This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Record Insider Selling After CFO Unexpectedly Quits
Pall Corporation (NYSE:PLL) Update

February 1, 2005

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Pall Corporation is a supplier of fine filters, principally made by the Company using its proprietary filter media, and other fluid clarification and separations equipment for the removal of solid, liquid and gaseous contaminants from a variety of liquids and gases. Metal and plastic housings for its filters and a variety of appurtenant devices are also offered. Pall's products are used to discover, develop and produce pharmaceuticals; produce safe drinking water; protect hospital patients; remove white blood cells from blood; enhance the quality and efficiency of manufacturing processes; keep equipment running efficiently, and protect the environment. The Company serves customers in two principal markets: life sciences and industrial. The two principal markets are further divided into five segments: Medical and BioPharmaceuticals (life sciences) and General Industrial, Aerospace and Microelectronics (industrial).

Summary of 3DAdvisors Findings for PLL

- **Insider Trading:** Record insider selling after CFO unexpectedly quits
- **Governance:** PLL always seems to find a way to bend if not break rules
- **Other:** Miscellaneous accounting and governance items

Discussion of 3DAdvisors Findings

We are always fascinated to find a company whose insiders, when acting en masse, have exhibited prescience the likes of which we have seen at Pall Corporation over the years. It is not often when insiders converge to sell at this company, but when they do, their actions should be heeded.

Interesting behavior at Pall, however, goes beyond insider trading. Company management has a track record of making decisions, related to compensation and other items inuring to their benefit, that regularly circumvent the spirit of certain rules designed to prevent self-serving actions. These behaviors, together with the insider trading behavior, have been documented in each of our earlier reports on the Company[1] and it appears they continue unabated. Most recently, insider selling has reached record levels in the wake of the abrupt resignation of CFO **John Adamovich** in October of 2004. All this prompts us to deliver this latest 3DA report updating management's behavior at Pall Corp.

Insider Trading: Record insider selling after CFO unexpectedly quits

Adamovich resigned without warning on Monday, October 18th, jumping ship to join Cablevision (NYSE:CVC) subsidiary Rainbow Media Enterprises which was expected to be spun-off from the parent by January, 2005. Adamovich, who had been acting CFO at Pall for over six years, will assume the role of Rainbow's Co-CFO. How he felt about the move, which will require he split the CFO duties, becomes an even more curious question in light of the fact that, in December, Cablevision announced that it was no longer planning to spin-off Rainbow. A subsequent SEC Form 8-K, filed by Rainbow, disclosed the contract details of its other Co-CFO, **Joseph Lhota**, but there has been no such disclosure regarding the details of Adamovich's contract, except for the initial press release announcing he was coming on board. We wonder, however, why his deal was not disclosed as a material contract, when Lhota's contract was mentioned separately in an 8-K wherein it was disclosed that he would receive a $725,000/yr base salary. Our calls to Rainbow confirm that Adamovich is currently employed by the company. Could it be that Adamovich, after the cancellation of the Rainbow Media spin-off, settled in at "less than material" status, with regards to his contract?

It seems to us that Adamovich's decision to leave Pall was not particularly amicable given that it seems little or no notice was given. Indeed, instead of finding a successor, the Company has tapped Pall president **Marcus Wilson** to fill the position. Another clue that the move was abrupt: Pall has disclosed that Adamovich resigned effective Monday, October 18th, yet the Company refrained from making the announcement until Friday, the 22nd, the same date that Rainbow Media announced he was coming on board.

Though we may never know the actual reasons for Adamovich's swift departure, what we do know is that, just over two weeks prior to the move, Pall insiders began aggressively unloading their holdings. Between October 1st and early January, nineteen officers and directors cleared out options (and the underlying shares) for almost 340,000 shares, most not set to expire for years (see Figure 1 below).

