PROASSURANCE CORP
Form 10-Q
November 06, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
ý Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2013 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 ý 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 ý 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	ý	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 ý
As of October 25, 2013, there were 61,673,933 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”, “likely”, “may”, “optimistic”, “possible”, “potential”, “preliminar “should”, “will” and other 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:

- changes in general economic conditions;
- 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;
- 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, the Financial Accounting Standards Board, the Securities and Exchange Commission or the Public Company Accounting Oversight Board;
- changes in laws or government regulations affecting the financial services industry, the property and casualty insurance industry or particular insurance lines underwritten by our subsidiaries;
- 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;
- 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;

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- 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 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 legal and accounting 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 merger of Medmarc Mutual Insurance Company, now Medmarc Casualty Insurance Company (Medmarc), Independent Nevada Doctors Insurance Exchange (IND), merged into ProAssurance Casualty Company effective October 1, 2013, and Eastern Insurance Holdings, Inc. (Eastern) into ProAssurance, include but are not limited to the following:

- the outcome of any potential claims asserted by either the policyholders or shareholders of any of these acquired entities relating to payments or other issues associated with the acquisition of the entities and subsequent mergers into ProAssurance;
- the businesses of ProAssurance and Medmarc, ProAssurance and IND or ProAssurance and Eastern may not be integrated successfully, or such integration may take longer to accomplish than expected;
- cost savings from the transactions may not be fully realized or may take longer to realize than expected;
- operating costs, customer loss and business disruption following one or all transactions, including adverse effects on relationships with employees, may be greater than expected;
- there may be restrictions on our ability to achieve continued growth through expansion into other states or through acquisitions or business combinations;
- governmental approvals of the Eastern merger may not be obtained or adverse regulatory conditions may be imposed in connection with governmental approvals of the merger;
- the board of directors of Eastern may withdraw its recommendation and support a competing acquisition proposal; and
- Eastern's shareholders may fail to approve the merger.

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, 2013	December 31, 2012
Assets		
Investments		
Fixed maturities, available for sale, at fair value; amortized cost, $3,104,248 and $3,224,332, respectively	$3,212,057	$3,447,999
Equity securities, trading, at fair value; cost, $211,188 and $187,891, respectively	249,699	202,618
Short-term investments	115,946	71,737
Business owned life insurance	53,922	52,414
Investment in unconsolidated subsidiaries	189,590	121,049
Other investments	36,459	31,085
Total Investments	3,857,673	3,926,902
Cash and cash equivalents	279,051	118,551
Premiums receivable	131,179	106,312
Receivable from reinsurers on paid losses and loss adjustment expenses	6,934	4,517
Receivable from reinsurers on unpaid losses and loss adjustment expenses	249,720	191,645
Prepaid reinsurance premiums	24,348	13,404
Deferred policy acquisition costs	30,245	23,179
Deferred tax asset	1,341	—
Real estate, net	41,373	41,502
Intangible assets	52,880	53,225
Goodwill	161,115	163,055
Other assets	127,973	234,286
Total Assets	$4,963,832	$4,876,578
Liabilities and Shareholders’ Equity		
Liabilities		
Policy liabilities and accruals		
Reserve for losses and loss adjustment expenses	$2,148,112	$2,054,994
Unearned premiums	281,568	233,861
Reinsurance premiums payable	37,507	45,591
Total Policy Liabilities	2,467,187	2,334,446
Deferred tax liability	—	14,585
Other liabilities	123,284	131,967
Long-term debt, at amortized cost	—	125,000
Total Liabilities	2,590,471	2,605,998
Shareholders’ Equity		
Common shares, par value $0.01 per share, 100,000,000 shares authorized, 62,092,164 and 61,867,034 shares issued, respectively	621	619
Additional paid-in capital	347,547	341,780
Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of $37,733 and $78,284, respectively	70,073	145,380
Retained earnings	1,963,140	1,782,857
	2,381,381	2,270,636
Treasury shares, at cost, 418,240 shares and 243,530 shares, respectively	(8,020)	(56)
Total Shareholders’ Equity	2,373,361	2,270,580
Total Liabilities and Shareholders’ Equity	$4,963,832	$4,876,578

See accompanying notes. 5

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

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total
Balance at December 31, 2012	$619	$341,780	$ 145,380	$1,782,857	$(56)	$2,270,580
Common shares reacquired	—	—	—	—	(7,964)	(7,964)
Common shares issued for compensation	—	2,807	—	—	—	2,807
Share-based compensation	—	6,930	—	—	—	6,930
Net effect of restricted and performance shares issued and stock options exercised	2	(3,970)	—	—	—	(3,968)
Dividends to shareholders	—	—	—	(46,375)	—	(46,375)
Other comprehensive income (loss)	—	—	(75,307)	—	—	(75,307)
Net income	—	—	—	226,658	—	226,658
Balance at September 30, 2013	$621	$347,547	$ 70,073	$1,963,140	$(8,020)	$2,373,361

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total
Balance at December 31, 2011	$346	$538,625	$ 130,037	$1,699,853	$(204,408)	$2,164,453
Common shares issued for compensation	—	2,213	—	—	—	2,213
Share-based compensation	—	6,381	—	—	—	6,381
Net effect of restricted and performance shares issued and stock options exercised	1	(3,748)	—	—	—	(3,747)
Dividends to shareholders	—	—	—	(23,005)	—	(23,005)
Other comprehensive income (loss)	—	—	28,899	—	—	28,899
Net income	—	—	—	174,204	—	174,204
Balance at September 30, 2012	$347	$543,471	$ 158,936	$1,851,052	$(204,408)	$2,349,398

See accompanying notes. 6

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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	
	2013	2012	2013	2012
Revenues				
Net premiums earned	$133,598	$127,125	$398,528	$395,050
Net investment income	33,889	33,910	99,282	101,912
Equity in earnings (loss) of unconsolidated subsidiaries	(305)	211	(3,500)	(4,082)
Net realized investment gains (losses):				
Other-than-temporary impairment (OTTI) losses	—	(142)	(71)	(1,566)
Portion of OTTI losses recognized in (reclassified from) other comprehensive income before taxes	—	—	—	(201)
Net impairment losses recognized in earnings	—	(142)	(71)	(1,767)
Other net realized investment gains (losses)	12,500	13,361	47,721	24,115
Total net realized investment gains (losses)	12,500	13,219	47,650	22,348
Other income	1,804	1,529	5,305	5,207
Total revenues	181,486	175,994	547,265	520,435
Expenses				
Losses and loss adjustment expenses	65,619	63,675	203,885	197,112
Reinsurance recoveries	(3,982)	(7,054)	(14,013)	(22,208)
Net losses and loss adjustment expenses	61,637	56,621	189,872	174,904
Underwriting, policy acquisition and operating expenses	33,348	33,280	105,592	103,083
Interest expense	322	350	1,085	2,002
Loss on extinguishment of debt	—	2,163	—	2,163
Total expenses	95,307	92,414	296,549	282,152
Gain on acquisition	494	—	35,986	—
Income before income taxes	86,673	83,580	286,702	238,283
Provision for income taxes				
Current expense (benefit)	12,687	19,017	36,902	56,612
Deferred expense (benefit)	10,629	4,457	23,142	7,467
Total income tax expense (benefit)	23,316	23,474	60,044	64,079
Net income	$63,357	$60,106	$226,658	$174,204
Other comprehensive income (loss), after tax, net of reclassification adjustments	(4,989)	18,885	(75,307)	28,899
Comprehensive income (loss)	$58,368	$78,991	$151,351	$203,103
Earnings per share:				
Basic	$1.02	$0.98	$3.67	$2.84

Diluted	$1.02	$0.97	$3.65	$2.82
Weighted average number of common shares outstanding:				
Basic	61,844	61,349	61,793	61,281
Diluted	62,108	61,875	62,040	61,804
Cash dividends declared per common share	$0.25	$0.13	$0.75	$0.38

See accompanying notes. 7

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

	Nine Months Ended September 30			
	2013		2012	
Operating Activities				
Net income	$226,658		$174,204	
Adjustments to reconcile income to net cash provided by operating activities:				
Depreciation and amortization	34,364		28,280	
Loss (gain) on extinguishment of debt	—		2,163	
Gain on acquisition	(35,986	)	—	
Net realized investment gains	(47,650	)	(22,348	)
Share-based compensation	6,930		6,381	
Deferred income taxes	23,142		7,467	
Policy acquisition costs, net amortization (net deferral)	(7,066	)	1,584	
Other	(8,367	)	(2,423	)
Other changes in assets and liabilities, excluding effect of business combinations:				
Premiums receivable	(21,881	)	(4,984	)
Reinsurance related assets and liabilities	(1,510	)	11,767	
Other assets	(34,016	)	(5,217	)
Reserve for losses and loss adjustment expenses	(104,387	)	(94,224	)
Unearned premiums	23,574		6,506	
Other liabilities	(29,844	)	(47,800	)
Net cash provided (used) by operating activities	23,961		61,356	
Investing Activities				
Purchases of:				
Fixed maturities, available for sale	(406,152	)	(533,780	)
Equity securities, trading	(73,292	)	(84,008	)
Other investments	(7,926	)	(9,539	)
Funding of tax credit limited partnerships	(58,801	)	(29,458	)
(Investment in) distributions from unconsolidated subsidiaries, net	(1,073	)	(6,451	)
Proceeds from sales or maturities of:				
Fixed maturities, available for sale	782,612		666,054	
Equity securities, trading	95,658		33,343	
Other investments	2,352		588	
Net sales or maturities (purchases) of short-term investments	(43,434	)	(48,230	)
Cash received from acquisitions	22,780		—	
Unsettled security transactions, net	(2,744	)	3,399	
Cash received (paid) for other assets	(8,253	)	(5,651	)
Net cash provided (used) by investing activities	301,727		(13,733	)

See accompanying notes. 8

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	Nine Months Ended September 30	
	2013	2012
Financing Activities		
Repayment of long-term debt	(125,000)	(57,660)
Repurchase of common stock	(1,990)	—
Dividends to shareholders	(30,842)	(22,922)
Other	(7,356)	218
Net cash provided (used) by financing activities	(165,188)	(80,364)
Increase (decrease) in cash and cash equivalents	160,500	(32,741)
Cash and cash equivalents at beginning of period	118,551	130,400
Cash and cash equivalents at end of period	$279,051	$97,659
Significant non-cash transactions		
Deposit transferred as consideration for acquisition	$153,700	$—

See accompanying notes.

