

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

PRE PAID LEGAL SERVICES INC

Form 10-Q

July 26, 2006

=====

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, 2006

| | 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:

Large accelerated filer | | Accelerated filer Non-accelerated file | |

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 21, 2006 was 14,515,909.

=====

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

PRE-PAID LEGAL SERVICES, INC.

FORM 10-Q

For the Quarter Ended June 30, 2006

CONTENTS

Part I. Financial Information

Item 1. Financial Statements:

- a) Consolidated Balance Sheets
as of June 30, 2006 (Unaudited) and December 31, 2005
- b) Consolidated Statements of Income (Unaudited)
for the three months and six months ended June 30, 2006 and 2005
- c) Consolidated Statements of Comprehensive Income (Unaudited)
for the three months and six months ended June 30, 2006 and 2005
- d) Consolidated Statements of Cash Flows (Unaudited)
for the six months ended June 30, 2006 and 2005
- e) Notes to Consolidated Financial Statements (Unaudited)

Item 1A. Risk Factors

Item 2. Management's Discussion and Analysis of Financial Condition And Results of Operations

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

Part II. Other Information

Item 1. Legal Proceedings

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 4. Submission of Matters to a Vote of Security Holders

Item 6. Exhibits

Signatures

ITEM 1. FINANCIAL STATEMENTS

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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

ASSETS

Current assets:

| | |
|--|----|
| Cash and cash equivalents..... | \$ |
| Available-for-sale investments, at fair value..... | |
| Membership fees receivable..... | |
| Inventories..... | |
| Refundable income taxes..... | |
| Deferred member and associate service costs..... | |
| Deferred income taxes..... | |
| Other assets..... | |

| | |
|--|---|
| Total current assets..... | 1 |
| Available-for-sale investments, at fair value..... | |
| Investments pledged..... | |
| Property and equipment, net..... | |
| Deferred member and associate service costs..... | |
| Other assets..... | |

| | |
|-------------------|------|
| Total assets..... | \$ 2 |
|-------------------|------|

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

| | |
|--|----|
| Membership benefits..... | \$ |
| Deferred revenue and fees..... | |
| Current portion of capital leases payable..... | |
| Current portion of notes payable..... | |
| Common stock dividends payable..... | |
| Income taxes payable..... | |
| Accounts payable and accrued expenses..... | |

| | |
|------------------------------------|--|
| Total current liabilities..... | |
| Capital leases payable..... | |
| Notes payable..... | |
| Deferred revenue and fees..... | |
| Deferred income taxes..... | |
| Other non-current liabilities..... | |

| | |
|------------------------|---|
| Total liabilities..... | 1 |
|------------------------|---|

Stockholders' equity:

| | |
|---|---|
| Common stock, \$.01 par value; 100,000 shares authorized; 19,368 and 20,326 issued at June 30, 2006 and December 31, 2005, respectively..... | 1 |
| Retained earnings..... | |
| Accumulated other comprehensive income..... | |
| Treasury stock, at cost; 4,852 shares held at June 30, 2006 and December 31, 2005, respectively..... | (|

| | |
|---------------------------------|--|
| Total stockholders' equity..... | |
|---------------------------------|--|

| | |
|---|------|
| Total liabilities and stockholders' equity..... | \$ 2 |
|---|------|

Jun
20

(Unau
\$

1

\$ 2

\$

1

(

\$ 2

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

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

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

| | Three Months Ended June 30, | | Si |
|--|--------------------------------|-----------|--------|
| | 2006 | 2005 | 20 |
| Revenues: | | | |
| Membership fees..... | \$ 103,111 | \$ 97,093 | \$ 204 |
| Associate services..... | 6,820 | 7,175 | 13 |
| Other..... | 1,267 | 1,351 | 2 |
| | 111,198 | 105,619 | 221 |
| Costs and expenses: | | | |
| Membership benefits..... | 36,490 | 33,710 | 72 |
| Commissions..... | 32,745 | 38,820 | 64 |
| Associate services and direct marketing..... | 7,584 | 7,963 | 14 |
| General and administrative..... | 13,020 | 12,337 | 25 |
| Other, net..... | 2,900 | 2,326 | 5 |
| | 92,739 | 95,156 | 182 |
| Income before income taxes..... | 18,459 | 10,463 | 38 |
| Provision for income taxes..... | 6,369 | 3,610 | 13 |
| Net income..... | \$ 12,090 | \$ 6,853 | \$ 25 |
| Basic earnings per common share..... | \$.81 | \$.45 | \$ 1 |
| Diluted earnings per common share..... | \$.81 | \$.44 | \$ 1 |
| Dividends declared per common share..... | \$ - | \$.30 | \$ |

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

PRE-PAID LEGAL SERVICES, INC.

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Amounts in 000's)
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, |
|---|--------------------------------|----------|---------------------------------|
| | 2006 | 2005 | |
| Net income..... | \$ 12,090 | \$ 6,853 | \$ 25,161 |
| Other comprehensive loss, net of tax: | | | |
| Foreign currency translation adjustment..... | 232 | (1) | 231 |
| Unrealized losses on investments: | | | |
| Unrealized holding losses arising during period..... | (178) | 163 | (15) |
| Reclassification adjustment for realized losses (gains) included in net income..... | 56 | 7 | 63 |
| | (122) | 170 | (52) |
| Other comprehensive loss, net of income taxes of (\$78) and \$110 for the three months and \$(226) and \$(311) for the six months ended June 30, 2006 and 2005, respectively..... | 110 | 169 | 279 |
| Comprehensive income..... | \$ 12,200 | \$ 7,022 | \$ 25,440 |

