

PROASSURANCE CORP
Form 10-Q
November 06, 2012
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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, 2012 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

(State or Other Jurisdiction of
Incorporation or Organization)

63-1261433

(IRS Employer Identification No.)

100 Brookwood Place, Birmingham, AL
(Address of Principal Executive Offices)

35209

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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 October 26, 2012, there were 30,735,123 shares of the registrant's common stock outstanding.

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FORWARD-LOOKING STATEMENTS

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

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

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

- general economic conditions, either nationally or in our market areas, that are different than anticipated;
- our ability to maintain our dividend payments;
- regulatory, legislative and judicial actions or decisions that could affect our business plans or operations;
- the enactment or repeal of tort reforms;
- the formation or dissolution of state-sponsored medical professional liability insurance entities that could remove or add sizable groups of physicians from or to the private insurance market;
- the impact of deflation or inflation;
- changes in the interest rate environment;
- changes in U.S. laws or government regulations regarding financial markets or market activity that may affect the U.S. economy and our business;
- changes in the ability of the U.S. government to meet its obligations that may affect the U.S. economy and our business;
- performance of financial markets affecting the fair value of our investments or making it difficult to determine the value of our investments;
- changes in accounting policies and practices that may be adopted by our regulatory agencies and the Financial Accounting Standards Board, the Securities and Exchange Commission, or the Public Company Accounting Oversight Board;
- changes in laws or government regulations affecting medical professional liability insurance or the financial community;
- the effects of changes in the healthcare delivery system, including but not limited to the Patient Protection and Affordable Care Act;
- consolidation of healthcare providers and entities that are more likely to self insure and not purchase medical professional liability insurance;
- uncertainties inherent in the estimate of loss and loss adjustment expense reserves and reinsurance, and changes in the availability, cost, quality, or collectability of insurance/reinsurance;
- the results of litigation, including pre- or post-trial motions, trials and/or appeals we undertake;
- allegation of bad faith which may arise from our handling of any particular claim, including failure to settle;
- loss of independent agents;
- changes in our organization, compensation and benefit plans;
- our ability to retain and recruit senior management;
- our ability to purchase reinsurance and collect recoveries from our reinsurers;

assessments from guaranty funds;

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

- changes to the ratings assigned by rating agencies to our insurance subsidiaries, individually or as a group;

provisions in our charter documents, Delaware law and state insurance law may impede attempts to replace or remove management or may impede a takeover;

state insurance restrictions may prohibit assets held by our insurance subsidiaries, including cash and investment

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securities, from being used for general corporate purposes;

taxing authorities can take exception to our tax positions and cause us to incur significant amounts of defense costs and, if our defense is not successful, additional tax costs, including interest and penalties;

insurance market conditions may alter the effectiveness of our current business strategy and impact our revenues; and expected benefits from completed and proposed acquisitions may not be achieved or may be delayed longer than expected due to business disruption, loss of customers, employees and key agents, increased operating costs or inability to achieve cost savings, and assumption of greater than expected liabilities, among other reasons.

Additional risks that could adversely affect the proposed mergers of Medmarc Insurance Group (Medmarc) and Independent Nevada Doctors Insurance Exchange (IND) into ProAssurance, include but are not limited to, the following:

- the businesses of ProAssurance and Medmarc or ProAssurance and IND may not be combined successfully, or such combination may take longer to accomplish than expected;
- the cost savings from either transaction may not be fully realized or may take longer to realize than expected;
- operating costs, customer loss and business disruption following either or both transactions, including adverse effects on relationships with employees, may be greater than expected;
- governmental approvals of either or both transactions may not be obtained or adverse regulatory conditions may be imposed in connection with governmental approvals of either or both transactions;
- there may be restrictions on our ability to achieve continued growth through expansion into other states or through acquisitions or business combinations;
- the board of directors of Medmarc or the Subscriber Advisory Committee (SAC) of IND may withdraw their recommendation in favor of a competing acquisition proposal; and
- those policyholders eligible to vote on the proposed Medmarc transaction may fail to approve it.

