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The $1.8 Billion Scandal at John Hancock

Masters of Deception, Part 2

"Wanna come to my room and watch a video of D'Alessandro making $100 million?"

Last year was a good one for David D'Alessandro, chairman and CEO of John Hancock Financial Services. He got paid $21.7 million, a figure that's shocking—but not surprising—to anyone who had closely followed Hancock's demutualization. By late 1999 it had become clear that the company was following a course that would enrich its insiders at the expense of its policyholders (who owned the company).

Until John Hancock issued its proxy statement on March 20, 2003, however, few realized just how much D'Alessandro would manage to siphon out of the company. Between 2000 and year's end 2003 his take from salary, bonuses, restricted stock, incentive plans, loan programs, options, change-in-control agreements, and other programs will have been approximately $100 million.

One could argue that it's shameful for the CEO of a large (though not huge) insurance company to be paid so highly, that it's outrageous that D'Alessandro was paid far more than his peers, and that something is wrong with the system when a CEO doing just an average job takes home $100 million for a few years' work.

We won't bother to make these arguments. Instead, we'll focus on two reasons why D'Alessandro's remuneration was illegitimate and unjustified. First, some of his compensation appears to be illegal. (We'll return to this later.) Second, D'Alessandro has achieved dreadful results by engaging in disgraceful behavior. We shall explain.

As we've discussed in previous articles, Hancock deceived its policyholders in many ways during the demutualization process (which was completed in early 2000). The company failed to inform policyholders that its intrinsic value was $30 to $40 per share and cashed out 75% of them at $17 per share concomitant with its IPO. The cashout cost Hancock's policyholders $1.8 billion (using a $35-per-share intrinsic value). We're not aware of another insurance company that has destroyed so much value in one transaction.

The $30-to-$40 per-share value mentioned above wasn't arrived at with the benefit of hindsight. David Schiff cited it in his testimony at the public hearing regarding Hancock's demutualization in November 1999. At that time Schiff was unaware that Hancock's financial advisor, Morgan Stanley, had come up with a similar valuation. In a five-page memorandum dated June 21, 1999, it estimated Hancock's "full value" to be greater than $33.33 per share. Hancock failed to disclose this to its policyholders in the 317 pages of "policyholder information statements" and information guides it sent them when recommending they vote for the demutualization plan.

The information in the memorandum was particularly important because of the way Hancock structured its demutualization. In general, about 70% of policyholders don't vote in mutual conversions. Hancock was undoubtedly aware of this, yet its demutualization plan contained an unusual feature: a default-to-cash provision (instead of a default to stock) for policyholders who didn't vote or didn't *request* stock. There were several reasons why the default to cash was prejudicial to policyholders, and therefore unfair: (1) the cashout price was much lower than intrinsic value, (2) policyholders receiving cash wouldn't benefit from the stock's almost certain appreciation, and (3) receipt of cash is taxable; receipt of stock is not.

Even rich, sophisticated policyholders have trouble understanding "policyholder information statements," and often fail to vote in conversions. In a fair conversion, however, policyholders aren't *penalized* because they don't vote. (For background about how mutuals have disenfranchised their policyholders and created laws to prevent them from having a say in corporate governance, see "The Big Fix" and "The Revolution Will Be Televised," *Schiff's Insurance Observer*, February 1998.)

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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.

Former Hancock chairman Stephen Brown had testified that "the demographics of [Hancock's] policyholder base...are heavily weighted towards smaller policyholders, older policyholders...Many of these small policyholders probably do not even have brokerage accounts." D'Alessandro, a PR and marketing man, says "the John Hancock brand stands for integrity." Hancock's policyholders were influenced by the company's advertising and branding and trusted Hancock. That was a mistake.

Some lawyers who represent demutualizing companies have argued that if policyholders don't vote, it's their tough luck. We disagree. Insurance is based on trust. Insurance companies aren't supposed to take advantage of their policyholders who don't complete and return confusing demutualization forms.

Hancock didn't want its small, old policyholders to become small, old shareholders. It crafted a conversion plan in which most policyholders were likely to receive insufficient compensation for their interests in the mutual company. When the demutualization was completed, it turned out that 62% of Hancock's policyholders didn't vote and that 75% were cashed out at $17 per share.

