PROASSURANCE CORP
Form 10-Q
November 03, 2009

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

þ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2009 or __________

o **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from __________ to __________

Commission file number 0-16533
ProAssurance Corporation

(Exact Name of Registrant as Specified in Its Charter)

Delaware	63-1261433
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)
100 Brookwood Place, Birmingham, AL	35209
(Address of Principal Executive Offices)	(Zip Code)

(205) 877-4400
(Registrant s Telephone Number, Including Area Code)

(Former Name, Former Address, and Former Fiscal Year, if Changed Since Last Report)

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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter), during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

As of October 23, 2009, there were 32,414,984 shares of the registrant s common stock outstanding.

TABLE OF CONTENTS

Table of Contents

FORWARD-LOOKING STATEMENTS

Any statements in this Form 10Q that are not historical facts are specifically identified as forward-looking statements. These statements are based upon our estimates and anticipation of future events and are subject to certain risks and uncertainties that could cause actual results to vary materially from the expected results described in the forward-looking statements. Forward-looking statements are identified by words such as, but not limited to, anticipate , believe , estimate , expect , hope , hopeful , intend , may , optimistic , preliminary , potential , project analogous expressions. There are numerous factors that could cause our actual results to differ materially from those in the forward-looking statements. Thus, sentences and phrases that we use to convey our view of future events and trends are expressly designated as forward-looking statements as are sections of this Form 10Q that are identified as giving our outlook on future business.

Forward-looking statements relating to our business include among other things: statements concerning liquidity and capital requirements, investment valuation and performance, return on equity, financial ratios, net income, premiums, losses and loss reserves, premium rates and retention of current business, competition and market conditions, the expansion of product lines, the development or acquisition of business in new geographical areas, the availability of acceptable reinsurance, actions by regulators and rating agencies, court actions, legislative actions, payment or performance of obligations under indebtedness, payment of dividends, and other matters.

These forward-looking statements are subject to significant risks, assumptions and uncertainties, including, among other things, the following factors that could affect the actual outcome of future events:

general economic conditions, either nationally or in our market areas, that are different than anticipated;

regulatory, legislative and judicial actions or decisions could affect our business plans or operations;

the enactment or repeal of tort reforms;

formation of state-sponsored malpractice insurance entities that could remove some physicians from the private insurance market;

the impact of deflation or inflation;

changes in the interest rate environment;

the effect that changes in laws or government regulations affecting the U.S. economy or financial institutions, including the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009, may have on the U.S. economy and our business;

performance of financial markets affecting the fair value of our investments or making it difficult to determine the value of our investments;

changes in accounting policies and practices that may be adopted by our regulatory agencies and the Financial Accounting Standards Board, or the Securities and Exchange Commission;

changes in laws or government regulations affecting medical professional liability insurance or the financial community;

the effects of changes in the health care delivery system;

uncertainties inherent in the estimate of loss and loss adjustment expense reserves and reinsurance, and changes in the availability, cost, quality, or collectability of insurance/reinsurance;

the results of litigation, including pre-or-post-trial motions, trials and/or appeals we undertake;

bad faith litigation which may arise from our handling of any particular claim, including failure to settle;

loss of independent agents;

changes in our organization, compensation and benefit plans;

our ability to retain and recruit senior management;

our ability to purchase reinsurance and collect payments from our reinsurers;

increases in guaranty fund assessments;

Table of Contents

- our ability to achieve continued growth through expansion into other states or through acquisitions or business combinations;
- changes to the ratings assigned by rating agencies to our insurance subsidiaries, individually or as a group;
- changes in competition among insurance providers and related pricing weaknesses in our markets; and
- the expected benefits from completed and proposed acquisitions may not be achieved or may be delayed longer than expected due to business disruption, loss of customers and employees, increased operating costs or inability to achieve cost savings, and assumption of greater than expected liabilities, among other reasons.

Our results may differ materially from those we expect and discuss in any forward-looking statements. The principal risk factors that may cause these differences are described in Item 1A, Risk Factors in our annual report on Form 10K and other documents we file with the Securities and Exchange Commission, such as our current reports on Form 8-K, and our regular reports on Forms 10-Q and 10-K.

We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made, and advise readers that the factors listed above could affect our financial performance and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements. Except as required by law or regulations, we do not undertake and specifically decline any obligation to publicly release the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

Table of Contents

ProAssurance Corporation and Subsidiaries
Condensed Consolidated Balance Sheets

(In thousands, except per share data)	**September 30 2009**	December 31 2008
Assets		
Investments		
Fixed maturities, available for sale, at fair value	**$3,524,404**	$2,961,568
Equity securities, available for sale, at fair value	**3,798**	6,981
Equity securities, trading, at fair value	**39,353**	11,852
Short-term investments	**137,908**	441,996
Business owned life insurance	**64,597**	63,440
Investment in unconsolidated subsidiaries	**47,392**	44,522
Other investments	**45,944**	45,583
Total Investments	**3,863,396**	3,575,942
Cash and cash equivalents	**20,758**	3,459
Premiums receivable	**126,205**	86,137
Receivable from reinsurers on paid losses and loss adjustment expenses	**33,266**	17,826
Receivable from reinsurers on unpaid losses and loss adjustment expenses	**258,112**	268,356
Prepaid reinsurance premiums	**12,859**	13,009
Deferred policy acquisition costs	**26,916**	19,505
Deferred taxes	**65,259**	138,034
Real estate, net	**43,747**	23,496
Amortizable intangibles	**10,305**	
Goodwill	**118,997**	72,213
Other assets	**89,620**	62,961
Total Assets	**$4,669,440**	$4,280,938
Liabilities and Stockholders Equity		
Liabilities		
Policy liabilities and accruals		
Reserve for losses and loss adjustment expenses	**$2,469,691**	$2,379,468
Unearned premiums	**272,290**	185,756
Reinsurance premiums payable	**111,813**	127,877
Total Policy Liabilities	**2,853,794**	2,693,101
Other liabilities	**116,461**	129,322
Long-term debt, at amortized cost, excluding $14.3 million and $0 carried at fair value, respectively	**49,725**	34,930
Total Liabilities	**3,019,980**	2,857,353
Stockholders Equity		
Common stock, par value $0.01 per share, 100,000,000 shares authorized, 34,208,040 and 34,109,196 shares issued, respectively	**342**	341

