

PROASSURANCE CORP
Form 10-K
February 28, 2008

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**United States
Securities and Exchange Commission
Washington, D.C. 20549
FORM 10-K**

(Mark One)

Annual report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 [Fee Required] for the fiscal year ended December 31, 2007,

or

Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 [No Fee Required] for the transition period from _____ to _____.

Commission file number: 001-16533

ProAssurance Corporation

(Exact name of registrant as specified in its charter)

Delaware

63-1261433

(State of incorporation or organization)

(I.R.S. 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)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange On Which Registered

Common Stock, par value \$0.01 per share

New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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):

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Large accelerated
filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(Do not check if a 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

The aggregate market value of voting stock held by non-affiliates of the registrant at June 30, 2007 was \$1,692,091,431.

As of February 15, 2008, the registrant had outstanding approximately 32,203,785 shares of its common stock.

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Documents incorporated by reference in this Form 10-K

- (i) The definitive proxy statement for the 2008 Annual Meeting of the Stockholders of ProAssurance Corporation (File No. 001-16533) is incorporated by reference into Part III of this report.
- (ii) The MAIC Holdings, Inc. Registration Statement on Form S-4 (File No. 33-91508) is incorporated by reference into Part IV of this report.
- (iii) The MAIC Holdings, Inc. Definitive Proxy Statement for the 1996 Annual Meeting (File No. 0-19439) is incorporated by reference into Part IV of this report.
- (iv) The Professionals Group, Inc. Registration Statement on Form S-4 (File No. 333-3138) is incorporated by reference into Part IV of this report.
- (v) The ProAssurance Corporation Registration Statement on Form S-4 (File No. 333-49378) is incorporated by reference into Part IV of this report.
- (vi) The ProAssurance Corporation Annual Report on Form 10-K for the year ended December 31, 2001 (Commission File No. 001-16533) is incorporated by reference into Part IV of this report.
- (vii) The ProAssurance Corporation Annual Report on the Form 10-K for the year ended December 31, 2002 (File No. 001-16533) is incorporated by reference in Part IV of this report.
- (viii) The ProAssurance Corporation Definitive Proxy Statement filed on April 16, 2004 (File No. 001-16533) is incorporated by reference into Part IV of this report.
- (ix) The ProAssurance Corporation Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 001-16533) is incorporated by reference into Part IV of this report.
- (x) The ProAssurance Corporation Registration Statement of Form S-4 (File No. 333-124156) is incorporated by reference in Part IV of this report.
- (xi) The ProAssurance Corporation Current Report on Form 8-K for event occurring on November 4, 2005 (File No. 001-16533) is incorporated by reference into Part IV of this report.
- (xii) The ProAssurance Corporation Registration Statement of Form S-4 (File No. 333-131874) is incorporated by reference in Part IV of this report.
- (xiii) The ProAssurance Corporation Current Report on Form 8-K for event occurring on September 13, 2006 (File No. 001-16533) is incorporated by reference into Part IV of this report.
- (xiv) The ProAssurance Corporation Current Report on Form 8-K for event occurring on May 12, 2007 (File No. 001-16533) is incorporated by reference into Part IV of this report.
- (xv) The ProAssurance Corporation Current Report on Form 8-K for event occurring November 5, 2007 (File No. 001-16533) is incorporated by reference into Part IV of this report.

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PART I

ITEM 1. BUSINESS.

General / Corporate Overview

We are a holding company for property and casualty insurance companies focused on professional liability insurance. Our executive offices are located at 100 Brookwood Place, Birmingham, Alabama 35209 and our telephone number is (205) 877-4400. Our stock trades on the New York Stock Exchange under the symbol PRA. Our website is www.ProAssurance.com.

The Investor Home Page on our website provides many resources for investors seeking to learn more about us. Whenever we file a document or report with the Securities and Exchange Commission (the SEC) on its EDGAR system, we make the document available on our website as soon as reasonably practical. This includes our annual report on Form 10K, our quarterly reports on Form 10Q and our current reports on Form 8K. We show details about stock trading by corporate insiders by providing access to SEC Forms 3, 4 and 5 when they are filed with the SEC. We maintain access to these reports for at least one year after their filing.

In addition to federal filings on our website, we make available the financial statements we file with state regulators, news releases that we issue, and certain investor presentations. We believe these documents provide important additional information about our financial condition and operations.

The Governance section of our website provides copies of the Charters for our Audit Committee, Internal Audit department, Compensation Committee and Nominating/Corporate Governance Committee. In addition you will find our Code of Ethics and Conduct, Corporate Governance Principles, Policy Regarding Determination of Director Independence and Share Ownership Guidelines for Management and Directors. We also provide the Pre-Approval Policy and Procedures for our Audit Committee and our Policy Regarding Stockholder-Nominated Director Candidates. Printed copies of these documents may be obtained from Frank O Neil, Senior Vice President, ProAssurance Corporation, either by mail at P.O. Box 590009, Birmingham, Alabama 35259-0009, or by telephone at (205) 877-4400 or (800) 282-6242.

Because the insurance business uses certain terms and phrases that carry special and specific meanings, we urge you to read the Glossary included in this section prior to reading this report.

Caution Regarding Forward-Looking Statements

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

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

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

- general economic conditions, either nationally or in our market area, that are worse than anticipated;
- regulatory, legislative and judicial actions or decisions that adversely affect our business plans or operations;
- inflation, particularly in loss costs trends;
- changes in the interest rate environment;
- performance of financial markets affecting the fair value of our investments or making it difficult to determine the value of our investments;
- changes in laws or government regulations affecting medical professional liability insurance;
- changes to our ratings assigned by rating agencies;
- the effects of changes in the health care delivery system;
- uncertainties inherent in the estimate of loss and loss adjustment expense reserves and reinsurance, and changes in the availability, cost, quality, or collectibility of insurance/reinsurance;
- the results of litigation, including pre-or-post-trial motions, trials and/or appeals we undertake;
- bad faith litigation which may arise from our handling of any particular claim, including failure to settle;
- changes in competition among insurance providers and related pricing weaknesses in our markets;
- loss of independent agents;
- our ability to purchase reinsurance and collect payments from our reinsurers;
- increases in guaranty fund assessments;
- our ability to achieve continued growth through expansion into other states or through acquisitions or business combinations;
- the expected benefits from acquisitions may not be achieved or may be delayed longer than expected due to, among other reasons, business disruption, loss of customers and employees, increased operating costs or inability to achieve cost savings, and assumption of greater than expected liabilities;
- changes in accounting policies and practices that may be adopted by our regulatory agencies and the Financial Accounting Standards Board;
- changes in our organization, compensation and benefit plans; and
- our ability to retain and recruit senior management.

Our results may differ materially from those we expect and discuss in any forward-looking statements. The principal risk factors that may cause these differences are described in Item 1A, Risk Factors in this report and other

documents we file with the Securities and Exchange Commission, such as our current reports on Form 8-K, and our regular reports on Forms 10-Q and 10-K.

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

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GLOSSARY OF SELECTED INSURANCE AND RELATED FINANCIAL TERMS

In an effort to help our investors and other interested parties better understand our report, we are providing a Glossary of Selected Insurance Terms. These definitions are taken from recognized industry sources such as A. M. Best and The Insurance Information Institute. This list is intended to be informative and explanatory, but we do not represent that it is a comprehensive glossary.

Accident year: The accounting period in which an insured event becomes a liability of the insurer.

Admitted company; admitted basis: An insurance company licensed and authorized to do business in a particular state. An admitted company doing business in a state is said to operate on an admitted basis and is subject to all state insurance laws and regulations pertaining to its operations. (See: Non-admitted company)

Adverse selection: The tendency of those exposed to a higher risk to seek more insurance coverage than those at a lower risk. Insurers react either by charging higher premiums or not insuring at all, as in the case of floods. Adverse selection can be seen as concentrating risk instead of spreading it.

Agent: An individual or firm that represents an insurer under a contractual or employment agreement for the purpose of selling insurance. There are two types of agents: independent agents, who represent one or more insurance companies but are not employed by those companies and are paid on commission, and exclusive or captive agents, who by contract are required to represent or favor only one insurance company and are either salaried or work on commission. Insurance companies that use employee or captive agents are called direct writers. Agents are compensated by the insurance company whose products they sell. By definition, with respect to a given insurer, an agent is not a broker (See: Broker)

Alternative markets: Mechanisms used to fund self-insurance. This includes captives, which are insurers owned by one or more insureds to provide owners with coverage. Risk-retention groups, formed by members of similar professions or businesses to obtain liability insurance, are also a form of self-insurance.

Assets; admitted; non-admitted: Property owned, in this case by an insurance company, including stocks, bonds, and real estate. Because insurance accounting is concerned with solvency and the ability to pay claims, insurance regulators require a conservative valuation of assets, prohibiting insurance companies from listing assets on their balance sheets whose values are uncertain, such as furniture, fixtures, debit balances, and accounts receivable that are more than 90 days past due (these are non-admitted assets). Admitted assets are those assets that can be easily sold in the event of liquidation or borrowed against, and receivables for which payment can be reasonably anticipated.

Bodily injury: Physical harm, sickness, disease or death resulting from any of these.

Broker: An intermediary between a customer and an insurance company. Brokers typically search the market for coverage appropriate to their clients and they usually sell commercial, not personal, insurance. Brokers are compensated by the insureds on whose behalf they are working. With respect to a given insurer, a broker is not an agent. (See: Agent)

Bulk reserves: Reserves for losses that have occurred but have not been reported as well as anticipated changes to losses on reported claims. Bulk reserves are the difference between (i) the sum of case reserves and paid losses and (ii) an actuarially determined estimate of the total losses necessary for the ultimate settlement of all reported and incurred but not reported claims, including amounts already paid. (See: Case Reserves)

Capacity: For an individual insurer, the maximum amount of premium or risk it can underwrite based on its financial condition. The adequacy of an insurer's capital relative to its exposure to loss is an important measure of solvency.

Capital: Stockholders' equity (GAAP) and policyholders' surplus (SAP). Capital adequacy is linked to the riskiness of an insurer's business. (See: Risk-Based Capital, Surplus, Solvency)

Case reserves: Reserves for future losses for reported claims as established by an insurer's claims department.

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Casualty insurance: Insurance which is primarily concerned with the losses caused by injuries to third persons (in other words, persons other than the policyholder) and the legal liability imposed on the insured resulting therefrom. (See: Professional liability insurance, Medical professional liability insurance)

Cede, cedant; ceding company: When a party reinsures its liability with another, it cedes business and is referred to as the cedant or ceding company.

Claim: Written or oral demands, as well as civil and administrative proceedings.

Claims-made policy; coverage: A form of insurance that pays claims presented to the insurer during the term of the policy or within a specific term after its expiration. It limits a liability insurers' exposure to unknown future liabilities. Under a claims-made policy, an insured event becomes a liability when the event is first reported to the insurer.

Combined ratio: The sum of the underwriting expense ratio and net loss ratio, determined in accordance with either SAP or GAAP.

Commission: Fee paid to an agent or insurance salesperson as a percentage of the policy premium. The percentage varies widely depending on coverage, the insurer, and the marketing methods.

Consent to settle: Clause provided in some professional liability insurance policies requiring the insurer to receive authority from an insured before settling a claim.

Damages; economic, non-economic and punitive: Monies awarded to a plaintiff or claimant. Economic damages are intended to compensate a plaintiff or claimant for quantifiable past and future losses, such as lost wages and/or medical costs. Non-economic damages are those awarded separately and apart from economic damages, that are intended to compensate the claimant or plaintiff for non-quantifiable losses such as pain and suffering or loss of consortium. Punitive damages are non-economic damages intended to punish the defendant for perceived outrageous conduct.

Direct premiums written: Premiums charged by an insurer for the policies that it underwrites, excluding any premiums that it receives as a reinsurer.

Direct writer(s): Insurance companies that sell directly to the public using exclusive agents or their own employees.

Domestic insurance company: Term used by a state to refer to any company incorporated there.

Excess & surplus lines; surplus lines: Property/casualty insurance coverage that isn't generally available from insurers licensed in the state (See: Admitted company) and must be purchased from a non-admitted company. Examples include risks of an unusual nature that require greater flexibility in policy terms and conditions than exist in standard forms or where the highest rates allowed by state regulators are considered inadequate by admitted companies. Laws governing surplus lines vary by state.

Excess coverage; excess limits: An insurance policy that provides coverage limits above another policy with similar coverage terms, or above a self-insured amount.

Extended reporting endorsement: Also known as a tail policy, or tail coverage. Provides protection for future claims filed after a claims-made policy has lapsed. Typically requires payment of an additional premium, the tail premium. Tail coverage may also be granted if the insured becomes disabled, dies or permanently retired from the covered occupation (i.e., the practice of medicine in medical liability policies.)

Facultative reinsurance: A generic term describing reinsurance where the reinsurer assumes all or a portion of a single risk. Each risk is separately evaluated and each contract is separately negotiated by the reinsurer.

Financial Accounting Standards Board (FASB): An independent board that establishes and communicates standards of financial reporting and reporting in the United States.

Frequency: Number of times a loss occurs per unit of risk or exposure. One of the criteria used in calculating premium rates.

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Front, fronting: A procedure in which a primary insurer acts as the insurer of record by issuing a policy, but then passes all or virtually all of the risk to a reinsurer in exchange for a commission. Often, the fronting insurer is licensed to do business in a state or country where the risk is located, but the reinsurer is not. The reinsurer in this scenario is often a captive or an independent insurance company that cannot sell insurance directly in a particular location.

Generally Accepted Accounting Principles; GAAP: A set of widely accepted accounting standards, set primarily by the Financial Accounting Standards Board (FASB), and used to standardize financial accounting of public companies.

Gross premiums written: Total premiums for direct insurance written and assumed reinsurance during a given period. The sum of direct and assumed premiums written.

Guaranty fund; assessment(s): The mechanism by which all 50 states, the District of Columbia and Puerto Rico ensure that solvent insurers fund the payment of claims against insurance companies that fail. The type and amount of claim covered by the fund varies from state to state.

Incurred but not reported (IBNR): Actuarially estimated reserves for estimated losses that have been incurred by insureds and reinsureds but not yet reported to the insurer or reinsurer including unknown future developments on losses which are known to the insurer or reinsurer. Insurance companies regularly adjust reserves for such losses as new information becomes available.

Incurred losses: Losses covered by the insurer within a fixed period, whether or not adjusted or paid during the same period, plus changes in the estimated value of losses from prior periods.

Insolvent; insolvency: Insurer's inability to pay debts. Typically the first sign of problems is inability to pass the financial tests regulators administer as a routine procedure. (See: Risk-based capital)

Investment income: Income generated by the investment of assets. Insurers have two sources of income, underwriting (premiums less claims and expenses) and investment income.

Liability insurance: A line of casualty insurance for amounts a policyholder is legally obligated to pay because of bodily injury or property damage caused to another person. (See: Bodily Injury, Casualty insurance, Professional liability insurance, Medical professional liability insurance)

Limits: The maximum amount payable under an insurance policy for a covered loss.

Long-tail: The long period of time between collecting the premium for insuring a risk and the ultimate payment of losses. This allows insurance companies to invest the premiums until losses are paid, thus producing a higher level of invested assets and investment income as compared to other lines of property and casualty business. Medical professional liability is considered a long tail line of insurance. (See: Medical professional liability, Professional liability)

Loss adjustment expenses (LAE): The expenses of settling claims, including legal and other fees and the portion of general expenses allocated to claim settlement costs.

Loss costs: The portion of an insurance rate used to cover claims and the costs of adjusting claims. Insurance companies typically determine their rates by estimating their future loss costs and adding a provision for expenses, profit, and contingencies.

Loss ratio: The ratio of incurred losses and loss-adjustment expenses to net premiums earned. This ratio helps measure the company's underlying profitability, or loss experience, on its total book of business.

Loss reserves: Liabilities established by insurers to reflect the estimated cost of claims payments and the related expenses that the insurer will ultimately be required to pay in respect of insurance or reinsurance it has written. They represent a liability on the insurer's balance sheet.

Medical malpractice: An act or omission by a health care provider that falls below a recognized standard of care. (See: Standard of Care)

Medical professional liability insurance: Insurance for the legal liability of an insured (and against loss, damage or expense incidental to a claim of such liability) arising out of death, injury or disablement of a person as the result of negligent deviation from the standard of care or other misconduct in rendering professional service.

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National Association of Insurance Commissioners: Generally referred to as the NAIC. The organization of insurance regulators from the 50 states, the District of Columbia and the four U.S. territories. The NAIC provides a forum for the development of uniform policy when uniformity is appropriate.

Net losses: Incurred losses and loss adjustment expenses for the period, net of anticipated reinsurance recoveries for the period.

Net loss ratio: The net loss ratio measures the ratio of net losses and loss adjustment expenses to net earned premiums determined in accordance with SAP or GAAP.

Net paid losses: Paid losses and loss adjustment expenses for the period, net of related reinsurance recoveries.

Net premium earned: The portion of net premium that is recognized for accounting purposes as income during a particular period. Equal to net premiums written plus the change in net unearned premiums during the period.

Net premiums written: Gross premiums written for a given period less premiums ceded to reinsurers during such period.

Non-admitted company; basis: Insurers licensed in some states, but not others. States where an insurer is not licensed call that insurer non-admitted. Non-admitted companies sell coverage that is unavailable from licensed insurers within a state and are generally exempt from most state laws and regulations related to rates and coverages. Policyholders of such companies generally do not have the same degree of consumer protection and financial recourse as policyholders of admitted companies. Non-admitted companies are said to operate on a non-admitted basis.

Nose coverage: See: Prior acts coverage.

Occurrence policy; coverage: Insurance that pays claims arising out of incidents that occur during the policy term, even if they are filed many years later. Under an occurrence policy the insured event becomes a liability when the event takes place.

Operating ratio: The operating ratio is the combined ratio, less the ratio of investment income (exclusive of realized gains and losses) to net earned premiums, if determined in accordance with GAAP. While the combined ratio strictly measures underwriting profitability, the operating ratio incorporates the effect of investment income.

Paid loss ratio: The ratio of net paid losses to net premiums earned. (See Loss ratio)

Paid to incurred ratio: The ratio of net paid losses to net incurred losses.

Policy: A written contract for insurance between an insurance company and policyholder stating details of coverage.

Premium: The price of an insurance policy; typically charged annually or semiannually.

Premiums written: The total premiums on all policies written by an insurer during a specified period of time, regardless of what portions have been earned.

Premium tax: A state tax on premiums for policies issued in the state, paid by insurers.

Primary company: In a reinsurance transaction, the insurance company that is reinsured.

Prior acts coverage: An additional coverage for claims-made policies, optionally made available by an insurer, that covers an insured for claims that occurred, but were not reported prior to the inception date, or retroactive date, of the policy. Sometimes called Nose Coverage.

Professional liability insurance: Covers professionals for negligence and errors or omissions that cause injury or economic loss to their clients. (See: Casualty insurance, Liability insurance, Medical professional liability insurance)

Property casualty insurance: Covers damage to or loss of policyholders property and legal liability for damages caused to other people or their property.

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Rate: The cost of insurance for a specific unit of exposure, such as for one physician. Rates are based primarily on historical loss experience for similar risks and may be regulated by state insurance offices.

Rating agencies: These agencies assess insurers' financial strength and viability to meet claims obligations. Some of the factors considered include company earnings, capital adequacy, operating leverage, liquidity, investment performance, reinsurance programs, and management ability, integrity and experience. A high financial rating is not the same as a high consumer satisfaction rating.

Reinsurance: Insurance bought by insurance companies. In a reinsurance contract the reinsurer agrees to indemnify another insurance or reinsurance company, the ceding company, against all or a portion of the insurance or reinsurance risks underwritten by the ceding company under one or more policies. Reinsurers don't pay policyholder claims. Instead, they reimburse insurers for claims paid.

Reinsured layer; retained layer: The retained layer is the cumulative portion of each loss, on a per-claim basis, which is less than an insurer's reinsurance retention for a given coverage year. Likewise, the reinsured layer is the cumulative portion of each loss that exceeds the reinsurance retention. (See: Reinsurance, Retention)

Reserves: A company's best estimate of what it will pay at some point in the future, for claims for which it is currently responsible.