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

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

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ProAssurance Corporation and Subsidiaries
Condensed Consolidated Balance Sheets (Unaudited)
(In thousands, except share data)

	September 30, 2012	December 31, 2011
Assets		
Investments		
Fixed maturities, available for sale, at fair value; amortized cost, \$3,325,657 and \$3,465,720, respectively	\$3,570,179	\$3,665,763
Equity securities, available for sale, at fair value; cost, \$6 at December 31, 2011	—	25
Equity securities, trading, at fair value; cost, \$169,144 and \$101,078, respectively	183,978	103,133
Short-term investments	167,516	119,421
Business owned life insurance	52,070	52,651
Investment in unconsolidated subsidiaries	120,670	111,324
Other investments	31,221	38,224
Total Investments	4,125,634	4,090,541
Cash and cash equivalents	97,659	130,400
Premiums receivable	125,204	120,220
Receivable from reinsurers on paid losses and loss adjustment expenses	9,292	4,175
Receivable from reinsurers on unpaid losses and loss adjustment expenses	231,250	247,658
Prepaid reinsurance premiums	16,100	12,568
Deferred policy acquisition costs	25,042	26,626
Deferred taxes	7,962	30,989
Real estate, net	41,111	40,432
Intangible assets	50,209	53,703
Goodwill	159,625	159,625
Other assets	83,578	81,941
Total Assets	\$4,972,666	\$4,998,878
Liabilities and Shareholders' Equity		
Liabilities		
Policy liabilities and accruals		
Reserve for losses and loss adjustment expenses	\$2,153,548	\$2,247,772
Unearned premiums	257,661	251,155
Reinsurance premiums payable	86,047	82,039
Total Policy Liabilities	2,497,256	2,580,966
Other liabilities	126,012	203,772
Long-term debt, \$35,507 at amortized cost and \$14,180 at fair value at December 31, 2011	—	49,687
Total Liabilities	2,623,268	2,834,425
Shareholders' Equity		
Common shares, par value \$0.01 per share, 100,000,000 shares authorized, 34,721,820 and 34,551,494 shares issued, respectively	347	346
Additional paid-in capital	543,471	538,625
Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of \$85,583 and \$70,022, respectively	158,936	130,037
Retained earnings	1,851,052	1,699,853

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Treasury shares, at cost, 3,997,951 shares	2,553,806	2,368,861
	(204,408)	(204,408)
Total Shareholders' Equity	2,349,398	2,164,453
Total Liabilities and Shareholders' Equity	\$4,972,666	\$4,998,878
See accompanying notes.		

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

	Total	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Other Capital Accounts	
Balance at December 31, 2011	\$2,164,453	\$ 130,037	\$1,699,853	\$334,563	
Net income	174,204	—	174,204	—	
Dividends to shareholders	(23,005	) —	(23,005) —	
Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments	28,899	28,899	—	—	
Common shares issued for compensation and net effect of restricted and performance shares issued and stock options exercised	(1,534) —	—	(1,534)
Share-based compensation	6,381	—	—	6,381	
Balance at September 30, 2012	\$2,349,398	\$ 158,936	\$1,851,052	\$339,410	

	Total	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Other Capital Accounts	
Balance at December 31, 2010	\$1,855,863	\$ 79,124	\$1,428,026	\$348,713	
Net income	146,494	—	146,494	—	
Dividends to shareholders	(7,632	) —	(7,632) —	
Change in net unrealized gains (losses) on investments, after tax, net of reclassification adjustments	43,224	43,224	—	—	
Common shares reacquired	(21,013) —	—	(21,013)
Common shares issued for compensation and net effect of performance shares issued and stock options exercised	(595) —	—	(595)
Share-based compensation	5,422	—	—	5,422	
Balance at September 30, 2011	\$2,021,763	\$ 122,348	\$1,566,888	\$332,527	
See accompanying notes.					

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Revenues				
Net premiums earned	\$ 127,125	\$ 134,627	\$ 395,050	\$ 403,766
Net investment income	33,910	34,116	101,912	106,573
Equity in earnings (loss) of unconsolidated subsidiaries	211	(2,264)	(4,082)	(6,044)
Net realized investment gains (losses):				
Other-than-temporary impairment (OTTI) losses	(142)	(1,389)	(1,566)	(4,291)
Portion of OTTI losses recognized in (reclassified from) other comprehensive income before taxes	—	(142)	(201)	(823)
Net impairment losses recognized in earnings	(142)	(1,531)	(1,767)	(5,114)
Other net realized investment gains (losses)	13,361	(10,441)	24,115	(534)
Total net realized investment gains (losses)	13,219	(11,972)	22,348	(5,648)
Other income	1,529	7,471	5,207	11,745
Total revenues	175,994	161,978	520,435	510,392
Expenses				
Losses and loss adjustment expenses	63,675	71,777	197,112	218,270
Reinsurance recoveries	(7,054)	(8,601)	(22,208)	(20,319)
Net losses and loss adjustment expenses	56,621	63,176	174,904	197,951
Underwriting, policy acquisition and operating expenses	33,280	34,954	103,083	103,534
Interest expense	350	932	2,002	2,645
Loss on extinguishment of debt	2,163	—	2,163	—
Total expenses	92,414	99,062	282,152	304,130
Income before income taxes	83,580	62,916	238,283	206,262
Provision for income taxes				
Current expense (benefit)	19,017	19,220	56,612	46,049
Deferred expense (benefit)	4,457	(9)	7,467	13,719
Total income tax expense (benefit)	23,474	19,211	64,079	59,768
Net income	\$ 60,106	\$ 43,705	\$ 174,204	\$ 146,494
Other comprehensive income, after tax, net of reclassification adjustments (see Note 9)	18,885	23,291	28,899	43,224
Comprehensive income	\$ 78,991	\$ 66,996	\$ 203,103	\$ 189,718
Earnings per share:				
Basic	\$ 1.96	\$ 1.43	\$ 5.69	\$ 4.79
Diluted	\$ 1.94	\$ 1.42	\$ 5.64	\$ 4.75

