3D ADVISORS

This 3DAdvisors Report Covers:

- ✓ **Insider Trading**: Insider Trading Behavior
- ✓ **Accounting**: Quality of Earnings Issues
- ✓ **Governance:** Corporate Governance Issues

Many Small Items Add Up to Big Behavioral Concerns
Pall Corporation (NYSE:PLL)

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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

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- **Governance:** Executive compensation appears excessive in other areas
- **Governance:** PLL benefit protection trust looks odd – and expensive
- **Insider Trading:** Selling at all-time highs, plus lots of option "skimming"
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Discussion of 3DAdvisors Findings

As observers of corporate behavior, we have seldom seen a company with as many interesting details as Pall Corporation displays. In the post-Sarbanes-Oxley era, we find it fascinating that Pall management consistently challenges the spirit of so many of the regulations put in place to stem the type of corporate malfeasance committed by Enron and others. The associated behaviors that we have observed at PLL are many and cover the entire spectrum of our 3D philosophy. For sure, a number of the actions we have uncovered seem small when viewed in isolation. The sheer number of them, however, both large and small, reveals a consensus of action that speaks much louder, in aggregate, than any single piece. It is clear to us that much of Pall's strategy and associated decision-making process is significantly compromised by management's personal motivations.

Governance: Executive compensation plans remind us of the pre-Enron days

A glance at the evolution of Pall's Performance Bonus computations, over the past five years, is both worthwhile and revealing. On the surface, the Company gauges top management's Performance Compensation based on Return on Equity targets. Fair enough, or so it would seem. Digging deeper, however, reveals that the ROE calculation is subject to quite thorough data mining before being used to estimate target levels. Pall uses the term "Net Earnings" to describe the numerator to be used in the calculation (average Shareholders' Equity the denominator). The components of "Net Earnings" however, used for comp-based ROE calculations have been significantly altered from the Net Earnings appearing on the Income Statement. Take a look at the description:

> "Net Earnings" shall mean, for any Fiscal Year, the after-tax consolidated net earnings of the Corporation and its subsidiaries as certified by the Corporation's independent accountants for inclusion in the annual report to shareholders ("Annual Report"), adjusted so as to eliminate the effects of any decreases in or charges to earnings for (a) the effect of foreign currency exchange rates, (b) any acquisitions, divestitures, discontinuance of business operations, restructuring or any other special charges, (c) the cumulative effect of any accounting changes, and (d) any "extraordinary items" as determined under generally accepted accounting principles, to the extent such decreases or charges referred to in clauses (a) through (d) are separately disclosed in the Corporation's Annual Report for the year.[1]

The above language was adopted in 2001 upon the renewal of the employment agreements with key Pall executives. Interestingly enough, these exclusions (from the ROE calculations) did not exist in the previous versions (circa 1997) of the Pall executive contracts. In those earlier versions, ROE was calculated using after-tax consolidated net earnings (sans exclusions). In addition, Pall management has been successful in lowering the target ROE levels as well, and significantly to boot. In the earlier version of the Performance Compensation plan, the ROE targets ranged between 12.5% (less than that, no performance bonus) and 19% (100% of the performance bonus). The current versions have much lower bars, just 10% to 15%, and this without including special charges, etc. Making this matter even more intriguing is the fact that the current language, which allows for the exclusion of the many charges, does not exclude special gains. In other words, if there are one-time gains (currency gains, asset sales, etc.), they are included in the ROE calculation, while charges are excluded. Currency Gains, for example, provided a very positive impact on sales in F/Y 2003, as exchange rates boosted sales in excess of $97 million (7.5%) as a result of the strength in the Euro.

This stacking of the deck had an important effect to certain key Pall executives in F/Y 2003. Eric Krasnoff (CEO and Chairman), for instance, received a $1 million bonus

[1] Pall Corporation SEC Form 10-Q for the quarter ended 1/26/02, Exhibit 10.1.

on top of his salary of $700,000. During the period, Pall had recognized restructuring charges of $47.5 million. Excluding these charges from the ROE calculation made the difference between full payment of Krasnoff's Performance Bonus and a much smaller payout, which, according to our calculations, would have been reduced by about 66%.

