SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT

TO THE HONORABLE UNITED STATES DISTRICT COURT JUDGE:

Lead Plaintiffs, David Harkness and Cai Yao Chen, individually and on behalf of all others similarly situated, by their attorneys, make the following allegations for their Second Amended Consolidated Class Action Complaint. These allegations are based on Lead Plaintiffs’ personal knowledge as to themselves and their purchases of Dynacq Healthcare, Inc. ("Dynacq" or the "Company") securities, and on information and belief derived from investigations of their counsel. The investigation of counsel included review of public filings by Dynacq with the United States Securities and Exchange Commission ("SEC"), press releases and other public statements issued or made by the Company and its officers, media reports about the Company, reports by securities analysts about the Company, surveys and orders issued by the Texas
Department of Health, other litigation involving Dynacq, and interviews with persons having knowledge about the Company’s activities during the relevant time period where indicated. Lead Plaintiffs believe that further evidentiary support will exist for the allegations after a reasonable opportunity for discovery. Many of the facts supporting the allegations contained herein are known only to defendants and are within their exclusive control.

**NATURE OF THE ACTION**

1. Lead Plaintiffs bring this action as a class action on behalf of themselves and all persons who purchased or otherwise acquired Dynacq securities, other than defendants and certain related persons and entities, during the period November 27, 2002 through December 19, 2003, inclusive (the “Class” and “Class Period,” respectively), to recover damages suffered by the Class as a result of defendants’ violations of the federal securities laws.

2. Dynacq is in the surgical specialty hospital business. According to the Company’s 2002 fiscal year Form 10-K, the Company’s strategy is to develop and operate hospitals focusing on certain surgical specialties, including, orthopedic surgery, neurosurgery, and general surgery. The Company’s surgical hospitals include operating rooms, pre- and post-operative space, intensive care units, nursing units, and diagnostic facilities.

3. As admitted by the Company in its 2002 fiscal year Form 10-K, the Company’s revenue recognition policy “is significant because it is the primary component of its results of operations.” Dynacq’s revenue recognition policy provides, “[r]evenue from patient services is recognized as performed based on net realizable amounts from patients, third party payors, and others for services rendered under reimbursement agreements. Allowances for discounts on services or adjustments for non-covered costs and expenses are recognized in the period in which the related revenues are provided.” The Company reports revenue on its financial statements, specifically its income statement, as “net patient service revenue.”
4. Between fiscal years 1999 and 2002, Dynacq's reported net patient service revenue grew 400%. In fiscal year 1999, the Company reported $16.2 million in net patient service revenue; in fiscal year 2000 $26 million; in fiscal year 2001 $43.8 million; and in fiscal year 2002 $64.8 million. Dynacq ends its fiscal year on August 31 and each of its interim reporting periods on November 30 (first quarter), February 28 (second quarter) and May 31 (third quarter). During this same four year time frame, the Company's reported diluted earnings per share increased from $0.19 (fiscal year 1999) to $1.03 (fiscal year 2002). In fact, in 2002, Forbes ranked Dynacq as No. 2 on its list of Best Small Companies. That same year, Fortune ranked the Company No. 2 on its list of fastest growing companies.

5. By the end of the third quarter of fiscal year 2003, the Company appeared to be on its way to another record-breaking year. According to the Company's Form 10-Q for the third quarter ending May 31, 2003, the Company had already recognized $64.7 million in net patient service revenue, compared to $48.3 million in reported net patient service revenue for the nine months ended May 31, 2002, an increase of $16.4 million. Unbeknownst to investors, however, the Company’s Form 10-Q for the third quarter of fiscal year 2003, filed with the SEC on July 14, 2003, would be the last publicly filed financial statement issued by the Company for more than a year, until July 31, 2004, when Dynacq finally filed its Form 10-K for fiscal 2003, which included restatements of its results for fiscal years 1999 through 2002. The Company's apparently rapid growth in fiscal years 2001 and 2002 was pure fiction, attributable to a massive accounting fraud engineered by the Company's senior management. The Company's fiscal year 2003 results through May 31, 2003, are equally a mirage. As the investing marketplace now knows, the Company's financial statements, and public statements about its financial performance issued during the Class Period, lacked any basis in reality because the Company
lacked the internal controls necessary to develop reliable financial statements, in large part due to a pervasively fraudulent business environment fostered by senior management. In fact, the Company, its senior management, and its outside auditors were well aware of the lack of internal controls due to the filing of a derivative law suit in March 2002, which specifically alleged that Dynacq failed to “implement and maintain an adequate internal control system,” as revealed in the Company’s own fiscal year 2002 Form 10-K. Moreover, the Company’s failure to maintain an adequate system of internal controls resulted in Dynacq’s inability to file its 2003 fiscal year and all subsequent financial statements with the SEC in a timely fashion, an inquiry by the SEC, the Company’s stock being delisted from the NASDAQ, and Dynacq’s outside auditor, Ernst & Young, LLP’s (“E&Y”) resignation as the Company’s independent auditor.

