

Edgar Filing: MEMBERWORKS INC - Form 10-Q

MEMBERWORKS INC  
Form 10-Q  
May 14, 2004

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

FORM 10-Q

X Quarterly report pursuant to Section 13 or 15(d) of the Securities  
----- Exchange Act of 1934 for the quarterly period ended March 31, 2004  
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 No. 0-21527

MEMBERWORKS INCORPORATED  
(Exact name of registrant as specified in its charter)

DELAWARE  
-----  
(State of Incorporation)

06-1276882  
-----  
(IRS Employer  
Identification No.)

680 Washington Boulevard  
Stamford, Connecticut  
-----  
(Address of principal executive offices)

06901  
-----  
(Zip Code)

(203) 324-7635  
(Registrant's 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 [ X ] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

[X] Yes [ ] No

The aggregate market value of the voting stock held by non-affiliates of the Registrant at April 29, 2004 was \$250,575,939. The aggregate market value was computed by reference to the closing price of the Registrant's Common Stock as of that date. For purposes of calculating this amount only, all directors, executive officers and shareholders reporting beneficial ownership of more than 10% of the Registrant's Common Stock are considered to be affiliates.

Indicate the number of shares outstanding of each of the registrant's class of common stock as of the latest practicable date: 10,529,199 shares of Common Stock, \$0.01 par value as of April 29, 2004.

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	March 31, 2004
	(Unaudited)
Assets	
Current assets:	
Cash and cash equivalents	\$ 118,9
Restricted cash	2,6
Accounts receivable (net of allowance for doubtful accounts of \$1,744 and \$1,743, at March 31, 2004 and June 30, 2003, respectively)	11,8
Prepaid membership materials	2,7
Prepaid expenses and other current assets	8,6
Membership solicitation and other deferred costs	58,8
Total current assets	203,6
Fixed assets, net	22,9
Goodwill (Note 4)	42,0
Intangible assets, net (Note 4)	6,0
Other assets	6,3
Total assets	\$ 281,0
Liabilities and Shareholders' Deficit	
Current liabilities:	
Current maturities of long-term obligations	\$ 3
Accounts payable	25,6
Accrued liabilities	56,2
Deferred membership fees	147,6
Deferred income taxes	5,3
Total current liabilities	235,2
Deferred income taxes	6,7
Other long-term liabilities	3,8
Convertible debt (Note 8)	90,0
Total liabilities	335,9
Commitments and contingencies (Note 9)	
Shareholders' deficit:	
Preferred stock, \$0.01 par value -- 1,000 shares authorized; no shares issued	1
Common stock, \$0.01 par value -- 40,000 shares authorized; 19,042 shares issued (17,847 shares at June 30, 2003)	152,8
Capital in excess of par value	2,1
Accumulated equity (deficit)	(4
Accumulated other comprehensive loss	(209,5
Treasury stock, 8,788 shares at cost (6,126 shares at June 30, 2003)	(54,8
Total shareholders' deficit	(54,8
Total liabilities and shareholders' deficit	\$ 281,0

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

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MEMBERWORKS INCORPORATED  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)  
 (In thousands, except per share data)

	Three months ended March 31,	
	2004	2003
Revenues	\$ 118,519	\$ 118,647
Expenses:		
Marketing	60,941	73,012
Operating	22,324	20,653
General and administrative	20,438	19,130
Amortization of intangible assets	258	336
Operating income	14,558	5,516
Settlement of investment related litigation	-	-
Loss on sale of subsidiary	-	-
Net loss on investment	-	-
Interest (expense) income, net	(1,265)	149
Other income (expense), net	672	(112)
Income before income taxes	13,965	5,553
Provision for income taxes	5,586	2,221
Net income	\$ 8,379	\$ 3,332
Basic earnings per share	\$ 0.81	\$ 0.27
Diluted earnings per share	\$ 0.68	\$ 0.25
Weighted average common shares used in earnings per share calculations:		
Basic	10,301	12,515
Diluted	13,380	13,104

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

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MEMBERWORKS INCORPORATED  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(In thousands)

	For the n M
	2004
Operating activities	
Net income	\$ 19,93
Adjustments to reconcile net income to net cash provided by operating activities:	
Change in deferred membership fees	(20,07
Change in membership solicitation and other deferred costs	19,15
Depreciation and amortization	7,64
Deferred income taxes	6,12
Tax benefit from employee stock plans	6,49
Gain on settlement of investment related litigation	-
Loss on sale of subsidiary	-
Net loss on investment	-
Other	92
Change in assets and liabilities:	
Restricted cash	50
Accounts receivable	(3,140
Prepaid membership materials	(963
Prepaid expenses and other current assets	(629
Other assets	(267
Accounts payable	(6,967
Accrued liabilities	(3,038
Net cash provided by operating activities	25,268
Investing activities	
Acquisition of fixed assets	(4,87
Settlement of investment related litigation	
Purchase price adjustments from sale of subsidiary	
Other investments	
Net cash (used in) provided by investing activities	(4,87
Financing activities	
Net proceeds from issuance of stock	23,63
Treasury stock purchases	(84,94
Net proceeds from issuance of long-term obligations	87,94
Payments of long-term obligations	(36

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Net cash provided by (used in) financing activities	26,27
Effect of exchange rate changes on cash and cash equivalents	3
Net increase in cash and cash equivalents	46,69
Cash and cash equivalents at beginning of period	72,26
Cash and cash equivalents at end of period	\$ 118,95

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

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### MEMBERWORKS INCORPORATED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, such statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The preparation of these consolidated financial statements in conformity with generally accepted accounting principles requires management of MemberWorks Incorporated ("the Company" or "MemberWorks") to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Operating results for the three and nine months ended March 31, 2004 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2004. For further information, refer to the financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K with respect to the fiscal year ended June 30, 2003.

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

#### NOTE 2 - RECLASSIFICATIONS

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

#### NOTE 3 - STOCK-BASED COMPENSATION

In accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), the Company applies the intrinsic value method in accounting for employee stock options. Accordingly, the Company generally does not recognize compensation expense with respect to stock-based awards to employees. If compensation cost for the Company's stock-based compensation plans had been determined based on the fair value (estimated using

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the Black-Scholes option-pricing model) at the grant dates for awards under those plans consistent with the method of Financial Accounting Standards Board Statement ("SFAS") No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), and SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure" ("SFAS 148"), the Company's pro forma net income and earnings per share would have been as follows:

	Three months ended March 31,		Ni
	2004	2003	20
Net income reported	\$ 8,379	\$ 3,332	\$ 1
Add: Stock-based employee compensation expense determined under the intrinsic value based method for all awards, net of related tax effects	-	-	
Deduct: Stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	1,145	1,456	
Pro forma net income	\$ 7,234	\$ 1,876	\$ 1
Earnings per share:			
As reported:			
Basic	\$ 0.81	\$ 0.27	\$
Diluted	\$ 0.68	\$ 0.25	\$
Pro forma:			
Basic	\$ 0.70	\$ 0.15	\$
Diluted	\$ 0.60	\$ 0.14	\$

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### MEMBERWORKS INCORPORATED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### NOTE 4 - GOODWILL AND OTHER INTANGIBLE ASSETS

The gross carrying value and accumulated amortization of goodwill and other intangibles are as follows (in thousands):

	As of March 31, 2004		As of Ju
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount
Amortized intangible assets:			
Membership and Client Relationships	\$ 13,405	\$ (7,511)	\$ 13,195
Other	950	(825)	950

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Total amortized intangible assets	\$ 14,355	\$ (8,336)	\$ 14,145
Intangible assets, net	\$ 6,019		\$ 6,656
Unamortized intangible assets:			
Goodwill	\$ 42,039		\$ 42,039

Acquired intangibles, except member relationships, are recorded at cost and are amortized on a straight-line basis over their estimated useful lives ranging from 3 to 20 years. The value of member relationships is amortized using an accelerated method based on estimated future cash flows. The future intangible amortization expense for the next five years is estimated to be as follows (in thousands):

Fiscal Year:

2004	1,090
2005	900
2006	755
2007	599
2008	485

As a result of increased integration of operations and management at three of its five reporting units during fiscal 2003, the Company aggregated these three reporting units into a single reporting unit for fiscal 2004 impairment testing purposes, resulting in a total of three reporting units in the current year. Goodwill was tested for impairment during the quarter ended September 30, 2003 as required by SFAS 142. The Company concluded that none of its goodwill was impaired. Fair value was estimated using discounted cash flow methodologies. In addition, the Company reassessed the estimated useful lives of its definite-lived intangible assets and determined that the lives were appropriate. The Company will test the goodwill of each of its reporting units annually or more frequently if impairment indicators exist.

