

PROASSURANCE CORP  
Form 10-Q  
November 06, 2007

**Table of Contents**

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

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2007 or \_\_\_\_\_**

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

**Commission file number 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  No

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

As of November 1, 2007 there were 32,672,841 shares of the registrant's common stock outstanding.

**TABLE OF CONTENTS**

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ITEM 4. CONTROLS AND PROCEDURES

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

ITEM 1A. RISK FACTORS

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

ITEM 6. EXHIBITS

SIGNATURE

EX-31.1 SECTION 302 CERTIFICATION OF THE CEO

EX-31.2 SECTION 302 CERTIFICATION OF THE CFO

EX-32.1 SECTION 906 CERTIFICATION OF THE CEO

EX-32.2 SECTION 906 CERTIFICATION OF THE CFO

---

**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 , project , should , expressions. There are numerous important 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 judgment, 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 important 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 and legislative actions or decisions that affect our business plans or operations;

inflation and changes in the interest rate environment;

performance of financial markets that affect the market value of our investments or that make it more difficult to determine the value of our investments;

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

changes to our ratings assigned by rating agencies;

the effects of health care changes, including managed care and government programs;

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

bad faith litigation which may arise from our involvement in the settlement of claims;

the results of litigation, including trials, post-trial motions and/or appeals we undertake that may be unsuccessful;

changes in competition among insurance providers and related pricing in some markets;

our ability to achieve 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 and the Financial Accounting Standards Board;

changes in our organization, compensation and benefit plans; and

ability to recruit and retain senior management.

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 various documents we file with the Securities and Exchange Commission, including the Registration Statement filed on February 15, 2006 and updated on June 2, 2006, as well as in our periodic reports filed 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, particularly in Item 1A, Risk Factors.

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 share data)

|  | September 30<br>2007<br>(Unaudited) | December 31<br>2006 |
|--|-------------------------------------|---------------------|
| <b>Assets</b>  |                                     |                     |
| Investments  |                                     |                     |
| Fixed maturities available for sale, at fair value   | <b>\$3,196,107</b>                  | \$3,136,222         |
| Fixed maturities, trading, at fair value   |                                     | 49,218              |
| Equity securities, available for sale, at fair value   | <b>7,482</b>                        | 7,220               |
| Equity securities, trading, at fair value  | <b>13,870</b>                       | 7,638               |
| Short-term investments   | <b>279,163</b>                      | 184,280             |
| Business owned life insurance  | <b>60,874</b>                       | 58,721              |
| Investment in unconsolidated subsidiaries  | <b>20,798</b>                       | 9,331               |
| Other  | <b>58,401</b>                       | 39,468              |
| <br>Total investments  | <br><b>3,636,695</b>                | <br>3,492,098       |
| <br>Cash and cash equivalents  | <br><b>2,535</b>                    | <br>29,146          |
| Premiums receivable  | <b>110,432</b>                      | 113,023             |
| Receivable from reinsurers on unpaid losses and loss adjustment expenses   | <b>344,741</b>                      | 370,763             |
| Prepaid reinsurance premiums   | <b>15,393</b>                       | 18,954              |
| Deferred taxes   | <b>108,190</b>                      | 112,201             |
| Real estate, net   | <b>23,348</b>                       | 23,135              |
| Other assets   | <b>192,818</b>                      | 183,533             |
|  | <b>\$4,434,152</b>                  | \$4,342,853         |
| <br><b>Liabilities and Stockholders Equity</b>   |                                     |                     |
| Liabilities  |                                     |                     |
| Policy liabilities and accruals:   |                                     |                     |
| Reserve for losses and loss adjustment expenses  | <b>\$2,596,885</b>                  | \$2,607,148         |
| Unearned premiums  | <b>248,043</b>                      | 253,773             |
| Reinsurance premiums payable   | <b>124,280</b>                      | 106,176             |
| <br>Total policy liabilities   | <br><b>2,969,208</b>                | <br>2,967,097       |
| Other liabilities  | <b>87,292</b>                       | 78,032              |
| Long-term debt   | <b>179,511</b>                      | 179,177             |
| <br>Total liabilities  | <br><b>3,236,011</b>                | <br>3,224,306       |
| Commitments and contingencies  |                                     |                     |
| Stockholders Equity  |                                     |                     |
| Common stock, par value \$0.01 per share 100,000,000 shares authorized,<br>33,557,816 and 33,398,028 shares issued, respectively | <b>336</b>                          | 334                 |
| Additional paid-in capital   | <b>506,094</b>                      | 495,848             |
| Accumulated other comprehensive income (loss), net of deferred tax<br>expense (benefit) of (\$4,721) and \$62, respectively      | <b>(8,771)</b>                      | 111                 |

Edgar Filing: PROASSURANCE CORP - Form 10-Q

|  |                    |             |
|--|--------------------|-------------|
| Retained earnings  | <b>741,803</b>     | 622,310     |
|  | <b>1,239,462</b>   | 1,118,603   |
| Treasury stock, at cost, 886,095 shares and 121,765 shares, respectively | <b>(41,321)</b>    | (56)        |
| Total stockholders' equity   | <b>1,198,141</b>   | 1,118,547   |
|  | <b>\$4,434,152</b> | \$4,342,853 |

*See accompanying notes*

Table of Contents

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

|   | <b>Total</b>       | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> | <b>Retained<br/>Earnings</b> | <b>Other<br/>Capital<br/>Accounts</b> |
|---|--------------------|--|------------------------------|---------------------------------------|
| Balance at December 31, 2006  | <b>\$1,118,547</b> | <b>\$ 111</b>  | <b>\$622,310</b>             | <b>\$496,126</b>                      |
| Cumulative effect of accounting change  | <b>2,670</b>       |  | <b>2,670</b>                 | <b>-</b>                              |
| Net income  | <b>116,823</b>     |  | <b>116,823</b>               | <b>-</b>                              |
| Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments  | <b>(8,882)</b>     | <b>(8,882)</b>   |                              | <b>-</b>                              |
| Purchase of treasury stock  | <b>(41,265)</b>    |  |                              | <b>(41,265)</b>                       |
| Common stock issued as compensation   | <b>3,136</b>       |  |                              | <b>3,136</b>                          |
| Stock-based compensation  | <b>6,377</b>       |  |                              | <b>6,377</b>                          |
| Common stock options exercised  | <b>735</b>         |  |                              | <b>735</b>                            |
| Balance at September 30, 2007   | <b>\$1,198,141</b> | <b>\$ (8,771)</b>  | <b>\$741,803</b>             | <b>\$465,109</b>                      |
|   |                    | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> | <b>Retained<br/>Earnings</b> | <b>Other<br/>Capital<br/>Accounts</b> |
|   | <b>Total</b>       |  |                              |                                       |
| Balance at December 31, 2005  | <b>\$ 765,046</b>  | <b>\$ (8,834)</b>  | <b>\$385,885</b>             | <b>\$387,995</b>                      |
| Net income  | <b>200,635</b>     |  | <b>200,635</b>               |                                       |
| Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments: |                    |  |                              |                                       |
| Continuing operations   | <b>9,063</b>       | <b>9,063</b>   |                              |                                       |
| Discontinued operations   | <b>373</b>         | <b>373</b>   |                              |                                       |
| Common stock issued as compensation   | <b>3,027</b>       |  |                              | <b>3,027</b>                          |



Edgar Filing: PROASSURANCE CORP - Form 10-Q

|  |             |        |           |           |
|--|-------------|--------|-----------|-----------|
| Equity issued in purchase transaction: |             |        |           |           |
| Common stock issued                    | 99,128      |        |           | 99,128    |
| Stock-based compensation:              |             |        |           |           |
| Continuing operations                  | 3,808       |        |           | 3,808     |
| Discontinued operations                | 642         |        |           | 642       |
| Common stock options exercised         | 239         |        |           | 239       |
| Balance at September 30, 2006          | \$1,081,961 | \$ 602 | \$586,520 | \$494,839 |

*See accompanying notes*

4

---

Table of Contents

**ProAssurance Corporation and Subsidiaries**  
**Condensed Consolidated Statements of Income (Unaudited)**  
(In thousands, except per share data)

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30</b>       |             | <b>September 30</b>      |             |
|  | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Revenues:  |                           |             |                          |             |
| Gross premiums written                                   | <b>\$ 149,138</b>         | \$ 163,273  | <b>\$ 440,186</b>        | \$ 452,264  |
| Net premiums written                                     | <b>\$ 139,483</b>         | \$ 152,043  | <b>\$ 401,809</b>        | \$ 421,004  |
| Premiums earned  | <b>\$ 147,130</b>         | \$ 163,043  | <b>\$ 446,437</b>        | \$ 465,932  |
| Premiums ceded   | <b>(11,622)</b>           | (13,599)    | <b>(41,089)</b>          | (36,637)    |
| Net premiums earned                                      | <b>135,508</b>            | 149,444     | <b>405,348</b>           | 429,295     |
| Net investment income                                    | <b>41,075</b>             | 38,699      | <b>128,194</b>           | 107,012     |
| Equity in earnings (loss) of unconsolidated subsidiaries | <b>(589)</b>              | (76)        | <b>1,241</b>             | 1,610       |
| Net realized investment gains (losses)                   | <b>1,321</b>              | (510)       | <b>(1,564)</b>           | (1,120)     |
| Other income   | <b>1,302</b>              | 1,688       | <b>4,409</b>             | 4,431       |
| <b>Total revenues</b>                                    | <b>178,617</b>            | 189,245     | <b>537,628</b>           | 541,228     |
| Expenses:  |                           |             |                          |             |
| Losses and loss adjustment expenses                      | <b>99,142</b>             | 124,165     | <b>338,793</b>           | 358,972     |
| Reinsurance recoveries                                   | <b>(11,034)</b>           | (10,128)    | <b>(52,844)</b>          | (30,693)    |
| Net losses and loss adjustment expenses                  | <b>88,108</b>             | 114,037     | <b>285,949</b>           | 328,279     |
| Underwriting, acquisition and insurance expenses         | <b>27,439</b>             | 25,859      | <b>79,913</b>            | 78,226      |
| Interest expense   | <b>3,006</b>              | 2,886       | <b>8,950</b>             | 8,074       |
| <b>Total expenses</b>                                    | <b>118,553</b>            | 142,782     | <b>374,812</b>           | 414,579     |
| Income from continuing operations before income taxes    | <b>60,064</b>             | 46,463      | <b>162,816</b>           | 126,649     |
| Provision for income taxes:                              |                           |             |                          |             |
| Current expense (benefit)                                | <b>14,997</b>             | 17,425      | <b>37,200</b>            | 42,524      |
| Deferred expense (benefit)                               | <b>1,955</b>              | (4,330)     | <b>8,793</b>             | (7,069)     |
|  | <b>16,952</b>             | 13,095      | <b>45,993</b>            | 35,455      |

Edgar Filing: PROASSURANCE CORP - Form 10-Q

|   |                  |           |                   |            |
|---|------------------|-----------|-------------------|------------|
| Income from continuing operations                     | <b>43,112</b>    | 33,368    | <b>116,823</b>    | 91,194     |
| Income from discontinued operations, net of tax       |                  |           |                   | 109,441    |
| Net income  | <b>\$ 43,112</b> | \$ 33,368 | <b>\$ 116,823</b> | \$ 200,635 |
| Basic earnings per share:                             |                  |           |                   |            |
| Income from continuing operations                     | <b>\$ 1.32</b>   | \$ 1.03   | <b>\$ 3.53</b>    | \$ 2.88    |
| Income from discontinued operations                   |                  |           |                   | 3.46       |
| Net income  | <b>\$ 1.32</b>   | \$ 1.03   | <b>\$ 3.53</b>    | \$ 6.34    |
| Diluted earnings per share:                           |                  |           |                   |            |
| Income from continuing operations                     | <b>\$ 1.23</b>   | \$ 0.96   | <b>\$ 3.31</b>    | \$ 2.71    |
| Income from discontinued operations                   |                  |           |                   | 3.17       |
| Net income  | <b>\$ 1.23</b>   | \$ 0.96   | <b>\$ 3.31</b>    | \$ 5.88    |
| Weighted average number of common shares outstanding: |                  |           |                   |            |
| Basic   | <b>32,779</b>    | 32,551    | <b>33,082</b>     | 31,640     |
| Diluted   | <b>35,604</b>    | 35,438    | <b>35,949</b>     | 34,525     |

