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PRE PAID LEGAL SERVICES INC
Form 10-Q/A
February 25, 2002

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

FORM 10-Q/A

(Mark One)

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended June 30, 2001

or

() 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: 1-9293

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.)

321 East Main Street
Ada, Oklahoma
(Address of principal executive offices)

74821-0145
(Zip Code)

(580) 436-1234

(Registrants' telephone number, including area code)

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 X
----- -----

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of August 10, 2001:

Common Stock \$.01 par value 21,350,908

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ITEM 1. FINANCIAL STATEMENTS OF REGISTRANT

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

ASSETS

| | June 30, 2001 |
|--|--------------------------------|
| | ----- (Unaudited, Restated) |
| Current assets: | |
| Cash and cash equivalents..... | \$ 9,800 |
| Available-for-sale investments, at fair value..... | 1,000 |
| Membership income receivable..... | 4,900 |
| Inventories..... | 900 |

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| | |
|--|---------|
| Net assets of discontinued operations..... | 4,2 |
| Deferred member and associate service costs..... | 12,5 |
| Deferred income taxes..... | 2,2 |
| <hr/> | |
| Total current assets..... | 35,9 |
| Available-for-sale investments, at fair value..... | 10,2 |
| Investments pledged..... | 4,3 |
| Property and equipment, net..... | 13,3 |
| Deferred member and associate service costs..... | 3,6 |
| Other assets..... | 6,7 |
| <hr/> | |
| Total assets..... | \$ 74,3 |
| <hr/> | |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | |
|---|---------|
| Current liabilities: | |
| Membership benefits..... | \$ 7,5 |
| Deferred revenue and fees..... | 19,0 |
| Current portion of capital lease obligation..... | |
| Accounts payable and accrued expenses..... | 3,5 |
| <hr/> | |
| Total current liabilities..... | 30,2 |
| Deferred revenue and fees..... | 5,1 |
| Deferred income taxes | |
| <hr/> | |
| Total liabilities..... | 35,4 |
| <hr/> | |
| Stockholders' equity: | |
| Common stock, \$.01 par value; 100,000 shares authorized; 24,747 and 24,740 issued at June 30, 2001 and December 31, 2000, respectively..... | 2 |
| Capital in excess of par value..... | 65,1 |
| Retained earnings..... | 39,5 |
| Accumulated other comprehensive income (loss)..... | 2 |
| Treasury stock, at cost; 3,397 and 2,480 shares held at June 30, 2001 and December 31, 2000, respectively..... | (66,2) |
| <hr/> | |
| Total stockholders' equity..... | 38,8 |
| <hr/> | |
| Total liabilities and stockholders' equity..... | \$ 74,3 |
| <hr/> | |

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, Restated)

Three Months Ended
June 30,

| | |
|------|------|
| 2001 | 2000 |
|------|------|

Revenues:

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| | | | |
|---|-----------|-----------|-------|
| Membership fees..... | \$ 67,108 | \$ 51,491 | \$ 1 |
| Associate services..... | 8,984 | 7,138 | |
| Product sales..... | 13 | 142 | |
| Other..... | 703 | 784 | |
| | ----- | ----- | ----- |
| | 76,808 | 59,555 | 1 |
| | ----- | ----- | ----- |
| Costs and expenses: | | | |
| Membership benefits..... | 21,782 | 16,585 | |
| Commissions..... | 31,457 | 27,054 | |
| Associate services and direct marketing..... | 7,786 | 5,604 | |
| General and administrative..... | 7,553 | 5,446 | |
| Product costs..... | 31 | 45 | |
| Other, net..... | 1,059 | 315 | |
| | ----- | ----- | ----- |
| | 69,668 | 55,049 | 1 |
| | ----- | ----- | ----- |
| Income from continuing operations before income taxes and cumulative effect of change in accounting principle..... | 7,140 | 4,506 | |
| Provision for income taxes..... | 2,317 | 1,316 | |
| | ----- | ----- | ----- |
| Income from continuing operations before cumulative effect of change in accounting principle..... | 4,823 | 3,190 | |
| Income (loss) from operations of discontinued UFL segment, net of applicable income taxes - Note 5..... | (102) | 229 | |
| | ----- | ----- | ----- |
| Income before cumulative effect of change in accounting principle | 4,721 | 3,419 | |
| Cumulative effect of adoption of SAB 101 (net of applicable income tax benefit of \$546)..... | - | - | |
| | ----- | ----- | ----- |
| Net income..... | 4,721 | 3,419 | |
| Less dividends on preferred shares..... | - | 2 | |
| | ----- | ----- | ----- |
| Net income applicable to common stockholders..... | \$ 4,721 | \$ 3,417 | \$ |
| | ----- | ----- | ----- |
| Basic earnings per common share from continuing operations before cumulative effect of accounting change..... | \$.22 | \$.14 | \$ |
| Basic earnings per common share from discontinued operations..... | - | .01 | |
| | ----- | ----- | ----- |
| Basic earnings per common share before cumulative effect of accounting change..... | .22 | .15 | |
| Cumulative effect of adoption of SAB 101..... | - | - | |
| | ----- | ----- | ----- |
| Basic earnings per common share..... | \$.22 | \$.15 | \$ |
| | ----- | ----- | ----- |
| Diluted earnings per common share from continuing operations before cumulative effect of accounting change..... | \$.22 | \$.14 | \$ |
| Diluted earnings per common share from discontinued operations... | - | .01 | |
| | ----- | ----- | ----- |
| Diluted earnings per common share before cumulative effect of accounting change..... | .22 | .15 | |
| Cumulative effect of adoption of SAB 101..... | - | - | |
| | ----- | ----- | ----- |
| Diluted earnings per common share..... | \$.22 | \$.15 | \$ |
| | ----- | ----- | ----- |

The accompanying notes are an integral part of these financials.

