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

Disclosure of Short Sale Leads Us to Other Issues Danaher Corporation (NYSE:DHR)

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Danaher Corp., formerly DMG Inc., designs, manufactures and markets industrial and consumer products and primarily operates in two business segments: process/environmental controls and tools and components. The process/environmental controls segment provides compact professional test tools and calibration equipment for electrical, industrial, electronic and calibration applications, as well as aircraft safety equipment and industrial control products. The tools and components segment provides general purpose mechanics' hand tools, primarily ratchets, sockets and wrenches, as well as specialized automotive service tools for the professional and do-it-yourself (DIY) markets and professional automotive equipment, tools and toolboxes through independent mobile distributors that sell primarily to professional mechanics.

Summary of 3DAdvisors Findings for DHR

- **Insider Trading:** Obscure insider short sale has us tracking Danaher
- **Governance:** Related-party action reads like a detective novel
- **Insider Trading:** Convergence of insider activity looks far from coincidental

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Discussion of 3DAdvisors Findings

Insider Trading: Obscure insider short sale has us tracking Danaher

It was a cleverly disguised short sale by the Rales brothers, back in 1996 that started us looking into their behavior. Not only was the fact that they managed to get the deal off interesting to us, but also the downright sneaky way its disclosure has been hidden, both at the time of the sale and ever since:

Back in May of 1996, the Rales brothers sold two million of their own shares (one million each). The brothers borrowed the shares from an entity called “Capital Yield Corporation”. After much searching, we have been able to come up with little on this entity. The only time its name has shown up has been the few mentions that have occurred in various, and obscure, Danaher filings.

The first such reference occurred in an amended S-3 registration statement covering the two million-share sale, back in 1996. At that time, the two million of the total shares sold were, in fact, borrowed. The short sales were clearly against the box. The brothers borrowed the shares to be sold from Capital Yield Corporation. They then pledged 2.11 million of their personal shares as collateral to back up the deal. Even though this sale happened a while ago, there are certain behavioral clues that surface that are worth knowing even today. By this, we mean the strange way that any reference to Capital Yield Corporation has been disclosed:

In the original May of '96, S-3 filing (covering the original 2 million share sale) there was absolutely no reference to Capital Yield Corporation or the borrowing of shares. Three days later however, the original S-3 was amended and, in an attachment, detail was revealed concerning Capital Yield Corporation, its loan of 2 million shares to the Rales brothers for their sale, and the pledging of Rales brothers shares as collateral. The very next day, however, (5/2/96) a second amendment (to the original S-3) was filed, this one without the attachment containing the detail concerning the Capital Yield Corporation and the borrowed shares. Consequently, those looking at only the original and the final amendment (which is what most would do) would have missed all reference to the Capital Yield Corporation situation and the fact that the shares to be sold were being borrowed. Yet the Company could still claim that it had made the disclosure.

If this second amendment were meant to imply that dealings with Capital Yield (revealed in the first amendment) never materialized and that there had been no shorting against the box, any inference to that effect would have been incorrect. Subsequent 13d's filed by Equity Group Holdings LLC (the100% Rales-owned entity that holds the majority of their shares) refer to this matter as follows: "The (Danaher) Shares beneficially owned by each of Steven M. Rales and Mitchell P. Rales include shares pledged as collateral to secure a loan of Shares to each of them by Capital Yield Corporation." This reference has only been included in 13d filings (no other public Danaher document mentions this) related to the Rales brothers' holdings, the most recent having been filed in April of '03. It is very clear to us that, for whatever reason, the brothers still owe the 2 million shares.

Clearly, a seven year-old sale such as this could be considered, by some, to be old news. We would argue, however, that more important than the transaction itself, the clever obfuscation of its disclosure provides an important insight into the behavior of the Brothers Rales. This type of behavior always causes us to pay careful attention going forward.

Governance: Related-party action reads like a detective novel

There is an interesting aspect of Danaher's recent disclosure practices. It is easy to see, when perusing the Related Party transactions (in the most recent Proxy Statement), how new auditors E&Y (who replaced Arthur Andersen) are forcing more disclosure. Indeed, the now-lengthy list of such transactions includes items as small as $1,200 legal fees paid to the firm of a Company Director. In the midst of all this apparent improved disclosure, however, are the areas of obfuscated revelations that really have our attention, and this time we're not talking about shares that have been pledged as collateral for stock loans but, instead, additional shares (owned by the Rales brothers) that have been pledged for lines of credit.

With regards to this, we point to a first-time disclosure that shows up in the most recent Proxy (Dated 4/1/03). In it, in a footnote, is a statement revealing that "Shares of Company Common Stock held by Equity Group Holdings LLC, Equity Group Holdings II LLC, and Equity Group Holdings III LLC are pledged to secure lines of credit with certain banks." Now, Equity Group Holdings (and related entities) is 100% controlled by the Rales brothers. It is this entity that holds the lion's portion (31.3 million shares) of their combined holdings, which total about 34 million shares. We know that at least 2.11 million of these shares have been pledged as collateral in a transaction related to the sale of borrowed shares.