*See accompanying notes*

Table of Contents

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

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30</b>       |             | <b>September 30</b>      |             |
|  | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Comprehensive income, after tax:   |                           |             |                          |             |
| Continuing operations:   |                           |             |                          |             |
| Income from continuing operations  | <b>\$43,112</b>           | \$33,368    | <b>\$116,823</b>         | \$ 91,194   |
| Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments | <b>19,411</b>             | 38,095      | <b>(8,882)</b>           | 9,063       |
| Comprehensive income, continuing operations  | <b>\$62,523</b>           | \$71,463    | <b>\$107,941</b>         | \$100,257   |
| Discontinued operations:   |                           |             |                          |             |
| Income from discontinued operations  | \$                        | \$          | \$                       | \$109,441   |
| Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments |                           |             |                          | 373         |
| Comprehensive income, discontinued operations  | \$                        | \$          | \$                       | \$109,814   |

*See accompanying notes*

**Table of Contents**

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

|   | <b>Nine Months Ended September 30</b> |                      |
|---|---------------------------------------|----------------------|
|   | <b>2007</b>                           | <b>2006</b>          |
| <b>Operating Activities</b>   |                                       |                      |
| Net income  | \$ 116,823                            | \$ 200,635           |
| Income from discontinued operations, net of tax                                     |                                       | (109,441)            |
| Depreciation and amortization   | 11,727                                | 15,225               |
| Net realized investment (gains) losses  | 1,564                                 | 1,120                |
| Net sales (purchases) of trading portfolio securities                               | 43,619                                | (47,378)             |
| Stock-based compensation  | 6,377                                 | 3,808                |
| Taxes paid related to gain on sale of discontinued operations                       |                                       | (54,565)             |
| Changes in assets and liabilities:  |                                       |                      |
| Premiums receivable   | 2,591                                 | 4,404                |
| Reserve for losses and loss adjustment expenses                                     | (10,263)                              | 138,644              |
| Unearned premiums   | (5,730)                               | (13,458)             |
| Reinsurance related assets and liabilities  | 47,687                                | 294                  |
| Other   | (7,184)                               | (4,820)              |
| <br>Net cash provided by operating activities                                       | <br><b>207,211</b>                    | <br><b>134,468</b>   |
| <b>Investing Activities</b>   |                                       |                      |
| Purchases of:   |                                       |                      |
| Fixed maturities available for sale   | (1,063,682)                           | (1,913,786)          |
| Equity securities available for sale  | (657)                                 |                      |
| Other investments   | (552)                                 |                      |
| Proceeds from sale or maturities of:  |                                       |                      |
| Fixed maturities available for sale   | 970,261                               | 1,505,036            |
| Equity securities available for sale  | 811                                   | 33,577               |
| Other investments   | 8,279                                 |                      |
| Net (increase) decrease in short-term investments                                   | (94,883)                              | (138,576)            |
| Proceeds from sale of discontinued operations, net of sales expense paid of \$4,080 |                                       | 371,038              |
| Other   | (13,925)                              | (3,665)              |
| <br>Net cash provided by (used by) investing activities                             | <br><b>(194,348)</b>                  | <br><b>(146,376)</b> |
| <b>Financing Activities</b>   |                                       |                      |
| Proceeds from options exercised   | 118                                   | 119                  |
| Treasury stock repurchased  | (41,265)                              |                      |
| Excess tax benefit from options exercised   | 1,673                                 | 851                  |
| <br>Net cash provided by (used by) financing activities                             | <br><b>(39,474)</b>                   | <br><b>970</b>       |

|  |                 |           |
|--|-----------------|-----------|
| Increase (decrease) in cash and cash equivalents | <b>(26,611)</b> | (10,938)  |
| Cash and cash equivalents at beginning of period | <b>29,146</b>   | 34,506    |
| Cash and cash equivalents at end of period       | <b>\$ 2,535</b> | \$ 23,568 |

**Significant Non-cash Transactions:**

|  |                  |           |
|--|------------------|-----------|
| Fixed maturities securities received as proceeds from sale of discontinued operations          | \$               | \$ 24,819 |
| Fixed maturity securities, available-for-sale, transferred to Other Investments, at fair value | <b>\$ 34,732</b> | \$        |
| Common stock issued in acquisition   | \$               | \$ 99,128 |

*See accompanying notes*

**Table of Contents**

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**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, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. The accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes contained in ProAssurance's December 31, 2006 report on Form 10-K.

**Reclassifications/Investment in Unconsolidated Subsidiaries**

In 2007, due to the increased significance of the amounts involved, ProAssurance has separately reported its investments in unconsolidated subsidiaries and its equity in the earnings of unconsolidated subsidiaries. Previously, investments in unconsolidated subsidiaries were included as a component of other investments and earnings of unconsolidated subsidiaries were considered as a component of net investment income. Prior period balances in this report have been reclassified to conform to the 2007 presentation. The reclassification had no effect on income from continuing operations, net income or total assets.

Investments in unconsolidated subsidiaries consist of ownership interests in non-public investment entities. ProAssurance uses the equity method of accounting for investments in entities in which its ownership interest does not require consolidation but for which ProAssurance's ownership interest is a greater than minor interest. ProAssurance includes its proportionate share of the income (losses) of its unconsolidated subsidiaries in its results of operations as a separate line item in its Consolidated Statements of Income.

**Accounting Changes**

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FAS 109, Accounting for Income Taxes* (FIN 48), to create a single model to address accounting for uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting for interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. ProAssurance adopted FIN 48 as of January 1, 2007. The cumulative effect of adopting FIN 48 increased retained earnings and reduced tax liabilities by \$2.7 million.

**Table of Contents**

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**1. Basis of Presentation (continued)**

**Recent Accounting Developments**

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements* (SFAS 157). The standard 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 require any new fair value measurements. The statement is effective for fiscal years beginning after November 15, 2007, unless early adopted. ProAssurance will adopt SFAS 157 on its effective date, and does not expect the implementation of SFAS 157 to have a material effect on its 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 allows many financial assets and liabilities and other items to be reported at fair value that are not currently measured at fair value; unrealized gains and losses on items for which the fair value has been elected would be reported in earnings at each subsequent reporting date. SFAS 159 also establishes new disclosure requirements with respect to fair values. SFAS 159 is effective for fiscal years beginning after November 15, 2007, unless early adopted. ProAssurance will adopt SFAS 159 on its effective date, but has not completed its determination of the effect, if any, of adoption on its results of operations or financial condition.

**2. Acquisitions**

ProAssurance acquired 100% of the outstanding shares of Physicians Insurance Company of Wisconsin, Inc. (PIC Wisconsin) on August 1, 2006 as a means of expanding its operations geographically. PIC Wisconsin is an insurance company that focuses on medical professional insurance; its largest premium states are Wisconsin and Iowa.

The acquisition was a stock-for-stock exchange accounted for as a purchase transaction in accordance with SFAS 141. The aggregate purchase price of \$103.7 million was allocated to the assets acquired and liabilities assumed based on their respective fair values at the date of acquisition. Goodwill of \$42.7 million was recognized equal to the excess of the purchase price over the fair values of the identifiable net assets acquired.

For additional information regarding the acquisition of PIC Wisconsin see Note 2 of the Notes to the Consolidated Financial Statements in ProAssurance's December 31, 2006 Annual Report on Form 10K.

**3. Discontinued Operations**

Effective January 1, 2006 ProAssurance sold its wholly owned subsidiaries, MEEMIC Insurance Company and MEEMIC Insurance Services (collectively, the MEEMIC Companies) to Motors Insurance Corporation, a subsidiary of GMAC Insurance Holdings, Inc., for total consideration of \$400 million before taxes and transaction expenses.

The MEEMIC Companies were the only active entities of ProAssurance's personal lines operations. In accordance with SFAS 144, results attributed to the personal lines operations are reported as discontinued operations in the Condensed Consolidated Financial Statements. In 2006, income from discontinued operations consists solely of the gain recognized on the sale of \$164.0 million net of related taxes of \$54.6 million.

For additional information regarding the sale of the MEEMIC Companies see Note 3 of the Notes to the Consolidated Financial Statements in ProAssurance's December 31, 2006 Annual Report on Form 10K.



Table of Contents

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**4. Investments**

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

|                   | <b>September 30, 2007</b> |                                       |  |                                     |
|-------------------|---------------------------|---------------------------------------|--|-------------------------------------|
|                   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>(Losses)</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|                   | <i>In thousands</i>       |                                       |  |                                     |
| Fixed maturities  | \$3,206,504               | \$16,696                              | \$(27,093)                               | \$3,196,107                         |
| Equity securities | 4,694                     | 2,827                                 | (39)                                     | 7,482                               |
|                   | <b>\$3,211,198</b>        | <b>\$19,523</b>                       | <b>\$(27,132)</b>                        | <b>\$3,203,589</b>                  |
|                   | <b>December 31, 2006</b>  |                                       |  |                                     |
|                   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>(Losses)</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|                   | <i>In thousands</i>       |                                       |  |                                     |
| Fixed maturities  | \$3,138,648               | \$22,725                              | \$(25,151)                               | \$3,136,222                         |
| Equity securities | 4,618                     | 2,602                                 |  | 7,220                               |
|                   | <b>\$3,143,266</b>        | <b>\$25,327</b>                       | <b>\$(25,151)</b>                        | <b>\$3,143,442</b>                  |

Proceeds from sales of fixed maturities and equity securities during the nine months ended September 30, 2007 and 2006 are \$789.5 million and \$1.3 billion, respectively, including proceeds from sales of adjustable rate, short-duration fixed maturities of approximately \$474.4 million and \$1.1 billion, respectively. Purchases of adjustable rate, short-duration fixed maturities approximated \$468.5 million and \$1.3 billion during the same respective periods.

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

|  | <b>Three Months Ended<br/>September 30</b> |             | <b>Nine Months Ended<br/>September 30</b> |             |
|--|--|-------------|---|-------------|
|  | <b>2007</b>                                | <b>2006</b> | <b>2007</b>                               | <b>2006</b> |
|  | <i>In thousands</i>                        |             |   |             |
| Gross realized gains                     | <b>\$1,163</b>                             | \$ 1,242    | <b>\$ 2,897</b>                           | \$ 1,995    |
| Gross realized (losses)                  | <b>(242)</b>                               | (2,030)     | <b>(502)</b>                              | (2,197)     |
| Other than temporary impairment (losses) | <b>(428)</b>                               | (372)       | <b>(4,602)</b>                            | (1,031)     |
| Trading portfolio net gains (losses)     | <b>828</b>                                 | 650         | <b>643</b>                                | 113         |
| Net realized investment gains (losses)   | <b>\$1,321</b>                             | \$ (510)    | <b>\$(1,564)</b>                          | \$(1,120)   |

In January 2007, ProAssurance transferred high yield asset backed bonds (previously considered as available-for-sale securities) having a fair value of approximately \$34.7 million to an investment fund created for the

purpose of managing such investments. ProAssurance maintains a direct beneficial interest in securities originally contributed to the fund, and the securities are included in the ProAssurance Balance Sheet as a component of other investments, at fair value (\$18.7 million at September 30, 2007, including net unrealized losses of \$5.9 million). During the nine months ended September 30, 2007 ProAssurance recognized other-than-temporary impairments of \$4.2 million related to the securities contributed to the fund.

Cash flows from the initial investment, approximately \$8.2 million to-date, are being re-invested in an undivided interest of the fund. The equity method of accounting is used to account for this undivided interest, as the investment is considered an investment in an unconsolidated subsidiary. At September 30, 2007 the carrying value of this undivided interest is \$8.4 million.

**Table of Contents**

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**5. Income Taxes**

The provision for income taxes is different from that which would be obtained by applying the statutory Federal income tax rate to income before taxes primarily because a portion of ProAssurance's investment income is tax-exempt.

ProAssurance adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. In accordance with the guidance provided in the statement, the cumulative effect of adoption, a \$2.7 million reduction in tax liabilities, was recorded as an increase to beginning retained earnings. At September 30, 2007 ProAssurance has no unrecognized tax benefits.

ProAssurance recognizes tax-related interest and penalties as components of tax expense. No significant interest or penalties were accrued or paid during the nine months ended September 30, 2007 nor was there any significant liability for such amounts at September 30, 2007.

ProAssurance files income tax returns in the U.S. federal jurisdiction and various states. With few exceptions, ProAssurance is no longer subject to examinations by authorities related to its U.S federal or state income tax filings for years before 2004.