Retention: The amount or portion of risk that an insurer retains for its own account. Losses in excess of the retention level up to the outer limit, if any, are paid by the reinsurer. In proportional treaties, the retention may be a percentage of the original policy's limit. In excess of loss business, the retention is a dollar amount of loss, a loss ratio or a percentage.

Retroactive date: Applicable only to claims-made policies. Claims that have occurred and have not been reported prior to this date are excluded from coverage. The retroactive date is generally the date coverage was first afforded to an insured by a company under a claims-made policy form, unless extended into the past by Prior Acts Coverage. (See: Prior Acts Coverage)

Return on equity: Net Income (or if applicable, Income from Continuing Operations) divided by the average of beginning and ending stockholders' equity. This ratio measures a company's overall after-tax profitability from underwriting and investment activity and shows how efficiently invested capital is being used.

Risk-Based Capital (RBC): A regulatory measure of the amount of capital required for an insurance company, based upon the volume and inherent riskiness of the insurance sold, the composition of its investment portfolio and other financial risk factors. Higher-risk types of insurance, liability as opposed to property business, generally necessitate higher levels of capital. The NAIC's RBC model law stipulates four levels of regulatory action with the degree of regulatory intervention increasing as the level of surplus falls below a minimum amount as determined under the model law. (See: National Association of Insurance Commissioners)

Risk management: Management of the varied risks to which a business firm or association might be subject. It includes analyzing all exposures to gauge the likelihood of loss and choosing options to better manage or minimize loss. These options typically include reducing and eliminating the risk with safety measures, buying insurance, and self-insurance.

Self-insurance: The concept of assuming a financial risk oneself, instead of paying an insurance company to take it on. Every policyholder is a self-insurer in terms of paying a deductible and co-payments. Larger policyholders often self-insure frequent or predictable losses to avoid insurance overhead expenses.

Severity: The average claim cost, statistically determined by dividing dollars of losses by the number of claims.

Solvent; solvency: Insurance companies' ability to pay the claims of policyholders. Regulations to promote solvency include minimum capital and surplus requirements, statutory accounting conventions, limits to insurance company investment and corporate activities, financial ratio tests, and financial data disclosure.

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Standard of care: The standard by which negligence is determined. The degree of skill associated with the activities and treatment from a reasonable, prudent, ordinary practitioner acting under the same or similar circumstances.

Statement of Financial Accounting Standards (SFAS): A formal document issued by the Financial Accounting Standards Board (FASB), which details accounting standards and guidance on selected accounting policies set out by the FASB.

Statutory Accounting Principles; SAP: More conservative standards than under GAAP accounting rules, they are imposed by state laws that emphasize the present solvency of insurance companies. SAP helps ensure that the company will have sufficient funds readily available to meet all anticipated insurance obligations by recognizing liabilities earlier or at a higher value than GAAP and assets later or at a lower value. For example, SAP requires that selling expenses be recorded immediately rather than amortized over the life of the policy. (See: Generally Accepted Accounting Principles, Admitted assets)

Surplus; statutory surplus: The excess of assets over total liabilities (including loss reserves) that protects policyholders in case of unexpectedly high claims. Statutory Surplus is determined in accordance with Statutory Accounting Principles.

Tail: The period of time that elapses between the occurrence of the loss event and the payment in respect thereof.

Tail coverage: See: Extended Reporting Endorsement

Third-party coverage: Liability coverage purchased by the policyholder as a protection against possible lawsuits filed by a third party. The insured and the insurer are the first and second parties to the insurance contract.

Tort: A civil wrong which may result in damages.

Treaty reinsurance: The reinsurance of a specified type or category of risks defined in a reinsurance agreement (a "treaty") between a primary insurer and a reinsurer. Typically, in treaty reinsurance, the primary insurer or reinsured is obligated to offer and the reinsurer is obligated to accept a specified portion of all such type or category of risks originally written by the primary insurer or reinsured.

Underwriting: The insurer's or reinsurer's process of reviewing applications submitted for insurance coverage, deciding whether to accept all or part of the coverage requested and determining the applicable premiums.

Underwriting expense ratio: Under GAAP, the ratio of underwriting, acquisition and other insurance expenses incurred to net premiums earned (for SAP, the ratio of underwriting expenses incurred to net premiums written.)

Underwriting expenses: The aggregate of policy acquisition costs, including commissions, and the portion of administrative, general and other expenses attributable to underwriting operations.

Underwriting income; loss: The insurer's profit on the insurance sales after all expenses and losses have been paid, before investment income or income taxes. When premiums aren't sufficient to cover claims and expenses, the result is an underwriting loss.

Underwriting profit: The amount by which net earned premiums exceed claims and expenses. (See: Underwriting Income)

Unearned premium: The portion of premium that represents the consideration for the assumption of risk for a future period. Such premium is not yet earned since the risk has not yet been assumed. May also be defined as the pro-rata portion of written premiums that would be returned to policyholders if all policies were terminated by the insurer on a given date.

Table of Contents**Business Overview**

We operate in a single business segment principally in the Mid-Atlantic, Midwest and Southern United States. We sell professional liability insurance primarily to physicians, dentists, other healthcare providers and healthcare facilities. We also have a small book of legal professional liability business in the Midwest.

Our top five states represented 55% of our gross premiums written for the year ended December 31, 2007. The following table shows our gross premiums written in these states for each of the periods indicated.

	Gross Written Premiums-Years Ended December 31					
	2007		2006 ⁽²⁾		2005 ⁽²⁾	
	(\$ in thousands)					
Alabama	\$ 95,641	17%	\$ 102,998	18%	\$ 111,462	19%
Ohio	89,607	16%	106,267	18%	131,102	23%
Florida	41,291	8%	53,469	9%	61,341	11%
Michigan	41,092	7%	43,757	8%	46,741	8%
Wisconsin ⁽¹⁾	40,680	7%	10,702	2%	52	
All other states	240,763	45%	261,790	45%	222,262	39%
Total	\$ 549,074	100%	\$ 578,983	100%	\$ 572,960	100%

(1) Not a top five state in 2006 and 2005

(2) Indiana was included in the top five states in 2006 and 2005 (gross premiums written of \$40,335 and \$41,129, respectively)

We believe we differentiate ourselves from our competitors in several ways. Our financial strength, commitment to a local market presence and personal service, and commitment to our physician heritage have allowed us to establish what we believe to be a leading position in our markets, thus enabling us to effectively compete on a basis other than just price.

We maintain 15 local claims and/or underwriting offices to ensure that we have a local presence in the markets we serve. We believe this emphasis on local knowledge allows us to maintain active relationships with our customers and be more responsive to their needs.

We believe our local knowledge also allows us to be more effective in evaluating claims because we have a detailed understanding of the medical and legal climates of each market. We also believe our insureds value our willingness and ability to defend non-meritorious claims.

Using our local knowledge and our experienced underwriting staff, we rigorously underwrite each application for coverage to ensure that we understand the risks we accept, and are able to develop an adequate price for that risk. By charging rates we believe to be adequate, we seek to maintain the strong financial position that allows us to protect our customers in the long-term.

Corporate Organization and History

We were incorporated in Delaware in June 2001. Our core operating subsidiaries are The Medical Assurance Company, Inc., ProNational Insurance Company, NCRIC, Inc., Physicians Insurance Company of Wisconsin, Inc., and Red Mountain Casualty Insurance Company, Inc. We also write a limited amount of medical professional liability insurance through Woodbrook Casualty Insurance, Inc. (formerly Medical Assurance of West Virginia, Inc.), which we consider to be a non-core operating subsidiary.

We are the successor to twelve insurance organizations and much of our growth has come through mergers and acquisitions. In each, we retained key personnel, allowing us to maintain a local presence and preserve important institutional knowledge in underwriting, claims, risk management and marketing. We believe that our ability to utilize this local knowledge is a critical factor in the operation of our companies. Our successful integration of each organization demonstrates our ability to grow effectively through acquisitions.

Our predecessor company, Medical Assurance, Inc. (Medical Assurance) was founded by physicians as a mutual company in Alabama and wrote its first policy in 1977. Medical Assurance demutualized and became a public company in 1991. Medical Assurance expanded through internal growth and the acquisition of professional liability insurance companies with strong regional identities in West Virginia, Indiana and Missouri, along with books of business in Ohio and Missouri.

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Professionals Group, Inc. which was combined with Medical Assurance to form ProAssurance, traces its roots to the Brown-McNeeley Fund, which was founded by the State of Michigan in 1975 to provide medical professional liability insurance to physicians. Physicians Insurance Company of Michigan, which ultimately became ProNational Insurance Company, was founded in 1980 to assume the business of the Fund. That company also expanded through internal growth and the acquisition of a book of business in Illinois and the acquisition of professional liability insurers in Florida and Indiana.

Recent Developments

In early July 2003 we received \$104.6 million from the issuance of 3.9% Convertible Debentures, due June 2023, having a face value of \$107.6 million. We utilized a substantial portion of the net proceeds from the sale of the Convertible Debentures to repay an outstanding term loan. We used the balance of the net proceeds from the sale of the Convertible Debentures for general corporate purposes, including contributions to the capital of our insurance subsidiaries to support the growth in insurance operations.

In April and May 2004, we received net proceeds of \$44.9 million from the issuance of \$46.4 million of trust preferred securities. These trust preferred securities have a 30-year maturity and are callable at par in December 2009. The interest rate on these securities adjusts quarterly to the 3-month London Interbank Offered Rate (LIBOR) plus 385 basis points. We used the balance of the net proceeds from the sale of the trust preferred securities for general corporate purposes, including contributions to the capital of our insurance subsidiaries to support the growth in insurance operations. See Note 10 to the Consolidated Financial Statements for more information regarding the Convertible Debentures and the trust preferred securities.

On January 4, 2006 we sold our personal lines operations (the MEEMIC companies), effective January 1, 2006, for \$400 million before taxes and transaction expenses. We recognized a gain on the sale in the first quarter of 2006 of \$109.4 million after consideration of sales expenses and estimated taxes. Sale proceeds are available to support the capital requirements of our professional liability insurance subsidiaries and other general corporate purposes. Additional information regarding the sale of the MEEMIC companies is provided in Note 3 to the Consolidated Financial Statements.

On August 3, 2005 we acquired all of the outstanding common stock of NCRIC Corporation and its subsidiaries (NCRIC) in an all stock merger. NCRIC's primary business is a single insurance company that provides medical professional liability insurance in the District of Columbia, Delaware, Maryland, Virginia and West Virginia.

Effective August 1, 2006 we completed our acquisition of Physicians Insurance Company of Wisconsin, Inc. (PIC Wisconsin) in an all stock merger. PIC Wisconsin is a stock insurance company that sells professional liability insurance to physicians, groups of physicians, dentists, and hospitals principally in the state of Wisconsin as well as other Midwestern states.

These acquisitions strategically expanded our geographic footprint and were in keeping with our desire to expand our professional liability operations through selective acquisitions. A more detailed description of the merger transactions is included in Note 2 to the Consolidated Financial Statements included herein.

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

In April 2007 our Board of Directors authorized \$150 million to be used for the repurchase of our common stock and debt securities. On December 4, 2007 we redeemed in cash the outstanding debentures of NCRIC using \$15.5 million of our outstanding authorization. These securities became our obligation when we acquired NCRIC. As of January 31, 2008 we have also used \$67.1 million of that authorization to repurchase 1.2 million shares of our stock.

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Products and Services

We sell professional liability insurance primarily to physicians, dentists, other healthcare providers and healthcare facilities. We also have a small book of legal professional liability business in the Midwest. We generate the majority of our premiums from individual and small group practices, but also insure large physician groups as well as hospitals. While most of our business is written in the standard market, we also offer medical professional liability insurance on an excess and surplus lines basis. We also offer professional office package and workers' compensation insurance products in connection with our medical professional liability products. We are licensed to do business in every state but Connecticut, Maine, New Hampshire, New York and Vermont.

Marketing

We utilize both direct marketing and independent agents to write our business. For the year ended December 31, 2007, we estimate that approximately 69% of our gross premiums written were produced through independent insurance agencies. These local agencies usually have producers who specialize in professional liability insurance and who we believe are able to convey the factors that differentiate our professional liability insurance products. No single agent or agency accounts for more than 10% of our total direct premiums written.

Our marketing is primarily directed to individual physicians, and those in smaller groups. We generally do not target large physician groups or facilities because of the difficulty in underwriting the individual risks within those groups and because their purchasing decisions are more focused on price. Our marketing emphasizes:

excellent claims service,

the sponsorship of risk management education seminars as an accredited provider of continuing medical education,

risk management consultation, loss prevention seminars and other educational programs,

legislative oversight and active support of proposed legislation we believe will have a positive effect on liability issues affecting the healthcare industry,

the dissemination of newsletters and other printed material with information of interest to the healthcare industry, and

endorsements by, and attendance at meetings of medical societies and related organizations.

These communications and services demonstrate our understanding of the insurance needs of the healthcare industry and promote a commonality of interest among us and our insureds. We believe that a local presence in our markets enables us to effectively provide these communications and services, all of which have helped us gain exposure among potential insureds.

Underwriting

Our underwriting process is driven by individual risk selection rather than by the size or other attributes of an account. Our pricing decisions are focused on achieving rate adequacy. We assess the quality and pricing of the risk, emphasizing loss history, practice specialty and location in making our underwriting decision. Our underwriters work closely with our local claims departments. This includes consulting with staff about claims histories and patterns of practice in a particular locale as well as monitoring claims activity.

Our underwriting focuses on knowledge of local market conditions and legal environments through our six regional underwriting offices located in Alabama, Indiana, Missouri, Michigan, the District of Columbia, and Wisconsin.

Our underwriters work with our field marketing force to identify business that meets our established underwriting standards and to develop specific strategies to write the desired business. In

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performing this assessment, our underwriters may also consult with internal actuaries regarding loss trends and pricing and utilize loss-rating models to assess the projected underwriting results of certain insured risks.

Our underwriters are also assisted by our local medical advisory committees that operate in our key states. These committees are comprised of local physicians, dentists and representatives of hospitals and healthcare entities and help us maintain close ties to the medical communities in these states, provide information on the practice of medicine in each state and provide guidance on critical underwriting issues.

Claims Management

We have 15 claims offices located in Alabama (2), Delaware, Florida (2), Illinois, Indiana, Kentucky, Michigan, Missouri, Ohio (2), Virginia, the District of Columbia, and Wisconsin so that we can provide localized and timely attention to claims. We offer our insureds a strong defense of claims that we believe are non-meritorious or those we believe cannot be settled by reasonable, good faith negotiations. Many of these claims are resolved by jury verdict, and we engage experienced trial attorneys in each venue to handle the litigation in defense of our policyholders.

Our claims department promptly and thoroughly investigates the circumstances surrounding a reported claim against an insured. As we investigate, our claims department establishes the appropriate case reserves for each claim. Thereafter, we monitor development of new information about the claim and adjust the case reserve as appropriate.

Through our investigation, and in consultation with the insured and appropriate experts, we evaluate the merit of the claim and either seek reasonable good faith settlement or aggressively defend the claim. If the claim is defended, our claims department carefully manages the case, including selecting defense attorneys who specialize in professional liability defense and obtaining medical, legal and/or other expert professionals to assist in the analysis and defense of the claim. As part of the evaluation and preparation process for medical professional liability claims, we meet regularly with medical advisory committees in our key states to examine claims, attempt to identify potentially troubling practice patterns and make recommendations to our staff.

We believe that our claims philosophy contributes to lower overall loss costs and results in greater customer loyalty. The success of this claims philosophy is based on our access to attorneys who have significant experience in the defense of professional liability claims and who are able to defend claims in an aggressive, cost-efficient manner.

Investments

The majority of our assets are held in the operating insurance companies. We oversee our investments to ensure that we apply a consistent management strategy to the entire portfolio.

Our overall investment strategy is to focus on maximizing current income from our investment portfolio while maintaining safety, liquidity, duration and portfolio diversification. The portfolio is generally managed by professional third party asset managers whose results we monitor and evaluate. The asset managers typically have the authority to make investment decisions within the asset class they are responsible for managing, subject to our investment policy and oversight. See Note 4 to the Consolidated Financial Statements for more detail on our investments.

Rating Agencies

Our claims-paying ability and financial strength are regularly evaluated and rated by two major rating agencies, A. M. Best and Fitch. In developing their claims-paying ratings, these agencies evaluate an insurer's ability to meet its obligations to policyholders. While these ratings may be of interest to shareholders, these are not ratings of securities nor a recommendation to buy, hold or sell any security.

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The following table presents the ratings of our group and our core subsidiaries as of February 28, 2008:

Rating Agency	Company / Rating						
	ProAssurance Group	Medical Assurance	NCRIC	PIC Wisconsin	ProNational	Red Mountain Casualty	Woodbrook Casualty
Fitch (www.fitchratings.com)	A (Strong)	A (Strong)	A (Strong)	A (Strong)	A (Strong)	A (Strong)	A (Strong)
A. M. Best (www.ambest.com)	A- (Excellent)	A- (Excellent)	B++ (Good)	A- (Excellent)	A- (Excellent)	A- (Excellent)	B (Fair)

The rating process is dynamic and ratings can change. If you are seeking updated information about our ratings, please visit the rating agency websites listed in the table.

Competition

Competition depends on a number of factors including pricing, size, name recognition, service quality, market commitment, market conditions, breadth and flexibility of coverage, method of sale, financial stability, ratings assigned by rating agencies and regulatory conditions. Many of these factors, such as market conditions and regulatory conditions are beyond our control. However, for those factors within our control, such as service quality, market commitment, financial strength and stability, we believe we have competitive strengths that make us a viable competitor in those states where we are currently writing insurance.

We believe that we have a competitive advantage due to our financial stability, local market presence, service quality, size, geographic scope and name recognition, as well as our heritage as a policyholder-founded company with a long-term commitment to the professional liability insurance industry. We have achieved these advantages through our balance sheet strength, claims defense expertise, strong ratings and ability to deliver a high level of service to our insureds and agents. We believe that these competitive strengths make us a viable competitor in the states where we are currently writing insurance.

We compete with many insurance companies and alternative insurance mechanisms such as risk retention groups or self-insuring entities. Many of our competitors concentrate on a single state and have an extensive knowledge of the local markets. We also compete with several large national insurers whose financial strength and resources may be greater than ours. The following table shows the top five companies that we believe are our direct competitors, based on 2006 Direct Written Premiums (latest NAIC data available) in our business footprint.

Competitors

Medical Protective (Berkshire Hathaway)
ISMIE Mutual Group
MAG Mutual Group
State Volunteer Mutual Ins Co.
Health Care Indemnity Inc.

Improvements in loss cost trends have allowed us to reduce rates in certain markets and offer targeted new business and renewal retention programs in selected markets. While both actions improve policyholder retention, they decrease our average premiums. While we reflect loss cost trends in our pricing, we have chosen not to aggressively compete on price alone, and we have not compromised our commitment to strict underwriting.

In spite of these reductions we have lost some insureds due to aggressive price-based competition which we face in virtually all of our markets. This competition comes mostly from established insurers that are willing to write coverage at rates that we believe do not meet our long-term profitability

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goals. We believe many competitors are also employing less-stringent underwriting standards than they have in the past and they appear to be offering more liberal coverage options.

We have also lost insureds as some physicians and hospitals have entered into alternative risk transfer mechanisms. Historically, these alternatives have been less attractive when prices soften in the traditional insurance markets.

If competitors become less disciplined in their pricing, or more permissive in their coverage terms, we would expect to lose additional business because our ongoing commitment to adequate rates and strong underwriting standards affects our willingness to write new business and to renew existing business in the face of this price-based competition. The combined effects of lower rates and the challenges of writing new business are expected to cause our gross written premiums to continue to decline in 2008.

Insurance Regulatory Matters

We are subject to regulation under the insurance and insurance holding company statutes of various jurisdictions including the domiciliary states of our insurance subsidiaries and other states in which our insurance subsidiaries do business. Our operating insurance subsidiaries are domiciled in Alabama, Michigan, the District of Columbia, and Wisconsin.