If either Adamovich's departure or events related to it are correlated with the insider movement, it would seem that employees learned first, then the board. We say this because selling by four board members began on October 5th with three of them selling on the same day, the 7th. What makes these director sales very unusual is there has never been a time when more than one of Pall's directors has sold on the same day. To see three of them act in unison, and during this same period prior to the CFO's

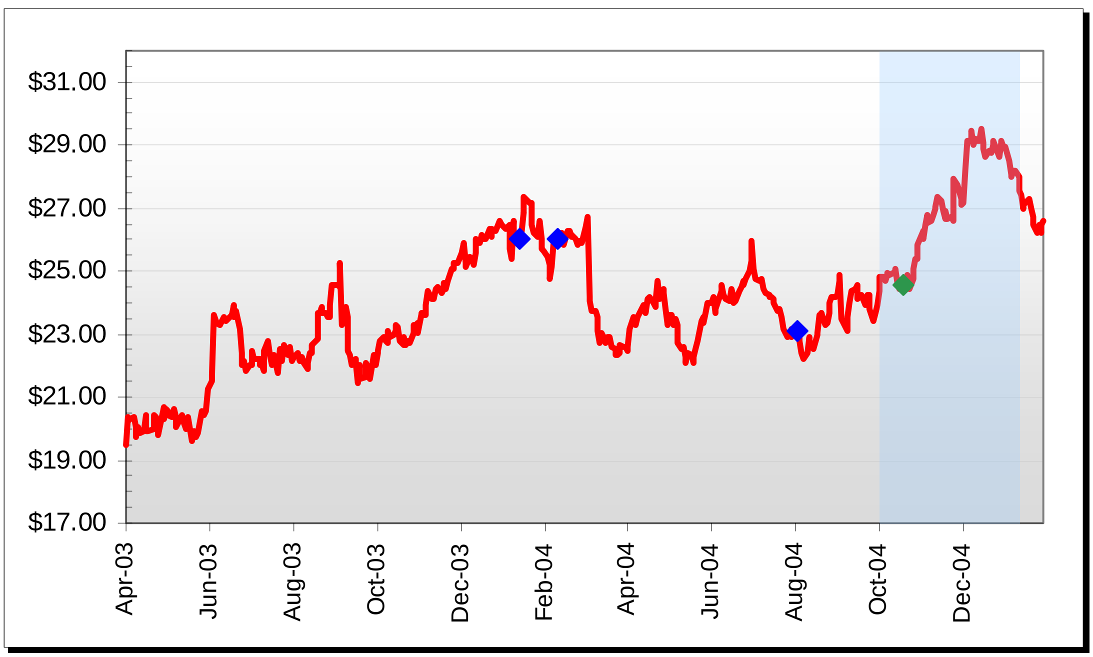
[1] *Insider Research Bulletin* (1/11/04), "Many Small Items Add Up to Big Behavior Concerns" (2/10/04), "Selling Continues While Comp Plans Get Richer" (7/30/04).

departure and in conjunction with the acceleration of selling by management, should not be written off as mere coincidence.

Looking back over the trading history at Pall, there has only been one other time when so many insiders converged to sell so many shares. This was back in Q4 of 1998 when thirteen of them unloaded about 215,000 shares in the $25 to $26 range just prior to their steep 40% drop to $15 early the next year. At that time, however, many of the options being exercised by insiders were expiring, providing some plausible cover for the convergence. That's not the case in this most recent round of heavy distribution by insiders.

Another prescient convergence of insider activity occurred in December of 2003 (first reported in our *Insider Research Bulletin* of 01/11/04) where eleven insiders sold just over 207,000 shares in the $26 range. Pall shares closed out 2003 near $28 only to fall sharply to just above around $22 (21% decline) by March, 2004.

