The world's most dangerous insurance publication℠

SCHIFF'S

INSURANCE OBSERVER

October 23, 2003
Volume 15 • Number 16

The $1.8 Billion Scandal at John Hancock

Masters of Deception, Part 1

Are members of John Hancock's board of directors a bunch of swindlers and con men who would dupe their policyholders and shareholders? In light of the complex schemes that John Hancock and its CEO David D'Alessandro have engaged in (and that *Schiff's* has exposed), this question begs to be asked. The answer should be of interest to policyholders, shareholders, insurance regulators, and law-enforcement officials.

As described in detail in *Schiff's* (July 18, 2003), when Hancock was in the process of converting from a mutual insurance company to a stock company in 1999, it repeatedly misled and deceived its policyholders (who owned the company), ultimately costing them $1.8 billion. The conversion was lucrative for Hancock's officers and directors—especially D'Alessandro, who played an important role in the conversion. In 1998 and 1999—before Hancock's conversion—D'Alessandro was paid $1.8 million and $1.7 million, respectively. From 2000 to 2003 he made about $100 million (not including the 2,050,000 stock options he received).

D'Alessandro's Brobdingnagian compensation is different from that of, say, Jack Welch, in that D'Alessandro—unlike Welch—has done a poor job. Welch—who got GE to pick up his dry-cleaning bills—created value; D'Alessandro has not. John Hancock is worth about the same today as it was in 1999, prior to its demutualization and IPO. Even if one measures D'Alessandro's performance by Hancock's stock performance—an inappropriate metric, as we shall discuss later—D'Alessandro has not done as well as his peers, virtually all of whom are paid much less than he.

In his "as-told-to" book *Brand Warfare*, D'Alessandro, whose background is in public relations, creates the impression that Hancock was a dying company when he arrived on the scene in 1984. According to the book, D'Alessandro "reinvent[ed]" Hancock's "sleepy old brand" and turned the company into a great success. The facts tell a somewhat different story. Hancock was one of the ten largest life insurance companies in America in 1984, and was rated "AAA" by Standard & Poor's. Today, still one of the ten largest, it is rated "AA."

D'Alessandro, who is often outspoken, didn't respond to our calls. We suspect, however, that he would like us to believe that he's done a great job, that he wasn't overpaid, that he didn't rip off Hancock's policyholder-shareholders, and that Hancock's directors—who rubber-stamped his compensation—were independent.

The evidence makes all this hard to believe.

On the following pages we'll take a look at the way Hancock has operated and how D'Alessandro, its chief operator, has extracted $100 million of value from the company for himself.

The Hearing

David Schiff and *Schiff's* have been deeply involved in mutual insurance issues relating to corporate governance, and have been dogged opponents of mutual holding companies and unfair demutualizations. David Schiff has testified *pro bono* at numerous regulatory and public hearings, including John Hancock's demutualization hearing in November 1999.

At Hancock's hearing, Schiff testified that the information guide and policyholder information statement that Hancock sent to its policyholders was "inaccurate," "incomplete," and "misleading." He stated that the reorganization was "coercive," that the IPO was unnecessary, that Hancock's "private market value" was "somewhere between $30 and $40 a share," and that Hancock's insiders would benefit from the artificially depressed IPO price. (The IPO was subsequently priced around book value—$17 per share.) Schiff also testified that Morgan Stanley's role as Hancock's financial advisor, provider of the requisite "fairness opinion," *and* lead underwriter in the IPO was an irreconcilable conflict of interest. (As underwriter, Morgan Stanley bought shares from Hancock at a discount to the depressed IPO price and resold the shares to its institutional clients, giving them the opportunity to arbitrage the difference between the IPO price and Hancock's intrinsic value of $30-to-$40 per share.)

continued

History has borne out *Schiff's* testimony. Seventy-five percent of Hancock's policyholders were cashed out at $17 per share—about $17 lower than the current price. Their loss totals $1.8 billion, and Hancock's insiders—especially D'Alessandro—have been enriched to a previously unheard of degree.

Morgan Stanley's 'Smoking Gun'

On June 21, 1999, Morgan Stanley sent a memorandum to John Hancock entitled "Considerations with respect to anti-takeover provisions." The memorandum (written at Hancock's request) estimated that Hancock's stock price would be $26.66 to $33.33 per share, a figure Morgan Stanley believed was considerably less than Hancock's "full value." Morgan Stanley wrote that Hancock's "growth potential" implied that Hancock's stock price might increase more rapidly than that of companies that lacked Hancock's attributes. Morgan Stanley also wrote that Hancock had a "particular vulnerability" to a hostile takeover at a "bid less than full value."

Hancock's officers and directors wanted anti-takeover provisions that would make Hancock immune to any takeover attempt for three years, and they needed a major investment banker to make the case that these anti-takeover provisions were warranted. Morgan Stanley—whose fees from Hancock will comprise tens of millions of dollars—gave Hancock what it wanted.

