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John Hancock's Unfair Demutualization Plan

Deceptive, Misleading and Coercive

Morgan Stanley Says Plan is "Fair"

Wit Capital Says Plan is "Unfair"

The Big Heat: Wit Capital Caves In

JOHN HANCOCK MUTUAL Life Insurance Company's demutualization is a milestone in the history of American mutual insurance. In 1998 Hancock threw in the towel on the now-discredited mutual-insurance-holding-company approach it had supported and announced that it would do a full demutualization, instead.

Sadly, Hancock's demutualization plan is structured in a manner that's unfair to the company's policyholder-owners. Some 2.1 million policyholders—including many large policyholders—who would have received about $1,500 of stock or less, will be *cashed out without their informed consent*. Hancock, which is not in need of additional equity, plans to do a $2 billion IPO. (The lead underwriter will be Morgan Stanley.) Most of the proceeds from the IPO will be used to cash out unwitting policyholders. If this plan is approved by the Massachusetts Division of Insurance and Hancock goes forward with its IPO as planned, institutional investors will, in all likelihood, get to buy Hancock shares at a significant discount to the company's intrinsic value. Meanwhile, 80% of policyholders will be cashed out in a manner that has negative tax consequences for them.

A public hearing regarding Hancock's plan will take place on November 17 and 18, in Boston. David Schiff, who opposes the plan, will be appearing as an "expert witness." Schiff, as always, will be testifying *pro bono*: he does not accept any fees, compensation, remuneration, or reimbursement of expenses. To read his November 8 pre-filed testimony in full, as well as that of former Vermont commissioner James Hunt, and senior officers of Wit Capital, go to www.HancockWatch.com., a website created by Adkins & Kelston, a law firm representing policyholders who are intervening in the proceedings.

Complex Plan

Like most demutualizations, Hancock's plan is extremely complicated and requires a significant base of knowledge and commitment of time to be fully understood. Given that it's so difficult for policyholders (and agents) to understand the plan, one would think that Hancock's directors, who have a fiduciary responsibility, would want to ensure that policyholders are able to comprehend what is happening. This could be accomplished by clear communication. The model we admire is that used by Warren Buffett in Berkshire Hathaway's annual letter to shareholders. (He has said that his letter is written so that it could be understood by an aunt who has been away traveling all year.) Hancock hasn't come close to this standard. Instead, its communication seems designed to take advantage of an aunt who's been away all year.

Hancock sent policyholders a seven-page glossy brochure that misinformed them of what their "membership rights" in the mutual insurer entail. By leading policyholders to believe that their rights are negligible, Hancock is coercing its policyholders to vote for a plan that is not in their best interests.

In addition to the glossy brochure, policyholders received a 317-page densely-worded "Policyholder Information Statement" (PIS) that omitted material disclosures and important information necessary to make an informed decision.

Included at the back of the PIS was a five-page Morgan Stanley "fairness opinion" signed by Derek Kirkland, managing director and co-head of Morgan's global insurance group. The fairness opinion, however, is window dressing: its abstruse verbiage contains so many caveats that the "opinion" is really no opinion at all.

Kirkland and Morgan Stanley also have material conflicts of interest (some of which were not disclosed to policyholders) that render them unfit to issue a fairness opinion in connection with the plan. Morgan Stanley was John Hancock's advisor in formulating the demutualization plan and, more importantly, will be the lead underwriter in Hancock's $2 billion initial public offering (which should generate about $100 million in fees for the underwriters). Morgan Stanley's substantial financial interest in seeing the plan approved creates an unconscionable conflict of interest that shouldn't be tolerated by the Massachusetts Division of Insurance. (Goldman Sachs had a similar conflict of interest in Principal Mutual's reorganization, and its opinion was subsequently thrown out by Terri Vaughan, Iowa's insurance commissioner.)

Incredibly, Derek Kirkland and Morgan Stanley had a conflict of interest in Provident Mutual's attempted mutual-holding-company conversion that is strikingly similar to their conflict of interest in the John Hancock matter. (Excerpts from David Schiff's cross-examination of Kirkland at the Provident hearing can be found on page 17 of the May 1998 issue of *Schiff's Insurance Observer*.)

Kirkland obviously knows a thing or two about insurance, and certainly holds himself out as an expert. And yet, at the Provident hearing, when given easy questions, his answers were simply amazing.

"Do you have an opinion," Schiff asked, "about what Provident Mutual is worth?"

"No," Kirkland replied. "We have not evaluated what Provident Mutual will be worth."