1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of ProAssurance Corporation and its consolidated subsidiaries (ProAssurance, PRA or the Company). 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, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes contained in ProAssurance’s December 31, 2012 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, 2013 for recognition or disclosure in its financial statements and notes to financial statements.

Stock Split

In 2012, the Board of Directors of ProAssurance Corporation (the Board) declared a two-for-one split of ProAssurance common shares which was effected December 27, 2012 in the form of a stock dividend. All share and per share information provided in this report reflects the effect of the split for all periods presented.

Accounting Changes Not Yet Adopted

Liabilities-Obligations Resulting from Joint and Several Liability Arrangements

Effective for fiscal years beginning after December 15, 2013, the Financial Accounting Standards Board (FASB) revised guidance related to obligations resulting from joint and several liability arrangements. The new guidance requires an entity to recognize, measure and disclose obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date, except for obligations already addressed within existing GAAP guidance. The new guidance requires retrospective application to all prior periods presented for any such arrangements that exist at the beginning of the fiscal year of adoption. ProAssurance plans to adopt the guidance beginning January 1, 2014. Adoption of this guidance is expected to have no effect on ProAssurance's results of operations or financial position.

Income Taxes-Presentation of Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists

Effective for fiscal years beginning after December 15, 2013, the FASB issued guidance related to the financial statement presentation of unrecognized tax benefits. The new guidance requires an entity to present unrecognized tax benefits as a reduction to a deferred tax asset resulting from a net operating loss carryforward, a similar tax loss, or tax credit carryforward except in circumstances where the relevant taxing authority does not permit offset or does not require offset and the entity does not intend to use the deferred tax asset for offset. The guidance requires prospective application for all unrecognized tax benefits that exist as of the effective date, but may be applied retrospectively. ProAssurance plans to adopt the guidance prospectively beginning January 1, 2014. Adoption of this guidance is expected to have no effect on ProAssurance's results of operations or financial position.

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Accounting Changes 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 adopted the guidance on January 1, 2013. Adoption of this guidance had no material effect on ProAssurance's results of operations or financial position.

Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income

Effective for interim and annual reporting periods beginning after December 15, 2012, the FASB revised guidance related to the disclosure of amounts reclassified out of accumulated other comprehensive income. The most significant provisions of the new guidance require entities to present additional disclosure, either on the face of the income statement or in the notes, regarding significant amounts reclassified, in their entirety, from accumulated other comprehensive income to net income. ProAssurance adopted the guidance on January 1, 2013. Adoption of this guidance had no material effect on ProAssurance’s results of operations or financial position as it impacts disclosures only.

Disclosures About Offsetting Assets and Liabilities

Effective for fiscal years beginning on or after January 1, 2013, the 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 adopted the guidance on January 1, 2013. Adoption of this guidance had no material effect on ProAssurance’s results of operations or financial position as it impacts disclosures only.

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2013

2. Acquisitions
All entities acquired in 2013 and 2012 were accounted for in accordance with GAAP relating to business combinations.
On January 1, 2013, ProAssurance completed the acquisition of Medmarc Mutual Insurance Company, now Medmarc Casualty Insurance Company (Medmarc), through a sponsored demutualization. Medmarc is based in Chantilly, Virginia and provides products liability insurance for medical technology and life sciences companies and also provides legal professional liability insurance. ProAssurance acquired Medmarc for cash of $153.7 million, including the funding of future policy credits for eligible members of $7.5 million. ProAssurance transferred all of the cash required to complete the transaction to a third-party conversion agent for the benefit of Medmarc eligible members on December 27, 2012; the deposit was classified as a part of Other Assets at December 31, 2012. ProAssurance incurred expenses related to the purchase of approximately $2.3 million during the first nine months of 2013 and approximately $1.0 million during the year ended December 31, 2012. These expenses were included as a part of operating expenses in the periods incurred.
During 2012, ProAssurance completed an acquisition of a reciprocal exchange that converted to a stock insurance company upon acquisition. The acquisition was not material to ProAssurance.
The purchase consideration for Medmarc was allocated to the assets acquired and liabilities assumed based on their estimated fair values on the acquisition date, as shown in the table below. The purchase consideration was less than the estimated fair value of the net assets acquired resulting in a gain on the acquisition of $36.0 million, including $0.5 million recognized during the third quarter of 2013 due to the redetermination of pre-acquisition tax liabilities. ProAssurance believes it was able to acquire Medmarc for less than the fair value of its net assets due to Medmarc's declining premium base and its small capital position relative to other insurers in the medical technology and life sciences products liability insurance market.

(In thousands)		
Fixed maturities, available for sale	$269,529	
Equity securities, trading	30,976	
Cash and short-term investments	24,008	
Other investments	5,340	
Premiums receivable	2,986	
Receivable from reinsurers on unpaid losses and LAE	73,107	
Intangible assets	3,630	
Other assets	14,614	
Reserve for losses and loss adjustment expenses	(201,072	)
Unearned premiums	(16,937	)
Deferred tax liabilities	(1,262	)
Other liabilities	(15,233	)
Fair value of net assets acquired	$189,686	
Gain on Acquisition	(35,986	)
Total purchase consideration	$153,700	

Intangible assets acquired principally consist of non-compete agreements, which are amortizable over their useful life of two years, and insurance licenses, which have an indefinite useful life and are not amortized.
ProAssurance believes that all contractual cash flows related to acquired receivables will be collected. The fair value of reserves for losses and loss adjustment expenses and related reinsurance recoverables were estimated based on the present value of the expected underlying net cash flows, including a 5% profit margin and a 5% risk premium, and were determined to be materially the same as the recorded cost basis acquired.

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ProAssurance Corporation and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
September 30, 2013

The following table provides Pro Forma Consolidated Results for the three and nine months ended September 30, 2013 and 2012 as if the Medmarc transaction had occurred on January 1, 2012. ProAssurance Actual Consolidated Results have been adjusted by the following, net of related tax effects, to reflect the Pro Forma Consolidated Results below.

- For the three and nine months ended September 30, 2012, the ProAssurance 2012 Actual Consolidated Results did not include Medmarc, and have been adjusted to include Medmarc's 2012 operating results. ProAssurance Actual Consolidated Results for the three and nine months ended September 30, 2013 included Medmarc operating results (Revenue of $10.4 million and $33.2 million, respectively, and Earnings of $1.9 million and $6.4 million, respectively).
- Certain costs included in ProAssurance actual results for the three and nine months ended September 30, 2013 have been reported in the Pro Forma Consolidated Results as if the costs had been incurred for the three and nine months ended September 30, 2012. Such costs include direct transaction costs and certain compensation costs directly related to the integration of Medmarc operations.
- Prior to the acquisition date, Medmarc reported on a statutory basis and expensed policy acquisition costs associated with successful contracts as incurred. After the acquisition date, in accordance with GAAP, Medmarc policy acquisition costs associated with successful contracts were capitalized and amortized to expense as the related premium revenues were earned, but no amortization was recognized for Medmarc policies written prior to the acquisition date. The Pro Forma Consolidated Results for both 2013 and 2012 have been adjusted to reflect policy acquisition costs as if Medmarc had followed GAAP guidance for these costs in pre-acquisition periods.
- Earnings for the three and nine months ended September 30, 2012, were reduced to reflect amortization of intangible assets and debt security premiums and discounts recorded as a part of the Medmarc purchase price allocation.
- The gain on the acquisition of $0.5 million and $36.0 million that was included in ProAssurance Actual Consolidated Results for the three and nine months ended September 30, 2013, respectively, has been reported in the Pro Forma Consolidated Results as being recognized during the three and nine months ended September 30, 2012.