NOTE 5 - FOREIGN CURRENCY INSTRUMENTS

MemberWorks uses purchased option contracts and forward contracts designated as cash flow hedges to protect against the foreign currency exchange risk inherent in its acquisition of Lavalife Inc. ("Lavalife"), which is denominated in Canadian dollars (see Note 15). During the quarter ended March 31, 2004, MemberWorks hedged a portion of the cash outflows associated with the acquisition. The risk of loss associated with purchased options is limited to premium amounts paid for the option contracts. The risk of loss associated with forward contracts is equal to the exchange rate differential from the time the contract is entered into until the time it is settled. These contracts expire on April 1, 2004 concurrent with the closing of the Lavalife acquisition.

The change in the fair value of a cash flow hedge is recognized currently in earnings and is reported as a component of other income, net. Hedge effectiveness is measured by comparing the hedging instrument's cumulative change in fair value from inception to maturity to the forecasted transaction's terminal value. As of March 31, 2004, MemberWorks held purchased option contracts and forward contracts with a notional amount of approximately \$103,522,000, a net asset value of \$867,000 and a net realized gain of \$403,000, net of taxes.

NOTE 6 - ALLOWANCE FOR MEMBERSHIP CANCELLATIONS

Accrued liabilities set forth in the accompanying condensed consolidated balance sheets as of March 31, 2004 and June 30, 2003 include an allowance for membership cancellations of \$16,353,000 and \$20,934,000, respectively. Recording



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an allowance for membership cancellations has the effect of reducing the amount of deferred membership fees recorded.

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### MEMBERWORKS INCORPORATED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### NOTE 7 - RESTRUCTURING CHARGES

During fiscal 2002, the Company announced the implementation of several cost saving initiatives due to a slowdown in consumer response rates and increased economic uncertainty in both the U.S. and abroad. This restructuring program included a workforce reduction, the closing of the Company's United Kingdom operations and the downsizing of the operational infrastructure throughout the Company. As a result of the restructuring program, the Company recorded restructuring charges of \$6,893,000 during the quarter ended December 31, 2001.

The following is a rollforward of the major components of the restructuring reserve (in thousands) which is recorded in accrued liabilities and other long-term liabilities:

	Workforce Reduction	Lease Obligations	Total
Restructuring reserve balance at June 30, 2002	\$ 391	\$ 2,546	\$ 2,937
Additions to the reserve	-	-	-
Charges to the reserve	300	836	1,136
Restructuring reserve balance at June 30, 2003	91	1,710	1,801
Additions to the reserve	-	-	-
Charges to the reserve	91	71	162
Restructuring reserve balance at March 31, 2004	\$ -	\$ 1,639	\$ 1,639

#### NOTE 8 - CONVERTIBLE DEBT

On September 30, 2003, the Company issued \$90,000,000 aggregate principal amount of 5.5% convertible senior subordinated notes ("Convertible Notes") due September 2010 in a private offering pursuant to rule 144A of the Securities Act of 1933, as amended. The Convertible Notes bear interest at the rate of 5.5% per year, which will be payable in cash semi-annually in arrears on April 1 and October 1 of each year. The first payment was due on April 1, 2004. Holders of the Convertible Notes may convert their notes into shares of MemberWorks common stock at any time prior to maturity at an initial conversion price of approximately \$40.37 per share, which is equivalent to an initial conversion rate of approximately 24.7739 shares per \$1,000 principal amount of the Convertible Notes. In accordance with Accounting Principles Board Opinion No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants," these Convertible Notes have been classified as a liability.

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On December 3, 2003, Memberworks filed on Form S-3 a shelf registration statement with the Securities and Exchange Commission covering the resale of the Convertible Notes and the common stock issuable upon their conversion, which was declared effective on April 9, 2004.

Debt issuance costs associated with this issuance were \$3,432,000 for the nine months ended March 31, 2004. Debt issuance costs are capitalized and amortized as interest expense over the term of the Convertible Notes using the effective interest method.

### NOTE 9 - COMMITMENTS AND CONTINGENCIES

The Company operates in leased facilities. Management expects that leases currently in effect will be renewed or replaced by other leases of a similar nature and term.

On March 25, 2004, MemberWorks entered into an amended and restated senior secured credit facility that allows borrowings of up to \$45,000,000. Borrowings under the senior secured credit facility accrue interest at either the Eurodollar rate, or the higher of the Prime rate or the Federal Funds rate, plus an applicable margin. As of March 31, 2004, the availability under the senior secured credit facility was further reduced by an outstanding letter of credit of \$5,495,000. Subsequent to the completion of the issuance of \$150,000,000 aggregate principal amount Senior Notes (see Note 15), the availability under the senior secured credit facility will be further reduced by one years worth of interest on the Senior Notes.

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### MEMBERWORKS INCORPORATED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Except as set forth below, in management's opinion, there are no significant legal proceedings to which the Company or any of its subsidiaries is a party or to which any of their properties are subject. The Company is involved in other lawsuits and claims generally incidental to its business including, but not limited to, various suits, including previously disclosed suits, brought against the Company by individual consumers seeking monetary and/or injunctive relief relating to the marketing of the Company's programs. In addition, from time to time, and in the regular course of its business, the Company receives inquiries from various federal and/or state regulatory authorities.

In March 2001, an action was instituted by plaintiff Teresa McClain against Coverdell & Company ("Coverdell"), a wholly-owned subsidiary of the Company, Monumental Life Insurance Company and other defendants in the United States District Court for the Eastern District of Michigan, Southern Division. The suit, which seeks unspecified monetary damages, alleges that Coverdell and the other defendants violated the Michigan Consumer Protection Act and other applicable Michigan laws in connection with the marketing of Monumental Life Insurance Company insurance products. The complaint includes a claim that the suit should be certified as a class action and the plaintiff has filed a motion for class certification to which all of the defendants have filed opposing papers regarding the same. The Court certified a class of Michigan residents. The Court of Appeals denied the defendants' petition for leave to appeal the certification order. The Company believes that the claims made against Coverdell are unfounded and Coverdell and the Company will vigorously defend their interests against this suit.

On January 24, 2003, the Company filed a motion with the Superior Court for the

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Judicial District of Hartford, Connecticut to vacate and oppose the confirmation of an arbitration award issued in December 2002. The arbitration, filed against the Company by MedValUSA Health Programs, Inc. ("MedVal") in September 2000, involved claims of breach of contract, breach of the duty of good faith and fair dealing, and violation of the Connecticut Unfair Trade Practices Act ("CUTPA"). Even though the arbitrators found that MemberWorks was not liable to MedVal for any compensatory damages, they awarded \$5,495,000 in punitive damages and costs against MemberWorks solely under CUTPA. MemberWorks believes that this arbitration award is unjustified and not based on any existing legal precedent. Specifically, the Company is challenging the award on a number of grounds, including that it violates a well defined public policy against excessive punitive damage awards, raises constitutional issues and disregards certain legal requirements for a valid award under CUTPA. The hearing on the Company's motion was held on February 10, 2003. On June 22, 2003, the Superior Court denied the Company's motion to vacate the award, and the Company filed an appeal of that decision. While the Company intends to take action to prevent the enforcement of the award by, among other things, vigorously pursuing an appeal, there can be no assurance that MemberWorks will be successful in its efforts. The Company has made no provision in its financial statements for this contingency because it believes that a loss is not probable. If the Company were ultimately unsuccessful in this or other available appeals, and a final non-appealable court order confirming the arbitration award is rendered, the payment of the award could have a material adverse effect on the Company's results of operations in the period in which the final order is entered.

On October 21, 2003, the Florida Attorney General's Office filed a civil complaint against the Company based upon concerns that some of its past marketing practices may have violated various consumer laws. The Company believes that any legitimate concerns have previously been fully addressed, including the implementation of industry-leading Best Marketing Practices and voluntary agreements incorporating those practices, such as the nationwide assurance agreement that the Company entered into with the State of Nebraska in 2001. The Company believes that the allegations of the complaint are unfounded and the Company intends to vigorously defend its interests in this matter. The Company further believes that the potential liability represented by the lawsuit and the final resolution of this matter will not be material to the Company.

### NOTE 10 - INCOME TAX EXPENSE

Income tax expense as a percentage of pre-tax income was 40% for the three and nine months ended March 31, 2004 and 2003. The effective tax rate was higher than the U.S. statutory rate for the three and nine months ended March 31, 2004 and 2003 primarily due to state taxes and other non-deductible items. Tax benefits resulting from the exercise of nonqualified stock options and the disqualifying dispositions of shares issued under the Company's stock based compensation plans reduced taxes payable by \$4,944,000 and \$344,000 during the quarters ended March 31, 2004 and 2003, respectively. Tax benefits resulting from the exercise of nonqualified stock options and the disqualifying dispositions of shares issued under the Company's stock based compensation plans reduced taxes payable by \$6,497,000 and \$641,000 during the nine months ended March 31, 2004 and 2003, respectively. Such benefits are credited to capital in excess of par value.