**6. Deferred Policy Acquisition Costs**

Costs that vary with and are directly related to the production of premiums (primarily premium taxes, commissions and underwriting salaries) are deferred to the extent they are recoverable against unearned premiums and are amortized as related premiums are earned. Income from continuing operations includes amortization of deferred policy acquisition costs, net of ceding commissions earned, of \$12.8 million and \$39.6 million for the three months and nine months ended September 30, 2007, respectively. Amortization of deferred policy acquisition costs, net of ceding commissions earned was \$14.1 million and \$41.0 million for the three months and nine months ended September 30, 2006, respectively.

**7. Reserves for Losses and Loss Adjustment Expenses**

ProAssurance establishes its reserve for losses based on estimates of individual claims and actuarially determined estimates of losses based on ProAssurance's past loss experience, available industry data and projections as to future claims frequency, severity, inflationary trends and settlement patterns. Estimating reserves, and particularly medical professional liability reserves, is a complex process. Claims may be resolved over an extended period of time, often five years or more, and may be subject to litigation. Estimating losses for liability claims requires ProAssurance to make and revise judgments and assessments regarding multiple uncertainties over an extended period of time. As a result, reserve estimates may vary significantly from the eventual outcome. The assumptions used in establishing ProAssurance's reserves are regularly reviewed and updated by management as new data becomes available. Changes to estimates of previously established reserves are included in earnings in the period in which the estimate is changed.

ProAssurance recognized favorable net loss development of \$25 million related to previously established reserves for the three months ended September 30, 2007. The favorable development reflects reductions in the Company's estimates of claim severity, principally for the 2003 through 2005 accident years. ProAssurance recognized \$60.6 million of favorable development for the nine months ended September 30, 2007.

ProAssurance recognized favorable net loss development of \$11.0 million for the three months and \$23.0 million for the nine months ended September 30, 2006 to reflect reductions in estimated claim severity principally for accident years 2003 and 2004.

Table of Contents

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**8. Long-term Debt**

Outstanding long-term debt, as of September 30, 2007 and December 31, 2006, consists of the following:

|   | <b>September<br/>30<br/>2007</b> | December 31<br>2006 |
|---|----------------------------------|---------------------|
|   | <i>In thousands</i>              |                     |
| Convertible Debentures due June 2023 (the Convertible Debentures), unsecured, principal of \$107.6 million bearing a fixed interest rate of 3.9%, net of unamortized discounts of \$1.7 million at September 30, 2007 and \$1.9 million at December 31, 2006. | <b>\$105,899</b>                 | \$ 105,677          |
| Trust Preferred Subordinated Debentures (the 2034 Subordinated Debentures; the 2032 Subordinated Debentures), unsecured, bearing interest at a floating rate, adjustable quarterly.   |                                  |                     |
|   | 9/30/2007                        |                     |
| Due   | Rate                             |                     |
| December 2032   | 9.62%                            | <b>15,464</b>       |
| April 2034  | 9.41%                            | <b>13,403</b>       |
| May 2034  | 9.41%                            | <b>32,992</b>       |
| Surplus Notes due May 2034 (the Surplus Notes), unsecured, net of unamortized discount of \$0.2 million, principal of \$12.0 million bearing a fixed interest rate of 7.7%, until May 2009.   | <b>11,753</b>                    | 11,641              |
|   | <b>\$179,511</b>                 | \$ 179,177          |

Convertibility

Holders of the Convertible Debentures may convert their debentures during the following quarter if the market value of ProAssurance common stock exceeds the product of the conversion price (currently \$41.83) multiplied by 120% for 20 of the last 30 trading days of a quarter. Upon conversion, holders will receive 23.9037 shares of common stock for each \$1,000 principal amount of debentures surrendered for conversion. During the quarter ended September 30, 2007 the criterion allowing conversion was met and holders may convert through December 31, 2007. To-date, no holders have requested conversion. If converted, ProAssurance has the right to deliver, in lieu of common stock, cash or a combination of cash and common stock.

Fair Value

At September 30, 2007, the fair value of the Convertible Debentures is approximately 133% of their face value of \$107.6 million, based on recent trading activity. At September 30, 2007, the fair value of the Surplus Notes approximates 100% of their face value of \$12.0 million based on available third party valuation information. The fair value of the 2034 and 2032 Subordinated Debentures approximates the face value of the debentures.

Additional Information

For additional information regarding the terms of ProAssurance's outstanding long-term debt see Note 10 of the Notes to the Consolidated Financial Statements in ProAssurance's December 31, 2006 Annual Report on Form 10K.



**Table of Contents**

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**9. Stockholders Equity**

At September 30, 2007 ProAssurance had 100 million shares of authorized common stock and 50 million shares of authorized preferred stock. The Board of Directors has the authority to determine the provisions for the issuance of shares of the preferred stock, including the number of shares to be issued, the designations, powers, preferences and rights, and the qualifications, limitations or restrictions of such shares. At September 30, 2007, the Board of Directors had not authorized the issuance of any preferred stock nor determined any provisions for the preferred stock.

As discussed in Note 1, ProAssurance adopted FIN 48 on January 1, 2007. In accordance with the guidance provided by FIN 48, ProAssurance increased retained earnings by the cumulative effect of adoption of \$2.7 million.

In April 2007, the Board of Directors authorized \$150 million to repurchase shares or debt securities. The timing and quantity of any purchases are dependent upon market conditions and any changes in ProAssurance's capital requirements, as well as limitations imposed by applicable securities laws and regulations, and the rules of the New York Stock Exchange. As of September 30, 2007 ProAssurance had repurchased approximately 764,000 common shares at a total cost of approximately \$41.3 million. Treasury shares are reported at cost, and are reflected on the balance sheet as an unallocated reduction of total equity.

**10. Commitments and Contingencies**

As a result of the acquisition of NCRIC, ProAssurance assumed the risk of loss for a judgment entered against NCRIC on February 20, 2004 by a District of Columbia Superior Court in favor of Columbia Hospital for Women Medical Center, Inc. ( CHW ) in the amount of \$18.2 million (the CHW Judgment ). The judgment is now on appeal to the District of Columbia Court of Appeals. ProAssurance has established a liability related to the judgment of \$21.5 million, which includes the estimated costs associated with pursuing the post-trial motions or appeal of a final judgment and projected post-trial interest, \$19.5 million of which was established as a component of the fair value of assets acquired and liabilities assumed in the allocation of the NCRIC purchase price. ProAssurance has posted a \$20.5 million appellate bond to secure payment of the CHW judgment plus interest and costs, in the event the judgment is ultimately affirmed and paid.

ProAssurance is involved in various other legal actions arising primarily from claims against itself related to insurance policies and claims handling, including but not limited to claims asserted by policyholders. Such legal actions have been considered by ProAssurance in establishing its reserves. The outcome of all legal actions is not presently determinable for a number of reasons. For example, in the event that ProAssurance or its insureds receive adverse verdicts, post-trial motions may be denied, in whole or in part; any appeals that may be undertaken may be unsuccessful; ProAssurance may be unsuccessful in legal efforts to limit the scope of coverage available to its insureds, and ProAssurance may become a party to bad faith litigation over the amount of the judgment above an insured's policy limits. However, ProAssurance's management is of the opinion, based on consultation with legal counsel, that the resolution of these actions will not have a material adverse effect on ProAssurance's financial position. However, to the extent that the cost of resolving these actions exceeds the corresponding reserves, the legal actions could have a material effect on ProAssurance's results of operations for the period in which any such action is resolved.

**Table of Contents**

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**11. Earnings Per Share**

The following table provides detailed information regarding the calculation of basic and diluted earnings per share for each period presented:

|   | <b>Three Months Ended</b> |          | <b>Nine Months Ended</b> |           |
|---|---------------------------|----------|--------------------------|-----------|
|   | <b>September 30</b>       |          | <b>September 30</b>      |           |
|   | <b>2007</b>               | 2006     | <b>2007</b>              | 2006      |
| <i>In thousands, except per share data</i>                                |                           |          |                          |           |
| <i>Basic earnings per share calculation:</i>                              |                           |          |                          |           |
| <i>Numerator:</i>   |                           |          |                          |           |
| Income from continuing operations, net of tax                             | <b>\$43,112</b>           | \$33,368 | <b>\$116,823</b>         | \$ 91,194 |
| Income from discontinued operations, net of tax                           |                           |          |                          | 109,441   |
| Net income  | <b>\$43,112</b>           | \$33,368 | <b>\$116,823</b>         | \$200,635 |
| <i>Denominator:</i>   |                           |          |                          |           |
| Weighted average number of common shares outstanding                      | <b>32,779</b>             | 32,551   | <b>33,082</b>            | 31,640    |
| <i>Basic earnings per share:</i>  |                           |          |                          |           |
| Income from continuing operations   | <b>\$ 1.32</b>            | \$ 1.03  | <b>\$ 3.53</b>           | \$ 2.88   |
| Income from discontinued operations                                       |                           |          |                          | 3.46      |
| Net income  | <b>\$ 1.32</b>            | \$ 1.03  | <b>\$ 3.53</b>           | \$ 6.34   |
| <i>Diluted earnings per share calculation:</i>                            |                           |          |                          |           |
| <i>Numerator:</i>   |                           |          |                          |           |
| Income from continuing operations, net of tax                             | <b>\$43,112</b>           | \$33,368 | <b>\$116,823</b>         | \$ 91,194 |
| Effect of assumed conversion of contingently convertible debt instruments | <b>742</b>                | 742      | <b>2,226</b>             | 2,226     |
| Income from continuing operations-diluted computation                     | <b>43,854</b>             | 34,110   | <b>119,049</b>           | 93,420    |
| Income from discontinued operations, net of tax                           |                           |          |                          | 109,441   |
| Net income-diluted computation  | <b>\$43,854</b>           | \$34,110 | <b>\$119,049</b>         | \$202,861 |
| <i>Denominator:</i>   |                           |          |                          |           |
| Weighted average number of common shares outstanding                      | <b>32,779</b>             | 32,551   | <b>33,082</b>            | 31,640    |
|   | <b>253</b>                | 315      | <b>295</b>               | 313       |

|  |                |         |                |         |
|--|----------------|---------|----------------|---------|
| Assumed exercise of stock options/issuance of nonvested stock awards |                |         |                |         |
| Assumed conversion of contingently convertible debt instruments      | <b>2,572</b>   | 2,572   | <b>2,572</b>   | 2,572   |
| Diluted weighted average equivalent shares                           | <b>35,604</b>  | 35,438  | <b>35,949</b>  | 34,525  |
| <i>Diluted earnings per share:</i>                                   |                |         |                |         |
| Income from continuing operations                                    | <b>\$ 1.23</b> | \$ 0.96 | <b>\$ 3.31</b> | \$ 2.71 |
| Income from discontinued operations                                  |                |         |                | 3.17    |
| Net income   | <b>\$ 1.23</b> | \$ 0.96 | <b>\$ 3.31</b> | \$ 5.88 |

In accordance with SFAS 128 "Earnings per Share", the diluted weighted average number of shares outstanding includes an incremental adjustment for the assumed exercise of dilutive stock options. Stock options are considered dilutive stock options when the option exercise price is below the average stock price during the quarter and the assumed conversion of the options, using the treasury stock method as specified by SFAS 128, produces an increased number of outstanding shares. The average number of ProAssurance's outstanding options not considered to be dilutive during the nine-months ended September 30, 2007 and 2006 is approximately 207,000 and 201,000, respectively.



**Table of Contents**

**ProAssurance Corporation and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**September 30, 2007**

**12. Stock Options and Share-based Payments**

ProAssurance provides performance-based stock compensation to employees under the ProAssurance 2004 Equity Incentive Plan and the ProAssurance Corporation Incentive Compensation Stock Plan. Share-based compensation expense of approximately \$2.6 million and \$6.4 million with a related tax benefit of approximately \$898,000 and \$2.2 million was recognized during the three and nine months ended September 30, 2007, respectively. Share-based compensation expense of approximately \$850,000 and \$3.8 million with a related tax benefit of approximately \$250,000 and \$1.2 million was recognized during the three and nine months ended September 30, 2006, respectively.

