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

Selling Continues While Comp Plans Get Richer
Pall Corporation (NYSE:PLL) Update

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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:** Already low insider holdings continue to decline
- **Governance:** Changes to incentive comp plans heavily favor executives
- **Accounting:** Recent sales growth aided by favorable currency translations
- **Accounting:** Interesting obfuscation with respect to earnings guidance
- **Accounting:** Curious treatment of V.I. Technologies investment

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Discussion of 3DAdvisors Findings

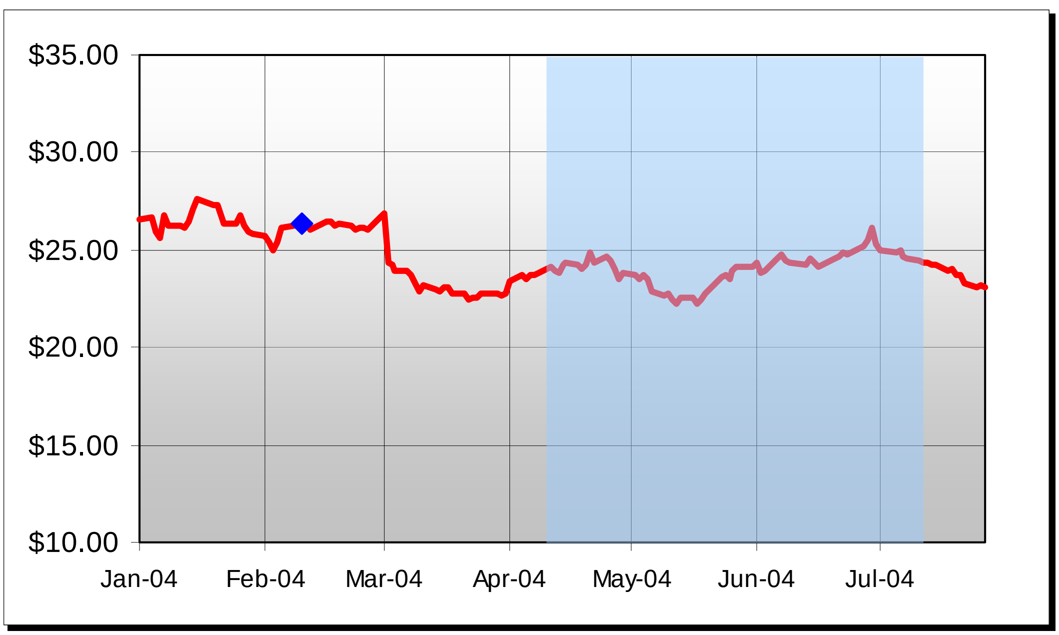
In our first report on Pall (02/11/04), we described indicative executive behavior we had uncovered in all three areas that we study: insider trading, accounting and governance. The self-serving compensation arrangements, the timing of changes to A/R allowances, and the apparent low desire, by both insiders and the pension fund, to hold Pall Corp. shares, among other items, combined to form a mosaic of behavior that investors should equate with increased risk. It came as no surprise to us that, soon after our February report, Pall shares dropped 17% in the wake of a Q2 earnings miss.

Since then, with the stock trading at lower prices, insiders have continued to show little interest in holding shares, as the selling has not abated. Making matters more interesting is the subtle disclosure that management has, once again, made its compensation plans even more generous with recent changes to its Executive Incentive Bonus Plan.

Insider Trading: Already low insider holdings continue to decline

Back in February we reported a round of significant insider dispositions by Pall insiders back in December. The transactions, which amounted to the heaviest month of sales dating back to 1995, were executed into momentum that lifted the issue from $22 in September 2003 to nearly $27 by year-end. By March the issue gave back nearly all earlier gains and has exhibited volatility ever since. Once again insiders have surfaced, this time selling just slightly less than they had in the prior round, dumping 181,000 shares from April 13th through July 14th at prices ranging between $23.90 and $26. Absent in the December round, Chairman, CEO **Eric Krasnoff** filed his largest sale to date, while CFO **John Adamovich** and Director **Edwin Martin** dumped 75% and 44% of their holdings, respectively. Not only are this year's sales on pace to break the unprecedented volume seen last year, but they have also had a significant effect on insiders' compliance with company mandated ownership guidelines.