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

| | Three Months Ended June 30, | | |
|--|--------------------------------|----------|----|
| | 2001 | 2000 | |
| Net income..... | \$ 4,721 | \$ 3,419 | \$ |
| Other comprehensive income (loss), net of tax: | | | |
| Foreign currency translation adjustment..... | 117 | 18 | |
| Unrealized gains on investments: | | | |
| Unrealized holding gains arising during period..... | (84) | 649 | |
| Less: reclassification adjustment for gains included in net income..... | - | - | |
| | (84) | 649 | |
| Other comprehensive income, net of income taxes of \$15 and \$359 for three months and \$183 and \$370 for the six months ended June 30, 2001 and 2000, respectively | 33 | 667 | |
| Comprehensive income..... | \$ 4,754 | \$ 4,086 | \$ |

The accompanying notes are an integral part of these financials.

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

| | Six Months June |
|--|--------------------|
| | 2001 |
| Cash flows from operating activities: | |
| Net income..... | \$ 12,397 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Cumulative effect of change in accounting principle..... | - |

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| | |
|---|----------|
| Income from discontinued operations..... | (56) |
| Provision for deferred income taxes..... | 901 |
| Depreciation and amortization..... | 1,906 |
| Compensation expense relating to contribution of stock to ESOP..... | 162 |
| Increase in Membership income receivable..... | (400) |
| Decrease (increase) in inventories..... | 558 |
| Increase in deferred member and associate service costs..... | (2,060) |
| (Increase) decrease in other assets..... | (110) |
| Increase in accrued Membership benefits..... | 754 |
| Increase in deferred revenue and fees..... | 3,003 |
| Decrease in accounts payable and accrued expenses..... | (3,299) |
| | ----- |
| Net cash provided by operating activities of continuing operations..... | 13,756 |
| | ----- |
| Cash flows from investing activities: | |
| Additions to property and equipment..... | (4,758) |
| Purchases of investments - available for sale..... | (2,843) |
| Maturities and sales of investments - available for sale..... | 8,771 |
| | ----- |
| Net cash provided by (used in) investing activities of continuing operations... | 1,170 |
| | ----- |
| Cash flows from financing activities: | |
| Proceeds from sale of common stock..... | 14 |
| Decrease in capital lease obligations..... | (141) |
| Purchases of treasury stock..... | (15,820) |
| Redemption of preferred stock..... | - |
| Dividends paid on preferred stock..... | - |
| | ----- |
| Net cash used in financing activities of continuing operations..... | (15,947) |
| | ----- |
| Net decrease in cash and cash equivalents..... | (1,021) |
| Cash and cash equivalents at beginning of period..... | 10,866 |
| | ----- |
| Cash and cash equivalents at end of period..... | \$ 9,845 |
| | ----- |
| Supplemental disclosure of cash flow information: | |
| Net cash used in discontinued operations..... | \$ (647) |
| | ----- |
| Cash paid for interest..... | \$ 1 |
| | ----- |
| Income taxes paid..... | \$ 8,400 |
| | ----- |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Except for per share amounts, dollar amounts in tables are in
thousands unless otherwise indicated)
(Unaudited, Restated)

Note 1 - Basis Of Presentation

The accompanying consolidated financial statements and notes thereto have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been omitted. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2000 Annual Report on Form 10-K, as amended and restated.

The consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying unaudited financial statements as of June 30, 2001, and for the three months and six months ended June 30, 2001 and 2000, reflect adjustments (which were normal and recurring) which, in the opinion of management, are necessary for a fair statement of the financial position and results of operations of the interim periods presented. Results for the three months and six months ended June 30, 2001 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 management 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.

As previously reported, in January 2001 and May 2001, the staff of the Division of Corporation Finance of the Securities and Exchange Commission ("SEC") reviewed the Company's 1999 and 2000 Forms 10-K, respectively. On May 11, 2001, the Company received a letter from the staff of the Division of Corporation Finance advising that, after reviewing the Company's Forms 10-K, it was the position of the Division that the Company's accounting for commission advance receivables was not in accordance with generally accepted accounting principles (GAAP). The Company subsequently appealed this decision to the Chief Accountant of the SEC. On July 25, 2001, the Company announced that the Chief Accountant concurred with the prior staff opinion of the Division of Corporation Finance. The Company subsequently announced that it would not pursue any further appeals and that it would amend its previously filed SEC reports to restate the Company's financial statements to reflect the SEC's position that the Company's advance commission payments should be expensed ratably over the first month of the related membership. The Company's first filing subsequent to this announcement was the Form 10-Q for the period ended June 30, 2001 and contained the Company's restated financial statements to reflect the Company's initial understanding of the SEC's position. As a result of the SEC's position, the Company and its prior independent auditor, Deloitte & Touche, mutually agreed that a change in auditor would be made and the Company on September 17, 2001 engaged Grant Thornton LLP to audit its restated consolidated financial statements for the years ended December 31, 2000, 1999 and 1998. After further consultations with the staff of the SEC, this new audit was completed and the amended and restated Form 10-K for the period ending December 31, 2000 has been filed. This amended Form 10-Q contains financial statements that have been

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restated on a basis consistent with the audited financial statements in the amended and restated Form 10-K and contain adjustments from those previously filed to conform to such presentation (the "restatement"). These financial statements have also been restated due to the effect of the Company's sale on December 31, 2001 of Universal Fidelity Life Insurance Co. (UFL), which is reported as and referred to as "discontinued operations" as discussed in Note 5 to the Consolidated Financial Statements. Additionally, the Company implemented SEC Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," ("SAB 101") effective January 1, 2000 and has deferred the non-refundable \$10 Membership fees and \$47 of the associate enrollment fees and the related direct incremental costs associated with services provided members and associates in return for such fees. At the time of the original filing we estimated the direct incremental costs related to the non-refundable Membership fee and associate enrollment fee to be in excess of \$10 and \$47, respectively. Based upon further review, estimated direct incremental costs of \$7 for the Membership fee and \$40 for the associate enrollment fee have been deferred. The implementation of SAB 101 resulted in a cumulative effect type charge of \$1.0 million ("Cumulative effect"), net of tax, in the consolidated income statement for the six months ended June 30, 2000. Primarily due to discontinued operations and including the effects of the restatement adjustments and SAB 101, total assets were reduced from \$93 million, as previously reported at June 30, 2001, to \$74 million, total liabilities were reduced from \$51 million to \$35 million and therefore stockholders' equity was reduced from \$42 million to \$39 million. A summary of the effects of these items on previously reported results of operations follows:

