

PROFESSIONALS DIRECT INC
Form 10QSB
August 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-QSB

(MARK ONE)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2006

TRANSITION REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number: **000-49786**

PROFESSIONALS DIRECT, INC.
(Exact Name of Small Business Issuer as Specified in its Charter)

Michigan
(State or Other Jurisdiction of
Incorporation or Organization)

38-3324634
(I.R.S. Employer Identification No.)

5211 Cascade Road, S.E.
Grand Rapids, Michigan 49546
(Address of Principal Executive Offices)

(616) 456-8899
(Issuer's Telephone Number,
Including Area Code)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

There were 333,300 shares of Common Stock outstanding as of July 31, 2006.

Transitional Small Business Disclosure Format (check one): Yes No .

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements**

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
(Unaudited)

| | | |
|---|-----------|---------------|
| <i>June 30,</i> | | 2006 |
| | | (000) |
| Assets | | |
| Fixed maturities held to maturity, at amortized cost | \$ | 5,189 |
| Fixed maturities available for sale, at fair value | | 32,752 |
| Other invested asset, at cost which approximates fair value | | 290 |
| Total investments | | 38,231 |
| Cash and cash equivalents | | 4,410 |
| Receivables: | | |
| Amounts due from reinsurers | | 23,085 |
| Other | | 2,127 |
| Prepaid reinsurance premiums | | 4,089 |
| Deferred acquisition costs | | 1,411 |
| Net deferred federal income taxes | | 1,547 |
| Other assets | | 1,320 |
| Total Assets | \$ | 76,220 |
| Liabilities and Shareholders' Equity | | |
| Liabilities | | |
| Loss and loss adjustment expense reserves | \$ | 39,926 |
| Unearned premiums | | 11,658 |
| Amounts due to reinsurers | | 2,147 |
| Other liabilities | | 2,977 |
| Accrued interest | | 1,335 |
| Surplus certificates | | 1,949 |
| Trust preferred securities | | 5,000 |
| Total Liabilities | | 64,992 |
| Shareholders' Equity | | |
| Preferred stock, no par (500,000 shares authorized, no shares issued) | | - |
| Common stock, no par (5,000,000 shares authorized, 333,500 shares issued and outstanding) | | 3,206 |
| Retained earnings | | 8,598 |
| Accumulated other comprehensive loss | | (576) |
| Total Shareholders' Equity | | 11,228 |
| Total Liabilities and Shareholders' Equity | \$ | 76,220 |

See accompanying notes to condensed consolidated financial statements.

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)
AND COMPREHENSIVE INCOME (LOSS)
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|----------|------------------------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| | (000) | (000) | (000) | (000) |
| Revenues | | | | |
| Net premiums earned | \$ 4,015 | \$ 3,853 | \$ 8,019 | \$ 7,556 |
| Fees and commissions | 232 | 125 | 444 | 164 |
| Net investment income | 368 | 273 | 727 | 512 |
| Finance and other income - including unusual gain of \$44 and \$157 in 2006 (Note 3) | 91 | 35 | 251 | 70 |
| Total revenues | 4,706 | 4,286 | 9,441 | 8,302 |
| Expenses | | | | |
| Losses and loss adjustment expenses | 3,135 | 3,339 | 5,970 | 7,276 |
| Operating and administrative | 1,128 | 1,026 | 2,076 | 1,880 |
| Interest | 142 | 109 | 281 | 219 |
| Total expenses | 4,405 | 4,474 | 8,327 | 9,375 |
| Income (loss) before federal income taxes (benefit) | 301 | (188) | 1,114 | (1,073) |
| Federal income taxes (benefit) | 66 | (74) | 316 | (381) |
| Net income (loss) | 235 | (114) | 798 | (692) |
| Other comprehensive income (loss) (Net of tax (benefit) of (\$26), \$96, (\$88) and (\$12), respectively) | (50) | 187 | (171) | (24) |
| Comprehensive income (loss) | \$ 185 | \$ 73 | \$ 627 | \$ (716) |
| Per share of common stock (not in thousands): | | | | |
| Basic and diluted net income (loss) per share | \$.70 | \$ (.34) | \$ 2.39 | \$ (2.07) |
| Basic and diluted comprehensive income (loss) per share | .55 | .22 | 1.88 | (2.15) |

See accompanying notes to condensed consolidated financial statements.