During the nine months ended September 30, 2007 ProAssurance granted approximately 267,000 options. The estimated fair value of the options averaged \$16.75 per option. Fair values were estimated as of the date of grant, using the Black-Scholes option pricing model and the following assumptions:

|                                  | <b>2007</b> |
|----------------------------------|-------------|
| Weighted average assumptions:    |             |
| Risk-free interest rate          | <b>4.7%</b> |
| Expected volatility              | <b>0.23</b> |
| Dividend yield                   | <b>0%</b>   |
| Expected average term (in years) | <b>5</b>    |

ProAssurance also granted Performance Shares awards to employees in March 2007 under the ProAssurance 2004 Equity Incentive Plan. The awards were issued to two groups of employees: PRA executive officers and other managers. The Performance Shares vest at 100% on December 31, 2009 based upon continued service and attainment of one of two Performance Measures. For both groups one Performance Measure is achievement of a specified financial goal; the other Performance Measure requires achievement of a specified peer group ranking. The number of Performance Shares that will be awarded if vesting criteria are met can vary between approximately 54,000 shares and 90,000 shares, depending upon the degree to which Performance Measures are attained. The fair value of each Performance Share was estimated on the date of grant as \$51.48 per share, based on the market value of ProAssurance common stock on that date.

**13. Subsequent Event**

On October 15, 2007 ProAssurance announced its decision to utilize approximately \$16 million of its outstanding repurchase authorization (see Note 9) to redeem its outstanding 2032 Debentures on December 4, 2007.

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and Notes to those statements which accompany this report as well as ProAssurance's Annual Report on Form 10K for the year ended December 31, 2006, which includes a Glossary of insurance terms and phrases. Throughout the discussion, references to ProAssurance, we, us and our refers to ProAssurance Corporation and its consolidated subsidiaries. The discussion contains certain forward-looking information that involves risks and uncertainties. As discussed under Forward-Looking Statements, our actual financial condition and operating results could differ significantly from these forward-looking statements.

**Critical Accounting Estimates**

Our Condensed Consolidated Financial Statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Preparation of these financial statements requires us to make estimates and assumptions that affect the amounts we report on those statements. We evaluate these estimates and assumptions on an on-going basis based on current and historical developments, market conditions, industry trends and other information that we believe to be reasonable under the circumstances. There can be no assurance that actual results will conform to our estimates and assumptions; reported results of operations may be materially affected by changes in these estimates and assumptions.

Management considers the following accounting estimates to be critical because they involve significant judgment by management and the effect of those judgments could result in a material effect on our financial statements.

*Reserve for Losses and Loss Adjustment Expenses (reserve for losses or reserve)*

The largest component of our liabilities is our reserve for losses and the largest component of expense for our operations is incurred losses. Net losses in any period reflect our estimate of net losses incurred related to the premiums earned in that period as well as any changes to our estimates of the reserve established for net losses of prior periods.

The estimation of medical professional liability losses is inherently difficult. Ultimate loss costs, even for similar events, vary significantly depending upon many factors, including but not limited to, the nature of the injury and the personal situation of the claimant or the claimants' family, the outcome of jury trials, the judicial climate where the insured event occurred, general economic conditions and the trend of health care costs. Medical professional liability claims are typically resolved over an extended period of time, often five years or more. The combination of changing conditions and the extended time required for claim resolution results in a loss cost estimation process that requires actuarial skill and the application of judgment, and such estimates require periodic revision.

In establishing our reserve for losses and loss adjustment expenses management considers a variety of factors including historical paid and incurred loss development trends, the effect of inflation on medical care, general economic trends and the legal environment. We perform an in-depth review of our reserve for losses on a semi-annual basis. Additionally, during each reporting period we update and review the data underlying the estimation of our reserve for losses and make adjustments that we believe best reflects emerging data. Any adjustments are reflected in the then-current operations. Due to the size of our reserve for losses, even a small percentage adjustment to these estimates could have a material effect on our results of operations for the period in which the adjustment is made.

**Table of Contents**

*Reinsurance*

We use insurance and reinsurance (collectively, reinsurance ) to provide capacity to write larger limits of liability, and to stabilize underwriting results in years in which higher losses occur. The purchase of reinsurance does not relieve us from the ultimate risk on our policies, but it does provide reimbursement from the reinsurer for certain losses we pay.

We evaluate each of our ceded reinsurance contracts at inception to determine if there is sufficient risk transfer to allow the contract to be accounted for as reinsurance under current accounting guidance. At September 30, 2007 all ceded contracts are accounted for as risk transferring contracts.

Our receivable from reinsurers on unpaid losses and loss adjustment expenses represents our estimate of the amount of our reserve for losses that will be recoverable under our insurance and reinsurance programs. We base our estimation of funds recoverable upon our expectation of ultimate losses and the portion of those losses that we estimate to be allocable to reinsurers based upon the terms of our reinsurance agreements. As losses are paid, the related amount expected to be collected from reinsurers is recorded as a receivable in other assets as it no longer relates to our recorded reserves.

We estimate premiums ceded under reinsurance agreements wherein the premium due to the reinsurer, subject to certain maximums and minimums, is based on losses reimbursed or to be reimbursed under the agreement. Our estimates of the amounts due from and to reinsurers are regularly reviewed and updated by management as new data becomes available. Our assessment of the collectibility of the recorded amounts receivable from reinsurers considers the payment history of the reinsurer, publicly available financial and rating agency data, our interpretation of the underlying contracts and policies, and responses by reinsurers. Appropriate reserves are established for balances we believe may not be ultimately collected.

Given the uncertainty of the ultimate amounts of our losses, our estimates of losses and related amounts recoverable may vary significantly from the eventual outcome. Any adjustments are reflected in then-current operations. Due to the size of our reinsurance balances, even a small adjustment to these estimates could have a material effect on our results of operations for the period in which the adjustment is made.

*Investment Valuations*

We evaluate our investments on at least a quarterly basis for declines in fair value below cost for the purpose of determining whether these declines represent other than temporary declines. Some of the factors we consider in the evaluation of our investments are:

the extent to which the fair value of the investments is less than its cost basis,

the length of time for which the fair value of the investment has been less than its cost basis,

the financial condition and near-term prospects of the issuer underlying the investment, taking into consideration the economic prospects of the issuer's industry and geographical region, to the extent that information is publicly available, and

our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.

When we judge a decline in fair value below cost to be other than temporary we reduce the cost basis of the investment to fair value and realize a loss in the current period income statement for the amount of the reduction. In subsequent periods, we base any measurement of gain or loss or decline in value upon the adjusted cost basis of the investment.

*Deferred Policy Acquisition Costs*

Policy acquisition costs, primarily commissions, premium taxes and underwriting salaries, vary directly with, and are primarily related to, the acquisition of new and renewal premiums. Such costs are capitalized and charged to expense as the related premium revenue is recognized. We evaluate the recoverability of our deferred policy acquisition costs and any amounts estimated to be unrecoverable are charged to expense in the current period.



**Table of Contents****Accounting Changes**

We adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FAS 109, Accounting for Income Taxes* (FIN 48) as of its effective date, January 1, 2007. FIN 48 creates a single model to address accounting for uncertainty in tax positions and clarifies the accounting for income taxes by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting for interim periods, disclosure and transition. The cumulative effect of adopting FIN 48 increased retained earnings and reduced our tax liability by \$2.7 million.

**Recent Accounting Pronouncements and Guidance**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) 157, *Fair Value Measurements* (SFAS 157). The standard 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 require any new fair value measurements. The statement is effective for fiscal years beginning after November 15, 2007, unless early adopted. We will adopt SFAS 157 on its effective date, and do not expect the implementation of SFAS 157 to have a material effect on our results of operations or financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 allows many financial assets and liabilities and other items to be reported at fair value that are not currently measured at fair value; unrealized gains and losses on items for which the fair value option has been elected would be reported in earnings at each subsequent reporting date. SFAS 159 also establishes new disclosure requirements with respect to fair values. SFAS 159 is effective for fiscal years beginning after November 15, 2007, unless early adopted. We will adopt SFAS 159 on its effective date, but have not completed our determination of the effect of adoption on our results of operations or financial condition.

**Recent Significant Events**

Effective January 1, 2006, we sold our personal lines operations and recognized a gain on the sale of \$109.4 million after consideration of sales expenses and estimated taxes. Additional information regarding the sale is provided in Note 3, *Discontinued Operations* of the Notes to the Condensed Consolidated Financial Statements.

Effective August 1, 2006 we acquired Physicians Insurance Company of Wisconsin, Inc. (PIC Wisconsin) in an all stock merger. The acquisition of PIC Wisconsin allowed ProAssurance to expand its medical professional liability business into the state of Wisconsin and adjacent states and into Nevada. This transaction strategically expanded our geographic footprint and was in keeping with our desire to expand our professional liability operations through selective acquisitions. A more detailed description of the merger transaction is provided in Note 2 of the Notes to the Condensed Consolidated Financial Statements.

During the first quarter of 2007 we reached a confidential settlement that ended all litigation and appeals stemming from, and related to, a \$217 million judgment on a malpractice verdict against insureds of one of our subsidiaries entered in Tampa, Florida in October 2006. The effect of the settlement has been reflected in our financial statements.

On April 2, 2007 our Board authorized \$150 million to repurchase our shares or debt securities. The timing and quantity of any repurchase is dependent upon market conditions and any changes in ProAssurance's capital requirements, as well as limitations imposed by applicable securities laws and regulations, and the rules of the New York Stock Exchange. As of September 30, 2007 we have repurchased approximately 764,000 common shares at a total cost of approximately \$41.3 million. On October 15, 2007 we announced our decision to utilize \$16 million of the authorization to redeem our outstanding 2032 Subordinated Debentures on December 4, 2007.

**Table of Contents**

A. Derrill Crowe, M.D. retired as Chief Executive Officer (CEO), effective July 1, 2007 and remains as non-executive Chairman of our Board. The Board of Directors elected W. Stancil Starnes to succeed Dr. Crowe as CEO. Mr. Starnes formerly served as President, Corporate Planning and Administration, of Brasfield & Gorrie, LLC, a large commercial construction firm. Prior to October 2006, Mr. Starnes served as the Senior and Managing Partner of Starnes & Atchison, LLP, Attorneys at Law, and was extensively involved with ProAssurance and its predecessor companies in the defense of its medical liability claims.

**Reclassifications**

Due to the increasing significance of the amounts involved, we have separately stated our investments in unconsolidated subsidiaries and our equity in the earnings of unconsolidated subsidiaries. Previously, investments in unconsolidated subsidiaries were included as a component of other investments, and earnings of unconsolidated subsidiaries were considered as a component of net investment income. The reclassification had no effect on income from continuing operations, net income or total assets.

**Liquidity and Capital Resources and Financial Condition**

*Overview*

ProAssurance Corporation is a holding company and is a legal entity separate and distinct from its subsidiaries. Because it has no other business operations, dividends from its operating subsidiaries represent a significant source of funds for its obligations, including debt service. The ability of our insurance subsidiaries to pay dividends is subject to limitation by state insurance regulations. See our discussions under Regulation of Dividends and Other Payments from Our Operating Subsidiaries in Part I, and in Note 15 of our Notes to the Consolidated Financial Statements in our December 31, 2006 Form 10K for additional information regarding dividend limitations. At September 30, 2007 we held cash and investments of approximately \$233 million outside of our insurance subsidiaries that are available for use without regulatory approval.

*Cash Flows*

The principal components of our cash flow are the excess of net investment income and premiums collected over net losses paid and operating costs, including income taxes. Timing delays exist between the collection of premiums and the ultimate payment of losses. Premiums are generally collected within the twelve-month period after the policy is written while our claim payments are generally paid over a more extended period of time. Likewise timing delays exist between the payment of claims and the collection of reinsurance recoveries.

Our operating activities provided positive cash flows of approximately \$207.2 million during the nine months ended September 30, 2007, which is composed of \$163.6 million from routine insurance operations and proceeds of \$43.6 million related to the sale of trading securities. In 2006, cash provided by operating activities of \$134.5 million is composed of net positive cash flows from routine insurance operations of \$236.4 million, offset by tax payments related to the sale of our personal lines operations of approximately \$54.6 million and purchases of trading securities of approximately \$47.4 million.

Exclusive of cash flows related to trading securities and the taxes paid on the MEEMIC transaction, the decline in operating cash flows during 2007 is principally attributable to an increase in payments for losses and loss adjustment expenses (gross loss payments), net of reinsurance reimbursements received (net loss payments). A number of factors influenced the growth in losses paid, including the maturing of the loss reserves established during the last several years of growth, and an increase in the number of large indemnity payments.