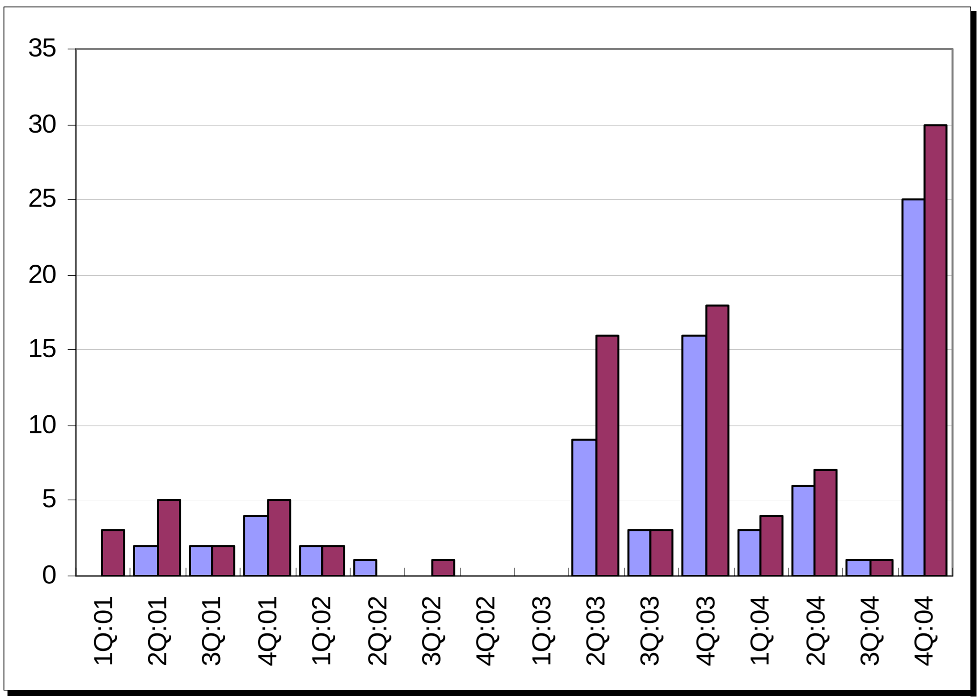
Figure 1. PLL Daily Closing Price, April 1, 2003 through January 28, 2005. Blue diamonds are the dates of our prior PLL reports. Blue shaded area is the period that 19 officers and directors sold a record 340,000 shares. Green diamond is the effective date of CFO's resignation (10/18/04). Source: Reuters and PLL SEC Filings.



Another revealing indication that Pall insiders are monetizing their shares at a more aggressive pace is the total number of transactions that have hit our screens. Insiders filed a record number of sale transactions in the fourth quarter of 2004, far outpacing anything we've seen in the past ten years. There were also 55% more option exercises during the quarter than we'd seen in 4Q:03, which had been the previous high by a considerable margin. More importantly, Pall insiders have shown a tendency, over the years, to hold their options until they approach the expiration date. In the two largest prior rounds of options exercises (December 1998 and December 2003), a significant number of the options exercised were set to expire within six months. Though a number of the options exercised in October 2004 (strike price of $23.18) were going to run out in November 2004, they constituted only a small percentage of the total options exercised between October and January.

In addition to the large number of transactions, the number of individuals involved in those transactions reached a record in the quarter. More insiders (18) sold shares during the quarter than we'd seen in any prior round. Since 1995, we've only found three instances of more than 10 insiders selling during a quarter (4Q:96, 4Q:98, 4Q:03).

Figure 2. Number Option Exercise Transactions (Blue Bars) and Sale Transactions (Red Bars) by PLL Insiders. Source: PLL SEC Filings.



- **John Miller (59)** – Senior V.P., Chief Technology Officer. Miller's behavior, like that exhibited by some of his peers, has become noticeably more aggressive in recent months. Miller hasn't been timid with his shares in the past, but this time we picked up on a subtle change in his activity. Since first registering as a Section 16 insider in 2000, Miller has shown a propensity for exercising his options and selling just those shares acquired in the transaction. That changed in January 2004, when he began exercising his options, selling the underlying shares, and then tapping into his common holdings to distribute additional shares. This routine intensified in early October when Miller, who held 24,295 vested options at the time, sold 3,170 shares out of his common holdings between October 1st and October 13th. Then, on December 6th and December 22nd he cleared out his last remaining vested options (expiration dates: 03/11, 10/12), dumped the newly-acquired 38,545 shares, and also sold an additional 13,278 shares out of his common holdings. Not only was this his largest distribution to date, **the selling trimmed his holdings by 62%**. Following the activity, Miller still holds 32,000 shares of common stock and will have 18,375 options vest in 2005 (see Appendix).

- **Neil MacDonald (54)** – Group V.P. and President, BioPharmaceuticals Group. MacDonald's recent activity was by far his most aggressive since becoming a filing insider back in 2000. On October 12th he exercised one option set to expire in May 2005 and then sold the 6,250 shares at $25. Two months later, he cleared out the remainder of his vested options including two additional series with plenty of time before expiration (expiration dates: 03/11 and 10/12) then sold the underlying 45,500 shares on December 6th and December 16th at roughly $28. Not only was this his largest sale and percentage reduction on record **(he sold 86% of his holdings)**, but the size of his sale isn't the only component of his behavior that led us to label his activity as atypical. This was the first time in the past four years that MacDonald has exercised more than one series of options in any time frame. It is quite evident that he reacted with a sense of urgency to monetize these options, as he left himself with just over 8,000 shares of common stock and 18,375 options not set to vest until March and October (see Appendix).