On February 1, 2000, Hancock completed its demutualization and IPO, cashing out 75% of its policyholder-owners—most of whom did not understand the implications of the transaction—at $17 per share. It issued 102 million shares (primarily to institutional investors) at the same price.

'Breach of Fiduciary Duty'

As a result of the demutualization, the IPO, the cashout, the inadequate disclosure to policyholders, and the extravagant compensation awarded to D'Alessandro, Hancock's directors (including D'Alessandro) have become defendants in a lawsuit accusing them of, among other things, breach of fiduciary duty, unjust enrichment, and waste of corporate assets due to excessive and illegal compensation to D'Alessandro and other insiders. Although the lawsuit doesn't address many of the issues raised in our July 18 issue, it does allude to the Morgan Stanley memorandum and states an obvious, but essential, fact: the information in the memorandum was not disclosed in the documents that Hancock sent to its policyholders when it asked them to vote for the conversion. (Policyholders were asked to approve the plan and to choose whether they wanted to receive cash or stock if the plan was approved.) If policyholders had been aware that Hancock had been valued at about $35 per share, it is inconceivable that they would have voted to be cashed out at $17 per share.

Because Morgan Stanley's five-page memorandum tells us what Hancock knew and when it knew it, it is understandable that the defendants' lawyers would want to distance the defendants from the memorandum.

Hale and Dorr, a large law firm with headquarters in Boston, is representing D'Alessandro, Hancock, and Hancock's directors. According to its website, Hale and Dorr has represented Hancock since at least 1974. Robert Fast, a member of Hancock's board of directors since 1989 and a defendant in the lawsuit, was a senior partner at Hale and Dorr until at least 2002. He is now "of counsel" to the firm and is therefore considered to be an "independent" director at Hancock.

In an August 8 motion to dismiss the lawsuit, Hale and Dorr (and the lawyers representing former chairman Stephen Brown), give the impression that D'Alessandro and the other directors were not aware of the Morgan Stanley memorandum: "Plaintiff's speculative and conclusory assertions that unnamed defendants knew of a valuation that John Hancock's investment banker prepared at some unspecified time before the IPO... [is] woefully devoid of transactional specificity or other supporting factual allegations..."

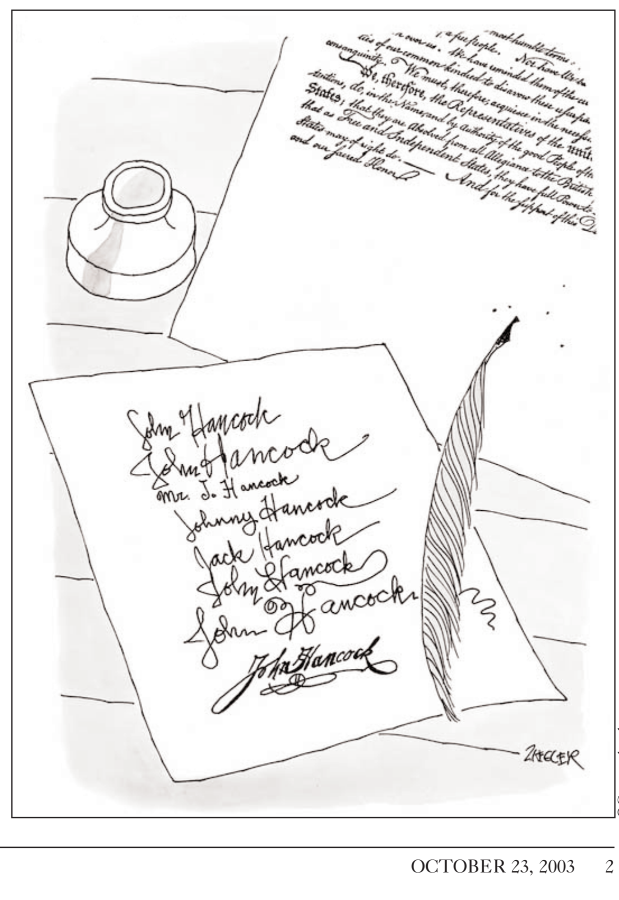
Let's eliminate the legalese and ask a simple question: did Hancock's directors know about the Morgan Stanley memorandum, or about Morgan Stanley's opinions regarding Hancock's valuation that were discussed in the memorandum?

There are compelling reasons to believe they did. First, Hancock's valuation, the pricing of its IPO, and the anti-takeover provisions were among the most important aspects of the demutualization. Indeed, the amount of compensation received by policyholders and the form it would take were probably the most important issues. These facts alone indicate that the directors should have been familiar with the memorandum or the issues it discussed.