Additional paid-in capital	**524,469**	518,687
Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of $41,137 and $(19,328), respectively	**76,394**	(35,898)
Retained earnings	**1,111,851**	970,891
	1,713,056	1,454,021
Treasury stock, at cost, 1,543,556 shares and 763,316 shares, respectively	**(63,596)**	(30,436)
Total Stockholders Equity	**1,649,460**	1,423,585
Total Liabilities and Stockholders Equity	**$4,669,440**	$4,280,938

See accompanying notes.

4

Table of Contents

ProAssurance Corporation and Subsidiaries
Condensed Consolidated Statements of Changes in Capital (Unaudited)

(In thousands)	**Total**	**Accumulated Other Comprehensive Income (Loss)**	**Retained Earnings**	**Other Capital Accounts**
Balance at December 31, 2008	**$1,423,585**	**$ (35,898)**	**$ 970,891**	**$488,592**
Cumulative effect adjustment for accounting change (see Note 1)		**(3,511)**	**3,511**	**--**
Net income	**137,449**		**137,449**	**--**
Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments	**115,803**	**115,803**		**--**
Purchase of treasury stock	**(38,144)**			**(38,144)**
Treasury shares issued in acquisition (see Note 3)	**5,161**			**5,161**
Common shares issued as compensation and net effect of stock options exercised	**756**			**756**
Share-based compensation	**4,850**			**4,850**
Balance at September 30, 2009	**$1,649,460**	**$ 76,394**	**$1,111,851**	**$461,215**

(In thousands)	Total	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Other Capital Accounts
Balance at December 31, 2007	$1,255,070	$ 9,902	$793,166	$452,002
Net income	101,433		101,433	
Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments	(65,719)	(65,719)		
Purchase of treasury stock	(80,335)			(80,335)
Common shares issued as compensation and net effect of stock options exercised	3,637			3,637
Share-based compensation	6,351			6,351
Conversion of convertible debentures	112,478			112,478
Balance at September 30, 2008	$1,332,915	$(55,817)	$894,599	$494,133

See accompanying notes.

Table of Contents

ProAssurance Corporation and Subsidiaries
Condensed Consolidated Statements of Income (Unaudited)

(In thousands, except per share data)	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	**2009**	2008
Revenues:				
Gross premiums written	**$168,559**	$126,122	**$434,714**	$374,393
Net premiums written	**$158,705**	$116,409	**$401,634**	$343,609
Premiums earned	**$143,477**	$123,733	**$398,212**	$382,158
Premiums ceded	**(11,521)**	(10,284)	**(34,621)**	(32,364)
Net premiums earned	**131,956**	113,449	**363,591**	349,794
Net investment income	**38,573**	39,845	**112,839**	122,218
Equity in earnings (loss) of unconsolidated subsidiaries	**1,637**	(1,967)	**328**	(3,916)
Net realized investment gains (losses):				
Other-than-temporary impairment losses (OTTI)	**(88)**	(29,862)	**(10,572)**	(36,169)
Less: portion of OTTI losses recognized in other comprehensive income (before taxes)			**172**	
Net impairment losses recognized in earnings	**(88)**	(29,862)	**(10,400)**	(36,169)
Other net realized investment gains (losses)	**7,363**	(4,374)	**15,222**	(4,842)
Total net realized investment gains (losses)	**7,275**	(34,236)	**4,822**	(41,011)
Other income	**3,153**	997	**7,224**	3,694
Total revenues	**182,594**	118,088	**488,804**	430,779
Expenses:				
Losses and loss adjustment expenses	**78,674**	73,739	**231,309**	242,033
Reinsurance recoveries	**(9,108)**	(8,516)	**(25,601)**	(29,457)
Net losses and loss adjustment expenses	**69,566**	65,223	**205,708**	212,576
Underwriting, acquisition and insurance expenses	**29,905**	24,527	**83,896**	75,927
Interest expense	**808**	1,141	**2,638**	5,855
Loss on extinguishment of debt	**2,839**		**2,839**	
Total expenses	**103,118**	90,891	**295,081**	294,358
Income before income taxes	**79,476**	27,197	**193,723**	136,421
Provision for income taxes:				
Current expense (benefit)	**21,595**	(228)	**31,257**	21,907
Deferred expense (benefit)	**2,680**	5,178	**25,017**	13,081

Total income tax expense (benefit)	**24,275**	4,950	**56,274**	34,988
Net income	**$ 55,201**	$ 22,247	**$137,449**	$101,433
Earnings per share:				
Basic	**$ 1.69**	$ 0.66	**$ 4.17**	$ 3.12
Diluted	**$ 1.67**	$ 0.66	**$ 4.13**	$ 2.98
Weighted average number of common shares outstanding:				
Basic	**32,701**	33,496	**32,988**	32,519
Diluted	**33,023**	33,866	**33,267**	34,561

See accompanying notes.