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six Months Ended June 30, | |
|---|------------------------------|-----------------|
| | 2006 (000) | 2005 (000) |
| Operating Activities | | |
| Net income (loss) | \$ 798 | \$ (692) |
| Adjustments to reconcile net income (loss) to net cash from operating activities: | | |
| Deferred federal income taxes | 119 | 11 |
| Gain from redemption of surplus certificates | (157) | - |
| Depreciation and amortization | 328 | 439 |
| Changes in operating assets and liabilities: | | |
| Amounts due from reinsurers | (5,210) | (11,364) |
| Other receivables | 44 | 221 |
| Prepaid reinsurance premiums | 86 | (155) |
| Federal income taxes recoverable | (466) | (392) |
| Deferred acquisition costs | (33) | (84) |
| Other assets | (99) | (102) |
| Loss and loss adjustment expense reserves | 4,458 | 11,801 |
| Amounts due to reinsurers | 292 | 274 |
| Unearned premiums | (118) | 1,204 |
| Other liabilities | 880 | (60) |
| Accrued interest | (318) | 64 |
| Net cash from operating activities | 604 | 1,165 |
| Investing Activities | | |
| Cost of fixed maturities acquired | (9,692) | (3,934) |
| Proceeds from sales or maturities of fixed maturities | 5,093 | 4,003 |
| Cost of property and equipment acquired | (309) | (105) |
| Net cash for investing activities | (4,908) | (36) |
| Financing Activities | | |
| Repayments of surplus certificates | (425) | - |
| Net repayments under lines of credit | (170) | (2,507) |
| Payment of debt issue costs | - | (119) |
| Proceeds from issuance of trust preferred securities | - | 3,000 |
| Net cash from (for) financing activities | (595) | 374 |
| Net Increase (Decrease) in Cash and Cash Equivalents | (4,899) | 1,503 |
| Cash and Cash Equivalents, beginning of period | 9,309 | 4,394 |
| Cash and Cash Equivalents, end of period | \$ 4,410 | \$ 5,897 |

Supplemental Disclosures of Cash Flow Information

| | | | | |
|-----------------------------|----|------------|----|-----|
| Federal income tax payments | \$ | 663 | \$ | - |
| Interest payments | | 599 | | 154 |

See accompanying notes to condensed consolidated financial statements.

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries (Professionals Direct Insurance Company (PDIC), a property and casualty insurance company providing professional liability insurance to attorneys; Professionals Direct Employer Organization, Inc., an inactive Michigan professional employer organization; Professionals Direct Finance, Inc. (Finance), a premium finance company; and Professionals Direct Insurance Services, Inc. (Services), a company providing underwriting, claims, accounting, information technology services and selling professionals liability and other insurance) plus Lawyers Direct Risk Purchasing Group, which the Company controls. Professionals Direct Statutory Trust I and Professionals Direct Statutory Trust II are accounted for under the equity method in the accompanying financial statements. They are not consolidated because the Company is not the primary beneficiary.

The condensed consolidated financial statements and notes as of and for the three and six-month periods ended June 30, 2006 and 2005 are unaudited. The condensed consolidated financial statements reflect all adjustments (consisting of normal recurring accruals) that are, in the opinion of management, necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the interim periods should not be considered indicative of results to be expected for the full year.

2. Income per Share

Basic income per share is computed by dividing net income or loss by the weighted average number of shares of common stock outstanding, 333,500 for all periods. Diluted income per share is equal to basic income per share because there are no dilutive instruments outstanding.

3. Unusual Gain

Other income includes an unusual gain of \$44 and \$157 for the three and six months ended June 30, 2006, respectively, the portion of principal surplus certificate holders forgave in return for early redemption.

Item 2. Management's Discussion and Analysis

The following discussion and analysis for the six months ended June 30, 2006 should be read in conjunction with the condensed consolidated financial statements and the notes thereto included elsewhere in this report. The following discussion of our financial condition and results of operations contains certain forward-looking statements. A discussion of the limitations of forward-looking statements appears at the end of this section.