Although Kirkland had already testified that Morgan Stanley was "continually involved in the valuation of securities" in connection with "public offerings, private placements, mergers, acquisitions and restructuring transactions" and that Morgan was a "leading financial advisor to the domestic insurance industry," both he and Provident's CEO professed not have any opinion about Provident's value. That raised the obvious question: if they didn't know what Provident was worth, how could they say that one form of reorganization was better than another—much less "fair"? "Fairness," after all, is relative. If there were other forms of reorganization that would have created greater value for Provident and its policyholders, then the plan that Morgan Stanley said was "fair" could not possibly be.

Kirkland, Morgan Stanley, and Provident received their comeuppance on September 17, 1999, when Judge Stephen E. Levin issued a damning decision finding that the directors and officers of Provident Mutual, in their attempt to convert Provident into a mutual-insurance holding company, had "breached their duty of disclosure [to policyholders] because they disseminated a Policyholder Information Statement which unfairly described the Plan of Conversion, and therefore prevented policyholders from making an informed vote on the Plan." In other words, policyholders were *tricked* into voting for the conversion plan.

Judge Levin permanently enjoined Provident from effectuating its conversion until it issued a Policyholder Information Statement (PIS) that contains something absent from the PIS sent to policyholders—the truth. (Provident recently withdrew its application to convert to a mutual holding company, and there's speculation that the company will now do a full demutualization.)

Which brings us back to the John Hancock plan.

Just as Provident breached its fiduciary duty to policyholders by sending out a PIS that failed to disclose material information, so, too, does Hancock. And just as Kirkland and Morgan had said that Provident's misleading and unfair plan was "fair," Kirkland and Morgan are opining that Hancock's plan and PIS are "fair."

The Abusive Cash-Out

As part of Hancock's plan, concurrent with its IPO about 80% of policyholders will be cashed out. Because the PIS sent to policyholders was misleading and coercive, the vast majority of policyholders will not have given their informed consent regarding this cash-out. Particularly troubling is the fact that unless a policyholder completes and returns a complicated "ballot," "taxpayer identification information," and "cash/stock compensation election," John Hancock "will assume that" the policyholder "prefer[s]" to be cashed out. (Even if a policyholder checks the "stock selection box," if the form he returns isn't properly signed and returned by November 30—many months before the IPO—he may be cashed out.)

This default-to-cash situation is unfair and prejudicial to policyholders who are allocated a small amount of shares. (The share allocation process is troubling, but we won't get into that here. For more information, see James Hunt's pre-filed testimony at www.HancockWatch.com.) There is little reason to think that policyholders would prefer to be cashed out at a price that will probably be considerably lower than Hancock's private market value, and there is little reason to think that most policyholders would prefer to receive cash—which is taxed as ordinary income—rather than stock, which would not be taxed at all.

It is cruelly ironic that Hancock's plan calls for unsophisticated policyholders to have to make the complicated cash/stock decision by November 30—and make it based upon inadequate and misleading information—whereas "sophisticated" (to use Kirkland's term) institutional investors will not have to make *any decision at all* until much later: *after* they've had the benefit of a "road show" not available to policyholders and *after* they are told the price that they will have to pay to buy shares. (Policyholders who have to choose between cash and stock are required to make their decision without knowing what the price of the stock will be. Furthermore, even if they choose stock, they won't receive their shares until approximately seven weeks after the IPO, and therefore won't have the opportunity that institutional investors will have: selling their stock in the public market on a favorable short-term basis.

Presumably, Hancock's officers and directors who are policyholders will receive stock rather than cash, and it is anticipated that they will also receive stock options in the future.

The Morgan Stanley Hustle

There's no reason for Hancock to cash out its uninformed policyholders. Furthermore, if Hancock plans to issue stock, it's only fair that shares be made available to its policyholders (who are the current owners), so that they can avoid having their economic interests diluted.

In an analogous situation—the 1998 MONY demutualization—stock was issued to institutional investors at a bargain-basement price. David Schiff protested this giveaway by speaking with

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MONY in advance, testifying at a New York State Department of Insurance hearing, and writing to New York's superintendent of insurance, Neil Levin, who's a former Goldman Sachs investment banker.

Schiff explained that a provision should be made for policyholders to buy shares. (This could be accomplished through subscription rights or some other method.) Schiff proposed another alternative as well: that policyholders be given an opportunity to buy restricted shares (at the offering price) after the offering.