Two metrics commonly used to analyze the operating cash flows of insurance companies are the paid-to-incurred ratio and the paid loss ratio.

**Table of Contents**

|                           | <b>Three Months Ended<br/>September 30</b> |       | <b>Nine Months Ended<br/>September 30</b> |       |
|---------------------------|--|-------|---|-------|
|                           | <b>2007</b>                                | 2006  | <b>2007</b>                               | 2006  |
| Paid-to-incurred ratio(1) | <b>98.2%</b>                               | 59.7% | <b>94.5%</b>                              | 60.0% |
| Paid loss ratio(2)        | <b>63.8%</b>                               | 45.5% | <b>66.7%</b>                              | 45.9% |

(1) Net loss payments divided by net losses and loss adjustment expenses

(2) Net loss payments divided by net earned premiums

Our paid-to-incurred and paid loss ratios are higher in 2007 than in 2006, primarily due to the 2007 increase in net loss payments. The ratios also increased in 2007 because the denominators of each ratio (net losses and loss adjustment expenses for the paid-to-incurred ratio; net earned premiums for the paid loss ratio) decreased in 2007 as compared to 2006. For a long-tailed business such as ProAssurance, the ratios for a short period of time should not be viewed in isolation. And, the ratios are less meaningful in periods of changing volume or in periods in which we have recorded amounts related to prior accident years.

The timing of our indemnity payments are affected by many factors, including the nature of the claims in process in any one period and the speed at which cases work through the trial and appellate process. The contractual obligations table included in our December 31, 2006 Form 10K included a projected pay out schedule for our December 31, 2006 reserves. In that table, which was largely based on historical payment patterns, we projected gross loss payments of approximately \$546 million during 2007. To-date in 2007, our gross loss payments total approximately \$349 million, which, when annualized, is consistent with the amount estimated for purposes of the table.

Cash flows in 2007 were also reduced due to a decline in premium receipts. These decreases to operating cash flows were partially offset by growth in cash flows from investment earnings, a reduction in premium payments to our reinsurers and lower federal tax payments.

**Investments**

We manage our investments to ensure that we will have sufficient liquidity to meet our obligations, taking into consideration the timing of cash flows from our investments as well as the expected cash flows to be generated by our operations. At our insurance subsidiaries the primary outflow of cash is related to the payment of claims and expenses. The payment of individual claims cannot be predicted with certainty; therefore, we rely upon the history of paid claims in estimating the timing of future claims payments. To the extent that we have an unanticipated shortfall in cash we may either liquidate securities or borrow funds under previously established borrowing arrangements. However, given the relatively short duration of our investments, we do not foresee any such shortfall.

We held cash and short-term securities of \$281.7 million at September 30, 2007 as compared to \$213.4 million at December 31, 2006. Since December 31, 2006 we have chosen to hold more funds in our short-term portfolio both as a means of managing the duration of our overall investment portfolio, and as a means of increasing our flexibility in a volatile marketplace.

During the third quarter of 2007 we sold the securities held in our fixed maturities trading portfolio (primarily treasury indexed) because we believed active trading of these securities no longer offered superior returns.

Other investments increased from \$39.5 million at December 31, 2006 to \$58.4 million at September 30, 2007. In January 2007 we contributed high-yield asset-backed bonds from our available-for-sale investment portfolio to a fund created for the purpose of managing such investments. We maintain a direct beneficial interest in securities originally contributed to the fund, which are included in our Balance Sheet as a component of other investments at fair value (\$18.7 million at September 30, 2007). Cash flows from our initial investment in the fund, which approximate \$8.2 million to-date at September 30, 2007, are being re-invested in an undivided interest of the fund. The undivided interest is considered as an investment in an unconsolidated subsidiary and is accounted for using the equity method.

As of September 30, 2007 our available-for-sale fixed maturity securities of \$3.20 billion comprise 88% of our total investments. The approximate \$60 million net increase as compared to our December 31, 2006 holdings reflects

the investment of operating cash flows, offset by a decline in fair value attributable to higher interest rates (as discussed below).



**Table of Contents**

Substantially all of our fixed maturities are either United States government agency obligations or investment grade securities as determined by national rating agencies. Our available-for-sale fixed maturities have a dollar weighted average rating of AA+ at September 30, 2007. The weighted average effective duration of our fixed maturity securities at September 30, 2007 is 4.24 years; the weighted average effective duration of our fixed maturity securities and our short-term securities combined is 3.92 years.

Changes in market interest rate levels generally affect our net income to the extent that reinvestment yields are different than the yields on maturing securities. Changes in market interest rates also affect the fair value of our fixed maturity securities. On a pre-tax basis, at September 30, 2007 our available-for-sale fixed maturity securities had net unrealized losses of approximately \$10.4 million with gross unrealized losses totaling \$27.1 million and gross unrealized gains of \$16.7 million. At December 31, 2006, on a pre-tax basis, our available-for-sale fixed maturity securities had net unrealized losses of approximately \$2.5 million with unrealized losses totaling \$25.2 million and unrealized gains totaling \$22.7 million. Almost all of the unrealized loss positions in our portfolio are interest-rate related. Due to the duration of our overall portfolio and our positive operating cash flows, we believe we have the ability and intent to hold these bonds to recovery of book value or maturity and do not consider the declines in value to be other than temporary. For a discussion of the potential effects that future changes in interest rates may have on our investment portfolio see Item 3, Quantitative and Qualitative Disclosures about Market Risk.

Equity investments represent less than 1% of our total investments and less than 2% of our capital at both September 30, 2007 and December 31, 2006. At September 30, 2007, the carrying value of our equity investments (including equities in our available-for-sale and trading portfolios) totaled \$21.4 million as compared to \$14.9 million at December 31, 2006.

*Reinsurance*

At September 30, 2007 our reinsurance recoverable on unpaid losses is \$344.7 million. Our receivable from reinsurers on paid losses, which is classified as a part of other assets, is \$42.1 million.

We purchase reinsurance from a number of companies to mitigate concentrations of credit risk. Our reinsurance broker assists us in the analysis of the credit quality of our reinsurers. We base our reinsurance buying decisions on an evaluation of the then-current financial strength, rating and stability of prospective reinsurers. However, the financial strength of our reinsurers, and their corresponding ability to pay us, may change in the future due to forces or events we cannot control or anticipate.

We have not experienced significant difficulties in collecting amounts due from reinsurers due to the financial condition of the reinsurer. Periodically, reinsurers may dispute our claim for reimbursement from them. We have established appropriate reserves for any balances that we believe may not be ultimately collected. Should future events lead us to believe that any reinsurer will not meet its obligations to us, adjustments to the amounts recoverable would be reflected in the results of current operations. Such an adjustment has the potential to be significant to the results of operations in the period in which it is recorded, however, we would not expect such an adjustment to have a material effect on our capital position or our liquidity.

Periodically, we reach commutation agreements with our reinsurers wherein we agree to terminate an existing reinsurance contract(s) for a specified final settlement. Premiums ceded and reinsurance recoveries are adjusted in the current period as necessary to reflect the amounts specified in the commutation agreement.

During the third quarter of 2007, we commuted all of our outstanding reinsurance arrangements with Alea London Limited for approximately \$2.0 million in cash. The transaction decreased premiums ceded for the quarter by approximately \$1.9 million and decreased reinsurance recoveries by approximately \$0.4 million.

**Table of Contents***Debt*

Our long-term debt at September 30, 2007 is comprised of the following.

|                              | Rate                  | <i>in thousands, except %</i> |                | First           |
|------------------------------|-----------------------|-------------------------------|----------------|-----------------|
|                              |                       | 2007                          |                | Redemption Date |
| Convertible Debentures       | 3.9%, fixed           | \$                            | <b>105,899</b> | July 2008       |
| 2034 Subordinated Debentures | 9.4%, Libor adjusted  |                               | <b>46,395</b>  | May 2009        |
| 2032 Subordinated Debentures | 9.6%, Libor adjusted  |                               | <b>15,464</b>  | December 2007   |
|                              | 7.7%, fixed until May |                               |                | May 2009*       |
| 2034 Surplus Notes           | 2009                  |                               | <b>11,753</b>  |                 |
|                              |                       | \$                            | <b>179,511</b> |                 |

\* *Subject to approval by the Wisconsin Commissioner of Insurance*

Our Convertible Debentures may be converted at the option of holders when the price of our common stock exceeds a specified price during 20 of the last 30 days of any quarter. Upon conversion, holders will receive 23.9037 shares of common stock for each \$1,000 principal amount of debentures surrendered for conversion. The criterion allowing conversion was met during the quarter ended September 30, 2007 and holders may convert through December 31, 2007. To-date, no holders have requested conversion. If converted, we have the right to deliver cash or a combination of cash and common stock, in lieu of common stock.

We intend to redeem the 2032 Subordinated Debentures in December, 2007.

A more detailed description of our debt is provided in Note 8 of the Notes to the Condensed Consolidated Financial Statements.

*Litigation*

We are involved in various legal actions arising primarily from claims against us related to insurance policies and claims handling, including, but not limited to, claims asserted by our policyholders. Legal actions are generally divided into two categories: Legal actions dealing with claims and claim-related actions which we consider in our evaluation of our reserve for losses and legal actions falling outside of these areas which we evaluate and reserve for separately as a part of our Other Liabilities.

Claim-related actions are considered as a part of our reserving process under the guidance provided by SFAS 60 *Accounting and Reporting by Insurance Enterprises*. We evaluate the likely outcomes from these actions giving consideration to the facts and laws applicable to each case, appellate issues, coverage issues, potential recoveries from our insurance and reinsurance programs, and settlement discussions as well as our historical claims resolution practices. This data is then given consideration in the overall evaluation of our reserve for losses.

For non-claim-related actions we evaluate each case separately and establish what we believe is an appropriate reserve under the guidance provided by SFAS 5 *Accounting for Contingencies*. As a result of the acquisition of NCRIC, ProAssurance assumed the risk of loss for a judgment entered against NCRIC on February 20, 2004 by a District of Columbia Superior Court in favor of Columbia Hospital for Women Medical Center, Inc. (CHW) in the amount of \$18.2 million (the CHW judgment). The CHW judgment is now on appeal to the District of Columbia Court of Appeals. ProAssurance has established a liability for this judgment of \$21.5 million, which includes the estimated costs associated with pursuing the post-trial motions or appeal of a final judgment and projected post-trial interest, \$19.5 million of which was established as a component of the fair value of assets acquired and liabilities assumed in the allocation of the NCRIC purchase price.

There are risks, as outlined in our Risk Factors, that individual actions could cost us more than our estimates. In particular, we or our insureds may receive adverse verdicts; post-trial motions may be denied, in whole or in part; any appeals that may be undertaken may be unsuccessful; we may be unsuccessful in our legal efforts to limit the scope of coverage available to insureds; and we may become a party to bad faith litigation over the settlement of a claim. To the extent that the cost of resolving these actions exceeds our estimates, the legal actions could have a material effect on ProAssurance's results of operations in the period in which any such action is resolved.

**Table of Contents**

**Overview of Results-Three and Nine Months Ended September 30, 2007 and 2006**

Income from continuing operations increased to \$43.1 million and \$116.8 million for the three- and nine-month periods ended September 30, 2007, respectively, from \$33.4 million and \$91.2 million for the same periods in 2006; an increase of 29% for the three-month period and 28% for the nine-month period. Income from continuing operations per diluted share increased to \$1.23 from \$0.96 for the comparative three-month periods and to \$3.31 from \$2.71 for the comparative nine-month periods.

Both the quarter and nine month periods reflect the benefit of an increased amount of favorable development. We recognized favorable development in 2007 of \$25.0 million during the third quarter and \$60.6 million during the year-to-date period as compared to \$11.0 million and \$23.0 million during the quarter and year-to-date periods, respectively, in 2006.

Net investment income increased in 2007 by \$2.4 million for the quarter and by \$21.2 million for the year-to-date period due to growth in our invested funds and improved yields.

Market conditions remain very competitive. Despite additional net earned premiums contributed by PIC Wisconsin (see below), premiums declined overall during 2007 by \$13.9 million for the comparative three-month periods and \$23.9 million for the comparative nine-month periods.

We acquired PIC Wisconsin effective August 1, 2006. Operating results for all periods in 2007 include the results of PIC Wisconsin while our results for the three- and nine-month periods ended September 30, 2006 only include PIC Wisconsin's operating results for the two month period subsequent to the date of acquisition.