Introduction

Revenues increased for all lines when compared to 2005. Losses and loss adjustment expenses decreased when compared to 2005 because there was significantly less adverse development in the first half of 2006. The following table and discussion compares the financial results for 2006 and 2005:

| | Six Months Ended June 30, | | | Percent Change |
|--|---|-------------|---------------|---------------------------|
| | 2006 | 2005 | Change | |
| | (in thousands of dollars, except for per share data) | | | |
| Revenues: | | | | |
| Net premiums earned | \$ 8,019 | \$ 7,556 | \$ 463 | 6.1% |
| Fees and commissions | 444 | 164 | 280 | 170.7% |
| Net investment income | 727 | 512 | 215 | 42.0% |
| Finance and other income | 251 | 70 | 181 | 258.6% |
| Total Revenues | 9,441 | 8,302 | 1,139 | 13.7% |
| Expenses: | | | | |
| Losses and loss adjustment expenses | 5,970 | 7,276 | (1,306) | (17.9%) |
| Operating and administrative | 2,076 | 1,880 | 196 | 10.4% |
| Interest | 281 | 219 | 62 | 28.3% |
| Total Expenses | 8,327 | 9,375 | (1,048) | (11.2%) |
| Income (loss) before federal income taxes (benefit) | 1,114 | (1,073) | 2,187 | 203.8% |
| Federal income taxes (benefit) | 316 | (381) | 697 | 182.9% |
| Net Income (Loss) | \$ 798 | \$ (692) | \$ 1,490 | 215.3% |
| Selected Balance Sheet Data: (at end of period) | | | | |
| Total investments and cash | \$ 42,641 | \$ 39,587 | \$ 3,054 | 7.7% |
| Total assets | 76,220 | 68,114 | 8,106 | 11.9% |
| Total liabilities | 64,992 | 58,542 | 6,450 | 11.0% |
| Total shareholders' equity | 11,228 | 9,572 | 1,656 | 17.3% |
| Per Share Data: | | | | |
| Net income (loss) | \$ 2.39 | \$ (2.07) | \$ 4.46 | 215.5% |
| Shareholders' equity | \$ 33.67 | \$ 28.70 | \$ 4.97 | 17.3% |

Results of Operations (000 omitted):

The following is a summary and analysis of the material revenue and expense components of our operational results for the first six months and second quarter of 2006 with comparisons to 2005.

Net Premiums Earned. Net premiums earned is equal to direct premiums earned (premiums earned for policies written) less ceded premiums earned (amounts ceded to reinsurers) and is our primary source of revenue. The increase in net premiums earned is the result of higher beginning net unearned premium partially offset by lower net premiums written. The higher beginning unearned premium resulted from increased direct premiums written in 2005 when compared to 2004.

The effects of these changes are seen in the table below:

| | Six Months Ended June 30, | | | |
|----------------------------------|----------------------------------|-------------|---------------|----------------|
| | 2006 | 2005 | Change | Percent |
| | (in thousands of dollars) | | | Change |
| Beginning gross unearned premium | \$ 11,776 | \$ 10,738 | \$ 1,038 | 9.7% |
| Beginning ceded unearned premium | (4,175) | (4,163) | (12) | (0.3%) |
| Beginning net unearned premium | 7,601 | 6,575 | 1,026 | 15.6% |
| Direct premiums written | 12,479 | 13,397 | (918) | (6.9%) |
| Ceded premiums written | (4,492) | (4,792) | 300 | 6.3% |
| Net premiums written | 7,987 | 8,605 | (618) | (7.2%) |
| Ending gross unearned premium | 11,658 | 11,942 | (284) | (2.4%) |
| Ending ceded unearned premium | (4,089) | (4,318) | 229 | 5.3% |
| Ending net unearned premium | 7,569 | 7,624 | (55) | (0.7%) |
| Net premiums earned | \$ 8,019 | \$ 7,556 | \$ 466 | 6.2% |

During the first six months of 2006, direct and net premiums written decreased. This decrease resulted from competitive pressure on renewal rates for larger law firms, primarily in Michigan and Florida.

For policies with 2006 effective dates, PDIC's retention is unchanged from 2005. Decisions on the appropriate level of reinsurance are impacted by a variety of factors from pricing, to availability and credit quality of reinsurers, and our level of surplus. As such, reinsurance retentions may vary from year to year. After analyzing our surplus, we decided to maintain our retention level, which market conditions allowed us to do.