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Weighted average number of common shares
outstanding:

Basic	30,674	30,557	30,641	30,577
Diluted	30,938	30,847	30,902	30,844

Cash dividends declared per common share	\$0.25	\$0.25	\$0.75	\$0.25
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See accompanying notes.

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

	Nine Months Ended September 30	
	2012	2011
Operating Activities		
Net income	\$ 174,204	\$ 146,494
Depreciation and amortization	28,280	27,182
Loss (gain) on extinguishment of debt	2,163	—
Net realized investment (gains) losses	(22,348	) 5,648
Share-based compensation	6,381	5,422
Deferred income taxes	7,467	13,719
Other	(2,423	) (328
Changes in assets and liabilities:		
Premiums receivable	(4,984	) (17,061
Other assets	(3,633	) 4,090
Reserve for losses and loss adjustment expenses	(94,224	) (21,008
Unearned premiums	6,506	21,652
Reinsurance related assets and liabilities	11,767	(8,510
Other liabilities	(47,800	) (70,882
Net cash provided by operating activities	61,356	106,418
Investing Activities		
Purchases of:		
Fixed maturities, available for sale	(533,780	) (597,762
Equity securities, trading	(84,008	) (87,787
Other investments	(9,539	) (429
Funding of tax credit limited partnerships	(29,458	) (21,542
(Investments in) distributions from unconsolidated subsidiaries, net	(6,451) —
Proceeds from sale or maturities of:		
Fixed maturities, available for sale	666,054	586,455
Equity securities, available for sale	—	3,836
Equity securities, trading	33,343	40,648
Other investments	588	596
Net sales or maturities (purchases) of short-term investments	(48,230	) 71,614
Unsettled security transactions, net	3,399	4,897
Cash received (paid) for other assets	(5,651	) (9,581
Net cash provided (used) by investing activities	(13,733	) (9,055
Financing Activities		
Repayment of long-term debt and related swap	(57,660) —
Repurchase of common stock	—	(21,013
Dividends to shareholders	(22,922) —
Other	218	(1,494

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Net cash provided (used) by financing activities	(80,364) (22,507)
Increase (decrease) in cash and cash equivalents	(32,741) 74,856	
Cash and cash equivalents at beginning of period	130,400	50,851	
Cash and cash equivalents at end of period	\$97,659	\$125,707	
See accompanying notes.			

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of ProAssurance Corporation and its consolidated subsidiaries (ProAssurance or PRA). The financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation, consisting of normal recurring adjustments, have been included. ProAssurance's results for the three- and nine-month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes contained in ProAssurance's December 31, 2011 report on Form 10-K. In connection with its preparation of the Condensed Consolidated Financial Statements, ProAssurance evaluated events that occurred subsequent to September 30, 2012 for recognition or disclosure in its financial statements and notes to financial statements.

Accounting Changes Not Yet Adopted

Intangibles-Goodwill and Other

Effective for fiscal years beginning after September 15, 2012, the FASB revised guidance related to impairment testing of indefinite-lived intangible assets. The new guidance permits an entity to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that an indefinite-lived intangible asset is impaired. Quantitative impairment testing is required only if the assessment of qualitative factors indicates it is more likely than not that impairment exists. ProAssurance plans to adopt the guidance beginning January 1, 2013. Adoption of this guidance is expected to have no effect on ProAssurance's results of operations or financial position.