| | As Previously reported | Effect of Restatement | Discon Opera |
|--|------------------------------|--------------------------|-----------------|
| | | | |
| Three Months Ended June 30, 2001 ----- | | | |
| Revenues..... | \$ 76,995 | \$ 80 | \$ |
| Costs and expenses..... | 69,822 | 215 | |
| | 7,173 | (135) | |
| Income from continuing operations before income taxes..... | 2,422 | (105) | |
| Provision for income taxes..... | 4,751 | (30) | |
| Income from continuing operations..... | - | - | |
| Income (loss) from discontinued operations..... | 4,751 | (30) | |
| Net income applicable to common shareholders..... | \$.22 | \$ - | \$ |
| Basic EPS..... | \$.22 | \$ - | \$ |
| Diluted EPS..... | \$.22 | \$ - | \$ |
| Six Months Ended June 30, 2001 ----- | | | |
| Revenues..... | \$ 147,813 | \$ (128) | \$ |
| Costs and expenses..... | 130,231 | (910) | |
| | 17,582 | 782 | |
| Income from continuing operations before income taxes..... | 5,912 | 55 | |
| Provision for income taxes..... | 5,912 | 55 | |

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| | | | |
|---|-----------|--------|----|
| Income from continuing operations..... | 11,670 | 727 | |
| Income from discontinued operations..... | - | - | |
| Net income applicable to common shareholders..... | \$ 11,670 | \$ 727 | \$ |
| Basic EPS..... | \$.54 | \$.03 | \$ |
| Diluted EPS..... | \$.54 | \$.03 | \$ |

| | As Previously reported | Effect of Restatement | Effect of Adoption of SAB 101 | Disco Opera |
|--|------------------------------|--------------------------|-------------------------------------|----------------|
| Three Months Ended June 30, 2000 | | | | |
| Revenues..... | \$ 60,200 | \$ (133) | \$ - | \$ |
| Costs and expenses..... | 55,868 | (494) | 138 | |
| Income from continuing operations before income taxes and cumulative change in accounting principle..... | 4,332 | 361 | (138) | |
| Provision (benefit) for income taxes..... | 1,255 | (71) | (48) | |
| Income from continuing operations before cumulative effect of change in accounting principle..... | 3,077 | 432 | (90) | |
| Income from discontinued operations..... | - | - | - | |
| Net income..... | 3,077 | 432 | (90) | |
| Dividends on preferred shares..... | 2 | - | - | |
| Net income applicable to common shareholders.... | \$ 3,075 | \$ 432 | \$ (90) | \$ |
| Basic EPS..... | \$.14 | \$.01 | \$ - | \$ |
| Diluted EPS..... | \$.14 | \$.01 | \$ - | \$ |

| | | | | |
|---|------------|---------|------|------|
| Six Months Ended June 30, 2000 | | | | |
| Revenues..... | \$ 116,133 | \$ 972 | \$ - | \$ (|
| Costs and expenses..... | 104,514 | (1,186) | 270 | (|
| Income from continuing operations before income | | | | |

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| | | | | |
|---|----------|----------|------------|-------|
| taxes and cumulative change in accounting principle..... | 11,619 | 2,158 | (270) | |
| Provision (benefit) for income taxes..... | 3,805 | 553 | (94) | |
| | ----- | ----- | ----- | ----- |
| Income from continuing operations before cumulative effect of change in accounting principle..... | 7,814 | 1,605 | (176) | |
| Income from discontinued operations..... | - | - | - | |
| | ----- | ----- | ----- | ----- |
| Cumulative effect of change in accounting principle..... | - | - | (1,013) | |
| | ----- | ----- | ----- | ----- |
| Net income..... | 7,814 | 1,605 | (1,189) | |
| Dividends on preferred shares..... | 4 | - | - | |
| | ----- | ----- | ----- | ----- |
| Net income applicable to common shareholders.... | \$ 7,810 | \$ 1,605 | \$ (1,189) | \$ |
| | ----- | ----- | ----- | ----- |
| Basic EPS..... | \$.35 | \$.07 | \$ (.05) | \$ |
| | ----- | ----- | ----- | ----- |
| Diluted EPS..... | \$.34 | \$.07 | \$ (.05) | \$ |
| | ----- | ----- | ----- | ----- |

Note 2 - Contingencies

Subsequent to December 31, 2000, the Company and various of its executive officers were named in multiple putative securities class action complaints filed in both the United States District Courts for the Eastern and Western Districts of Oklahoma seeking unspecified damages on the basis of allegations that the Company issued false and misleading financial information, primarily related to the method the Company used to account for commission advance receivables from sales associates. These complaints have been transferred to Western District of Oklahoma where motions to consolidate them into a single proceeding are pending. An amended and consolidated complaint was filed on June 14, 2001, and the Company filed a motion to dismiss the complaint on July 24, 2001. The plaintiffs filed a response to the motion to dismiss on September 4, 2001 and the Company's reply brief was filed on September 24, 2001. Under the Private Securities Litigation Reform Act of 1995, discovery is stayed during the pendency of a motion to dismiss. Costs of defense of these cases through the motion to dismiss stage are not expected to be material. While the outcome of these cases is uncertain, the Company believes these actions are without merit and will vigorously defend these actions. However, an unfavorable decision in this litigation could have a material adverse effect on the Company's financial position, results of operations and cash flows.

Also, in January 2001, the Company received inquiries from the Division of Enforcement of the SEC requesting information relating primarily to the Company's accounting policies for commission advance receivables from sales associates. The Company has had no further contact from the Division of Enforcement. The Division of Enforcement's inquiries were informal and did not constitute a formal investigation or proceeding. The Company is unable to determine the ultimate outcome of this inquiry, including whether the Division of Enforcement will continue the inquiry subsequent to the Company's decision to restate its financial statements.