Figure 1. PLL Daily Closing Prices, January 2, 2004 to July 28, 2004. The blue diamond is the date of our first report on PLL; the blue shaded area is the period during which recent insider sales took place. Source: Reuters and Vickers.



In 1999, Pall established guidelines for its executives, requiring them to hold a certain amount of common stock based on a multiple of their base salary. The CEO, President, and other named execs were expected to accumulate common stock valued at 250%, 175% and 125% of their salary, and had until July 2002 and July 2003 to reach 50% and 100% of their targets. However, in late 2002, and with all of the named executives yet to meet their targets, the Company modified the guidelines, increasing the ownership levels based on new multiples of 375% for the CEO, 250% for the

President, and 200% for named executives. After failing to meet their targets in the three years originally provided, execs were munificently given an additional four years to comply with the new guidelines, but their procrastination continues. President **Marcus Wilson**, who was appointed to his position less than a year ago, is the only named executive to increase his common stock holdings since the guidelines were altered. While we recognize that they still have two years to accumulate shares, this group has shown reluctance over the past five years to acknowledge the intended purpose of the plan: to align their interests with those of the shareholders.

Table 1. PLL Executive Ownership Guideline Compliance*. Source: PLL SEC Filings.

Named Executives	**Common Holdings 10/02**	**Common Holdings 07/04**	***Required Ownership***
Eric Krasnoff	79,850	44,366	*109,430*
Marcus Wilson	5,618	10,738	*51,560*
Donald Stevens	22,492	4,887	*28,300*
John Adamovich	7,223	6,698	*27,600*
Samuel Wortham	16,268	16,268	*24,400*

* Each named executive has until July 2006 to meet his target.

Pall's 26 directors and executive officers as a group hold 3.4% of the outstanding shares. This total, however, is misleading as Company founder, and largest shareholder, **Abraham Appel**, holds almost 2.8 million shares, or 2.2% of the outstanding shares. Take his holdings out of the equation and you have the remaining Pall officers and directors holding just 1.2%. Making matters more interesting is the fact that Appel is on the compensation committee. Technically an outside director, it would seem that he has a great deal more personal interest in Pall than the typical "independent director" as envisioned by Sarbanes-Oxley.

The recent round of insider selling serves to confirm our original thoughts on the insider picture at Pall, namely that insiders are far more interested in cash than holding company stock.

- **John Adamovich (51)** – Group V.P., CFO, Treasurer. We're constantly monitoring the behavior of corporate CFOs, even more so around earnings reporting season. Adamovich's recent activity jumped out at us instantly. Since joining the Company in 1998 he'd sold a total of 95,677 shares, a majority of which were disposed of in late 2001 ahead of a three-month, 21% slide. Since then he's never sold more than 20,000 per quarter. On June 29th he sold 33,750 shares at $25.43 and **reduced his actionable position by 75%**. In addition to the large reduction, we were intrigued to find that Adamovich is far from meeting the Company's ownership guidelines, which require him to common stock valued at two times his base salary (2003 salary: $331,396), or roughly 27,600 shares. Adamovich currently holds 6,698 shares of common.

- **Eric Krasnoff (52)** – Chairman, CEO. On April 13th Krasnoff executed his largest-ever sale since assuming his position in 1994, disposing of 120,000 shares at roughly $24. The disposition, which **monetized 27% of his holdings**, was larger than the total number of shares he sold between 1997 and 2003. After the sale, Krasnoff holds 44,366 shares of common stock, which is well short of the 80,000 shares he is required to hold under the Company's ownership targets.

- **Edwin Martin (73)** – Director. Though Martin's term is not set to expire until 2005, he began reducing his holdings recently through his June 4th to June 28th activity, which included sales totaling 8,000 shares, **equal to 44% of his position**. Since joining the board in 1993, Martin's only prior selling came in September and December 1998 when he sold 28,000 at prices close to current levels.