Disclosures About Offsetting Assets and Liabilities

Effective for fiscal years beginning on or after January 1, 2013, the Financial Accounting Standards Board (FASB) revised guidance related to disclosures about certain assets and liabilities in an entity's financial statements. The guidance requires disclosures related to the net and gross positions of certain financial instruments and transactions that are either eligible for offset in accordance with existing GAAP guidance or subject to an agreement that requires such offset. The guidance must be applied retrospectively for all prior periods presented. ProAssurance plans to adopt the guidance beginning January 1, 2013. Adoption of this guidance is expected to have no effect on ProAssurance's results of operations or financial position as it impacts disclosures only.

Accounting Changes

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

Effective for fiscal years beginning after December 15, 2011, the FASB revised guidance regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The guidance permits deferral of qualifying costs only when associated with successful contract acquisitions. Internal selling agent and underwriter salary and benefit costs allocated to unsuccessful contracts, as well as advertising costs, are excluded. The guidance must be applied prospectively, but may be applied retrospectively for all prior periods. ProAssurance prospectively adopted the guidance on January 1, 2012. Adoption of this guidance had no material effect on ProAssurance's results of operations or financial position.

Fair Value Measurements

Effective for interim and annual reporting periods beginning after December 15, 2011, the FASB revised guidance related to fair value measurements and disclosures, all of which are to be applied prospectively. The new guidance increases disclosure requirements regarding valuation methods used to determine fair value measurements categorized as Level 3, as well as the sensitivity to change of those measurements, and requires additional disclosures regarding the consideration given to highest and best use in fair value measurements of nonfinancial assets. The guidance also

requires that when fair value measurements of items not carried at fair value are disclosed, the fair value measurements are to be categorized by level of the fair value hierarchy. Additionally, the guidance also clarifies or revises certain fair value measurement principles related to the valuation of financial instruments managed within a portfolio, the valuation of instruments classified as a part of shareholders' equity, the appropriate application of the highest and best use valuation premise, and the consideration of premium and discounts in a fair value measurement. ProAssurance adopted the guidance on January 1, 2012. Adoption of this guidance had no material effect on ProAssurance's results of operations or financial position.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement

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

- Level 1: quoted (unadjusted) market prices in active markets for identical assets and liabilities. For ProAssurance, Level 1 inputs are generally quotes for debt or equity securities actively traded in exchange or over-the-counter markets.
- Level 2: market data obtained from sources independent of the reporting entity (observable inputs). For ProAssurance, Level 2 inputs generally include quoted prices in markets that are not active, quoted prices for similar assets or liabilities, and results from pricing models that use observable inputs such as interest rates and yield curves that are generally available at commonly quoted intervals.
- Level 3: the reporting entity's own assumptions about market participant assumptions based on the best information available in the circumstances (non-observable inputs). For ProAssurance, Level 3 inputs are used in situations where little or no Level 1 or 2 inputs are available or are inappropriate given the particular circumstances. Level 3 inputs include results from pricing models for which some or all of the inputs are not observable, discounted cash flow methodologies, single non-binding broker quotes and adjustments to externally quoted prices that are based on management judgment or estimation.

Fair values of assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011, including financial instruments for which ProAssurance has elected fair value, are shown in the following tables. The tables also indicate the fair value hierarchy of the valuation techniques utilized to determine those fair values. For some assets, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. When this is the case, the asset is categorized based on the level of the most significant input to the fair value measurement. Assessments of the significance of a particular input to the fair value measurement requires judgment and consideration of factors specific to the assets being valued.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement (continued)

(In thousands)	September 30, 2012			Total Fair Value
	Fair Value Measurements Using Level 1	Level 2	Level 3	
Assets:				
Fixed maturities, available for sale				
U.S. Treasury obligations	\$—	\$218,542	\$—	\$218,542
U.S. Government-sponsored enterprise obligations	—	62,691	—	62,691
State and municipal bonds	—	1,206,113	7,175	1,213,288
Corporate debt, multiple observable inputs	—	1,453,004	—	1,453,004
Corporate debt, limited observable inputs:				
Private placement senior notes	—	—	349	349
Other corporate debt, NRSRO ratings available	—	—	16,570	16,570
Other corporate debt, NRSRO ratings not available	—	—	6,847	6,847
Residential mortgage-backed securities	—	375,673	—	375,673
Agency commercial mortgage-backed securities	—	71,462	—	71,462
Other commercial mortgage-backed securities	—	76,742	—	76,742
Other asset-backed securities	—	70,986	4,025	75,011
Equity securities				
Financial	66,885	—	—	66,885
Utilities/Energy	29,207	—	—	29,207
Consumer oriented	46,394	—	—	46,394
Technology	10,543	—	—	10,543
Industrial	16,374	—	—	16,374
All other	14,575	—	—	14,575
Short-term investments	72,632	94,884	—	167,516
Financial instruments carried at fair value, classified as a part of:				
Investment in unconsolidated subsidiaries	—	—	31,479	31,479
Total assets	\$256,610	\$3,630,097	\$66,445	\$3,953,152
Liabilities:				
2019 Note payable	—	—	—	—
Interest rate swap agreement	—	—	—	—
Total liabilities	\$—	\$—	\$—	\$—