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NOTE 11 - EARNINGS PER SHARE

Basic and diluted earnings per share amounts are determined in accordance with the provisions of SFAS No. 128, "Earnings Per Share." The following table sets forth the reconciliation of the numerators and denominators in the computation of basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended March 31,	
	2004	2003
Numerator:		
Income available to common shareholders used in basic earnings per share	\$ 8,379	\$ 3,332
Add back: Interest expense on convertible securities	742	-
Income available to common shareholders after assumed conversion of convertible debt for diluted earnings per share	\$ 9,121	\$ 3,332
Denominator:		
Weighted average number of common shares outstanding - basic	10,301	12,515
Effect of dilutive securities:		
Convertible securities	2,229	-
Options	850	589
Weighted average number of common shares outstanding - diluted	13,380	13,104
Basic earnings per share	\$ 0.81	\$ 0.27
Diluted earnings per share	\$ 0.68	\$ 0.25

The diluted earnings per share calculation excludes the effect of potentially dilutive shares when their effect is antidilutive. For the three months ended March 31, 2004 and 2003, the Company had 0 and 2,812,000 shares, respectively, of potentially dilutive stock options outstanding that are not included in the calculation as they are antidilutive. For the nine months ended March 31, 2004 and 2003, the Company had 6,000 and 3,108,000 shares, respectively, of potentially dilutive stock options that are not included in the calculations as they are antidilutive.

NOTE 12 - COMPREHENSIVE INCOME

The components of comprehensive income are as follows (in thousands):

	Three months ended March 31,		Ni
	2004	2003	
Net income	\$ 8,379	\$ 3,332	\$ 1
Foreign currency translation gain (loss)	(5)	72	20

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Comprehensive income	\$ 8,374	\$ 3,404	\$ 1
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NOTE 13 - NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), which was revised in December 2003. FIN 46 clarifies the application of Accounting Research Bulletin No. 51 and provides guidance on the identification of and reporting for variable interest entities. FIN 46 is effective immediately for variable interest entities formed after January 31, 2003 and is effective for periods ending after March 15, 2004 for any variable interest entity formed prior to February 1, 2003. The adoption of FIN 46 did not have a material impact on the Company's financial statements.

In May 2003, the Financial Accounting Standards Board issued SFAS No.150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). This statement requires that certain financial instruments that were accounted for as equity under previous guidance be classified as liabilities in statements of financial position. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 did not have a material impact on the Company's financial statements.

MEMBERWORKS INCORPORATED  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 14 - GUARANTOR AND NONGUARANTOR FINANCIAL STATEMENTS

On April 13, 2004, MemberWorks entered into an agreement to sell an aggregate of \$150.0 million of Senior Notes ("Senior Notes") in private placements pursuant to Rule 144A (see Note 15). The Senior Notes will be unsecured obligations and will rank pari passu in right of payment to all of the Company's existing and future senior unsecured indebtedness and senior in right of payment to all of the Company's existing and future subordinated indebtedness that expressly provides for its subordination to the Notes. The Senior Notes will be fully and unconditionally guaranteed by all of the Company's existing and future domestic subsidiaries and certain of the Company's existing and future foreign subsidiaries.

The following consolidating financial information presents the consolidating balance sheets as of March 31, 2004 and June 30, 2003, the related statements of operations for each of the three and nine month periods ended March 31, 2004 and 2003 and the related statements of cash flows for the nine month periods ended March 31, 2004 and 2003. The information includes the elimination entries necessary to consolidate MemberWorks ("Parent") with the guarantor and nonguarantor entities.

Investments in subsidiaries are accounted for by the Parent using the equity method of accounting. The guarantor and nonguarantor subsidiaries are presented on a combined basis. The principal elimination entries eliminate investments in subsidiaries and intercompany balances and transactions.

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MEMBERWORKS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)

		As of March 31,		
		Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
Assets		(in thousand)		
Current assets:				
Cash and cash equivalents	\$ 105,417	\$ 12,256	\$ 1,28	
Restricted cash	-	2,682		
Accounts receivable	4,903	3,736		3,21
Intercompany receivable	-	6,039		1,04
Prepaid membership materials	1,977	163		56
Prepaid expenses and other current assets	6,260	1,921		50
Membership solicitation and other deferred costs	49,423	6,609		2,77
Total current assets	167,980	33,406		9,38
Fixed assets, net	20,277	588		2,05
Goodwill	-	35,320		6,71
Intangible assets, net	-	6,019		
Other assets	6,305	47		
Investment in subsidiaries	59,276	-		
Total assets	\$ 253,838	\$ 75,380		\$ 18,15
Liabilities and Shareholders' (Deficit) Equity				
Current liabilities:				
Current maturities of long-term obligations	\$ 309	\$ 20		
Accounts payable	10,046	13,083		2,54
Accrued liabilities	50,332	3,826		2,05
Intercompany payable	6,073	1,012		
Deferred membership fees	141,921	1,229		4,53
Deferred income taxes	3,426	(360)		2,30
Total current liabilities	212,107	18,810		11,44
Deferred income taxes	4,097	3,181		(50)
Other long-term liabilities	2,518	-		1,32
Convertible debt	90,000	-		
Total liabilities	308,722	21,991		12,27
Shareholders' (deficit) equity:				
Preferred stock	-	-		
Common stock	190	6		
Capital in excess of par value	152,804	52,296		9,56
Accumulated (deficit) equity	2,110	1,087		(3,22)
Accumulated other comprehensive loss	(458)	-		(45)

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Treasury stock	(209,530)	-	
Total shareholders' (deficit) equity	(54,884)	53,389	5,889
Total liabilities and shareholders' (deficit) equity	\$ 253,838	\$ 75,380	\$ 18,157

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MEMBERWORKS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	As of June 30,		
	Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
Assets	(in thousand)		
<b>Current assets:</b>			
Cash and cash equivalents	\$ 51,895	\$ 18,716	\$ 1,644
Restricted cash	-	2,732	-
Accounts receivable	2,811	3,907	1,999
Intercompany receivable	686	298	-
Prepaid membership materials	1,762	170	26
Prepaid expenses and other current assets	6,032	1,031	50
Membership solicitation and other deferred costs	73,856	1,853	2,177
Total current assets	137,042	28,707	6,596
Fixed assets, net	22,193	535	2,244
Goodwill	-	35,320	6,711
Intangible assets, net	-	6,656	-
Other assets	3,426	60	-
Investment in subsidiaries	56,419	-	-
Total assets	\$ 219,080	\$ 71,278	\$ 15,551
<b>Liabilities and Shareholders' (Deficit) Equity</b>			
<b>Current liabilities:</b>			
Current maturities of long-term obligations	\$ -	\$ 244	\$ -
Accounts payable	17,678	13,018	1,944
Accrued liabilities	53,692	3,333	2,088
Intercompany payable	-	804	18
Deferred membership fees	163,276	1,007	3,366
Deferred income taxes	662	(1,701)	1,911
Total current liabilities	235,308	16,705	9,487

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Deferred income taxes	2,456	3,260	(57)
Other long-term liabilities	1,599	63	1,46
	-----		-----
Total liabilities	239,363	20,028	10,38
	-----		-----
Shareholders' (deficit) equity			
Preferred stock	-	-	
Common stock	178	6	
Capital in excess of par value	122,425	52,296	9,56
Accumulated (deficit) equity	(17,829)	(1,052)	(3,92)
Accumulated other comprehensive loss	(469)	-	(46)
Treasury stock	(124,588)	-	
	-----		-----
Total shareholders' (deficit) equity	(20,283)	51,250	5,16
	-----		-----
Total liabilities and shareholders' (deficit) equity	\$ 219,080	\$ 71,278	\$ 15,55
	=====		=====

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MEMBERWORKS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	For the three months ended		
	Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
	-----		
	(in thousand)		
Revenues	\$ 98,329	\$ 15,310	\$ 5,21
Expenses:			
Marketing	51,773	7,813	1,35
Operating	17,216	2,992	2,45
General and administrative	16,762	2,719	95
Amortization of intangible assets	-	258	
	-----		-----
Operating income	12,578	1,528	45
Equity in income of subsidiaries	1,214	-	
Interest (expense) income, net	(1,317)	26	2
Other income, net	681	(1)	(
	-----		-----
Income before income taxes	13,156	1,553	47
Provision for income taxes	4,777	621	18
	-----		-----



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Net income	\$	8,379	\$	932	\$	28
	=====					

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	For the three months ended		
	Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
	(in thousand)		
Revenues	\$ 102,939	\$ 12,821	\$ 3,08
Expenses:			
Marketing	65,870	6,173	96
Operating	16,891	3,134	82
General and administrative	15,808	2,588	73
Amortization of intangible assets	-	336	
Operating income	4,370	590	55
Equity in income of subsidiaries	703	-	
Interest (expense) income, net	110	35	
Other income, net	(98)	-	(1
Income before income taxes	5,085	625	54
Provision for income taxes	1,753	250	21
Net income	\$ 3,332	\$ 375	\$ 32