Fees and Commissions. Fees and commissions originate from two primary sources. First are membership fees, which are earned by Lawyers Direct Risk Purchasing Group ("Lawyers Direct"), an affiliate organized and managed by Services, as part of the Lawyers Direct(r) program for one to five person law firms. Second are commissions, which are earned from placing insurance with unrelated third parties and performing management services. Fees and commissions earned in the first half of 2006 were \$444, an increase of \$280 when compared to the first half of 2005. While fees from Lawyers Direct were \$10 less than in 2005, commission income increased \$290. This resulted from placing more business with other carriers in 2006 and the reversal of contingent ceding commissions in 2005 caused by adverse loss development.

Net Investment Income. Net investment income is comprised of interest on fixed maturity investments and realized investment gains and losses. The net investment income increase of \$215 or 42% in the first six months of 2006 as compared to 2005 is primarily attributable to an improvement in average yield resulting from an increase in interest rates. The tax equivalent book yield on the portfolio increased 80 basis points from a year ago and is now over 4.3%.

Finance and Other Income. Finance income is generated from premium financing incidental to the sale of PDIC's insurance policies. Premium financing is offered to PDIC policyholders in Michigan and selected other states. Finance income was \$24 higher in the first half of 2006 than in the first half of 2005, principally because the rate being charged was increased in the fourth quarter of 2005. During the first six months of 2006, PDIC redeemed 341 surplus certificates as part of a redemption program. This redemption resulted in an unusual gain of \$157, the portion of principal surplus certificate holders forgave in return for early redemption.

Losses and Loss Adjustment Expenses. Overall profitability is materially influenced by the loss estimate for current year claims, plus the favorable or adverse development related to estimates for prior years' claims. During the first six months of 2006, PDIC recorded losses and loss adjustment expenses of \$5,970 of which \$5,585 was for claims made and reported in 2006 and \$385 was for claims made and reported in prior years. During the first six months of 2005, PDIC recorded losses and loss adjustment expenses of \$7,276 of which \$5,320 was for claims made and reported in 2005 and \$1,956 was for claims made and reported in prior years. The increases in prior years' losses resulted from adjusting those years' loss ratios to reflect current experience.

The loss ratio is the sum of the losses and loss adjustment expenses incurred expressed as a percentage of net premiums earned. The loss ratio for the first six months of 2006 was 74.4% compared to 96.3% in 2005. In the first half of 2006, the increase in estimate for prior years' claims resulted in an increase in the loss ratio of 4.8%. In the first half of 2005, the increase in estimate for prior years' claims resulted in an increase in the loss ratio of 25.9%.

PDIC maintains reserves for payment of losses and loss adjustment expenses for reported claims and for claims incurred but not reported arising from policies that have been issued. PDIC provides for the estimated ultimate cost of those claims without regard to how long it takes to settle them or the time value of money. The determination of reserves involves actuarial and statistical projections of what PDIC expects to be the cost of the ultimate settlement and administration of such claims based on facts and circumstances then known, estimates of future trends in claim severity, and other variable factors such as inflation and changing judicial theories of liability.

Management estimates of the loss reserve liability are reviewed by independent actuaries twice each year. Several variables and methodologies are used to calculate the appropriate amount of the loss reserve liability that should be recorded. Key variables utilized to develop the loss reserve estimate include:

- Loss reporting patterns
- Payment patterns
- Loss severity trend rates
- Application of Michigan loss patterns and loss to premium relationships to non-Michigan business
- Case reserve setting patterns

The key actuarial methodologies used include:

- Incurred development method
- Paid development method
- Case development method
- Incurred Bornhuetter-Ferguson method

Paid Bornhuetter-Ferguson method
Frequency/severity method

Small changes to any of the assumptions regarding the key variables can significantly alter the outcome of the actuarial analysis. Because of the number of factors considered, it is neither practical nor meaningful to isolate a single variable and calculate the impact of changing that item.

An in-depth review of loss reserves is undertaken on a semi-annual basis. However, management continually reviews and updates the data underlying the estimation of its loss reserves and makes adjustments when we believe the emerging data supports a change. Any adjustments necessary are reflected in current operations. As a result of the variety of variables and methodologies that are considered, there is a significant risk that actual incurred losses will develop differently from these estimates.