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

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

| | Six Months Ended June 30, |
|--|---------------------------------|
| | 2006 |
| Cash flows from operating activities: | |
| Net income..... | \$ 25,161 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| (Benefit) for deferred income taxes..... | (620) |
| Depreciation and amortization..... | 4,042 |
| Cash provided by operating activities before changes in assets and liabilities..... | 28,583 |

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

| | |
|---|-----------|
| Decrease in Membership income receivable..... | 375 |
| Decrease in inventories..... | 438 |
| Decrease (increase) in income tax receivable..... | (175) |
| (Increase) in deferred member and associate service costs..... | (15) |
| Increase in other assets..... | (2,219) |
| Increase in accrued Membership benefits..... | 274 |
| Increase in deferred revenue and fees..... | 891 |
| Increase in other non-current liabilities..... | 294 |
| Decrease in income tax payable..... | (1,738) |
| Increase (decrease) in accounts payable and accrued expenses and other..... | 229 |
| | ----- |
| Net cash provided by operating activities..... | 26,937 |
| | ----- |
| Cash flows from investing activities: | |
| Additions to property and equipment..... | (5,910) |
| Purchases of investments - available for sale..... | (8,559) |
| Maturities and sales of investments - available for sale..... | 10,576 |
| | ----- |
| Net cash provided by (used in) investing activities..... | (3,893) |
| | ----- |
| Cash flows from financing activities: | |
| Proceeds from exercise of stock options..... | 222 |
| Tax benefit on exercise of stock options..... | 636 |
| Proceeds from issuance of debt..... | 85,000 |
| Decrease in capital lease obligations..... | (310) |
| Common stock dividends paid..... | (4,643) |
| Repayments of debt..... | (23,532) |
| Purchases of treasury stock..... | (37,569) |
| | ----- |
| Net cash provided by (used in) financing activities | 19,804 |
| | ----- |
| Net increase (decrease) in cash and cash equivalents..... | 42,848 |
| Cash and cash equivalents at beginning of period..... | 33,957 |
| | ----- |
| Cash and cash equivalents at end of period..... | \$ 76,805 |
| | ----- |
| Supplemental disclosure of cash flow information: | |
| Cash paid for interest..... | \$ 1,317 |
| | ----- |
| Cash paid for income taxes..... | \$ 14,998 |
| | ----- |

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

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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

in conjunction with the consolidated financial statements and notes thereto included in our 2005 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, 2006, and for the three month and six month periods ended June 30, 2006 and 2005, 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, 2006 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.

Reclassifications

Certain amounts in the prior periods presented have been reclassified to conform to the current period financial statement presentation. These reclassifications have no effect on previously reported net income.

Note 2 - Contingencies

We and various executive officers have been named as defendants in a putative securities class action originally filed in the United States District Court for the Western District of Oklahoma in early 2001 seeking unspecified damages on the basis of allegations that we issued false and misleading financial information, primarily related to the method we used to account for commission advance receivables from sales associates. On March 5, 2002, the Court granted our motion to dismiss the complaint, with prejudice, and entered a judgment in favor of the defendants. Plaintiffs thereafter filed a motion requesting reconsideration of the dismissal which was denied. The plaintiffs appealed the judgment and the order denying their motion to reconsider the judgment to the Tenth Circuit Court of Appeals. In August 2002 the lead institutional plaintiff withdrew from the case, leaving two individual plaintiffs as lead plaintiffs on behalf of the putative class. The briefing in the appeal was completed and on January 14, 2004 oral argument was held in the appeal. On July 14, 2006 the Tenth Circuit Court of Appeals entered an Order and Judgment affirming the trial court's dismissal with prejudice in our favor.

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. As of July 14, 2006, we were aware of 11 separate lawsuits involving approximately 400 plaintiffs in multiple counties in Mississippi. Certain of the Mississippi lawsuits also name our former provider attorney in Mississippi as a defendant. In Mississippi, we filed lawsuits in the United States District Court for the Southern and Northern Districts of Mississippi in which we seek to compel arbitration of the various Mississippi claims under the Federal Arbitration Act and the terms of our Membership agreements. One of the federal courts has ordered arbitration of a case involving 8 plaintiffs. These cases are all in various stages of litigation, including trial settings in Mississippi in August 2006, and seek varying amounts of actual and punitive damages. We have tried three separate lawsuits in Mississippi. The first trial in Mississippi on these cases resulted in a unanimous jury verdict in our favor, including other named defendants, on all claims on October 19, 2004, while the second and third trials in Mississippi resulted in insubstantial plaintiffs' verdicts on February 15, 2005 and May 9,

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

2005, respectively. On August 16, 2005 the Circuit Judge in the February 15, 2005 trial overturned the jury's finding of fraud and fraudulent misrepresentation on the grounds that the evidence was insufficient to support those claims and reduced the damages awarded by the jury to a total of \$525 for four plaintiffs. On July 18, 2005 the Circuit Judge in the May 9, 2005 trial entered an order granting plaintiff's motion to reconsider the submission of the issue of punitive damages to the jury, and trial on that issue was held in November 2005. The trial on that issue resulted in punitive damage verdicts against us and against our chief executive officer in the collective total amount of \$9.9 million. As of July 14, 2006, our motions for post judgment relief are pending with the trial court. Pre-Paid will seek appellate relief in that case. Although the amount of Membership fees paid by the plaintiffs in the Mississippi cases is \$500,000 or less, certain of the cases seek damages of \$90 million. The ultimate outcome of any particular case is not determinable.