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2012

2. Fair Value Measurement (continued)

(In thousands)	December 31, 2011			Total Fair Value
	Fair Value Measurements Using Level 1	Level 2	Level 3	
Assets:				
Fixed maturities, available for sale				
U.S. Treasury obligations	\$—	\$283,865	\$—	\$283,865
U.S. Government-sponsored enterprise obligations	—	68,104	—	68,104
State and municipal bonds	—	1,221,187	7,200	1,228,387
Corporate debt, multiple observable inputs	—	1,359,866	—	1,359,866
Corporate debt, limited observable inputs:				
Private placement senior notes	—	—	612	612
Other corporate debt, NRSRO ratings available	—	—	6,310	6,310
Other corporate debt, NRSRO ratings not available	—	—	1,160	1,160
Residential mortgage-backed securities	—	452,932	—	452,932
Agency commercial mortgage-backed securities	—	81,530	—	81,530
Other commercial mortgage-backed securities	—	81,188	—	81,188
Other asset-backed securities	—	101,809	—	101,809
Equity securities				
Financial	25,281	—	—	25,281
Utilities/Energy	18,748	—	—	18,748
Consumer oriented	29,711	—	—	29,711
Technology	7,556	—	—	7,556
Industrial	9,185	—	—	9,185
All other	12,677	—	—	12,677
Short-term investments	111,359	8,062	—	119,421
Financial instruments carried at fair value, classified as a part of:				
Investment in unconsolidated subsidiaries	—	—	23,841	23,841
Other investments	—	—	15,873	15,873
Total assets	\$214,517	\$3,658,543	\$54,996	\$3,928,056
Liabilities:				
2019 Note payable	—	—	14,180	14,180
Interest rate swap agreement	—	—	4,659	4,659
Total liabilities	\$—	\$—	\$18,839	\$18,839

The fair values for securities included in the Level 2 category, with the few exceptions described below, have been developed by third party, nationally recognized pricing services. These services use complex methodologies to determine values for securities and subject the values they develop to quality control reviews. Management reviews service-provided values for reasonableness by comparing data among pricing services and to available market and trade data. Values that appear inconsistent are further reviewed for appropriateness. If a value does not appear reasonable, the valuation is discussed with the service that provided the value and would be adjusted, if necessary. No such adjustments have been necessary in 2012 or 2011.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement (continued)

Level 2 Valuations

Below is a summary description of the valuation methodologies primarily used by the pricing services for securities in the Level 2 category, by security type:

U.S. Treasury obligations are valued based on quoted prices for identical assets, or, in markets that are not active, quotes for similar assets, taking into consideration adjustments for variations in contractual cash flows and yields to maturity.

U.S. Government-sponsored enterprise obligations are valued using pricing models that consider current and historical market data, normal trading conventions, credit ratings, and the particular structure and characteristics of the security being valued, such as yield to maturity, redemption options, and contractual cash flows. Adjustments to model inputs or model results are included in the valuation process when necessary to reflect recent events, such as regulatory, government or corporate actions or significant economic, industry or geographic events that would affect the security's fair value.

State and municipal bonds are valued using a series of matrices that consider credit ratings, the structure of the security, the sector in which the security falls, yields, and contractual cash flows. Valuations are further adjusted, when necessary, to reflect recent events such as significant economic or geographic events or ratings changes that would affect the security's fair value.

Corporate debt with multiple observable inputs consists primarily of corporate bonds, but also includes a small number of bank loans. The methodology used to value Level 2 corporate bonds is the same as the methodology previously described for U.S. Government-sponsored enterprise obligations. Bank loans are valued by an outside vendor based upon a widely distributed, loan-specific listing of average bid and ask prices published daily by an investment industry group. The publisher of the listing derives the averages from data received from multiple market-makers for bank loans.

