PROASSURANCE CORP
Form 10-Q
November 04, 2008

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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, 2008 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 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

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

As of October 24, 2008 there were 33,505,234 shares of the registrant s common stock outstanding.

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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, 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 area, that are different than anticipated;
- regulatory, legislative and judicial actions or decisions that affect our business plans or operations;
- inflation, particularly in loss costs trends;
- changes in the interest rate environment;
- the effect that the 2008 Emergency Economic Stabilization Act 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 laws or government regulations affecting medical professional liability insurance or the financial community;
- changes to our ratings assigned by rating agencies;
- 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 collectibility 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;
- changes in competition among insurance providers and related pricing weaknesses in our markets;
- loss of independent agents;

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

increases in guaranty fund assessments;

our ability to achieve continued growth through expansion into other states or through acquisitions or business combinations;

the expected benefits from acquisitions may not be achieved or may be delayed longer than expected due to, among other reasons, business disruption, loss of customers and employees, increased operating costs or inability to achieve cost savings, and assumption of greater than expected liabilities;

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

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- changes in our organization, compensation and benefit plans;
- our ability to retain and recruit senior management; and
- our proposed transaction with PICA may not be approved by PICA s mutual policyholders or regulators.

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.

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ProAssurance Corporation and Subsidiaries
Condensed Consolidated Balance Sheets

(In thousands, except share data)	**September 30 2008 (Unaudited)**	December 31 2007
Assets		
Investments		
Fixed maturities available for sale, at fair value	**$3,041,171**	$3,236,739
Equity securities, available for sale, at fair value	**8,538**	15,451
Equity securities, trading, at fair value	**15,160**	14,173
Short-term investments	**298,707**	229,817
Business owned life insurance	**62,990**	61,509
Investment in unconsolidated subsidiaries	**46,453**	26,767
Other	**51,008**	54,939
Total Investments	**3,524,027**	3,639,395
Cash and cash equivalents	**4,564**	30,274
Premiums receivable	**90,938**	98,693
Receivable from reinsurers on paid losses and loss adjustment expenses	**17,804**	39,567
Receivable from reinsurers on unpaid losses and loss adjustment expenses	**279,427**	327,111
Prepaid reinsurance premiums	**13,255**	14,835
Deferred policy acquisition costs	**20,954**	22,120
Deferred taxes	**135,447**	103,105
Real estate, net	**23,725**	24,004
Goodwill	**72,213**	72,213
Other assets	**158,008**	69,491
Total Assets	**$4,340,362**	$4,440,808
Liabilities and Stockholders Equity		
Liabilities		
Policy liabilities and accruals:		
Reserve for losses and loss adjustment expenses	**$2,481,404**	$2,559,707
Unearned premiums	**210,188**	218,028
Reinsurance premiums payable	**126,079**	128,582
Total Policy Liabilities	**2,817,671**	2,906,317
Other liabilities	**131,480**	115,263
Long-term debt	**58,296**	164,158
Total Liabilities	**3,007,447**	3,185,738
Stockholders Equity		
Common stock, par value $0.01 per share 100,000,000 shares authorized, 34,104,006 and 33,570,685 shares issued, respectively	**341**	336
Additional paid-in capital	**517,003**	505,923
	(55,817)	9,902

Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of ($30,054) and $5,334, respectively		
Retained earnings	**894,599**	793,166
	1,356,126	1,309,327
Treasury stock, at cost, 598,772 shares and 1,128,111 shares, respectively	**(23,211)**	(54,257)
Total Stockholders Equity	**1,332,915**	1,255,070
Total Liabilities and Stockholders Equity	**$4,340,362**	$4,440,808

See accompanying notes

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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, 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	**3,687**			**3,687**
Share-based compensation	**6,351**			**6,351**
Net effect of stock options exercised	**(50)**			**(50)**
Conversion of convertible debentures	**112,478**			**112,478**
Balance at September 30, 2008	**$1,332,915**	**$ (55,817)**	**$894,599**	**$494,133**

(In thousands)	Total	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Other Capital Accounts
Balance at December 31, 2006	$1,118,547	$ 111	$622,310	$496,126
Cumulative effect of accounting change	2,670		2,670	
Net income	116,823		116,823	
Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments	(8,882)	(8,882)		
Purchase of treasury stock	(41,265)			(41,265)
Common shares issued as compensation	3,136			3,136
Share-based compensation	6,377			6,377
Net effect of stock options exercised	735			735
Balance at September 30, 2007	$1,198,141	$ (8,771)	$741,803	$465,109