On April 19, 2002, counsel in certain of the above-referenced Alabama suits also filed a similar suit against us and certain officers in the District Court of Creek County, Oklahoma on behalf of Jeff and Jana Weller individually and doing business as Hi-Tech Auto making similar allegations relating to our Memberships and seeking unspecified damages on behalf of a "nationwide" class. The Pre-Paid defendants' preliminary motions in this case were denied, and on June 17, 2003, the Oklahoma Court of Civil Appeals reversed the trial court's denial of the Pre-Paid defendants' motion to compel arbitration, finding that the trial court erred when it denied Pre-Paid's motion to compel arbitration pursuant to the terms of the valid Membership contracts, and remanded the case to the trial court for further proceedings consistent with that opinion. On December 3, 2004, the District Court ordered the plaintiffs to proceed with the arbitration. On October 16, 2005 plaintiff Jana Weller died, and on December 20, 2005 we filed a Suggestion of Death Upon the Record with respect thereto. On April 13, 2006 we filed a motion to dismiss the case based on the failure of timely substitution of the parties and failure to prosecute. The ultimate outcome of this case is not determinable.

On October 3, 2005 we received a Civil Investigative Demand from the Commissioner of Consumer Protection of the State of Connecticut requesting information relating to our memberships and commissions to associates in Connecticut. Subsequent to our submission of responsive materials, a representative of the State informed us that no action will be taken in this matter. This matter will not appear in this statement in future legal proceedings disclosures.

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. The ultimate outcome of this 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.

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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

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, 2006 was \$2.5 million. 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 and, 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. At June 30, 2006 we have accrued \$472,000 for this assessment.

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 12 million shares during subsequent board meetings. At June 30, 2006, we had purchased 10.5 million treasury shares under these authorizations for a total consideration of \$260.1 million, an average price of \$24.81 per share. We purchased and formally retired 622,300 shares of our common stock during the 2006 second quarter for \$21.4 million, or an average price of \$34.40 per share, reducing our common stock by \$6,223 and our retained earnings by \$21.4 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.

| | Three Months Ended June 30, | | |
|---------------------------|--------------------------------|------|------|
| | 2006 | 2005 | 2004 |
| Basic Earnings Per Share: | 2.00 | 1.80 | 1.60 |

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

| | | | |
|---|-----------|----------|------|
| Earnings: | | | |
| Net income..... | \$ 12,090 | \$ 6,853 | \$ 2 |
| Shares: | | | |
| Weighted average shares outstanding..... | 14,863 | 15,397 | 1 |
| Diluted Earnings Per Share: | | | |
| Earnings: | | | |
| Net income..... | \$ 12,090 | \$ 6,853 | \$ 2 |
| Shares: | | | |
| ----- | | | |
| Weighted average shares outstanding..... | 14,863 | 15,397 | 1 |
| Assumed exercise of options..... | 94 | 273 | |
| Weighted average number of shares, as adjusted..... | 14,957 | 15,670 | 1 |
| Shares issued pursuant to option exercises..... | 89 | 53 | |

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 months and six months ended June 30, 2006 and 2005.

Note 5 - Recently Issued Accounting Pronouncements

In November 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") FAS 115-1 and FAS 124-1 "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The adoption of this FSP January 1, 2006 did not have a material effect on our consolidated financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154 "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20, and FASB Statement No. 3" ("SFAS 154"). SFAS 154 replaces APB Opinion No. 20, "Accounting Changes," and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for the accounting for and reporting of a change in accounting principle. This statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 31, 2005.

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"). The proceeds

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

will be used primarily to fund further share repurchases, including a tender offer for 1 million shares at \$35 per share, to refinance \$15.3 million of existing bank indebtedness and general working capital purposes. After payment of an origination fee of 1%, lender costs and other debt, the net proceeds of the Term Facility we received were \$58.8 million.

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 default interest rate (Wells Fargo base rate plus 150 basis points) at June 30, 2006 was 9.75%. 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 which we are remodeling to relocate and expand our existing customer service facility in Duncan.

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 nine month period ending September 30, 2006 of at least \$60 million (\$55 million for us and our top tier direct subsidiaries) and for the twelve month period ending 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.

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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

September 2008 to August 2011. This loan, which has a balance of \$14.1 million, 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, 2006 was 7.38%. 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, 2015. The interest rate at June 30, 2006 was 6.88%. The loan is primarily 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.

A schedule of outstanding balances as of June 30, 2006 is as follows:

| | |
|---|-----------|
| Senior loan..... | \$ 75,000 |
| Real estate loan..... | 14,095 |
| Aircraft loan..... | 10,843 |
| | ----- |
| Total notes payable..... | 99,938 |
| Less: Current portion of notes payable..... | (17,187) |
| | ----- |
| Long term portion..... | \$ 82,751 |
| | ----- |

A schedule of future maturities as of June 30, 2006 is as follows:

| | |
|-------------------------------|-----------|
| Repayment Schedule commencing | |
| July 2006: | |
| Year 1..... | \$ 17,187 |
| Year 2..... | 18,437 |
| Year 3..... | 18,437 |
| Year 4..... | 18,437 |
| Year 5..... | 18,437 |
| Thereafter..... | 9,003 |
| | ----- |
| Total notes payable..... | \$ 99,938 |
| | ----- |

Note 7 - Share-based Compensation

During the six months ended June 30, 2006, the stock option activity under our stock option plans was as follows:

| | Weighted Average Price | Number of Shares | Weighted Average Remaining Contractual Term (In Years) | Aggre Intri Val |
|--|------------------------------|---------------------|---|-----------------------|
| | ----- | ----- | ----- | ----- |

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

| | | | | | |
|---|----------|-----------|------|--|------|
| Outstanding, January 1, 2006..... | \$ 20.94 | 507,167 | | | |
| Granted..... | - | - | | | |
| Cancelled..... | 19.93 | (1,344) | | | |
| Exercised..... | 17.76 | (215,861) | | | |
| | | | | | |
| Outstanding, June 30, 2006..... | \$ 23.32 | 289,962 | 1.64 | | \$ 3 |
| | | | | | |
| Options exercisable as of June 30, 2006.... | \$ 23.32 | 289,962 | 1.64 | | \$ 3 |
| | | | | | |

Other information pertaining to option activity during the six months ended June 30, 2006 and 2005 was as follows:

| | 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 | \$ |
| Total intrinsic value of stock options exercised..... | \$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 employee options and therefore recognize any

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

share-based payments' expense from the issuance of employee stock options in 2006. The options outstanding at December 31, 2005 did not and will not impact 2006 consolidated results of operations and financial position since all option-holders were fully vested in such options at December 31, 2005.