On June 7, 2001 and August 3, 2001, shareholder derivative actions were filed by alleged company shareholders, Bruce A. Hansen and Donna L. Hansen, and Roger Strykowski, respectively, against all of the directors of the Company seeking unspecified actual and punitive damages on behalf of the Company based on allegations of breach of fiduciary duty, corporate waste and mismanagement by

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the defendant directors. The derivative actions are in the preliminary pleading stage. The complaints allege that the defendant directors caused the Company to violate generally accepted accounting principles and federal securities laws by improperly capitalizing commission expenses, caused the Company to allegedly pay increased salaries and bonuses based upon financial performance which was allegedly improperly inflated and caused the Company to expend significant dollars in connection with the defense of its accounting policy, including cost incurred in connection with the defense of the securities class actions described above, and in connection with purchase of its own shares on the open market at allegedly artificially inflated prices. The Company believes that these derivative actions are related to the securities class actions described above and may be intended to circumvent the restrictions on the securities class actions imposed by the Private Securities Litigation Reform Act of 1995. While the outcome of these cases is uncertain, based on the information currently available to the Company, it appears that the complaints should be dismissed because the plaintiffs failed to make or excuse the requisite demand that the Company pursue the claims of alleged misconduct.

In the second quarter of 2001 and through January 4, 2002, multiple lawsuits were filed against the Company, certain sales associates and other unnamed defendants in Alabama state courts by current or former members seeking unspecified actual and punitive damages for alleged breach of contract and fraud in connection with the sale of memberships. As of January 30, 2002, the Company was aware of 20 separate lawsuits involving approximately 110 plaintiffs that have been filed in multiple counties in Alabama and it is possible that additional cases will be filed. These cases make allegations similar to allegations made in cases previously filed against the Company in Alabama state courts by multiple plaintiffs which was previously settled for a payment of \$1.5 million to settle claims by 97 separate claimants. In January 2002, one of the law firms representing individual plaintiffs filed a putative class action on behalf of all Alabama residents purchasing memberships seeking damages and injunctive relief based on alleged failures to provide coverage under the memberships. Based on the Company's preliminary investigation of the new cases, the facts involved are in many respects significantly different from the facts involved in the case the company previously settled. These cases are all in the preliminary stages and the ultimate outcome is not determinable.

On June 29, 2001, an action was filed in the District Court of Canadian County, Oklahoma by Gina Cotwitz against the Company. This action is a putative class action on behalf of all sales associates of the Company and alleges violations of the Oklahoma Consumer Protection Act, the Oklahoma Uniform Consumer Credit Code and breach of contract in connection with certain of the Company's practices relating to advancing commissions to sales associates. The Company has filed an answer denying the plaintiff's claims and raising affirmative defenses and intends to vigorously defend this case. The case is in the preliminary stages and the ultimate outcome is not determinable.

The Company is a defendant in various other legal proceedings that are routine and incidental to its business. The Company will vigorously defend its interests in these proceedings. While the ultimate outcome of these proceedings is not determinable, the Company does not currently anticipate that these contingencies will result in any material adverse effect to its financial condition or results of operation.

Note 3 - Treasury Stock Purchases

The Company announced on April 6, 1999, a treasury stock purchase program authorizing management to acquire up to 500,000 shares of the Company's common stock. The Board of Directors has increased such authorization from 500,000 shares to 3 million shares during subsequent board meetings. At June 30, 2001, the Company had purchased 2.6 million shares under these authorizations for a total consideration of \$62.6 million, an average price of \$24.07 per share.

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Treasury stock purchases will be made at prices that are considered attractive by management and at such times that management believes will not unduly impact the Company's liquidity. No time limit has been set for completion of the purchase program. The Company obtained on November 6, 2001 a \$17.5 million line of credit facility that may be used for additional purchases.

Note 4 - Earnings Per Share

Basic earnings per common share are computed by dividing net income applicable to common stockholders by the weighted average number of shares of common stock outstanding during the respective periods.

Diluted earnings per common share are computed by dividing net income applicable to common stockholders by the weighted average number of shares of common stock and common stock equivalents outstanding during the respective periods. The \$3.00 Cumulative Convertible Preferred stock and the Special Preferred stock are considered to be dilutive common stock equivalents for all periods through the conversion/redemption date and the number of shares issuable on conversion of the \$3.00 Cumulative Convertible Preferred stock and the Special Preferred Stock is added to the weighted average number of common shares. At December 31, 2000 all such shares had been converted or redeemed. The weighted average number of common shares is also increased by the number of 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, | |
|--|--------------------------------|----------|
| | 2001 | 2000 |
| Basic Earnings Per Share: | | |
| Earnings: | | |
| Income from continuing operations before cumulative effect of change in accounting principle..... | \$ 4,823 | \$ 3,190 |
| Less dividends on preferred shares..... | - | 2 |
| | \$ 4,823 | \$ 3,188 |
| Income from continuing operations before cumulative effect of change in accounting principle applicable to common stockholders..... | | |
| Shares: | | |
| Weighted average shares outstanding..... | 21,403 | 22,516 |
| Diluted Earnings Per Share: | | |
| Earnings: | | |
| Income from continuing operations before cumulative effect of change in accounting principle available to common stockholders after assumed conversions..... | \$ 4,823 | \$ 3,190 |
| Shares: | | |
| Weighted average shares outstanding..... | 21,403 | 22,516 |
| Assumed conversion of preferred stock..... | - | 69 |
| Assumed exercise of options..... | 26 | 149 |
| | 21,429 | 22,694 |

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| | | |
|---|--------|--------|
| Weighted average number of shares, as adjusted..... | 21,429 | 22,734 |
| | ----- | ----- |

Note 5 - Discontinued Operations

On December 31, 2001 the Company completed the sale of its wholly owned subsidiary UFL. The Company received a \$2.8 million dividend and \$1.2 million from the sale of 100% of UFL stock. Net assets of \$4.2 million and \$4.5 million have been segregated on the June 30, 2001 and December 31, 2000 Consolidated Balance Sheets, respectively. The sale is not expected to have a significant impact on reported earnings or stockholders' equity for 2001. Assets and liabilities of UFL's discontinued operations were as follows:

| | June 30, | Decemb |
|--|----------|--------|
| | ----- | ----- |
| | 2001 | 20 |
| | ----- | ----- |
| Cash..... | \$ 57 | \$ |
| Available-for-sale investments, current..... | 185 | |
| Amount due from coinsurer..... | 14,449 | |
| Available-for-sale investments, non-current..... | 7,416 | |
| Investment pledged..... | 1,800 | |
| Property and equipment, net..... | 741 | |
| Goodwill, net..... | 578 | |
| Other assets..... | 2,898 | |
| | ----- | ----- |
| Total assets..... | 28,124 | |
| | ----- | ----- |
| Accident and health reserves..... | 14,449 | |
| Life insurance reserves, current..... | 968 | |
| Accounts payable and accrued expenses..... | 716 | |
| Life insurance reserves, non-current..... | 7,744 | |
| | ----- | ----- |
| Total Liabilities..... | 23,877 | |
| | ----- | ----- |
| Net assets of UFL's discontinued operations..... | \$ 4,247 | \$ |
| | ----- | ----- |