Insurance companies are also affected by a variety of state and federal legislative and regulatory measures and judicial decisions. These could include new or updated definitions of risk exposure and limitations on business practices. In addition, individual state insurance departments may prevent premium rates for some classes of insureds from reflecting the level of risk assumed by the insurer for those classes.

There is currently limited federal regulation of the insurance business, but each state has a comprehensive system for regulating insurers operating in that state. In addition, these insurance regulators periodically examine each insurer's financial condition, adherence to statutory accounting practices, and compliance with insurance department rules and regulations.

Our operating subsidiaries are required to file detailed annual reports with the state insurance regulators in each of the states in which they do business. The laws of the various states establish agencies with broad authority to regulate, among other things, licenses to transact business, premium rates for certain types of coverage, trade practices, agent licensing, policy forms, underwriting and claims practices, reserve adequacy, transactions with affiliates, and insurer solvency. Many states also regulate investment activities on the basis of quality, distribution and other quantitative criteria. States have also enacted legislation regulating insurance holding company systems, including acquisitions, the payment of dividends, the terms of affiliate transactions, and other related matters.

Applicable state insurance laws, rather than federal bankruptcy laws, apply to the liquidation or reorganization of insurance companies.

Insurance Regulation Concerning Change or Acquisition of Control

The insurance regulatory codes in our operating subsidiaries' respective domiciliary states each contain provisions (subject to certain variations) to the effect that the acquisition of control of a domestic insurer or of any person that directly or indirectly controls a domestic insurer cannot be consummated without the prior approval of the domiciliary insurance regulator. In general, a presumption of control arises from the direct or indirect ownership, control or possession with the power to vote or possession of proxies with respect to 10% (5% in Alabama) or more of the voting securities of a domestic insurer or of a person that controls a domestic insurer. A person seeking to acquire control, directly or indirectly, of a domestic insurance company or of any person controlling a domestic insurance company must generally file an application for approval of the proposed change of control with the relevant insurance regulatory authority.

In addition, certain state insurance laws contain provisions that require pre-acquisition notification to state agencies of a change in control of a non-domestic insurance company admitted in that state. While such pre-acquisition notification statutes do not authorize the state agency to disapprove the change of control, such statutes do authorize certain remedies, including the issuance of a cease and

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desist order with respect to the non-domestic admitted insurers doing business in the state if certain conditions exist, such as undue market concentration.

Statutory Accounting and Reporting

Insurance companies are required to file detailed quarterly and annual reports with the state insurance regulators in each of the states in which they do business, and their business and accounts are subject to examination by such regulators at any time. The financial information in these reports is prepared in accordance with Statutory Accounting Principles (SAP). Insurance regulators periodically examine each insurer's financial condition, adherence to SAP, and compliance with insurance department rules and regulations.

Regulation of Dividends and Other Payments from Our Operating Subsidiaries

Our operating subsidiaries are subject to various state statutory and regulatory restrictions which limit the amount of dividends or distributions an insurance company may pay to its shareholders without prior regulatory approval. Generally, dividends may be paid only out of earned surplus. In every case, surplus subsequent to the payment of any dividends must be reasonable in relation to an insurance company's outstanding liabilities and must be adequate to meet its financial needs.

State insurance holding company acts generally require domestic insurers to obtain prior approval of extraordinary dividends. Under the insurance holding company acts governing our principal operating subsidiaries except NCRIC and PIC Wisconsin, a dividend is considered to be extraordinary if the combined dividends and distributions to the parent holding company in any 12 month period are more than the greater of either the insurer's net income for the prior fiscal year or 10% of its surplus at the end of the prior fiscal year.

The regulations governing District of Columbia insurers, which have jurisdiction over NCRIC, deems a dividend to be extraordinary if the combined dividends and distributions made in any 12 month period exceeds the lesser of:

net income less capital gains; or

10% surplus at the prior calendar year end.

The regulations governing Wisconsin insurers deems a dividend to be extraordinary if the amount exceeds the lesser of:

10% of a company's capital and surplus as of December 31 of the preceding year; or

the greater of:

Statutory net income for the preceding calendar year, minus realized capital gains for that calendar year; or

The aggregate of statutory net income for the three previous calendar years minus realized capital gains for those calendar years, minus dividends paid or credited and distributions made within the first two of the preceding three calendar years.

If insurance regulators determine that payment of a dividend or any other payments to an affiliate (such as payments under a tax-sharing agreement or payments for employee or other services) would, because of the financial condition of the paying insurance company or otherwise, be a detriment to such insurance company's policyholders, the regulators may prohibit such payments that would otherwise be permitted.

Risk-Based Capital

In order to enhance the regulation of insurer solvency, the National Association of Insurance Commissioners (NAIC) specifies risk-based capital (RBC) requirements for property and casualty insurance companies. At December 31, 2007, all of ProAssurance's insurance subsidiaries exceeded the minimum RBC levels.

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Investment Regulation

Our operating subsidiaries are subject to state laws and regulations that require diversification of investment portfolios and that limit the amount of investments in certain investment categories. Failure to comply with these laws and regulations may cause non-conforming investments to be treated as non-admitted assets for purposes of measuring statutory surplus and, in some instances, would require divestiture. We believe that our operating subsidiaries are in compliance with state investment regulations.

Guaranty Funds

Admitted insurance companies are required to be members of guaranty associations which administer state Guaranty Funds. These associations levy assessments (up to prescribed limits) on all member insurers in a particular state on the basis of the proportionate share of the premiums written by member insurers in the covered lines of business in that state. Maximum assessments permitted by law in any one year generally vary between 1% and 2% of annual premiums written by a member in that state. Some states permit member insurers to recover assessments paid through surcharges on policyholders or through full or partial premium tax offsets, while other states permit recovery of assessments through the rate filing process.

Shared Markets

State insurance regulations may force us to participate in mandatory property and casualty shared market mechanisms or pooling arrangements that provide certain insurance coverage to individuals or other entities that are otherwise unable to purchase such coverage in the commercial insurance marketplace. Our operating subsidiaries participation in such shared markets or pooling mechanisms is not material to our business at this time.

Total shareholders' equity

12,189 11,920

Total liabilities and shareholders' equity

\$ 30,148 \$ 30,197

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**NORTHROP GRUMMAN CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)**

	Six Months Ended June 30	
<i>\$ in millions</i>	2009	2008
Operating Activities		
Sources of Cash – Continuing Operations		
Cash received from customers		
Progress payments	\$ 3,560	\$ 3,319
Collections on billings	13,298	12,983
Other cash receipts	20	37
Total sources of cash – continuing operations	16,878	16,339
Uses of Cash – Continuing Operations		
Cash paid to suppliers and employees	(15,554)	(14,855)
Interest paid, net of interest received	(141)	(153)
Income taxes paid, net of refunds received	(467)	(482)
Excess tax benefits from stock-based compensation		(45)
Other cash payments	(58)	(7)
Total uses of cash – continuing operations	(16,220)	(15,542)
Cash provided by continuing operations	658	797
Cash provided by discontinued operations		4
Net cash provided by operating activities	658	801
Investing Activities		
Proceeds from sale of business, net of cash divested		175
Payments for businesses purchased	(33)	
Additions to property, plant, and equipment	(297)	(277)
Payments for outsourcing contract costs and related software costs	(37)	(77)
Decrease in restricted cash	3	37
Other investing activities, net	2	10
Net cash used in investing activities	(362)	(132)
Financing Activities		
Net borrowings (payments) under lines of credit	3	(3)
Principal payments of long-term debt	(72)	(109)
Proceeds from exercises of stock options and issuances of common stock	17	82
Dividends paid	(269)	(261)

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Excess tax benefits from stock-based compensation		45
Common stock repurchases	(423)	(805)
Net cash used in financing activities	(744)	(1,051)
Decrease in cash and cash equivalents	(448)	(382)
Cash and cash equivalents, beginning of period	1,504	963
Cash and cash equivalents, end of period	\$ 1,056	\$ 581

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Table of Contents**NORTHROP GRUMMAN CORPORATION**

<i>\$ in millions</i>	Six Months Ended	
	June 30	
	2009	2008
Reconciliation of Net Earnings to Net Cash Provided by Operating Activities		
Net earnings	\$ 783	\$ 759
Adjustments to reconcile to net cash provided by operating activities		
Depreciation	280	276
Amortization of assets	75	109
Stock-based compensation	55	83
Excess tax benefits from stock-based compensation		(45)
Pre-tax gain on sale of business		(58)
Decrease (increase) in		
Accounts receivable	(3,340)	(3,691)
Inventoried costs	(354)	(304)
Prepaid expenses and other current assets	(75)	(40)
Increase (decrease) in		
Progress payments	3,252	3,370
Accounts payable and accruals	(241)	215
Deferred income taxes	61	121
Income taxes payable	(48)	(84)
Retiree benefits	171	46
Other non-cash transactions, net	39	40
Cash provided by continuing operations	658	797
Cash provided by discontinued operations		4
Net cash provided by operating activities	\$ 658	\$ 801
Non-Cash Investing and Financing Activities		
Sale of business		
Liabilities assumed by purchaser		\$ (18)
Mandatorily redeemable convertible preferred stock converted into common stock		\$ 350

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**NORTHROP GRUMMAN CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited)**

<i>\$ in millions, except per share</i>	Six Months Ended June 30	
	2009	2008
Common Stock		
At beginning of period	\$ 327	\$ 338
Common stock repurchased	(10)	(10)
Conversion of preferred stock		6
Employee stock awards and options	2	3
At end of period	319	337
Paid-in Capital		
At beginning of period	9,645	10,661
Common stock repurchased	(427)	(795)
Conversion of preferred stock		344
Employee stock awards and options	25	125
At end of period	9,243	10,335
Retained Earnings		
At beginning of period	5,590	7,387
Net earnings	783	759
Adoption of new accounting standards		(3)
Dividends declared	(269)	(266)
At end of period	6,104	7,877
Accumulated Other Comprehensive Loss		
At beginning of period	(3,642)	(699)
Other comprehensive income, net of tax	165	13
At end of period	(3,477)	(686)
Total shareholders' equity	\$ 12,189	\$ 17,863
Cash dividends declared per share	\$.83	\$.77

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**NORTHROP GRUMMAN CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)****1. BASIS OF PRESENTATION**

Principles of Consolidation The unaudited condensed consolidated financial statements include the accounts of Northrop Grumman Corporation and its subsidiaries (the company). All material intercompany accounts, transactions, and profits are eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements of the company have been prepared by management in accordance with the instructions to Form 10-Q of the Securities and Exchange Commission. These statements include all adjustments of normal recurring nature considered necessary by management for a fair presentation of the condensed consolidated financial position, results of operations, and cash flows. The results reported in these financial statements are not necessarily indicative of results that may be expected for the entire year. These financial statements should be read in conjunction with the audited consolidated financial statements, including the notes thereto contained in the company's 2008 Annual Report on Form 10-K, updated by the Current Report on Form 8-K filed on April 22, 2009 (2008 Form 10-K).

The quarterly information is labeled using a calendar convention; that is, first quarter is consistently labeled as ending on March 31, second quarter as ending on June 30, and third quarter as ending on September 30. It is management's long-standing practice to establish actual interim closing dates using a fiscal calendar, which requires the businesses to close their books on a Friday near these quarter-end dates in order to normalize the potentially disruptive effects of quarterly closings on business processes. The effects of this practice only exist within a reporting year.

Accounting Estimates The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). The preparation thereof requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Estimates have been prepared on the basis of the most current and best available information and actual results could differ materially from those estimates.

Accumulated Other Comprehensive Loss The components of accumulated other comprehensive loss are as follows:

<i>\$ in millions</i>	June 30, 2009	December 31, 2008
Cumulative translation adjustment	\$ 34	\$ 10
Unrealized gain (loss) on marketable securities and cash flow hedges, net of tax (expense) benefit of \$(3) as of June 30, 2009 and \$20 as of December 31, 2008	3	(32)
Unamortized benefit plan costs, net of tax benefit of \$2,286 as of June 30, 2009 and \$2,358 as of December 31, 2008	(3,514)	(3,620)
Total accumulated other comprehensive loss	\$ (3,477)	\$ (3,642)

Subsequent Events Management has evaluated subsequent events after the balance sheet date through the financial statement issuance date for appropriate accounting and disclosure.

Financial Statement Reclassifications Certain amounts in the prior period notes to the condensed consolidated financial statements have been reclassified to reflect the business operations realignments effective in 2009 (see Note 6).

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NORTHROP GRUMMAN CORPORATION

2. NEW ACCOUNTING STANDARDS

Adoption of New Accounting Standards

The disclosure requirements of the previously deferred provisions of Statement of Financial Accounting Standards (SFAS) No. 157 *Fair Value Measurements* for nonfinancial assets and liabilities, are presented in Note 3.

The disclosure requirements of SFAS No. 161 *Disclosures about Derivative Instruments and Hedging Activities* are presented in Note 3.

Adoption of the accounting requirements of SFAS No. 141(R) *Business Combinations* did not have a significant impact on the company's results of operations or financial position.

The accounting and presentation requirements of SFAS No. 160 *Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51* had no impact on the financial statements as the company's non-controlling interests were not material.

The disclosure requirements of FASB Staff Position (FSP) FAS 107-1 and APB 28-1 *Interim Disclosures about Fair Value of Financial Instruments*, and FSP 157-4 *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which took effect on April 1, 2009, are presented in Note 3, where material.

Standards Issued But Not Yet Effective

In June 2009, the FASB issued SFAS No. 167 *Amendments to FASB Interpretation No. 46(R)*. Among other things, SFAS No. 167 amends FIN 46(R) to replace the calculation for determining which entities, if any, have a controlling financial interest in a variable interest entity (VIE) from a quantitative based risks and rewards calculation, to a qualitative approach that focuses on identifying which entities have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and, the obligation to absorb losses of the entity or the right to receive benefits from the entity. This standard also requires ongoing assessments as to whether an enterprise is the primary beneficiary of a VIE (previously, reconsideration was only required upon the occurrence of specific events), modifies the presentation of consolidated VIE assets and liabilities, and requires additional disclosures about a company's involvement in VIEs. SFAS No. 167 will be effective for the company beginning January 1, 2010. Management is currently evaluating the effect that adoption of this standard will have on the company's consolidated financial position and results of operations when it becomes effective in 2010.

Other new pronouncements issued but not effective until after June 30, 2009, are not expected to have a significant effect on the company's consolidated financial position or results of operations.

3. FAIR VALUE OF FINANCIAL INSTRUMENTS

Investments in Marketable Securities – The company holds a portfolio of marketable securities, primarily consisting of equity and debt securities that are classified as either trading or available-for-sale and can be liquidated without restriction. These assets are recorded at fair value, substantially all of which are based upon quoted market prices for identical instruments in active markets and are considered Level 1 inputs. As of June 30, 2009, and December 31, 2008, respectively, there were marketable equity securities of \$47 million and \$44 million included in prepaid expenses and other current assets and \$200 million and \$180 million of marketable equity securities included in

miscellaneous other assets.

Derivative Financial Instruments and Hedging Activities The company utilizes derivative financial instruments in order to manage exposure to interest rate risk and foreign currency exchange rate risk. The company does not use derivative financial instruments for trading or speculative purposes, nor does it use leveraged financial instruments. Interest rate swap agreements utilize floating interest rates as an offset to the fixed-rate characteristics of certain long-term debt instruments. Foreign currency forward contracts are used to manage foreign currency exchange risk related to receipts from customers and payments to suppliers denominated in foreign currencies.

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Derivative financial instruments are recognized as assets or liabilities in the financial statements and measured at fair value, substantially all of which are based on active or inactive markets for identical or similar instruments or model-derived valuations whose inputs are observable and thus considered Level 2 inputs. Changes in the fair value of derivative financial instruments that qualify and are designated as fair value hedges are recorded in earnings from continuing operations, while the effective portion of the changes in the fair value of derivative financial instruments that qualify and are designated as cash flow hedges are recorded in other comprehensive income. Credit risk related to derivative financial instruments is considered minimal and is managed by requiring high credit standards for counterparties and periodic settlements of the underlying transactions.

For derivative financial instruments not designated as hedging instruments as well as the ineffective portion of cash flow hedges, gains or losses resulting from changes in the fair value are reported in Other, net in the condensed consolidated statements of operations. Unrealized gains or losses on cash flow hedges are reclassified from other comprehensive income to earnings from continuing operations upon the recognition of the underlying transactions.

As of June 30, 2009, interest rate swaps with notional values totaling \$400 million, and foreign currency purchase and sale forward contract agreements with notional values of \$177 million and \$89 million, respectively, were designated as hedging instruments. The remaining notional values outstanding at June 30, 2009, under foreign currency purchase and sale forward contracts of \$88 million and \$18 million, respectively, were not designated as hedging instruments.

In October 2008, the company entered into two forward-starting interest rate swaps with a notional value totaling \$400 million. The fair value of the forward-starting swap agreements was a \$58 million liability at December 31, 2008, and was included in other current liabilities. The company designated these swaps as cash flow hedges of future interest payments on \$400 million of financing expected to occur in 2009. These swaps were settled as of June 8, 2009, and the related impact on the condensed consolidated statements of operations was not material.

All other derivative fair values and related unrealized gains and losses at June 30, 2009, and December 31, 2008, were not material.

The carrying amounts of other financial instruments not listed in the table below approximate fair value due to the short-term nature of these items.

Carrying amounts and the related estimated fair values of the company's financial instruments not recorded at fair value in the financial statements are as follows:

<i>\$ in millions</i>	June 30, 2009		December 31, 2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash surrender value of life insurance policies	\$ 224	\$ 224	\$ 240	\$ 240
Long-term debt	(3,841)	(4,321)	(3,920)	(4,369)

Cash Surrender Value of Life Insurance Policies The company maintains whole life insurance policies on a group of executives for use as a funding source for deferred compensation arrangements. These policies are recorded at their cash surrender value as determined by the insurance carrier. Additionally, the company has split-dollar life insurance policies on former officers and executives from acquired businesses which are recorded at the lesser of their cash

surrender value or premiums paid. The policies are utilized as a partial funding source for supplemental employee retirement plans and amounts associated with these policies are recorded in miscellaneous other assets in the condensed consolidated statements of financial position.

Long-Term Debt The fair value of the long-term debt was calculated based on interest rates available for debt with terms and maturities similar to the company's existing debt arrangements.

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4. COMMON STOCK DIVIDENDS AND CONVERSION OF PREFERRED STOCK

Dividends on Common Stock In May 2009, the company's board of directors approved an increase to the quarterly common stock dividend, from \$.40 per share to \$.43 per share, for shareholders of record as of June 1, 2009.

In April 2008, the company's board of directors approved an increase to the quarterly common stock dividend, from \$.37 per share to \$.40 per share, for shareholders of record as of June 2, 2008.

Conversion of Preferred Stock On February 20, 2008, the company's board of directors approved the redemption of the 3.5 million shares of mandatorily redeemable convertible preferred stock on April 4, 2008. Prior to the redemption date, substantially all of the preferred shares were converted into common stock at the election of shareholders. All remaining unconverted preferred shares were redeemed by the company on the redemption date. As a result of the conversion and redemption, the company issued approximately 6.4 million shares of common stock.

5. BUSINESS ACQUISITIONS AND DISPOSITIONS

Acquisitions

In April 2009, the company acquired Sonoma Photonics, Inc., as well as assets from Swift Engineering's Killer Bee Unmanned Air Systems product line for an aggregate amount of approximately \$33 million. The operating results since acquisition are reported in the Aerospace Systems segment. The assets, liabilities, and results of operations of these two acquisitions were not material to the company's consolidated financial position or results of operations, and thus pro-forma financial information is not presented. The condensed consolidated financial statements reflect preliminary estimates of the fair value of the assets acquired and liabilities assumed and the related allocation of the purchase price for the entities acquired. Management does not expect adjustments to these estimates, if any, to have a material effect on the company's condensed consolidated financial position or results of operations.

In October 2008, the company acquired 3001 International, Inc. (3001 Inc.) for approximately \$92 million in cash. 3001 Inc. provides geospatial data production and analysis, including airborne imaging, surveying, mapping and geographic information systems for U.S. and international government intelligence, defense and civilian customers. The operating results of 3001 Inc. are reported in the Information Systems segment. The assets, liabilities, and results of operations of 3001 Inc. were not material to the company's consolidated financial position or results of operations.