We used the modified prospective method at the date of adoption and therefore results for the 2005 first quarter have not been restated. Had compensation expense for employee stock options granted under our stock option plans been determined based on fair value at the grant date consistent with SFAS No. 123, our net income and earnings per share for the 2005 period would have been the pro forma amounts indicated below and were estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

| | |
|--------------------------------|------------|
| Risk free interest rate | 5.16% |
| Expected volatility | 29.46% |
| Dividend yield | 0.0% |
| Weighted average expected life | 5.92 years |

| | Six Months Ended June 30, 2005 |
|--|--------------------------------------|
| | |
| Net Income: | |
| As reported..... | \$ 15,801 |
| Deduct: | |
| Total share-based employee compensation expense determined under fair value based method for all awards, net of related tax effects: | |
| Stock option plans..... | (117) |
| Pro forma net income..... | \$ 15,684 |
| Basic Earnings Per Common Share: | |
| As reported..... | \$ 1.02 |
| Pro forma..... | \$ 1.01 |
| Diluted Earnings Per Common Share: | |
| As reported..... | \$ 1.00 |
| Pro forma..... | \$ 1.00 |

ITEM 1A. RISK FACTORS

There are a number of risk factors that could affect our financial condition or results of operations. See Note 2 - Contingencies and Part II, Item 1 - Legal Proceedings. Please refer to page 14 and 15 of our 2005 Annual Report on Form 10-K for a description of other risk factors. There has 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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

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, 2005, 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 2006 compared to the second quarter of 2005 and the first quarter of 2006 (Table amounts in 000's). The sum of the percentages in the tables may not total due to rounding.:

| Three Months Ended June 30, 2006 compared to Three Months Ended June 30, 2005 and compared to Three Months Ended March 31, 2006 | Three Months Ended June 30, 2006 | % of Total Revenue | % Change from Prior Year | % Change from Sequential Period | Three Months Ended June 30, 2005 | % of Total Revenue |
|---|--|--------------------------|--------------------------------------|---|--|--------------------------|
| Revenues: | | | | | | |
| Membership fees..... | \$103,111 | 92.7 | 6.2 | 1.4 | \$97,093 | 91.9 |
| Associate services..... | 6,820 | 6.1 | (4.9) | (2.1) | 7,175 | 6.8 |
| Other..... | 1,267 | 1.1 | (6.2) | .8 | 1,351 | 1.3 |
| | 111,198 | 100.0 | 5.3 | 1.1 | 105,619 | 100.0 |
| Costs and expenses: | | | | | | |
| Membership benefits..... | 36,490 | 32.8 | 8.3 | 2.4 | 33,710 | 31.9 |
| Commissions..... | 32,745 | 29.5 | (15.7) | 2.7 | 38,820 | 36.8 |
| Associate services and direct marketing..... | 7,584 | 6.8 | (4.8) | 3.9 | 7,963 | 7.5 |
| General and administrative..... | 13,020 | 11.7 | 5.5 | 4.4 | 12,337 | 11.7 |
| Other, net..... | 2,900 | 2.6 | 24.7 | 6.5 | 2,326 | 2.2 |
| | 92,739 | 83.4 | (2.5) | 3.0 | 95,156 | 90.1 |
| Income before income taxes..... | 18,459 | 16.6 | 76.4 | (7.5) | 10,463 | 9.9 |
| Provision for income taxes..... | 6,369 | 5.7 | 76.4 | (7.5) | 3,610 | 3.4 |
| Net income..... | \$12,090 | 10.9 | 76.4 | (7.5) | \$ 6,853 | 6.5 |

| | Three Months Ended | | |
|---|--------------------|-----------|-----------|
| | 6/30/2006 | 3/31/2006 | 6/30/2005 |
| New Memberships: | | | |
| New legal service membership sales..... | 146,043 | 158,426 | 174,000 |
| New "stand-alone" IDT membership sales..... | 6,461 | 6,800 | 8,000 |
| Total new membership sales..... | 152,504 | 165,226 | 182,000 |
| New "add-on" IDT membership sales..... | 98,156 | 100,405 | 116,000 |

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

| | | | |
|--|-----------|-----------|--------|
| Average Annual Membership fee..... | \$327.34 | \$327.43 | \$333 |
| Active Memberships: | | | |
| Active legal service memberships at end of period..... | 1,484,498 | 1,488,308 | 1,490, |
| Active "stand-alone" IDT memberships at end of period (see note below)..... | 57,167 | 54,453 | 39, |
| Total active memberships at end of period..... | 1,541,665 | 1,542,761 | 1,529, |
| | | | |
| Active "add-on" IDT memberships at end of period (see note below)..... | 507,049 | 485,246 | 397, |
| New Sales Associates: | | | |
| New sales associates recruited..... | 45,517 | 49,776 | 69, |
| Average enrollment fee paid by new sales associates..... | \$49.70 | \$49.82 | \$51 |
| Average Membership fee in force: | | | |
| Average Annual Membership fee..... | \$291.22 | \$288.92 | \$281 |

Note - reflects 6,451 net transfers from "add-on" status to "stand-alone" status during the quarter ended June 30, 2006.