The results of operations of the UFL segment have been segregated and reported as discontinued operations in the Consolidated Statements of Income. Cash flow impacts of discontinued operations have been segregated in the Consolidated Statements of Cash Flows. Details of income from discontinued operations, net of income tax, are as follows:

| | Three Months Ended | | Si |
|---------------|--------------------|--------|-------|
| | June 30, | | |
| | ----- | ----- | ----- |
| | 2001 | 2000 | 20 |
| | ----- | ----- | ----- |
| Revenues..... | \$ 267 | \$ 512 | \$ |
| | ----- | ----- | ----- |

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| | | | | | |
|---|----|-------|----|-----|----|
| Income (loss) from discontinued operations, net of tax benefit of \$0 and \$180 for three months and \$0 and \$103 for the six months ended June 30, 2001 and 2000, respectively..... | \$ | (102) | \$ | 229 | \$ |
| | | | | | |

Note 6 - Recent Issued Accounting Pronouncements and Accounting Change

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," ("SFAS 133") was issued in June 1998. This Statement, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. SFAS 133, as amended, applies to all entities and is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. The Company adopted SFAS 133, as amended, on January 1, 2001 as required. The Company did not hold any derivative instruments at January 1, 2001 and there was no effect on the consolidated financial statements upon the adoption of SFAS 133.

In July 2001, the Financial Accounting Standards Board issued new pronouncements: SFAS 141, "Business Combinations"; SFAS 142, "Goodwill and Other Intangible Assets"; and SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 141, which requires the purchase method of accounting for all business combinations, applies to all business combinations initiated after June 30, 2001 and to all business combinations accounted for by the purchase method that are completed after June 30, 2001. SFAS 141 will not apply to the Company unless it enters into a future business combination. SFAS 142 requires that goodwill as well as other intangible assets be tested annually for impairment. In addition, the Statement eliminates the current requirement to amortize goodwill or intangible assets with indeterminate lives, and is effective for fiscal years beginning after December 15, 2001. SFAS 143 requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred and a corresponding increase in the carrying amount of the related long-lived asset. SFAS 143 is effective for fiscal years beginning after June 15, 2002. The Company does not expect SFAS 142 or 143 to materially impact its reported results.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", (SFAS 144") is effective for the Company for the fiscal year beginning January 1, 2002, and addresses accounting and reporting for the impairment or disposal of long-lived assets. SFAS 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" and APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business." SFAS 144 retains the fundamental provisions of SFAS No. 121 and expands the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. The Company estimates that the new standard will not have a material impact on its financial statements but is still in the process of evaluating the impact on its financial statements.

Codification of Statutory Accounting Principles

In March 1998, the National Association of Insurance Commissioners adopted the Codification of Statutory Accounting Principles (the "Codification"). The Codification, which is intended to standardize regulatory accounting and

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reporting to state insurance departments, is effective January 1, 2001. However, statutory accounting principles will continue to be established by individual state laws and permitted practices. The State of Oklahoma will require adoption of the Codification for the preparation of statutory financial statements effective January 1, 2001. The Company's adoption of the Codification increased the statutory capital and surplus of its regulated subsidiaries as of January 1, 2001 by \$798,000.

Accounting Change

SEC Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," ("SAB 101") was issued December 1999. This Staff Bulletin summarizes certain of the staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. SAB 101 was effective no later than the fourth fiscal quarter of the fiscal years, beginning after December 15, 1999. The Company implemented SAB 101 in the fourth quarter of 2000 but effective January 1, 2000, and has deferred the non-refundable \$10 Membership and \$47 of the associate enrollment fees and the related direct incremental costs associated with services provided members and associates in return for such fees. These deferred revenues and related costs will be amortized to income over the estimated life of the Membership or the estimated average active service period of associates which at June 30, 2001 were 3.6 years and one year, respectively. The implementation of SAB 101 resulted in a cumulative effect type adjustment of \$1.0 million, net of tax, which decreased net income for the six months ended June 30, 2000. See Note 1.

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors and Stockholders
Pre-Paid Legal Services, Inc.

We have reviewed the accompanying consolidated balance sheet of Pre-Paid Legal Services, Inc. and subsidiaries as of June 30, 2001, and the related consolidated statements of income, comprehensive income and cash flows for the three-month and six-month periods ended June 30, 2001 and 2000. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, the consolidated financial statements referred to above have been restated primarily to change the accounting treatment for payments to associates for membership commission advances and related revenue recognition to be consistent with such treatment. Additionally, as discussed in Note 6 the Company changed certain of its revenue recognition policies as a result of the adoption of Staff Accounting Bulletin No. 101 "Revenue Recognition in Financial Statements."

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet as of December 31, 2000, and the related consolidated statements of income,

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comprehensive income, cash flows and changes in stockholders' equity for the year then ended (not presented herein) and in our report dated January 30, 2002, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2000, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

GRANT THORNTON LLP

Oklahoma City, Oklahoma
February 22, 2002

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND

RESULTS OF OPERATIONS

Results of Operations

The Company reported net income applicable to common shares of \$12.4 million, or \$.57 per diluted common share, for the six months ended June 30, 2001, up 51% from net income applicable to common stockholders of \$8.2 million, or \$.36 per diluted common share, for the comparable period of the prior year after an after-tax charge of \$1.0 million relating to the cumulative effect on prior years of adopting SAB 101. See Note 6.

