

UNIVERSITY OF ROCHESTER

William E. Simon Graduate School of Business Administration

Finance 423

Corporate Financial Policy & Control

Professor G. William Schwert

Spring 1996

Quiz #8: Monday, May 20, 1996

(10 points) The story below from the *Wall Street Journal* of May 16, 1996 describes the new antitakeover insurance product offered by Aon. For a fee of 2.25% per \$1 million of coverage, a company can purchase insurance from Aon to cover the costs of a successful takeover fight. Read the following excerpts from the article and answer the questions at the end.

HD Aon Offers Defense Against Hostile Bids For U.S. Companies

Insurance Product Reimburses Concerns for Their Costs Of Warding Off Raiders

BY By Michael R. Sesit, Staff Reporter of The Wall Street Journal

PD 05/16/96

SN The Wall Street Journal, A4

CY (Copyright (c) 1996, Dow Jones & Company, Inc.)

LP LONDON -- The financial-services industry is offering U.S. companies the corporate world's version of kidnap and ransom insurance.

The new product, which will be launched today by big Chicago-based insurance holding company Aon Corp. and underwritten at Lloyd's of London, is designed to reimburse companies for the costs associated with warding off a hostile takeover bid or a proxy fight with dissident shareholders. Dubbed "Hostile Takeover Defense Insurance," it is mostly aimed at the management of small and medium-size U.S. companies.

TD The policy pays only if a company's defense is successful. Yet Jeremy Culverhouse, a director of the Nicholson Leslie Group, a London insurance broker owned by Aon, says it is still worthwhile. That is because it can buy management valuable time to negotiate a higher offer, he says.

"Anything you can do to alleviate the costs that a shareholder incurs and ensure that he gets the highest value possible makes sense," says Purna Saggurti, a managing director at J. P. Morgan & Co. in New York.

The expenses of battling a hostile takeover attempt -- which include paying for lawyers, investment bankers, accountants, proxy firms, stockbrokers, asset appraisers and investor-relations consultants -- can be staggering. Adrian Blackshaw, a director of TOI Corporate Services Ltd., a London company that specializes in developing corporate-insurance products and a co-designer of Aon's new product, says that the average U. S. company will spend an amount equal to 2.25%-2.5% of its market capitalization to defend against a hostile bid.

With the new Aon policy, a company can buy \$1 million of insurance for as little as \$22,500. Basic coverage will be available in increments of \$1 million, up to \$5 million, but Aon is willing to negotiate higher limits subject to underwriters' discretion. The policy runs for 15 months but only kicks in after three months. That is to protect underwriters from having to request company information that might violate U.S. insider-trading rules. Subsequent renewals are available for 12-month periods with no waiting time.

"This isn't anything a General Motors would buy; a really big company doesn't need something like this," said Judith Thoyer, a partner at Paul, Weiss, Rifkind, Wharton & Garrison in New York. "It's really aimed

at the middle-market company, anywhere from a \$50 million market capitalization to a \$400 million to \$500 million cap company, where the cost of defense is a meaningful number."

Nonetheless, others point out that the Aon policy could have paid for a large chunk of the \$11 million pretax charge that RJR Nabisco Holdings Corp. took for its proxy fight with financier Bennett S. LeBow for control of the tobacco and food company.

Aon says that the three month waiting period before the policy becomes effective is to avoid insider trading laws. What other reasons might they have for imposing this requirement? Why is this requirement waived for renewals?

What is the expected cost of having this insurance in place for the remaining life of the firm? Explain how you would estimate this number.

What is the expected benefit from purchasing this insurance? Explain how you would estimate this number.

How do you think the stock market would react to the announcement the a company had purchased this insurance? *Why?*

DO NOT

WRITE

ON

THIS

PAGE