- **Gregory Scheessele (43)** – Senior V.P., Manufacturing. Scheessele exercised two series of options to acquire 13,250 shares on June 30th. Considering he doesn't hold any common stock and should be building a position to comply with the guidelines, we would expect him to hold some or all of the shares. Instead, he sold all the shares he acquired at $26. Though he does have plenty of time to meet his target ownership level, Scheessele's behavior further reinforces our belief that executives are in no hurry to comply with the Company's ownership policies.

Governance; Changes to incentive comp plans heavily favor executives

In our first Pall report, we covered the fact that the company's incentive plans are designed to give its top executives plenty of latitude to insure full attainment of their incentive bonuses. These bonuses are based on R.O.E. targets that have been data-mined in favor of the insiders. This was accomplished by using a definition of "Net Earnings", for the R.O.E. calculation, that would exclude charges related to FX rates, restructuring or acquisitions, or other extraordinary items. The beauty of the definition, at least from the standpoint of company insiders, is that while it excluded charges it did not exclude special gains. But there was more. As described in our February report, Pall annually lowered the bar for its target R.O.E. levels, even ***after*** the slick definitional change went into effect.

The rewards keep getting bigger while the bar keeps coming down. Pall doesn't broadcast the fact that, in instituting its 2004 Executive Incentive Bonus Plan, it, once again, significantly tipped the scales in management's favor with regards to their ability to achieve raised bonus targets. Prior to the new deal, executive incentive bonuses were capped at the lesser of $1 million or 100% of the executive's base salary for the year. In the new deal, the bonus cap has been raised to the lesser of $2 million or 150% of base salary.

But, true to form, not only has Pall management seen to it that it has a bigger brass ring to grab but it has also seen to it that, in the case of an impending miss, discretionary adjustments can be made to change targets, mid-stream. This was done by inserting a complex formula for an "Intermediate R.O.E. Target" that could be attained if the target for "Maximum R.O.E. Target" is not attained (bolding is ours for emphasis):

> At the time it establishes the Minimum and Maximum R.O.E. Targets for any Fiscal Year beginning on or after August 3, 2003, the Committee may also (A) establish one or more R.O.E. targets (each, an "Intermediate R.O.E. Target") for such year that are greater than the Minimum R.O.E. Target but less than the Maximum R.O.E. Target for such year, and

> (B) **determine the Performance Percentage that will apply if the Return on Equity exceeds the Minimum R.O.E. Target, or equals any of the Intermediate R.O.E. Targets** established for such year. If one or more Intermediate R.O.E. Targets are established for any such Fiscal Year and the Return on Equity for such year exceeds the Minimum R.O.E Target or any Intermediate R.O.E Target established for the year (the "Achieved Target") but is less than the next highest Intermediate R.O.E Target established for the year (the "Next Highest Target"), the Performance Percentage for such year shall be equal to the Performance Percentage that would apply if the Return on Equity were equal to the Achieved Target, plus the percentage resulting from multiplying (1) the excess of the Performance Percentage that would apply if the Return on Equity were equal to the Next Highest Target, over the Performance Percentage that would apply if the Return on Equity were equal to the Achieved Target, by (2) the percentage resulting from dividing (x) the excess of the Return on Equity over the Achieved Target, by (y) the excess of the Next Highest Target over the Achieved Target. If the Return on Equity for the year exceeds the highest Intermediate R.O.E. Target for the year but is less than the Maximum R.O.E. Target for the year, the Performance Percentage for the year shall be determined in the manner described in the preceding sentence but for this purpose, the Maximum R.O.E. Target for the year shall be treated as the Next Highest Target for the year.[1]

The above calculation seems to be a case of the Compensation Committee (of which Pall's largest shareholder is a member) allowing management to be able to pay out incentive compensation at its discretion. If the creation of "Intermediate R.O.E. Targets" was not enough, the fact that, in sentence B (above), the Committee can "determine the Performance Percentage that will apply" suggests they virtually have carte blanche to not only change the targets, but they can possibly set performance percentages after the fact once they see how things are going.