Membership fees totaled \$126.4 million during 2001 compared to \$99.6 million for 2000, an increase of 27%. 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 increased 12% during the six months ended June 30, 2001 to 371,832 from 332,655 during the comparable period of 2000. At June 30, 2001, there were 1,179,705 active Memberships in force compared to 965,849 at June 30, 2000, an increase of 22%. Additionally, the average annual fee per Membership has increased from \$241 for all Memberships in force at June 30, 2000 to \$249 for all Memberships in force at June 30, 2001, a 3% increase. This increase is a result of a higher portion of active Memberships containing the additional pre-trial hours benefit at an additional cost and increased sales of the Business Owners' Legal Solutions plan.

Associate services revenue increased 43% from \$13.4 million for the first six months of 2000 to \$19.1 million during the same period of 2001 primarily as a result of more new associates recruited and of the Fast Start program which generated training fees of approximately \$10.7 million during the first six months of 2001 compared to \$7.9 million for the comparable period of 2000. The field training program, titled Fast Start to Success ("Fast Start") is aimed at increasing the level of new Membership sales per associate. Fast Start requires a training fee of \$184 per new associate and upon successful completion of the program provided for the payment of certain training bonuses through June 30, 2001. The \$10.7 million and \$7.9 million for the six month periods ending June 30, 2001 and 2000, respectively, in training fees was comprised of \$184 from

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each of approximately 58,363 new sales associates who elected to participate in Fast Start during the first six months of 2001 compared to 43,019 that participated during the comparable quarter of 2000. New associates enrolled during the first six months of 2001 were 61,191 compared to 46,592 for the same period of 2000, an increase of 31%. Effective April 2001, the Company modified its compensation plan to consolidate the lower four levels of its compensation structure into two levels. At the same time, the Company implemented a two-year advance at the lowest commission level for associates who participate in the training program. Associates who do not participate in the training program receive only earned commissions until they meet the advancement qualification requiring them to produce 50 new memberships in their organization in order to advance to the next compensation level and qualify for up to 3 years commission advance. Effective October 1, 2001 the Company implemented a policy whereby the associate receives only earned commissions on the first three sales unless the associate has successfully completed the Fast Start training program.

Product sales declined 96% during the six months ended June 30, 2001 to \$33,000 from \$811,000 for the comparable period of 2000 primarily due to the concentration on Membership sales as opposed to the sale of goods and services following the TPN acquisition. Product sales are expected to be immaterial in 2001 and future periods as the Company no longer encourages product sales.

Other income remained relatively constant at \$1.7 million for the first six months of 2000 and \$1.6 million during the same period of 2001.

Primarily as a result of the increase in Membership fees and associate services, total revenues increased to \$147.1 million for the six months ended June 30, 2001 from \$115.4 million during the comparable period of 2000, an increase of 27%.

Membership benefits totaled \$41.8 million for the six months ended June 30, 2001 compared to \$31.7 million for the comparable period of 2000, an increase of 32%, and represented 33.1% and 31.8% of Membership fees for 2001 and 2000, respectively. 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 benefit.

Commissions to associates increased 14% to \$55.1 million for the six months ended June 30, 2001 compared to \$48.5 million for the comparable period of 2000, and represented 44% and 49% of Membership fees for such periods. These amounts were reduced by \$1.2 million and \$900,000, respectively, representing Membership lapse fees. These fees are determined by applying the prime interest rate to the advance commission balance pertaining to lapsed Memberships. The Company realizes and recognizes this fee only when the amount of the calculated fee is collected by withholding from cash commissions payments due the associate, because the Company's ability to recover fees in excess of current payments is primarily dependent on the associate selling new Memberships which qualify for advance commissions. Commissions to associates per new membership sold were \$150 per membership for the six months ended June 30, 2001 compared to \$145 for the comparable period of 2000.

Associate services and direct marketing expenses increased to \$16.0 million for the six months ended June 30, 2001 from \$9.9 million for the comparable period of 2000. Fast Start bonuses incurred were approximately \$6.2 million during the first six months of 2001 compared to \$3.5 million in the same period of 2000. Additional costs due to increased enrollment of new associates and purchases of marketing and promotional supplies by associates also contributed to the increase. These expenses also include marketing costs, other than commissions, that are directly associated with new Membership sales.

General and administrative expenses during the six months ended June 30, 2001 and 2000 were \$13.9 million and \$10.6 million, respectively, and

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represented 11.0% and 10.6% of Membership fees for such years. Management expects gradual decreases in general and administrative expenses when expressed as a percentage of Membership fees as a result of certain economies of scale.

Product costs declined to \$32,000 for the six months ended June 30, 2001 from \$590,000 for the comparable period of 2000 in conjunction with the 96% decline in product sales. Product costs are expected to be immaterial in 2001 and future periods as the Company no longer encourages product sales.

Other expenses, which include depreciation and amortization and premium taxes reduced by interest income, increased to \$2.0 million for the 2001 period from \$931,000 for the comparable period of 2000. Depreciation and amortization increased to \$1.9 million for the first six months of 2001 from \$1.3 million for the comparable period of 2000. Premium taxes increased from \$900,000 for the six months ended 2000 to \$1.0 million for the same period of 2001. Interest income declined by approximately \$154,000 from the first six months of 2000 to \$1.2 million due to lower investment balances and lower interest rates.

The Company has recorded a provision for income taxes of \$6.0 million (32.6% of pretax income) for the first six months of 2001 compared to \$4.4 million (33.0% of pretax income) for the same period of 2000.

The results of operations of the UFL segment have been segregated and reported as discontinued operations in the Consolidated Statements of Income. Income from discontinued operations, net of income tax, are \$56,000, net of tax of \$0 and \$372,000 net of tax benefit of \$103,000 for the six months ended June 30, 2001 and 2000, respectively.

The Company did not pay dividends during the first six months of 2001 due to the fact that during the second quarter of 2000, all shares of preferred stock were converted into shares of common stock or repurchased by the Company. Dividends paid on outstanding preferred stock were \$4,000 for the six-month period ended June 30, 2000.

Second Quarter of 2001 compared to the Second Quarter of 2000

The results of operations in the second quarter of 2001, compared to the second quarter of 2000, reflect increases in revenues and expenses primarily as a result of the same factors discussed in the comparison of the first six months of 2001 to the first six months of 2000.