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
(In thousands)	ProAssurance Pro Forma Consolidated Results	ProAssurance Actual Consolidated Results	ProAssurance Pro Forma Consolidated Results	ProAssurance Actual Consolidated Results
Revenue	$181,486	$181,486	$547,265	$547,265
Earnings	$62,603	$63,357	$189,593	$226,658

	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
(In thousands)	ProAssurance Pro Forma Consolidated Results	ProAssurance Actual Consolidated Results	ProAssurance Pro Forma Consolidated Results	ProAssurance Actual Consolidated Results
Revenue	$186,571	$175,994	$551,532	$520,435
Earnings	$62,678	$60,106	$214,361	$174,204

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3. 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 measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012, 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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	September 30, 2013			
	Fair Value Measurements Using			Total
(In thousands)	Level 1	Level 2	Level 3	Fair Value
Assets:				
Fixed maturities, available for sale				
U.S. Treasury obligations	$—	$176,548	$—	$176,548
U.S. Government-sponsored enterprise obligations	—	36,374	—	36,374
State and municipal bonds	—	1,182,087	5,025	1,187,112
Corporate debt, multiple observable inputs	—	1,372,499	—	1,372,499
Corporate debt, limited observable inputs:				
Private placement senior notes	—	—	—	—
Other corporate debt, NRSRO ratings available	—	—	9,853	9,853
Other corporate debt, NRSRO ratings not available	—	—	881	881
Residential mortgage-backed securities	—	247,883	—	247,883
Agency commercial mortgage-backed securities	—	31,366	—	31,366
Other commercial mortgage-backed securities	—	66,031	—	66,031
Other asset-backed securities	—	78,815	4,695	83,510
Equity securities				
Financial	80,016	—	—	80,016
Utilities/Energy	32,515	—	—	32,515
Consumer oriented	64,330	—	—	64,330
Industrial	57,149	—	—	57,149
All other	15,689	—	—	15,689
Short-term investments	108,765	7,181	—	115,946
Financial instruments carried at fair value, classified as a part of:				
Investment in unconsolidated subsidiaries	—	—	44,656	44,656
Total assets	$358,464	$3,198,784	$65,110	$3,622,358

	December 31, 2012			
	Fair Value Measurements Using			Total
(In thousands)	Level 1	Level 2	Level 3	Fair Value
Assets:				
Fixed maturities, available for sale				
U.S. Treasury obligations	$—	$205,857	$—	$205,857
U.S. Government-sponsored enterprise obligations	—	56,947	—	56,947
State and municipal bonds	—	1,212,804	7,175	1,219,979
Corporate debt, multiple observable inputs	—	1,455,333	—	1,455,333
Corporate debt, limited observable inputs:				
Private placement senior notes	—	—	346	346
Other corporate debt, NRSRO ratings available	—	—	13,835	13,835
Other corporate debt, NRSRO ratings not available	—	—	1,010	1,010
Residential mortgage-backed securities	—	289,850	—	289,850
Agency commercial mortgage-backed securities	—	59,464	—	59,464
Other commercial mortgage-backed securities	—	74,106	—	74,106
Other asset-backed securities	—	67,237	4,035	71,272
Equity securities				
Financial	70,900	—	—	70,900
Utilities/Energy	31,383	—	—	31,383
Consumer oriented	51,100	—	—	51,100
Industrial	29,695	—	—	29,695
All other	19,540	—	—	19,540
Short-term investments	59,761	11,976	—	71,737
Financial instruments carried at fair value, classified as a part of:				
Investment in unconsolidated subsidiaries	—	—	33,739	33,739
Total assets	$262,379	$3,433,574	$60,140	$3,756,093

The fair values for securities included in the Level 2 category, with the few exceptions described below, have been developed by one of several third party, nationally recognized pricing services, including services that price only certain types of securities. Each service uses complex methodologies to determine values for securities and subject the values they develop to quality control reviews. Management has selected a primary source for each type of security in the portfolio, and reviews the values provided for reasonableness by comparing data to alternate 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 2013 or 2012.

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 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. Valuations 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. Valuations of subprime home equity loans use the same valuation 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 Vice President of Investments for our subsidiaries, 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.
- Exclusive of Investments in unconsolidated subsidiaries, which are valued at net asset value (NAV), the securities noted in the disclosure are primarily NRSRO rated corporate debt instruments for which comparable market inputs are commonly available for evaluating the securities in question. Valuation of these corporate debt instruments is not overly sensitive to changes in the unobservable inputs used.

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Level 3 Valuation Methodologies
State and municipal bonds consists of auction rate municipal bonds valued internally using either published quotes for similar securities or values produced by discounted cash flow models 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, 2013 and December 31, 2012 all of these bonds were rated A- or better.
Corporate debt with limited observable inputs consists of certain corporate bonds and, at December 31, 2012, private placement senior notes guaranteed by large regional banks. 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, 2013, the average rating of rated securities was A-.
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 consist of limited partnership (LP) and limited liability company (LLC) interests valued using the NAV provided by the LP/LLC, which approximates the fair value of the interest.
Such interests include the following:

	Unfunded Commitments	Fair Value	
(In thousands)	September 30, 2013	September 30, 2013	December 31, 2012
Investments in LPs/LLCs:			
Secured debt fund (1)	$27,800	$12,342	$—
Long equity fund (2)	None	5,813	—
Long/Short equity fund (3)	None	6,128	17,115
Non-public equity funds (4)	40,353	20,373	16,624
		$44,656	$33,739

(1) The LP is structured to provide income and capital appreciation primarily through investments in senior secured debt. Redemptions are not allowed. Income and capital are to be periodically distributed at the discretion of the LP over an anticipated time frame that spans from 7 to 9 years.

(2) The LP holds long equities of public international companies. Redemptions are allowed at the end of any calendar month with a prior notice requirement of 15 days and are paid within 10 days of the end of the calendar month of the redemption request.

(3) 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 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.

(4) Comprised of interests in two unrelated LP funds, each 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 LPs. One LP allows redemption by special consent; the other does not permit redemption. 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.

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Quantitative Information Regarding Level 3 Valuations
Quantitative Information about Level 3 Fair Value Measurements

(In millions)	Fair Value at September 30, 2013	December 31, 2012	Valuation Technique	Unobservable Input	Range (Weighted Average)
Assets:					
State and municipal bonds	$5.0	$7.2	Market Comparable Securities	Comparability Adjustment	0% - 10% (5%)
			Discounted Cash Flows	Comparability Adjustment	0% - 10% (5%)
Corporate debt with limited observable inputs	$10.7	$15.2	Market Comparable Securities	Comparability Adjustment	0% - 5% (2.5%)
			Discounted Cash Flows	Comparability Adjustment	0% - 5% (2.5%)
Other asset-backed securities	$4.7	$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.
Fair Value Measurements - Level 3 Assets
The following tables (the Level 3 Tables) present summary information regarding changes in the fair value of assets measured at fair value using Level 3 inputs.

	September 30, 2013 Level 3 Fair Value Measurements – Assets					
(In thousands)	State and Municipal Bonds	Corporate Debt	Asset-backed Securities	Investment in Unconsolidated Subsidiaries	Other Investments	Total
Balance June 30, 2013	$5,025	$11,359	$ 4,679	$ 44,549	$ —	$65,612
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Net investment income	—	(1)	—	—	—	(1)
Equity in earnings of unconsolidated subsidiaries	—	—	—	1,301	—	1,301
Net realized investment gains (losses)	—	—	—	—	—	—
Included in other comprehensive income	—	(221)	16	—	—	(205)
Purchases	—	—	—	2,354	—	2,354
Sales	—	(503)	—	(3,548)	—	(4,051)
Transfers in	—	100	—	—	—	100
Transfers out	—	—	—	—	—	—
Balance September 30, 2013	$5,025	$10,734	$ 4,695	$ 44,656	$ —	$65,110
Change in unrealized gains (losses) included in earnings for the above period	$—	$—	$ —	$ 1,301	$ —	$1,301

for Level 3 assets held at period-end

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	September 30, 2013					
	Level 3 Fair Value Measurements – Assets					
(In thousands)	State and Municipal Bonds	Corporate Debt	Asset-backed Securities	Investment in Unconsolidated Subsidiaries	Other Investments	Total
Balance December 31, 2012	$7,175	$15,191	$ 4,035	$ 33,739	$ —	$60,140
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Net investment income	—	(103)	(17)	—	—	(120)
Equity in earnings of unconsolidated subsidiaries	—	—	—	3,582	—	3,582
Net realized investment gains (losses)	(44)	(69)	—	—	—	(113)
Included in other comprehensive income	—	(514)	(81)	—	—	(595)
Purchases	—	7,470	1,356	20,975	—	29,801
Sales	(2,106)	(1,368)	(18)	(13,640)	—	(17,132)
Transfers in	—	100	1,701	—	—	1,801
Transfers out	—	(9,973)	(2,281)	—	—	(12,254)
Balance September 30, 2013	$5,025	$10,734	$ 4,695	$ 44,656	$ —	$65,110
Change in unrealized gains (losses) included in earnings for the above period for Level 3 assets held at period-end	$—	$—	$ —	$ 3,582	$ —	$3,582

	September 30, 2012					
	Level 3 Fair Value Measurements – Assets					
(In thousands)	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

	September 30, 2012					
	Level 3 Fair Value Measurements – Assets					
(In thousands)	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)
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

Transfers

There were no transfers between the Level 1 and Level 2 categories during the three and nine months ended September 30, 2013 or 2012.

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 nine months ended September 30, 2012 related to an interest in an LLC. 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, 2013 and September 30, 2012 related to securities held for which the level of market activity for identical or nearly identical securities varies from period to period. The securities were valued using multiple observable inputs when those inputs were available; otherwise the securities were valued using limited observable inputs.

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Fair Value Measurements - Level 3 Liabilities
The following tables present information for the three and nine months ended September 30, 2012 regarding liabilities for which ProAssurance had elected fair value treatment.

	September 30, 2012 Level 3 Fair Value Measurements - Liabilities		
(In thousands)	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	$—	$—	$—

	September 30, 2012 Level 3 Fair Value Measurements - Liabilities		
(In thousands)	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	$—	$—	$—

The 2019 Note Payable (the Note) and a related interest rate swap agreement (the Swap) were measured at fair value on a recurring basis during 2012 and 2011, with changes in the fair value of each liability recorded in net realized investment gains (losses). ProAssurance assumed both liabilities as part of a previous acquisition. The fair value option was elected for the Note and the Swap because valuation at fair value better reflected the economics of the related liabilities and eliminated the inconsistency that would have otherwise resulted from carrying the Note on an amortized cost basis and the Swap at fair value. Both the Note and the Swap were repaid in July 2012. The fair values of these liabilities were determined using the present value of the expected underlying cash flows of each instrument, discounted at rates available on the valuation date for similar instruments issued by entities with a similar credit standing to ProAssurance.