Residential and commercial mortgage backed securities. Agency pass-through securities are valued using a matrix, considering the issuer type, coupon rate and longest cash flows outstanding. The matrix is developed daily based on available market information. Agency and non-agency collateralized mortgage obligations are both valued using models that consider the structure of the security, current and historical information regarding prepayment speeds, ratings and ratings updates, and current and historical interest rate and interest rate spread data. Evaluations of Alt-A mortgages include a review of collateral performance data, which is generally updated monthly.

Other asset-backed securities are valued using models that consider the structure of the security, monthly payment information, current and historical information regarding prepayment speeds, ratings and ratings updates, and current and historical interest rate and interest rate spread data. Spreads and prepayment speeds consider collateral type. Evaluations of subprime home equity loans use the same evaluation methodology as previously described for Alt-A mortgages.

Short-term investments included in the Level 2 category are commercial paper and certificates of deposit maturing within one year, carried at cost which approximates the fair value of the security due to the short term to maturity.

Level 3 Valuations

Below is a summary description of the valuation processes and methodologies used as well as quantitative information regarding securities in the Level 3 category.

Level 3 Valuation Processes

Level 3 securities are priced by the Company's Vice President of Investments, who reports to the Chief Financial Officer.

Level 3 valuations are computed quarterly. Prices are evaluated quarterly against prior period prices and the expected change in price.

The Company's Level 3 valuations are not overly sensitive to changes in the unobservable inputs used. The securities noted in the disclosure are primarily investment grade debt where comparable market inputs are commonly available

for evaluating the securities in question.

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2012

2. Fair Value Measurement (continued)

Level 3 Valuation Methodologies

State and municipal bonds consists of auction rate municipal bonds valued internally using published quotes for similar securities or by using a model based on discounted cash flows using yields currently available on fixed rate securities with a similar term and collateral, adjusted to consider the effect of a floating rate and a premium for illiquidity. At September 30, 2012 and December 31, 2011 all of these bonds were rated A- or better.

Corporate debt with limited observable inputs consists of private placement senior notes guaranteed by large regional banks and contain corporate bonds. Valuations are determined using dealer quotes for similar securities or discounted cash flow models using yields currently available for similar securities. Similar securities are defined as securities having like terms and payment features that are of comparable credit quality. Assessments of credit quality are based on NRSRO ratings, if available, or are subjectively determined by management if not available. At September 30, 2012, the average rating of rated securities, primarily NRSRO ratings, was BBB+.

Other asset-backed securities consists of securitizations of receivables valued using dealer quotes for similar securities or discounted cash flow models using yields currently available for similar securities.

Investment in unconsolidated subsidiaries and Other investments consist of limited partnership (LP) and limited liability company (LLC) interests valued using the net asset value (NAV) provided by the LP/LLC, which approximates the fair value of the interest.

Such interests included the following:

(In thousands)	Unfunded	Fair Value	
	Commitments	September 30,	December 31,
	September 30,	September 30,	2011
	2012	2012	
Investment in unconsolidated subsidiaries:			
LP primarily invested in long/short equities (1)	None	\$17,740	\$17,123
LPs primarily invested in non-public equities (2)	\$46,712	13,739	6,718
		31,479	23,841
Other investments:			
LLC primarily invested in private equity and debt (3)	None	—	15,873
		\$31,479	\$39,714

The LP holds both long and short U.S. and North American equities, and targets absolute returns using a strategy designed to take advantage of event-driven market opportunities. Redemptions are allowed with a notice (1) requirement of up to 45 days and are paid within 30 days of the redemption date, unless the redemption request is for 90% or more of the requestor's capital balance. Redemptions at the 90% and above level will be paid at 90%, with the remainder paid after the LP's annual audit.

The LPs are structured to provide capital appreciation through diversified investments in private equity, which can include investments in buyout, venture capital, mezzanine debt, distressed debt and other private equity-oriented (2) LPs. Redemptions are not allowed for one of the LPs, except by special permission of the LP. Income and capital are to be periodically distributed at the discretion of the LP over an anticipated time frame that spans from 4 to 7 years.

The LLC converted into a publicly traded investment fund during the second quarter of 2012. Prior to conversion, (3) the LLC was structured to provide income through diversified investments in private equity, including mezzanine debt, distressed debt, syndicated bank loans and other private equity-oriented investments.

Liabilities are valued using the present value of expected underlying cash flows of the instrument, discounted at rates available on the valuation date for similar instruments issued by entities with a similar credit standing to ProAssurance.