6

Table of Contents

ProAssurance Corporation and Subsidiaries
Condensed Consolidated Statements of Comprehensive Income
(Unaudited)

(In thousands)	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	**2009**	2008
Comprehensive income:				
Net income	**$ 55,201**	$ 22,247	**$ 137,449**	$ 101,433
Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments	**67,050**	(40,811)	**115,803**	(65,719)
Comprehensive income	**$ 122,251**	$ (18,564)	**$ 253,252**	$ 35,714

See accompanying notes.

Table of Contents

ProAssurance Corporation and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Unaudited)

(In thousands)	Nine Months Ended September 30 2009	2008
Operating Activities		
Net income	**$ 137,449**	$ 101,433
Loss on extinguishment of debt	**2,839**	
Depreciation and amortization	**14,346**	12,201
Net realized investment (gains) losses	**(4,822)**	41,011
Share-based compensation	**4,850**	6,351
Deferred income taxes	**25,017**	13,081
Changes in assets and liabilities, net of the effects of acquisitions:		
Premiums receivable	**(20,844)**	7,755
Reserve for losses and loss adjustment expenses	**(70,768)**	(78,303)
Unearned premiums	**36,780**	(7,840)
Reinsurance related assets and liabilities	**(15,663)**	68,524
Other liabilities	**(82,521)**	(29,284)
Other	**(10,722)**	9,958
Net cash provided by operating activities	**15,941**	144,887
Investing Activities		
Purchases of:		
Fixed maturities available for sale	**(754,888)**	(632,679)
Equity securities available for sale	**(140)**	(2,650)
Equity securities trading	**(23,278)**	(3,691)
Other investments	**(292)**	(278)
Cash invested in unconsolidated subsidiaries	**(2,542)**	(23,601)
Proceeds from sale or maturities of:		
Fixed maturities available for sale	**580,635**	691,493
Equity securities available for sale	**5,264**	417
Equity securities trading	**18,698**	815
Other investments	**1,740**	3,587
Net sales or maturities (purchases) of short-term investments, excluding unsettled redemptions	**320,874**	(117,395)
Cash paid for acquisitions, net of cash received	**(124,208)**	
Other	**13,150**	(11,613)
Net cash provided (used) by investing activities	**35,013**	(95,595)
Financing Activities		
Repurchase of treasury stock	**(38,143)**	(80,335)
Book overdraft	**9,661**	5,167
Repayment of debt	**(7,190)**	
Other	**2,017**	166

Net cash provided (used) by financing activities		**(33,655)**		(75,002)
Increase (decrease) in cash and cash equivalents		**17,299**		(25,710)
Cash and cash equivalents at beginning of period		**3,459**		30,274
Cash and cash equivalents at end of period	**$**	**20,758**	$	4,564
Significant Non-cash Transactions:				
Common stock issued in acquisition, from treasury	**$**	**5,161**	$	
Unsettled redemption of short-term money market investment	**$**		$	48,505
Equity increase due to conversion of debt	**$**		$	112,478

See accompanying notes.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of ProAssurance Corporation and its consolidated subsidiaries (ProAssurance or PRA). The financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation, consisting of normal recurring adjustments, have been included. Operating results for the three- and nine-month periods ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes contained in ProAssurance s December 31, 2008 report on Form 10-K. ProAssurance has evaluated subsequent events through November 2, 2009 which is the date the financial statements were issued.

Certain reclassifications have been made in the prior period consolidated financial statements to conform to the current period presentation.

Accounting Changes Adopted

FASB Accounting Standards Codification

On July 1, 2009 the FASB published the FASB Accounting Standards Codification (the Codification) as the single source of authoritative nongovernmental GAAP, effective for interim and annual periods ending after September 15, 2009. The Codification is not intended to change current GAAP, but rather to provide all the authoritative literature related to a particular topic in one place. Upon the effective date, all pre-existing accounting standard documents were superseded and accounting literature not included in the Codification became non-authoritative. ProAssurance has adopted use of the Codification as of the quarter ending September 30, 2009; adoption had no effect on ProAssurance s results of operations or financial position.

Subsequent Events

Effective for fiscal years, and interim periods within those fiscal years, ending on or after June 15, 2009, GAAP guidance was revised to more clearly set forth the period after the balance sheet date during which management should evaluate events or transactions for potential recognition or disclosure in the financial statements, the circumstances under which events or transactions after the balance sheet date should be recognized and the disclosures that should be made regarding such events. ProAssurance adopted the revised guidance as of the quarter ended June 30, 2009; adoption had no effect on ProAssurance s results of operations or financial position.

