsored agencies and enterprises as well as mortgage-backed securities, auction rate certificates and state and municipal tax-exempt bonds.

We generally advance significant commissions at the time a Membership is sold. During the six months ended June 30, 2007, we advanced commissions, net of chargebacks, of \$61.9 million on new Membership sales compared to \$62.1 million for the same period of 2006. Since approximately 95% of Membership fees are collected on a monthly basis, a significant cash flow deficit is created on a per Membership basis at the time a Membership is sold. Since there are no further commissions paid on a Membership during the advance period, we typically derive significant positive cash flow from the Membership over its remaining life.

We expense advance commissions ratably over the first month of the related Membership. As a result of this accounting policy, our commission expenses are all recognized over the first month of a Membership and there is no commission expense recognized for the same Membership during the remainder of the advance period. We

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track our unearned advance commission balances outstanding in order to ensure the advance commissions are recovered before any renewal commissions are paid and for internal purposes of analyzing our commission advance program. While not recorded as an asset, unearned advance commission balances from associates as of June 30, 2007, and related activity for the six month period then ended, were:

|  | (Amounts in<br>000[s]) |
|--|------------------------|
| Beginning unearned advance commission payments (1)   | \$ 188,647             |
| Advance commission payments, net   | 61,870                 |
| Earned commissions applied   | (61,991)               |
| Advance commission payment write-offs  | (1,888)                |
| Ending unearned advance commission payments before<br>estimated unrecoverable payments (1) | 186,638                |
| Estimated unrecoverable advance commission payments (1)                                    | (41,825)               |
| Ending unearned advance commission payments, net (1)                                       | \$ 144,813             |

(1) These amounts do not represent fair value, as they do not take into consideration timing of estimated recoveries.

The ending unearned advance commission payments, net, above includes net unearned advance commission payments to non-vested associates of \$53.0 million. As such, at June 30, 2007 future commission payments and related expense should be reduced as unearned advance commission payments of \$91.8 million are recovered. Commissions are earned by the associate as Membership premiums are earned by us, usually on a monthly basis. For additional information concerning these commission advances, see our Annual report on Form 10-K under the heading *Commissions to Associates* in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations.

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We believe that we have significant ability to finance any future growth in Membership sales based on our recurring cash flow and existing amount of cash and cash equivalents and unpledged investments at June 30, 2007 of \$80.3 million. We expect to maintain cash and investment balances, including pledged investments, on an ongoing basis of approximately \$20 to \$30 million in order to meet expected working capital needs and regulatory capital requirements. Cash balances in excess of this amount would be used for discretionary purposes such as additional treasury stock purchases subject to limitations in the Term Facility.

#### *Notes Payable*

See Note 6 Notes Payable in Item 1 above.

#### *Parent Company Funding and Dividends*

Although we are the operating entity in many jurisdictions, our subsidiaries serve as operating companies in various states that regulate Memberships as insurance or specialized legal expense products. The most significant of these wholly owned subsidiaries are Pre-Paid Legal Casualty, Inc. (PPLCI), Pre-Paid Legal Services Inc. of Florida (PPLSIF) and Legal Service Plans of Virginia, Inc. (LSPV). The ability of these entities to provide funds to us is subject to a number of restrictions under various insurance laws in the jurisdictions in which they conduct business, including limitations on the amount of dividends and management fees that may be paid and requirements to maintain specified levels of capital and reserves. In addition PPLCI will be required to maintain its stockholders' equity at levels sufficient to satisfy various state or provincial regulatory requirements, the most restrictive of which is currently \$3 million. Additional capital requirements of these entities, or any of our regulated subsidiaries, will be funded by us in the form of capital contributions or surplus debentures. At June 30, 2007, none of these entities had funds available for payment of substantial dividends without the prior approval of the insurance commissioner. We received a \$1.6 million dividend from LSPV during March 2007 and a \$7.4 million dividend from PPLCI during April 2007.