Total revenues increased 29% or approximately \$17.2 million to \$76.8 million in the second quarter of 2001 compared to \$59.6 million in the second quarter of 2000, primarily as a result of increases in membership premiums. The membership premium increase of 30% primarily resulted from an increase in the number of average active memberships during the second quarter of 2001 compared to the similar period in 2000.

Membership benefits totaled \$21.8 million in the 2001 second quarter compared to \$16.6 million in the 2000 second quarter and resulted in a loss ratio of 32% for both periods.

Commissions to associates increased 16% to \$31.4 million for the three months ended June 30, 2001 compared to \$27.1 million for the comparable period of 2000, and represented 47% and 53% of Membership fees for such periods. These amounts were reduced by \$640,000 and \$481,000, respectively, representing Membership lapse fees. Commissions to associates per new membership sold were \$165 per membership for the three months ended June 30, 2001 compared to \$158 for the comparable period of 2000.

The above factors resulted in a 2001 second quarter net income applicable

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to common shareholders of \$4.7 million, or \$.22 per share, diluted, compared to \$3.4 million, or \$.15 per share, for the second quarter of 2000.

The results of operations of the UFL segment have been segregated and reported as discontinued operations in the Consolidated Statements of Income. Income (loss) from discontinued operations, net of income tax, are \$(102,000), net of tax of \$0 and \$229,000 net of tax benefit of \$180,000 for the three months ended June 30, 2001 and 2000, respectively.

Liquidity and Capital Resources

General

Consolidated net cash provided by operating activities of continuing operations was \$13.8 million for the first six months of 2001 compared to cash provided of \$7.4 million for the 2000 period. The increase of \$6.4 million in cash provided by operating activities during the first six months of 2001 compared to the same period of 2000 resulted primarily from the increase in net income of \$4.2 million, an increase in deferred member and associate service cost of \$3.5 million, a \$1.2 million increase in the provision for deferred income taxes and a \$1.1 million increase in accounts payable and accrued expenses offset by a decrease in deferred revenue and fees of \$4.8 million.

Consolidated net cash provided by investing activities of continuing operations was \$1.2 million for the first six months of 2001 compared to net cash used in investing activities of \$5.1 million for the comparable period of 2000. This \$6.2 million increase in cash provided by investing activities resulted primarily from the \$7.9 million change in the maturities and sales of investments offset by a \$563,000 increase in the purchases of investments and the \$2.2 million increase in net additions to property and equipment.

Net cash used in financing activities of continuing operations during the first six months of 2001 was \$15.9 million compared to \$3.0 million for the comparable period of 2000. This \$12.9 million change was primarily comprised of the \$12.5 million used to acquire treasury stock during the first six months of 2001.

The Company had a consolidated working capital surplus of \$5.7 million at June 30, 2001, a decrease of \$1.6 million compared to a consolidated working capital of \$7.3 million at December 31, 2000. The \$1.6 million decrease in working capital during the first six months of 2001 was primarily the result of a \$900,000 increase in deferred Membership revenue and fees, a \$800,000 increase in Membership benefits, a \$1.0 million decrease in cash and a \$2.1 million decrease in deferred income taxes offset by a \$3.3 million decrease in accounts payable and accrued expenses.

At June 30, 2001 the Company reported \$25.6 million in cash and investments (after utilizing more than \$15.8 million to purchase approximately 917,000 shares of its common stock during the six months ending June 30, 2001) compared to \$31.5 million at December 31, 2000. The Company's investments consist of common stocks, investment grade (rated Baa or higher) preferred stocks and investment grade 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.

The Company generally advances significant commissions at the time a Membership is sold. During the six months ended June 30, 2001, the Company advanced commissions of \$55.1 million on new Membership sales compared to \$49.0 million for the same period of 2000. Since approximately 94% of Membership premiums are collected on a monthly basis, a significant cash flow deficit is created at the time a Membership is sold. This deficit is reduced as monthly premiums are remitted and commissions payable on those Memberships are withheld

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to recover the advance.

The Company expenses advance commissions ratably over the first month of the related membership. As a result of this accounting policy, the Company's 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. The Company tracks its advance commission payments outstanding for internal purposes of analyzing its commission advance program. While not recorded as an asset, unearned commission payments to associates for the six months ended June 30, 2001 were:

(Amounts in 000)

| | |
|---|------------|
| Beginning unearned advance commission payments (1)..... | \$ 167,193 |
| Advance commission payments, net..... | 55,147 |
| Earned commissions applied..... | (28,234) |
| Advance commission payment write-offs..... | (929) |
| | ----- |
| Ending unearned advance commission payments before estimated unrecoverable payments (1)..... | 193,177 |
| Estimated unrecoverable advance commission payments (1)..... | (12,770) |
| Ending unearned advance commission payments, net (1)..... | ----- |
| | \$ 180,407 |
| | ----- |

(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 \$16.8 million. As such, at June 30, 2001 future commission payments and related expense should be reduced as unearned advance commission payments of \$163.6 million are recovered. Commissions are earned by the associate as Membership premiums are earned by the Company, usually on a monthly basis. The Company reduces unearned advance commission payments or remits payment to an associate, as appropriate, when commissions are earned. Should a Membership lapse before the advances have been recovered for each commission level, the Company generates an immediate "charge-back" to the applicable sales associate to recapture up to 50% of any unearned advance. This charge-back is deducted from any future advances that would otherwise be payable to the associate for additional new Memberships. Any remaining unearned advance commission payment may be recovered by withholding future residual earned commissions due to an active associate on active Memberships. Additionally, even though a commission advance may have been fully recovered on a particular Membership, no additional commission earnings from any Membership are paid to an associate until all previous advances on all Memberships, both active and lapsed, have been recovered.