Fair Value

Effective for fiscal years, and interim periods within those fiscal years, ending on or after June 15, 2009, the FASB revised existing GAAP guidance regarding the valuation of assets or liabilities when the volume and level of market transactions for those assets or liabilities has significantly decreased. The revised guidance clarifies factors to be considered in determining whether there has been a significant decrease in market activity for an asset in relation to normal activity and provides additional guidance on when the use of multiple (or different) valuation techniques may be warranted and considerations for determining the weight that should be applied to the various techniques. The revisions also establish a requirement that conclusions about whether transactions are orderly be based on the weight of the evidence and require entities to disclose any changes to valuation techniques (and related inputs) that result from a conclusion that markets are not orderly and the effect of the change, if practicable. ProAssurance adopted the revised guidance as of the quarter ended June 30, 2009; adoption had no significant effect on ProAssurance s results of operations or financial position.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

1. Basis of Presentation (continued)

Effective for fiscal years, and interim periods within those fiscal years, ending on or after June 15, 2009, the FASB has revised previously existing guidance to require publicly traded companies to provide disclosures about fair values of financial instruments for interim reporting periods as well as in annual financial statements and in any summarized financial information issued at interim reporting periods. ProAssurance adopted the revised guidance as of the quarter ended June 30, 2009; adoption had no effect on ProAssurance s results of operations or financial position.

Investments Disclosure Requirements; Other-than-temporary Impairments

Effective for fiscal years, and interim periods within those fiscal years, ending on or after June 15, 2009, the FASB altered previously existing GAAP guidance for investments in debt and equity securities. The new guidance specifies that disclosures for debt and equity securities should be provided for interim as well as annual periods. GAAP guidance related to other-than-temporary impairments was also altered. Previous investment guidance required that an impairment of a debt security be considered as other-than-temporary unless management could assert both the intent and the ability to hold the impaired security until recovery of value. The revised impairment guidance specifies that an impairment be considered as other-than-temporary unless an entity can assert that it has no intent to sell the security and that it is not more likely than not that the entity will be required to sell the security before recovery of its anticipated amortized cost basis. The new guidance also establishes the concept of credit loss. Credit loss is defined as the difference between the present value of the cash flows expected to be collected from a debt security and the amortized cost basis of the security. The new guidance states that in instances in which a determination is made that a credit loss exists but the entity does not intend to sell the debt security and it is not more likely than not that the entity will be required to sell the debt security before the anticipated recovery of its remaining amortized cost basis an impairment is to be separated into (a) the amount of the total impairment related to the credit loss and (b) the amount of total impairment related to all other factors. The credit loss component of the impairment is to be recognized in income of the current period. The non-credit component is to be recognized as a part of other comprehensive income. Transition provisions require a cumulative effect adjustment to reclassify the noncredit component of a previously recognized other-than-temporary impairment from retained earnings to accumulated other comprehensive income if an entity does not intend to sell and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis . ProAssurance adopted this guidance as of the beginning of its quarter ended June 30, 2009. As of April 1, 2009, ProAssurance debt securities included non-credit impairment losses previously recognized in earnings of approximately $5.4 million. In accordance with the transition provisions of the revised guidance, these credit losses, net of tax, were reclassified from retained earnings to accumulated comprehensive income as of April 1, 2009 (a $3.5 million increase to retained earnings; a $3.5 million decrease to accumulated other comprehensive income).

Convertible Debentures

Effective January 1, 2009 previous GAAP guidance regarding the accounting for Convertible Debentures has been revised. The revised guidance requires issuers to account for convertible debt securities that allow for either mandatory or optional cash settlement (including partial cash settlement) by separating the liability and equity components in a manner that reflects the issuer s nonconvertible debt borrowing rate at the time of issuance and requires recognition of additional (non-cash) interest expense in subsequent periods based on the nonconvertible rate. Additionally, when such debt instruments are repaid or converted, any consideration transferred at settlement is to be allocated between the extinguishment of the liability component and the reacquisition of the equity component. The revised guidance is applicable to the Convertible Debentures which ProAssurance converted in July 2008. ProAssurance adopted the revised guidance as of its effective date January 1, 2009; adoption had no effect on 2009 operating results because no convertible debt has been outstanding during 2009. The cumulative effect of adoption, which would be an increase to additional paid-in capital of $65,000 and an offsetting decrease to retained earnings of the same amount, has not been recorded because the effect is immaterial and would not change total stockholders equity.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

1. Basis of Presentation (continued)

Non-controlling Interests in Subsidiaries

Effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, existing GAAP guidance was revised to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. ProAssurance adopted this guidance as of its effective date, January 1, 2009. Adoption did not have an effect on ProAssurance s results of operations or financial position.

Business Combinations

Existing GAAP guidance related to business combinations has been revised effective prospectively for combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The revision retains the previous requirement that the acquisition method of accounting be used for all business combinations but provides new or additional guidance including: defining the acquirer in a transaction, the valuation of assets and liabilities when noncontrolling interests exist, the treatment of contingent consideration, the treatment of costs incurred to effect the acquisition, the treatment of reorganization costs, and the valuation of assets and liabilities when the purchase price is below the net fair value of assets acquired. ProAssurance adopted the new guidance as of its effective date, January 1, 2009 and accounted for its acquisitions of MCGA Corporation (Mid-Continent), Georgia Lawyers Insurance Company (Georgia Lawyers) and Podiatry Insurance Company of America (PICA) during the first and second quarters of 2009 in accordance with the revised guidance (see Note 3).

Accounting Changes Not Yet Adopted

Consolidation of Variable Interest Entities

In June 2009 the FASB issued new guidance (effective for fiscal years beginning after November 15, 2009 and interim periods within those fiscal years) which changes how a reporting entity determines whether or not to consolidate its interest in an entity that is insufficiently capitalized or is not controlled through voting (or similar) rights. The determination of whether a reporting entity is required to consolidate another entity will now be based on, among other things, the other entity s purpose and design and the reporting entity s ability to direct the activities of the other entity that most significantly impact the other entity s economic performance. The revised guidance also requires a reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A reporting entity will be required to disclose how its involvement with a variable interest entity affects the reporting entity s financial statements. Management is currently evaluating the new guidance and has not yet completed its determination of the impact on ProAssurance s results of operations or financial position.