- **Heinz Ulrich Hensgen (52)** – Group V.P., President, European Operations. Though he's been a member of the executive ranks since 2000, Hensgen's activity has been constrained due to the limited number of equity awards he's received over the years. Due to the small number of options he holds, he's had the choice of exercising the options and holding the shares to shore up his diminutive common stock holdings, or, he could just have sold the shares. We can't say that we're entirely surprised that he chose the latter route, but that he did so while accepting a slim spread between the exercise price and market price does leave us questioning his decision. On October 8th, Hensgen exercised an option with a $21.15 strike price that was set to expire in May 2005. He then monetized the 14,000 shares at $25, which by an insiders' standards, isn't that handsome a profit. Then, on January 11th, Hensgen exercised the last remaining vested options in his possession (the same $21.15s), and sold those shares at $27. **In doing so, he reduced his holdings by 95%**. Now, **Hensgen holds 1,288 shares of common stock, no vested options, and no options vesting until January 2006** (see Appendix).

- **Andrew Denver (56)** – Senior V.P. and President, Asia Group. Denver, a Section 16 filer since September 2002, surfaced on January 7th with his first-ever sale. He exercised all of his vested options which were comprised of two series not set to expire until April 2012 and October 2012, and then monetized all 31,750 shares at roughly $28, effectively **shedding his entire position**. Not only is Denver out of common shares, but he will only have a total of 15,750 shares vest throughout 2005 (see Appendix). This is very rare to see a high-ranking executive carrying no holdings in form of either common stock or vested options.

- **Lisa McDermott** (age not disclosed) – VP, Finance and Chief Accounting Officer. On the surface, the 3,425 shares McDermott sold on October 5th and December 6th at $24 and $29 might not seem that notable. But after examining her trading history (she's never been a heavy seller) and taking into account her position as the chief accountant (and one of the two who've signed the Company's financials since the CFO's exit) her sales, no matter the size, need to be taken seriously. McDermott (formerly Lisa Kobarg) had only sold twice in the past six years since she joined the Company, including a 2,500-share sale in December 2001 at $25, and 7,425 shares she distributed in December 2003 at roughly $26. Both sales preceded share price weakness. Now, McDermott is showing a resistance to holding any Company stock, as the recent sale **wiped out her entire actionable position** (common stock plus exercisable options). Since she didn't receive a January 2005 option award, her unvested options holdings are quite thin. Between March 2005 and October 2006, she will have just 13,700 options vest (see Appendix), nearly the same amount as she's monetized over the past twelve months.

There are three sales by veteran directors that we deem to be very significant. On October 7th, **Ulrich Haynes (73)**, **Edwin Martin (73)**, and **Daniel Carroll (58)** each sold 73%, 37% and 38% of their holdings, respectively, marking the first time that three directors sold on the same day. Haynes' sale was his first since he moved 14,000 shares back in September 1998, just months before the issue slid from $24 to $15. It's probably no coincidence that the same week, Martin, who along with Haynes are the two most experienced Pall board members, executed his first and considerably largest sale to date of 20,000 shares.

Table 1. Holdings Reductions (Common Stock and Exercisable Options) for Key Insiders Since the Departure of CFO. Source: PLL SEC Filings.

Insider	Position	Holdings Reduction since October 2004
D. Carroll	Director	38.4%
S. Chisolm	President, Microelectronics Grp	88.3%
A. Denver	President, Pall Asia	100.0%
H.U. Hensgen	President, European Operations	95.6%
N. MacDonald	President, BioPharmaceutical Grp	86.6%
E. Martin	Director	37.3%
L. McDermott	VP, Finance, Chief Accounting Officer	100.0%
J. Miller	SVP, Chief Technology Officer	61.7%
J. Western	President, Aerospace Grp	64.8%

<u>Governance: PLL always seems to find a way to bend if not break rules</u>

Pall is the only company that we've spotted that still is getting away with loaning the necessary capital to insiders, interest-free, in order for them to exercise their options. They are getting around Sarbanes-Oxley in this case by stating that due to the fact that certain of its options were granted prior to the law's enactment, and that those previously-granted options came with a program to provide loans for their exercise, certain loans have occurred and remain on the books:

Indebtedness of Executive Officers and Directors under Stock Option Plans

Under options granted to executive officers and directors under the Company's stock option plans prior to July 30, 2002 (the date of enactment of the Sarbanes-Oxley Act of 2002), optionees could elect to defer payment of the purchase price of the Common Stock upon their exercise of options and thereby became indebted to the Company for the deferred amounts. The following table sets forth certain information with respect to all executive officers and directors who were indebted to the Company under the stock option plans in an amount in excess of $60,000 at any time from the start of the Company’s 2004 fiscal year (August 1, 2003) to September 28, 2004. The second column of the table shows the largest amount of indebtedness outstanding during that period by each of such executive officers and directors, and the last column shows the principal amount outstanding as of September 28, 2004. All of the indebtedness shown in the table is non-interest-bearing (see the Summary Compensation Table above) and payable on demand.[2]

	Amount of indebtedness	
Executive	**Largest**	**Sept 28, 2004**
Eric Krasnoff	$720,000	$720,000
John Miller	128,407	128,407
Heywood Shelley	120,400	120,400
Donald Stevens	317,021	-0-
James D. Watson	292,500	292,500

What the Company does not come out and say is not only are these interest-free loans still outstanding, they are still being offered. Krasnoff had zero outstanding as of F/Y end 2003 and has borrowed the entire $720,000 (in the above chart) through Q3 of 2004. Ditto for John Miller who had $63,000 outstanding as of F/Y end 2003 and now has raised his total to $128,407.

In another instance, Pall clearly ignored the rules last year when, in a patent dispute with Mykrolis Corp., Mykrolis accused Pall of infringing two of its patents for technology used in semiconductor manufacturing. The U.S. District Court for Massachusetts issued a preliminary injunction in April of 2004 against Pall to stop selling certain fluid separation devices, an injunction which Pall violated and was found in Contempt of Court this past January. Though the amounts involved were not material, the fact stands that this serves as another example where Pall chooses not to “take the high road” with its practices.

Another place where Pall skirts the rules is the compensation area. Our earlier reports deal with Pall’s regular data-mining of its compensation plans, which are designed to give top executives plenty of latitude to insure full attainment of their incentive bonuses. To do this, the Company bases its bonus targets on a definition for “Net Earnings” (used in the R.O.E. model calculation) that excludes charges related to negative FX changes, restructuring or acquisitions, or any other extraordinary items. Yet

[2] Pall Corporation Proxy Statement (DEF 14A), filed 10/13/04, page 12.

while excluding all extraordinary ***charges***, nothing in the definition for “Net Earnings” would throw out extraordinary ***gains***. Pall has further stacked the deck by lowering its R.O.E. targets over the years, making it easier for its executives to claim bonuses. Indeed, if earlier minimum and maximum target ranges for R.O.E. had not been lowered from 12.5%-19% to 10%-15% in 2003, CEO Krasnoff would have received far less than his $1 million bonus. In fairness to Pall, however, it should be noted that the current year’s bonus targets have moved up a bit to include a 12% to 17% range.

Pall’s explanation for these annual changes in the bonus calculation is to point out that, by doing so, the Company is getting around the IRS $1 million maximum compensation level whereby payouts exceeding that amount are not deductible. By using the safe harbor that performance-based compensation is exempt from the $1 million limitation, Pall is, once again, circumventing a rule.

Central to this argument is the fact that Pall regularly pushes the envelope on loans to officers and compensation issues, among others. Given management’s proclivity towards this behavior, we increasingly wonder how many other of such shenanigans, heretofore undisclosed, may be going on.

Other: Miscellaneous accounting and governance items

- **Environmental contingencies:** Pall Corp. finds itself dealing with environmental matters on a number of fronts. The significant issues involve actual findings that cite groundwater contaminants above allowable levels in at least three major instances (Ann Arbor, MI; Pinellas Park, FL; and Glen Cove, NY). The Company’s balance sheet contains environmental liabilities totaling $28.2 million as of October 31, 2004. Pall then goes on to state that it is in “substantial” compliance with applicable environmental laws. ”Substantial”, however, does not mean “in compliance” and it would seem that Pall is not able to state the latter and may be exposed to undetermined amounts.

  In the Ann Arbor case alone, the city has sued Pall seeking damages, including the cost of replacing a municipal water supply well allegedly affected by the groundwater contamination, as well as injunctive relief in the form of an order requiring Pall to remediate the soil and groundwater beneath the city. Given the actual findings of groundwater contaminants above allowable levels in all three cases, it is our opinion that the chances of the Company settling all associated pending environmental issues, including remediation and fines, for anywhere near $28 million, seem slim.