It may be worth noting that while the restructuring charge was separately disclosed in the income statement, giving it a claim to legitimacy under item (d) in the above passage from the Pall 10-Q, the charge, having appeared as an operating charge in the income statement, apparently did not qualify for treatment as an "extraordinary item" under the provisions of GAAP, which would seem to question that legitimacy under the same item (d) above.

Pall explains the changes in the bonus calculation by pointing out that they are getting around the IRS $1 million maximum compensation level whereby payouts exceeding that amount are not deductible. Performance Based compensation, Pall goes on to explain, is exempt from the $1 million limitation. To us, it is clear that, with Pall's ability to move the ROE targets (they have been coming down in each of the last three years), not to mention the exclusions mentioned above, the envelope is being pushed with regards to performance criteria for incentive compensation purposes.

Another area where Pall challenges the spirit of certain regulations: The Internal Revenue Code states that, among other things, these types of performance goals must be determined by a compensation committee compromised solely of two or more outside directors. The problem is that one of the members of the compensation committee is founder-director and largest stockholder, **Abraham Appel**. Technically an outside director, it would seem that Appel has a great deal more personal interest in Pall than the typical "independent director" as envisioned by Sarbanes-Oxley.

Governance: Executive compensation appears excessive in other areas

Several other aspects of the employment agreements of both CEO **Eric Krasnoff (49)** and President **Jeremy Hayward-Surry (58)** caught our attention. There are absolutely no provisions in either contract to cover 'termination for cause". The agreements read so that, in the event of termination, by either party, the executive is entitled to every benefit, including accelerated vesting of all option positions, no matter the reason for the termination.

What's more, Krasnoff's contract automatically renews each year and does not terminate until he reaches the age of 65. Hayward-Surry's reads the same way. We have seen many employment contracts over the years yet never have come across one without "termination for cause" clearly spelled out. We suppose that the perpetual nature of these contracts and absence of "for cause" termination provisions is not a first, but the fact certainly adds to the self-serving nature of management agreements with the Company.

In addition to the above, we also note that cost of living index provisions apply to these executive agreements even in the event of salary increases.

Governance: PLL benefit protection trust seems odd – and expensive

Pall has established a Benefits Protection Trust to which it makes voluntary contributions. The purpose is to fund the Company's obligations under its Supplementary Pension Plan and Supplementary Profit-Sharing Plan as well as the Company's obligation to pay the Annual Contract Pension provided for under the employment agreements of both Krasnoff and Hayward-Surry. In the event of a change of control of the Company, the trust fund must be used to satisfy the above obligations. As of Y/E 2003, the Trust was funded to the tune of $32.3 million.

Rabbi Trusts, which are generally used to cover change of control contingencies, are typically not funded. If the obligations were just shown as liabilities on the balance sheet or in a Rabbi Trust, no such protection would be offered. We find this interesting and wonder what drives the need for the extra protection that the Pall trust provides?

So it would appear that possible future compensation and benefits payments to the top few officials are being well funded by cash payments into to a trust, although it is likely that no current tax benefit of such payments is available to the Company and the future benefits can only be gotten if certain deferred tax assets can be recovered in the future.

Insider Trading: Selling at all-time highs, plus lots of options "skimming"

Over the years, we have been accustomed to insider accumulation at Pall, not distribution. The Company maintains employee stock ownership guidelines and, in the pre-Sarbanes-Oxley era, was regularly loaning, interest-free, to insiders for their stock purchases. In fact, as of October 2003, loans were still outstanding, to five insiders, totaling $730,000 (this disclosure only itemized loans greater than $60,000 outstanding, so we must assume more exist).

The first surge of executive sales on Pall Corporation caught our eye last June. The selling seemed to go against the "insider accumulation culture" cultivated by the Company over the years. The shares had just spiked up from their $20 trading range and we had noted that a number of the sellers had unloaded their highest-ever amounts. More importantly, a number of them had been skimming for small profits that is exercising options and selling the underlying shares for small profits when the options were not close to being in danger of expiration. Further intriguing us at the time was the fact that the sales were by lower ranking insiders, not the likes of CEO Krasnoff or President Hayward-Surry.