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ProAssurance Corporation and Subsidiaries
 Notes to Condensed Consolidated Financial Statements (Unaudited)
 September 30, 2012

2. Fair Value Measurement (continued)

Quantitative Information Regarding Level 3 Valuations

Quantitative Information about Level 3 Fair Value Measurements

(In millions)	Fair Value at September 30, 2012	Valuation Technique	Unobservable Input	Range (Weighted Average)
Assets:				
State and municipal bonds	\$7.2	Market Comparable Securities	Comparability Adjustment	0% - 10% (5%)
		Discounted Cash Flows	Comparability Adjustment	0% - 10% (5%)
Corporate debt with limited observable inputs	\$23.8	Market Comparable Securities	Comparability Adjustment	0% - 5% (2.5%)
		Discounted Cash Flows	Comparability Adjustment	0% - 5% (2.5%)
Other asset-backed securities	\$4.0	Market Comparable Securities	Comparability Adjustment	0% - 5% (2.5%)
		Discounted Cash Flows	Comparability Adjustment	0% - 5% (2.5%)

The significant unobservable inputs used in the fair value measurement of the entity's corporate bonds are the valuations of comparable securities with similar issuer, credit quality and maturity. Changes in the availability of comparable securities could result in changes in the fair value measurements.

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement (continued)

The following tables (the Level 3 Tables) present summary information regarding changes in the fair value of assets and liabilities measured at fair value using Level 3 inputs, including financial instruments for which ProAssurance has elected fair value accounting.

(In thousands)	September 30, 2012					
	Level 3 Fair Value Measurements – Assets					
	State and Municipal Bonds	Corporate Debt	Asset-backed Securities	Investment in Unconsolidated Subsidiaries	Other Investments	Total
Balance June 30, 2012	\$7,175	\$10,510	\$ 1,795	\$ 24,028	\$ —	\$43,508
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Equity in earnings of unconsolidated subsidiaries	—	—	—	419	—	419
Net realized investment gains (losses)	—	14	—	—	—	14
Included in other comprehensive income	—	15	25	—	—	40
Purchases	—	6,978	4,939	7,032	—	18,949
Sales	—	(1,051)	(1,118)	—	—	(2,169)
Transfers in	—	9,220	—	—	—	9,220
Transfers out	—	(1,920)	(1,616)	—	—	(3,536)
Balance September 30, 2012	\$7,175	\$23,766	\$ 4,025	\$ 31,479	\$ —	\$66,445
Change in unrealized gains (losses) included in earnings for the above period for Level 3 assets held at period-end	\$—	\$—	\$—	\$ 419	\$—	\$419

(In thousands)	September 30, 2012					
	Level 3 Fair Value Measurements – Assets					
	State and Municipal Bonds	Corporate Debt	Asset-backed Securities	Investment in Unconsolidated Subsidiaries	Other Investments	Total
Balance December 31, 2011	\$7,200	\$8,082	\$ —	\$ 23,841	\$ 15,873	\$54,996
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Equity in earnings of unconsolidated subsidiaries	—	—	—	1,189	—	1,189
Net realized investment gains (losses)	—	14	—	—	(131)	(117)
Included in other comprehensive income	—	593	25	—	—	618
Purchases	—	8,915	6,734	7,032	—	22,681
Sales	(25)	(1,138)	(1,118)	(583)	—	(2,864)

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Transfers in	—	9,220	—	—	—	9,220
Transfers out	—	(1,920)	(1,616)	—	(15,742)	(19,278)
Balance September 30, 2012	\$7,175	\$23,766	\$ 4,025	\$ 31,479	\$—	\$66,445
Change in unrealized gains (losses) included in earnings for the above period for Level 3 assets held at period-end	\$—	\$—	\$—	\$ 1,189	\$—	\$1,189

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement (continued)

(In thousands)	September 30, 2011					
	Level 3 Fair Value Measurements – Assets					
	State and Municipal Bonds	Corporate Debt	Asset-backed Securities	Investment in Unconsolidated Subsidiaries	Other Investments	Total
Balance June 30, 2011	\$7,325	\$7,830	\$ 1,684	\$ 25,127	\$—	\$41,966
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Equity in earnings of unconsolidated subsidiaries	—	—	—	(297)	—	(297)
Net realized investment gains (losses)	—	—	—	—	—	—
Included in other comprehensive income	—	(638)	—	—	—	(638)
Purchases	—	—	—	—	—	—
Sales	(75)	—	—	—	—	(75)
Transfers in	—	2,904	—	—	16,191	19,095
Transfers out	—	—	(1,684)	—	—	(1,684)
Balance September 30, 2011	\$7,250	\$ 10,096	\$—	\$ 24,830	\$ 16,191	\$58,367
Change in unrealized gains (losses) included in earnings for the above period for Level 3 assets held at period-end	\$—	\$—	\$—	\$ (297)	\$—	\$(297)