Dispositions

In April 2008, the company sold its Electro-Optical Systems (EOS) business for \$175 million in cash to L-3 Communications Corporation and recognized a gain of \$19 million, net of taxes of \$39 million. EOS, formerly a part of the Electronic Systems segment, produces night vision and applied optics products and had sales of approximately \$53 million through April 2008. Operating results of this business are reported as discontinued operations in the condensed consolidated statements of operations for all applicable periods presented.

6. SEGMENT INFORMATION

In January 2009, the company streamlined its organizational structure by reducing the number of operating segments from seven to five. The five segments are Information Systems, which combines the former Information Technology and Mission Systems segments; Aerospace Systems, which combines the former Integrated Systems and Space Technology segments; Electronic Systems; Shipbuilding; and Technical Services. These five segments are considered

reportable segments in accordance with SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information*. Creation of the Information Systems and Aerospace Systems segments is intended to strengthen alignment with customers, improve the company's ability to execute on programs and win new business, and enhance cost competitiveness. Product sales are predominantly generated in

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the Aerospace Systems, Electronic Systems and Shipbuilding segments, while the majority of the company's service revenues are generated by the Information Systems and Technical Services segments.

During the first quarter of 2009, the company realigned certain logistics, services, and technical support programs and transferred assets from the Information Systems and Electronic Systems segments to the Technical Services segment. This realignment is intended to strengthen the company's core capability in aircraft and electronics maintenance, repair and overhaul, life cycle optimization, and training and simulation services.

Sales and segment operating income in the following tables have been revised to reflect the above realignments for all periods presented.

During the first quarter of 2009, the company transferred certain optics and laser programs from the Information Systems segment to the Aerospace Systems segment. As the operating results of this business were not considered material, the prior year sales and segment operating income in the following tables were not reclassified to reflect this business transfer.

During the first quarter of 2008, the company recorded a pre-tax charge of \$272 million for cost growth on the LHD 8 contract and an additional \$54 million, primarily for schedule impacts on other ships and impairment of purchased intangibles at the Gulf Coast shipyards.

The following table presents segment sales and service revenues for the three and six months ended June 30, 2009, and 2008.

<i>\$ in millions</i>	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2009	2008	2009	2008
Sales and Service Revenues				
Aerospace Systems	\$ 2,673	\$ 2,472	\$ 5,129	\$ 4,833
Electronic Systems	1,967	1,665	3,755	3,210
Information Systems	2,585	2,512	5,076	4,810
Shipbuilding	1,524	1,688	2,899	2,952
Technical Services	702	634	1,334	1,192
Intersegment eliminations	(494)	(343)	(916)	(645)
Total sales and service revenues	\$ 8,957	\$ 8,628	\$ 17,277	\$ 16,352

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The following table presents segment operating income reconciled to total operating income for the three and six months ended June 30, 2009, and 2008.

<i>\$ in millions</i>	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2009	2008	2009	2008
Operating Income				
Aerospace Systems	\$ 257	\$ 236	\$ 515	\$ 488
Electronic Systems	251	201	480	410
Information Systems	204	207	427	419
Shipbuilding	14	126	98	(92)
Technical Services	43	42	80	71
Intersegment eliminations	(50)	(28)	(90)	(54)
Total segment operating income	719	784	1,510	1,242
Non-segment factors affecting operating income				
Unallocated income (expense)	21	(43)	(32)	(75)
Net pension adjustment	(76)	69	(152)	128
Royalty income adjustment	(11)	(4)	(18)	(25)
Total operating income	\$ 653	\$ 806	\$ 1,308	\$ 1,270

Unallocated Income (Expense) Unallocated income (expense) generally includes the portion of corporate expenses not considered allowable or allocable under applicable U.S. Government Cost Accounting Standards (CAS) regulations and the Federal Acquisition Regulation, and therefore not allocated to the segments, for costs related to management and administration, legal, environmental, certain compensation and retiree benefits, and other expenses. Unallocated income (expense) for the three and six months ended June 30, 2009, reflects a gain resulting from a legal settlement (see Note 9), net of other legal provisions and related expenses.

Net Pension Adjustment The net pension adjustment reflects the difference between pension expense determined in accordance with U.S. GAAP and pension expense allocated to the operating segments determined in accordance with CAS.

Royalty Income Adjustment Royalty income is included in segment operating income and reclassified to other income for financial reporting purposes.

7. EARNINGS PER SHARE

Basic Earnings Per Share Basic earnings per share from continuing operations are calculated by dividing earnings from continuing operations available to common shareholders by the weighted-average number of shares of common stock outstanding during each period.

Diluted Earnings Per Share Diluted earnings per share include the dilutive effect of stock options and other stock awards granted to employees under stock-based compensation plans. The dilutive effect of these securities totaled

3.8 million shares and 4.5 million shares for the three and six months ended June 30, 2009, respectively. The dilutive effect of these securities totaled 5.1 million shares and 8.0 million shares (including 41,000 shares and 2.2 million shares for the company's mandatorily redeemable convertible preferred stock) for the three and six months ended June 30, 2008, respectively. For the six months ended June 30, 2008, the diluted earnings per share calculation included \$1 million of dividends added back to earnings and the weighted-average diluted shares outstanding included the company's mandatorily redeemable convertible preferred stock (See Note 4).

The weighted-average diluted shares outstanding for the three and six months ended June 30, 2009, exclude stock options to purchase approximately 8.4 million and 10.6 million shares, respectively, because such options have an exercise price in excess of the average market price of the company's common stock during the period.

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The weighted-average diluted shares outstanding for the three and six months ended June 30, 2008, exclude stock options to purchase approximately 1.4 million and 1.3 million shares, respectively.

Share Repurchases The table below summarizes the company's share repurchases beginning January 1, 2008:

Authorization Date	Amount Authorized (in millions)	Average Price Per Share	Total Shares Retired (in millions)	Shares Repurchased (in millions)	
				Six Months Ended June 30,	
				2009	2008
December 19, 2007	\$ 2,500	\$ 63.44	31.4	10.0	10.3

Share repurchases take place at management's discretion or under pre-established non-discretionary programs from time to time, depending on market conditions, in the open market, and in privately negotiated transactions. The company retires its common stock upon repurchase and has not made any purchases of common stock other than in connection with these publicly announced repurchase programs. As of June 30, 2009, the company has \$508 million remaining under this authorization for share repurchases.

8. GOODWILL AND OTHER PURCHASED INTANGIBLE ASSETS**Goodwill**

The changes in the carrying amounts of goodwill for the six months ended June 30, 2009, were as follows:

<i>\$ in millions</i>	Balance as of December 31, 2008	Transfers	Acquired	Purchase Accounting Adjustments	Balance as of June 30, 2009
Aerospace Systems	\$ 3,748	\$ 41	\$ 5	\$ 7	\$ 3,801
Electronic Systems	2,428	(26)			2,402
Information Systems	6,399	(138)		6	6,267
Shipbuilding	1,141				1,141
Technical Services	802	123			925
Total	\$ 14,518	\$ -	\$ 5	\$ 13	\$ 14,536

Transfers During the first quarter of 2009, the company realigned certain logistics, services, and technical support programs and transferred assets from the Information Systems and Electronic Systems segments to the Technical Services segment. As a result of this realignment, goodwill of approximately \$123 million was reallocated between these segments. Additionally during the first quarter of 2009, the company transferred certain optics and laser programs from the Information Systems segment to the Aerospace Systems segment resulting in the reallocation of goodwill of approximately \$41 million.

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The table below summarizes the company's aggregate purchased intangible assets:

<i>\$ in millions</i>	June 30, 2009			December 31, 2008		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Contract and program intangibles	\$ 2,672	\$ (1,770)	\$ 902	\$ 2,642	\$ (1,720)	\$ 922
Other purchased intangibles	100	(77)	23	100	(75)	25
Total	\$ 2,772	\$ (1,847)	\$ 925	\$ 2,742	\$ (1,795)	\$ 947

The company's purchased intangible assets are subject to amortization and are being amortized on a straight-line basis over an aggregate weighted-average period of 21 years. Aggregate amortization expense for the three and six months ended June 30, 2009, was \$26 million and \$52 million, respectively.

The table below shows expected amortization for purchased intangibles for the remainder of 2009 and for the next five years:

<i>\$ in millions</i>	
Year ending December 31	
2009 (July 1 - December 31)	\$ 51
2010	93
2011	56
2012	55
2013	45
2014	36

9. LITIGATION

U.S. Government Investigations and Claims Departments and agencies of the U.S. Government have the authority to investigate various transactions and operations of the company, and the results of such investigations may lead to administrative, civil or criminal proceedings, the ultimate outcome of which could be fines, penalties, repayments or compensatory or treble damages. U.S. Government regulations provide that certain findings against a contractor may lead to suspension or debarment from future U.S. Government contracts or the loss of export privileges for a company or an operating division or subdivision. Suspension or debarment could have a material adverse effect on the company because of its reliance on government contracts.

On June 22, 2007, a putative class action was commenced against the Northrop Grumman Pension Plan and the Northrop Grumman Retirement Plan B and their corresponding administrative committees, styled as *Skinner et al. v.*

Northrop Grumman Pension Plan, etc., et al. filed in the U.S. District Court for the Central District of California. The putative class representatives alleged violations of ERISA and breaches of fiduciary duty concerning a 2003 modification to the Northrop Grumman Retirement Plan B. The modification relates to the employer funded portion of the pension benefit available during a five-year transition period that ended on June 30, 2008. The plaintiffs dismissed the Northrop Grumman Pension Plan, and on March 10, 2008, the trial court granted summary judgment in favor of all remaining defendants on all claims. The plaintiffs appealed that ruling to the Ninth Circuit Court of Appeals, and on May 21, 2009, the Ninth Circuit reversed the decision of the trial court, finding that there was an ambiguity in a 1998 summary plan description related to the employer funded component of the pension benefit. The Ninth Circuit remanded the matter back to the trial court for further proceedings consistent with its ruling.

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As previously disclosed, on April 2, 2009, the company reached an agreement with the U.S. Government to settle two legal matters. The first matter involved potentially substantial claims by the U.S. Department of Justice and a restricted U.S. Government customer relating to certain microelectronic parts produced by the Space and Electronics Sector of former TRW Inc., now a part of the company. The second matter covered by the settlement agreement involved a lawsuit filed by the company in 1996 against the U.S. Government in the U.S. Court of Federal Claims for recovery of uncompensated performance costs, investments and a reasonable profit on the Tri-Service Standoff Attack Missile (TSSAM) program which the customer terminated for convenience. The U.S. Department of Justice valued both of these claims at \$325 million, and as such, the settlement amounts for the two matters are equal and offset each other. The company had previously recorded an accrual for its settlement offer on the microelectronics parts matter. Since these matters were settled jointly and at equal values, the company recognized a gain of \$99 million in the second quarter of 2009 representing the remainder of the accrued settlement offer, net of expenses. The settlement agreement did not have an impact on the company's cash flows.

In the second quarter of 2007, the U.S. Coast Guard issued a revocation of acceptance under the Deepwater Program for eight converted 123-foot patrol boats (the vessels) based on alleged hull buckling and shaft alignment problems and alleged nonconforming topside equipment on the vessels. The company submitted a written response that argued that the revocation of acceptance was improper, and in late December 2007, the Coast Guard advised Integrated Coast Guard Systems (the contractors' joint venture for performing the Deepwater Program, the Joint Venture) that the Coast Guard was seeking \$96.1 million from the Joint Venture as a result of the revocation of acceptance of the eight vessels delivered under the 123-foot conversion program. The majority of the costs associated with the 123-foot conversion effort are associated with the alleged structural deficiencies of the vessels, which were converted under contracts with the company and a subcontractor to the company. In May 2008, the Coast Guard advised the Joint Venture that the Coast Guard would support an investigation by the U.S. Department of Justice of the Joint Venture and its subcontractors instead of pursuing its \$96.1 million claim independently. The Department of Justice had previously issued subpoenas related to the Deepwater Program, pursuant to which the company has provided responsive documents. On February 6, 2009, the U.S. Department of Justice notified the U.S. District Court for the Northern District of Texas that the U.S. Government is not intervening at this time in what was then a sealed False Claims Act complaint. On February 12, 2009, the Court unsealed the complaint filed by Michael J. DeKort, a former Lockheed Martin employee, against Integrated Coast Guard Systems, Lockheed Martin Corporation and the company, relating to the 123-foot conversion effort. Based upon the information available to the company to date, the company believes that it has substantive defenses to any potential claims but can give no assurance that the company will prevail in this litigation.

In August 2008, the company disclosed to the Antitrust Division of the U.S. Department of Justice possible violations of federal antitrust laws in connection with the bidding process for certain maintenance contracts at a military installation in California. In February 2009, the company and the Department of Justice signed an agreement admitting the company into the Corporate Leniency Program. As a result of the company's acceptance into the Program, the company will be exempt from federal criminal prosecution and criminal fines relating to the matters the company reported to the Department of Justice if the company complies with certain conditions, including its continued cooperation with the government's investigation and its agreement to make restitution if the government was harmed by the violations.

Based upon the available information regarding matters that are subject to U.S. Government investigations, the company believes that the outcome of any such matters would not have a material adverse effect on its consolidated financial position, results of operations or cash flows.

Litigation Various claims and legal proceedings arise in the ordinary course of business and are pending against the company and its properties. Based upon the information available, the company believes that the resolution of any of these various claims and legal proceedings would not have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

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The company is one of several defendants in litigation brought by the Orange County Water District in Orange County Superior Court in California on December 17, 2004, for alleged contribution to volatile organic chemical contamination of the County's shallow groundwater. The lawsuit includes counts against the defendants for violation of the Orange County Water District Act, the California Super Fund Act, negligence, nuisance, trespass and declaratory relief. Among other things, the lawsuit seeks unspecified damages for the cost of remediation, payment of attorney fees and costs, and punitive damages. The June 2009 trial date has been vacated and a status conference has been set for late July 2009.

Insurance Recovery The company is pursuing legal action against an insurance provider arising out of a disagreement concerning the coverage of certain losses related to Hurricane Katrina (see Note 10). The company commenced the action against Factory Mutual Insurance Company (FM Global) on November 4, 2005, which is now pending in the U.S. District Court for the Central District of California, Western Division. In August 2007, the District Court issued an order finding that the excess insurance policy provided coverage for the company's Katrina-related loss. In November 2007, FM Global filed a notice of appeal of the District Court's order. On August 14, 2008, the U.S. Court of Appeals for the Ninth Circuit reversed the earlier summary judgment order in favor of the company, holding that the FM Global excess policy unambiguously excludes damage from the storm surge caused by Hurricane Katrina under its Flood exclusion. The Ninth Circuit remanded the case to the District Court to determine whether the California efficient proximate cause doctrine affords the company coverage under the policy even if the Flood exclusion of the policy is unambiguous. The company filed a Petition for Rehearing En Banc, or in the Alternative, For Panel Rehearing with the Ninth Circuit on August 27, 2008. On April 2, 2009, the Ninth Circuit denied the company's Petition for Rehearing and remanded the case to the District Court. On June 10, 2009, the company filed a motion seeking leave of court to file a complaint adding AON Risk Services, Inc. of Southern California as a defendant. Based on the current status of the litigation, no assurances can be made as to the ultimate outcome of this matter.

During 2008, the company received notification from Munich-American Risk Partners (Munich Re), the only remaining insurer within the primary layer of insurance coverage with which a resolution has not been reached, that it will pursue arbitration proceedings against the company related to approximately \$19 million owed by Munich Re to Northrop Grumman Risk Management Inc. (NGRMI), a wholly-owned subsidiary of the company, for certain losses related to Hurricane Katrina. The company was subsequently notified that Munich Re also will seek reimbursement of approximately \$44 million of funds previously advanced to NGRMI for payment of claim losses of which Munich Re provided reinsurance protection to NGRMI pursuant to an executed reinsurance contract, and \$6 million of adjustment expenses. The company believes that NGRMI is entitled to full reimbursement of its covered losses under the reinsurance contract and has substantive defenses to the claim of Munich Re for return of the funds paid to date.

Provisions for Legal & Investigative Matters Litigation accruals are recorded as charges to earnings when management, after taking into consideration the facts and circumstances of each matter, including any settlement offers, has determined that it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The ultimate resolution of any exposure to the company may vary from earlier estimates as further facts and circumstances become known. During the three months ended June 30, 2009, the company recorded provisions totaling \$35 million for various legal and investigative matters.

10. COMMITMENTS AND CONTINGENCIES

Contract Performance Contingencies Contract profit margins may include estimates of revenues not contractually agreed to between the customer and the company for matters such as contract changes, negotiated settlements, claims

and requests for equitable adjustment for previously unanticipated contract costs. These estimates are based upon management's best assessment of the underlying causal events and circumstances, and are included in determining contract profit margins to the extent of expected recovery based on contractual entitlements and the probability of successful negotiation with the customer. As of June 30, 2009, the recognized amounts related to the aforementioned items are not material individually or in the aggregate.

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In conjunction with its second quarter 2009 review of contract cost estimates to reflect costs for improved design, engineering, production and quality processes and the weld inspections undertaken as a result of leaks discovered in the USS San Antonio's (LPD17) lube oil system, the company's Gulf Coast Shipbuilding operations began conducting an assessment of a quality issue relating to certain pipe welds that could affect ships currently in production and previously delivered. The company is currently working with its customers to determine the nature, scope and potential impact of this issue and to determine the extent of rework that will be required to satisfactorily resolve this issue. Based on information available to date, including ongoing technical analysis of the issue, the company does not believe that this matter will have a material adverse effect upon its consolidated financial position, results of operations or cash flows.

Guarantees of Subsidiary Performance Obligations From time to time in the ordinary course of business, the company guarantees performance obligations of its subsidiaries under certain contracts. In addition, the company's subsidiaries may enter into joint ventures, teaming and other business arrangements (the Business Arrangements) to support the company's products and services in domestic and international markets. The company generally aims to limit its exposure to its subsidiary's investment in the Business Arrangement, or to the extent of such subsidiary's obligations under the applicable contract. In some cases, however, the company may be required to guarantee performance by the Business Arrangement and, in such cases, the company generally obtains cross-indemnification from the other members of the Business Arrangement. At June 30, 2009, the company is not aware of any existing event of default that would require it to satisfy any of these guarantees.

Environmental Matters In accordance with company policy on environmental remediation, the estimated cost to complete remediation has been accrued where it is probable that the company will incur such costs in the future to address environmental impacts at currently or formerly owned or leased operating facilities, or at sites where it has been named a Potentially Responsible Party (PRP) by the Environmental Protection Agency, or similarly designated by other environmental agencies. These accruals do not include any litigation costs related to environmental matters. To assess the potential impact on the company's consolidated financial statements, management estimates the total reasonably possible remediation costs that could be incurred by the company, taking into account currently available facts on each site as well as the current state of technology and prior experience in remediating contaminated sites. These estimates are reviewed periodically and adjusted to reflect changes in facts and technical and legal circumstances. Management estimates that as of June 30, 2009, the range of reasonably possible future costs for environmental remediation sites is \$187 million to \$267 million, of which \$236 million is accrued in other current liabilities. Factors that could result in changes to the company's estimates include: modification of planned remedial actions, increases or decreases in the estimated time required to remediate, discovery of more extensive contamination than anticipated, changes in laws and regulations affecting remediation requirements, and improvements in remediation technology. Should other PRPs not pay their allocable share of remediation costs, the company may have to incur costs in addition to those already estimated and accrued. Based upon the available information, the company believes that the outcome of these matters would not have a material adverse effect on its consolidated financial position, results of operations or cash flows.

Hurricane Impacts During the third quarter of 2008, the Gulf Coast shipyards were affected by Hurricane Gustav. As a result of the storm, the Gulf Coast shipyards experienced a shut-down for several days, and a resulting minor delay in ship construction throughout the yards; however the storm caused no significant physical damage to the yards. Shipbuilding's sales and operating income in 2008 were reduced by approximately \$100 million and \$13 million, respectively, during the second half of 2008 due to lost production and additional costs resulting from the shut-down.