Superintendent Levin didn't bother to respond to Schiff. (By sheer coincidence, Levin's former employer, Goldman, Sachs, was the lead underwriter of MONY's IPO.)

Hancock and Morgan Stanley were probably familiar with the circumstances surrounding the MONY demutualization, and, undoubtedly, are aware that a demutualization can be a highly charged issue. Yet Hancock went ahead with a plan that would cash out 80% of its policyholders and make no provision for policyholders to participate in an IPO.

In a May 26, 1999 letter, Morgan Stanley's Kirkland advised John Hancock that a "subscription rights offering would be technically possible," but advised against it for a variety of reasons, many of which were absurd. ("The offering will only benefit those policyholders who participate." "These shares will not be available for sale in an IPO, which will reduce Hancock's ability to sell its shares to institutional investors.")

Kirkland implied that if institutions didn't get in on the ground floor, "coverage of Hancock by research analysts also will be limited, because analysts historically are reluctant to cover companies with limited institutional ownership." (Kirkland seemed to overlook the fact that John Hancock is a household name and one of the largest life insurance companies in America; its size virtually assures that analysts will cover it. But even that is beside the point.)

"Without analyst coverage," wrote Kirkland, "Hancock also risks having a less liquid market for its shares, making it more difficult for *institutions* to buy and sell sizable blocks of stock and therefore *hurting the liquidity and ultimately the value of the stock* held by policyholders." [Emphasis added.]

Kirkland's thoughts on "liquidity" are not surprising. Morgan Stanley, after all, is a securities dealer. It makes money trading stocks and transacting an institutional brokerage business.

But there are many investors who don't share Kirkland's self-serving opinions. Take Warren Buffett, for example, who wrote the following: "One of the ironies of the stock market is the emphasis on activity. Brokers, using terms such as 'marketability' and 'liquidity' sing the praises of companies with high share turnover….But investors should understand that what is good for the croupier is not good for the customer. A hyperactive stock market is the pickpocket of enterprise." Buffett knows that value is inherent in the enterprise, not in the trading activity of the enterprise's shares.

We suspect that Kirkland knows this as well, but you can't tell it from his statements. He wrote that if institutions weren't given an opportunity to buy a meaningful part of Hancock's shares, then institutions would view Hancock's individual shareholders as " 'overhang'—future selling pressure that will limit share price appreciation." In short, Kirkland seems to be espousing the view that over the long run stock prices are controlled by the supply of shares rather than by underlying business fundamentals—that the price of a company's stock is not determined by the company's earnings, growth, and book value, for example, but rather by how many shares are available for institutions to purchase.

Wit Capital's Monkey Wrench

In pre-filed written testimony submitted on November 8, two senior executives of Wit Capital messed up the Hancock/Morgan scheme, and the stunning turn of events that followed exposed the cynical nature of Wall Street.

Wit Capital is a publicly-traded online investment banking firm. Its "goal is to empower individual investors—giving them access to opportunities and resources long available only to institutions and wealthy investors." Wit was formed in 1996 and is now populated by high-level investment-banking executives who left major firms to work at Wit. Wit has been an underwriter of 154 public offerings, and its own shares sport a market cap of $1.6 billion.

In his written statement, William Feeley, managing director and head of capital markets at Wit, wrote that Wit could provide a program by which Hancock policyholders could participate in Hancock's IPO. He also said the following: that Wit has experienced "very high rates of participation" in its "Directed Share Programs"; that Wit "disagre[ed] with a number of the positions and statements made by Morgan Stanley"; that Wit didn't see eye-to-eye with Morgan Stanley regarding the institutional ownership issue; and that "absent an offering in the form outlined herein, we find that [Hancock's] Plan is *prejudicial to Hancock policyholders* and that the *financial loss associated with the transfer to outside investors at the expense of policyholder-owners is unfair and prejudicial to them*." [Emphasis added.]

Robert Mendelson, Wit's senior vice president and co-general counsel, concurred with his colleague's opinion. (The statements submitted by Feeley and Mendelson can be viewed at www.HancockWatch.com.)

The weight of evidence against the Hancock/Morgan approach, combined with Wit Capital's opinions, posed a threat to Hancock's plan, and to Morgan Stanley, which expects to profit from Hancock's demutualization (as well as from the demutualizations of other large insurance companies in the future).

On the morning of November 10, *The Wall Street Journal* ran the following headline: "Wit Assails Advice Morgan Stanley Gave John Hancock." The article that followed was a mere 400 words.