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

In November 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") FAS 115-1 and FAS 124-1 "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The adoption of this FSP January 1, 2006 did not have a material effect on our consolidated financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154 "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20, and FASB Statement No. 3" ("SFAS 154"). SFAS 154 replaces APB Opinion No. 20, "Accounting Changes," and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for the accounting for and reporting of a change in accounting principle. This statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 31, 2005.

Results of Operations - Second Quarter of 2006 compared to Second Quarter of 2005

Net income increased 76% for the second quarter of 2006 to \$12.1 million from \$6.9 million for the prior year's second quarter primarily due to an increase in membership fees of \$6 million and a decrease in commissions of \$6.1 million, from \$38.8 million to \$32.7 million for the previous year's comparable

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

quarter. Diluted earnings per share increased 84% to 81 cents per share from 44 cents per share for the prior year's comparable quarter due to the 76% increase in net income and an approximate 5% decrease in the weighted average number of outstanding shares.

Membership fees totaled \$103.1 million during the 2006 second quarter compared to \$97.1 million for 2005, an increase of 6%. 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 16.6% during the three months ended June 30, 2006 to 152,504 from 182,790 during the comparable period of 2005. At June 30, 2006, there were 1,541,665 active Memberships in force compared to 1,529,347 at June 30, 2005, an increase of .8%. Additionally, the average annual fee per Membership has increased from \$282 for all Memberships in force at June 30, 2005 to \$291 for all Memberships in force at June 30, 2006, primarily as a result of a larger number of Identity Theft Shield memberships.

Associate services revenue decreased by approximately \$355,000 from the second quarter of 2006 compared to the comparable period of 2005 with a 35% decrease in new associates recruited. Total new associates enrolled during the second quarter of 2006 were 45,517 compared to 69,790 for the same period of 2005. Average enrollment fees paid by new sales associates during the 2006 second quarter were \$50 compared to \$51 for the comparable period of 2005 due to specialized reduced rate \$49 enrollment programs aimed at varying market niches. We expect to continue some form of reduced enrollment programs for the remainder of the year. Associate fees decreased from \$7.2 million for the second quarter of 2005 to \$6.8 million during the comparable period of 2006. Future revenues from associate services will depend primarily on the number of new associates enrolled, the average enrollment fee paid 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. The eService fees increased 32% to \$3.3 million during the second quarter of 2006 compared to \$2.5 million for the comparable period of 2005.

Other revenue decreased \$84,000 from \$1.4 million for the 2005 first quarter to \$1.3 million for the 2006 second quarter.

Primarily as a result of the increase in Membership fees, total revenues increased to \$111.2 million for the three months ended June 30, 2006 from \$105.6 million during the comparable period of 2005, an increase of 5%.

Membership benefits totaled \$36.5 million for the three months ended June 30, 2006 compared to \$33.7 million for the comparable period of 2005, and represented 35% of Membership fees for both periods. This Membership benefit ratio (Membership benefits as a percentage of Membership fees) pertaining to legal service plans should remain near current levels as substantially all active Memberships provide for a capitated cost in the absence of any changes in the capitated benefit level, which has not changed significantly since 1993. However, the higher benefit ratio of the Identity Theft Shield Membership may increase the blended benefit ratio if we continue to increase the number of Identity Theft Shield Memberships in force.

Commissions to associates decreased 15.7% to \$32.7 million for the three months ended June 30, 2006 compared to \$38.8 million for the comparable period of 2005, and represented 32% and 40% of Membership fees for the respective periods. Commissions to associates are primarily dependent on the number of new memberships sold, including add-on membership sales, during a period. New memberships sold during the three months ended June 30, 2006 totaled 152,504, a 17% decrease from the 182,790 sold during the comparable period of 2005.

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

Commissions to associates per new membership sold were \$215 per membership for the three months ended June 30, 2006 compared to \$212 for the comparable period of 2005. 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.

Associate services and direct marketing expenses decreased to \$7.6 million for the three months ended June 30, 2006 from \$8.0 million for the comparable period of 2005. 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 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 three months ended June 30, 2006 and 2005 were \$13.0 million and \$12.3 million, respectively, and represented 13% of Membership fees for both periods.

Other expenses, net, which include depreciation and amortization, interest expense and premium taxes reduced by interest income, was \$2.9 million for the three months ended June 30, 2006 compared to \$2.3 million for the 2005 comparable period. Depreciation increased slightly to \$2.0 million for the second quarter of 2006 from \$1.8 million for the comparable period of 2005. Interest expense increased to \$867,000 during the 2006 period from \$633,000 during the comparable period of 2005 as a result of higher average interest rate and additional debt. We expect interest expense will increase further in future period as a result of the \$80 million new senior financing we closed on June 23, 2006. Premium taxes decreased from \$499,000 for the three months ended June 30, 2005 to \$484,000 for the comparable period of 2006, primarily as a result of a change in regulatory requirements in certain jurisdictions where we pay premium taxes. Interest income increased \$74,000 to \$452,000 for the three months ended June 30, 2006 from \$378,000 for the comparable period of 2005, primarily due to an increase in interest rates.

We have recorded a provision for income taxes of \$6.4 million and \$3.6 million (34.5% of pretax income) for both periods.

Results of Operations - Second Quarter of 2006 compared to First Quarter of 2006

Second quarter 2006 membership fees increased 1% to \$103.1 million from \$101.7 million for the first quarter of 2006. Associate services revenues decreased during the 2006 second quarter by approximately \$143,000 to \$6.8 million from \$7.0 million for the 2006 first quarter and associate services and direct marketing expenses increased by \$282,000 during the same period. Membership benefits totaled \$36.5 million in the second quarter of 2006 compared to \$35.6 million for the 2006 first quarter and represented 35% of membership fees for the two periods. Commissions to associates totaled \$32.7 million in the 2006 second quarter compared to \$31.9 million for the 2006 first quarter and represented 32% and 31%, respectively, of membership fees for the two periods. General and administrative expenses increased during the 2006 second quarter to \$13 million compared to \$12.5 million for the 2006 first quarter and represented

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

13% and 12%, respectively, of membership fees for the two periods.