#### *Contractual Obligations*

There have been no material changes outside of the ordinary course of business in our contractual obligations from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006.

### **Critical Accounting Policies**

Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates and assumptions are affected by management's application of accounting policies. If these estimates or assumptions are incorrect, there could be a material change in our financial condition or operating results. Many of these "critical accounting policies" are common in the insurance and financial services industries; others are specific to our business and operations. Our critical accounting policies include estimates relating to revenue recognition related to Membership and associate fees, deferral of Membership and associate related costs, expense recognition related to commissions to associates, accrual of incentive awards payable and accounting for legal contingencies. Each of these accounting policies and the application of critical accounting policies and estimates was discussed in our Annual Report on Form 10-K for the year ended December 31, 2006. There were no significant changes in the application of critical accounting policies or estimates during the first six months of 2007. We are not aware of any reasonably likely events or circumstances which would result in different amounts being reported that would materially affect our financial condition or results of operations.

### **Capital and Dividend Plans**

We continue to evaluate the desirability of additional share repurchases and additional cash dividends. We declared dividends of \$0.50 per share during 2004 and \$0.60 per share during 2005 and have previously announced that we will continue share repurchases, pay a dividend, or both, depending on our financial condition, available resources and market conditions, as well as compliance with our various loan covenants which limit our ability to repurchase shares or pay cash dividends. We expect to continue our open market repurchase program when we can acquire shares at prices we believe are attractive as we have existing authorization from the Board to purchase an additional 1.1 million shares. Based on recent increases in our common stock market price, we may reduce or defer further stock repurchases. We also continue to evaluate additional sources of financing that may enable us to accelerate the repurchase program at prices we believe are attractive.

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### **Forward-Looking Statements**

All statements in this report other than purely historical information, including but not limited to, statements relating to our future plans and objectives, expected operating results and the assumptions on which such forward-looking statements are based, constitute "Forward-Looking Statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and are based on our historical operating trends and financial condition as of June 30, 2007 and other information currently available to management. We caution that the Forward-Looking Statements are subject to all the risks and uncertainties incident to our business, including but not limited to risks described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006. Moreover, we may make acquisitions or dispositions of assets or businesses, enter into new marketing arrangements or enter into financing transactions. None of these can be predicted with certainty and, accordingly, are not taken into consideration in any of the Forward-Looking Statements made herein. For all of the foregoing reasons, actual results may vary materially from the Forward-Looking Statements. We assume no obligation to update the Forward-Looking Statements to reflect events or circumstances occurring after the date of the statement.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### *Interest Rate Risk*

Our consolidated balance sheets include a certain amount of assets and liabilities whose fair values are subject to market risk. Due to our significant investment in fixed-maturity investments, interest rate risk represents the largest market risk factor affecting our consolidated financial position. Increases and decreases in prevailing interest rates generally translate into decreases and increases in fair values of those instruments. Additionally, fair values of interest rate sensitive instruments may be affected by the creditworthiness of the issuer, prepayment options, relative values of alternative investments, liquidity of the instrument and other general market conditions.

As of June 30, 2007, substantially all of our investments consist of common stocks, investment grade (rated Baa or higher) bonds primarily issued by corporations, the United States Treasury, federal agencies, federally sponsored agencies and enterprises as well as mortgage-backed securities, auction rate certificates and state and municipal tax-exempt bonds. We do not hold any investments classified as trading account assets or derivative

financial instruments.

The table below summarizes the estimated effects of hypothetical increases and decreases in interest rates on our fixed-maturity investment portfolio. It is assumed that the changes occur immediately and uniformly, with no effect given to any steps that we might take to counteract that change.