In the years after a claim is reported, there is a significant amount of uncertainty over what the ultimate loss will be. Therefore, the estimate of future loss costs for claims recently reported tends to be less accurate. As claims get older, the estimate of future loss costs may be less inaccurate, but are still subject to material fluctuations until the claims are paid or otherwise closed. Eventually, all claims in a particular year are paid or closed and no additional development, favorable or adverse, will be experienced because the amount of the loss is certain.

Another factor that impacts incurred losses is development related to claims reported in prior years. Favorable or adverse development occurs when subsequent estimates of the loss change. A subsequent decrease in estimate results in favorable development; a subsequent increase in estimate results in adverse development. Favorable or adverse development is reflected as a decrease or increase in the current year's losses and loss adjustment expenses.

The estimation of ultimate liability for losses and loss adjustment expenses is an inherently uncertain process and does not represent an exact calculation of that liability. Claims may not be brought until several years after the acts or omissions that gave rise to the claim occurred. Ultimate loss costs, even for similar events, vary significantly depending upon many factors. Professional liability claims are typically resolved over an extended period of time, often three 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 expertise and the application of significant judgment. Such estimates require periodic revision. PDIC's current reserve policy recognizes this uncertainty by maintaining case supplement reserves (commonly referred to as IBNR reserves) to provide for the possibility that actual results may be less favorable compared to the estimated costs as developed during the normal case reserve estimation process. The case supplement reserve is determined by estimating the ultimate liability for all claims which have been made and reported and then subtracting the case reserves. Case supplement reserves as a percentage of total reserves at June 30, 2006 were 42.9%. PDIC does not discount its reserves to recognize the time value of money.

When a claim is reported to PDIC, claims personnel establish a case reserve for the estimated amount of the ultimate payment. This estimate reflects an informed judgment based upon general insurance reserving practices and on the experience and knowledge of the estimator regarding the nature and value of the specific claim, the severity of injury or damage, and the policy provisions relating to the type of loss. The claims staff periodically adjusts the loss estimate as more information becomes available.

Each quarter, PDIC computes its estimated liability using appropriate principles and procedures. Because the establishment of loss reserves is an inherently uncertain process, however, there can be no assurance that losses will not exceed reserves. Adjustments in aggregate reserves, if any, are reflected in the operating results of the period during which such adjustments are made. As required by insurance regulatory authorities, PDIC annually receives a statement of opinion from its appointed actuary concerning the reasonableness of its reserves.

Operating and Administrative Expenses. Operating and administrative expenses for the first six months of 2006 compared to the same period for 2005 increased \$196 or 10.4%. This increase is the result of reduced ceding commissions earned in 2006 compared to 2005 and increased compensation costs and insurance assessments. Ceding commissions have declined consistent with decreases in ceded premium and account for \$95 of the increase. Compensation costs and insurance assessments account equally for the remainder of the increase.

Interest Expense. Interest expense for the first six months of 2006 increased \$62 from the same period in 2005 because of increases in interest rates and outstanding debt.

Income Taxes. The effective federal income tax rate for the 2006 expense is 28.4% and for the 2005 benefit is 35.5%. While the 2005 effective rate approximates the expected rate, the 2006 effective rate is lower because of tax-exempt interest income.

Financial Condition, Liquidity, and Capital Resources (000 omitted):

Professionals Direct, Inc. is a legal entity separate and distinct from its subsidiaries. Because the parent holding company has no other business operations, management fees and dividends from its subsidiaries represent the principal source of funds for its obligations, including debt service. The management fees paid by PDIC are pre-approved by the Office of Financial and Insurance Services, the regulatory body in Michigan responsible for the oversight of the insurance subsidiary. Under the terms of the plan that governed the Company's conversion from a mutual insurance company to a stock insurance company, PDIC is prohibited from making any dividend payments to Professionals Direct, Inc. until such time as the surplus certificates are repaid in full. The management fees paid by the remaining subsidiaries are determined from time-to-time by the Board of Directors. The payment of management fees and dividends by the other subsidiaries is limited only by solvency requirements.

The primary sources of liquidity, on both a short-term and long-term basis, are funds provided by insurance premiums collected, net investment income, recoveries from reinsurance, and proceeds from the maturity or sale of invested assets. The primary uses of cash, on both a short-term and long-term basis, are losses, loss adjustment expenses, operating expenses, reinsurance premiums, taxes, debt repayment and acquisition of investments.