See accompanying notes

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

(In thousands, except per share data)	Three Months Ended September 30 **2008**	2007	Nine Months Ended September 30 **2008**	2007
Revenues:				
Gross premiums written	**$126,122**	$149,138	**$374,393**	$440,186
Net premiums written	**$116,409**	$139,483	**$343,609**	$401,809
Premiums earned	**$123,733**	$147,130	**$382,158**	$446,437
Premiums ceded	**(10,284)**	(11,622)	**(32,364)**	(41,089)
Net premiums earned	**113,449**	135,508	**349,794**	405,348
Net investment income	**39,845**	41,075	**122,218**	128,194
Equity in earnings (loss) of unconsolidated subsidiaries	**(1,967)**	(589)	**(3,916)**	1,241
Net realized investment gains (losses)	**(34,236)**	1,321	**(41,011)**	(1,564)
Other income	**997**	1,302	**3,694**	4,409
Total revenues	**118,088**	178,617	**430,779**	537,628
Expenses:				
Losses and loss adjustment expenses	**73,739**	99,142	**242,033**	338,793
Reinsurance recoveries	**(8,516)**	(11,034)	**(29,457)**	(52,844)
Net losses and loss adjustment expenses	**65,223**	88,108	**212,576**	285,949
Underwriting, acquisition and insurance expenses	**24,527**	27,439	**75,927**	79,913
Interest expense	**1,141**	3,006	**5,855**	8,950
Total expenses	**90,891**	118,553	**294,358**	374,812
Income before income taxes	**27,197**	60,064	**136,421**	162,816
Provision for income taxes:				
Current expense (benefit)	**(228)**	14,997	**21,907**	37,200
Deferred expense (benefit)	**5,178**	1,955	**13,081**	8,793
	4,950	16,952	**34,988**	45,993
Net income	**$ 22,247**	$ 43,112	**$101,433**	$116,823
Earnings per share:				
Basic	**$ 0.66**	$ 1.32	**$ 3.12**	$ 3.53

Diluted	**$ 0.66**	$ 1.23	**$ 2.98**	$ 3.31
Weighted average number of common shares outstanding:				
Basic	**33,496**	32,779	**32,519**	33,082
Diluted	**33,866**	35,604	**34,561**	35,949

See accompanying notes

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

(In thousands)	Three Months Ended September 30 **2008**	2007	Nine Months Ended September 30 **2008**	2007
Comprehensive income:				
Net income	**$ 22,247**	$43,112	**$101,433**	$116,823
Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments	**(40,811)**	19,411	**(65,719)**	(8,882)
Comprehensive income (loss)	**$(18,564)**	$62,523	**$ 35,714**	$107,941

See accompanying notes

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

(In thousands)	Nine Months Ended September 30 2008	2007
Operating Activities		
Net Income	**$ 101,433**	$ 116,823
Depreciation and amortization	**12,201**	11,727
Net realized investment (gains) losses	**41,011**	1,564
Net sales (purchases) of trading portfolio securities	**(2,876)**	43,619
Share-based compensation	**6,351**	6,377
Deferred income taxes	**13,081**	8,793
Changes in assets and liabilities:		
Premiums receivable	**7,755**	2,591
Reserve for losses and loss adjustment expenses	**(78,303)**	(10,263)
Unearned premiums	**(7,840)**	(5,730)
Reinsurance related assets and liabilities	**68,524**	24,331
Other	**(19,326)**	7,379
Net cash provided by operating activities	**142,011**	207,211
Investing Activities		
Purchases of:		
Fixed maturities available for sale	**(632,679)**	(1,076,729)
Equity securities available for sale	**(2,650)**	(657)
Other investments	**(278)**	(552)
Cash invested in unconsolidated subsidiaries	**(23,601)**	(10,226)
Proceeds from sale or maturities of:		
Fixed maturities available for sale	**691,493**	970,292
Equity securities available for sale	**417**	811
Other investments	**3,587**	8,279
Net (increase) decrease in short-term investments, excluding unsettled redemptions	**(117,395)**	(96,566)
Other	**(11,613)**	9,329
Net cash provided (used) by investing activities	**(92,719)**	(196,019)
Financing Activities		
Repurchase of treasury stock	**(80,335)**	(41,265)
Excess tax benefit from options exercised	**165**	1,673
Book overdraft	**5,167**	12,257
Other	**1**	117
Net cash provided (used) by financing activities	**(75,002)**	(27,218)

Increase (decrease) in cash and cash equivalents	**(25,710)**	(16,026)
Cash and cash equivalents at beginning of period	**30,274**	21,236
Cash and cash equivalents at end of period	**$ 4,564**	$ 5,210
Significant Non-cash Transactions:		
Fixed maturity securities transferred, at fair value, to other investments	**$**	$ 34,732
Unsettled redemption of short-term money market investment	**$ 48,505**	$
Equity increase due to conversion of debt see Notes 7 and 8	**$ 112,478**	$

See accompanying notes

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2008

1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of ProAssurance Corporation and its consolidated subsidiaries (ProAssurance). 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 nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes contained in ProAssurance s December 31, 2007 report on Form 10-K.