Fair Value

In August 2009 the FASB issued updated guidance regarding the valuation of liabilities at fair value; the guidance is effective for the first reporting period that begins after issuance of the guidance. The updated guidance clarifies that when a quoted price in an active market for an identical liability is not available, fair value should be determined using quoted prices for identical or similar liabilities traded as assets or using another valuation technique described in existing GAAP guidance for determining fair values. Such techniques include present value techniques, and techniques based on the amount that a reporting entity would pay on the measurement date to transfer or enter into an identical liability. Adoption of this guidance is not expected to have a significant effect on the valuation of ProAssurance liabilities.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

2. Fair Value Measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A three level hierarchy has been established for valuing assets and liabilities based on how transparent (observable) the inputs are that are used to determine fair value, with the inputs considered most observable categorized as Level 1 and those that are the least observable categorized as Level 3. Hierarchy levels are defined as follows:

Level 1: quoted (unadjusted) market prices in active markets for identical assets and liabilities. For ProAssurance, Level 1 inputs are generally quotes for debt or equity securities actively traded in exchange or over-the-counter markets.

Level 2: market data obtained from sources independent of the reporting entity (observable inputs). For ProAssurance, Level 2 inputs generally include quoted prices in markets that are not active, quoted prices for similar assets/liabilities, and other observable inputs such as interest rates and yield curves that are generally available at commonly quoted intervals.

Level 3: the reporting entity s own assumptions about market participant assumptions based on the best information available in the circumstances (non-observable inputs). For ProAssurance, Level 3 inputs are used in situations where little or no Level 1 or 2 inputs are available or are inappropriate given the particular circumstances. Level 3 inputs include results from pricing models and discounted cash flow methodologies as well as adjustments to externally quoted prices that are based on management judgment or estimation.

The following tables present information about ProAssurance s assets and liabilities measured at fair value on a recurring basis as of September 30, 2009, and indicate the fair value hierarchy of the valuation techniques utilized to determine such value. For some assets, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. When this is the case, the asset is categorized based on the level of the most significant input to the fair value measurement. ProAssurance s assessment of the significance of a particular input to the fair value measurement requires judgment, and considers factors specific to the assets being valued.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

2. Fair Value Measurement (continued)

Assets and liabilities measured at fair value on a recurring basis as of September 30, 2009, including financial instruments for which ProAssurance has elected fair value accounting, are as follows:

	September 30, 2009 Fair Value Measurements Using			
(In thousands)	Level 1	Level 2	Level 3	Total Fair Value
Assets:				
Fixed maturities, available for sale				
Government/government agencies	$	$ 228,253	$	$ 228,253
State and municipal bonds		1,476,664	9,585	1,486,249
Corporate bonds		983,831	20,685	1,004,516
Residential mortgage-backed securities		570,871		570,871
Commercial mortgage-backed securities		162,155		162,155
Other asset-backed securities		71,455	905	72,360
Equity securities, available for sale	3,798			3,798
Equity securities, trading	39,353			39,353
Short-term investments(1)	108,875	29,033		137,908
Other investments(2)			14,810	14,810
Total assets	$152,026	$3,522,262	$45,985	$3,720,273
Liabilities:				
2019 Note Payable	$	$	$14,264	$ 14,264
Interest rate swap agreement			3,707	3,707
Total liabilities	$	$	$17,971	$ 17,971

(1) Short-term investments are reported at amortized cost, which approximates fair value.

(2) Our other investments also include $31.1 million of investments accounted for using the cost

method that are
not included in
the table above.

Level 3 assets in the table consist primarily of auction rate municipal bonds (included in State and Municipal bonds), private placement senior notes (included in Corporate bonds), an asset-backed bond (included in Other asset-backed securities) and a beneficial interest in asset-backed securities held in a private investment fund (included in Other Investments).

The auction rate municipal bonds are rated A or better. The private placement senior notes are unconditionally guaranteed by large regional banks rated AA- or better. The asset-backed bond is rated AA and is collateralized by a timber trust. The fair values of these three types of assets are primarily derived using pricing models, which may require multiple market input parameters, considered appropriate for the asset being valued.

The asset-backed securities held in a private investment fund are primarily backed by manufactured housing, recreational vehicle receivables, and subprime securities. These securities have an average rating of CCC, and are valued using a broker dealer quote.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

2. Fair Value Measurement (continued)

The following tables present additional information about assets and liabilities measured at fair value using Level 3 inputs, including financial instruments for which ProAssurance has elected fair value accounting, for the three and nine months ended September 30, 2009:

	Level 3 Fair Value Measurements Assets					
(In thousands)	State and Municipal Bonds	Corporate Bonds	Asset-backed Securities	Equity Securities	Other Investments	Total
Balance June 30, 2009	$ 8,954	$ 23,050	$ 759	$ 72	$ 14,082	$ 46,917
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of net realized investment gains (losses)		(16)		(72)		(88)
Included in other comprehensive income	706	427	146		1,006	2,285
Purchases, sales or settlements	(75)	(689)			(278)	(1,042)
Transfers in						
Transfers out		(2,087)				(2,087)
Balance September 30, 2009	$ 9,585	$ 20,685	$ 905	$	$ 14,810	$ 45,985
The amount of total gains (losses) for the three months ended September 30, 2009 included in earnings attributable to the change in unrealized gains (losses) relating to assets still held at September 30, 2009	$	$ (16)	$	$ (72)	$	$ (88)
Balance January 1, 2009	$	$ 36,472	$ 1,327	$ 357	$ 14,576	$ 52,732
Total gains (losses) realized and						

unrealized:						
Included in earnings, as a part of net realized investment gains (losses)		(342)		(357)	(536)	(1,235)
Included in other comprehensive income	(315)	196	114		1,081	1,076
Purchases, sales or settlements	(125)	(11,385)	(21)		(311)	(11,842)
Transfers in	10,025	2,000				12,025
Transfers out		(6,256)	(515)			(6,771)
Balance September 30, 2009	$ 9,585	$ 20,685	$ 905	$	$ 14,810	$ 45,985
The amount of total gains (losses) for the nine months ended September 30, 2009 included in earnings attributable to the change in unrealized gains (losses) relating to assets still held at September 30, 2009	$	$ (342)	$	$ (357)	$ (536)	$ (1,235)

14

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

2. Fair Value Measurement (continued)

	Level 3 Fair Value Measurements		Liabilities
(In thousands)	2019 Note Payable	Interest rate swap agreement	Total
Balance June 30, 2009	$(13,903)	$(3,301)	$(17,204)
Total gains (losses) realized and unrealized:			
Included in earnings as a part of net realized investment gains (losses)	(546)	(406)	(952)
Included in other comprehensive income			
Purchases, sales or settlements	185		185
Transfers in			
Transfers out			
Balance September 30, 2009	$(14,264)	$(3,707)	$(17,971)
The amount of total gains (losses) for the three months ended September 30, 2009 included in earnings attributable to the change in unrealized gains (losses) relating to liabilities still held at September 30, 2009	$ (546)	$ (406)	$ (952)

	Level 3 Fair Value Measurements		Liabilities
(In thousands)	2019 Note Payable	Interest rate swap agreement	Total
Balance January 1, 2009	$	$	$
Total gains (losses) realized and unrealized:			
Included in earnings as a part of net realized investment gains (losses)	(1,843)	982	(861)
Included in other comprehensive income			
Purchases, sales or settlements	(12,421)	(4,689)	(17,110)
Transfers in			
Transfers out			
Balance September 30, 2009	$(14,264)	$(3,707)	$(17,971)
The amount of total gains (losses) for the nine months ended September 30, 2009 included in earnings attributable to the change in unrealized gains (losses) relating to liabilities still held at September 30, 2009	$ (1,843)	$ 982	$ (861)

Transfers into Level 3 include:

A corporate bond valued at $2 million was valued using multiple observable inputs at December 31, 2008, but such information has not been available in 2009. In 2009, the bond has been valued using a single broker dealer quote.

Municipal bonds totaling $10 million were valued using multiple observable inputs at December 31, 2008. Such inputs have been unavailable in 2009 and the bonds were valued using a pricing model at both June 30, 2009 and September 30, 2009.

We transferred the following securities out of Level 3 to Level 2. While there was no active market for the security or nearly identical securities during the latter portion of 2008, market activity increased in 2009, which provided multiple observable inputs that could be used to value the securities.

Asset-backed securities valued at $515,000.

A private placement bond (included in Corporate bonds) valued at $4 million that was a new issue during 2008.

Two corporate bonds, having a combined value of $2.2 million.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

2. Fair Value Measurement (continued)

Fair Value Option Elections

ProAssurance elected to account for a liability assumed in the acquisition of PICA at fair value on a recurring basis, specifically the 2019 Note Payable bearing a floating interest rate discussed further in Note 8. The 2019 Note Payable has a related interest rate swap intended to mitigate the market risk of future interest rate changes on the 2019 Note Payable. The interest rate swap is carried at fair value with changes in fair value recorded in other income. Electing the fair value option allows ProAssurance to account for the note payable at fair value, which is more consistent with management s view of the underlying economics and reduces the accounting irregularity that would otherwise result from carrying the note payable on an amortized cost basis and the interest rate swap at fair value. As of September 30, 2009, the 2019 Note Payable had a fair value of $14.3 million recorded in Long-term Debt and an outstanding principal balance of $17.8 million. During the third quarter of 2009 the fair value of the interest rate swap liability increased by $406,000 and the fair value of the 2019 Note Payable increased by $546,000; a combined loss of $952,000 was recognized related to the changes in fair value. Year-to-date in 2009, the fair value of the interest rate swap liability decreased by $1.0 million and the fair value of the 2019 Note Payable increased by $1.8 million; a combined loss of $861,000 was recognized related to the changes in fair value. Gains or losses from changes in the fair value of the 2019 Note Payable and related interest rate swap are included in net realized investments gains (losses) on the ProAssurance income statement.

3. Acquisitions

Each of the following business combination transactions has a 2009 acquisition date and accordingly all have been accounted for in accordance with the December 2007 revisions to GAAP relating to business combinations. The final purchase price allocations of all acquired businesses are subject to the completion of the valuation of certain assets and liabilities and will be finalized within one year of the transaction date or sooner. All of the entities acquired in 2009 are considered to be a part of ProAssurance s pre-existing reporting segment, the professional liability segment. ProAssurance operates in a single reporting segment.