Financial Instruments - Methodologies Other Than Fair Value

The following table provides the estimated fair value of our financial instruments that, in accordance with GAAP for the type of investment, are measured using a methodology other than fair value. All fair values provided fall within the Level 3 fair value category.

(In thousands)	September 30, 2013		December 31, 2012	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
BOLI	$53,922	$53,922	$52,414	$52,414
Investment in unconsolidated subsidiaries	144,934	142,460	87,310	91,528
Other investments	36,459	47,900	31,085	38,656
Other assets	15,396	15,396	11,400	11,385
Financial liabilities:				
Revolving credit agreement	$—	$—	$125,000	$125,000
Other liabilities	12,623	12,570	12,130	12,085

The fair value of the BOLI was equal to the cash surrender value associated with the policies on the valuation date.

Investment in unconsolidated subsidiaries consisted of investments in tax credit partnerships and a non-controlling interest in a limited liability company. Fair values of investments in tax credit partnerships were based on the present value of the cash flows expected to be generated by the partnerships discounted at rates for investments with similar risk structures and repayment periods. The fair value of the LLC interest was estimated as the proceeds ProAssurance would receive upon liquidation of the LLC.

Other investments listed in the table above include interests in certain investment fund LPs/LLCs accounted for using the cost method, investments in Federal Home Loan Bank (FHLB) common stock carried at cost, and an annuity investment carried at amortized cost. The estimated fair value of the LP/LLC interests were based on the NAVs provided by the LP/LLC managers. The estimated fair value of the FHLB common stock was based on the amount ProAssurance would receive if its membership were canceled, as the membership cannot be sold. The fair value of the annuity was the present value of the expected future cash flows discounted using a rate available in active markets for similarly structured instruments.

Other assets and Other liabilities primarily consisted of related investment assets and liabilities associated with funded deferred compensation agreements. Other assets also included a secured note receivable. Fair value of the note is based on the present value of the expected cash flows, discounted at market rates on the valuation date for secured notes receivable with similar credit standings and similar payment structures. Other liabilities also included certain contractual liabilities related to prior business combinations. Fair values of the funded deferred compensation assets and liabilities were based on the NAVs of the underlying securities. The fair values of the business combination liabilities were based on the present value of the expected cash flows, discounted at ProAssurance's assumed incremental borrowing rate on the valuation date for unsecured liabilities with similar repayment structures.

The fair value of the revolving credit agreement was estimated based on the present value of expected future cash outflows under the agreement, discounted at rates available on the valuation date for similar debt issued by entities with a similar credit standing to ProAssurance.

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4. Investments
Available-for-sale securities at September 30, 2013 and December 31, 2012 included the following:

	September 30, 2013			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities				
U.S. Treasury obligations	$169,567	$7,931	$(950)	$176,548
U.S. Government-sponsored enterprise obligations	34,024	2,662	(312)	36,374
State and municipal bonds	1,142,920	51,603	(7,411)	1,187,112
Corporate debt	1,340,407	56,409	(13,583)	1,383,233
Residential mortgage-backed securities	239,952	9,667	(1,736)	247,883
Agency commercial mortgage-backed securities	30,936	494	(64)	31,366
Other commercial mortgage-backed securities	63,178	3,022	(169)	66,031
Other asset-backed securities	83,264	575	(329)	83,510
	$3,104,248	$132,363	$(24,554)	$3,212,057

	December 31, 2012			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities				
U.S. Treasury obligations	$191,642	$14,266	$(51)	$205,857
U.S. Government-sponsored enterprise obligations	52,110	4,837	—	56,947
State and municipal bonds	1,134,744	85,329	(94)	1,219,979
Corporate debt	1,375,880	96,187	(1,543)	1,470,524
Residential mortgage-backed securities	272,990	17,070	(210)	289,850
Agency commercial mortgage-backed securities	57,234	2,255	(25)	59,464
Other commercial mortgage-backed securities	69,062	5,049	(5)	74,106
Other asset-backed securities	70,670	1,203	(601)	71,272
	$3,224,332	$226,196	$(2,529)	$3,447,999

The recorded cost basis and estimated fair value of available-for-sale fixed maturities at September 30, 2013, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(In thousands)	Amortized Cost	Due in one year or less	Due after one year through five years	Due after five years through ten years	Due after ten years	Total Fair Value
Fixed maturities, available for sale						
U.S. Treasury obligations	$169,567	$17,864	$120,344	$34,520	$3,820	$176,548
U.S. Government-sponsored enterprise obligations	34,024	—	28,239	7,145	990	36,374
State and municipal bonds	1,142,920	54,127	394,324	485,306	253,355	1,187,112
Corporate debt	1,340,407	111,860	605,867	628,504	37,002	1,383,233
Residential mortgage-backed securities	239,952					247,883
Agency commercial mortgage-backed securities	30,936					31,366
Other commercial mortgage-backed securities	63,178					66,031
Other asset-backed securities	83,264					83,510
	$3,104,248					$3,212,057

Excluding investments in bonds and notes of the U.S. Government and U.S. Government-sponsored enterprise obligations, no investment in any entity or its affiliates exceeded 10% of shareholders' equity at September 30, 2013.
Cash and securities with a carrying value of $37.1 million at September 30, 2013 were on deposit with various state insurance departments to meet regulatory requirements.

Business Owned Life Insurance (BOLI)

ProAssurance holds BOLI policies on management employees that are carried at the current cash surrender value of the policies (original cost $33 million). The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. ProAssurance is the owner and principal beneficiary of these policies.

Other Investments

Other Investments at September 30, 2013 and December 31, 2012 was comprised as follows:

(In thousands)	September 30, 2013	December 31, 2012
Investments in LPs/LLCs, at cost	$31,495	$25,092
FHLB capital stock, at cost	3,449	4,278
Other, principally an annuity, at amortized cost	1,515	1,715
	$36,459	$31,085

FHLB capital stock is not marketable, but may be liquidated by terminating membership in the FHLB. The liquidation process can take up to five years.

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Unconsolidated Subsidiaries
ProAssurance holds investments in unconsolidated subsidiaries, accounted for under the equity method. The investments include the following:

	September 30, 2013		Carrying Value	
(In thousands)	Unfunded Commitments*	Percentage Ownership	September 30, 2013	December 31, 2012
Investment in LPs/LLCs:				
Tax credit partnerships	$27,062	See below	$144,934	$87,310
Secured debt fund	27,800	< 20%	12,342	—
Long equity fund	None	< 20%	5,813	—
Long/Short equity fund	None	< 20%	6,128	17,115
Non-public equity funds	40,353	< 20%	20,373	16,624
			$189,590	$121,049

* Unfunded commitments are included in the carrying value of tax credit partnerships, only.

Tax credit partnership interests held by ProAssurance generate investment returns by providing tax benefits to fund investors in the form of project operating losses and tax credits. The related properties are principally low income housing projects. ProAssurance's ownership percentage relative to two of the tax credit partnership interests was almost 100%; these interests had a carrying value of $63.6 million at September 30, 2013. ProAssurance's ownership percentage relative to the remaining tax credit partnership interests was less than 20%; these interests had a carrying value of $81.3 million at September 30, 2013. All are accounted for under the equity method as ProAssurance does not have the ability to exert control over the partnerships.

The Secured debt fund is structured to provide interest distributions and capital appreciation primarily through investments in senior secured debt.

The Long equity fund targets long-term total returns through holdings in public international companies.

The Long/Short equity fund targets absolute returns using a strategy designed to take advantage of event-driven market opportunities.

The Non-public equity funds hold diversified private equities and are structured to provide capital appreciation.

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Investments Held in a Loss Position

The following tables provide summarized information with respect to investments held in an unrealized loss position at September 30, 2013 and December 31, 2012, including the length of time the investment had been held in a continuous unrealized loss position.

	September 30, 2013					
	Total		Less than 12 months		More than 12 months	
(In thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Fixed maturities, available for sale						
U.S. Treasury obligations	$38,186	$(950)	$34,840	$(696)	$3,346	$(254)
U.S. Government-sponsored enterprise obligations	5,789	(312)	5,789	(312)	—	—
State and municipal bonds	193,840	(7,411)	191,873	(7,371)	1,967	(40)
Corporate debt	338,627	(13,583)	327,203	(12,903)	11,424	(680)
Residential mortgage-backed securities	65,616	(1,736)	64,928	(1,700)	688	(36)
Agency commercial mortgage-backed securities	2,617	(64)	2,284	(58)	333	(6)
Other commercial mortgage-backed securities	10,681	(169)	10,681	(169)	—	—
Other asset-backed securities	22,846	(329)	20,066	(108)	2,780	(221)
	$678,202	$(24,554)	$657,664	$(23,317)	$20,538	$(1,237)
Other investments						
Investments in LPs/LLCs carried at cost	$8,885	$(151)	$7,430	$(115)	$1,455	$(36)

	December 31, 2012					
	Total		Less than 12 months		More than 12 months	
(In thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Fixed maturities, available for sale						
U.S. Treasury obligations	$4,073	$(51)	$4,073	$(51)	$—	$—
State and municipal bonds	11,234	(94)	9,232	(65)	2,002	(29)
Corporate debt	90,154	(1,543)	81,878	(1,377)	8,276	(166)
Residential mortgage-backed securities	10,721	(210)	10,029	(205)	692	(5)
Agency commercial mortgage-backed securities	1,643	(25)	498	(2)	1,145	(23)
Other commercial mortgage-backed securities	2,100	(5)	1,103	(1)	997	(4)
Other asset-backed securities	10,746	(601)	7,707	(20)	3,039	(581)
	$130,671	$(2,529)	$114,520	$(1,721)	$16,151	$(808)
Other investments						
Investments in LPs/LLCs carried at cost	$9,474	$(851)	$8,697	$(688)	$777	$(163)

As of September 30, 2013, there were 872 debt securities (31.1% of all available-for-sale fixed maturity securities held) in an unrealized loss position representing 520 issuers. The single greatest unrealized loss position was approximately $0.5 million; the second greatest unrealized loss position was approximately $0.4 million. The securities were evaluated for impairment as of September 30, 2013.