As Pall shares rallied to new highs late last year, and into January, the same insiders surfaced again, this time selling far more than they did last June. Though the numbers do not look large on the surface, further inspection reveals that they are very large for the insiders involved. The same option skimming that was evident in June appeared again in the recent round.

- **Neil Macdonald (53)** – Group V.P. Exercised options for 18,750 shares at $22.72, selling the shares for $25.50 each, netting him less than $3.00 per share before taxes. The options were not expiring until May of 2005. He cleared out of his entire holdings of these long-vested options. The sale was his largest-ever.

- **Lisa Kobarg (age not disclosed)** – Controller. Exercised options for 7,425 shares in December and sold them for $25.61. Of the total, 5,500 of the options were exercised between $22.09 and $23.51. Only 2,500 of the options were set to expire in December of 2004 with the rest doing so between 2011 and 2012. These were her largest-ever sales.

- **Riichi Inoue (55)** – Senior V.P. Exercised options for 27,125 shares and sold the underlying shares for $26 each. Of the total, 12,500 of them were exercised at $23.78 and were not expiring until 2011; 5,000 were exercised at $22.09 (expiring 2011 and the remainder exercised at $16.13 (expiring 2012). These were his largest-ever sales.

- **Reed Sarver (44)** – Senior V.P. Exercised options for 17,500 shares, selling them for between $26 and $27 each. Of these options, 12,500 were exercisable between $22.09 and $21.865 and were not expiring until at least 2011. Interesting is the fact that, in the past, we have noted that Sarver has waited for expiration before cashing out. This is the first time we have seen him cash in so many options with so much time remaining until expiration. These were his largest-ever sales.

- **John Adamovich (50)** – Treasurer and CFO. Adamovich exercised options for 12,375 shares and sold 16,375 for prices around $26. Though he was not skimming like the others (his options were exercised at $16.13), his options were not set to expire until 2012. The sale amounted to 37% of his actionable holdings.

The list goes on with Senior V.P. **Charles Grimm (63)** selling 35,000 shares, COO **Donald Stevens (58)**, selling 35,000 shares, Senior V.P. **Gregory Scheessle (43)** selling 11,125 shares, and **Hensen Heinz Ulrich (51)** selling 7,000 shares. All of these were the largest sales we have on record for each insider.

Pall is quite tight with regards to certain disclosures. For instance, it does not disclose biographies of officers, choosing instead just to list them, along with their ages and a generic “Senior (or Group) Vice President” title. The Company provides little other detail about these officers. Although this makes things more difficult for us to analyze, the collective actions of these Executive Officers speak louder than the actions of just one.

<u>Accounting: Pension fund selling is consistent with insider behavior</u>

Pall’s under funded Pension recorded a relatively large Minimum Pension Liability of $33 million in F/Y 2003. Though the Company did not make large cash contributions to the Pension Fund during the year, Pall did deliver about 255,000 shares to the fund. The fund immediately registered the shares for sale in November. The registration statement covering the shares indicates that the Company does not intend to own any shares after these are sold.

Over the years, we have become accustomed to seeing various pension funds selling shares of their related company stock. These are usually companies that typically hold company shares and, when selling some, are doing so to meet pension obligations. In the Pall case, however, the game seems different. The fact that the Pension has no plans to hold the shares (or any shares, for that matter) tells us that the Company believes that the maximum funding benefit can be gotten by selling the stock rather than holding it with the expectation of its increasing value. The latter is the practice, in most cases, where a company contributes its own stock to a pension plan.