Trends or uncertainties that may have an impact on short-term or long-term liquidity include changes in the cost and availability of reinsurance, changes in interest rates and changes in investment income. As the costs of obtaining reinsurance may change in the future, we intend to adjust the rates we charge our customers. However, such rate changes may be limited by competition or regulation. We believe that we will be able to manage reinsurance costs so the impact on overall liquidity is minimized.

When interest rates decline, the cost of borrowing decreases and the market value of our investment portfolio, which primarily consists of debt securities, generally increases. At the same time, the overall yield on new investments tends to decrease. When interest rates increase, the opposite effects are realized. Interest rates continue to climb from the historical lows experienced in the last few years. We believe that it is unlikely material gains will be realized on portfolio assets or be a source of liquidity during 2006.

At June 30, 2006, cash and cash equivalents totaled \$4,410 which management believes represents the liquid assets necessary to meet operating, loss and reinsurance payments.

Our net cash flow from operations for the first six months of 2006 was \$604 compared to \$1,165 for the first six months of 2005, a decrease of \$561. As written and ceded premiums stabilize, so does cash flow from operations. Cash flow for both periods was invested in fixed maturities and used to repay lines of credit and redeem surplus certificates.

To provide additional liquidity, we have three lines of credit available from a bank. The first line is a \$1,800 revolving line used by Finance to finance insurance premiums and bears interest at .5% over the bank's prime rate. The second line for \$1,000 can be used for general corporate purposes and bears interest at 1% over the bank's prime rate. The third line is a \$3,000 declining balance facility that matures October 1, 2006. As a result of the declining balance feature, the maximum credit available under this facility at June 30, 2006 was \$1,600. None of the lines had outstanding balances as of June 30, 2006. These lines of credit require, among other things, that we maintain a minimum tangible net worth of \$7,500, that PDIC maintain a minimum surplus of not less than 240% of the Authorized Control Level Risk Based Capital (as defined by the National Association of Insurance Commissioners), and that we deliver periodic financial reports to the bank. The Company was in compliance with all covenants as of June 30, 2006. The bank has a security interest in substantially all assets of the Company, Services and Finance. In addition, the shares of PDIC are pledged, subject to the rights of policyholders under insurance laws and the authority of insurance regulators.

Based on historical trends, market conditions and our business plans, we believe that our existing resources and sources of funds will be sufficient to meet our short-term and long-term liquidity needs over the next year and beyond. Because economic, market and regulatory conditions may change, however, there can be no assurance that our funds will be sufficient to meet these liquidity needs. In addition, competition, pricing, the frequency and severity of losses and interest rates could significantly affect our short-term and long-term liquidity needs.

Critical Accounting Estimates and Judgments:

The notes to the consolidated financial statements contain a summary of the Company's significant accounting policies presented on pages 20 through 23 of the Annual Report to Shareholders for the year ended December 31, 2005. Certain of these policies are important to the portrayal of the Company's financial condition, because they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain.

The condensed consolidated financial statements include certain amounts, based upon informed estimates and judgments made by management, for transactions not yet complete or for which the ultimate resolution is not certain. Such estimates and judgments affect the reported amounts in the financial statements. Although management believes that they are making the best decisions based upon information then available, it is possible that as conditions and experience develop, these estimates may change and may be materially different from originally reported in the financial statements. Our reserves for unpaid losses and loss adjustment expenses and the related amounts due from reinsurers represent the most critical estimates present within the financial statements. Amounts recoverable from reinsurers are estimated in a manner consistent with the provisions of the reinsurance agreement and the establishment of the liability for loss and loss adjustment expenses.

Forward-Looking Statements:

This report contains forward-looking statements, including, but not limited to, statements relating to the Company's business objectives and strategy. Such forward-looking statements are based on current expectations, management beliefs, certain assumptions made by the Company's management, and estimates and projections about the Company's industry. Words such as "believes", "estimates", "expects", "forecasts", "intends", "judgment", "objective", "plans", "predicts" and variations of such words and similar expressions are intended to identify such forward-looking statements. Determination of loss and loss adjustment expense reserves and amounts due from reinsurers are based substantially on estimates and the amounts so determined are inherently forward-looking.

Forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict with respect to timing, extent, likelihood and

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degree of occurrence. Therefore, actual results and outcomes may differ materially from those expressed, forecasted, or contemplated by any such forward-looking statements. Other factors, some of which are listed below, also influence our results of operations, financial condition and business of the Company and its subsidiaries:

Future economic conditions and the legal and regulatory environment in the markets served by the Company's subsidiaries;

Reinsurance market conditions, including changes in pricing and availability of reinsurance;

Financial market conditions, including, but not limited to, changes in interest rates and the values of investments;

Inflation;

Credit worthiness of the issuers of investment securities, reinsurers and others with whom the Company and its subsidiaries do business;

Estimates of loss reserves and trends in losses and loss adjustment expenses;

Changing competition;

The Company's ability to execute its business plan;

The effects of war and terrorism on investment and reinsurance markets;

The effects of hurricanes, earthquakes and other natural disasters on investment and reinsurance markets;

Changes in financial ratings issued by independent organizations, including A.M. Best, Standard & Poors and Moody's;

The Company's ability to enter new markets successfully and capitalize on growth opportunities;

The Company's ability to comply with internal control audit requirements that are expected to become effective in 2007; and

Changes in the laws, rules and regulations governing insurance holding companies and insurance companies, as well as applicable tax and accounting matters.

Changes in any of these factors, or others, could have an adverse affect on the business or results of operations of the Company or its subsidiaries. Unless required by law, the Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Item 3. Controls and Procedures

The Company's Chief Executive Officer and Vice President of Finance, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Sections 13a-15(e) and 15d-15(e) of the regulations promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the most recent fiscal quarter covered by this quarterly report (the "Evaluation Date"), have concluded that as of the Evaluation Date, the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files

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or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are designed to ensure that information required to be disclosed in those reports is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure. There were no changes in the Company's internal control over financial reporting identified in connection with the Company's evaluation of controls that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION**Item 4. Submission of Matters to a Vote of Security Holders**

On May 9, 2006, the Company held its 2006 Annual Meeting of Shareholders. The purpose of the meeting was to elect three directors for terms expiring in 2009.

Three candidates nominated by the Governance Committee of the Board of Directors were elected by the shareholders to serve as directors of the Company at the meeting. The following sets forth the results of the voting with respect to each candidate:

| Name of Candidate | Term Expires | Shares Voted | |
|---------------------|--------------|--------------|---------|
| David W. Crooks | 2009 | For | 181,514 |
| | | Withheld | 2,000 |
| Thomas F. Dickinson | 2009 | For | 166,914 |
| | | Withheld | 16,600 |
| Blake W. Krueger | 2009 | For | 168,114 |
| | | Withheld | 15,400 |

The following directors continued as directors of the Company after the meeting:

Continuing Directors with Terms Expiring in 2008:

Stephen M. Tuuk
Thomas J. Ryan
Joseph A. Fink

Continuing Directors with Terms Expiring in 2007:

Tracy T. Larsen
Mary L. Ursul
Julius A. Otten

Item 6. Exhibits

- (a) Exhibits. The following documents are filed as exhibits to this report on Form 10-QSB:

| Exhibit No. | Document |
|-------------|----------|
|-------------|----------|

| | |
|-----|---|
| 3.1 | Amended and Restated Articles of Incorporation. Previously filed as an exhibit to the Company's Registration Statement on Form 10-SB/A filed on July 8, 2002. Here incorporated by reference. |
|-----|---|

| | |
|-----|--|
| 3.2 | Amended and Restated Bylaws. Previously filed as an exhibit to the Company's Registration Statement on Form 10-SB/A filed on July 8, 2002. Here incorporated by reference. |
|-----|--|

| | |
|------|---|
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
|------|---|

| | |
|------|---|
| 31.2 | Certification of the Vice President of Finance pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
|------|---|

| | |
|----|---|
| 32 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit, except for those portions expressly incorporated by reference in this filing, is furnished for the information of the Commission and is not deemed "filed" as part of this filing. |
|----|---|

SIGNATURES

In accordance with the requirements of the Exchange Act, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: August 14, 2006

PROFESSIONALS DIRECT, INC.

/s/ Stephen M. Tuuk
Stephen M. Tuuk, President and Chief
Executive
Officer (authorized to sign on behalf of
company)

/s/ Stephen M. Westfield
Stephen M. Westfield, Vice President of
Finance
(principal financial and accounting officer)

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