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As of December 31, 2012, there were 142 debt securities (5.7% of all available-for-sale fixed maturity securities held) in an unrealized loss position representing 131 issuers. The single greatest unrealized loss position approximated $0.6 million; the second greatest unrealized loss position approximated $0.2 million. The securities were evaluated for impairment as of December 31, 2012.

Each quarter, ProAssurance performs a detailed analysis for the purpose of assessing whether any of the securities it holds in an unrealized loss position have suffered an other-than-temporary impairment in value. A detailed discussion of the factors considered in the assessment is included in Note 1 of the Notes to Consolidated Financial Statements included in ProAssurance's December 31, 2012 Form 10-K.

Fixed maturity securities held in an unrealized loss position at September 30, 2013, excluding asset-backed securities, have paid all scheduled contractual payments and are expected to continue doing so. Expected future cash flows of asset-backed securities held in an unrealized loss position were estimated as part of the September 30, 2013 impairment evaluation using the most recently available six-month historical performance data for the collateral (loans) underlying the security or, if historical data was not available, sector based assumptions, and equaled or exceeded the current amortized cost basis of the security.

Net Investment Income

Net investment income by investment category was as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
Fixed maturities	$30,672	$32,747	$93,687	$100,110
Equities	2,394	1,907	7,000	4,556
Short-term investments and Other invested assets	2,000	90	2,514	588
Business owned life insurance	633	653	1,508	1,571
Investment fees and expenses	(1,810)	(1,487)	(5,427)	(4,913)
Net investment income	$33,889	$33,910	$99,282	$101,912

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Net Realized Investment Gains (Losses)
Realized investment gains and losses are recognized on the specific identification basis. The following table provides detailed information regarding net realized investment gains (losses):

	Three Months Ended September 30		Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
Total other-than-temporary impairment losses:				
State and municipal bonds	$—	$—	$(71)	$—
Residential mortgage-backed securities	—	(94)	—	(557)
Corporate debt	—	(48)	—	(878)
Other investments	—	—	—	(131)
Portion recognized in (reclassified from) Other Comprehensive Income:				
Residential mortgage-backed securities	—	—	—	(201)
Net impairment losses recognized in earnings	—	(142)	(71)	(1,767)
Gross realized gains, available-for-sale securities	7,708	4,269	14,631	10,418
Gross realized (losses), available-for-sale securities	(5,305)	(452)	(6,269)	(635)
Net realized gains (losses), trading securities	5,818	933	14,650	1,660
Change in unrealized holding gains (losses), trading securities	3,355	7,874	23,784	12,779
Decrease (increase) in the fair value of liabilities carried at fair value	—	(401)	—	(1,245)
Other	924	1,138	925	1,138
Net realized investment gains (losses)	$12,500	$13,219	$47,650	$22,348

No significant impairment losses were recognized in the 2013 three- and nine-month periods. Significant impairment losses recognized during the 2012 three- and nine-month periods were as follows:

- ProAssurance recognized impairment losses related to certain residential mortgage-backed securities during the first two quarters of 2012 because carrying values for those securities were greater than the future cash flows expected to be received from the securities.
- ProAssurance recognized impairments related to corporate debt securities during the first quarter of 2012 because the credit standing of the issuers had deteriorated.

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

	Three Months Ended September 30		Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
Balance beginning of period	$413	$6,138	$3,301	$5,870
Additional credit losses recognized during the period, related to securities for which:				
OTTI has been previously recognized	—	—	—	268
Reductions due to:				
Securities sold during the period (realized)	(330)	—	(3,218)	—
Balance September 30	$83	$6,138	$83	$6,138

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Other information regarding sales and purchases of available-for-sale securities is as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
(In millions)	2013	2012	2013	2012
Proceeds from sales (exclusive of maturities and paydowns)	$319.2	$129.6	$494.8	$346.9
Purchases	$98.8	$186.6	$406.2	$533.8

5. Income Taxes

ProAssurance estimates its annual effective tax rate at the end of each quarterly reporting period which is used to record the provision for income taxes in the interim financial statements. 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, because ProAssurance utilizes tax credit benefits transferred from tax credit partnership investments, and in 2013, because ProAssurance recognized a non-taxable gain related to an acquisition.

The IRS has concluded an examination of the 2009 and 2010 returns and has issued a Notice of Proposed Adjustment (NOPA) for these years which would increase our current tax liability by approximately $130 million. ProAssurance has begun the IRS appeals process and is unable to reliably predict the timing of the final resolution or the ultimate outcome. The contested issues affect only the timing of when certain expense items are deductible for tax purposes and resolution of the NOPA would have no effect on our recorded tax expense, exclusive of interest found to be due on past-due taxes, if any.

At September 30, 2013, ProAssurance had a receivable for federal income taxes of $45 million, which was carried as a part of Other Assets. ProAssurance had a payable for federal income taxes of $20 million at December 31, 2012, which was carried as a part of Other Liabilities.

Except for the 2006 tax year, the statutes of limitation are closed for all years prior to 2009. The statutes for the 2006, 2009 and 2010 tax years have been extended until September 30, 2014.

6. Deferred Policy Acquisition Costs

Policy acquisition costs, most significantly commissions, premium taxes, and underwriting salaries and benefits, that are primarily and directly related to the successful production of new and renewal insurance contracts are capitalized as policy acquisition costs and amortized to expense as the related premium revenues are earned.

Amortization of deferred policy acquisition costs was $15.4 million and $43.2 million for the three and nine months ended September 30, 2013, respectively, and $14.0 million and $43.5 million for the three and nine months ended September 30, 2012, respectively.

7. Reserve for Losses and Loss Adjustment Expenses

The reserve for losses is established based on estimates of individual claims and actuarially determined estimates of future 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 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 $49.4 million and $141.0 million related to previously established reserves for the three and nine months ended September 30, 2013, respectively. The favorable net loss development reflected reductions in the Company's estimates of claims severity. Development recognized for the three and nine months ended September 30, 2013 principally related to the 2005 through 2011 accident years.

For the three and nine months ended September 30, 2012, ProAssurance recognized favorable net loss development of $50.0 million and $157.5 million, respectively, to reflect reductions in estimated claim severity principally for accident years 2004 through 2010.

8. Commitments and Contingencies

ProAssurance is involved in various legal actions related to insurance policies and claims handling including, but not limited to, claims asserted by policyholders. These types of legal actions arise in the Company’s ordinary course of business and, in accordance with GAAP for insurance entities, are considered as a part of the Company’s loss reserving process, which is described in detail under “Accounting Policies – Losses and Loss Adjustment Expenses” in Note 1 of the Notes to Consolidated Financial Statements in ProAssurance's 2012 Form 10-K.

ProAssurance has commitments primarily related to non-public investment entities totaling approximately $198.3 million, expected to be paid as follows: $18.3 million in 2013, $112.6 million in 2014 and 2015 combined, $35.4 million in 2016 and 2017 combined, and $32.0 million thereafter.

ProAssurance has entered into a definitive agreement with Eastern Insurance Holdings, Inc. (Eastern) (NASDAQ: EIHI) to acquire its outstanding common shares. The all-cash transaction has an estimated value of $205 million. The transaction is expected to close by January 1, 2014 and is subject to customary conditions, including regulatory and Eastern shareholder approval.

9. Long-term Debt

ProAssurance has a revolving credit agreement (the "Agreement"), which expires in 2016 and permits aggregate outstanding borrowings of up to $150 million at any time during the term of the Agreement. The interest rate on a borrowing is set at the time the borrowing is initiated or renewed, and is based on various factors including ProAssurance's credit rating, whether the borrowing is secured or unsecured, and the term of the benchmark interest rate selected (one, three, or six months). Repayment of a borrowing is permitted at the end of the selected interest rate term. ProAssurance had no outstanding borrowings under the Agreement as of September 30, 2013 and $125 million outstanding as of December 31, 2012. We maintained an outstanding balance under the Agreement of $125 million from December 31, 2012 to September 2013.

Covenant Compliance

The Agreement contains customary representations, covenants and events constituting default, and remedies for default. The Agreement also defines financial covenants regarding permitted leverage ratios and minimum net worth. ProAssurance is currently in compliance with all covenants.

Loss on Extinguishment

ProAssurance recognized a $2.2 million loss on extinguishment of debt during the third quarter of 2012 upon repayment of the Note Payable due February 2019, which was carried at fair value.

Additional Information

For additional information regarding ProAssurance's long-term debt, see Note 10 of the Notes to Consolidated Financial Statements included in ProAssurance's December 31, 2012 Form 10-K.

10. Shareholders' Equity

At September 30, 2013 and December 31, 2012, ProAssurance had 100 million shares of authorized common stock and 50 million shares of authorized preferred stock. The Board has the authority to determine provisions for the issuance of preferred shares, including the number of shares to be issued, the designations, powers, preferences and rights, and the qualifications, limitations or restrictions of such shares. To date, the Board has not approved the issuance of preferred stock.

ProAssurance declared cash dividends of $0.25 per common share for each of the first three quarters of 2013, totaling $46.4 million, which included the third quarter dividend of $15.5 million that was paid in October 2013. ProAssurance declared cash dividends of $0.125 per common share for each of the first three quarters of 2012, totaling $23.0 million, which included the third quarter dividend of $7.7 million that was paid in October 2012. The liability for unpaid dividends was included in Other liabilities. No dividends were paid in first quarter 2013 because payment of the regular fourth quarter 2012 dividend was accelerated into December 2012.