Accounting: "Percentage of completion" accounting thinly disclosed

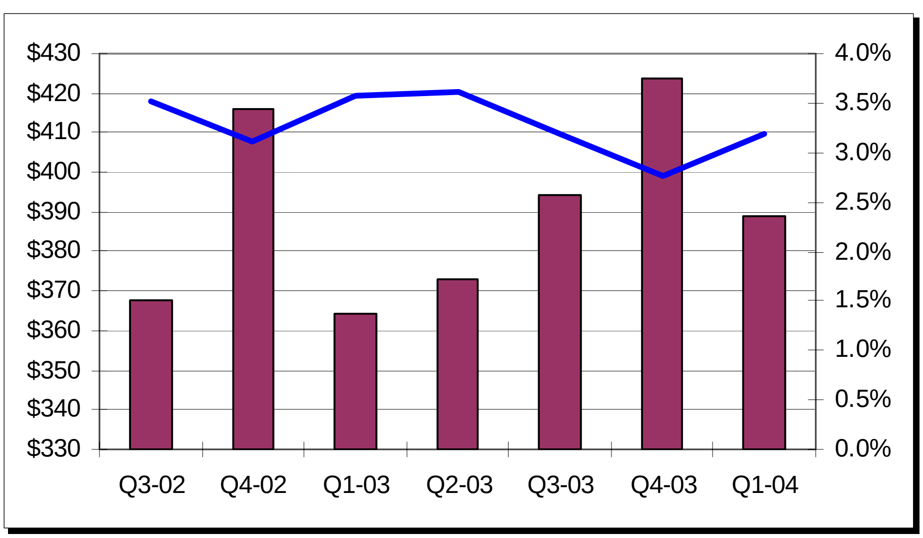
Pall discloses that "Long-Term contracts are accounted for under the percentage of completion method based upon the ratio of costs incurred to date compared with estimated total costs to complete them. The cumulative impact of revisions to total estimated costs is reflected in the period of the change, including anticipated losses. Such revisions could result in a material adjustment in the period of the change."

There is no disclosure of the magnitude of any exposure. Nor does disclosure exist of the amount of related unbilled receivables.

Accounting: Movement in A/R allowance has a timing feel to it

In the fourth quarter of both 2002 and 2003, the Company significantly dropped its allowance for doubtful accounts as a percentage of gross accounts receivable. The fact that receivables increased substantially while the allowance for doubtful accounts decrease substantially had an obvious impact on the bottom line, just in time for year-end. In fact, while gross A/Rs increased to a record $423.6 million in Q4 of 2003, the allowance for doubtful accounts declined to just $11.7 million (2.76%). We note that in Q1 of 2004, the reverse occurs: A/Rs *drop* by 8% to $389.0 million, while allowance for doubtful accounts *increases* to $12.4 million (3.19%).

Figure 1. Gross Accounts Receivable (red bars and left hand scale, millions $) and Allowance for Doubtful Accounts as a Percentage of Gross A/Rs (blue line and right hand scale, percentage). Source: PLL SEC Filings.



Accounting: Cash flow looks OK on paper, but…

With 61% of Pall's revenues coming from overseas operations, the Company has $400 million in expatriated earnings where no taxes have been paid as they will remain permanently invested offshore. What's unusual about the situation is that the Company briefly discloses, in its 2003 10K, that it has brought some earnings back in to the U.S. recently. "We utilized our cash flow from operations as well as a tax-efficient transfer of overseas cash to achieve this reduction ($169,590) in total debt".

Granted, the repatriation of the undisclosed amount of foreign earnings may have been advantageous at the time. The fact that they chose the course of repatriation, with the potential attendant IRS scrutiny, as opposed to other funding options seems interesting, especially given the fact that the Company also reduced its dividend so dramatically in 2003 (a 40% reduction), a period when U.S. corporations have been increasing their dividends, not cutting them. In fact, Pall has reduced its dividend in each of the two years since the U.S. Filter acquisition. Overall, a 54% reduction for the two-year period.

To this we would reiterate that, as opposed to funding the Pension with cash, the Company chose to do so with Pall Corporation stock.

Accounting: Interesting impairment timing

Pall owns 13.4% (6.2 million shares) of V.I Technologies (VITX), a publicly traded company. VITX shares have not only dropped significantly in the past few years, they have been volatile of late. The timing of VITX related impairment write-offs have been somewhat curious. After a significant ($14.5 million, or $.12 per share) write-down of the asset in Q4 of 2002, Pall continues to carry the 6.2 million VITX shares on its books at $2.09 each. This in spite of the fact that certain members of VITX management disclosed, in Q1 of 2004 (Pall's Y/E is August 2) that they had entered into agreements to sell 3.7 million shares for $3.4 million (less than $1 per share). It would seem that further impairment charges related to the VITX shares could be in order.