So we now know that, outside of the pledged shares (related to the short sale) an additional number of Rales-related shares are pledged to secure lines of credit. The amount pledged in this manner must be considered material enough for E&Y auditors to require the first-time disclosure. There is no mention as to how many shares have been pledged. It does seem that the related lines of credit are related to Rales interests and not those of Danaher.

Maybe this is a nit, but an interesting fact relating to this new disclosure lies in its very placement in the Proxy. For all prior years, detail regarding holdings of the Brothers Rales has been Footnote Number 1 in the Proxy section, “Beneficial Ownership of Common Stock by Directors, Officers etc”. This year, the same Rales-related footnote, containing the first-time disclosure of additional pledged shares, has been moved down from the Marquee spot to that of Footnote Number 6 (Six out of 13), right in the middle of the pack. From Lead Item to Supporting Cast? Odd treatment, and certainly one that does not seem consistent with apparent efforts elsewhere in Danaher's documents (such as Related Party Items) that seem to imply that they are improving their disclosure.

Improving disclosure of Related Party Transactions does not insure they are proper. Take Danaher's $147 million purchase transaction, in 2000, involving Warner Electric Company. The Rales brothers controlled Warner Electric at the time of the deal. Even now, in the wake of what appears to be a deal very much at conflict with shareholders’ interests, the Rales Brothers again have their finger in the pie. This is accomplished through yet-another company controlled by the Rales Brothers, Colfax Corp., which continues to act as the primary distributor/reseller of a key Warner Electric Product in Europe. This product line was one of the assets acquired by Danaher in the '00 Warner acquisition. In '02, Danaher sold $3 million in product to Colfax. The distribution deal was extended in January of '02 for three years. So it remains quite evident that the Rales brothers continue to reap personal benefit from Danaher's dealings.

Warner Electric is another example of Danaher's mirage-like disclosure (here today, gone tomorrow). In the initial Proxy disclosure concerning the Warner Electric acquisition, there had been no mention of the continuing combination of Rales-related interests with those of Danaher’s (described above). Consequently, one could infer, thanks to the inclusion of the Colfax-Danaher dealings in the most recent Proxy, that Danaher is improving its disclosure. The problem with the assumption is that the recent Proxy, though including reference to the extended current Colfax-Danaher interests, has dropped a second and very interesting item about that original Warner Electric acquisition, a detail that was contained in the previous year's proxy: Missing is the detail revealing that an additional Danaher (and Rales-related) executive also made out on the Warner deal. He is Philip Knisely, an Executive Vice President of Danaher. Knisely had been with Colfax, the Rales-controlled entity that still holds the distribution rights to the key Warner Electric product line mentioned above. He joined Danaher in June of '00, one month before the closing of the Warner Electric acquisition. At the time of the acquisition, Knisely held 5% of Warner Electric. Odd that the reference to Knisely having owned a beneficial stake in Warner had been stricken from the following year's Proxy, the very Proxy that seems to boast such improved disclosure of Related Party Dealings.

Then there's the matter of Current CEO Lawrence Culp's $500,000 interest free loan, extended to him in July 2000 in connection with promotion to the position. The loan has been in the process of being forgiven ratably. By October of this year, the loan will be completely forgiven. Not only has the loan been forgiven, Culp has been receiving gross-up payments to cover taxes payable related to the forgiving of the loan.

And one add-on item. As evidence of the Company's free spending practices, it should be noted that country club memberships (paid for by Danaher) are quite common at the Company. We've seen evidence of this in employment deals involving as little as $250,000 (salary and bonus) all the way up the chain.

<u>Insider Trading: Convergence of insider behavior looks far from coincidental</u>

Allow us to paint this picture for you. It starts with a 5.75 million-share sale, by the Rales brothers (split evenly between them) back in May of 2001. Making the May of '01 event more interesting was the fact that **Patrick Allender (56)**, the current Danaher CFO, then-largest-ever sale (45,000 shares at just under $58) occurred on May 8th of '01 (the same time period of that 5.75 million sale by the Rales brothers). We find it's interesting that Allender has recently sold a larger block of his stock. It is his first sale since that 5/'01 transaction. He dropped 70,000 shares, on April 22nd, at prices in the $70.50 range. This becomes very interesting when you consider that his move again parallels one by Steven Rales, a 1.2 million-share sale (he says it's related to his divorce) that occurred on the same day as Allender's (April 22) and in the same price range. Now, both Rales' and Allender's last previous sales were in May of '01. Granted, the divorce could have been a contributing factor to the recent Steven Rales sale. It's the timing of his sale however, that's interesting. Seems awful coincidental that the two insiders (Allender and Rales) have surfaced, once again at the same time, and neither had sold a share in the interim. I doubt that Allender is undergoing similar pressures as Rales lays claim to.

Adding a bit more detail to the timing game here is yet-another recent sale by an insider. He is **Steve Simms**, Executive Vice President (I have found no disclosure of his duties) and he sold 80,000 shares on May 19th for $68.11 each. This was just a few weeks after Rales and Allender's April sales. Another interesting and potentially important thread here is that, prior to his recent sale, Simms had not sold since February of '01, basically in the same time frame that Rales and Allender last trimmed their holdings in that same year.

When you consider the fact that Danaher shares had traded at higher prices, in early '02, than what the three fetched from these recent sales, the timing of the three's convergence looks even more interesting.