Results of Operations - First six months of 2006 compared to first six months of

2005

Membership revenues increased 8% the first half 2006 to a record \$204.9 million compared to \$189.6 million for the first half of 2005. Net income increased 59% for the first half of 2006 to \$25.2 million from \$15.8 million for the prior year's comparable period primarily due to the increase of \$15.3 million in membership fees and a decrease in commission expense of \$5.9 million caused by fewer new memberships sold during the 2006 period, partially offset by an increase in Membership benefits expense of \$5.7 million and an increase in general and administrative expenses of \$2.1 million. Diluted earnings per share increased 65% to \$1.65 per share from \$1.00 per share for the prior year's comparable six month period due to the 59% increase in net income and an approximate 3% decrease in the weighted average number of outstanding shares.

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 13% during the six months ended June 30, 2006 to 317,730 from 363,669 during the comparable period of 2005. At June 30, 2006, there were 1,541,665 active Memberships in force compared to 1,529,347 at June 30, 2005, an increase of 1%. Additionally, the average annual fee per Membership has increased from \$282 for all Memberships in force at June 30, 2005 to \$291 for all Memberships in force at June 30, 2006, primarily as a result of a larger number of Identity Theft Shield memberships.

Associate services revenue decreased 3% from \$14.2 million for the first six months of 2005 to \$13.8 million during the comparable period of 2006 primarily as a result of a 22% decrease in new associates recruited. Total new associates enrolled during the first six months of 2006 were 95,293 compared to 122,734 for the same period of 2005. We expect to continue some form of reduced enrollment programs for the remainder of the year. 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 largely offset by the direct and indirect cost to the Company of training (including training bonuses paid), providing associate services and other direct marketing expenses. The eService fees increased 36% to \$6.4 million during the first half of 2006 compared to \$4.7 million for the comparable period of 2005.

Other revenue decreased slightly from \$2.7 million for the six month period ending June 2005 to \$2.5 million for the same period of 2006.

Primarily as a result of the increase in Membership fees, total revenues increased to \$221.2 million for the six months ended June 30, 2006 from \$206.5 million during the comparable period of 2005 an increase of 7%.

Membership benefits totaled \$72.1 million for the six months ended June 30, 2006 compared to \$66.4 million for the comparable period of 2005, and represented 35% of Membership fees for both periods. This Membership benefit ratio (Membership benefits as a percentage of Membership fees) should remain near current levels as substantially all active Memberships provide for a capitated cost in the absence of any changes in the capitated benefit level, which has not changed significantly since 1993. However, the higher benefit ratio of the Identity Theft Shield Membership may increase the blended benefit ratio if the Company continues to sell significant numbers of Identity Theft Shield Memberships.

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

Commissions to associates decreased 8% to \$64.6 million for the six months ended June 30, 2006 compared to \$70.5 million for the comparable period of 2005, and represented 32% and 37% of Membership fees for such periods. Commissions to associates are primarily dependent on the number of new memberships sold during a period. New memberships sold during the six months ended June 30, 2006 totaled 317,730, a 13% decrease from the 363,669 sold during the comparable period of 2005. Commissions to associates per new membership sold were \$203 per membership for the six months ended June 30, 2006 compared to \$194 for the comparable period of 2005. 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 \$14.9 million for the six months ended June 30, 2006 from \$17.1 million for the comparable period of 2005. The decrease was primarily a result of fewer new associates enrolled during the six month period. 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, 2006 and 2005 were \$25.5 million and \$23.4 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, interest expense and premium taxes reduced by interest income, was \$5.6 million for the six months ended June 30, 2006 compared to \$5.0 million for the 2005 comparable period. Depreciation increased to \$4.0 million for the first half of 2006 from \$3.7 million for the comparable period of 2005. Interest expense increased to \$1.5 million during the 2006 period from \$1.2 million during the comparable period of 2005 as a result of higher indebtedness and higher average interest rates. We expect interest expense will increase further in future period as a result of the \$80 million new senior financing we closed on June 23, 2006. Premium taxes decreased from \$1.1 million for the six months ended June 30, 2005 to \$872,000 for the comparable period of 2006. Interest income increased \$70,000 to \$839,000 for the six months ended June 30, 2006 from \$769,000 for the comparable period of 2005, primarily due to higher average interest rates.

We have recorded a provision for income taxes of \$13.3 million (34.5% of pretax income) for the first six months of 2006 compared to \$8.3 million (34.5% of pretax income) for the same period of 2005.

Liquidity and Capital Resources

General

Consolidated net cash provided from operating activities for the first six months of 2006 increased \$6.5 million to \$26.9 million from \$20.4 million for the 2005 period, although cash provided from operating activities before changes in working capital items increased \$9.6 million from \$19.0 million to \$28.6 million. The increase of \$9.6 million resulted primarily from the increase in net income of \$9.4 million.

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

Consolidated net cash used in investing activities was \$3.9 million for the first six months of 2006 compared to \$3.2 million of net cash provided for the comparable period of 2005. This \$7.1 million change in investing activities resulted from a \$3.1 million increase in additions to property and equipment and a \$5.0 million increase in investment purchases, partially offset by the \$1.0 million increase in the maturities and sales of investments.

Net cash provided by financing activities during the first six months of 2006 was \$19.8 million compared to \$27.2 million net cash used in the comparable period of 2005. This \$47.0 million change was primarily comprised of the \$82.7 million increase in proceeds from issuance of debt; a \$7.8 million decrease in common stock dividends paid offset by \$26.0 million increase in purchases of treasury stock; \$3.0 million decrease in proceeds from exercise of stock options and \$14.4 million increase in repayments of debt.