- **Companies largest shareholder still considered “Independent”:** In yet-another example of Pall skirting around the spirit of a rule, the Company continues to retain **Abraham Appel** on its Audit, Compensation and Planning & Governance committees. Appel is Pall’s largest individual shareholder, controlling almost 2.8 million shares (2.3% of common). Though technically an outside director, it is easy to understand that Appel has a significant personal interest in Pall, much more than the typical “independent director” as envisioned by the drafters of Sarbanes-Oxley.

- **Ownership guidelines are illusory**: Ownership guidelines at Pall are seldom met and when compliance deadlines approach, the Company has a history of raising them (heralding the associated benefits to shareholders of such a move) and moving out the target compliance date. In 2002 as the original compliance date (established in the 1999 guidelines) loomed, Pall raised the ownership targets, moving the compliance date to 2006 in the process. In September of 2004, ownership compliance of most executives still remained well-below required levels. Pall again raised the required ownership levels, moving out the compliance date until 2007. In that effort, the company went to some length to describe how CEO Krasnoff's holdings complied with the guidelines. What it avoided saying was that eight out of eleven other key insiders did not meet the targets at the time. Insiders at Pall continue to exhibit little desire to accumulate positions.

- **Percentage of completion accounting remains thinly disclosed:** Pall continues to disclose that its long term contracts are accounted for under the percentage of completion method. At the same time, however, the Company provides no further disclosure except to identify the existence of the practice, and no mention as to the magnitude of any exposure or the amount of any related unbilled receivables.

- **Dividends have dropped for four straight years**: In an era where the significance of dividends have taken center stage, it's interesting to note that Pall has decreased its dividend steadily since 2001, and this in the face of evolving executive incentive plans that have increased the flow of bonus cash to insiders.

Appendix

Option Vesting Schedules for Selected Pall Corp. Insiders

Grant Date	Options	Price	Date Exercisable	Expiration Date	Remaining Options in Series	Unvested Options in Series	Vesting Dates of Remaining Options
Steven Chisolm, SVP and President, Microelectronics Group. Common stock holdings: 2,544 shares							
10/02/02	38,500	$16.13	10/03/03	10/02/12	19,250	19,250	10/03/05, 10/03/06
Andrew Denver, SVP and President, Pall Asia. Common stock holdings: 0 shares							
04/28/02	25,000	$20.60	04/29/03	04/28/12	12,500	12,500	04/29/05, 04/29/06
10/02/02	38,500	$16.13	10/03/03	10/02/12	19,250	19,250	10/03/05, 10/03/06
Heinz Ulrich Hensgen, GVP and President, European Operations. Common stock holdings: 1,288 shares							
01/19/05	6,500	$27.00	01/20/06	01/19/12	6,500	6,500	01/20/06, 01/20/07, 01/20/08, 01/20/09
Neil MacDonald, GVP and President, BioPharmaceuticals Group. Common stock holdings: 8,027 shares							
03/18/10	35,000	$22.09	03/19/02	03/18/11	8,750	8,750	03/19/05
10/02/02	38,500	$16.13	10/03/03	10/02/12	19,250	19,250	10/03/05, 10/03/06
01/19/05	6,500	$27.00	01/20/06	01/19/12	6,500	6,500	01/20/06, 01/20/07, 01/20/08, 01/20/09
Lisa McDermott, VP Finance. Common stock holdings: 0 shares							
03/18/01	6,000	$22.09	03/19/02	03/18/11	1,500	1,500	03/19/05
10/02/02	7,700	$16.13	10/03/03	10/02/12	3,850	3,850	10/03/05, 10/03/06
John Miller, SVP, CTO. Common stock holdings: 32,169 shares							
03/18/01	35,000	$22.09	03/19/02	03/18/11	10,750	8,750	03/19/05
10/02/02	38,500	$16.13	10/03/03	10/02/12	19,250	19,250	10/03/05, 10/03/06

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James Western, President, Aerospace Group. Common stock holdings: 1,127 shares							
03/18/01	6,000	$22.09	03/19/02	03/18/11	2,000	1,500	03/19/05
11/03/02	6,000	$17.84	11/04/03	11/03/12	3,000	3,000	11/03/05, 11/03/06