Furthermore, unlike certain aspects of the conversion—the actuarial assumptions in the closed block, for example—the issues addressed in the memorandum (valuation and anti-takeover provisions), are easy to understand and are issues with which CEOs and directors of public companies often deal.

All of Hancock's directors appear to be sophisticated business people. Most have been president, CEO, vice-chairman, or chairman of a large company, and most of the outside directors have served on the boards of public companies other than John Hancock. As of March 26, 2003, many of Hancock's pre-IPO directors were still on the board. Of the eight directors who left, two had been CEO of Hancock and one had been vice chairman. Three others are now over 70, and another, Samuel Bodman, is currently Deputy Secretary of Commerce.

continued



The "independence" of Hancock's directors is a subject for discussion, and, as we shall later see, many of the directors have close connections with Hancock, D'Alessandro, and other Hancock directors. These connections—and the board's actions—raise serious questions about many of the directors' ability to act independently.

Since Hancock's directors appear to be knowledgeable business people, their lawyers would have difficulty arguing that they were incapable of understanding the memorandum or the issues it discussed. Accordingly, one line of defense is to contend that the directors were unaware of the memorandum or the issues. The defendants' October 14 motion for dismissal states the following: "Plaintiff merely posits, without any particularized facts, that the defendants knew of inside information (the supposedly 'undisclosed' valuation estimate by John Hancock's investment banker)..."

Hancock's lawyers use the *lack of knowledge* angle often: "Plaintiff continues to be unable to point to any specific facts supporting an inference that" directors Wayne Budd, Edward Linde, and John M. Connors, Jr. "ever had possession of the valuation." Hancock's lawyers assert that because Linde was "an outside director" he "certainly cannot be presumed to have had access to the valuation." They use the same argument to defend Connors.

There's a problem with this defense. A letter written by Stephen Brown, Hancock's former chairman and CEO, states that Hancock's directors were indeed aware of all the issues in Morgan Stanley's memorandum.

John Hancock's 'Smoking Gun'

On June 21, 1999, the day Hancock received the Morgan Stanley memorandum, Brown wrote to Neil Levin, New York's commissioner of insurance, and attached a copy of the memorandum. Brown's letter began, "I am writing to address two concerns that the New York Department has expressed recently regarding the three-year period of takeover protection in John Hancock's proposed plan of demutualization."

Brown said he understood that the insurance department was concerned that the *three-year* anti-takeover provisions proposed by Hancock "might somehow represent an abrogation of the Board of Director's fiduciary duties," and then tried to allay Commissioner Levin's concerns. "I can assure you, as Chairman of John Hancock's board," Brown wrote, "that we believe the adoption of this provision does represent the considered *exercise* of the Board's duty to act in the best interests of our policyholders and future shareholders."

The next sentence in Brown's letter is so damning that is difficult to see how Hancock's lawyers can explain it away: "Our Board has engaged in a long and careful process, with the assistance of our advisors, of reviewing all the issues surrounding this provision."

If Brown's statement is true, then Hancock's directors—as part of their "long and careful process"—were clearly aware of "all the issues" in Morgan Stanley's memorandum.

Because the issues in the memorandum were so important, and because Brown told Levin that the board had reviewed "all the issues," it appears that Hancock's board knew about Morgan Stanley's opinions regarding Hancock's "full value." The board's actions raise several questions. Since Hancock's "full value" was greater than $33.33 per share, why did the company cash out 75% of its shareholders at $17 per share? Why did the company issue 102 million shares in an IPO priced at $17 per share? And why did D'Alessandro receive so much money for *creating* value when, in fact, the value was already there?

Part 2 of this article will be published tomorrow. We will examine D'Alessandro's compensation and performance, and some of his comments. We will also examine how part of his compensation appears to be a violation of Massachusetts law.

In Part 3 we will examine Hancock's board of directors, and appraise the "independence" of various directors. We will also discuss relationships, transactions, and payments involving directors that were not disclosed in Hancock's proxy statement.

The world's most dangerous insurance publication℠

SCHIFF'S INSURANCE OBSERVER

Editor and Writer . . . . David Schiff
Production Editor . . . . Bill Lauck
Foreign Correspondent . . Isaac Schwartz
Copy Editor . . . . John Cauman
Publisher . . . . Alan Zimmerman
Subscription Manager . . . . . . Pat LaBua

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (212) 712-1999
E-mail: David@InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
One SNL Plaza
P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

Annual subscriptions are $149.
For questions regarding subscriptions please call (434) 977-5877.

Insurance Communications Co. (ICC) is controlled by Schiff Publishing. SNL Financial LC is a research and publishing company that focuses on banks, thrifts, real estate investment companies, insurance companies, energy and specialized financial-services companies. SNL is a nonvoting stockholder in ICC and provides publishing services to it.