We purchased and formally retired 622,300 shares of our common stock during the 2006 second quarter for \$21.4 million, or an average price of \$34.40 per share, reducing our common stock by \$6,223 and our retained earnings by \$21.4 million. We had positive consolidated working capital of \$37.5 million at June 30, 2006, an increase of \$40.6 million compared to a consolidated working capital deficit of \$3.1 million at December 31, 2005. The increase was primarily due to a \$42.8 million increase in cash and cash equivalents and a decrease in income taxes payable of \$1.7 million partially offset by an decrease of \$6.3 million in the current portion of available-for-sale investments, an increase of \$1.5 million in the current portion of notes payable, a decrease in common stock dividends payable of \$4.6 million and a \$1.0 million increase in deferred revenue and fees. The \$37.5 million positive working capital at June 30, 2006 would have been a \$48.5 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 short term or the long term.

At June 30, 2006 we reported \$100.4 million in cash and cash equivalents and unpledged investments compared to \$59.9 million at December 31, 2005. 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 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, 2006, we advanced commissions, net of chargebacks, of \$62.1 million on new Membership sales compared to \$71.8 million for the same period of 2005. 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 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, 2006, and related activity for the six month period then ended, were:

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

| | (Amounts in 0 |
|--|---------------|
| Beginning unearned advance commission payments (1)..... | \$ 195,79 |
| Advance commission payments, net..... | 62,05 |
| Earned commissions applied..... | (63,18 |
| Advance commission payment write-offs..... | (1,80 |
| <hr/> | |
| Ending unearned advance commission payments before | |
| estimated unrecoverable payments (1)..... | 192,85 |
| Estimated unrecoverable advance commission payments (1)..... | (37,07 |
| <hr/> | |
| Ending unearned advance commission payments, net (1)..... | \$ 155,78 |
| <hr/> | |

(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 \$44.1 million. As such, at June 30, 2006 future commission payments and related expense should be reduced as unearned advance commission payments of \$112 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.

We believe that we have significant ability to finance expected 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, 2006 of \$100.4 million. We expect to maintain cash and investment balances, including pledged investments, on an on-going 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.

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"). The proceeds will be used primarily to fund further share repurchases, including a tender offer for 1 million shares at \$35 per share, to refinance \$15.3 million of existing bank indebtedness and general working capital purposes. After payment of an origination fee of 1%, lender costs and other debt, the net proceeds of the Term Facility we received were \$58.8 million.

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 LIBO Rate plus 250 basis points. The default interest rate (Wells Fargo base rate plus 150 basis points) at June 30, 2006 was 9.75%. 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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

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 which we are remodeling to relocate and expand our existing customer service facility in Duncan.

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 nine month period ending September 30, 2006 of at least \$60 million (\$55 million for us and our top tier direct subsidiaries) and for the twelve month period ending 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.

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, which has a balance of \$14.1 million, 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, 2006 was 7.38%. 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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

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, 2015. The interest rate at June 30, 2006 was 6.88%. The loan is primarily 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.

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") and Pre-Paid Legal Services Inc. of Florida ("PPLSIF"). The ability of PPLCI and PPLSIF to provide funds to us is subject to a number of restrictions under various insurance laws in the jurisdictions in which PPLCI and PPLSIF 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 PPLCI or PPLSIF, or any of our regulated subsidiaries, will be funded by us in the form of capital contributions or surplus debentures. At June 30, 2006, neither PPLSIF nor PPLCI had funds available for payment of substantial dividends without the prior approval of the insurance commissioner.

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, 2005 except as disclosed below:

| As of June 30, 2006: | Payments Due by Period (In Tho | | | |
|-------------------------|--------------------------------|---------------------|-----------|------|
| Contractual Obligations | Total | Less than 1 year | 1-3 years | 3-5 |
| Long-term debt..... | \$ 99,938 | \$ 17,187 | \$ 36,874 | \$ 3 |

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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

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, 2005. There were no significant changes in the application of critical accounting policies or estimates during the first six months of 2006. 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. On July 5, we commenced a tender offer for 1 million shares of common stock at \$35.00 per share which is set to expire on August 2, 2006. We expect to resume our open market repurchase program after the expiration of the tender offer as we have existing authorization from the Board to purchase an additional 515,356 shares in addition to the 1 million shares authorized pursuant to our pending tender offer. We also continue to evaluate additional sources of financing that may enable us to accelerate the repurchase program at prices we believe are attractive.

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, 2006 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, 2005. 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

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.

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

As of June 30, 2006, substantially all of our investments were in investment grade (rated Baa or higher) fixed-maturity investments and interest-bearing money market accounts including certificates of deposit. 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) Fair Value | Hypothetical change in interest rate (bp = basis points) |
|---|--------------------------|---|
| | ----- | ----- |
| Fixed-maturity investments at June 30, 2006 (1)..... | \$ 25,177 | 100 bp increase 200 bp increase 50 bp decrease 100 bp decrease |
| Fixed-maturity investments at December 31, 2005 (1).... | \$ 27,541 | 100 bp increase 200 bp increase 50 bp decrease 100 bp decrease |
| ----- | | |

(1) Excluding short-term investments with a fair value of \$2.6 million at June 30, 2006 and December 31, 2005.

The table above illustrates, for example, that an instantaneous 200 basis point increase in market interest rates at June 30, 2006 would reduce the estimated fair value of our fixed-maturity investments by approximately \$2.3 million at that date. At December 31, 2005, 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 interest rate risk by purchasing investments that can be readily liquidated should the interest rate environment begin to significantly change.