The hypothetical changes in market interest rates reflect what could be deemed best and worst case scenarios. The fair values shown in the following table are based on contractual maturities. Significant variations in market interest rates could produce changes in the timing of repayments due to prepayment options available. The fair value of such instruments could be affected and, therefore, actual results might differ from those reflected in the following table:

|   | (In 000's) | Hypothetical change<br>in<br>interest rate<br>(bp = basis points) | Estimated<br>fair value<br>after<br>hypothetical<br>change in<br>interest rate |
|---|------------|---|--|
|   | Fair value |   |  |
| Fixed-maturity investments at June 30, 2007 (1)     | \$ 27,487  | 100 bp increase   | \$ 24,997  |
|   |            | 200 bp increase   | 25,591   |
|   |            | 50 bp decrease  | 27,979   |
|   |            | 100 bp decrease   | 28,471   |
| Fixed-maturity investments at December 31, 2006 (1) | \$ 31,420  | 100 bp increase   | \$ 30,170  |
|   |            | 200 bp increase   | 28,975   |
|   |            | 50 bp decrease  | 31,965   |
|   |            | 100 bp decrease   | 32,568   |

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- (1) Excluding short-term investments with a fair value of \$38.8 million (Certificates of deposit, auction rate securities and EURO deposits) at June 30, 2007 and \$42.4 million at December 31, 2006.

The table above illustrates, for example, that an instantaneous 200 basis point increase in market interest rates at June 30, 2007 would reduce the estimated fair value of our fixed-maturity investments by approximately \$1.9 million at that date. At December 31, 2006, an instantaneous 200 basis point increase in market interest rates would have reduced the estimated fair value of our fixed-maturity investments by approximately \$2.7 million at that date. The definitive extent of the interest rate risk is not quantifiable or predictable due to the variability of future interest rates, but we do not believe such risk is material.

We primarily manage our exposure to investment interest rate risk by purchasing investments that can be readily liquidated should the interest rate environment begin to significantly change.

As of June 30, 2007, we had \$82.8 million in notes payable outstanding at interest rates indexed to the 30 day LIBOR rate that exposes us to the risk of increased interest costs if interest rates rise. Assuming a 100 basis point increase in interest rates on the floating rate debt, annual interest expense would increase by approximately \$828,000. As of June 30, 2007, we had not entered into any interest rate swap agreements with respect to the term loans or our floating rate municipal bonds.

#### *Foreign Currency Exchange Rate Risk*

Although we are exposed to foreign currency exchange rate risk inherent in revenues, net income and assets and liabilities denominated in Canadian dollars, the potential change in foreign currency exchange rates is not a substantial risk, as approximately 1% of our revenues are derived outside of the United States.

#### **ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of June 30, 2007, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) during the quarter ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### **ITEM 1. LEGAL PROCEEDINGS.**

See Note 2 of the Notes to Consolidated Financial Statements included in Part I, Item 1 of this report for information with respect to legal proceedings.

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### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

#### **Issuer Purchases of Equity Securities**

The following table provides information about our purchases of stock in the open market during the second quarter of 2007.

| Period     | Total Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans or<br>Programs | Maximum Number<br>of Shares that May<br>Yet Be Purchased<br>Under the Plans or<br>Programs (1) |
|------------|--|---------------------------------------|--|--|
| April 2007 | 172,195                                | \$ 59.18                              | 172,195  | 1,125,577  |
| May 2007   | 7,338                                  | 61.78                                 | 7,338  | 1,118,239  |
| June 2007  | 6,282                                  | 63.98                                 | 6,282  | 1,111,957  |
| Total      | 185,815                                | \$ 59.44                              | 185,815  |  |

- (1) We announced on April 6, 1999, a treasury stock purchase program authorizing management to acquire up to 500,000 shares of our common stock in the open market. The Board of Directors has subsequently from time to time increased such authorization from 500,000 shares to 13 million shares. The most recent authorization was for 1 million additional shares on March 7, 2007 and there has been no time limit set for completion of the repurchase program.

See Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operation-Liquidity and Capital Resources" for a description of loan covenants that limit our ability to repurchase shares and pay dividends.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

The 2007 Annual Meeting of Shareholders of the Company (the "Annual Meeting") was held on May 16, 2007. The following matters were submitted to a vote of the Company's shareholders at the Annual Meeting.

#### **Proposal 1 Election of Directors.**

The results of the election for the director were as follows:

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|                    | Votes For  | Abstentions and<br>Votes Withheld |
|--------------------|------------|-----------------------------------|
| Peter K. Grunebaum | 11,122,481 | 461,555                           |
| Orland G. Aldridge | 11,210,768 | 373,268                           |
| Duke R. Ligon      | 11,500,529 | 83,507                            |

Our Board of Directors currently consists of seven members and is divided into three classes as nearly equal in size as possible, with the term of office of one class expiring each year. The new terms of service of Messrs. Grunebaum, Aldridge and Ligon will expire in 2010. The terms of the other four directors of the Company did not expire at the Annual Meeting. The names of such other directors and the year of expiration of their respective terms are as follows: Martin H. Belsky □ 2008, Harland C. Stonecipher □ 2008; John W. Hail □ 2009 and Thomas W. Smith □ 2009.

Proposal 2 □ Ratify the selection of Grant Thornton LLP as our independent registered public accounting firm.

| Votes For  | Votes Against | Abstentions |
|------------|---------------|-------------|
| 11,572,385 | 6,422         | 5,228       |

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**ITEM 6. EXHIBITS.**

(a) Exhibits:

| <b><u>Exhibit No.</u></b> | <b><u>Description</u></b>  |
|---------------------------|--|
| 3.1                       | Amended and Restated Certificate of Incorporation of the Company, as amended (Incorporated by reference to Exhibit 3.1 of the Company's Report on Form 8-K dated June 27, 2005)  |
| 3.2                       | Amended and Restated Bylaws of the Company (Incorporated by reference to Exhibit 3.1 of the Company's Report on Form 10-Q for the period ended June 30, 2003)  |
| *10.1                     | Employment Agreement effective January 1, 1993 between the Company and Harland C. Stonecipher (Incorporated by reference to Exhibit 10.1 of the Company's Annual Report on Form 10-KSB for the year ended December 31, 1992)   |
| *10.2                     | Agreements between Shirley Stonecipher, New York Life Insurance Company and the Company regarding life insurance policy covering Harland C. Stonecipher (Incorporated by reference to Exhibit 10.21 of the Company's Annual Report on Form 10-K for the year ended December 31, 1985)                |
| *10.3                     | Amendment dated January 1, 1993 to Split Dollar Agreement between Shirley Stonecipher and the Company regarding life insurance policy covering Harland C. Stonecipher (Incorporated by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-KSB for the year ended December 31, 1992) |
| *10.4                     | Form of New Business Generation Agreement Between the Company and Harland C. Stonecipher (Incorporated by reference to Exhibit 10.22 of the Company's Annual Report on Form 10-K for the year ended December 31, 1986)   |
| *10.5                     | Amendment to New Business Generation Agreement between the Company and Harland C. Stonecipher effective January, 1990 (Incorporated by reference to Exhibit 10.12 of the Company's Annual Report on Form 10-KSB for the year ended December 31, 1992)  |
| *10.6                     |  |

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Amendment No. 2 to New Business Generation Agreement between the Company and Harland C. Stonecipher effective January, 1990 (Incorporated by reference to Exhibit 10.13 of the Company's Annual Report on Form 10-K for the year ended December 31, 2002)