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MEMBERWORKS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	For the nine months ended		
	Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
	(in thousand)		
Revenues	\$ 299,505	\$ 43,308	\$ 13,81
Expenses:			
Marketing	168,897	21,852	3,59
Operating	52,360	9,350	6,23

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General and administrative	47,778	7,808	2,81
Amortization of intangible assets	-	847	
<hr/>			
Operating income	30,470	3,451	1,16
Equity in income of subsidiaries	2,846	-	
Interest (expense) income, net	(2,479)	82	8
Other income, net	497	32	(7
<hr/>			
Income before income taxes	31,334	3,565	1,17
Provision for income taxes	11,395	1,426	47
<hr/>			
Net income	\$ 19,939	\$ 2,139	\$ 70
<hr/>			

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	For the nine months ended		
	Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
	(in thousand)		
Revenues	\$ 291,320	\$ 37,588	\$ 9,45
Expenses:			
Marketing	187,899	17,355	3,20
Operating	47,241	8,997	2,33
General and administrative	46,607	7,854	2,29
Amortization of intangible assets	-	1,075	
<hr/>			
Operating income	9,573	2,307	1,61
Settlement of investment related litigation	19,148	-	
Loss on sale of subsidiary	(959)	-	
Net loss on investment	(206)	-	
Equity in income of subsidiaries	2,418	-	
Interest (expense) income, net	417	89	4
Other income, net	(144)	2	(3
<hr/>			
Income before income taxes	30,247	2,398	1,63
Provision for income taxes	11,132	959	65
<hr/>			
Net income	\$ 19,115	\$ 1,439	\$ 97
<hr/>			

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	For the nine months ended M		
	Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
	(in thousands)		
Operating activities			
Net income	\$ 19,939	\$ 2,139	\$ 707
Adjustments to reconcile net income to net cash provided by operating activities:			
Change in deferred membership fees	(21,355)	222	1,059
Change in membership solicitation and other deferred costs	24,433	(4,756)	(521)
Depreciation and amortization	6,037	1,073	539
Deferred income taxes	4,405	1,262	460
Tax benefit from employee stock plans	6,497	-	-
Other	811	117	-
Change in assets and liabilities:			
Restricted cash	-	50	-
Accounts receivable	(2,092)	171	(1,219)
Intercompany receivable & payable	6,759	(5,533)	(1,226)
Prepaid membership materials	(665)	7	(305)
Prepaid expenses and other current assets	130	(767)	8
Other assets	195	(462)	-
Accounts payable	(7,560)	(7)	600
Accrued liabilities	(3,442)	561	(157)
Net cash provided by operating activities	34,092	(5,923)	(55)
Investing activities			
Acquisition of fixed assets	(4,252)	(279)	(345)
Investment in subsidiaries	(2,846)	-	-
Net cash used in by investing activities	(7,098)	(279)	(345)
Financing activities			
Net proceeds from exercise of stock options	23,632	-	-
Treasury stock purchases	(84,942)	-	-
Net proceeds from issuance of convertible debt	87,948	-	-
Payments of long-term obligations	(110)	(258)	-
Net cash provided by (used in) financing activities	26,528	(258)	-
Effect of exchange rate changes on cash and cash equivalents	-	-	35
Net increase (decrease) in cash and cash equivalents	53,522	(6,460)	(365)
Cash and cash equivalents at beginning of period	51,895	18,716	1,649
Cash and cash equivalents at end of period	\$ 105,417	\$ 12,256	\$ 1,284

MEMBERWORKS INCORPORATED  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	For the nine months end		
	Parent	Guarantor Subsidiaries	Nonguarantor Subsidiaries
	(in thousa		
Operating activities			
Net income	\$ 19,115	\$ 1,439	\$ 9
Adjustments to reconcile net income to net cash provided by operating activities:			
Change in deferred membership fees	(17,836)	(682)	(8
Change in membership solicitation and other deferred costs	29,373	280	6
Depreciation and amortization	7,057	1,356	7
Deferred income taxes	10,262	813	6
Tax benefit from employee stock plans	641	-	
Gain on settlement of investment related litigation	(19,148)	-	
Loss on sale of subsidiary	959	-	
Net loss on investment	206	-	
Other	1,609	-	
Change in assets and liabilities:			
Restricted cash	-	4,348	
Accounts receivable	(7,555)	284	(2
Intercompany receivable & payable	1,762	1,485	(3,2
Prepaid membership materials	(219)	6	(
Prepaid expenses and other current assets	(648)	(275)	1
Other assets	(397)	48	
Accounts payable	(3,119)	709	
Accrued liabilities	4,637	84	
Net cash provided by (used in) operating activities	26,699	9,895	(1,0
Investing activities			
Acquisition of fixed assets	(3,962)	(96)	(
Settlement of investment related litigation	19,148	-	
Purchase price adjustments from sale of subsidiary	(750)	-	
Investment in subsidiaries	(2,418)	-	
Other investments	(500)	-	
Net cash (used in) provided by investing activities	11,518	(96)	(

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Financing activities			
Net proceeds from exercise of stock options	3,177	-	
Treasury stock purchases	(25,323)	-	
Payments of long-term obligations	-	(1,001)	
	-----		
Net cash used in financing activities	(22,146)	(1,001)	
	-----		
Effect of exchange rate changes on cash and cash equivalents	-	-	
	-----		
Net increase (decrease) in cash and cash equivalents	16,071	8,798	(1,001)
Cash and cash equivalents at beginning of period	34,476	8,463	2,500
	-----		
Cash and cash equivalents at end of period	\$ 50,547	\$ 17,261	\$ 1,500
	=====		

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MEMBERWORKS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 15 -SUBSEQUENT EVENT

Acquisition of Lavalife Inc.

On April 1, 2004, MemberWorks completed its acquisition of all of the assets and outstanding capital stock of Lavalife, a leading provider of online and IVR-based interactive personals services. Lavalife will operate as a wholly-owned subsidiary of MemberWorks. The purchase price, excluding fees and expenses, was CAD\$152,500,000, or \$116,300,000, and is subject to certain adjustments. The acquisition was funded with cash on hand and borrowings under the Company's \$45,000,000 senior secured credit facility. The acquisition will be accounted for under the purchase method of accounting.

\$150,000,000 9.25% Senior Notes due 2014

On April 13, 2004, MemberWorks issued \$150,000,000 in aggregate principal amount of 9.25% Senior Notes due 2014 ("Senior Notes"). These Senior Notes were sold at 98.418% of the principal amount which results in an effective rate of 9.5%. Interest is payable in cash semi-annually in arrears on April 1 and October 1 of each year, with the first payment due on October 1, 2004. A portion of the proceeds from the offering of these Senior Notes was used to repay amounts borrowed under the senior secured credit facility to fund a portion of the Lavalife acquisition. The Company intends to use the remaining proceeds for general corporate purposes, including working capital, future acquisitions and purchases of MemberWorks common stock under the Company's stock buyback program to the extent permitted under the indenture governing the Senior Notes and the senior secured credit facility.

The offering of Senior Notes was made solely by means of a private placement to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended, and to certain persons in offshore transactions pursuant to Regulation S under the Securities Act. The Senior Notes have not been registered under the Securities Act and may not be offered or sold in the United States, or to a U.S. person, absent registration or an applicable exemption from registration requirements. MemberWorks intends to use its best efforts to register these Senior Notes within 120 days after the issue date.

MEMBERWORKS INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

MemberWorks designs and manages innovative membership programs and provides organizations with an opportunity to leverage the expertise of an outside provider in offering these membership programs to their customers. Membership programs offer selected products and services from a variety of vendors for either an annual fee or a monthly fee. MemberWorks derives its revenues principally from renewable membership fees, which are billed to the customer either on an annual or monthly basis. In the case of annual programs, the Company receives full payment at or near the beginning of the membership period, but recognizes the revenue as the member's refund privilege expires. Membership fees that are billed monthly are recognized when earned. MemberWorks has traditionally marketed its membership programs with an up-front annual membership fee. However, during fiscal 2003, the Company expanded its marketing of membership programs in which the membership fee is payable in monthly installments. It is the Company's intention to further increase the mix of monthly payment programs during fiscal 2004. Profitability and cash flow generated from renewal memberships exceed that of new memberships due to the absence of solicitation costs associated with new member procurement.

In accordance with Financial Accounting Standards Board ("FASB") Statement 131, "Disclosures about Segments of an Enterprise and Related Information," MemberWorks operates in one reportable operating segment.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those policies that are important to the Company's financial condition and results of operations and involve subjective or complex judgments on the part of management, often as a result of the need to make estimates. The following areas all require the use of judgments and estimates: membership cancellation rates, deferred marketing costs, valuation of goodwill and intangible assets, estimation of remaining useful lives of intangible assets and valuation of deferred tax assets. Estimates in each of these areas are based on historical experience and various assumptions that MemberWorks believes are appropriate. Actual results may differ from these estimates. MemberWorks believes the following represent the critical accounting policies of the Company as contemplated by Financial Reporting Release No. 60, "Cautionary Advice Regarding Disclosure about Critical Accounting Policies." For a summary of all of the Company's significant accounting policies, see Note 2 of the Notes to the consolidated financial statements located in the Company's 2003 Annual Report on Form 10-K.