At September 30, 2013, prior Board authorizations of $127.1 million for the repurchase of common shares or the retirement of outstanding debt remained available for use. ProAssurance repurchased approximately 175,000 shares, having a total cost of $8.0 million, during the nine months ended September 30, 2013 and did not repurchase any common shares during the nine months ended September 30, 2012.

Share-based compensation expense was $2.2 million and $6.9 million for the three and nine months ended September 30, 2013, respectively, and $1.3 million and $6.4 million for the three and nine months ended September 30, 2012, respectively. Related tax benefits were $0.8 million and $2.4 million for the three and nine months ended September 30, 2013, respectively, and $0.5 million and $2.2 million for the three and nine months ended September 30, 2012, respectively.

ProAssurance awarded approximately 39,000 restricted share units and 146,000 base performance share units to employees in February 2013. The fair value of each unit awarded was estimated at $46.97, equal to the market value of a ProAssurance common share on the date of grant. All awards are charged to expense as an increase to equity over the service period (generally the vesting period) associated with the award. Restricted share units and performance share units vest in their entirety at the end of a three-year period following the grant date based on a continuous service requirement and, for performance share units, achievement of a performance objective. Partial vesting is permitted for retirees. A ProAssurance common share is issued for each unit once vesting requirements are met, except that units sufficient to satisfy required tax withholdings are paid in cash. The number of common shares issued for performance share units varies from 75% to 125% of base awards depending upon the degree to which stated performance objectives are achieved. ProAssurance issued approximately 32,000 and 120,000 common shares to employees in February 2013 related to restricted share units and performance share units, respectively, granted in 2010. Shares issued for performance share units were awarded at the maximum level (125%).

ProAssurance issued approximately 41,000 and 19,000 common shares to employees in February 2013 and 2012, respectively, as bonus compensation, as approved by the Compensation Committee of the Board. The shares issued were valued at fair value (the market price of a ProAssurance common share on the date of award).

Other Comprehensive Income (Loss) (OCI)

For all periods presented, OCI was comprised of unrealized gains and losses arising during the period related to available-for-sale securities less reclassification adjustments for gains (losses) from available-for-sale securities, including reclassifications of non-credit impairment losses, recognized in current period net income, net of tax. At September 30, 2013 and December 31, 2012, accumulated other comprehensive income was comprised entirely of unrealized gains and losses from available-for-sale securities, including non-credit impairment losses previously recognized in OCI of $0.5 million and $0.9 million, respectively, net of tax. All tax effects have been computed using a 35% rate.

Amounts reclassified from accumulated other comprehensive income to net income during the three and nine months ended September 30, 2013 and 2012 included the following:

	Three Months Ended September 30		Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
Reclassifications from accumulated other comprehensive income to net income, available for sale securities:				
Realized investment gains (losses)	$2,403	$3,675	$8,638	$8,348
Non-credit impairment losses reclassified to earnings, due to sale of securities or reclassification as a credit loss	—	—	(347)	(201)
Total amounts reclassified, before tax effect	2,403	3,675	8,291	8,147
Tax effect (at 35%)	(841)	(1,286)	(2,902)	(2,851)
Net reclassification adjustments	$1,562	$2,389	$5,389	$5,296

11. Variable Interest Entities

ProAssurance holds passive interests in a number of entities that are considered to be Variable Interest Entities (VIEs) under GAAP guidance. ProAssurance's VIE interests principally consist of interests in LPs/LLCs formed for the purpose of achieving diversified equity and debt returns. ProAssurance VIE interests carried as a part of Other Investments totaled $31.5 million at September 30, 2013 and $25.1 million at December 31, 2012. ProAssurance VIE interests carried as a part of Investment in Unconsolidated Subsidiaries totaled $26.5 million at September 30, 2013 and $33.7 million at December 31, 2012.

ProAssurance has not consolidated these VIE's because it has either very limited or no power to control the activities that most significantly affect the economic performance of these entities and is not the primary beneficiary of any of the entities. ProAssurance’s involvement with each entity is limited to its direct ownership interest in the entity. ProAssurance has no arrangements or agreements of significance with any of the entities to provide other financial support to or on behalf of the entity. At September 30, 2013, ProAssurance’s maximum loss exposure relative to these investments was limited to the carrying value of ProAssurance’s investment in the VIE.

12. Earnings Per Share

Diluted weighted average shares is calculated as basic weighted average shares plus the effect, calculated using the treasury stock method, of assuming that dilutive stock options have been exercised and that performance and restricted share units have vested. All outstanding stock options, performance share and restricted share units had a dilutive effect for the three- and nine-month periods ended September 30, 2013 and 2012.

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

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and Notes to those statements which accompany this report. A glossary of insurance terms and phrases is available on the investor section of our website. Throughout the discussion, references to "ProAssurance", "PRA", "Company", "we", "us" and "our" refer to ProAssurance Corporation and its consolidated subsidiaries. The discussion contains certain forward-looking information that involves risks and uncertainties. As discussed under the heading "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 conformity with U.S. generally accepted accounting principles (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 ongoing 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

The largest component of our liabilities is our reserve for losses and loss adjustment expenses ("reserve for losses" or "reserve"), and the largest component of expense for our operations is incurred losses and loss adjustment expenses (also referred to as "loss and loss adjustment expenses", "incurred losses", "losses incurred", and "losses"). Incurred losses reported in any period reflect our estimate of losses incurred related to the premiums earned in that period as well as any changes to our estimates of the reserve established for losses of prior periods.

The estimation of long-tailed insurance losses is inherently difficult and is subject to significant judgment on the part of management. Loss costs, even for claims with similar characteristics, can vary significantly depending upon many factors, including but not limited to: the nature of the claim, including whether or not the claim is an individual or a mass tort claim, and the personal situation of the claimant or the claimant's family, the outcome of jury trials, the legislative and judicial climate where any potential litigation may occur, general economic conditions and, for claims involving bodily harm, the trend of healthcare costs. Long-tailed insurance is characterized by the extended period of time typically required to resolve claims, 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 significant judgment, and such estimates require periodic revision.

Our reserves are established by management after taking into consideration a variety of factors including premium rates, claims frequency, historical paid and incurred loss development trends, the expected effect of inflation, general economic trends, the legal and political environment, and the conclusions reached by our internal and consulting actuaries. We update and review the data underlying the estimation of our reserve for losses each reporting period and make adjustments to loss estimation assumptions that we believe best reflect emerging data. Both our internal and consulting actuaries perform an in-depth review of our reserve for losses on at least a semi-annual basis using the loss and exposure data of our insurance subsidiaries, supplemented to the extent necessary by relevant industry loss and exposure data.

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Acquired Reserves
The acquisition of Medmarc increased our loss reserves by $201.1 million which represented the fair value of Medmarc's loss reserves at the time of the acquisition. The estimated fair value was calculated as the present value of the expected underlying net cash flows, including a 5% profit margin and a 5% risk premium. Expected net cash flows were derived from the expected loss payment patterns included in an actuarial analysis of Medmarc reserves performed as of December 31, 2012. Actuarial methods used to evaluate Medmarc reserves included the Bornhuetter-Ferguson Method (Paid and Reported) and the Development Method (Paid and Reported) described in Item 2 of ProAssurance's 2012 Form 10K. The Adjusted Reported, Adjusted Paid, and the Expected Loss Methods, described below, were also used to evaluate Medmarc's reserves. We supplemented Medmarc data with relevant industry data where sufficient Medmarc historical data was not available. Approximately 85% of the reserves assumed in the Medmarc acquisition are products liability reserves and approximately 15% are professional liability reserves.
The Adjusted Reported and the Adjusted Paid Methods are based on the premise that the relative change in a given accident year's adjusted reported loss estimates (Adjusted Reported Method) or adjusted paid losses (Adjusted Paid Method) from one evaluation point to the next is similar to changes observed for earlier accident years at the same evaluation points. In the Adjusted Reported Method reported loss estimates are adjusted to reflect a common case reserve adequacy basis. In the Adjusted Paid Method, the historical paid loss experience is adjusted to reflect a common claim settlement rate basis.
The Expected Loss Method estimates ultimate loss amounts based on an expected ratio of losses per exposure, with the exposure measure often being premium. The expected ratio is then applied to the exposure measure to project ultimate losses for each accident year under evaluation.
Initial Reserve Estimates-Current Accident Year
Considerable judgment is required in both the pricing of our business and in establishing our initial reserves for any current accident year period. The targeted loss ratio in our pricing varies to some extent by jurisdiction, type of coverage and policy limits. For our physician professional liability business, which represents the majority of our premiums, we are, on average, targeting a 75% loss ratio. Due to the lack of available open or closed claims data for the current accident year period, we heavily rely on the loss assumptions used in pricing our business in making our initial estimate of physician professional losses for the current accident year period. For our physician business, we presently and have historically utilized loss ratios that are approximately 8 to 10 percentage points above the ratios we have targeted in our pricing for the current accident year. We believe this appropriately considers inherent risks associated with our physician professional rate development process and the historic volatility of medical professional liability (MPL) losses and produces a reasonable best estimate of the reserves required to cover actual ultimate losses. We follow the same practice in establishing initial loss reserves for our other professional liability lines. In the current environment this equates to an overall average initial loss ratio of approximately 85% for our professional liability business.
Severity is defined as the average cost of resolving claims and the severity trend is the increase, or decrease, in severity from period to period. Although we remain uncertain regarding the ultimate severity trend to project into the future for our MPL business, as discussed in following paragraphs, we have given consideration to observed lower loss costs for this business and reduced rates in recent years. For example, on average, excluding our podiatry business acquired in 2009, we have gradually reduced the premium rates we charge on our standard physician renewal business (our largest MPL line) by approximately 17% from the beginning of 2006 to September 30, 2013.