On June 21, 1999, Stephen Brown, Hancock's former chairman, wrote to Neil Levin, then New York's commissioner of insurance, saying that Hancock's board "has engaged in a long and careful process, with the assistance of our advisors, of reviewing all the issues surrounding" an important anti-takeover provision in its plan. These "issues"—which were discussed in Morgan Stanley's memorandum—included Hancock's "full value" and "stock market valuation."

Brown's letter provides compelling evidence that the board knew that Hancock's "full value" was greater than $33.33 per share. Why then, did it approve the cashout and $17-per-share IPO? A look at who benefited may provide some answers.

On May 2, 2003, twenty-six days before he and other Hancock directors were sued, David D'Alessandro participated in a conference call and discussed why he was paid so much:

> "The [compensation] committee's plan was to reward the executives for value created at the IPO...and value sustained for three years...Roughly speaking, [the] goal [was] to pay me about 1% of the value created and sustained for this...almost three-year period....I'll be glad to show you the data. About $5.3 billion was created...and I was given 728,000 restricted shares which represents not 1% of the value creation, but about 0.4% of that $5.3 billion."

D'Alessandro said he was paid "for value created at the IPO." Certainly, the mere fact that a company conducts an IPO is no indication that value has been created. An IPO can create value for a company's owners if stock is issued at a price that's higher than the company's intrinsic value. (A company whose intrinsic value is $35 per share will create value *for its pre-IPO owners* if it issues shares in an IPO priced at, say, $50 per share. This is a zero-sum game, however. For every dollar of value created for the pre-IPO owners, a dollar is lost for the new owners.)

Conversely, a company whose intrinsic value is $35 per share will destroy value if it conducts an IPO at $17 per share. This is exactly what Hancock did. After cashing out 75% of its policyholders, it sold 102 million shares in an IPO priced at $17. By cashing out policyholders for inadequate consideration and then diluting the remaining policyholders' interests by issuing stock for half of its intrinsic value, Hancock transferred to new shareholders about $1.8 billion of value that had belonged to policyholders.

There are many good reasons why D'Alessandro and Hancock's board knew—or should have known—that Hancock's intrinsic value was much greater than $17 per share. Morgan Stanley's memorandum and Schiff's testimony had valued the company at about $35 per share. Weeks after the offering, D'Alessandro borrowed a significant amount of money from Hancock to buy stock. Three months after the IPO, when the stock was about 20% higher than the IPO price, chairman Brown told a conference-call audience that Hancock was considering a share repurchase "because we believe our stock is significantly undervalued." A year after the IPO—when Hancock's shares had doubled—D'Alessandro told shareholders that the company's "stock price does not fully reflect the company's prospects." (If D'Alessandro thought the stock price was too low then—when it was $34.40—why wouldn't he have thought that it was ridiculously low at $17?) Finally, by the end of 2002, Hancock spent more than $1 billion to repurchase stock at an average price of $35.80 per share.

David D'Alessandro is like a man who starts out on third base and says he's hit a triple. He claims that "$5.3 billion was created" and that he was supposed to get "about one-percent" of that. We don't know how he arrived at this wild figure, but we suppose he took the number of shares outstanding after the offering (about 316 million) and multiplied that by the difference between Hancock's IPO price and the stock price on May 1, 2003 (about $12 per share), and then added in the money that Hancock's policyholders received when they were cashed out.

Whatever method he used is irrelevant. Hancock was worth about $35 per share when it conducted its IPO, and its stock is around that price right now. D'Alessandro destroyed $1.8 of value for Hancock's owners, and in doing so allowed outside investors to make $1.8 billion.

On the May 2 conference call, D'Alessandro mentioned that he was paid not only for value created, but for value "sustained" over three years. Since he destroyed value with the IPO, he deserves no compensation for creating value. The best one can say about his performance is that he "sustained" Hancock's value for three years. We're not aware of anyone else who got $100 million for having sustained value that was already there.

Although Hancock's stock price has risen from its ridiculously underpriced IPO, Hancock's stock slightly underperformed Morgan Stanley's life insurance peer group index as of December 31, 2002. Despite this average performance, D'Alessandro was paid far more than his peers.

Illegal Compensation?

Was it legal for Hancock to "*reward*" D'Alessandro "for value created at the IPO"? Massachusetts' demutualization statute, Chapter 175, § 19E(9), prohibits directors and officers of a mutual company from receiving any "fee, commission, or other valuable consideration whatsoever, other than their usual regular salaries and compensation, for in any manner aiding, promoting, or assisting in such [demutualization] conversion."