Revenue recognition

Membership fees are billed through clients of the Company primarily through credit cards. In the case of annually billed membership programs, members may cancel their membership in the program generally for a prorata refund of the membership fee based on the remaining portion of the membership period. In accordance with Staff Accounting Bulletin 101, "Revenue Recognition in Financial Statements" ("SAB 101"), deferred membership fees are recorded, net of estimated cancellations, and are amortized as revenues from membership fees upon the expiration of membership refund privileges. An allowance for membership

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cancellations is established based on management's estimates and is updated regularly. In determining the estimate of allowance for membership cancellations, management analyzes historical cancellation experience, current economic trends and changes in customer demand for the Company's products. Actual membership cancellations are charged against the allowance for membership cancellations on a current basis. If actual cancellations differ from the estimate, the revenues would be impacted.

### Membership solicitation and other deferred costs

The Company's marketing expenses are comprised of telemarketing, direct mail, refundable royalty payments, non-refundable royalty payments and advertising costs. Telemarketing and direct mail costs are direct response advertising costs which are accounted for in accordance with American Institute of Certified Public Accountants Statement of Position 93-7, "Reporting on Advertising Costs" ("SOP 93-7"). Under SOP 93-7, direct response advertising costs are deferred and charged to operations over the membership period as revenues from membership fees are recognized. Refundable royalty payments are also deferred and charged to operations over the membership period in order to match the marketing costs with the associated revenues from membership fees. Advertising costs and non-refundable royalty payments, which include fee per pitch, fee per sale and fee per impression marketing arrangements, are expensed when incurred.

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### MEMBERWORKS INCORPORATED MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Total membership solicitation costs incurred to obtain a new member are generally less than the estimated total membership fees. However, if total membership solicitation costs were to exceed total estimated membership margins, an adjustment would be made to the membership solicitation and other deferred costs balance and marketing expenses to the extent of any impairment.

### Valuation of goodwill and other intangibles

MemberWorks reviews the carrying value of its goodwill and other intangible assets and assesses the remaining estimated useful lives of its intangible assets in accordance with FASB Statement No. 142, "Goodwill and Other Intangible Assets." The Company reviews the carrying value of its goodwill and other intangible assets for impairment by comparing such amounts to their fair values. MemberWorks is required to perform this comparison at least annually or more frequently if circumstances indicate possible impairment. When determining fair value, the Company utilizes various assumptions, including projections of future cash flows. A change in these underlying assumptions would cause a change in the results of the tests and, as such, could cause fair value to be less than the carrying amounts. In such an event, MemberWorks would then be required to record a corresponding charge, which would negatively impact earnings. Goodwill at July 1, 2003 and 2002 was tested for impairment during the quarters ended September 30, 2003 and 2002, respectively. The Company concluded that none of its goodwill was impaired as of July 1, 2003 or 2002.

### Income Taxes

The Company accounts for income taxes under the provisions of FASB Statement No. 109, "Accounting for Income Taxes." Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and

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their respective tax bases. MemberWorks estimates current tax provisions or benefits based on a projected effective tax rate for the fiscal year ended June 30, 2004 using the most currently available information and forecasts. The projected effective tax rate is updated for actual results and estimates when they become known. In addition, MemberWorks assesses the realization of deferred tax assets considering various assumptions, including estimates of future taxable income and ongoing tax strategies. A change in these underlying assumptions would impact the results of operations.

THREE MONTHS ENDED MARCH 31, 2004 VS. THREE MONTHS ENDED MARCH 31, 2003

REVENUES. Revenues were \$118.5 million for the quarter ended March 31, 2004 compared to \$118.6 million for the quarter ended March 31, 2003. Revenues in the March 31, 2003 quarter benefited from the Company's initiative to migrate its members that participated in full money back refund policy programs to prorata refund policy programs, which was completed during fiscal 2003. As a result of this migration, revenues which would have been recognized at the end of a membership year under a full money back refund policy program were recognized during the membership year as the refund privileges expired in accordance with SAB 101. Revenues in the March 31, 2004 quarter benefited from the formation of new client partnerships and expanded product marketing with certain existing clients. The Company has continued its strategic initiative to shift new marketing towards members on a monthly payment program, and as a result, the renewal revenues from annual payment programs as a percentage of total revenues decreased to 42% in 2004 from 48% in 2003. Revenues from members who are charged on a monthly payment program increased to \$45.9 million for the quarter ended March 31, 2004 from \$20.1 million for the quarter ended March 31, 2003 primarily due to an increase in members enrolled in a monthly payment plan and an increase in the average monthly price point. The increase in members enrolled in monthly payment programs was more than offset by a decrease in members enrolled in annual payment programs. Net active members decreased 3% to 6.1 million at March 31, 2004 from 6.3 million at March 31 2003. Net active members decreased due to decreased levels of marketing during the March 2004 quarter.

MARKETING EXPENSES. Marketing expenses consist of costs incurred to obtain new members and royalties paid to clients. Marketing expenses decreased 17% to \$60.9 million for the quarter ended March 31, 2004 from \$73.0 million for the quarter ended March 31, 2003 and, as a percentage of revenue, marketing expenses decreased to 51.4% in 2004 from 61.5% in 2003. The improvement in the marketing expense ratio is primarily due to the increase in the mix of marketing in the Company's more profitable Online and MemberLink channels in combination with the increase in the profitability of monthly revenues due to the maturing membership base.

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### MEMBERWORKS INCORPORATED MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

OPERATING EXPENSES. Operating expenses consist of member service call center costs, membership benefit costs and membership program fulfillment costs. Operating expenses increased 8% to \$22.3 million for the quarter ended March 31, 2004 from \$20.7 million for the quarter ended March 31, 2003. As a percentage of revenues, operating expenses increased to 18.8% for the quarter ended March 31, 2004 from 17.4% for the quarter ended March 31, 2003. These increases were due to increased call center and other membership benefit costs incurred to service



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the membership base.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses primarily include personnel-related costs, occupancy costs and other overhead costs. General and administrative expenses increased 7% to \$20.4 million for the quarter ended March 31, 2004 versus \$19.1 million for the quarter ended March 31, 2003. As a percentage of revenues, general and administrative expenses increased to 17.2% in 2004 from 16.1% in 2003 primarily due to higher employee related costs.

**INTEREST EXPENSE, NET.** Interest expense, net consists primarily of interest expense, interest income and the amortization of debt issuance costs related to the Company's line of credit and convertible senior subordinated notes. Interest expense, net was \$1.3 million for the quarter ended March 31, 2004 compared to interest income, net of \$0.1 million for the quarter ended March 31, 2003. The increase in interest expense is due to the issuance of the convertible senior subordinated notes in September 2003 ("Convertible Notes").

**PROVISION FOR INCOME TAXES.** During the quarter ended March 31, 2004, the Company recorded a tax provision of \$5.6 million based on an effective tax rate of approximately 40%. The effective tax rate was higher than the U.S. federal statutory rate for the quarter ended March 31, 2004 primarily due to state taxes and other non-deductible items. During the quarter ended March 31, 2003, the Company recorded a tax provision of \$2.2 million based on an effective tax rate of approximately 40%.

**NINE MONTHS ENDED MARCH 31, 2004 VS. NINE MONTHS ENDED MARCH 31, 2003**

**REVENUES.** Revenues increased 5% to \$355.5 million for the nine months ended March 31, 2004 from \$337.7 million for the nine months ended March 31, 2003. The increase in revenues is primarily due to an increase in the weighted average program price point and the formation of new client partnerships and expanded product marketing with certain existing clients. As a result of the Company's strategic initiative to shift new marketing towards members on a monthly payment program, renewal revenues from annual payment programs as a percent of total revenues decreased to 41% in 2004 from 48% in 2003. Revenues from members who are charged on a monthly payment program increased to \$115.0 million for the nine months ended March 31, 2004 from \$53.9 million for the nine months ended March 31, 2003 due to an increase in members enrolled in a monthly payment plan and an increase in the average monthly price point. The increase in members enrolled in monthly payment programs was more than offset by a decrease in members enrolled in annual payment programs.

**MARKETING EXPENSES.** Marketing expenses decreased 7% to \$194.3 million for the nine months ended March 31, 2004 from \$208.5 million for the nine months ended March 31, 2003 and, as a percentage of revenue, marketing expenses decreased to 54.7% in 2004 from 61.7% in 2003. The improvement in the marketing expense ratio is primarily due to the increase in the mix of marketing in the Company's more profitable Online and MemberLink channels in combination with the increase in the profitability of monthly revenues due to the maturing membership base.