Accounting: Recent sales growth aided by favorable currency translations

With about 70% of its sales coming from Asia and Europe, Pall has found most of its recent sales growth coming from currency gains. Through the first nine months of F/Y 2004, foreign currency gains were responsible for 8% of the reported 11% sales growth for the period. This heavy dependency on foreign sales also inured to Pall's benefit as it carried a 28% effective tax rate in 2003, and it was even lower in Q3 of 2004 at 24%.

Accounting: Interesting obfuscation with respect to earnings guidance

An interesting dialogue appeared in Pall's Q3 conference call. In it, questions were raised about Q4. When asked about what he felt about Pall's $1.25 to $1.40 EPS guidance, without indicating that the upper end of the range had been lowered, CEO Krasnoff hinted that the midpoint of the range would be safe ground and that it would take a "big quarter" in Q4 (just two months away) to achieve this:

Analyst:
"Hey, guys. Maybe two more months in the fiscal year here, and I know you don't give quarterly guidance, but I guess this time you kind of have to because you give annual

[1] Pall Corp. SEC Form 10-Q for the period ended 4/30/2004, Exhibit 10

guidance. And it seems quite a wide range for, you know, whether your last communiqué was 125 to 140. So is it safe to say we can narrow that now somewhat? Would you suggest that maybe the 140 is unrealistic at this point? You know, any guidance would be great."

Eric Krasnoff, Pall Corp. Chairman, CEO:
"Sure. The range we provide at the beginning of year I think has proved to be sturdy and durable. We would have corrected that guidance if we felt we were on one of the ends of it. So if you look towards the midpoint of the range that we set out at the beginning of year, I think you're on very safe ground."

Analyst:
"That would imply, I guess, a fourth quarter up more sequentially in year-over-year than you are used to. So can you quantify a couple of things, the consulting fees and absence of cost, is that more than a penny? Is there high visibility or is this just hoping, Eric, that's what I am trying to get to."

Krasnoff:
"No, we have good visibility. You heard from Don on the Industrial businesses and that covered 60% of Pall is up quite nicely and it shows you what we expect on the pharmaceutical side. So we expect to have what you're calling a big quarter, yes."

Making this matter more interesting was a follow-up line of questioning, during the conference call, where management had to be wrestled with before clarifying whether the guidance was pro forma or not:

Analyst:
"Okay. And my final question: If you can just remind me, your guidance for $1.25 to $1.40 for the full year, is that pro forma?"

Krasnoff:
"No."

John Adamovich, Pall Corporation CFO:
"No."

Krasnoff:
"No. That's as reported."

Adamovich:
"When you say "pro forma" do you mean, just to clarify, do you mean excluding any restructures and one-time charges?"

***Analyst*:**
"That excludes charges."

Adamovich:
"Yes, it would."

***Analyst*:**
"That excludes charges?"

Adamovich:
"Yes."

Accounting: Curious treatment of V.I. Technologies investment

We have been finding Pall's handling of its 6.1 million-share position in V.I Technologies (VITEX) interesting. Back in 2002, Pall had written off $14.5 million ($.12 per share) of this investment to impairment. As of 10/31/2003, this investment was recorded on the books at a fair value of $2.09 per share, this in spite of the fact that certain members of VITEX management had entered into agreements to sell 3.7 million of their shares at prices less than $1 each.

As of 4/30/2004, Pall carried its VITEX investment on the books at a reduced fair market value of $1.27 per share. The company apparently staved off further impairment charges by no doubt convincing its auditors that previous volatility in VITEX shares had declined due to the company's successful cash raising efforts via a common stock sale. Yet, in spite of the alleged newfound stability in VITEX shares, in a thinly disclosed phrase, Pall disclosed (in its 10-Q) that it had sold 225,000 of its VITEX shares during the quarter at a loss of $161,000.

Certainly, the loss is immaterial but we are curious that it seems that Pall is not sure what to do yet with its VITEX investment. It has gone from recording impairment charges in the income statement to recording unrealized gains and losses in Other Consolidated Income and now has quietly sold some shares at a loss. What seems clear is that the VITEX prospects have been disappointing and it is unlikely that real benefit to future sales and prospects will come from this investment.