Also during the third quarter of 2008, a subcontractor's operations in Texas were severely impacted by Hurricane Ike. The subcontractor produces compartments for two of the LPD amphibious transport dock ships under construction at the Gulf Coast shipyards. As a result of the delays and cost growth caused by the subcontractor's resulting production impacts, Shipbuilding's 2008 operating income was reduced by approximately \$23 million during the second half of 2008.

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In August 2005, the company's Gulf Coast operations were significantly impacted by Hurricane Katrina and the company's shipyards in Louisiana and Mississippi sustained significant windstorm damage from the hurricane. As a result of the storm, the company incurred costs to replace or repair destroyed or damaged assets, suffered losses under its contracts, and incurred substantial costs to clean up and recover its operations. As of the date of the storm, the company had a comprehensive insurance program that provided coverage for, among other things, property damage, business interruption impact on net profitability, and costs associated with clean-up and recovery. The company has recovered a portion of its Hurricane Katrina claim and expects that its remaining claim will be resolved separately with the two remaining insurers, including FM Global (See Note 9).

The company has full entitlement to any insurance recoveries related to business interruption impacts resulting from these hurricanes. However, because of uncertainties concerning the ultimate determination of recoveries related to business interruption claims, in accordance with company policy, no such amounts are recognized until they are resolved with the insurers. Furthermore, due to the uncertainties with respect to the company's disagreement with FM Global in relation to the Hurricane Katrina claim, no receivables have been recognized by the company in the accompanying condensed consolidated financial statements for insurance recoveries from FM Global.

In accordance with U.S. Government cost accounting regulations affecting the majority of the company's contracts, the cost of insurance premiums for property damage and business interruption coverage, other than coverage of profit, is an allowable expense that may be charged to contracts. Because a substantial portion of long-term contracts at the shipyards are flexibly-priced, the government customer would benefit from a portion of insurance recoveries in excess of the net book value of damaged assets and clean-up and restoration costs paid by the company. When such insurance recoveries occur, the company is obligated to return a portion of these amounts to the government.

Co-Operative Agreements In 2003, Shipbuilding executed agreements with the states of Mississippi and Louisiana whereby Shipbuilding leases facility improvements and equipment from Mississippi and from a non-profit economic development corporation in Louisiana in exchange for certain commitments by Shipbuilding to these states. As of June 30, 2009, Shipbuilding has fully met its obligations under the Mississippi agreement and has met all but one requirement under the Louisiana agreement. Failure by Shipbuilding to meet the remaining Louisiana commitment would result in reimbursement by Shipbuilding to Louisiana in accordance with the agreement. As of June 30, 2009, Shipbuilding expects that the remaining commitment under the Louisiana agreement will be met based on its most recent business plan.

Financial Arrangements In the ordinary course of business, the company uses standby letters of credit and guarantees issued by commercial banks and surety bonds issued principally by insurance companies to guarantee the performance on certain contracts and to support the company's self-insured workers' compensation plans. At June 30, 2009, there were \$519 million of unused stand-by letters of credit, \$129 million of bank guarantees, and \$447 million of surety bonds outstanding.

The company has also guaranteed a \$200 million loan made to Shipbuilding in connection with the Gulf Opportunity Zone Industrial Revenue Bonds issued in December 2006. Under the loan agreement, the company guaranteed repayment of the principal and interest to the Trustee and the underlying bondholders.

Indemnifications The company has retained certain warranty, environmental, income tax, and other potential liabilities in connection with certain divestitures. The settlement of these liabilities is not expected to have a material adverse effect on the company's consolidated financial position, results of operations, or cash flows.

U.S. Government Claims Annually, the company files cost submissions to the U.S. Government to support its claimed amounts of overhead, home office and other indirect costs. On occasions, these cost submissions result in questioned costs, claims and or penalty assertions by the U.S. Government which give rise to dispute resolution in various forms. The company believes it has adequately provided for the ultimate outcome of any such matters based on, among other considerations, its assessment of the relevant government regulations. The company does

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not believe that the outcome of any such matters would have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

Operating Leases Rental expense for operating leases, excluding discontinued operations, for the three and six months ended June 30, 2009 was \$144 million and \$284 million, respectively, net of immaterial amounts of sublease rental income, and \$163 million and \$301 million, respectively, for the three and six months ended June 30, 2008.

Related Party Transactions For all periods presented, the company had no material related party transactions.

11. RETIREMENT BENEFITS

The cost of the company's pension plans and medical and life benefits plans is shown in the following table:

<i>\$ in millions</i>	Three Months Ended June 30				Six Months Ended June 30			
	Pension Benefits		Medical and Life Benefits		Pension Benefits		Medical and Life Benefits	
	2009	2008	2009	2008	2009	2008	2009	2008
Components of Net Periodic Benefit Cost								
Service cost	\$ 164	\$ 180	\$ 12	\$ 13	\$ 329	\$ 361	\$ 24	\$ 27
Interest cost	337	334	41	42	674	668	82	83
Expected return on plan assets	(389)	(474)	(12)	(16)	(778)	(949)	(24)	(32)
Amortization of:								
Prior service cost (credit)	12	10	(15)	(16)	24	20	(30)	(32)
Net loss from previous years	85	7	7	6	170	13	14	11
Net periodic benefit cost	\$ 209	\$ 57	\$ 33	\$ 29	\$ 419	\$ 113	\$ 66	\$ 57
Defined contribution plans cost	\$ 78	\$ 75			\$ 160	\$ 150		

Employer Contributions In 2009, the company expects to contribute the required minimum funding level of approximately \$126 million to its pension plans and approximately \$178 million to its other post-retirement benefit plans and also expects to make additional voluntary pension contributions totaling approximately \$500 million. As of June 30, 2009, contributions of \$236 million and \$84 million have been made to the company's pension plans and its medical and life benefit plans, respectively.

Defined Contribution Plans The company also sponsors 401(k) defined contribution plans in which most employees are eligible to participate, including certain bargaining unit employees. Company contributions for most plans are based on a cash matching of employee contributions up to 4 percent of compensation. Certain hourly employees are covered under a target benefit plan. The company also participates in a multiemployer plan for certain of the company's union employees. In addition to the 401(k) defined contribution benefit, non-union represented employees hired after June 30, 2008, are eligible to participate in a defined contribution program in lieu of a defined benefit pension plan.

12. STOCK COMPENSATION PLANS

At June 30, 2009, Northrop Grumman had stock-based compensation awards outstanding under the following plans: the 2001 Long-Term Incentive Stock Plan, the 1993 Long-Term Incentive Stock Plan, both applicable to employees, and the 1993 Stock Plan for Non-Employee Directors and 1995 Stock Plan for Non-Employee Directors, as amended. All of these plans were approved by the company's shareholders. Share-based awards under the employee plans consist of stock option awards (Stock Options) and restricted stock awards (Stock Awards).

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Table of Contents**NORTHROP GRUMMAN CORPORATION****Compensation Expense**

Total pre-tax stock-based compensation expense for the six months ended June 30, 2009, and 2008, was \$51 million, and \$83 million, respectively, of which \$10 million and \$9 million related to Stock Options and \$41 million and \$74 million, related to Stock Awards, respectively. Tax benefits recognized in the condensed consolidated statements of operations for stock-based compensation during the six months ended June 30, 2009, and 2008, were \$20 million and \$32 million, respectively. In addition, the company realized tax benefits of \$1 million and \$22 million from the exercise of Stock Options and \$47 million and \$94 million from the issuance of Stock Awards in the six months ended June 30, 2009 and 2008, respectively.

At June 30, 2009, there was \$215 million of unrecognized compensation expense related to unvested awards granted under the company's stock-based compensation plans, of which \$29 million relates to Stock Options and \$186 million relates to Stock Awards. These amounts are expected to be charged to expense over a weighted-average period of 1.6 years.

Stock Options

The fair value of each of the company's Stock Option awards is estimated on the date of grant using a Black-Scholes option-pricing model that uses the assumptions noted in the table below. The fair value of the company's Stock Option awards is expensed on a straight-line basis over the vesting period of the options, which is generally three to four years. Expected volatility is based on an average of (1) historical volatility of the company's stock and (2) implied volatility from traded options on the company's stock. The risk-free rate for periods within the contractual life of the Stock Option award is based on the yield curve of a zero-coupon U.S. Treasury bond on the date the award is granted with a maturity equal to the expected term of the award. The company uses historical data to estimate future forfeitures. The expected term of awards granted is derived from historical experience under the company's stock-based compensation plans and represents the period of time that awards granted are expected to be outstanding.

The significant weighted-average assumptions relating to the valuation of the company's Stock Options for the six months ended June 30, 2009 and 2008, were as follows:

	2009	2008
Dividend yield	3.3%	1.8%
Volatility rate	25%	20%
Risk-free interest rate	1.7%	2.8%
Expected option life (years)	6	6

The weighted-average grant date fair value of Stock Options granted during the six months ended June 30, 2009 and 2008, was \$7 and \$15, per share, respectively.

Stock Option activity for the six months ended June 30, 2009, was as follows:

Shares	Weighted-	Weighted-Average	Aggregate
Under Option	Average	Remaining	Intrinsic
(in thousands)	Exercise	Contractual Term	Value
	Price		(\$ in
			millions)

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Outstanding at January 1, 2009	13,481	\$ 54	4.2 years	\$ 18
Granted	2,711	45		
Exercised	(443)	43		
Cancelled and forfeited	(298)	54		
Outstanding at June 30, 2009	15,451	\$ 53	4.3 years	\$ 19
Vested and expected to vest in the future at June 30, 2009	15,254	\$ 53	4.1 years	\$ 19
Exercisable at June 30, 2009	11,551	\$ 52	3.4 years	\$ 17
Available for grant at June 30, 2009	8,734			

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The total intrinsic value of options exercised during the six months ended June 30, 2009 and 2008, was \$3 million and \$57 million, respectively. Intrinsic value is measured as the excess of the fair market value at the date of exercise (for options exercised) or at June 30, 2009 (for outstanding options), over the applicable exercise price.

Stock Awards

Compensation expense for Stock Awards is measured at the grant date based on fair value and recognized over the vesting period. The fair value of Stock Awards is determined based on the closing market price of the company's common stock on the grant date. For purposes of measuring compensation expense, the amount of shares ultimately expected to vest is estimated at each reporting date based on management's expectations regarding the relevant performance criteria. In the table below, the share adjustment resulting from the final performance measure is considered granted in the period that the related grant is vested. During the six months ended June 30, 2009, 2.5 million shares of common stock were issued to employees in settlement of prior year stock awards that were fully vested, with a total value upon issuance of \$111 million and a grant date fair value of \$161 million. During the six months ended June 30, 2008, 2.9 million shares of common stock were issued to employees in settlement of prior year stock awards that were fully vested, with a total value upon issuance of \$233 million and a grant date fair value of \$155 million. There were 1.6 million Stock Awards granted in the six months ended June 30, 2008, with a weighted-average grant date fair value of \$74 per share.

Stock Award activity for the six months ended June 30, 2009, was as follows:

	Stock Awards (in thousands)	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term
Outstanding at January 1, 2009	3,276	\$ 75	1.4 years
Granted (including performance adjustment on shares vested)	2,354	45	
Vested	(185)	66	
Forfeited	(173)	71	
Outstanding at June 30, 2009	5,272	\$ 62	1.7 years
Available for grant at June 30, 2009	2,251		

13. INCOME TAXES

The company's effective tax rates on income from continuing operations were 33.9 percent and 34.0 percent for the three and six months ended June 30, 2009, and 34.6 percent and 35.0 percent for the same periods in 2008. The company accounts for uncertain tax positions in accordance with the recognition standards established by Financial Accounting Standards Board Interpretation No. (FIN) 48 *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement 109. In this regard, an uncertain tax position represents the company's expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes.

The company recognizes accrued interest and penalties related to uncertain tax positions in federal and foreign income tax expense. The company files income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The IRS is currently examining the company's U.S. income tax returns for 2001-2006. In addition, open tax years related to state and foreign jurisdictions remain subject to examination, but are not material.

In 2008, the company reached a tentative partial settlement agreement with Internal Revenue Service (IRS) Appeals on substantially all of the remaining issues from the IRS examination of the company's tax returns for the years ended 2001-2003. This agreement is subject to review by the Congressional Joint Committee on Taxation (Joint Committee). Although the final outcome is not determinable until the Joint Committee completes its review during 2009, it is reasonably possible that the company may recognize net tax benefits of approximately \$50 million during 2009.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Northrop Grumman Corporation
Los Angeles, California

We have reviewed the accompanying condensed consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries as of June 30, 2009, and the related condensed consolidated statements of operations for the three-month and six-month periods ended June 30, 2009 and 2008, and of cash flows and of changes in shareholders' equity for the six-month periods ended June 30, 2009 and 2008. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial position of Northrop Grumman Corporation and subsidiaries as of December 31, 2008, and the related consolidated statements of operations and comprehensive (loss) income, cash flows, and changes in shareholders' equity for the year then ended (not presented herein); and in our report dated February 10, 2009 (April 21, 2009 as to the reclassification of segment information described in notes 1, 7, and 11), we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial position as of December 31, 2008 is fairly stated, in all material respects, in relation to the consolidated statement of financial position from which it has been derived.

/s/ Deloitte & Touche LLP
Los Angeles, California
July 22, 2009

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

The following discussion should be read along with the unaudited condensed consolidated financial statements included in this Form 10-Q, as well as the company's 2008 Annual Report on Form 10-K, updated by the Current Report on Form 8-K filed on April 22, 2009 (2008 Form 10-K), filed with the Securities and Exchange Commission, which provides a more thorough discussion of the company's products and services, industry outlook, and business trends. See discussion of consolidated results starting on page I-24 and discussion of results by segment starting on page I-27.

Northrop Grumman provides technologically advanced, innovative products, services, and integrated solutions in information and technical services, aerospace, electronics, and shipbuilding to its global customers. As a prime contractor, principal subcontractor, partner, or preferred supplier, Northrop Grumman participates in many high-priority defense and commercial technology programs in the U.S. and abroad. Northrop Grumman conducts most of its business with the U.S. Government, principally the Department of Defense (DoD). The company also conducts business with local, state, and foreign governments and has domestic and international commercial sales.

Business Outlook and Operational Trends There have been no material changes to the company's products and services, industry outlook, or business trends from those disclosed in the company's 2008 Form 10-K.

Economic Opportunities, Challenges, and Risks The President's budget proposal for fiscal year 2010 provides an indication as to the direction of defense spending, and Congress is now weighing in on this proposal. The armed services are well along in their development of the Quadrennial Defense Review and their fiscal year 2011 budget requests, which will provide additional guidance on longer term priorities and plans. Given the current era of irregular warfare, the company expects an increase in investments for intelligence, surveillance and reconnaissance (ISR) systems, cyber-security, and information collection, processing, and distribution for the warfighter to make timely decisions. Battlefield lessons from Iraq and Afghanistan should influence force structure and spending decisions as the DoD looks to enhance current readiness. Many allied countries are focusing their development and procurement efforts on advanced electronics and information systems capabilities to enhance their interoperability with U.S. forces. The size of future U.S. and international defense budgets is expected to remain responsive to the international security environment. The fiscal year 2010 budget submitted by the President of the United States requests \$533.7 billion in discretionary authority for the DoD base budget, representing approximately a 4 percent increase over the fiscal 2009 appropriated level. The 2010 budget includes reductions in certain programs in which the company participates or for which the company expects to compete. However, the company believes that spending on recapitalization and modernization of homeland security and defense assets will continue to be a national priority, with particular emphasis on areas involving intelligence, persistent surveillance, directed energy systems, cyber-security, energy-saving technologies and non-conventional warfare capabilities.

Recent Developments in U.S. Cost Accounting Standards (CAS) Pension Recovery Rules The CAS Board published an Advance Notice of Proposed Rulemaking (ANPRM) on September 2, 2008 and has indicated it will issue a Notice of Proposed Rulemaking (NPRM - the last published proposed version in the rulemaking process prior to the issuance of a final CAS rule) in July or August of 2009. The ANPRM described a framework which would partially harmonize the CAS rules with the Pension Protection Act of 2006 (PPA) requirements. The ANPRM included provisions for a transition period from the existing CAS requirement to a partially harmonized CAS requirement. After the PPA effective date for eligible government contractors (including Northrop Grumman), which were granted a delay in their PPA effective date, the proposed rule would partially mitigate the near-term mismatch between PPA-amended ERISA minimum contribution requirements which would not yet be recoverable under CAS. However, unless provisions in the ANPRM are revised in the final rule, government contractors maintaining defined benefit pension plans in general

would still experience a timing mismatch between required contributions and the CAS recoverable pension costs. It is anticipated that contractors will be entitled to seek an equitable adjustment to prices of previously negotiated contracts subject to

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CAS for increased contract costs which result from mandatory changes required by the final rule. The CAS Board is required to issue its final rule no later than January 1, 2010.

Certain notable events or activities during 2009 included the following:

Notable events for the three months ended June 30, 2009

- n LHD 8 delivered to the U.S. Navy.
- n *New York* (LPD 21) completed builder's sea trials.
- n *USS Carl Vinson* (CVN 70) completed initial sea trials.
- n The Department of Justice microelectronics claim and the company's claim against the U.S. Government for the termination of the TSSAM program were jointly settled at no cost to the company.
- n Backlog reduced by \$5.1 billion due to termination for convenience of the Kinetic Energy Interceptor program see page 33.
- n Quarterly common stock dividend increased from \$.40 per share to \$.43 per share.

Notable events for the six months ended June 30, 2009

- n Voluntary pension pre-funding contributions totaled \$214 million.
- n The company repurchased 10 million common shares for \$437 million.
- n The company streamlined its organizational structure from seven to five operating segments.
- n The company realigned certain logistics, services, and technical support programs and assets from Information Systems and Electronic Systems to Technical Services.

CRITICAL ACCOUNTING POLICIES, ESTIMATES, AND JUDGMENTS

Use of Estimates There have been no material changes to the company's critical accounting policies, estimates, or judgments from those discussed in the company's 2008 Form 10-K.

Table of Contents**CONSOLIDATED OPERATING RESULTS**

Selected financial highlights are presented in the table below.

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>\$ in millions, except per share</i>	2009	2008	2009	2008
Sales and service revenues	\$ 8,957	\$ 8,628	\$ 17,277	\$ 16,352
Cost of sales and service revenues	7,530	7,025	14,446	13,547
General and administrative expenses	774	797	1,523	1,535
Operating income	653	806	1,308	1,270
Interest expense	(70)	(72)	(143)	(149)
Other, net	13	5	21	27
Federal and foreign income taxes	202	256	403	402
Diluted earnings per share from continuing operations	1.21	1.40	2.38	2.15
Net cash provided by operating activities	830	607	658	801

Sales and Service Revenues

Sales and service revenues consist of the following:

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>\$ in millions</i>	2009	2008	2009	2008
Product sales	\$ 5,420	\$ 4,849	\$ 9,990	\$ 9,243
Service revenues	3,537	3,779	7,287	7,109
Sales and service revenues	\$ 8,957	\$ 8,628	\$ 17,277	\$ 16,352

Sales and service revenues for the three and six months ended June 30, 2009, increased \$329 million and \$925 million, respectively, as compared with the same periods in 2008, reflecting higher sales in all operating segments except Shipbuilding. Sales and service revenues at Shipbuilding for the three and six month periods were reduced by \$100 million for revised estimates to complete LPD-class ships and LHA 6. See the Segment Operating Results section below for further information.

Cost of Sales and Service Revenues

Cost of sales and service revenues is comprised of the following:

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>\$ in millions</i>	2009	2008	2009	2008
Cost of Sales and Service Revenues				

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Cost of product sales	\$ 4,345	\$ 3,793	\$ 7,980	\$ 7,522
<i>% of product sales</i>	80.2%	78.2%	79.9%	81.4%
Cost of service revenues	3,185	3,232	6,466	6,025
<i>% of service revenues</i>	90.0%	85.5%	88.7%	84.8%
General and administrative expenses	774	797	1,523	1,535
<i>% of total sales and service revenues</i>	8.6%	9.2%	8.8%	9.4%
Cost of sales and service revenues	\$ 8,304	\$ 7,822	\$ 15,969	\$ 15,082

Cost of Product Sales and Service Revenues The increase in cost of product sales as a percentage of product sales for the three months ended June 30, 2009, as compared with the same period in 2008, is primarily due to a \$105 million pre-tax charge at Shipbuilding for cost growth on LPD-class ships and LHA 6. The decrease in cost of product sales as a percentage of product sales for the six months ended June 30, 2009, as compared to the same period in 2008, is primarily due to a \$326 million pre-tax charge at Shipbuilding in the first quarter of

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2008, offset by a partial reversal of this charge in the first quarter 2009. See the Segment Operating Results section below for further information.