Interest Rate Risk

We are exposed to market risk related to changes in interest rates. As of June 30, 2006, we had \$99.9 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

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

by approximately \$999,000. As of June 30, 2006, 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, 2006, 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, 2006, 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.

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 2006.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number Shares that May Be Purchased Under the Plans or Programs (1) |
|-----------------|--|---------------------------------|--|---|
| April 2006..... | 45,900 | \$ 34.13 | 45,900 | 1,091,756 |
| May 2006..... | 365,800 | 34.27 | 365,800 | 725,956 |
| June 2006..... | 210,600 | 34.67 | 210,600 | 1,515,356 |

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

| | | | |
|------------|---------|----------|---------|
| Total..... | 622,300 | \$ 34.40 | 622,300 |
|------------|---------|----------|---------|

(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 12,000,000 shares. The most recent authorization was for 1,000,000 additional shares on June 28, 2006 and there has been no time limit set for completion of the repurchase program. Effective July 5, 2006, we commenced a self-tender offer for up to 1,000,000 shares of our common stock at a fixed purchase price of \$35.00 per share which will expire at 5:00 p.m., New York City time, on August 2, 2006, unless we extend the offer.

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 2006 Annual Meeting of Shareholders of the Company (the "Annual Meeting") was held on May 17, 2006. 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:

| | Votes For | Abstentions and Votes Withheld |
|-----------------|------------|-----------------------------------|
| John W. Hail | 13,288,068 | 436,734 |
| Thomas W. Smith | 13,576,913 | 147,889 |

The number of members of the Board of Directors is divided into three classes equal in size, with the term of office of one class expiring each year. The new terms of service of Messrs. Hail and Smith will expire in 2009. 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: Peter K. Grunebaum - 2007, Orland G. Aldridge - 2007; Martin H. Belsky - 2008 and Harland C. Stonecipher - 2008.

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

| Votes For | Votes Against | Abstentions |
|------------|---------------|-------------|
| 13,707,606 | 7,771 | 9,425 |

ITEM 6. EXHIBITS.

(a) Exhibits:

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

| Exhibit No. ----- | Description ----- |
|----------------------|--|
| 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 | 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 | Security Agreement dated June 11, 2002 between Bank of Oklahoma, N.A. and the Company (Incorporated by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the six months ended June 30, 2002) |
| 10.10 | 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) |
| *10.11 | 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) |
| 10.12 | Aircraft purchase agreement dated December 9, 2004 by and between S&S Aviation, LLC and the Company (Incorporated by reference to Exhibit 10.13 of the Company's Report on Form 10-K for the year ended December 31, 2004) |
| 10.13 | Aircraft purchase agreement dated December 9, 2004 by and between Harland C. Stonecipher and/or Shirley A. Stonecipher and Stonecipher Aviation, LLC and the Company (Incorporated by reference to Exhibit 10.14 of the Company's Report on Form 10-K for the year ended December 31, 2004) |
| 10.14 | Assignment and Assumption of Lease dated December 20, 2004 between Harland C. and Shirley Stonecipher and the Company (Incorporated by reference to Exhibit 10.15 of the Company's Report on Form 10-K for the year ended December 31, 2004) |
| *10.15 | Amended Deferred Compensation Plan effective January 1, 2005 (Incorporated by reference to Exhibit 10.16 of the Company's Report on Form |

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

- 10-K for the year ended December 31, 2004)
- 10.16 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)
 - 10.17 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)
 - 10.18 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)
 - 10.19 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)
 - 10.20 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)
 - 10.21 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)
 - 10.22 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)
 - 10.23 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
-

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

<

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)

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

Date: July 25, 2006 /s/ Harland C. Stonecipher

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

Date: July 25, 2006 /s/ Randy Harp

Randy Harp
Chief Operating Officer
(Duly Authorized Officer)

Date: July 25, 2006 /s/ Steve Williamson

Steve Williamson
Chief Financial Officer
(Principal Financial and
Accounting Officer)

Exhibit 31.1

CERTIFICATION

I, Harland C. Stonecipher, Chief Executive Officer, certify that:

- (1) I have reviewed this quarterly report on Form 10-Q of Pre-Paid Legal Services, Inc.;
- (2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- (3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- (4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 13 (a)-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

statements for external purposes in accordance with generally accepted accounting principles;

- (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- (5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 25, 2006

/s/ Harland C. Stonecipher

Harland C. Stonecipher
Chairman, Chief Executive
Officer and President

Exhibit 31.2

CERTIFICATION

I, Steve Williamson, Chief Financial Officer, certify that:

- (1) I have reviewed this quarterly report on Form 10-Q of Pre-Paid Legal Services, Inc.;
- (2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- (3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- (4) The registrant's other certifying officer(s) and I are responsible for

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 13 (a)-15(f)) for the registrant and have:

- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- (5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 25, 2006 /s/ Steve Williamson

Steve Williamson
Chief Financial Officer

Exhibit 32.1

Certification Pursuant to 18 U.S.C. Section 1350

Pursuant to 18 U.S.C. ss. 1350, the undersigned officer of Pre-Paid Legal Services, Inc. (the "Company"), hereby certifies that the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (the "Report") fully

Edgar Filing: PRE PAID LEGAL SERVICES INC - Form 10-Q

complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 25, 2006 /s/ Harland C. Stonecipher

Harland C. Stonecipher
Chairman, Chief Executive
Officer and President

Exhibit 32.2

Certification Pursuant to 18 U.S.C. Section 1350

Pursuant to 18 U.S.C. ss. 1350, the undersigned officer of Pre-Paid Legal Services, Inc. (the "Company"), hereby certifies that the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (the "Report") fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 25, 2006 /s/ Steve Williamson

Steve Williamson
Chief Financial Officer