**OPERATING EXPENSES.** Operating expenses increased 15% to \$66.8 million for the nine months ended March 31, 2004 from \$57.9 million for the nine months ended March 31, 2003. As a percentage of revenues, operating expenses increased to 18.8% for the nine months ended March 31, 2004 from 17.1% for the nine months ended March 31, 2003. These increases were due to increased call center and other membership benefit costs incurred to service the membership base.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses increased 3% to \$58.4 million for the nine months ended March 31, 2004 versus \$56.8 million for the nine months ended March 31, 2003 primarily due to higher salary and employee related costs. As a percentage of revenues, general and

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administrative expenses decreased to 16.4% in 2004 from 16.8% in 2003 primarily due to leveraging the increase in our reported revenues.

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### MEMBERWORKS INCORPORATED MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

**INTEREST EXPENSE, NET.** Interest expense, net increased to \$2.3 million for the nine months ended March 31, 2004 from interest income, net of \$0.6 million for the nine months ended March 31, 2003. The increase is due to the issuance of the Convertible Notes in September 2003.

**PROVISION FOR INCOME TAXES.** During the nine months ended March 31, 2004, the Company recorded a tax provision of \$13.3 million based on an effective tax rate of approximately 40%. The effective tax rate was higher than the U.S. federal statutory rate for the nine months ended March 31, 2004 primarily due to state taxes and other non-deductible items. During the nine months ended March 31, 2003, the Company recorded a tax provision of \$12.7 million based on an effective tax rate of approximately 40%.

#### LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operating activities was \$25.3 million for the nine months ended March 31, 2004 versus \$33.1 million for the nine months ended March 31, 2003. The decrease in operating cash flow in the nine months ended March 31, 2004 versus the prior year was primarily due to the impact of changes in assets and liabilities which reduced cash by \$15.0 million in the nine months ended March 31, 2004 and reduced cash by \$2.1 million in the nine months ended March 31, 2003. The \$12.9 million decrease in changes in assets and liabilities over the prior year was primarily driven by the Company's transition to monthly billing which resulted in a \$4.6 million decrease in the allowance for cancellations, timing of certain vendor payments and the release of cash held in escrow in the first quarter of fiscal 2003. Operating cash flow also decreased over the prior year period due to increased operating expenses, general and administrative expenses and interest expense during the nine months ended March 31, 2004. These decreases were partially offset by an increase in marketing margin before deferral (revenues before deferral less marketing costs before deferral) which had a positive impact on cash flow from operations of \$160.2 million in the nine months ended March 31, 2004 compared to \$140.2 million in the nine months ended March 31, 2003. The improvement in the marketing margin before deferral is primarily due to the increase in the mix of marketing in the Company's more profitable Online and MemberLink channels in combination with the increase in the profitability of monthly revenues due to the maturing membership base as well as lower marketing levels.

The Company's management believes that revenues before deferral and marketing costs before deferral are important measures of liquidity. Revenues before deferral are revenues before the application of SAB 101 and represent the actual membership fees billed during the current reporting period less an allowance for membership cancellations. Marketing costs before deferral are marketing costs before the application of SAB 101 and SOP 93-7 and represent the Company's obligation for marketing efforts that occurred during the current reporting period.

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Revenues before deferral for the nine months ended March 31, 2004 and 2003 are calculated as follows:

		March 31
		----- 2004 -----
Revenues reported in the Statements of Operations	\$	355,507
Change in deferred membership fees		(20,074)
		-----
Revenues before deferral	\$	335,433
		=====

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MEMBERWORKS INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Revenues before deferral increased 5% to \$335.4 million for the nine months ended March 31, 2004 from \$318.3 million for the nine months ended March 31, 2003. The increase in revenues before deferral is primarily due to an increase in the weighted average program price point of both annual and monthly payment programs. New annual weighted average price points increased to \$107 for the nine months ended March 31, 2004 from \$102 for the nine months ended March 31, 2003. Monthly weighted average price points increased to \$11.36 for the nine months ended March 31, 2004 from \$10.00 for the nine months ended March 31, 2003. Revenues before deferral from members who are charged on a monthly payment program were \$120.5 million during the nine months ended March 31, 2004 and \$53.9 million during the nine months ended March 31, 2003 due to the increases in the average monthly members billed each period and the weighted average price point. The increase in revenues from monthly payment programs was partially offset by a decrease in revenues from annual payment programs. The following table summarizes the average monthly members billed each quarter during the nine months ended March 31:

		Fiscal Year 2004
		-----
First Quarter		955
Second Quarter		1,239
Third Quarter		1,343

The following table summarizes the components of revenues before deferral for the nine months ended March 31:

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2004

New annual	19%
Renewal annual	45%
Monthly	36%

As a percentage of total revenues before deferral, renewal revenues from annual payment programs decreased to 45% in the nine months ended March 31, 2004 from 46% in the nine months ended March 31, 2003 due to the Company's strategic initiative to shift new marketing towards members on a monthly payment program. This shift to monthly payment programs has a near-term negative impact on operating cash flow due to the timing of revenues collected relative to the corresponding timing of marketing expenditures.

Marketing costs before deferral for the nine months ended March 31, 2004 and 2003 are calculated as follows:

	March 31	
	----- 2004 -----	
Marketing expenses reported in the Statements of Operations	\$ 194,342	\$
Change in membership solicitation and other deferred costs	(19,156)	
	-----	-----
Marketing costs before deferral	\$ 175,186	\$
	=====	=====

Marketing costs before deferral decreased 2% to \$175.2 million for the nine months ended March 31, 2004 from \$178.1 million for the nine months ended March 31, 2003. As a percent of revenues before deferral, marketing expenses before deferral were 52.2% for the nine months ended March 31, 2004 and 56.0% for the nine months ended March 31, 2003. These decreases were primarily due to the increase in the mix of marketing in the Company's more profitable Online and MemberLink channels in combination with the increase in the profitability of monthly revenues due to the maturing membership base and lower marketing levels in the March 2004 quarter. The lower marketing levels are reflected in the 3% decrease in the membership base which was 6.1 million as of March 31, 2004 compared to 6.3 million at March 31, 2003.

MEMBERWORKS INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Net cash used in investing activities was \$4.9 million during the nine months ended March 31, 2004 versus net cash provided by investing activities of \$13.8 million during the nine months ended March 31, 2003. Net cash provided by investing activities during the nine months ended March 31, 2003 included \$19.1 million of proceeds related to the settlement of a lawsuit and \$0.8 million of

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funds paid in connection with a purchase price adjustment related to the sale of iPlace, Inc. Capital expenditures were \$4.9 million during the nine months ended March 31, 2004 and \$4.1 million during the nine months ended March 31, 2003.

Net cash provided by financing activities was \$26.3 million for the nine months ended March 31, 2004 versus net cash used in financing activities of \$23.1 million for the nine months ended March 31, 2003. The increase in cash provided by financing activities was primarily due to the issuance of \$90.0 million aggregate principal amount convertible senior subordinated notes ("Convertible Notes") due September 2010. The Convertible Notes bear interest at the rate of 5.5% per year, which will be payable in cash semi-annually in arrears on April 1 and October 1 of each year, with the first payment due on April 1, 2004. The net proceeds were be used for general corporate purposes, including mergers and acquisitions and additional repurchases of the Company's common stock under its stock buyback program. Upon the occurrence of a change in control, holders of the Convertible Notes may require the Company to repurchase all or part of the Convertible Notes for cash. In addition, the Company received \$23.6 million from the exercise of stock options during the nine months ended March 31, 2004. These increases in financing activities during the nine months ended March 31, 2004 were offset by increased spending under the Company's stock repurchase program. The Company purchased 2,662,000 shares for \$84.9 million, an average price of \$31.91, during the nine months ended March 31, 2004 compared to 1,432,000 shares for \$25.3 million, an average price of \$17.69, during the nine months ended March 31, 2003. The Company utilized cash from operations, stock option exercises and the issuance of the Convertible Notes to repurchase shares.

During the nine months ended March 31, 2004, the Board of Directors authorized 3.0 million additional shares to be repurchased under the buyback program. As of March 31, 2004, the Company had 1,317,000 shares available for repurchase under its buyback program.

As of March 31, 2004, the Company had cash and cash equivalents of \$119.0 million. In addition, on March 25, 2004, MemberWorks entered into an amended and restated senior secured credit facility that allows borrowings of up to \$45.0 million. Borrowings under the senior secured credit facility accrue interest at either the Eurodollar rate, or the higher of the Prime rate or the Federal Funds rate, plus an applicable margin. As of March 31, 2004, the availability under the senior secured credit facility was reduced by an outstanding letter of credit of \$5.5 million and pursuant to the completion of the issuance of the \$150.0 million aggregate principal amount of Senior Notes ("Senior Notes") issued on April 13, 2004 (discussed below), the availability under the senior secured credit facility have been further reduced by one years worth of interest on the Senior Notes. As of April 29, 2004, the availability under the senior secured credit facility is approximately \$25.6 million. As of March 31, 2004, the effective interest rate for borrowings under the senior secured credit facility was 4.0%. The senior secured credit facility has certain financial covenants, including a maximum debt coverage ratio, potential restrictions on additional borrowings and potential restrictions on additional stock repurchases. As of March 31, 2004, the Company was in compliance with all such debt covenants.