The increase in cost of service revenues as a percentage of service revenues for the three and six months ended June 30, 2009, as compared to the same periods in 2008, is primarily due to lower performance results on service programs.

General and Administrative Expenses In accordance with industry practice and the regulations that govern the cost accounting requirements for government contracts, most general corporate expenses incurred at both the segment and corporate locations are considered allowable and allocable costs on government contracts. For most components of the company, these costs are allocated to contracts in progress on a systematic basis and contract performance factors include this cost component as an element of cost. General and administrative expenses primarily relate to segment operations. General and administrative expenses as a percentage of total sales and service revenues decreased to 8.6 percent and 8.8 percent, respectively, for the three and six months ended June 30, 2009, primarily due to the recognition of a net gain from a litigation settlement.

Operating Income

The company considers operating income to be an important measure for evaluating its operating performance and, as is typical in the industry, defines operating income as revenues less the related cost of producing the revenues and general and administrative expenses. Operating income for the company is further evaluated for each of the business segments in which the company operates.

Management of the company internally manages its operations by reference to segment operating income. Segment operating income is defined as operating income before unallocated expenses and net pension adjustment, neither of which affect the segments, and the reversal of royalty income, which is classified as other income for financial reporting purposes. Segment operating income is one of the key metrics management uses to evaluate operating performance. Segment operating income is not, however, a measure of financial performance under U.S. GAAP, and may not be defined and calculated by other companies in the same manner.

The table below reconciles segment operating income to total operating income:

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>\$ in millions</i>	2009	2008	2009	2008
Segment operating income	\$ 719	\$ 784	\$ 1,510	\$ 1,242
Unallocated income (expense)	21	(43)	(32)	(75)
Net pension adjustment	(76)	69	(152)	128
Royalty income adjustment	(11)	(4)	(18)	(25)
Total operating income	\$ 653	\$ 806	\$ 1,308	\$ 1,270

Segment Operating Income Segment operating income for the three months ended June 30, 2009, decreased \$65 million, or 8 percent, as compared to the same period in 2008. Segment operating income was 8.0 percent and 9.1 percent of sales and service revenues for the three months ended June 30, 2009, and 2008, respectively. The decrease in segment operating income is primarily due to a \$105 million pre-tax charge at Shipbuilding for cost growth on LPD-class ships and LHA 6. See Segment Operating Results section below for more information.

Segment operating income for the six months ended June 30, 2009, increased \$268 million, or 22 percent, as compared to the same period in 2008. Segment operating income was 8.7 percent and 7.6 percent of sales and service revenues for the six months ended June 30, 2009, and 2008, respectively. The increase in segment operating income is primarily due to the first quarter 2008 pre-tax charge of \$326 million at Shipbuilding on the LHD 8 and other programs and margin on increased sales volume at all other operating segments, partially offset by the \$105 million pre-tax charge at Shipbuilding for cost growth on LPD-class ships and LHA 6. Segment operating income at Shipbuilding for the six-month period in 2009 also included cost growth of \$38 million each on the DDG 51 and LPD programs, offset by a \$54 million favorable adjustment on the LHD 8 for risk retirement and increased escalation recovery. See the Segment Operating Results section below.

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Unallocated Income (Expense) Unallocated income (expense) generally includes the portion of corporate expenses not considered allowable or allocable under applicable CAS regulations and the Federal Acquisition Regulation (FAR), and therefore not allocated to the segments, such as management and administration, legal, environmental, certain compensation and retiree benefits, and other expenses. Unallocated income (expense) for the three months ended June 30, 2009, decreased \$64 million, as compared to the same period in 2008. Unallocated expenses for the six months ended June 30, 2009, decreased \$43 million, or 57 percent, as compared to the same period in 2008. The decrease for the three and six month periods ended June 30, 2009, is primarily due to a gain resulting from a legal settlement, net of other legal provisions and related expenses.

Net Pension Adjustment Net pension adjustment reflects the difference between pension expense determined in accordance with U.S. GAAP and pension expense allocated to the operating segments determined in accordance with CAS. For the three months ended June 30, 2009, and 2008, pension expense determined in accordance with U.S. GAAP was \$209 million and \$57 million, respectively, and pension expense determined in accordance with CAS was \$133 million and \$126 million, respectively. For the six months ended June 30, 2009, and 2008, pension expense determined in accordance with U.S. GAAP was \$419 million and \$113 million, respectively, and pension expense determined in accordance with CAS was \$267 million and \$241 million, respectively. The increases in U.S. GAAP and CAS pension expense are primarily the result of negative returns on plan assets in 2008.

Royalty Income Adjustment Royalty income is included in segment operating income and reclassified to other income for financial reporting purposes. See *Other, net* below.

Interest Expense

Interest expense for the three and six months ended June 30, 2009, decreased \$2 million and \$6 million, respectively, as compared with the same period in 2008. The decrease is primarily due to a lower average debt balance.

Other, net

Other, net for the three and six months ended June 30, 2009, increased \$8 million and decreased \$6 million, respectively, as compared with the same periods in 2008. The increase for the three-month period is primarily due to increased royalty income at Aerospace Systems. The decrease for the six-month period is primarily due to lower royalty income at Electronic Systems. Other, net includes interest income for all periods presented.

Federal and Foreign Income Taxes

The company's effective tax rate on earnings from continuing operations for the three months ended June 30, 2009, was 33.9 percent compared with 34.6 percent for the same period in 2008. For the six months ended June 30, 2009, the company's effective tax rate on earnings from continuing operations was 34.0 percent compared with 35.0 percent for the same period in 2008.

Discontinued Operations

Discontinued operations for the three and six months ended June 30, 2008, represents the net operating results of the Electro-Optical Systems business formerly reported in the Electronic Systems segment. See Note 5 to the condensed consolidated financial statements in Part I, Item 1.

Diluted Earnings Per Share

Diluted earnings per share from continuing operations for the three months ended June 30, 2009, were \$1.21 per share, as compared with \$1.40 per share in the same period in 2008. Earnings per share are based on weighted average diluted shares outstanding of 325.8 million for the three months ended June 30, 2009, and 344.1 million for the same period in 2008.

Diluted earnings per share from continuing operations for the six months ended June 30, 2009, were \$2.38 per share, as compared with \$2.15 per share in the same period in 2008. Earnings per share are based on weighted average diluted shares outstanding of 328.9 million for the six months ended June 30, 2009, and 346.7 million for the same period in 2008. See Note 7 to the condensed consolidated financial statements in Part I, Item 1.

Net Cash Provided by Operating Activities

For the three months ended June 30, 2009, net cash provided by operating activities was \$830 million as compared with \$607 million for the same period in 2008. The increase of \$223 million was primarily due to lower working capital requirements in the 2009 period.

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For the six months ended June 30, 2009, net cash provided by operating activities was \$658 million as compared with \$801 million for the same period in 2008. The decrease of \$143 million was primarily due to discretionary pension contributions of \$214 million and higher trade working capital requirements in the 2009 period.

SEGMENT OPERATING RESULTS**Basis of Presentation**

In January 2009, the company streamlined its organizational structure by reducing the number of operating segments from seven to five. The five segments are Aerospace Systems, which combines the former Integrated Systems and Space Technology segments; Electronic Systems; Information Systems, which combines the former Information Technology and Mission Systems segments; Shipbuilding; and Technical Services. Creation of the Aerospace Systems and Information Systems segments is intended to strengthen alignment with customers, improve the company's ability to execute on programs and win new business, and enhance cost competitiveness.

During the first quarter of 2009, the company realigned certain logistics, services, and technical support programs and transferred assets from the Information Systems and Electronic Systems segments to the Technical Services segment. This realignment is intended to strengthen the company's core capability in aircraft and electronics maintenance, repair and overhaul, life cycle optimization, and training and simulation services.

The sales and segment operating income in the following tables have been revised to reflect the above realignments for all periods presented.

During the first quarter of 2009, the company transferred certain optics and laser programs from the Information Systems segment to the Aerospace Systems segment. As the operating results of this business were not considered material, the prior year sales and segment operating income in the following tables were not reclassified to reflect this business transfer.

<i>\$ in millions</i>	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2009	2008	2009	2008
Sales and Service Revenues				
Aerospace Systems	\$ 2,673	\$ 2,472	\$ 5,129	\$ 4,833
Electronic Systems	1,967	1,665	3,755	3,210
Information Systems	2,585	2,512	5,076	4,810
Shipbuilding	1,524	1,688	2,899	2,952
Technical Services	702	634	1,334	1,192
Intersegment eliminations	(494)	(343)	(916)	(645)
Total sales and service revenues	\$ 8,957	\$ 8,628	\$ 17,277	\$ 16,352
Segment Operating Income (Loss)				
Aerospace Systems	\$ 257	\$ 236	\$ 515	\$ 488
Electronic Systems	251	201	480	410
Information Systems	204	207	427	419
Shipbuilding	14	126	98	(92)
Technical Services	43	42	80	71
Intersegment eliminations	(50)	(28)	(90)	(54)

Total segment operating income	\$ 719	\$ 784	\$ 1,510	\$ 1,242
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Operating Performance Assessment and Reporting The company manages and assesses the performance of its businesses based on its performance on individual contracts and programs obtained generally from government organizations using the financial measures referred to below, with consideration given to the company's critical accounting policies and estimation process. Based on this approach and the nature of the company's operations, the discussion of results of operations generally focuses around the company's five segments versus distinguishing between products and services. Product sales are predominantly generated in the Aerospace

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Systems, Electronic Systems and Shipbuilding segments, while the majority of the company's service revenues are generated by the Information Systems and Technical Services segments.

Sales and Service Revenues Period-to-period sales reflect performance under new and ongoing contracts. Changes in sales and service revenues are typically expressed in terms of volume. Unless otherwise described, volume generally refers to increases (or decreases) in reported revenues incurred due to varying production activity levels, delivery rates, or service levels on individual contracts. Volume changes will typically carry a corresponding income change based on the margin rate for a particular contract.

Segment Operating Income Segment operating income reflects the aggregate performance results of contracts within a business area or segment. Excluded from this measure are certain costs not directly associated with contract performance, including the portion of corporate expenses such as management and administration, legal, environmental, certain compensation and other retiree benefits, and other expenses not considered allowable or allocable under applicable CAS regulations and the FAR, and therefore not allocated to the segments. Changes in segment operating income are typically expressed in terms of volume, as discussed above, or performance. Performance refers to changes in contract margin rates. These changes typically relate to profit recognition associated with revisions to total estimated costs at completion of the contract (EAC) that reflect improved (or deteriorated) operating performance on a particular contract. Operating income changes are accounted for on a cumulative to date basis at the time an EAC change is recorded.

Operating income may also be affected by, among other things, the effects of workforce stoppages, the effects of natural disasters (such as hurricanes and earthquakes), the resolution of disputed items with the customer, recovery of insurance proceeds, and other discrete events. At the completion of a long-term contract, any originally estimated costs not incurred or reserves not fully utilized (such as warranty reserves) could also impact contract earnings. Where such items have occurred, and the effects are material, a separate description is provided.

Contract Descriptions

For convenience, a brief description of certain programs discussed in this Form 10-Q is included in the Glossary of Programs beginning on page I-36.

AEROSPACE SYSTEMS**Business Description**

Aerospace Systems is a premier developer, integrator, producer and supporter of manned and unmanned aircraft, spacecraft, high-energy laser systems, microelectronics and other systems and subsystems critical to maintaining the nation's security and leadership in aerospace science and technology. These systems are used, primarily by government customers, in many different mission areas including intelligence, surveillance and reconnaissance; communications; battle management; strike operations; electronic warfare; missile defense; earth observation; space science; and space exploration. The segment consists of four areas of business: Strike and Surveillance Systems (S&SS); Space Systems (SS); Battle Management and Engagement Systems (BM&ES); and Advanced Programs and Technology (AP&T).

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>\$ in millions</i>	2009	2008	2009	2008
Sales and Service Revenues	\$ 2,673	\$ 2,472	\$ 5,129	\$ 4,833
Segment Operating Income	257	236	515	488
<i>As a percentage of segment sales</i>	9.6%	9.5%	10.0%	10.1%

Sales and Service Revenues

Aerospace Systems revenue for the three months ended June 30, 2009, increased \$201 million, or 8 percent, as compared with the same period in 2008. The increase is primarily due to \$95 million in higher sales at S&SS, \$57 million in higher sales at SS, \$25 million in higher sales at AP&T, and \$22 million in higher sales at BM&ES. The increase at S&SS is primarily due to higher sales volume associated with manned and unmanned

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aircraft programs such as the F/A-18, F-35, Global Hawk High-Altitude Long-Endurance (HALE) Systems, and B-2 programs, partially offset by decreased activity on the Intercontinental Ballistic Missile (ICBM) program. The increase at SS is primarily due to the ramp-up of certain restricted programs awarded in 2008, partially offset by decreased sales volume on the National Polar-orbiting Operational Environmental Satellite System (NPOESS) program. The increase at AP&T is due to higher sales volume associated with the Unmanned Combat Air System Carrier Demonstration (UCAS-D) program and restricted programs, partially offset by lower sales volume on the Airborne Laser (ABL) as the program transitions from the hardware integration phase to test phase. The increase at BM&ES is due to higher sales volume on the Broad Area Maritime Surveillance (BAMS) Unmanned Aircraft System, Joint Surveillance Target Attack Radar System (Joint STARS) and E-2C Hawkeye programs, partially offset by lower sales volume on the E-2D Advanced Hawkeye program.

Aerospace Systems revenue for the six months ended June 30, 2009, increased \$296 million, or 6 percent, as compared with the same period in 2008. The increase is primarily due to \$165 million in higher sales at S&SS, \$104 million in higher sales volume at SS, \$23 million in higher sales at BM&ES, and \$12 million of higher sales at AP&T. The increase at S&SS is primarily due to higher sales volume associated with increased deliveries and ramp-up on production on manned and unmanned aircraft programs, such as the F-35, F/A-18, Global Hawk HALE Systems, and B-2 programs, partially offset by decreased activity on the ICBM program. The increase at SS is primarily due to the ramp-up of restricted programs awarded in 2008, partially offset by lower sales volume on the NPOESS program. The increase at BM&ES is due to higher sales volume on the BAMS Unmanned Aircraft System and Joint STARS programs, partially offset by lower sales volume driven by the completion of deliveries on the EA-6B and the winding down of the system design & development phase of the E-2D Advanced Hawkeye program. The increase at AP&T was primarily due to higher sales volume associated with the UCAS-D program, partially offset by the termination of the Air Mobility Tanker program in the fourth quarter of 2008 and lower sales volume on the ABL as the program transitions from the hardware integration phase to test phase.

Segment Operating Income

Operating income at Aerospace Systems for the three months ended June 30, 2009, increased \$21 million, or 9 percent, as compared with the same period in 2008. The increase is primarily due to the higher sales volume discussed above.

Operating income at Aerospace Systems for the six months ended June 30, 2009, increased \$27 million, or 6 percent, as compared with the same period in 2008. The increase is primarily due to the higher sales volume discussed above.

ELECTRONIC SYSTEMS**Business Description**

Electronic Systems is a leading designer, developer, manufacturer and integrator of a variety of advanced electronic and maritime systems for national security and select non-defense applications. Electronic Systems provides systems to U.S. and international customers for such applications as airborne surveillance, aircraft fire control, precision targeting, electronic warfare, automatic test equipment, inertial navigation, integrated avionics, space sensing, intelligence processing, air and missile defense, communications, mail processing, biochemical detection, ship bridge control and radar, ship machinery controls, and shipboard components. The segment is composed of seven areas of business: Aerospace Systems; Defensive Systems; Government Systems; Land Forces; Naval & Marine Systems; Navigation Systems; and Space & Intelligence, Surveillance & Reconnaissance (Space & ISR) Systems.

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>\$ in millions</i>	2009	2008	2009	2008

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Sales and Service Revenues	\$ 1,967	\$ 1,665	\$ 3,755	\$ 3,210
Segment Operating Income	251	201	480	410
<i>As a percentage of segment sales</i>	<i>12.8%</i>	<i>12.1%</i>	<i>12.8%</i>	<i>12.8%</i>

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Table of Contents**Sales and Service Revenues**

Electronic Systems revenue for the three months ended June 30, 2009, increased \$302 million, or 18 percent, as compared with the same period in 2008. The increase is primarily due to higher sales of \$72 million in Space & ISR Systems, \$67 million in Aerospace Systems, \$52 million in Defensive Systems, \$34 million in Naval & Marine Systems, \$33 million in Navigation Systems, and \$21 million in Government Systems. The increase in Space & ISR Systems is due to higher volume on the Space Based Infrared System (SBIRS) program. The increase in Aerospace Systems is due to higher volume on the F-35 program, electronic warfare programs and intercompany programs. The increase in Defensive Systems is due to higher deliveries associated with the Large Aircraft Infrared Countermeasures (LAIRCM) IDIQ program. The increase in Naval & Marine Systems is due to higher volume on power and propulsion systems for the *Virginia*-class submarine program, intercompany programs, and increased volume on restricted programs. The increase in Navigation Systems is due to higher deliveries associated with space programs. The increase in Government Systems is due to higher volume on postal automation programs.

Electronic Systems revenue for the six months ended June 30, 2009, increased \$545 million, or 17 percent, as compared with the same period in 2008. The increase is primarily due to higher sales of \$118 million in Defensive Systems, \$117 million in Space & ISR Systems, \$96 million in Aerospace Systems, \$60 million in Naval & Marine Systems, \$55 million in Government Systems, and \$46 million in Navigation Systems. The increase in Defensive Systems is due to higher deliveries associated with the LAIRCM IDIQ program. The increase in Space & ISR Systems is due to higher volume on the SBIRS program. The increase in Aerospace Systems is due to higher volume on the F-35 program and electronic warfare programs. The increase in Naval & Marine Systems is due to higher volume on power and propulsion systems for the *Virginia*-class submarine program and increased volume on restricted programs. The increase in Government Systems is due to higher volume on postal automation programs. The increase in Navigation Systems is due to higher deliveries associated with space programs.

Segment Operating Income

Operating income at Electronic Systems for the three months ended June 30, 2009, increased \$50 million, or 25 percent, as compared with the same period in 2008. The increase is primarily due to \$38 million from the higher sales volume discussed above and \$12 million in net performance improvements across various programs. The 2008 period included a \$20 million charge for the company's MESA Wedgetail radar program.

Operating income at Electronic Systems for the six months ended June 30, 2009, increased \$70 million, or 17 percent, as compared with the same period in 2008. The increase is due to the higher sales volume discussed above. Operating income in 2008 includes royalty income of \$19 million related to patent infringement settlements, offset by the performance adjustment on MESA Wedgetail described above.

INFORMATION SYSTEMS**Business Description**

Information Systems is a leading global provider of advanced solutions for the DoD, national intelligence, federal, civilian, state and local agencies, and commercial customers. Products and services are focused on the fields of command, control, communications, computers and intelligence, missile and air defense, airborne reconnaissance, intelligence processing, decision support systems, information technology systems engineering and systems integration. The segment consists of four areas of business: Defense Systems (DSD); Intelligence Systems (ISD); Civil Systems (CSD); and Advisory Services (ASD).