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Consideration of Severity

The severity trend assumption is a key assumption for both pricing models and the actuarial estimation of reserves. The severity trend is an explicit component of our pricing models, whereas in our reserving process the severity trend's impact is implicit. Our estimate of this trend and our expectations about changes in this trend impact a variety of factors, from the selection of expected loss ratios to the ultimate point estimates established by management. Because of the implicit and wide-ranging nature of severity trend assumptions on the loss reserving process it is not practical to specifically isolate the impact of changing severity trends. However, because severity is an explicit component of our pricing process, we can better isolate the impact that changing severity can have on our loss costs and loss ratios as regards our pricing models. For our MPL business, which comprised 89% of our gross earned premium in the first nine months of 2013, our current pricing models assume a severity trend of 2% to 3% in most states and lines of business. If the severity trend were to be higher by 1 percentage point, the impact would be an increase in our expected loss ratio of this business of 3.2 percentage points, based on current claim disposition patterns. An increase in the severity trend of 3 percentage points would result in a 10.1 percentage point increase in our expected loss ratio. Due to the long tailed nature of MPL claims and the previously discussed historical volatility of loss costs, selection of a severity trend assumption is a subjective process that is inherently likely to prove inaccurate over time. Given the long-tail and volatility, we are generally cautious in making changes to the severity assumptions within our pricing model. Also of note is that all open claims and accident years are generally impacted by a change in the severity trend, which compounds the effect of such a change.

For the 2004 to 2009 accident years both our internal and consulting actuaries have observed an unprecedented reduction in the frequency of MPL claims (or number of claims per exposure unit) that cannot be attributed to any single factor, which has complicated the selection of an appropriate severity trend for our pricing models for this business. It has also made it more challenging to factor severity into the various actuarial methodologies we use to evaluate our reserves. We believe that much of the reduction in claim frequency is the result of a decline in the filing of frivolous lawsuits that have historically been dismissed or otherwise result in no payment of indemnity on the part of our insureds. With fewer frivolous claims being filed we expect that the claims that are filed have the potential for greater average losses, or greater severity. As a result, we cannot be certain as to the impact this decline will ultimately have on the average cost of claims. Based on a weighted average of payments, 85% of our MPL claims are resolved after eight years for a given accident year. Due to this long tail, it can take several years before we are able to determine what impact, if any, has resulted from the decline in frequency and whether the expected increase in severity will materialize.

Development of Prior Accident Year Reserves

We re-evaluate our previously established reserves each period based on our most recently available claims data and currently available industry trend information. Changes to previously established reserve estimates are recognized in the current period if management’s best estimate of ultimate losses differs from the estimate previously established. While management considers a variety of variables in determining its best estimate, in general, as claims age, our methodologies for estimating reserves give more weight to actual loss costs which, as a whole, continue to indicate that ultimate loss costs will be lower than our previous estimates. The development recognized in the first nine months of both 2013 and 2012 was primarily attributable to the favorable resolution of MPL claims during the period and an evaluation of established case reserves and paid claims data that indicated that the actual severity associated with the remaining MPL claims will aggregately be lower than we had previously estimated. The Critical Accounting Estimates discussion in our 2012 Form 10K and our discussion of acquired reserves, above, include additional information regarding the methodologies used to evaluate our reserves.

Any change in our estimate of net ultimate losses for prior years is reflected in net income in the period in which such changes are made. Over the past several years such changes have been to reduce our estimate of net ultimate losses, resulting in a reduction of reported losses for the period and a corresponding increase in pre-tax income.

We recognized net favorable reserve development of $49.4 million and $141.0 million during the three and nine months ended September 30, 2013, respectively.

Due to the size of our reserve for losses and the large number of claims outstanding at any point in time, even a small percentage adjustment to our total reserve estimate could have a material effect on our results of operations for the

period in which the adjustment is made.

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Reinsurance

We use insurance and reinsurance (collectively, “reinsurance”) to provide capacity to write larger limits of liability, to provide reimbursement for losses incurred under the higher limit coverages we offer, and to provide protection against losses in excess of policy limits. The purchase of reinsurance does not relieve us from the ultimate risk on our policies, but it does provide reimbursement for certain losses we pay.

We make a determination of the amount of insurance risk we choose to retain based upon numerous factors, including our risk tolerance and the capital we have to support it, the price and availability of reinsurance, volume of business, level of experience with a particular set of claims and our analysis of the potential underwriting results. We purchase reinsurance from a number of companies to mitigate concentrations of credit risk. We utilize a reinsurance broker to assist us in the placement of our reinsurance program and in the analysis of the credit quality of our reinsurers. The determination of which reinsurers we choose to do business with is based upon an evaluation of their then-current financial strength, rating and stability.

We evaluate each of our ceded reinsurance contracts at inception to confirm that there is sufficient risk transfer to allow the contract to be accounted for as reinsurance under current accounting guidance. At September 30, 2013, all ceded contracts were 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 reinsurance programs. We base our estimate 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 and conditions of our reinsurance agreements. Our assessment of the collectability 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.

Given the uncertainty inherent in our estimates of losses and related amounts recoverable from reinsurers, these estimates may vary significantly from the ultimate outcome.

Under the terms of certain of our reinsurance agreements, the amount of premium that we cede to our reinsurers is based in part on the losses we recover under the agreements. Therefore we make an estimate of premiums ceded under these reinsurance agreements subject to certain maximums and minimums. Any adjustments to our estimates of losses recoverable under our reinsurance agreements or the premiums owed under our agreements are reflected in then-current operations. Due to the size of our reinsurance balances, an adjustment to these estimates could have a material effect on our results of operations for the period in which the adjustment is made.

The financial strength of our reinsurers and their ability to pay us may change in the future due to forces or events we cannot control or anticipate. We have not experienced significant collection difficulties due to the financial condition of any reinsurer as of September 30, 2013; however, reinsurers may periodically dispute our demand for reimbursement from them based upon their interpretation of the terms of our agreements. 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 material 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.

Investment Valuations

We record the majority of our investments at fair value as shown in the table below. At September 30, 2013 the distribution of our investments based on GAAP fair value hierarchies (levels) was as follows:

	Distribution by GAAP Fair Value Hierarchy			September 30, 2013
	Level 1	Level 2	Level 3	Total Investments
Investments recorded at:				
Fair value	9%	83%	2%	94%
Other valuations				6%
Total Investments				100%

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. All of our fixed maturity and equity security investments are carried at fair value. Our short-term securities are carried at amortized cost, which approximates fair value.

Because of the number of securities we own and the complexity and cost of developing accurate fair values, we utilize multiple independent pricing services to assist us in establishing the fair value of individual securities. The pricing services provide fair values based on exchange traded prices, if available. If an exchange traded price is not available, the pricing

services, if possible, provide a fair value that is based on multiple broker/dealer quotes or that has been developed using pricing models. Pricing models vary by asset class and utilize currently available market data for securities comparable to ours to estimate the fair value for our security. The pricing services scrutinize market data for consistency with other relevant market information before including the data in the pricing models. The pricing services disclose the types of pricing models used and the inputs used for each asset class. Determining fair values using these pricing models requires the use of judgment to identify appropriate comparable securities and to choose a valuation methodology that is appropriate for the asset class and available data.

The pricing services provide a single value per instrument quoted. We review the values provided for reasonableness each quarter by comparing market yields generated by the supplied value versus market yields observed in the market place. We also compare yields indicated by the provided values to appropriate benchmark yields and review for values that are unchanged or that reflect an unanticipated variation as compared to prior period values. In addition, we compare provided information for consistency with our other pricing services, known market data and information from our own trades, considering both values and valuation trends. We also review weekly trades versus the prices supplied by the services. If a supplied value appears unreasonable, we discuss the valuation in question with the pricing service and make adjustments if deemed necessary. To date, our review has not resulted in any changes to the values supplied by the pricing services.

The pricing services do not provide a fair value unless an exchange traded price or multiple observable inputs are available. As a result, the pricing services may provide a fair value for a security in some periods but not others, depending upon the level of recent market activity for the security or comparable securities.

Level 1 Investments

Fair values for our equity and a portion of our short-term securities are determined using exchange traded prices. There is little judgment involved when fair value is determined using an exchange traded price. In accordance with GAAP, for disclosure purposes we classify securities valued using an exchange traded price as Level 1 securities.

Level 2 Investments

Most fixed income securities do not trade daily, and thus exchange traded prices are generally not available for these securities. However, market information (often referred to as observable inputs or market data, including but not limited to, last reported trade, non-binding broker quotes, bids, benchmark yield curves, issuer spreads, two sided markets, benchmark securities, offers and recent data regarding assumed prepayment speeds, cash flow and loan performance data) is available for most of our fixed income securities. We determine fair value for a large portion of our fixed income securities using available market information. In accordance with GAAP, for disclosure purposes we classify securities valued based on multiple market observable inputs as Level 2 securities.

Level 3 Investments

When a pricing service does not provide a value for one of our fixed maturity securities, management estimates fair value using either a single non-binding broker quote or pricing models that utilize market based assumptions which have limited observable inputs. The process involves significant judgment in selecting the appropriate data and modeling techniques to use in the valuation process. For disclosure purposes we classify fixed maturity securities valued using limited observable inputs as Level 3 securities.