(In thousands)	September 30, 2011					
	Level 3 Fair Value Measurements – Assets					
	State and Municipal Bonds	Corporate Debt	Asset-backed Securities	Investment in Unconsolidated Subsidiaries	Other Investments	Total
Balance December 31, 2010	\$7,550	\$21,229	\$ 2,220	\$ 25,112	\$—	\$56,111
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Equity in earnings of unconsolidated subsidiaries	—	—	—	(282)	—	(282)
Net realized investment gains (losses)	—	—	314	—	—	314
Included in other comprehensive income	—	(1,352)	(15)	—	—	(1,367)
Purchases	—	—	1,684	—	—	1,684
Sales	(300)	(8,504)	(1,921)	—	—	(10,725)
Transfers in	—	6,350	—	—	16,191	22,541
Transfers out	—	(7,627)	(2,282)	—	—	(9,909)
Balance September 30, 2011	\$7,250	\$ 10,096	\$—	\$ 24,830	\$ 16,191	\$58,367

Change in unrealized gains (losses)
included in earnings for the above
period for Level 3 assets held at
period-end

\$—	\$—	\$—	\$ (282)	\$—	\$(282)
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ProAssurance Corporation and Subsidiaries
 Notes to Condensed Consolidated Financial Statements (Unaudited)
 September 30, 2012

2. Fair Value Measurement (continued)

Transfers

There were no transfers between the Level 1 and Level 2 categories during the three and nine months ended September 30, 2012 or 2011.

Transfers shown in the preceding Level 3 Tables are as of the end of the period and were to or from Level 2, unless otherwise noted.

The transfers of Other investments reported in the Level 3 Tables for the 2012 nine-month period and the 2011 three- and nine-month periods relate to an interest in an LLC. The interest in the LLC, a cost method investment, was not carried at fair value at December 31, 2010. During 2011, the LLC announced a planned conversion to a public fund. Subsequent to the announcement, ProAssurance, through the recognition of OTTI, carried the LLC interest at fair value, based on the NAV provided by fund management; such valuation is considered to be in the Level 3 category. The LLC converted into a publicly traded investment fund during the second quarter of 2012 and the interest in the LLC was valued using Level 1 inputs at September 30, 2012.

All remaining transfers during the three and nine months ended September 30, 2012 and September 30, 2011 related to securities held for which there was little market activity for identical or nearly identical securities during the period and represented transfers to or from Level 2. Such securities were valued using multiple observable inputs when those inputs were available; otherwise the securities were valued using limited observable inputs.

(In thousands)	September 30, 2012		
	Level 3 Fair Value Measurements - Liabilities		
	2019 Note Payable	Interest rate swap agreement	Total
Balance June 30, 2012	\$ 14,777	\$ 4,734	\$ 19,511
Total (gains) losses realized and unrealized:			
Included in earnings as a part of:			
Net realized investment (gains) losses	—	401	401
Loss on extinguishment of debt	2,163	—	2,163
Settlements	(16,940)	(5,135)	(22,075)
Balance September 30, 2012	\$—	\$—	\$—
Change in unrealized (gains) losses included in earnings for the above period for Level 3 liabilities outstanding at period-end	\$—	\$—	\$—

(In thousands)	September 30, 2012		
	Level 3 Fair Value Measurements - Liabilities		
	2019 Note Payable	Interest rate swap agreement	Total
Balance December 31, 2011	\$ 14,180	\$ 4,659	\$ 18,839
Total (gains) losses realized and unrealized:			
Included in earnings as a part of:			
Net realized investment (gains) losses	769	476	1,245
Loss on extinguishment of debt	2,163	—	2,163
Settlements	(17,112)	(5,135)	(22,247)
Balance September 30, 2012	\$—	\$—	\$—
Change in unrealized (gains) losses included in earnings for the above period for Level 3 liabilities outstanding at period-end	\$—	\$—	\$—

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ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2012

2. Fair Value Measurement (continued)

(In thousands)	September 30, 2011		
	Level 3 Fair Value Measurements - Liabilities		
	2019 Note Payable	Interest rate swap agreement	Total
Balance June 30, 2011	\$15,863	\$3,852	\$19,715
Total (gains) losses realized and unrealized:			