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

Accounting Changes

In September 2006, the FASB issued Statement of Financial Accounting Standards 157, *Fair Value Measurements* (SFAS 157). The standard establishes a revised definition of fair value: fair value is 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. SFAS 157 also establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 is applicable to other accounting pronouncements that require or permit fair value measurements but does not establish new guidance regarding the assets and liabilities required or allowed to be measured at fair value. The statement is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. ProAssurance adopted SFAS 157 on January 1, 2008. ProAssurance did not recognize any cumulative effect related to the adoption of SFAS 157 and adoption did not have a significant effect on ProAssurance s results of operations or financial condition.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits many financial assets and liabilities to be reported at fair value that are not otherwise required under GAAP to be measured at fair value. Under SFAS 159 guidance, the election of fair value treatment is specific to individual assets and liabilities, with changes in fair value recognized in earnings as they occur. The election of fair value measurement is generally irrevocable. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. ProAssurance adopted SFAS 159 on January 1, 2008 but did not elect fair value measurement for any financial assets or liabilities that were not otherwise required to be measured at fair value.

Recent Accounting Developments

In May 2008, the FASB issued FASB Staff Position (FSP) APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement),* which will alter the accounting for ProAssurance s Convertible Debentures. FSP APB 14-1 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, FSP APB 14-1 requires that 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. FSP APB 14-1 is effective for ProAssurance on January 1, 2009, and must be applied retrospectively with a cumulative effect adjustment being made as of the earliest period presented. Early adoption is not permitted. ProAssurance is currently assessing

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2008

1. Basis of Presentation (continued)

the impact that the adoption will have on its financial condition and results of operations, but expects no impact on ending Total Stockholders Equity after the conversion of the Convertible Debentures (July 2, 2008).

In December 2007 the FASB issued SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements.* SFAS 160 amends Accounting Research Bulletin 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. ProAssurance will adopt the Statement on its effective date. Adoption is not expected to have an effect on ProAssurance s results of operations or financial position.

In December 2007 the FASB issued SFAS 141 (Revised 2007), *Business Combinations.* SFAS 141R replaces FASB Statement No. 141, *Business Combinations,* but retains the fundamental requirement in SFAS 141 that the acquisition method (referred to as the purchase method in SFAS 141) of accounting be used for all business combinations. SFAS 141R provides new or additional guidance with respect to business combinations 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. SFAS 141R applies prospectively to business 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. Earlier adoption is prohibited. ProAssurance will adopt the Statement on its effective date.

2. Fair Value Measurement

Effective January 1, 2008 ProAssurance adopted SFAS 157 which establishes a framework for measuring fair value and requires specific disclosures regarding assets and liabilities that are measured at fair value.

As defined in SFAS 157, fair value is 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. SFAS 157 establishes a three level hierarchy 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 by SFAS 157 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 developed based on the best information available in the circumstances (unobservable 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.

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2008

2. Fair Value Measurement (continued)

The following tables present information about ProAssurance s assets measured at fair value on a recurring basis as of September 30, 2008, and indicate the fair value hierarchy of the valuation techniques utilized to determine such value. No liabilities are measured at fair value at September 30, 2008. 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 in the table based on the lowest level input that is significant to the fair value measurement in its entirety. ProAssurance s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the assets being valued.

Assets measured at fair value on a recurring basis as of September 30, 2008 are as follows:

	September 30, 2008			
	Fair Value Measurements Using			Total
(In thousands)	Level 1	Level 2	Level 3	Fair Value
Assets:				
Fixed maturities, available for sale				
U.S. Government and				
Government-sponsored enterprises	$	$ 227,761	$	$ 227,761
Asset-backed securities		864,712	1,578	866,290
Corporate bonds		547,038	39,393	586,431
State and municipal bonds		1,360,689		1,360,689
Equity securities, available-for-sale	8,188		350	8,538
Equity securities, trading	15,160			15,160
Other investments(1)			18,218	18,218
Short-term investments(2)	105,224	193,483		298,707
Total assets	$128,572	$3,193,683	$59,539	$3,381,794

(1) Other investments also include investments of $32.8 million accounted for using the cost method that are not included in the table above.

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

Level 3 assets in the above table consist primarily of asset-backed securities (as shown in the table), private placement senior notes (included in Corporate bonds), and a beneficial interest in asset-backed securities held in a private investment fund (included in Other Investments).

The private placement senior notes are unconditionally guaranteed by large regional banks rated A or better. The asset-backed securities have a weighted average rating of AA or better, and are collateralized by a timber trust and a Fannie Mae mortgage backed security. The fair value of these assets are primarily derived using pricing models that may require multiple market input parameters as is 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, have an average rating of BB, and are valued using a broker dealer quote.

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2008

2. Fair Value Measurement (continued