We also classify as Level 3 securities our investment interests that are carried at fair value based on a fund-provided net asset value (NAV) for our interest. All investments valued in this manner are LP or LLC interests that hold debt and equity securities. At September 30, 2013 interests valued using a fund-provided NAV totaled $44.7 million, or 1% of total investments, and were classified as part of our Investment in Unconsolidated Subsidiaries.

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Investments - Other Valuation Methodologies

Certain of our investments, in accordance with GAAP for the type of investment, are measured using methodologies other than fair value. At September 30, 2013 these investments had a carrying value of approximately $235.3 million, which represented approximately 6% of total investments, as shown in the following table. Additional information about these investments is provided in Notes 3 and 4 of the Notes to Condensed Consolidated Financial Statements.

(In thousands)	Carrying Value	GAAP Measurement Method
Other investments:		
Investments in LP/LLCs, at cost	$31,495	Cost
Federal Home Loan Bank (FHLB) capital stock	3,449	Cost
Other	1,515	Amortized cost
Total other investments	36,459	
Investment in unconsolidated subsidiaries:		
Investments in tax credit partnerships	144,934	Equity
Business owned life insurance	53,922	Cash surrender value
Total investments - Other valuation methodologies	$235,315	

Investment Impairments

We evaluate our investments on at least a quarterly basis for declines in fair value that represent other than temporary impairment (OTTI). We consider an impairment to be an OTTI if we intend to sell the security or if we believe we will be required to sell the security before we fully recover the amortized cost basis of the security. Otherwise, we consider various factors in our evaluation, as discussed below.

For debt securities, we consider whether we expect to fully recover the amortized cost basis of the security, based upon consideration of some or all of the following:

- third party research and credit rating reports;
- the current credit standing of the issuer, including credit rating downgrades;
- the extent to which the decline in fair value is attributable to credit risk specifically associated with the security or its issuer;
- our internal assessments and those of our external portfolio managers regarding specific circumstances surrounding a security, which can cause us to believe the security is more or less likely to recover its value than other securities with a similar structure;
- for asset-backed securities, the origination date of the underlying loans, the remaining average life, the probability that credit performance of the underlying loans will deteriorate in the future, and our assessment of the quality of the collateral underlying the loan;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency;
- recoveries or additional declines in fair value subsequent to the balance sheet date; and
- our intent to sell and whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost basis.

In assessing whether we expect to recover the cost basis of debt securities, particularly asset-backed securities, we must make a number of assumptions regarding the cash flows that we expect to receive from the security in future periods. These judgments are subjective in nature and may subsequently be proved to be inaccurate.

We evaluate our cost method interests in LPs/LLCs for OTTI by considering whether there has been a decline in fair value below the recorded value, which involves assumptions and estimates. We receive a report from each of the LPs/LLCs at least quarterly which provides us a NAV for our interest. The NAV is based on the fair values of securities held by the LP/LLC as determined by the LP/LLC manager. We consider the most recent NAV provided, the performance of the LP/LLC relative to the market, the stated objectives of the LP/LLC, the cash flows expected

from the LP/LLC and audited financial statements of the entity, if available, in considering whether an OTTI exists.

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Our investments in tax credit partnerships are evaluated for OTTI by comparing cash flow projections of the underlying projects generating the tax credits to our recorded basis, and by considering our ability to utilize the tax credits generated by the investments.
We also evaluate our holdings of FHLB securities for impairment. We consider the current capital status of the FHLB, whether the FHLB is in compliance with regulatory minimum capital requirements, and the FHLB’s most recently reported operating results.

Deferred Policy Acquisition Costs
Policy acquisition costs (primarily commissions, premium taxes and underwriting salaries) which are directly related to the successful acquisition of new and renewal premiums are capitalized as deferred policy acquisition costs and charged to expense as the related premium revenue is recognized. We evaluate the recoverability of our deferred policy acquisition costs each reporting period, and any amounts estimated to be unrecoverable are charged to expense in the current period. As of September 30, 2013 we have not determined that any amounts are unrecoverable.
Deferred Taxes
Deferred federal income taxes arise from the recognition of temporary differences between the bases of assets and liabilities determined for financial reporting purposes and the bases determined for income tax purposes. Our temporary differences principally relate to loss reserves, unearned premiums, deferred policy acquisition costs, and unrealized investment gains (losses). Deferred tax assets and liabilities are measured using the enacted tax rates expected to be in effect when such benefits are realized. We review our deferred tax assets quarterly for impairment. If we determine that it is more likely than not that some or all of a deferred tax asset will not be realized, a valuation allowance is recorded to reduce the carrying value of the asset. In assessing the need for a valuation allowance, management is required to make certain judgments and assumptions about our future operations based on historical experience and information as of the measurement period regarding reversal of existing temporary differences, carryback capacity, future taxable income (including its capital and operating characteristics) and tax planning strategies. As of September 30, 2013, a valuation allowance has not been deemed necessary.
Unrecognized Tax Benefits
We evaluate tax positions taken on tax returns and recognize positions in our financial statements when it is more likely than not that we will sustain the position upon resolution with a taxing authority. If recognized, the benefit is measured as the largest amount of benefit that has a greater than fifty percent probability of being realized. We review uncertain tax positions each period, considering changes in facts and circumstances, such as changes in tax law, interactions with taxing authorities and developments in case law, and make adjustments as we consider necessary. Adjustments to our unrecognized tax benefits may affect our income tax expense, and settlement of uncertain tax positions may require the use of cash. At September 30, 2013, our liability for unrecognized tax benefits approximated $4.8 million, and related accrued interest approximated $1.3 million.
Goodwill
Management evaluates the carrying value of goodwill annually during the fourth quarter. If, at any time during the year, events occur or circumstances change that would more likely than not reduce the fair value below the carrying value, we also evaluate goodwill at that time. We evaluate goodwill as one reporting unit because we operate as a single operating segment and our segment components are economically similar. We estimate the fair value of our reporting unit on the evaluation date based on market capitalization and an expected premium that would be paid to acquire control of our Company (a control premium). We then perform a sensitivity analysis using a range of historical stock prices and control premiums. We concluded as of our last evaluation date, October 1, 2013, that the fair value of our reporting unit exceeded the carrying value and no adjustment to impair goodwill was necessary.
Goodwill is recognized in conjunction with acquisitions as the excess of the purchase consideration for the acquisition over the fair value of identifiable assets acquired and liabilities assumed. The fair value of identifiable assets and liabilities, and thus goodwill, is subject to redetermination within a measurement period of up to one year following completion of an acquisition. During the first quarter of 2013 goodwill was reduced by $1.9 million related to the re-determination of the fair value of assets and liabilities associated with an acquisition completed in 2012, and no additional goodwill was recognized related to acquisitions completed in 2013.

Accounting Changes

We are not aware of any accounting changes not yet adopted as of September 30, 2013 that would have a material effect on our results of operations or financial position. Note 1 of the Notes to Condensed Consolidated Financial Statements provides additional detail regarding accounting changes.

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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 the holding company has no other business operations, dividends from its operating subsidiaries represent a significant source of funds for its obligations, including debt service and shareholder dividends. At September 30, 2013, we held cash and liquid investments of approximately $301.0 million outside our insurance subsidiaries that were available for use without regulatory approval. Our holding company also has $150 million available under a revolving credit agreement, as discussed in this section under the heading "Debt." During the nine months ended September 30, 2013 our insurance subsidiaries paid dividends of $118 million, including extraordinary dividends of $5 million. In addition, our insurance subsidiaries paid ordinary dividends of $180 million in October 2013, and, in aggregate, are permitted to pay additional dividends of approximately $21 million over the remainder of 2013 without the prior approval of state insurance regulators. The payment of any dividend requires prior notice to the insurance regulator in the state of domicile, and the regulator may prevent the dividend if, in its judgment, payment of the dividend would have an adverse effect on the surplus of the insurance subsidiary.

Operating Activities and Related Cash Flows

The principal components of our operating cash flows are the excess of premiums collected and net investment income over losses paid and operating costs, including income taxes. Timing delays exist between the collection of premiums and the payment of losses associated with the premiums. Premiums are generally collected within the twelve-month period after the policy is written, while claim payments for those policies are generally paid over a more extended period of time. Likewise, timing delays exist between the payment of claims and the collection of any associated reinsurance recoveries. Our operating activities provided cash flows of approximately $24.0 million and $61.4 million for the nine months ended September 30, 2013 and 2012, respectively.

Operating cash flows for the nine months ended September 30, 2013 and 2012 compare as follows:

(In millions)	Operating Cash Flow
Cash provided (used) by operating activities for the nine months ended September 30, 2012	$61
Increase (decrease) in operating cash flows:	
Decrease in premium receipts (1)	(28)
Increase in payments to reinsurers (2)	(6)
Decrease in losses paid, net of reinsurance recoveries (3)	14
Decrease in deposit contracts (4)	(5)
Increase in Federal and state income tax payments (5)	(1)
Net cash provided (used) by acquisitions (6)	(11)
Cash provided (used) by operating activities for the nine months ended September 30, 2013	$24

(1) The reduction in premium receipts reflected lower premium volume written during the preceding twelve months exclusive of acquisitions.

(2) Approximately $5 million of the increase in reinsurance payments is attributable to a higher volume of premiums ceded under quota share and fronting arrangements as discussed under the heading "Ceded Premiums Written."

(3) The timing of our net loss payments varies from period to period because the process for resolving claims is complex and occurs at an uneven pace depending upon the circumstances of the individual claim. The decrease in loss payments for the first nine months of 2013 primarily reflected a smaller number of claims resolved with large indemnity payments. We have not seen evidence in our loss data that suggests the decrease in loss payments for the nine-month period represents a change in loss trends and as such have not changed our loss assumptions for the current period.