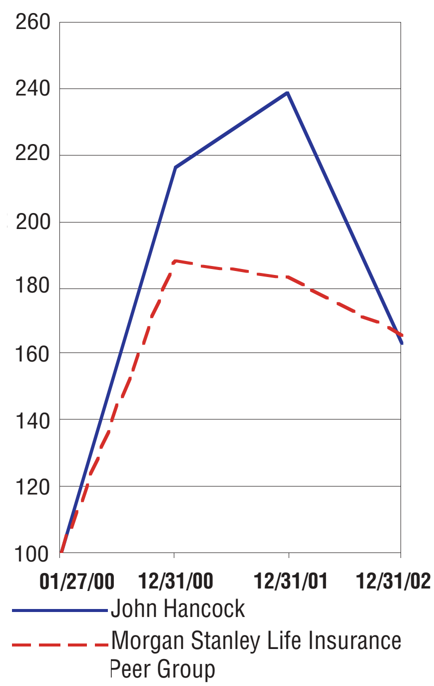
This is a sensible law. A mutual's directors and officers are fiduciaries; they don't deserve extra compensation because a mutual they control—but is owned by its policyholders—merely converts its corporate structure from mutual to stock.

Hancock was aware that it was against the law give its CEO extra "valuable consideration" for "aiding, promoting, or assisting" in the conversion. Nevertheless D'Alessandro received "valuable consideration" *because* Hancock converted from a mutual to a stock company.

On May 28, Hancock issued a press release that stated, "No executive officer was compensated for the IPO." Page 20 of Hancock's 2001 proxy statement, however, notes that D'Alessandro received a $1,960,000 "incentive award" because he and Hancock "met or exceeded several important objectives," the first of which was that Hancock "successfully converted to a publicly-traded stock company."

Hancock's Stock Has Underperformed

David D'Alessandro was compensated as if John Hancock's stock far outperformed it peers. In fact, from its IPO to the end of 2002 (the period covered in Hancock's most recent proxy statement), Hancock's stock underperformed Morgan Stanley's life insurance peer group index. This underperformance is especially notable because Hancock's IPO was priced at $17, a deep discount to the company's intrinsic value. Virtually all of the gain in Hancock's stock price since its IPO can be attributed to this fact. By pricing the IPO at a steep discount to its full value, Hancock cost its owners (its mutual policyholders) about $1.8 billion.



In the August 8 motion to dismiss the lawsuit against D'Alessandro and other directors, Hancock's lawyers make some creative arguments. They admit that the law prohibits remuneration for "aiding, promoting, or assisting" in the conversion, but argue that it doesn't prohibit remuneration "for value created *by or after* the IPO."

Even if D'Alessandro could be paid for value created by the IPO, why would Hancock pay him for this alleged (and, in fact, nonexistent) value creation if he hadn't aided, promoted, or assisted in the conversion?

Regardless, even if Hancock could somehow get around the legal prohibitions and pay D'Alessandro for value created *by* the IPO, that doesn't alter the reality that it gave him an "incentive award" *because* it "successfully converted to a public company."

Hancock argues that the law has an exclusion for "usual salary and compensation" and implies that D'Alessandro's remuneration was part of his "usual salary and compensation." Since a demutualization is an extraordinary occurrence (it happened once in John Hancock Mutual Life Insurance Company's 138-year history), it's not logical that a mutual CEO's "*usual* salary and compensation" would include an "incentive award" for *demutualizing* his company.

On September 29, Hancock and Manulife held a conference call to discuss Manulife's $10-billion-in-stock acquisition of Hancock. David D'Alessandro, who has been paid far more than Manulife's CEO, claimed that he's not planning to leave after the deal closes, even though he will no longer be top man in the company.

"We're very excited about the future of this company," D'Alessandro said of the proposed unification of Manulife and Hancock, "and the kind of money we can make—frankly—running such a large organization."

Policyholders and shareholders should watch David D'Alessandro very carefully—just to make sure that he doesn't make off with $1 billion of their money this time around.

Part 3 of "The $1.8 Billion Scandal at John Hancock" will be published later in the week. We will publish "David D'Alessandro's Declaration of Independence" tomorrow.