Wit Flip-flops – Suffers TKO

By the afternoon of November 10, Wit Capital, the champion of the individual, the company whose mission is "to empower investors…through the use of the Internet," was, apparently, beginning to understand that on Wall Street it's one thing to *talk* about empowering the little guy, and quite another thing to actually try to do so—especially if it's at the expense of the powers that be.

What actually transpired the morning and afternoon of November 10 may never be known, but at some point Wit decided that it wanted to disavow its 18-page pre-filed written testimony that was so damaging to Hancock and Morgan Stanley.

Why? One can only surmise.

In its role as an online investment bank, Wit needs to receive allocations of shares in other investment bankers' underwritings. In order to receive these allocations, Wit needs to maintain a good relationship with these firms. Ordinarily, that wouldn't seem like a difficult thing given that Wit's honchos are a bunch of high-powered Wall Street folks with years of experience.

The day after *The Wall Street Journal's* first article, another article appeared. This time the headline read, "Wit's Chief Says Criticism of Advice Was Premature."

Although Wit's pre-filed testimony was detailed, Ron Readmond, Wit's co-chief executive, told *The Wall Street Journal* that Wit had made its statement "*without the opportunity to fully review the facts or talk to Morgan Stanley or John Hancock*." He also said that he believed that "Morgan Stanley has provided sound and thoughtful guidance to John Hancock."

We called Readmond to find out more about his epiphanic 180-degree turnaround, but, apparently, he'd left work early and was unavailable for comment over the weekend.

But let's examine his words.

He claimed that Wit had made its statement "*without the opportunity* to fully review the facts." Who denied Wit this "opportunity"?

Readmond claimed that Wit had made its statement "without the opportunity *to fully review the facts*." What "facts"? The relevant ones are in public documents. (Or, equally important, are *missing* from public documents).

Why is it relevant, as Readmond told *The Wall Street Journal*, that Wit had made its statement "without the opportunity to fully review the facts *or talk to Morgan Stanley or John Hancock*"?

Policyholders, who are required to make *their* decisions by November 30, don't get to talk to Morgan Stanley or John Hancock. (Policyholders *can* call an often busy toll-free "Conversion Information Center" and speak with uninformed clerks.)

What is relevant is that policyholders must make their decisions based on the Policyholder Information Statement (PIS), and the PIS is supposed to speak for itself. It either provides full and fair disclosure or it doesn't. And the plan itself is either fair or unfair.

So what accounts for Wit's turnabout? Did it feel the heat from Morgan Stanley? Did it get squeezed by the big firms that want to protect their turf? Did it realize that it could end up sleeping the big sleep if it continued to provoke the lords of Wall Street and attack them in the place that hurts them most—their wallets?

Readmond told *The Wall Street Journal* that, to the best of his knowledge, Morgan Stanley hadn't contacted Wit to complain. But had Morgan Stanley complained to someone else? Did some other investment bank that expects to participate in the Hancock IPO call Wit to complain? Did Wit's advisors hear complaints?

Wit's sudden reversal leaves a foul smell in the air, and it sends a message that it's not a good idea to mess with Morgan Stanley or any other "bulge bracket" underwriter, because if you do, you'll be crushed.

But Wit's words are set in type and available for the world to see on www.HancockWatch.com. Wit's executives won't be testifying at the Hancock hearing, but their words will be there, and the Massachusetts commissioner, Linda Ruthardt, may choose to wonder what really transpired between Wit, Morgan, and Hancock.

When it comes to demutualizations, the regulators aren't really in control. The process is dominated by the big mutuals, their associations, their lobbyists, their lawyers, and their investment bankers.

Hancock's demutualization plan is wrong, and so is Morgan Stanley's fairness opinion. But they've got a lot of money on their side, and they've created the rules.

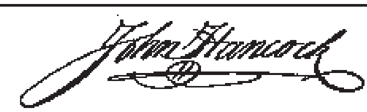
As the great fight trainer, Charley Goldman, once said: "Never play a guy at his own game: Nobody makes up a game in order to get beat at it."

Nowhere to Hide

Hancock and Morgan Stanley won't get beaten at *their* game. But it's likely that they'll be beaten at a different game. The stakes in the John Hancock deal are too large, and the company's profile is too high. Does it really believe that it can cash out 80% of its policyholders and justify a bad deal by using Morgan Stanley's conflict-of-interest-tainted opinion?

We shall see.

In the meantime, Hancock and Derek Kirkland can ponder the words of Joe Louis, who said of Billy Conn, "He can run, but he can't hide."



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