**Table of Contents****Results of Operations-Three and Nine Months Ended September 30, 2007 Compared to Three and Nine Months Ended September 30, 2006**

Selected consolidated financial data for each period is summarized in the table below.

|   | <i>\$ in thousands</i>             |           |            |                                   |           |             |
|---|------------------------------------|-----------|------------|-----------------------------------|-----------|-------------|
|   | Three Months Ended<br>September 30 |           |            | Nine Months Ended<br>September 30 |           |             |
|   | 2007                               | 2006      | Change     | 2007                              | 2006      | Change      |
| Revenues:   |                                    |           |            |                                   |           |             |
| Gross premiums written                            | <b>\$149,138</b>                   | \$163,273 | \$(14,135) | <b>\$440,186</b>                  | \$452,264 | \$ (12,078) |
| Net premiums written                              | <b>\$139,483</b>                   | \$152,043 | \$(12,560) | <b>\$401,809</b>                  | \$421,004 | \$ (19,195) |
| Premiums earned                                   | <b>\$147,130</b>                   | \$163,043 | \$(15,913) | <b>\$446,437</b>                  | \$465,932 | \$ (19,495) |
| Premiums ceded                                    | <b>(11,622)</b>                    | (13,599)  | 1,977      | <b>(41,089)</b>                   | (36,637)  | (4,452)     |
| Net premiums earned                               | <b>135,508</b>                     | 149,444   | (13,936)   | <b>405,348</b>                    | 429,295   | (23,947)    |
| Net investment income                             | <b>41,075</b>                      | 38,699    | 2,376      | <b>128,194</b>                    | 107,012   | 21,182      |
| Equity in earnings of unconsolidated subsidiaries | <b>(589)</b>                       | (76)      | (513)      | <b>1,241</b>                      | 1,610     | (369)       |
| Net realized investment gains (losses)            | <b>1,321</b>                       | (510)     | 1,831      | <b>(1,564)</b>                    | (1,120)   | (444)       |
| Other income                                      | <b>1,302</b>                       | 1,688     | (386)      | <b>4,409</b>                      | 4,431     | (22)        |
| Total revenues                                    | <b>178,617</b>                     | 189,245   | (10,628)   | <b>537,628</b>                    | 541,228   | (3,600)     |
| Expenses:   |                                    |           |            |                                   |           |             |
| Losses and loss adjustment expenses               | <b>99,142</b>                      | 124,165   | (25,023)   | <b>338,793</b>                    | 358,972   | (20,179)    |
| Reinsurance recoveries                            | <b>(11,034)</b>                    | (10,128)  | (906)      | <b>(52,844)</b>                   | (30,693)  | (22,151)    |
| Net losses and loss adjustment expenses           | <b>88,108</b>                      | 114,037   | (25,929)   | <b>285,949</b>                    | 328,279   | (42,330)    |
| Underwriting, acquisition and insurance expenses  | <b>27,439</b>                      | 25,859    | 1,580      | <b>79,913</b>                     | 78,226    | 1,687       |
| Interest expense                                  | <b>3,006</b>                       | 2,886     | 120        | <b>8,950</b>                      | 8,074     | 876         |

Edgar Filing: PROASSURANCE CORP - Form 10-Q

|   |                  |           |          |                   |            |             |
|---|------------------|-----------|----------|-------------------|------------|-------------|
| Total expenses  | <b>118,553</b>   | 142,782   | (24,229) | <b>374,812</b>    | 414,579    | (39,767)    |
| Income from continuing operations before income taxes | <b>60,064</b>    | 46,463    | 13,601   | <b>162,816</b>    | 126,649    | 36,167      |
| Income taxes  | <b>16,952</b>    | 13,095    | 3,857    | <b>45,993</b>     | 35,455     | 10,538      |
| Income from continuing operations                     | <b>43,112</b>    | 33,368    | 9,744    | <b>116,823</b>    | 91,194     | 25,629      |
| Income from discontinued operations, net of tax       |                  |           |          |                   | 109,441    | (109,441)   |
| Net income  | <b>\$ 43,112</b> | \$ 33,368 | \$ 9,744 | <b>\$ 116,823</b> | \$ 200,635 | \$ (83,812) |
| Continuing Operations:                                |                  |           |          |                   |            |             |
| Net loss ratio  | <b>65.0%</b>     | 76.3%     | (11.3)   | <b>70.5%</b>      | 76.5%      | (6.0)       |
| Underwriting expense ratio                            | <b>20.2%</b>     | 17.3%     | 2.9      | <b>19.7%</b>      | 18.2%      | 1.5         |
| Combined ratio  | <b>85.2%</b>     | 93.6%     | (8.4)    | <b>90.2%</b>      | 94.7%      | (4.5)       |
| Operating ratio                                       | <b>54.9%</b>     | 67.7%     | (12.8)   | <b>58.6%</b>      | 69.8%      | (11.2)      |
| Return on equity*                                     | <b>14.7%</b>     | 13.4%     | 1.3      | <b>13.4%</b>      | 13.2%      | 0.2         |

\* Annualized

Table of ContentsPremiums

|                        | <i>\$ in thousands</i>             |           |            |                                   |                  |           |            |      |
|------------------------|------------------------------------|-----------|------------|-----------------------------------|------------------|-----------|------------|------|
|                        | Three Months Ended<br>September 30 |           |            | Nine Months Ended<br>September 30 |                  |           |            |      |
|                        | 2007                               | 2006      | Change     | 2007                              | 2006             | Change    |            |      |
| Gross premiums written | <b>\$149,138</b>                   | \$163,273 | \$(14,135) | (9%)                              | <b>\$440,186</b> | \$452,264 | \$(12,078) | (3%) |
| Premiums earned        | <b>\$147,130</b>                   | \$163,043 | \$(15,913) | (10%)                             | <b>\$446,437</b> | \$465,932 | \$(19,495) | (4%) |
| Premiums ceded         | <b>(11,622)</b>                    | (13,599)  | 1,977      | (15%)                             | <b>(41,089)</b>  | (36,637)  | (4,452)    | 12%  |
| Net premiums earned    | <b>\$135,508</b>                   | \$149,444 | \$(13,936) | (9%)                              | <b>\$405,348</b> | \$429,295 | \$(23,947) | (6%) |

*Gross Premiums Written*

Premiums written declined during 2007 as compared to 2006 due to the effects of increased competition and rate reductions. Additional premiums from the acquisition of PIC Wisconsin partially offset the reduction in premium in our existing book of business. (The operations of PIC Wisconsin are included for nine months in 2007 versus August and September in 2006.) In periods of market softening, our strategy is to maintain our underwriting and pricing discipline and grow through selective acquisitions.

We face strong price-based competition in virtually all of our markets, with some competitors offering coverage at rates that we do not believe to be profitable on a long-term basis. Additionally, a number of physicians and hospitals are seeking to lower their costs through the use of alternative risk transfer approaches such as self insurance and risk sharing pools, although these alternatives become less attractive as prices soften in the traditional insurance markets.

Our ongoing commitment to adequate rates and strong underwriting standards limits our ability to write new business and to renew existing business in the face of this price-based competition. Improvements in loss cost trends have allowed us to reduce rates in certain markets in 2007 and to offer targeted new business and renewal retention programs in selected markets. While this improves retention of business, it decreases our average premium rates. The combined effects of lower rates and the challenges of writing new business are expected to cause our gross written premiums to continue to decline throughout the remainder of 2007 and into 2008.

Physician premiums represent 85% and 86% of gross written premiums for the nine-month periods ended September 30, 2007 and 2006, respectively. Comparatively, physician premiums have declined by approximately 11% for the third quarter and by approximately 4% during the year-to-date periods ended September 30, 2007.

|                              | <i>in thousands</i>                |           |            |                                   |           |            |
|------------------------------|------------------------------------|-----------|------------|-----------------------------------|-----------|------------|
|                              | Three Months Ended<br>September 30 |           |            | Nine Months Ended<br>September 30 |           |            |
|                              | 2007                               | 2006      | Change     | 2007                              | 2006      | Change     |
| <b>Physician Premiums*</b>   |                                    |           |            |                                   |           |            |
| PRA pre-acquisition business | <b>\$112,201</b>                   | \$133,186 | \$(20,985) | <b>\$326,173</b>                  | \$381,737 | \$(55,564) |

|                           |                  |           |            |                  |           |            |
|---------------------------|------------------|-----------|------------|------------------|-----------|------------|
| PIC Wisconsin acquisition | <b>12,390</b>    | 6,556     | 5,834      | <b>47,674</b>    | 6,556     | 41,118     |
|                           | <b>\$124,591</b> | \$139,742 | \$(15,151) | <b>\$373,847</b> | \$388,293 | \$(14,446) |

\* Exclusive of tail premiums



**Table of Contents**

Our overall retention rate (exclusive of PIC Wisconsin and excess and surplus lines business) based on the number of physician risks that renew with us is approximately 86% in both the three- and nine-month periods ended September 30, 2007, as compared to 80% and 84% for the three- and nine-month periods ended September 30, 2006, respectively. Our charged rates for physicians that renewed during 2007 reflect a decrease of approximately 1% for the first nine months of 2007, a decrease of approximately 2.9% for the third quarter, and a decrease of approximately 4.5% for the month of September (on a weighted average basis). Charged rates include the effects of filed rates, surcharges and discounts.

Premiums written for non-physician coverages represent approximately 11% of our total gross written premiums for the nine-month periods ended September 30, 2007 (9% for the same period in 2006), and include premiums attributable to the PIC Wisconsin acquisition as follows:

|  | <i>In thousands</i>       |                     |                  |                          |                     |                  |
|--|---------------------------|---------------------|------------------|--------------------------|---------------------|------------------|
|  | <b>Three Months Ended</b> |                     |                  | <b>Nine Months Ended</b> |                     |                  |
|  | <b>2007</b>               | <b>September 30</b> | <i>Change</i>    | <b>2007</b>              | <b>September 30</b> | <i>Change</i>    |
|  | <b>2006</b>               |                     | <b>2006</b>      |                          |                     |                  |
| <b>Non-physician Premiums*</b>                                       |                           |                     |                  |                          |                     |                  |
| Hospital coverages:<br>PRA pre-acquisition<br>business               | <b>\$ 4,353</b>           | \$ 5,452            | <i>\$(1,099)</i> | <b>\$15,836</b>          | \$19,701            | <i>\$(3,865)</i> |
| PIC Wisconsin<br>acquisition   | <b>3,232</b>              | 1,928               | <i>1,304</i>     | <b>8,705</b>             | 1,928               | <i>6,777</i>     |
|  | <b>7,585</b>              | 7,380               | <i>205</i>       | <b>24,541</b>            | 21,629              | <i>2,912</i>     |
| Other non-physician<br>coverages:<br>PRA pre-acquisition<br>business | <b>7,709</b>              | 7,683               | <i>26</i>        | <b>19,561</b>            | 19,068              | <i>493</i>       |
| PIC Wisconsin<br>acquisition   | <b>1,141</b>              | 731                 | <i>410</i>       | <b>2,462</b>             | 731                 | <i>1,731</i>     |
|  | <b>8,850</b>              | 8,414               | <i>436</i>       | <b>22,023</b>            | 19,799              | <i>2,224</i>     |
|  | <b>\$16,435</b>           | \$15,794            | <i>\$ 641</i>    | <b>\$46,564</b>          | \$41,428            | <i>\$ 5,136</i>  |

\* Exclusive of tail premiums

Hospital and facility coverages are the most significant component of non-physician premiums, representing approximately 50% of non-physician premiums on a year-to-date basis in both 2007 and 2006. Other non-physician coverages consists primarily of professional liability coverages provided to lawyers and to health care professionals such as dentists and nurses.

We are required to offer extended reporting endorsement or tail policies to insureds that are discontinuing their claims-made coverage with us, but we do not market such coverages separately. The amount of tail premium written and earned can vary widely from period to period. Because of this volatility, we separate premiums associated with tail coverages from our other premiums. In 2007, tail premiums totaled \$8.1 million during the three-month period and \$19.8 million during the nine-month period (5% and 4% of gross written premiums, respectively), increasing by \$376,000 and declining by \$2.8 million when compared to the same respective periods in 2006.