	Three Months Ended		Six Months Ended	
	June 30		June 30	
<i>\$ in millions</i>	2009	2008	2009	2008

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Sales and Service Revenues	\$ 2,585	\$ 2,512	\$ 5,076	\$ 4,810
Segment Operating Income	204	207	427	419
<i>As a percentage of segment sales</i>	7.9%	8.2%	8.4%	8.7%

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Table of Contents**Sales and Service Revenues**

Information Systems revenue for the three months ended June 30, 2009, increased \$73 million, or 3 percent, as compared with the same period in 2008. The increase is primarily due to \$87 million in higher sales in ISD and \$83 million in higher sales in DSD, partially offset by \$89 million in lower sales in CSD. The increase in ISD is primarily due to increased activity on existing restricted programs as well as additional revenues from 3001 International, Inc. (3001 Inc.), which was acquired in the fourth quarter of 2008. The increase in DSD is primarily due to higher revenues on the Trailer Mounted Support System (TMSS), Airborne and Maritime/Fixed Stations Joint Tactical Radio Systems (AMF JTRS), and Integrated Base Defense Security System (IBDSS). The decrease in CSD is related to lower volume on the New York City Wireless (NYCWIn) program, as well as program completions and lower volume for state and local programs.

Information Systems revenue for the six months ended June 30, 2009, increased \$266 million, or 6 percent, as compared with the same period in 2008. The increase is primarily due to \$188 million in higher sales in ISD and \$164 million in higher sales in DSD, partially offset by \$111 million in lower sales in CSD. The increase in ISD is due to program growth on the Counter Narco-Terrorism Program Office (CNTPO), Guardrail Common Sensor System-Improved Indefinite Delivery Indefinite Quality (IDIQ), and restricted programs, as well as additional revenues from 3001 Inc., which was acquired in the fourth quarter of 2008. The increase in DSD is primarily due to ramp-up on the TMSS and AMF JTRS programs, as well as higher volume on IBDSS. The decrease in CSD is primarily due to lower volume on NYCWiN, as well as program completions and lower volume for state and local programs.

Segment Operating Income

Operating income at Information Systems for the three months ended June 30, 2009, decreased \$3 million, or 1 percent, as compared with the same period in 2008. The decrease comprises \$8 million in lower net performance results, partially offset by \$5 million from the higher sales volume discussed above. The decrease in performance results is primarily due to lower performance on state and local programs.

Operating income at Information Systems for the six months ended June 30, 2009, increased \$8 million, or 2 percent, as compared with the same period in 2008. The increase is primarily due to \$22 million from the higher sales volume discussed above, partially offset by lower performance results on state, and local programs.

SHIPBUILDING**Business Description**

Shipbuilding is the nation's sole industrial designer, builder, and refueler of nuclear-powered aircraft carriers and one of only two companies capable of designing and building nuclear-powered submarines for the U.S. Navy. Shipbuilding is also one of the nation's leading full service systems providers for the design, engineering, construction, and life cycle support of major surface ships for the U.S. Navy, U.S. Coast Guard, international navies, and for commercial vessels of all types. The segment includes the following areas of business: Aircraft Carriers; Expeditionary Warfare; Surface Combatants; Submarines; Coast Guard & Coastal Defense; Fleet Support; Commercial; and Services & Other.

<i>\$ in millions</i>	Three Months Ended June 30		Six Months Ended June 30	
	2009	2008	2009	2008
Sales and Service Revenues	\$ 1,524	\$ 1,688	\$ 2,899	\$ 2,952
Segment Operating Income (Loss)	14	126	98	(92)
<i>As a percentage of segment sales</i>	0.9%	7.5%	3.4%	3.1%

Sales and Service Revenues

Shipbuilding revenue for the three months ended June 30, 2009, decreased \$164 million, or 10 percent, as compared with the same period in 2008. The decrease is primarily due to \$182 million in lower sales at Expeditionary Warfare, partially offset by \$57 million in higher sales in Submarines. The decrease in Expeditionary Warfare is primarily due to a \$100 million revenue reduction related to revised estimates to

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complete LPD-class ships and LHA 6. The lower sales volume at Expeditionary Warfare also reflects the delivery of the LHD 8.

Shipbuilding revenue for the six months ended June 30, 2009, decreased \$53 million, or 2 percent, as compared with the same period in 2008. The decrease is primarily due to \$77 million lower sales at Surface Combatants and \$54 million in lower sales at Expeditionary Warfare, partially offset by \$85 million in higher sales at Submarines. The decrease at Surface Combatants is due primarily to lower sales volume on the DDG 51 program. The decrease at Expeditionary Warfare is primarily due to the revenue reduction on the LPD-class ships and LHA 6 and delivery of the LHD 8, partially offset by the first quarter 2008 sales adjustment of \$134 million on the LHD 8 program. The increase in Submarines is due to higher sales volume on the construction of the *Virginia*-class submarines.

Segment Operating Income (Loss)

Operating income at Shipbuilding for the three months ended June 30, 2009, decreased \$112 million, or 89 percent, to \$14 million as compared with \$126 million for the same period in 2008. The decrease is primarily due to a \$105 million pre-tax charge for cost growth on the LPD-class ships and LHA 6 discussed above. These adjustments resulted from second quarter 2009 Gulf Coast program reviews and reflect additional expense to improve design, engineering, production, and quality processes. The adjustments for the LPD class primarily reflect increased production cost estimates. The LHA 6 adjustment reflects increased costs to mature the ship's engineering and design work and reduce future production risk.

Operating income at Shipbuilding for the six months ended June 30, 2009, was \$98 million as compared with an operating loss of \$92 million for the same period in 2008. The increase is primarily due to the effects of the first quarter 2008 pre-tax charge of \$326 million on LHD 8 and other programs, partially offset by the charges on the LPD-class ships and LHA 6 in the second quarter of 2009 discussed above. Operating income for the six-month period in 2009 also included cost growth of \$38 million each on the DDG 51 and LPD programs, offset by a \$54 million favorable adjustment on the LHD 8 for risk retirement and increased escalation recovery.

TECHNICAL SERVICES**Business Description**

Technical Services is a leading provider of logistics, infrastructure, and sustainment support, while also providing a wide array of technical services, including training and simulation. The segment consists of three areas of business: Systems Support (SSG); Training & Simulation (TSG); and Life Cycle Optimization & Engineering (LCOE).

<i>\$ in millions</i>	Three Months Ended		Six Months Ended June 30	
	2009	2008	2009	2008
Sales and Service Revenues	\$ 702	\$ 634	\$ 1,334	\$ 1,192
Segment Operating Income	43	42	80	71
<i>As a percentage of segment sales</i>	6.1%	6.6%	6.0%	6.0%

Sales and Service Revenues

Technical Services revenue for the three months ended June 30, 2009, increased \$68 million, or 11 percent, as compared with the same period in 2008. The increase is primarily due to \$64 million in higher sales at LCOE and \$18 million in higher sales at TSG, partially offset by \$15 million in lower sales at SSG. The increase at LCOE is primarily due to higher demand on the CNTPO program. The increase at TSG is primarily due to higher volume on various training and simulation programs including the Joint Warfighting Center Support (JWFC), Global Linguistic Solutions (GLS), and the U.S. Army's Battle Command Training Branch programs. The decrease at SSG is primarily

due to the completion of the Joint Base Operations Support (JBOSC) program in 2008.

Technical Services revenue for the six months ended June 30, 2009, increased \$142 million, or 12 percent, as compared with the same period in 2008. The increase is primarily due to \$119 million higher sales at LCOE,

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\$57 million in higher sales at TSG, partially offset by \$29 million in lower sales at SSG. The increase at LCOE is due to additional volume on the Hunter CLS and CNTPO programs. The increase at TSG is driven by higher demand for various training and simulation programs including the JWFC, GLS, and African Contingency Operations Training Assistance programs. The decrease at SSG is primarily due to the completion of the JBOSC program in 2008.

Segment Operating Income

Operating income at Technical Services for the three months ended June 30, 2009, remained essentially unchanged, as compared with the same period in 2008. The decrease in margin rate reflects a change in program mix from the prior year.

Operating income at Technical Services for the six months ended June 30, 2009, increased \$9 million, or 13 percent, as compared with the same period in 2008. The increase is due to the higher sales volume discussed above.

BACKLOG**Definition**

Total backlog at June 30, 2009, was approximately \$70.4 billion. Total backlog includes both funded backlog (firm orders for which funding is contractually obligated by the customer) and unfunded backlog (firm orders for which funding is not currently contractually obligated by the customer). Unfunded backlog excludes unexercised contract options and unfunded IDIQ orders. For multi-year services contracts with non-federal government customers having no stated contract values, backlog includes only the amounts committed by the customer. Backlog is converted into sales as work is performed or deliveries are made.

Backlog consisted of the following at June 30, 2009, and December 31, 2008:

	June 30, 2009			December 31, 2008		
	Funded	Unfunded	Total Backlog	Funded	Unfunded	Total Backlog
<i>\$ in millions</i>						
Aerospace Systems	\$ 8,408	\$ 16,340	\$ 24,748	\$ 7,648	\$ 22,883	\$ 30,531
Electronic Systems	7,962	2,809	10,771	8,391	2,124	10,515
Information Systems	4,934	4,677	9,611	5,310	4,672	9,982
Shipbuilding	12,587	8,426	21,013	14,205	8,148	22,353
Technical Services	1,836	2,383	4,219	1,840	2,831	4,671
Total backlog	\$ 35,727	\$ 34,635	\$ 70,362	\$ 37,394	\$ 40,658	\$ 78,052

New Awards

The estimated value of contract awards included in backlog during the six months ended June 30, 2009, was approximately \$14.6 billion. Significant new awards during this period include \$637 million for the power and propulsion systems for the *Virginia*-class submarine program, \$536 million for the Global Hawk HALE program, \$494 million for construction preparation of the *Gerald R. Ford* class aircraft carrier, \$403 million for the SBIRS Follow On-program, \$387 million for the E2-D Low Rate Initial Production program, \$350 million for the B-2 program, \$286 million for LAIRCM IDIQ, and various restricted awards, \$276 million for the Battlefield Airborne Communication Node program.

Backlog Adjustment

In the second quarter of 2009, the company was notified that the Kinetic Energy Interceptor (KEI) program was terminated for convenience by the Missile Defense Agency. The KEI termination was recorded as a reduction to total backlog of \$5.1 billion at Aerospace Systems.

LIQUIDITY AND CAPITAL RESOURCES

The company endeavors to ensure the most efficient conversion of operating results into cash for deployment in growing its businesses and maximizing shareholder value. The company actively manages its capital resources through working capital improvements, capital expenditures, strategic business acquisitions, investment in

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independent research and development, debt repayments, voluntary pension contributions, and returning cash to its shareholders through dividend payments and repurchases of common stock.

Company management uses various financial measures to assist in capital deployment decision making including net cash provided by operations and free cash flow. Management believes these measures are useful to investors in assessing the company's financial performance.

The table below summarizes key components of cash flow provided by operating activities.

<i>\$ in millions</i>	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2009	2008	2009	2008
Net earnings	\$ 394	\$ 495	\$ 783	\$ 759
Non-cash income and expense ¹	216	317	471	541
Retiree benefit funding less than expense	176	15	171	46
Trade working capital decrease (increase)	223	27	(719)	(407)
Change in income tax balances	(179)	(196)	(48)	(84)
Gain on sale of business		(58)		(58)
Cash provided by discontinued operations		7		4
Net cash provided by operating activities	\$ 830	\$ 607	\$ 658	\$ 801

⁽¹⁾ Includes depreciation and amortization, stock-based compensation expense, and deferred income taxes.

Free Cash Flow

Free cash flow represents cash from operating activities less capital expenditures and outsourcing contract and related software costs. The company believes free cash flow is a useful measure for investors as it reflects the ability of the company to grow by funding strategic business acquisitions and return value to shareholders through repurchasing its shares and paying dividends.

Free cash flow is not a measure of financial performance under U.S. GAAP, and may not be defined and calculated by other companies in the same manner. This measure should not be considered in isolation or as an alternative to operating results presented in accordance with U.S. GAAP as indicators of performance.

For 2009, cash generated from operations supplemented by borrowings under credit facilities, if necessary, is expected to be sufficient to service debt and contract obligations, finance capital expenditures, fund required and voluntary benefits contributions, continue acquisition of shares under the share repurchase program, and continue paying dividends to the company's shareholders. Additionally, were longer-term funding to be desired, the company believes it could, under current market conditions, access the capital markets for debt financing.

The table below reconciles net cash provided by operating activities to free cash flow:

<i>\$ in millions</i>	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2009	2008	2009	2008
Net cash provided by operating activities	\$ 830	\$ 607	\$ 658	\$ 801

Less:				
Capital expenditures	(135)	(134)	(297)	(277)
Outsourcing contract and related software costs	(19)	(42)	(37)	(77)
Free cash flow	\$ 676	\$ 431	\$ 324	\$ 447

Cash Flows

The following is a discussion of the company's major operating, investing and financing activities for the six months ended June 30, 2009, and 2008, respectively, as classified on the condensed consolidated statements of cash flows located in Part I, Item 1.

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Operating Activities Cash flows from operating activities for the six months ended June 30, 2009, decreased \$143 million as compared to the same period in 2008 and reflects a \$214 million discretionary pension contribution and higher trade working capital requirements in the 2009 period. In July 2009, the company made a further \$286 million discretionary pension contribution, bringing the total discretionary contributions in 2009 to \$500 million.

Investing Activities Net cash used in investing activities for the six months ended June 30, 2009, was \$362 million compared to \$132 million in the same period of 2008. The increase is primarily due to the effects of the \$175 million in proceeds received from the sale of the Electro-Optical Systems business in 2008; the 2009 acquisitions of Sonoma Photonics, Inc., and the assets from Swift Engineering's Killer Bee Unmanned Air Systems product line for \$33 million; and the release in 2008 of \$37 million in restricted cash related to the Gulf Opportunity Zone Industrial Development Revenue Bonds. See Notes 5 and 10 to the condensed consolidated financial statements in Part I, Item 1.

Financing Activities Net cash used in financing activities for the six months ended June 30, 2009, was \$744 million compared to \$1.1 billion in the same period of 2008. The decrease is primarily due to the lower cost of share repurchases.

NEW ACCOUNTING STANDARDS

See Note 2 to the condensed consolidated financial statements in Part I, Item 1 for information related to new accounting standards.

FORWARD-LOOKING STATEMENTS AND PROJECTIONS

Statements in this Form 10-Q that are in the future tense, and all statements accompanied by terms such as believe, project, expect, trend, estimate, forecast, assume, intend, plan, guidance, anticipate, outlook, variations thereof and similar terms are intended to be forward-looking statements as defined by federal securities law. Forward-looking statements are based upon assumptions, expectations, plans and projections that are believed valid when made, but that are subject to the risks and uncertainties identified under Risk Factors in the company's 2008 Form 10-K, as amended or supplemented by the information, if any, in Part II, Item 1A below, that may cause actual results to differ materially from those expressed or implied in the forward-looking statements.

The company intends that all forward-looking statements made will be subject to the safe harbor protection of the federal securities laws pursuant to Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are based upon, among other things, the company's assumptions with respect to:

- n impact of domestic and global economic uncertainties on financial markets, access to capital, value of goodwill or other assets;
- n changes in government funding, including with respect to the 2010 budget of the U.S. Government;
- n changes in statutes and regulations impacting the company's eligibility to perform work that might give rise to organizational conflicts of interest;
- n future revenues;
- n expected program performance and cash flows;

- n compliance with regulatory, technical, operational, and quality requirements;
- n returns or losses on pension plan assets and variability of pension actuarial and related assumptions and regulatory requirements;
- n the outcome of litigation, claims, appeals, bid protests, and investigations;
- n hurricane-related insurance recoveries;
- n environmental remediation;
- n acquisitions and divestitures of businesses;
- n performance issues with, and financial viability of, joint ventures, and other business arrangements;
- n performance issues with, and financial viability of, key suppliers and subcontractors;
- n product performance and the successful execution of internal plans;

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- n successful negotiation of contracts with labor unions;
- n the availability and retention of skilled labor;
- n allowability and allocability of costs under U.S. Government contracts;
- n effective tax rates and timing and amounts of tax payments;
- n the results of any audit or appeal process with the Internal Revenue Service; and
- n anticipated costs of capital investments.

You should consider the limitations on, and risks associated with, forward-looking statements and not unduly rely on the accuracy of predictions contained in such forward-looking statements. As noted above, these forward-looking statements speak only as of the date when they are made. The company does not undertake any obligation to update forward-looking statements to reflect events, circumstances, changes in expectations, or the occurrence of unanticipated events after the date of those statements. Moreover, in the future, the company, through senior management, may make forward-looking statements that involve the risk factors and other matters described in this Form 10-Q as well as other risk factors subsequently identified, including, among others, those identified in the company's filings with the Securities and Exchange Commission on Form 10-K, Form 10-Q and Form 8-K.

CONTRACTUAL OBLIGATIONS

There have been no material changes to the company's contractual obligations from those discussed in the company's 2008 Form 10-K.

GLOSSARY OF PROGRAMS

Listed below are brief descriptions of the programs mentioned in this Form 10-Q.

Program Name

Program Description

African Contingency Operations Training Assistance (ACOTA)

Provide peacekeeping training to militaries in African nations via the Department of State. The program is designed to improve the ability of African governments to respond quickly to crises by providing selected militaries with the training and equipment required to execute humanitarian or peace support operations.

Air Mobility Tanker

Program to replace the U.S. Air Force aerial refueling tanker fleet.

Airborne and Maritime/Fixed Stations Joint Tactical Radio Systems (AMF JTRS)

AMF JTRS will develop a communications capability that includes two software-defined, multifunction radio form factors for use by the U.S. Department of Defense and potential use by the U.S. Department of Homeland Security. Northrop Grumman has the responsibility for leading the Joint Tactical Radio (JTR) integrated product team and co-development of the JTR small airborne (JTR-SA) hardware and software. The company will also provide common JTR software for

two JTR form factors, wideband power amplifiers, and the use of Northrop Grumman's Advanced Communications Test Center in San Diego as the integration and test site for the JTR-SA radio, waveforms and ancillaries.

Airborne Laser (ABL)

Design and develop the system's Chemical Oxygen Iodine Laser (COIL) and the Beacon Illuminator Laser (BILL) for Missile Defense Agency's Airborne Laser, providing a capability to destroy boost-phase missiles at very long range.

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Program Name	Program Description
Battlefield Airborne Communications Node (BACN)	Install the BACN system in three Bombardier BD-700 Global Express aircraft for immediate fielding and install the BACN system into two Global Hawk Block 20 unmanned aerial vehicles.
Battle Command Training	Operates the computer-based simulations, models and automated tools used for the collection and analysis of information used by U.S. Army Battle Command Training Program.
B-2 Stealth Bomber	Maintain strategic, long-range multi-role bomber with war-fighting capability that combines long range, large payload, all-aspect stealth, and near-precision weapons in one aircraft.
Broad Area Maritime Surveillance (BAMS) Unmanned Aircraft System	A maritime derivative of the Global Hawk that provides persistent maritime Intelligence, Surveillance, and Reconnaissance (ISR) data collection and dissemination capability to the Maritime Patrol and Reconnaissance Force.
Counter Narco Terrorism Programs and Operations (CNTPO)	Counter Narco Terrorism Programs and Operations provide support to the U.S. Government, coalition partners, and host nations in Technology Development and Application Support; Training; Operations and Logistics Support; and Professional and Executive Support. The program provides equipment and services to research, develop, upgrade, install, fabricate, test, deploy, operate, train, maintain, and support new and existing federal Government platforms, systems, subsystems, items, and host-nation support initiatives.
Deepwater Modernization Program	Multi-year program to modernize and replace the Coast Guard's aging ships and aircraft, and improve command and control and logistics systems. The company has design and production responsibility for surface ships.
DDG 51	Build Aegis guided missile destroyer, equipped for conducting anti-air, anti-submarine, anti-surface and strike operations.

E-2 Hawkeye

The U.S. Navy's airborne battle management command and control mission system platform providing airborne early warning detection, identification, tracking, targeting, and communication capabilities. The company is developing the next generation capability including radar, mission computer, vehicle, and other system enhancements, to support the U.S Naval Battle Groups and Joint Forces, called the E-2D. Recently the USN approved Milestone C for Low Rate Initial Production.