ProAssurance acquired 100% of the outstanding shares of Mid-Continent and Georgia Lawyers during the first quarter of 2009 as a means of expanding its professional liability business. Assets acquired and liabilities assumed were recorded based on estimated fair values as of the date of acquisition. The excess of the purchase price over the fair values of the identifiable net assets acquired was recognized as goodwill totaling $18.0 million for the two acquisitions. Approximately $17 million of the goodwill is expected to be tax deductible. The consideration for these acquisitions included 100,533 ProAssurance common shares, which were reissued from treasury stock. The shares, which had a cost basis of approximately $5.0 million, were valued at $5.2 million, based on the market value of ProAssurance common shares on the date of closing.

On April 1, 2009 ProAssurance acquired Podiatry Insurance Company of America and subsidiaries (PICA) through a cash sponsored demutualization as a means of expanding its professional liability insurance operations. PICA provides professional liability insurance primarily to podiatric physicians, chiropractors and other healthcare providers throughout the United States and had gross written premium of approximately $96 million in 2008. ProAssurance purchased all of PICA s outstanding stock created in the demutualization for $120 million in cash and $15 million in premium credits to eligible policyholders to be paid over a three year period beginning in 2010. Total purchase consideration transferred had a fair value of $133.8 million on the acquisition date, April 1, 2009. As summarized in the table below, the purchase consideration was allocated, on a preliminary basis, to the acquired assets and liabilities assumed based on their estimated fair values on the acquisition date. Preliminary goodwill of $29.0 million was recognized equal to the excess of the

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

3. Acquisitions (continued)

purchase price over the net fair value of the identifiable assets acquired and liabilities assumed. None of the goodwill is expected to be tax deductible. ProAssurance incurred expenses related to the purchase of approximately $2.5 million during 2009, primarily in the second quarter, and $710,000 during 2008, primarily in the fourth quarter. These expenses have been included as a part of insurance expenses in the period incurred.

The fair value of identifiable assets acquired and liabilities assumed in the PICA acquisition by major category are as follows:

(In thousands)	
Preliminary fair value of identifiable assets acquired and liabilities assumed:	
Fixed maturities, available for sale	$ 218,766
Equity securities, available for sale	1,193
Equity securities, trading	15,628
Short-term investments	14,114
Premiums receivable	19,426
Reinsurance recoverable	3,998
Intangible assets:	
Goodwill	29,034
Other intangibles	23,200
Real estate	20,178
Deferred tax assets	13,833
Other assets	15,635
Reserve for losses and loss adjustment expenses	(155,176)
Unearned premiums	(47,183)
Long-term debt	(16,803)
Other liabilities	(22,043)
Fair value of net assets acquired	$ 133,800

ProAssurance believes that all contractual cash flows related to acquired receivables will be collected. The fair value of net assets acquired includes preliminary fair value adjustments to record real estate assets at appraised market values. Certain liabilities were also adjusted including long-term debt fair valued using average spreads for financial instruments with similar credit ratings and maturities and an interest rate swap valued by determining the present value of the future cash flows. The fair value of reserves for losses and loss adjustment expenses and related reinsurance recoverables were estimated based on the present value of the expected underlying net cash flows including a profit margin and a risk premium and were determined to be materially the same as the recorded cost basis acquired.

Intangible assets acquired include the following:

(In millions)	**Estimated Fair Value**	**Estimated Useful Life**
Trade names	$ 2.0	7 years

Renewal rights	$ 5.2	15 years
Non-compete agreements	$ 0.7	2 years
Internally developed software	$ 1.7	5 years
State license agreements	$13.6	Indefinite

Intangibles with definite lives are being amortized over the estimated useful life of the asset. Intangibles with an indefinite life are not amortized.

The following table discloses the amount of PICA revenues and earnings since the acquisition on April 1, 2009 that are included in ProAssurance consolidated results for the nine months ended September 30, 2009. The table also includes supplemental pro forma information reflecting the combined results of ProAssurance and PICA as if the acquisition had occurred at the beginning of the current and prior year annual reporting periods (on January 1, 2009 and January 1, 2008, respectively), adjusted to exclude transaction costs and include pro forma amortization of certain intangibles recognized in the purchase price allocation.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

3. Acquisitions (continued)

	Actual PICA Results Included in ProAssurance Consolidated Results Nine Months Ended September 30	Supplemental Pro forma Combined Results Nine Months Ended September 30	
(In thousands)	**2009**	**2009**	**2008**
Revenue	**$ 58,329**	**$513,728**	$511,017
Earnings	**$ 5,769**	**$145,316**	$109,920

4. Investments

The amortized cost and estimated fair value of available-for-sale fixed maturities and equity securities are as follows:

	September 30, 2009			
(In thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Fixed maturities				
U.S. Treasury and agency obligations	**$ 221,709**	**$ 7,193**	**$ (649)**	**$ 228,253**
State and municipal bonds	**1,414,438**	**73,288**	**(1,477)**	**1,486,249**
Corporate bonds	**970,257**	**41,341**	**(7,082)**	**1,004,516**
Residential mortgage-backed securities	**557,021**	**26,262**	**(12,412)**	**570,871**
Commercial mortgage-backed securities	**164,190**	**2,319**	**(4,354)**	**162,155**
Other asset-backed securities	**70,377**	**2,646**	**(663)**	**72,360**
	3,397,992	**153,049**	**(26,637)**	**3,524,404**
Equity securities	**2,755**	**1,115**	**(72)**	**3,798**
	$3,400,747	**$154,164**	**$(26,709)**	**$3,528,202**