**Table of Contents***Premiums Earned*

Because premiums are generally earned pro rata over the entire policy period, fluctuations in premiums earned tend to lag those of premiums written. Our policies generally carry a term of one year. Premiums earned for the three and nine months ended September 30, 2007, as compared to the same periods in 2006 reflect changes in written premiums that have occurred during 2006 and 2007, on a pro rata basis. Tail premiums are 100% earned in the period written because the policies insure only incidents that occurred in prior periods and are not cancellable.

|                              | <i>In thousands</i>       |           |               |                          |           |               |
|------------------------------|---------------------------|-----------|---------------|--------------------------|-----------|---------------|
|                              | <b>Three Months Ended</b> |           |               | <b>Nine Months Ended</b> |           |               |
|                              | <b>2007</b>               | 2006      | <i>Change</i> | <b>2007</b>              | 2006      | <i>Change</i> |
| Premiums Earned              |                           |           |               |                          |           |               |
| PRA pre-acquisition business | <b>\$127,306</b>          | \$149,351 | \$(22,045)    | <b>\$386,732</b>         | \$452,240 | \$(65,508)    |
| PIC Wisconsin acquisition    | <b>19,824</b>             | 13,692    | 6,132         | <b>59,705</b>            | 13,692    | 46,013        |
|                              | <b>\$147,130</b>          | \$163,043 | \$(15,913)    | <b>\$446,437</b>         | \$465,932 | \$(19,495)    |

As discussed under Gross Premiums Written, our premium growth has declined for the first nine months of 2007 and is likely to continue to decrease during the remainder of 2007.

In the twelve months that follow the acquisition of an insurance subsidiary, our premiums earned include premiums related to the subsidiary's unexpired policies on the date of acquisition (unearned premium). Such premiums are earned over the remaining term of the associated policy. In 2007, earned premium includes approximately \$72,000 and \$10.1 million for the three- and nine-month periods related to the unexpired policies acquired in the PIC Wisconsin transaction. In 2006, earned premium includes approximately \$11.8 million and \$21.8 million for the three- and nine-month periods, respectively, related to unexpired policies acquired in the PIC Wisconsin and NCRIC transactions.

*Premiums Ceded*

Premiums ceded represent the portion of earned premiums that we pay our reinsurers for their assumption of a portion of our losses. The premium that we cede to our reinsurers is determined, in part, by the loss experience (subject to minimums and maximums) of the business ceded to them. It takes a number of years before all losses are known, and in the intervening period premiums due to the reinsurer are estimated. Ceded premium estimates are revised as loss estimates are revised.

In the third quarter of 2007, we reduced premiums ceded by approximately \$1.9 million due to the commutation of certain reinsurance arrangements. In the second quarter of 2007 we increased premiums ceded by approximately \$2.6 million due to revisions to our estimates of the losses allocable to certain prior accident year reinsurance treaties. A commutation adjustment was also recorded in the first quarter of 2006 which reduced 2006 premiums ceded by approximately \$2.7 million.

Exclusive of the amounts in the preceding paragraphs, our reinsurance expense ratio (ceded premiums as a percentage of premiums earned) is 9.2% and 9.0% for the three and nine months ended September 30, 2007, as compared to 8.3% and 8.4% for the same periods in 2006. Most of the increase in the ratio in 2007 is because earned premium declines have been concentrated in our retained layers of coverage rather than in our ceded layers. Thus, the proportion of ceded premiums to premiums earned has increased.

Table of ContentsLosses and Loss Adjustment Expenses

The determination of calendar year losses involves the actuarial evaluation of incurred losses for the current accident year and the actuarial re-evaluation of incurred losses for prior accident years, including the reserve amounts required for losses in excess of policy limits.

Accident year refers to the accounting period in which the insured event becomes a liability of the insurer. For occurrence policies the insured event becomes a liability when the event takes place; for claims-made policies the insured event generally becomes a liability when the event is first reported to the insurer. We believe that measuring losses on an accident year basis is the most indicative measure of the underlying profitability of the premiums earned in that period since it associates policy premiums earned with our estimate of the losses incurred related to those policy premiums. Calendar year results include the operating results for the current accident year and any changes in estimates related to prior accident years.

The following table summarizes net losses and net loss ratios for the three and nine months ended September 30, 2007 and 2006 by separating losses between the current accident year and all prior accident years.

|                       | <i>In millions</i>        |         |                 |                     |         |                 |
|-----------------------|---------------------------|---------|-----------------|---------------------|---------|-----------------|
|                       | <b>Three Months Ended</b> |         |                 | <b>Net Losses</b>   |         |                 |
|                       | <b>September 30</b>       |         |                 | <b>September 30</b> |         |                 |
|                       | <b>2007</b>               | 2006    | <i>Change</i>   | <b>2007</b>         | 2006    | <i>Change</i>   |
| Current accident year | <b>\$113.1</b>            | \$125.0 | <i>\$(11.9)</i> | <b>\$346.5</b>      | \$351.3 | <i>\$ (4.8)</i> |
| Prior accident years  | <b>(25.0)</b>             | (11.0)  | <i>(14.0)</i>   | <b>(60.6)</b>       | (23.0)  | <i>(37.6)</i>   |
| Calendar year         | <b>\$ 88.1</b>            | \$114.0 | <i>\$(25.9)</i> | <b>\$285.9</b>      | \$328.3 | <i>\$(42.4)</i> |

|                       | <b>Net Loss Ratios*</b>   |        |               |                         |        |               |
|-----------------------|---------------------------|--------|---------------|-------------------------|--------|---------------|
|                       | <b>Three Months Ended</b> |        |               | <b>Net Loss Ratios*</b> |        |               |
|                       | <b>September 30</b>       |        |               | <b>September 30</b>     |        |               |
|                       | <b>2007</b>               | 2006   | <i>Change</i> | <b>2007</b>             | 2006   | <i>Change</i> |
| Current accident year | <b>83.5%</b>              | 83.7%  | <i>(0.2)</i>  | <b>85.5%</b>            | 81.8%  | <i>3.7</i>    |
| Prior accident years  | <b>(18.5%)</b>            | (7.4%) | <i>(11.1)</i> | <b>(15.0%)</b>          | (5.3%) | <i>(9.7)</i>  |
| Calendar year         | <b>65.0%</b>              | 76.3%  | <i>(11.3)</i> | <b>70.5%</b>            | 76.5%  | <i>(6.0)</i>  |

\* *Net losses as specified divided by net premiums earned.*

Current accident year net losses increased by approximately \$4.4 million and \$39.0 million for the three and nine month periods of 2007 due to the acquisition of PIC Wisconsin. PIC Wisconsin is included in our results for nine months in 2007 versus only August and September in 2006.

Our current accident year loss ratio for the nine-month period has increased in 2007 as compared to 2006 because the mix of premiums earned in 2007 was more heavily weighted to states, particularly the states in which PIC Wisconsin operates, where higher initial loss ratios are expected. The 2007 ratio also reflects an increase due to additional current accident year losses recognized in the first quarter of 2007 with regard to losses in excess of policy

limits.

We recognized favorable loss development of approximately \$25.0 million during the three-month period ended September 30, 2007 related to our previously established (prior accident year) reserves. The favorable development primarily resulted from reductions to our estimates of claim severity, principally for the 2003 through 2005 accident years. We recognized favorable development of \$60.6 million for the nine months ended September 30, 2007.

During the three and nine months ended September 30, 2006 we recognized favorable development of \$11.0 million and \$23.0 million, respectively, related to our previously established (prior accident year) reserves, primarily to reflect reductions in our estimates of claim severity, within our retained layer of risk, principally for the 2003 and 2004 accident years.

**Table of Contents**

Assumptions used in establishing our reserve are regularly reviewed and updated by management as new data becomes available. Any adjustments necessary are reflected in then current operations. Due to the size of our reserve, even a small percentage adjustment to the assumptions can have a material effect on our results of operations for the period in which the change is made.

**Net Investment Income, Net Realized Investment Gains (Losses); Equity (Loss) in Earnings of Unconsolidated Subsidiaries**

|                       | <i>\$ in thousands</i>    |             |               |                          |                  |               |          |     |
|-----------------------|---------------------------|-------------|---------------|--------------------------|------------------|---------------|----------|-----|
|                       | <b>Three Months Ended</b> |             |               | <b>Nine Months Ended</b> |                  |               |          |     |
|                       | <b>September 30</b>       |             |               | <b>September 30</b>      |                  |               |          |     |
|                       | <b>2007</b>               | <b>2006</b> | <i>Change</i> | <b>2007</b>              | <b>2006</b>      | <i>Change</i> |          |     |
| Net investment income | <b>\$41,075</b>           | \$38,699    | \$2,376       | 6%                       | <b>\$128,194</b> | \$107,012     | \$21,182 | 20% |

Net investment income is primarily derived from the interest income earned by our fixed maturity securities and also includes interest income from short-term, trading portfolio and cash equivalent investments, dividend income from equity securities, earnings from other investments and increases in the cash surrender value of business owned executive life insurance contracts. Investment fees and expenses are deducted from investment income.

The 2007 increase in net investment income is due to several factors, the most significant being higher average invested funds. Positive cash flows from our insurance operations and the PIC Wisconsin merger significantly increased average invested funds during 2007 as compared to 2006.

Improved yields have also contributed to the growth of our net investment income. Market interest rates of the past several years have allowed us to consistently invest new and matured funds at rates that exceed the average held in our portfolio. Average yields for our available-for-sale fixed maturity securities during 2007 and 2006 are as follows:

|                                     | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                     | <b>September 30</b>       |             | <b>September 30</b>      |             |
|                                     | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Average income yield                | <b>4.6%</b>               | 4.5%        | <b>4.6%</b>              | 4.4%        |
| Average tax equivalent income yield | <b>5.4%</b>               | 5.2%        | <b>5.3%</b>              | 5.1%        |

Net investment income by investment category is as follows:

|                               | <i>In thousands</i>       |             |                          |             |
|-------------------------------|---------------------------|-------------|--------------------------|-------------|
|                               | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|                               | <b>September 30</b>       |             | <b>September 30</b>      |             |
|                               | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Fixed maturities              | <b>\$36,970</b>           | \$35,098    | <b>\$111,149</b>         | \$ 93,148   |
| Equities                      | <b>87</b>                 | 67          | <b>226</b>               | 269         |
| Short-term investments        | <b>4,070</b>              | 3,828       | <b>11,779</b>            | 12,311      |
| Other invested assets         | <b>966</b>                | 184         | <b>7,106</b>             | 2,473       |
| Business owned life insurance | <b>99</b>                 | 567         | <b>1,254</b>             | 1,707       |
| Investment expenses           | <b>(1,117)</b>            | (1,045)     | <b>(3,320)</b>           | (2,896)     |
| Net investment income         | <b>\$41,075</b>           | \$38,699    | <b>\$128,194</b>         | \$107,012   |

The increase in investment income from fixed maturities and the increase in investment expenses are both principally due to the increase in invested funds as discussed above. Income from other invested assets is principally

derived from non-public investment partnerships/limited liability companies and our income from these holdings varies from period to period. The decline in business owned life insurance is the result of a one time reduction in the growth of cash surrender values due to a restructuring of this portfolio during the quarter.

**Table of Contents**

The components of net realized investment gains (losses) are shown in the following table.

|  | <i>In thousands</i>       |         |                          |           |
|--|---------------------------|---------|--------------------------|-----------|
|  | <b>Three Months Ended</b> |         | <b>Nine Months Ended</b> |           |
|  | <b>September 30</b>       |         | <b>September 30</b>      |           |
|  | <b>2007</b>               | 2006    | <b>2007</b>              | 2006      |
| Net gains (losses) from sales          | <b>\$ 921</b>             | \$(788) | <b>\$ 2,395</b>          | \$ (202)  |
| Other-than-temporary impairment losses | <b>(428)</b>              | (372)   | <b>(4,602)</b>           | (1,031)   |
| Trading portfolio gains (losses)       | <b>828</b>                | 650     | <b>643</b>               | 113       |
| Net realized investment gains (losses) | <b>\$1,321</b>            | \$(510) | <b>\$(1,564)</b>         | \$(1,120) |

In the third quarter of 2007 we recognized other-than-temporary impairment losses of \$428,000 related to certain fixed maturity securities and a passive investment that we hold in a non-public investment pool. We also recognized impairment losses of \$4.2 million in the first quarter of 2007 related to certain high yield asset backed bonds, particularly those with sub-prime loan exposures.