The Company has the contractual right to require associates to repay unearned advance commission payments from sources other than earned commissions including cash (a) from all associates either (i) upon termination of the associate relationship, which includes but is not limited to when an associate becomes non-vested or (ii) when it is ascertained that earned commissions are insufficient to repay the unearned advance commission payments and (b) upon demand, from agencies or associates who are parties to the associate agreements signed between October 1989 and July 1992 or July 1992 to August 1998, respectively. The sources, other than earned commissions, that may be available to recover associate unearned advance commission payments are potentially

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subject to limitation based on applicable state laws relating to creditors' rights generally. Historically, the Company has not demanded repayments of the unearned advance commissions from associates, including terminated associates, because collection efforts would likely increase costs and have the potential to disrupt the Company's relationships with its sales associates. This business decision by the Company has a significant effect on the Company's cash flow by electing to defer collection of advance payments of which approximately \$12.8 million were not expected to be collected from future commissions at June 30, 2001. However, the Company regularly reviews the unearned advance commission payments status of associates and will exercise its right to require associates to repay advances when management believes that such action is appropriate.

The Company believes that it has significant ability to finance expected future growth in Membership sales based on its existing amount of cash and cash equivalents and unpledged investments at June 30, 2001 of \$21.2 million. The Company expects to maintain cash and investment balances, including pledged investments, on an on-going basis of approximately \$25 to \$35 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 treasury stock purchases. The Company continues to consider incurring indebtedness in order to continue or increase the rate of stock purchases, including financing its new corporate headquarters in order to allow cash flow from operations to continue to be used to purchase stock.

Subsequent event

On November 6, 2001, the Company entered into a \$17.5 million line of credit with Bank of Oklahoma, N.A. in order to fund additional treasury stock purchases. The line of credit provides for immediate funding of up to \$17.5 million with scheduled repayments beginning February 15, 2002 and ending November 15, 2002 with interest at the Libor rate plus 2% per annum or the prime rate minus 1/2 percent per annum as selected by the Company. The loan is secured by the Company's rights to receive membership fees on a portion of its memberships. The terms of this loan have various covenants customary for similar transactions.

Parent Company Funding and Dividends

Although the Company is the operating entity in many jurisdictions, the Company's 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 PPLCI, UFL and PPLSIF. The ability of PPLCI and PPLSIF to provide funds to the Company 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 will be funded by the Company in the form of capital contributions or surplus debentures. At June 30, 2001, neither UFL nor PPLSIF had funds available for payment of substantial dividends without the prior approval of the respective insurance commissioners. PPLCI had approximately \$5 million in surplus funds available for payment of an ordinary dividend.

Forward-Looking Statements

All statements in this report concerning Pre-Paid Legal Services, Inc. (the "Company") other than purely historical information, including but not limited to, statements relating to the Company's future plans and objectives, discussions with the staff of the SEC, 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

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on the Company's historical operating trends and financial condition as of June 30, 2001 and other information currently available to management. The Company cautions that the Forward-Looking Statements are subject to all the risks and uncertainties incident to its business, including but not limited to risks described below. Moreover, the Company 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. The Company assumes no obligation to update the Forward-Looking Statements to reflect events or circumstances occurring after the date of the statement.

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 33 and 34 of the Company's 2000 Annual Report on Form 10-K, as amended and restated, for a description of other risk factors.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

As of June 30, 2001, substantially all of the Company's investments were in investment grade (rated Baa or higher) fixed-maturity investments, interest-bearing money market accounts and a collateralized repurchase agreement. The Company does 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 the Company's fixed-maturity investment portfolio. It is assumed that the changes occur immediately and uniformly, with no effect given to any steps that management 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 (dollars in 000's):

| | Fair Value | Hypothetical change in interest rate (bp=basis points) |
|--|------------|--|
| | ----- | ----- |
| Fixed-maturity investments at June 30, 2001 (1)..... | \$ 21,435 | 100 bp increase 200 bp increase |

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| | | |
|--|-----------|-----------------|
| | | 50 bp decrease |
| | | 100 bp decrease |
| Fixed-maturity investments at December 31, 2000 (1)..... | \$ 25,480 | 100 bp increase |
| | | 200 bp increase |
| | | 50 bp decrease |
| | | 100 bp decrease |

(1) Excluding short-term investments with a fair value of \$3.9 million at June 30, 2001 and December 31, 2000, respectively. Includes UFL investments with a fair value of \$9.4 million and \$9.1 million at June 30, 2001 and December 31, 2000, respectively

The table above illustrates, for example, that an instantaneous 200 basis point increase in market interest rates at June 30, 2001 would reduce the estimated fair value of the Company's fixed-maturity investments by approximately \$1.7 million at that date. At December 31, 2000, an instantaneous 200 basis point increase in market interest rates would have reduced the estimated fair value of the Company's fixed-maturity investments by approximately \$1.7 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 the Company does not believe such risk is material.

The Company primarily manages its exposure to interest rate risk by purchasing investments that can be readily liquidated should the interest rate environment begin to significantly change.

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

The 2001 Annual Meeting of Shareholders of the Company (the "Annual Meeting") was held on May 25, 2001. The following matters were submitted to a vote of the Company's shareholders at the Annual Meeting.

Election of Three Directors.

The results of the election for each of the Company's three directors whose terms expired as of the Annual Meeting were as follows:

| | Votes For | Abstentions and Votes Withheld |
|------------------------|------------|-----------------------------------|
| | ----- | ----- |
| Shirley A. Stonecipher | 18,965,811 | 395,638 |
| Peter K. Grunebaum | 19,045,917 | 315,532 |
| Randy Harp | 18,720,980 | 640,469 |

The Board of Directors of the Company consists of ten members and is divided into three classes as nearly equal in size as possible, with the term of office of one class expiring each year. The new terms of service of Ms. Stonecipher and Messrs. Grunebaum and Harp will expire in 2004. The terms of the other seven directors of the Company did not expire at the Annual Meeting. The

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names of such other directors and the year of expiration of their respective terms are as follows: Harland C. Stonecipher - 2002; Wilburn L. Smith - 2002; Martin H. Belsky - 2002; Kathleen S. Pinson - 2003; David A. Savula - 2003; John W. Hail - 2003; and John A. Addison - 2003.

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

(a) Exhibits: None

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.

Date: February 22, 2002

/s/ Randy Harp

Randy Harp
Chief Operating Officer
(Duly Authorized Officer)

Date: February 22, 2002

/s/ Steve Williamson

Steve Williamson
Chief Financial Officer
(Principal Accounting Officer)