	December 31, 2008			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities				
U.S. Treasury and agency obligations	$ 172,653	$ 6,992	$ (2,477)	$ 177,168
State and municipal bonds	1,349,430	26,268	(19,492)	1,356,206
Corporate bonds	627,811	6,823	(40,852)	593,782

Residential mortgage-backed securities	576,537	17,932	(10,082)	584,387
Commercial mortgage-backed securities	193,737		(22,878)	170,859
Other asset-backed securities	84,653	120	(5,607)	79,166
	3,004,821	58,135	(101,388)	2,961,568
Equity securities	7,949	558	(1,526)	6,981
	$3,012,770	$58,693	$(102,914)	$2,968,549

ProAssurance maintains a direct beneficial interest in a private investment fund focused on managing high yield asset-backed bonds. The securities held in the fund are included in Other Investments, at fair value totaling $9.6 million at September 30, 2009 (recorded cost basis of $19.5 million). These securities are evaluated for other-than-temporary impairment quarterly. At September 30, 2009 unrealized losses reflect continued dislocations in the markets for these securities. Management s evaluation of expected future cash flows does not indicate additional credit loss related to the securities.

Proceeds from sales of fixed maturities and equity securities during the nine months ended September 30, 2009 and 2008 are $333.4 million and $376.7 million, respectively.

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

4. Investments (continued)

Net realized investment gains (losses) are comprised of the following:

	Three Months Ended September 30		Nine Months Ended September 30	
(In thousands)	**2009**	2008	**2009**	2008
Gross realized gains	**$ 5,896**	$ 2,395	**$ 12,463**	$ 3,484
Gross realized (losses)	**(2,304)**	(5,495)	**(3,746)**	(6,438)
Other-than-temporary impairment (losses)	**(88)**	(29,862)	**(10,400)**	(36,169)
Trading portfolio net gains (losses)	**4,723**	(1,274)	**7,366**	(1,888)
Fair value adjustments, net	**(952)**		**(861)**	
Net realized investment gains (losses)	**$ 7,275**	$(34,236)	**$ 4,822**	$(41,011)

During the three and nine months ended September 30, 2009, ProAssurance recorded other-than-temporary impairment losses as listed in the table below.

	Three Months Ended September 30		Nine Months Ended September 30	
(In thousands)	**2009**	2008	**2009**	2008
Total other-than-temporary impairment losses (realized and unrealized):				
Residential mortgage-backed securities (1)	**$**	$ (788)	**$ (2,703)**	$ (5,930)
Corporate bonds	**(16)**	(19,606)	**(3,749)**	(20,119)
Equities	**(72)**	(9,468)	**(494)**	(9,767)
Other(2)			**(3,626)**	(353)
Portion recognized in Other Comprehensive Income(3):				
Residential mortgage-backed securities			**172**	
Net impairment losses recognized in earnings	**$(88)**	$(29,862)	**$(10,400)**	$(36,169)

(1) Includes unrealized impairment losses of approximately $61,000 that were recognized in earnings in the first quarter of 2009 but reclassified

from retained earnings to other comprehensive income on April 1, 2009

(2) Includes $3.1 million in the first quarter of 2009 related to a reduction of the amount expected to be received from the dissolution of the Reserve Primary Fund

(3) In accordance with GAAP, prior to April 1, 2009 all OTTI losses were recognized in earnings

Table of Contents

ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2009

4. Investments (continued)

The following table presents a roll forward of cumulative credit losses recorded in earnings related to impaired debt securities for which the non-credit portion of the other-than-temporary impairment is recorded in Other Comprehensive Income.

(In thousands)	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2009
Balance beginning of period	$1,404	$ 0
Credit losses recognized related to impaired securities held at April 1, 2009 for which a portion of the impairment is recorded in Other Comprehensive Income (see Note 1 regarding impairments)		
Additional credit losses recognized during the period, related to securities for which:		
No OTTI has been previously recognized		1,329
OTTI has been previously recognized		75
Reductions due to:		
Securities sold during the period (realized)		
Securities which will be sold in coming periods		
Securities for which it has become more likely than not that the security will be required to be sold prior to anticipated recovery of amortized cost basis		
Accretion recognized during the period related to cash flows that are expected to exceed the amortized cost basis of the security		
Balance September 30, 2009	$1,404	$ 1,404

Credit losses recognized in 2009 included residential mortgage backed securities and corporate bonds. ProAssurance estimates the portion of loss attributable to credit using a discounted cash flow model that relies on actual collateral performance measures (default rate, voluntary prepayment rate, and loss severity), if available, or sector based assumptions if not. These assumptions are applied throughout the remaining term of the security, based upon the underlying transactions structure, including payment priorities and performance triggers.

The following table provides summarized information with respect to available-for-sale securities held in an unrealized loss position at September 30, 2009, including the length of time the securities have been held in a continuous unrealized loss position.

	September 30, 2009					
	Total		Less than 12 months		More than 12 months	
(In thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

Fixed maturities, available for sale						
U.S. Treasury and agency obligations	**$ 39,819**	**$ (649)**	**$32,785**	**$ (581)**	**$ 7,034**	**$ (68)**
State and municipal bonds	**43,583**	**(1,477)**	**12,107**	**(353)**	**31,476**	**(1,124)**
Corporate bonds	**122,820**	**(7,082)**	**46,254**	**(1,320)**	**76,566**	**(5,762)**
Residential mortgage-backed securities	**44,113**	**(12,412)**	**17,813**	**(5,205)**	**26,300**	**(7,207)**
Commercial mortgage-backed securities	**73,121**	**(4,354)**				