On April 1, 2004, MemberWorks completed its acquisition of all of the assets and outstanding capital stock of Lavalife Inc. ("Lavalife"), a leading provider of online and IVR-based interactive personals services. Lavalife will operate as a wholly-owned subsidiary of MemberWorks. The purchase price, excluding fees and expenses, was CAD\$152.5 million, or \$116.3 million, and is subject to certain adjustments. The acquisition was funded with cash on hand and borrowings under the Company's \$45.0 million senior secured credit facility. The acquisition will be accounted for under the purchase method of accounting.

MEMBERWORKS INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

On April 13, 2004, MemberWorks issued \$150.0 million in aggregate principal amount of 9.25% Senior Notes due 2014. These Senior Notes were sold at 98.418% of the principal amount which results in an effective rate of 9.5%. Interest is payable in cash semi-annually in arrears on April 1 and October 1 of each year, with the first payment due on October 1, 2004. A portion of the proceeds from the offering of these Senior Notes was used to repay amounts borrowed under the senior secured credit facility to fund a portion of the Lavalife acquisition. The Company intends to use the remaining proceeds for general corporate purposes, including working capital, future acquisitions and purchases of MemberWorks' common stock under the Company's stock buyback program to the extent permitted under the indenture governing the Senior Notes and the senior secured credit facility. The offering was made solely by means of a private placement to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended, and to certain persons in offshore transactions pursuant to Regulation S under the Securities Act. The Senior Notes have not been registered under the Securities Act and may not be offered or sold in the United States, or to a U.S. person, absent registration or an applicable exemption from registration requirements.

Subsequent to the of acquisition of Lavalife and the issuance of the senior notes discussed above, the Company believes that existing cash balances, together with funds available under its senior secured credit facility, will be sufficient to meet its funding requirements for the foreseeable future.

The Company did not have any material commitments for capital expenditures as of March 31, 2004. The Company intends to utilize its existing cash balances, cash generated from operations and cash generated from the issuance of the senior notes to fulfill any capital expenditure requirements for the remainder of fiscal 2004.

#### COMMITMENTS

The Company is not aware of any factors that are reasonably likely to adversely affect liquidity trends, other than the risk factors presented in the Forward Looking Statements in this Form 10-Q filing. The Company does not have off-balance sheet arrangements, non-exchange traded contracts or material related party transactions.

Future minimum payments of contractual obligations as of March 31, 2004 are as follows (amounts in thousands):

	Payments Due by Period			
	Total	Less than 1 year	1-3 years	4-5 years
Operating leases	\$ 22,190	\$ 6,042	\$ 8,481	\$ 4,767
Capital leases	1,269	309	710	250
Convertible notes payable	90,000	-	-	-
Other long-term obligations	20	20	-	-

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Total payments due	\$ 113,479	\$ 6,371	\$ 9,191	\$ 5,01
	=====	=====	=====	=====

The Company operates in leased facilities. Management expects that leases currently in effect will be renewed or replaced by other leases of a similar nature and term.

On March 4, 2004, MemberWorks announced it entered into an agreement to acquire Lavalife. On April 1, 2004, MemberWorks completed its acquisition of all of the assets and outstanding capital stock of Lavalife. The purchase price, excluding fees and expenses, was CAD\$152.5 million, or \$116.3 million, and is subject to certain adjustments. The acquisition was funded with cash on hand and borrowings under the Company's \$45.0 million senior secured credit facility. The acquisition will be accounted for under the purchase method of accounting.

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MEMBERWORKS INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), which was revised in December 2003. FIN 46 clarifies the application of Accounting Research Bulletin No. 51 and provides guidance on the identification of and reporting for variable interest entities. FIN 46 is effective immediately for variable interest entities formed after January 31, 2003 and is effective for periods ending after March 15, 2004 for any variable interest entity formed prior to February 1, 2003. The adoption of FIN 46 did not have a material impact on the Company's financial statements.

In May 2003, the FASB issued Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). This statement requires that certain financial instruments that were accounted for as equity under previous guidance be classified as liabilities in statements of financial position. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 did not have a material impact on the Company's financial statements.

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MEMBERWORKS INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements that are based on current expectations, estimates, forecasts and projections about the

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industry in which MemberWorks operates and the Company's management's beliefs and assumptions. These forward-looking statements include statements that do not relate solely to historical or current facts and can be identified by the use of words such as "believe," "expect," "estimate," "project," "continue" or "anticipate." These forward-looking statements are made pursuant to safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements are not guarantees of future performance and are based on a number of assumptions and estimates that are inherently subject to significant risks and uncertainties, many of which are beyond our control, cannot be foreseen and reflect future business decisions that are subject to change. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Among the many factors that could cause actual results to differ materially from the forward-looking statements are:

- o higher than expected membership cancellations or lower than expected membership renewal rates;
- o changes in the marketing techniques of credit card issuers;
- o increases in the level of commission rates and other compensation required by marketing partners to actively market with MemberWorks;
- o potential reserve requirements by business partners such as the Company's credit card processors;
- o unanticipated termination of marketing agreements;
- o the Company's ability to integrate acquired businesses into the Company's management and operations and operate successfully;
- o the extent to which MemberWorks can continue to successfully develop and market new products and services and introduce them on a timely basis;
- o unanticipated changes in or termination of the Company's ability to process membership fees through third parties, including credit card processors and bank card associations;
- o the Company's ability to develop and implement operational and financial systems to manage growing operations;
- o the Company's ability to recover from a complete or partial system failure or impairment, other hardware or software related malfunctions or programming errors;
- o the degree to which the Company is leveraged;
- o the Company's ability to obtain financing on acceptable terms to finance the Company's growth strategy and to operate within the limitations imposed by financing arrangements;
- o further changes in the already competitive environment for the Company's products or competitors' responses to the Company's strategies;
- o changes in the growth rate of the overall U.S. economy, or the international economy where MemberWorks does business, such that credit availability, interest rates, consumer spending and related consumer debt are impacted;
- o additional government regulations and changes to existing government regulations of the Company's industry, including the Federal Trade Commission's 2003 Amendment to its Telemarketing Sales Rule which creates a national do-not-call list;
- o the Company's ability to compete with other companies that have financial or other advantages;
- o adverse movement in foreign exchange rates;
- o the Company's ability to attract and retain active members and users;
- o adverse results of litigation or regulatory matters; and
- o new accounting pronouncements.

Many of these factors are beyond MemberWorks' control, and, therefore, its business, financial condition, results of operations and cash flows may be adversely affected by these factors.

MemberWorks cautions that such factors are not exclusive. All of the



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forward-looking statements made in this Quarterly Report on Form 10-Q are qualified by these cautionary statements and readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. Except as required by law, MemberWorks does not have any intention or obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

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### MEMBERWORKS INCORPORATED

#### Item 3. Quantitative and Qualitative Disclosures about Market Risk

##### Interest Rate Risk

As of March 31, 2004, the Company has a senior secured credit facility that allows borrowings of up to \$45.0 million. Borrowings under the senior secured credit facility accrue interest at either the Eurodollar rate, or the higher of the Prime rate or the Federal Funds rate, plus an applicable margin. There were no borrowings outstanding under this senior secured credit facility as of March 31, 2004. As of March 31, 2004, the availability under the senior secured credit facility was reduced by an outstanding letter of credit of \$5.5 million and pursuant to the completion of the issuance of the Senior Notes on April 13, 2004, the availability under the senior secured credit facility have been further reduced by one years worth of interest on the Senior Notes. As of April 29, 2004, the availability under the senior secured credit facility is approximately \$25.6 million. In addition, the Company has \$90.0 million aggregate principal amount of 5.5% convertible senior subordinated notes due September 2010. The Convertible Notes bear interest at the rate of 5.5% per year payable in cash semi-annually in arrears on April 1 and October 1 of each year. The first payment was due on April 1, 2004. Management believes that an increase in the Prime rate or the Federal Funds rate would not be material to the Company's financial position or its results of operations. If the Company is not able to renew its existing credit facility agreement, which matures on March 25, 2005, it is possible that any replacement lending facility obtained by the Company may be more sensitive to interest rate changes. The Company does not currently hedge interest rates.