Our investment income, although increased as compared to 2006, decreased by approximately \$3.5 million as compared to net investment income for the 2007 second quarter. The primary reason for the decrease is a \$2.3 million reduction in earnings from other investments, which includes a \$1.5 million reduction in distributions from one of our investment funds. As previously discussed, earnings from business owned life insurance also decreased during the quarter, which reduced earnings as compared to the second quarter by approximately \$500,000. Additionally, during the third quarter we sold the treasury indexed securities that primarily comprised our fixed maturity trading portfolio; these securities contributed a particularly favorable return during the second quarter.

***Equity in Earnings (Loss) of Unconsolidated Subsidiaries***

Equity in earnings (loss) of unconsolidated subsidiaries is derived from our ownership interests in non-public investment entities accounted for on the equity basis. During the third quarter of 2007 two such investment entities reported losses for the quarter. Our income from these holdings varies from period to period.

**Underwriting, Acquisition and Insurance Expenses**

|  | <i>\$ in thousands</i>    |          |                |                          |          |                |
|--|---------------------------|----------|----------------|--------------------------|----------|----------------|
|  | <b>Three Months Ended</b> |          |                | <b>Nine Months Ended</b> |          |                |
|  | <b>September 30</b>       |          |                | <b>September 30</b>      |          |                |
|  | <b>2007</b>               | 2006     | <i>Change</i>  | <b>2007</b>              | 2006     | <i>Change</i>  |
| Underwriting, acquisition and insurance expenses | <b>\$27,439</b>           | \$25,859 | <i>\$1,580</i> | <b>\$79,913</b>          | \$78,226 | <i>\$1,687</i> |
|  |                           |          | <i>6%</i>      |                          |          | <i>2%</i>      |

|                            | <b>Three Months Ended</b> |       |               | <b>Nine Months Ended</b> |       |               |
|----------------------------|---------------------------|-------|---------------|--------------------------|-------|---------------|
|                            | <b>September 30</b>       |       |               | <b>September 30</b>      |       |               |
|                            | <b>2007</b>               | 2006  | <i>Change</i> | <b>2007</b>              | 2006  | <i>Change</i> |
| Underwriting expense ratio | <b>20.2%</b>              | 17.3% | <i>2.9</i>    | <b>19.7%</b>             | 18.2% | <i>1.5</i>    |

Stock based compensation costs and the acquisition of PIC Wisconsin have increased our underwriting, operating and acquisition expenses in 2007. However, these increases have been largely offset by other expense reductions, the most significant being lower commissions and premium taxes due to reduced premium volume at our other insurance subsidiaries. Professional fees and guaranty fund assessments have also decreased.



The increase in the underwriting expense ratio as compared to 2006 is due both to the overall increase in expenses, and to the detrimental effect on the ratio of lower premium volume in 2007. The PIC Wisconsin acquisition has little effect on the underwriting expense ratio because the increase in expenses is proportional to the increase in premium volume.

**Table of Contents**

Underwriting, acquisition and insurance expenses in 2007 and 2006 include stock based compensation expense of approximately \$2.6 million and \$850,000 for the third quarter of each year and \$6.4 million and \$3.8 million for the nine-month periods, respectively. Approximately \$1.2 million and \$980,000 of stock based compensation expense for the nine-month periods ended September 30, 2007 and 2006, respectively, relates to awards given to employees who are eligible for retirement. Awards issued to retirement eligible employees are expensed when granted rather than over the vesting period of the award.

We awarded 100,000 options with a fair value of \$1.8 million to our new CEO during the third quarter of 2007. As of September 30, 2007 the options are fully vested and have been fully expensed, resulting in an increase to the underwriting expense ratio of approximately 1.3 points for the quarter and approximately 0.4 points for the year to date period.

Guaranty fund assessments totaled approximately \$1.0 million and \$890,000 for the three and nine months ended September 30, 2007 as compared to \$314,000 and \$1.4 million for the three and nine months ended September 30, 2006, respectively. Included in Guaranty Fund expenses is an assessment by the Florida Insurance Guaranty Association, Inc. for \$1.0 million for the three and nine months ended September 30, 2007 and \$1.2 million for the nine months ended September 30, 2006. We will have the ability to recoup these assessments with a premium surcharge to our Florida insureds.

**Interest Expense**

Interest expense increased for the three- and nine-month periods ended September 30, 2007 as compared to the same periods in 2006 primarily because we assumed \$11.6 million of debt as a part of the PIC Wisconsin merger.

**Taxes**

Our effective tax rate for each period is significantly lower than the 35% statutory rate because a considerable portion of our net investment income is tax-exempt. The effect of tax-exempt income on our effective tax rate is shown in the table below:

|                    | <b>Three Months Ended<br/>September 30</b> |             | <b>Nine Months Ended<br/>September 30</b> |             |
|--------------------|--|-------------|---|-------------|
|                    | <b>2007</b>                                | <b>2006</b> | <b>2007</b>                               | <b>2006</b> |
| Statutory rate     | <b>35%</b>                                 | 35%         | <b>35%</b>                                | 35%         |
| Tax-exempt income  | <b>(7%)</b>                                | (7%)        | <b>(7%)</b>                               | (8%)        |
| Other              |  |             |   | 1%          |
| Effective tax rate | <b>28%</b>                                 | 28%         | <b>28%</b>                                | 28%         |

**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We believe that we are principally exposed to three types of market risk related to our investment operations. These risks are interest rate risk, credit risk and equity price risk.

**Interest Rate Risk**

Our fixed maturities portfolio is exposed to interest rate risk. Fluctuations in interest rates have a direct impact on the market valuation of these securities. As interest rates rise, market values of fixed income portfolios fall and vice versa. Certain of the securities are held in an unrealized loss position; we have the current ability and intent to keep such securities until recovery of book value or maturity.

The following table summarizes estimated changes in the fair value of our available-for-sale and trading fixed maturity securities for specific hypothetical changes in interest rates as of September 30, 2007.

| Interest Rates          | <i>in millions, except duration</i> |          |           | December 31, 2006 |           |
|-------------------------|-------------------------------------|----------|-----------|-------------------|-----------|
|                         | September 30, 2007                  | Change   | Effective | Portfolio         | Effective |
|                         | Portfolio Value                     | in Value | Duration  | Value             | Duration  |
| 200 basis point rise    | \$2,922                             | \$(274)  | 4.60      | \$2,911           | 4.31      |
| 100 basis point rise    | \$3,058                             | \$(138)  | 4.55      | \$3,057           | 4.20      |
| Current rate *          | \$3,196                             | \$       | 4.24      | \$3,185           | 3.89      |
| 100 basis point decline | \$3,325                             | \$ 129   | 3.79      | \$3,306           | 3.55      |
| 200 basis point decline | \$3,445                             | \$ 249   | 3.54      | \$3,422           | 3.51      |

\* *Current rates are as of September 30, 2007 and December 31, 2006.*

Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including the maintenance of the existing level and composition of fixed income security assets, and should not be relied on as indicative of future results.

Certain shortcomings are inherent in the method of analysis presented in the computation of the fair value of fixed rate instruments. Actual values may differ from those projections presented should market conditions vary from assumptions used in the calculation of the fair value of individual securities, including non-parallel shifts in the term structure of interest rates and changing individual issuer credit spreads.

ProAssurance's cash and short-term investment portfolio at September 30, 2007 was on a cost basis which approximates its fair value. This portfolio lacks significant interest rate sensitivity due to its short duration.

**Table of Contents**

**Credit Risk**

We have exposure to credit risk primarily as a holder of fixed income securities. We control this exposure by emphasizing investment grade credit quality in the fixed income securities we purchase.

As of September 30, 2007, 98.8% of our fixed maturity securities are rated investment grade. We believe that this concentration in investment grade securities reduces our exposure to credit risk on these fixed income investments to an acceptable level. However, even investment grade securities can rapidly deteriorate and result in significant losses.

As of September 30, 2007, our fixed maturity securities include securities with a fair value of approximately \$25.6 million (including unrealized losses of \$1.8 million) that are supported by collateral classified as sub-prime, of which approximately 66% are AAA rated, 23% are AA+, and 11% are A. Additionally, we have approximately \$4.2 million (including unrealized losses of \$2.7 million) of exposure to below investment grade fixed income securities with sub-prime exposure within a high-yield investment fund; the average rating of these securities is BB-.

**Equity Price Risk**

At September 30, 2007 the fair value of our investment in common stocks was \$21.4 million. These securities are subject to equity price risk, which is defined as the potential for loss in market value due to a decline in equity prices. The weighted average Beta of this group of securities is 0.95. Beta measures the price sensitivity of an equity security or group of equity securities to a change in the broader equity market, in this case the S&P 500 Index. If the value of the S&P 500 Index increased by 10%, the fair value of these securities would be expected to increase by 9.5% to \$23.4 million. Conversely, a 10% decrease in the S&P 500 Index would imply a decrease of 9.5% in the fair value of these securities to \$19.3 million. The selected hypothetical changes of plus or minus 10% do not reflect what could be considered the best or worst case scenarios and are used for illustrative purposes only.

**Table of Contents**

**ITEM 4. CONTROLS AND PROCEDURES**

The Chief Executive Officer and Chief Financial Officer of the Company evaluated the effectiveness of our disclosure controls and procedures (as defined in SEC Rule 13a-15(e)) as of September 30, 2007. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

There have been no significant changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, those controls during the quarter.

Our management excluded PIC Wisconsin's systems and processes from the scope of ProAssurance's assessment of internal control over financial reporting as of December 31, 2006 in reliance on the guidance set forth in Question 3 of a Frequently Asked Questions interpretive release issued by the staff of the Securities and Exchange Commission's Office of the Chief Accountant and the Division of Corporation Finance in June 2004 (and revised on October 6, 2004). We excluded PIC Wisconsin from that scope because we expected substantially all of its significant systems and processes to be converted to those of ProAssurance during 2007.

**Table of Contents****PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

See Note 10 to the Condensed Consolidated Financial Statements.

**ITEM 1A. RISK FACTORS**

See Risk Factors in Part 1, Item 1A of the 2006 Form 10K and in Part II, Item 1A of the June 30, 2007 Form 10Q. The risk factor *Our revenues may fluctuate with insurance market conditions* is revised to the following:

We derive a significant portion of our insurance premium revenue from medical malpractice risks. Our policy is to charge adequate premiums on risks that meet our underwriting standards. We have lowered our rates were warranted by loss costs improvements, however, some competitors may or are currently offering rates that are lower than we consider to be justified. Increased competition in our markets makes it difficult for us to develop new business and may reduce our retention of current business, although our retention has not eroded in 2007. Our competitors may be come even less disciplined in their pricing, or more permissive in their terms. We cannot predict whether, when or how market conditions will change, or the manner in which, or the extent to which any such changes may impact the results of our operations.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Items 2(a) and (b) are inapplicable.

(c) Information required by Item 703 of Regulation S-K

**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period                                   | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid<br>per Share | Total Number<br>of Shares<br>Purchased as<br>Part<br>of Publicly<br>Announced<br>Plans or<br>Programs | Approximate<br>Dollar<br>Value of Shares                       |
|--|---|---------------------------------------|---|--|
|  |   |                                       |   | that May Yet Be<br>Purchased Under<br>the Plans or<br>Programs |
| July 1, 2007-<br>July 31, 2007           | 193,118                                   | \$55.56                               | 193,118   | \$ 119,256,076   |
| August 1, 2007-<br>August 31, 2007       | 203,442                                   | \$51.69                               | 203,442   | \$ 108,735,790   |
| September 1, 2007-<br>September 30, 2007 |   | \$                                    |   | \$ 108,735,790   |
| Total                                    | 396,560                                   | \$53.57                               | 396,560   |  |

**ITEM 6. EXHIBITS**

31.1 Certification of Principal Executive Officer of ProAssurance as required under SEC rule 13a-14(a).

31.2 Certification of Principal Financial Officer of ProAssurance as required under SEC rule 13a-14(a).

Edgar Filing: PROASSURANCE CORP - Form 10-Q

- 32.1 Certification of Principal Executive Officer of ProAssurance as required under SEC Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code, as amended (18 U.S.C. 1350).
- 32.2 Certification of Principal Financial Officer of ProAssurance as required under SEC Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code, as amended (18 U.S.C. 1350).

**Table of Contents**

**SIGNATURE**

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.

PROASSURANCE CORPORATION

November 6, 2007

/s/ Edward L. Rand, Jr.  
Edward L. Rand, Jr.  
Chief Financial Officer  
(Duly authorized officer and principal financial officer)

36