- \*10.7 Stock Option Plan, as amended effective May 2003 (Incorporated by reference to Exhibit 10.7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2004)
- 10.8 Loan agreement dated June 11, 2002 between Bank of Oklahoma, N.A. and the Company (Incorporated by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the six-months ended June 30, 2002)
- 10.9 Form of Mortgage dated July 23, 2002 between Bank of Oklahoma, N.A. and the Company (Incorporated by reference to Exhibit 10.3 of the Company's Quarterly Report on Form 10-Q for the six months ended June 30, 2002)
- \*10.10 Deferred compensation plan effective November 6, 2002 (Incorporated by reference to Exhibit 10.14 of the Company's Annual Report on Form 10-K for the year ended December 31, 2002)
- \*10.11 Amended Deferred Compensation Plan effective January 1, 2005 (Incorporated by reference to Exhibit 10.16 of the Company's Report on Form 10-K for the year ended December 31, 2004)
- 10.12 Purchase Agreement dated August 19, 2005 between us and Learjet, Inc., with Addendum. (Incorporated by reference to Exhibit 10.1 of the Company's Report on Form 8-K dated August 19, 2005)
- 10.13 Loan Agreement dated November 30, 2005 between Pre-Paid legal Services, Inc and Bank of Oklahoma, N.A. and First United Bank and Trust (Incorporated by reference to Exhibit 10.1 of the Company's Report on Form 8-K dated November 30, 2005)

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- 10.14 Aircraft Chattel Mortgage, Security Agreement and Assignment of Rents dated November 30, 2005 between Pre-Paid legal Services, Inc and Bank of Oklahoma, N.A. and First United Bank and Trust (Incorporated by reference to Exhibit 10.2 of the Company's Report on Form 8-K dated November 30, 2005)
- 10.15 Credit Agreement dated June 23, 2006 among Pre-Paid Legal Services, Inc, the lenders signatory thereto and Wells Fargo Foothill, Inc. as Arranger and Administrative Agent and Bank of Oklahoma, N.A. (Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed June 27, 2006)
- 10.16 Security Agreement dated June 23, 2006 between Pre-Paid Legal Services, Inc and certain of its subsidiaries and Wells Fargo Foothill, Inc., as Agent (Incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed June 26, 2006)
- 10.17 Guaranty Agreement dated June 23, 2006 between certain subsidiaries of Pre-Paid Legal Services, Inc. and Wells Fargo Foothill, Inc., as Agent (Incorporated by reference to Exhibit 10.3 of the Company's Current Report on Form 8-K filed June 27, 2006)

- 10.18 Mortgage, Assignment of Rents and Leases and Security Agreement by Pre-Paid Legal Services, Inc. in favor of Wells Fargo Foothill, Inc as Agent (Incorporated by reference to Exhibit 10.4 of the Company's Current Report on Form 8-K filed June 26, 2006)
- 10.19 First Amendment to Loan Agreement dated June 23, 2006 between Pre-Paid Legal Services, Inc. and Bank of Oklahoma, N.A. (Incorporated by reference to Exhibit 10.5 of the Company's of the Company's Current Report on Form 8-K filed June 26, 2006)
- 31.1 Certification of Harland C. Stonecipher, Chairman, Chief Executive Officer and President, Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934
- 31.2 Certification of Steve Williamson, Chief Financial Officer, Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934
- 32.1 Certification of Harland C. Stonecipher, Chairman, Chief Executive Officer and President, Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Steve Williamson, Chief Financial Officer, Pursuant to 18 U.S.C. Section 1350

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\* Constitutes a management contract or compensatory plan or arrangement required to be filed as an exhibit to this report.

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**SIGNATURES**

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

**PRE-PAID LEGAL SERVICES, INC.**  
(Registrant)

Date: July 23, 2007

/s/ Harland C. Stonecipher  
Harland C. Stonecipher  
Chairman, Chief Executive  
Officer and President  
(Principal Executive Officer)

Date: July 23, 2007

/s/ Randy Harp  
Randy Harp  
Chief Operating Officer  
(Duly Authorized Officer)

Date: July 23, 2007

/s/ Steve Williamson  
Steve Williamson  
Chief Financial Officer  
(Principal Financial and



Accounting Officer)