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Program Name	Program Description
EA-6B	The EA-6B (Prowler) primary mission is to jam enemy radar and communications, thereby preventing them from directing hostile surface-to-air missiles at assets the Prowler protects. When equipped with the improved ALQ-218 receiver and the next generation ICAP III (Increased Capability) Airborne Electronic Attack (AEA) suite the Prowler is able to provide rapid detection, precise classification, and highly accurate geolocation of electronic emissions and counter modern, frequency-hopping radars. A derivative/variant of the EA-6B ICAP III mission system is also being incorporated into the F/A-18 platform and designated the EA-18G.
F-35 Development (Joint Strike Fighter)	Design, integration, and/or development of the center fuselage and weapons bay, communications, navigations, identification subsystem, systems engineering, and mission systems software as well as provide ground and flight test support, modeling, simulation activities, and training courseware.
F/A-18	Produce the center and aft fuselage sections, twin vertical stabilizers, and integrate all associated subsystems for the F/A-18 Hornet strike fighters.
<i>Gerald R. Ford</i> -class Aircraft Carrier	Design and construction for the new class of Aircraft Carriers.
Global Hawk High-Altitude Long-Endurance (HALE) Systems	Provide the Global Hawk HALE unmanned aerial system for use in the global war on terror and has a central role in Intelligence, Reconnaissance, and Surveillance supporting operations in Afghanistan and Iraq.
Global Linguists Solutions (GLS)	Provide interpretation, translation and linguist services in support of Operation Iraqi Freedom.
Guardrail Common Sensor System-Improved	Sole source IDIQ contract which will encompass efforts for the upgrade and modernization of the current field Guardrail systems.

Hunter CLS	Operate, maintain, train and sustain the multi-mission Hunter Unmanned Aerial System in addition to deploying Hunter support teams.
Intercontinental Ballistic Missile (ICBM)	Maintain readiness of the nation's ICBM weapon system.
Integrated Base Defense Security System (IBDSS)	Integrated Based Defense Security System contract is an IDIQ acquisition vehicle to provide the USAF and other DoD customers with integrated base defense security solutions, utilizing comprehensive and integrated technology to satisfy a wide array of security concerns both CONUS and OCONUS.
Joint Base Operations Support (JBOSC)	Provides all infrastructure support needed for launch and base operations at the NASA Spaceport.

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Program Name	Program Description
Joint Surveillance Target Attack Radar System (Joint STARS)	Joint STARS detects, locates, classifies, tracks and targets hostile ground movements, communicating real-time information through secure data links with U.S. Air Force and Army command posts.
Joint Warfighting Center Support (JWFC)	Provide non-personal general and technical support to the USJFCOM Joint Force Trainer / Joint Warfighting Center to ensure the successful worldwide execution of the Joint Training and Transformation missions.
Kinetic Energy Interceptor (KEI)	Develop mobile missile-defense system with the unique capability to destroy a hostile missile during its boost, ascent or midcourse phase of flight.
Large Aircraft Infrared Counter-measures Indefinite Delivery and Indefinite Quantity (LAIRCM IDIQ)	Infrared countermeasures systems for C-17 and C-130 aircraft. The IDIQ contract will further allow for the purchase of LAIRCM hardware for foreign military sales and other government agencies.
LHA	Detail design and construct amphibious assault ships for use as an integral part of joint, interagency, and multinational maritime forces.
LHD	The multipurpose amphibious assault ship LHD is the centerpiece of an Expeditionary Strike Group (ESG). In wartime, these ships deploy very large numbers of troops and equipment to assault enemy-held beaches. Like LPD, only larger, in times of peace, these ships have ample space for non-combatant evacuations and other humanitarian missions. The program of record is 8 ships of which Makin Island (LHD 8) is the last.
LPD	The LPD 17 San Antonio Class is the newest addition to the U.S. Navy's 21st Century amphibious assault force. The 684-foot-long, 105-foot-wide ships have a crew of 360 and are used to transport and land 700 to 800 Marines, their equipment, and supplies by embarked air cushion or conventional landing craft and assault vehicles, augmented by helicopters or other rotary wing aircraft. The ships will support amphibious assault,

special operations, or expeditionary warfare & humanitarian missions.

MESA Wedgetail

Joint program with Boeing to supply MESA radar antenna for AEW&C aircraft.

New York City Wireless (NYCWiN)

Provide New York City's broadband public-safety wireless network.

National Polar-orbiting
Operational
Environmental Satellite
System (NPOESS)

Design, develop, integrate, test, and operate an integrated system comprised of two satellites with mission sensors and associated ground elements for providing global and regional weather and environmental data.

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Program Name	Program Description
Space Based Infrared System (SBIRS)	Space-based surveillance systems for missile warning, missile defense, battlespace characterization and technical intelligence. SBIRS will meet United States infrared space surveillance needs through the next 2-3 decades.
Trailer Mounted Support System (TMSS)	Trailer Mounted Support System is a key part of the Army's SICPS Program providing workspace, power distribution, lighting, environmental conditioning (heating and cooling) tables and a common grounding system for commanders and staff at all echelons.
Unmanned Combat Air System Carrier Demonstration (UCAS-D)	A development / demonstration contract that will design, build and test two demonstration vehicles that will conduct a carrier demonstration. The technology demonstrations are to show carrier control area operations, catapult launch, and an arrested landing of a low observable unmanned aerial vehicle.
<i>USS Carl Vinson</i>	Refueling and complex overhaul of the nuclear-powered aircraft carrier <i>USS Carl Vinson</i> (CVN 70).
<i>Virginia-class Submarines</i>	Construct the newest attack submarine in conjunction with Electric Boat.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rates The company is exposed to market risk, primarily related to interest rates and foreign currency exchange rates. Financial instruments subject to interest rate risk include fixed-rate long-term debt obligations, variable-rate short-term borrowings under the credit agreement, short-term investments, and long-term notes receivable. At June 30, 2009, substantially all outstanding borrowings were fixed-rate long-term debt obligations of which a significant portion are not callable until maturity. The company has a modest exposure to interest rate risk resulting from two interest rate swap agreements. The company's sensitivity to a 1 percent change in interest rates is tied to its \$2 billion credit agreement, which had no balance outstanding at June 30, 2009, or December 31, 2008, and the aforementioned interest rate swap agreements. See Note 3 to the condensed consolidated financial statements in Part I, Item 1.

Derivatives The company does not hold or issue derivative financial instruments for trading purposes. The company may enter into interest rate swap agreements to manage its exposure to interest rate fluctuations. At June 30, 2009, and December 31, 2008, two and four interest rate swap agreements were in effect, respectively. See Note 3 to the condensed consolidated financial statements in Part I, Item 1.

Foreign Currency The company enters into foreign currency forward contracts to manage foreign currency exchange rate risk related to receipts from customers and payments to suppliers denominated in foreign currencies. At June 30, 2009 and December 31, 2008, the amount of foreign currency forward contracts outstanding was not material. The company does not consider the market risk exposure related to foreign currency exchange to be material to the condensed consolidated financial statements. See Note 3 to the condensed consolidated financial statements in Part I, Item 1.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The company's principal executive officer (Chairman and Chief Executive Officer) and principal financial officer (Corporate Vice President and Chief Financial Officer) have evaluated the company's disclosure controls and procedures as of June 30, 2009, and have concluded that these controls and procedures are effective to ensure that information required to be disclosed by the company in the reports that it files or submits under the

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Securities Exchange Act of 1934 (15 USC § 78a et seq) is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. These disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the company in the reports that it files or submits is accumulated and communicated to management, including the principal executive officer and the principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls over Financial Reporting

During the six months ended June 30, 2009, no change occurred in the company's internal controls over financial reporting that materially affected, or is likely to materially affect, the company's internal controls over financial reporting.

Table of Contents**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

U.S. Government Investigations and Claims Departments and agencies of the U.S. Government have the authority to investigate various transactions and operations of the company, and the results of such investigations may lead to administrative, civil or criminal proceedings, the ultimate outcome of which could be fines, penalties, repayments or compensatory or treble damages. U.S. Government regulations provide that certain findings against a contractor may lead to suspension or debarment from future U.S. Government contracts or the loss of export privileges for a company or an operating division or subdivision. Suspension or debarment could have a material adverse effect on the company because of its reliance on government contracts.

On June 22, 2007, a putative class action was commenced against the Northrop Grumman Pension Plan and the Northrop Grumman Retirement Plan B and their corresponding administrative committees, styled as *Skinner et al. v. Northrop Grumman Pension Plan, etc., et al.* filed in the U.S. District Court for the Central District of California. The putative class representatives alleged violations of ERISA and breaches of fiduciary duty concerning a 2003 modification to the Northrop Grumman Retirement Plan B. The modification relates to the employer funded portion of the pension benefit available during a five-year transition period that ended on June 30, 2008. The plaintiffs dismissed the Northrop Grumman Pension Plan, and on March 10, 2008, the trial court granted summary judgment in favor of all remaining defendants on all claims. The plaintiffs appealed that ruling to the Ninth Circuit Court of Appeals, and on May 21, 2009, the Ninth Circuit reversed the decision of the trial court, finding that there was an ambiguity in a 1998 summary plan description related to the employer funded component of the pension benefit. The Ninth Circuit remanded the matter back to the trial court for further proceedings consistent with its ruling.

As previously disclosed, on April 2, 2009, the company reached an agreement with the U.S. Government to settle two legal matters. The first matter involved potentially substantial claims by the U.S. Department of Justice and a restricted U.S. Government customer relating to certain microelectronic parts produced by the Space and Electronics Sector of former TRW Inc., now a part of the company. The second matter covered by the settlement agreement involved a lawsuit filed by the company in 1996 against the U.S. Government in the U.S. Court of Federal Claims for recovery of uncompensated performance costs, investments and a reasonable profit on the Tri-Service Standoff Attack Missile (TSSAM) program which the customer terminated for convenience. The U.S. Department of Justice valued both of these claims at \$325 million, and as such, the settlement amounts for the two matters are equal and offset each other. The company had previously recorded an accrual for its settlement offer on the microelectronics parts matter. Since these matters were settled jointly and at equal values, the company recognized a gain of \$99 million in the second quarter of 2009 representing the remainder of the accrued settlement offer, net of expenses. The settlement agreement did not have an impact on the company's cash flows.

In the second quarter of 2007, the U.S. Coast Guard issued a revocation of acceptance under the Deepwater Program for eight converted 123-foot patrol boats (the vessels) based on alleged hull buckling and shaft alignment problems and alleged nonconforming topside equipment on the vessels. The company submitted a written response that argued that the revocation of acceptance was improper, and in late December 2007, the Coast Guard advised Integrated Coast Guard Systems (the contractors' joint venture for performing the Deepwater Program, the Joint Venture) that the Coast Guard was seeking \$96.1 million from the Joint Venture as a result of the revocation of acceptance of the eight vessels delivered under the 123-foot conversion program. The majority of the costs associated with the 123-foot conversion effort are associated with the alleged structural deficiencies of the vessels, which were converted under contracts with the company and a subcontractor to the company. In May 2008, the Coast Guard advised the Joint Venture that the Coast Guard would support an investigation by the U.S. Department of Justice of the Joint Venture and its

subcontractors instead of pursuing its \$96.1 million claim independently. The Department of Justice had previously issued subpoenas related to the Deepwater Program, pursuant to which the company has provided responsive documents. On February 6, 2009, the U.S. Department of Justice notified the U.S. District Court for the Northern District of Texas that the U.S. Government is not intervening at this time in what was then a sealed False Claims Act complaint. On

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February 12, 2009, the Court unsealed the complaint filed by Michael J. DeKort, a former Lockheed Martin employee, against Integrated Coast Guard Systems, Lockheed Martin Corporation and the company, relating to the 123-foot conversion effort. Based upon the information available to the company to date, the company believes that it has substantive defenses to any potential claims but can give no assurance that the company will prevail in this litigation.

In August 2008, the company disclosed to the Antitrust Division of the U.S. Department of Justice possible violations of federal antitrust laws in connection with the bidding process for certain maintenance contracts at a military installation in California. In February 2009, the company and the Department of Justice signed an agreement admitting the company into the Corporate Leniency Program. As a result of the company's acceptance into the Program, the company will be exempt from federal criminal prosecution and criminal fines relating to the matters the company reported to the Department of Justice if the company complies with certain conditions, including its continued cooperation with the government's investigation and its agreement to make restitution if the government was harmed by the violations.

Based upon the available information regarding matters that are subject to U.S. Government investigations, the company believes that the outcome of any such matters would not have a material adverse effect on its consolidated financial position, results of operations or cash flows.

Litigation Various claims and legal proceedings arise in the ordinary course of business and are pending against the company and its properties. Based upon the information available, the company believes that the resolution of any of these various claims and legal proceedings would not have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

The company is one of several defendants in litigation brought by the Orange County Water District in Orange County Superior Court in California on December 17, 2004, for alleged contribution to volatile organic chemical contamination of the County's shallow groundwater. The lawsuit includes counts against the defendants for violation of the Orange County Water District Act, the California Super Fund Act, negligence, nuisance, trespass and declaratory relief. Among other things, the lawsuit seeks unspecified damages for the cost of remediation, payment of attorney fees and costs, and punitive damages. The June 2009 trial date has been vacated and a status conference has been set for late July 2009.

Other Matters

The company is pursuing legal action against an insurance provider arising out of a disagreement concerning the coverage of certain losses related to Hurricane Katrina (see Note 10 to the condensed consolidated financial statements in Part I, Item 1). The company commenced the action against Factory Mutual Insurance Company (FM Global) on November 4, 2005, which is now pending in the U.S. District Court for the Central District of California, Western Division. In August 2007, the District Court issued an order finding that the excess insurance policy provided coverage for the company's Katrina-related loss. In November 2007, FM Global filed a notice of appeal of the District Court's order. On August 14, 2008, the U.S. Court of Appeals for the Ninth Circuit reversed the earlier summary judgment order in favor of the company, holding that the FM Global excess policy unambiguously excludes damage from the storm surge caused by Hurricane Katrina under its Flood exclusion. The Ninth Circuit remanded the case to the District Court to determine whether the California efficient proximate cause doctrine affords the company coverage under the policy even if the Flood exclusion of the policy is unambiguous. The company filed a Petition for Rehearing En Banc, or in the Alternative, For Panel Rehearing with the Ninth Circuit on August 27, 2008. On April 2, 2009, the Ninth Circuit denied the company's Petition for Rehearing and remanded the case to the District Court. On June 10, 2009, the company filed a motion seeking leave of court to file a complaint adding AON Risk Services, Inc. of Southern California as a defendant. Based on the current status of the litigation, no assurances can be made as to the ultimate outcome of this matter.

During 2008, the company received notification from Munich-American Risk Partners (Munich Re), the only remaining insurer within the primary layer of insurance coverage with which a resolution has not been reached, that it will pursue arbitration proceedings against the company related to approximately \$19 million owed by Munich Re to Northrop Grumman Risk Management Inc. (NGRMI), a wholly-owned subsidiary of the

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company, for certain losses related to Hurricane Katrina. The company was subsequently notified that Munich Re also will seek reimbursement of approximately \$44 million of funds previously advanced to NGRMI for payment of claim losses of which Munich Re provided reinsurance protection to NGRMI pursuant to an executed reinsurance contract, and \$6 million of adjustment expenses. The company believes that NGRMI is entitled to full reimbursement of its covered losses under the reinsurance contract and has substantive defenses to the claim of Munich Re for return of the funds paid to date.

Item 1A. Risk Factors

There are no material changes to the risk factors previously disclosed in the company's 2008 Annual Report on Form 10-K, updated by the Current Report on Form 8-K filed on April 22, 2009.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities The table below summarizes the company's repurchases of common stock during the three months ended June 30, 2009.

Period	Total Number of Shares Purchased⁽¹⁾	Average Price Paid per Share⁽²⁾	Total Numbers of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
April 1 through April 30, 2009	1,925,172	\$ 45.94	1,925,172	\$ 692 million
May 1 through May 31, 2009	1,889,900	48.78	1,889,900	600 million
June 1 through June 30, 2009	1,936,600	47.41	1,936,600	508 million
Total	5,751,672	\$ 47.37	5,751,672	\$ 508 million⁽¹⁾

⁽¹⁾ On December 19, 2007, the company's board of directors authorized a share repurchase program of up to \$2.5 billion of its outstanding common stock. As of June 30, 2009, the company has \$508 million remaining on this authorization for share repurchases.

Share repurchases take place at management's discretion or under pre-established, non-discretionary programs from time to time, depending on market conditions, in the open market, and in privately negotiated transactions. The company retires its common stock upon repurchase and has not made any purchases of common stock other than in connection with these publicly announced repurchase programs.

⁽²⁾ Includes commissions paid.

Item 3. Defaults upon Senior Securities

No information is required in response to this item.

Item 4. Submission of Matters to a Vote of Security Holders

a) *Annual Meeting*

The annual meeting of stockholders of Northrop Grumman Corporation was held May 20, 2009.

b) *Election of Directors*

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The following Director nominees were elected at the annual meeting:

Lewis W. Coleman
 Thomas B. Fargo
 Victor H. Fazio
 Donald E. Felsing
 Stephen E. Frank
 Bruce S. Gordon
 Madeleine Kleiner
 Karl J. Krapek
 Richard B. Myers
 Aulana L. Peters
 Kevin W. Sharer
 Ronald D. Sugar

c) *The matters voted upon at the meeting and the results of each vote are as follows:*

Directors	Votes For	Votes Against	Votes Abstaining
Lewis W. Coleman	270,636,112	20,460,675	1,417,192
Thomas B. Fargo	284,813,151	6,269,311	1,431,517
Victor H. Fazio	275,003,640	15,909,987	1,600,353
Donald E. Felsing	282,941,385	7,992,455	1,580,140
Stephen E. Frank	270,523,266	20,442,951	1,547,763
Bruce S. Gordon	282,587,859	8,436,484	1,489,637
Madeleine Kleiner	282,599,131	8,286,127	1,628,722
Karl J. Krapek	280,713,679	10,034,312	1,765,989
Richard B. Myers	283,244,575	7,891,405	1,378,000
Aulana L. Peters	269,917,998	21,140,709	1,455,273
Kevin W. Sharer	278,577,445	12,489,635	1,446,899
Ronald D. Sugar	283,539,697	7,898,381	1,075,902

	Votes For	Votes Against	Votes Abstaining	Broker Non-Votes
Ratification of the appointment of Deloitte & Touche LLP as the company's independent auditors for 2009	288,545,389	3,091,876	876,715	0
Stockholder Proposal regarding a report on space based weapons	11,103,870	216,574,763	39,807,247	25,028,100
Stockholder Proposal regarding a vote on executive compensation	106,833,126	148,049,646	12,599,474	25,031,734
Stockholder Proposal regarding right of 10% stockholders to call a special meeting	141,028,186	124,669,859	1,787,835	25,028,100

Item 5. Other Information

No information is required in response to this item.

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Item 6. Exhibits

- *10.1 Northrop Grumman Corporation 1993 Stock Plan for Non-Employee Directors (As Amended and Restated January 1, 2010)
- *12(a) Computation of Ratios of Earnings to Fixed Charges
- *15 Letter from Independent Registered Public Accounting Firm
- *31.1 Rule 13a-15(e)/15d-15(e) Certification of Ronald D. Sugar (Section 302 of the Sarbanes-Oxley Act of 2002)
- *31.2 Rule 13a-15(e)/15d-15(e) Certification of James F. Palmer (Section 302 of the Sarbanes-Oxley Act of 2002)
- **32.1 Certification of Ronald D. Sugar pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- **32.2 Certification of James F. Palmer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- **101 Northrop Grumman Corporation Quarterly Report on Form 10-Q for the quarter ended June 30, 2009, formatted in XBRL (eXtensible Business Reporting Language); (i) the Condensed Consolidated Statements of Operations, (ii) Condensed Consolidated Statements of Financial Position, (iii) Condensed Consolidated Statements of Cash Flows, (iv) Condensed Consolidated Statements of Changes in Shareholders' Equity, and (v) Notes to Condensed Consolidated Financial Statements, tagged as blocks of text

* Filed with this Report

** Furnished with this Report

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NORTHROP GRUMMAN CORPORATION
(Registrant)

By: **/s/ Kenneth N. Heintz**
Kenneth N. Heintz
Corporate Vice President, Controller and
Chief Accounting Officer
(Principal Accounting Officer)

Date: July 23, 2009

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