##### Foreign Currency Risk

The Company has international sales and facilities in Canada and, therefore, is subject to foreign currency rate exposure. Canadian sales have been denominated in the Canadian dollar and its functional currency is the local currency. Assets and liabilities of the Canadian subsidiary are translated into U.S. dollars at the exchange rate in effect as of the balance sheet date. Income and expense items are translated at the average exchange rate for the period. Accumulated net translation adjustments are recorded in shareholders' equity. Foreign exchange transaction gains and losses are included in the results of operations and were not material for all periods presented. As a result, the Company's financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic condition. To the extent the Company incurs expenses that are based on locally denominated sales volume paid in local currency, the exposure to foreign exchange risk is reduced. The Company has determined that the impact of a near-term 10% appreciation or depreciation of the U.S. dollar would have an insignificant effect on its financial position, results of operations and cash flows.

In connection with the acquisition of Lavalife, MemberWorks employed policies and procedures to manage foreign currency risks associated with the purchase

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price, which was denominated in Canadian dollars. MemberWorks' objective in managing its exposure to foreign currency exchange rate fluctuations was to reduce the impact of adverse fluctuations on cash flows associated with foreign currency exchange rate changes. Accordingly, MemberWorks utilized foreign currency option contracts and forward contracts to hedge its exposure related to the Lavalife acquisition.

MemberWorks monitors its foreign currency exchange exposures to ensure the overall effectiveness of its foreign currency hedge positions. However, there can be no assurance that MemberWorks' foreign currency hedging activities will substantially offset the impact of fluctuations in currency exchange rates on its results of operations and financial position.

### Market Risk

The Company does not have material exposure to market risk with respect to investments, as the Company does not hold any marketable securities as of March 31, 2004. MemberWorks does not use derivative financial instruments for speculative or trading purposes. However, this does not preclude the Company's adoption of specific hedging strategies in the future.

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MEMBERWORKS INCORPORATED

### Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures.

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report and have concluded that the Company's disclosure controls and procedures were effective. The Company's disclosure controls and procedures are designed to ensure that material information relating to MemberWorks and its consolidated subsidiaries that is required to be disclosed in its reports under the Exchange Act is accumulated and communicated to the chief executive officer and chief financial officer.

Notwithstanding the foregoing, although there can be no assurance that the Company's disclosure controls and procedures will detect or uncover all failures of persons within the Company and its consolidated subsidiaries to disclose material information otherwise required to be set forth in the Company's periodic reports, the Chief Executive Officer's and Chief Financial Officer's evaluation concluded that they are reasonably effective to do so.

Changes in internal control over financial reporting.

During the third quarter of fiscal 2004 there were no changes in the Company's internal control over financial reporting that could have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

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MEMBERWORKS INCORPORATED

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### PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

Except as set forth below, in management's opinion, there are no significant legal proceedings to which the Company or any of its subsidiaries is a party or to which any of their properties are subject. The Company is involved in other lawsuits and claims generally incidental to its business including, but not limited to, various suits, including previously disclosed suits, brought against the Company by individual consumers seeking monetary and/or injunctive relief relating to the marketing of the Company's programs. In addition, from time to time, and in the regular course of its business, the Company receives inquiries from various federal and/or state regulatory authorities.

In March 2001, an action was instituted by plaintiff Teresa McClain against Coverdell & Company ("Coverdell"), a wholly-owned subsidiary of the Company, Monumental Life Insurance Company and other defendants in the United States District Court for the Eastern District of Michigan, Southern Division. The suit, which seeks unspecified monetary damages, alleges that Coverdell and the other defendants violated the Michigan Consumer Protection Act and other applicable Michigan laws in connection with the marketing of Monumental Life Insurance Company insurance products. The complaint includes a claim that the suit should be certified as a class action and the plaintiff has filed a motion for class certification to which all of the defendants have filed opposing papers regarding the same. The Court certified a class of Michigan residents. The Court of Appeals denied the defendants' petition for leave to appeal the certification order. The Company believes that the claims made against Coverdell are unfounded and Coverdell and the Company will vigorously defend their interests against this suit.

On January 24, 2003, the Company filed a motion with the Superior Court for the Judicial District of Hartford, Connecticut to vacate and oppose the confirmation of an arbitration award issued in December 2002. The arbitration, filed against the Company by MedValUSA Health Programs, Inc. ("MedVal") in September 2000, involved claims of breach of contract, breach of the duty of good faith and fair dealing, and violation of the Connecticut Unfair Trade Practices Act ("CUTPA"). Even though the arbitrators found that MemberWorks was not liable to MedVal for any compensatory damages, they awarded \$5.5 million in punitive damages and costs against MemberWorks solely under CUTPA. MemberWorks believes that this arbitration award is unjustified and not based on any existing legal precedent. Specifically, the Company is challenging the award on a number of grounds, including that it violates a well-defined public policy against excessive punitive damage awards, raises constitutional issues and disregards certain legal requirements for a valid award under CUTPA. The hearing on the Company's motion was held on February 10, 2003. On June 22, 2003, the Superior Court denied the Company's motion to vacate the award, and the Company filed an appeal of that decision. While the Company intends to take action to prevent the enforcement of the award by, among other things, vigorously pursuing an appeal, there can be no assurance that MemberWorks will be successful in its efforts. The Company has made no provision in its financial statements for this contingency because it believes that a loss is not probable. If the Company were ultimately unsuccessful in this or other available appeals, and a final non-appealable court order confirming the arbitration award is rendered, the payment of the award could have a material adverse effect on the Company's results of operations in the period in which the final order is entered.

On October 21, 2003, the Florida Attorney General's Office filed a civil complaint against the Company based upon concerns that some of its past marketing practices may have violated various consumer laws. The Company believes that any legitimate concerns have previously been fully addressed, including the implementation of industry-leading Best Marketing Practices and

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voluntary agreements incorporating those practices, such as the nationwide assurance agreement that the Company entered into with the State of Nebraska in 2001. The Company believes that the allegations of the complaint are unfounded and the Company intends to vigorously defend its interests in this matter. The Company further believes that the potential liability represented by the lawsuit and the final resolution of this matter will not be material to the Company.

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### MEMBERWORKS INCORPORATED PART II. OTHER INFORMATION (CONTINUED)

#### Item 2. Changes in Securities and Use of Proceeds and Issuer Purchases of Equity Securities

On September 30, 2003, the Company completed the sale of \$90.0 million aggregate principal amount of 5.5% convertible senior subordinated notes due September 2010 to qualified institutional buyers pursuant to Rule 144A of the Securities Act of 1933, as amended.

On December 3, 2003, MemberWorks filed on Form S-3 a shelf registration statement with the Securities and Exchange Commission covering the Convertible Notes and the common stock issuable upon their conversion, which was declared effective on April 9, 2004.

The following table summarizes the shares of MemberWorks' equity securities purchased by or on behalf of MemberWorks:

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number Shares Purchased Part of Public Announced Programs
January 1, 2004 to January 31, 2004	96,800	\$29.36	96,800
February 1, 2004 to February 29, 2004	75,400	\$34.88	75,400
March 1, 2004 to March 31, 2004	11,600	\$33.68	11,600
<b>Total</b>	<b>183,800</b>	<b>\$31.90</b>	<b>183,800</b>

- (1) The Board of Directors authorized during fiscal 2004 the following share amounts to be purchased under the Company's stock buyback program:
- July 2003 - authorized an additional 1,000,000 shares, no expiration
  - September 2003 - authorized an additional 1,000,000 shares, no expiration
  - January 2004 - authorized an additional 1,000,000 shares, no expiration

#### Item 6. Exhibits and Reports on Form 8-K

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- a) Exhibits
  - 14 Code of Conduct
  - 31.1 Rule 13a-14(a) CEO Certification.
  - 31.2 Rule 13a-14(a) CFO Certification.
  - 32.1 CEO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.2 CFO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

a) Reports on Form 8-K

On January 27, 2004, the Company furnished on Form 8-K under Item 7 "Financial Statements and Exhibits" and Item 12 "Results of Operations and Financial Condition" a press release announcing fiscal year 2004 second quarter results.

On March 3, 2004, the Company filed on Form 8-K under Item 5 "Other Events" and Item 7 "Financial Statements and Exhibits" a press release announcing an agreement to acquire Lavalife Inc.

On March 26, 2004, the Company filed on form 8-K under Item 7 "Financial Statements and Exhibits" and Item 9 "Regulation FD" financial and other information pertaining to the offering of \$150.0 million aggregate principal amount of Senior Notes and the acquisition of Lavalife Inc.

On March 26, 2004, the Company filed on form 8-K under Item 5 "Other Events" and Item 7 "Financial Statements and Exhibits" a press release announcing the offering of \$150.0 million of Senior Notes pursuant to Rule 144A of the Securities Act of 1933.

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MEMBERWORKS INCORPORATED  
SIGNATURES

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

MEMBERWORKS INCORPORATED  
(Registrant)

Date: May 14, 2004                      By:            /s/ Gary A. Johnson  
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Gary A. Johnson, President, Chief  
Executive Officer and Director

May 14, 2004                      By:            /s/ James B. Duffy  
-----  
James B. Duffy, Executive Vice President and  
Chief Financial Officer (Principal Financial  
and Accounting Officer)

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