6. E&Y is equally at fault for the losses suffered by the Class. E&Y rendered an unqualified opinion on Dynacq’s original fiscal year 2002 financial statements, which unqualified opinion was false and misleading. Moreover, E&Y never withdrew its opinion (although the Company did later put investors on notice that its 2002 financials were unreliable). E&Y knew or was severely reckless in not knowing that Dynacq’s financial statements lacked a reasonable basis as a result of E&Y having been put on notice of the deficiency in Dynacq’s internal controls by the derivative suit filed against Dynacq in March 2002 and the fact that E&Y had themselves been paid $135,700 in non-audit consulting fees during that same period, which, \textit{inter alia}, raises serious questions regarding E&Y’s independence.\footnote{E&Y has a history of difficulties related to independence issues. E&Y’s auditor independence, and the resulting audit opinions thereon, have been called into question on a number of occasions. In fact, the SEC, in an administrative proceeding (File No. 3-10933) issued on April 16, 2004, found that “[t]he evidence demonstrates that it is necessary to order EY to cease and desist in order to protect public investors and the capital markets. Based on my observation of the witnesses and my review of record, I conclude that EY will likely commit future violations absent an explicit directive to cease and desist . . . In addition, the evidence shows that EY has an utter disdain for the Commission’s rules and regulations on auditor independence.” Moreover, the SEC ordered that E&Y:} Not coincidentally, E&Y was the fourth auditor to work for Dynacq since 1995.
7. The defendants' shenanigans involved in part the fraudulent recognition of revenue allegedly earned at the Company's flagship operation, the 37-bed acute care Vista Hospital in Pasedena, Texas. With an average per patient hospital bill of $50,000, Vista Hospital accounted for approximately 90% of Dynacq’s reported revenues during fiscal year 2002 and the first nine months of 2003. However, Dynacq’s public filings, and the public statements of defendants, failed to disclose that the Company had been reporting as “net patient revenue” an overstated portion of the amount that Vista Hospital billed to workers’ compensation insurance carriers, even though the carriers were paying on average only a small fraction of the billed amount pursuant to applicable regulations of the Texas Workers’ Compensation Commission.

8. As shown herein, carriers were refusing to pay the amounts billed because Dynacq applied the “stop loss” exception under worker’s compensation laws as a rule, rather than as an exception. In addition, Vista itself admitted in litigation filed in November 2002 that some carriers had refused to pay bills after reports (that Vista claimed were false) surfaced concerning substandard care and the performance of unnecessary surgeries by Vista’s doctors, including key surgeon, Dr. Eric Scheffey (“Scheffey”), who has a history of suspensions by the Texas State Board of Medical Examiners (“TSBME”) for overbilling and performing
unnecessary surgeries, as discussed further herein. Indeed, there is an ongoing investigation of Dynacq by the Texas Worker’s Compensation Commission (“TWCC”).

9. Even worse, a former employee of the Company in the collections department of Vista Healthcare from November 2000 to January 2002 related that Dynacq engaged in extensive and egregious fraudulent claims submissions practices to government entities and private insurance carriers. The former employee stated that she and many other collectors were instructed to falsify claims submissions in order that the Company receive payment for otherwise non-covered services. Moreover, she stated that the Company regularly submitted claims for services that it did not provide. These practices often entailed changing the medical reasons supplied for certain procedures, without the knowledge of the doctors who had made the diagnosis and performed the procedures or ordered the services in question.

10. As a result of Dynacq’s overstatement of net patient revenue and through other accounting manipulations discussed herein, Defendants materially misrepresented Dynacq’s financial results for at least 2002 and 2003.

11. On September 15, 2003, Barron’s published an article reporting that Dynacq may be improperly recognizing revenue and that Scheffey’s license had been suspended again, this time in August of 2003. The very next day, Dynacq moved quickly to dispel the article’s accusations and to neutralize its effect. On September 16, 2003, the Company issued a news release in which it falsely stated that the underpayments by Texas Mutual (a worker’s compensation carrier that Vista had sued for nonpayment) had “long since been fully accounted for.” Defendants also continued to conceal that the Company lacked internal controls necessary to develop reliable financial statements and that the Company had failed to put into place disclosure controls, accounting controls and controls over the safeguarding of assets. Defendants
also concealed their accounting manipulations relating to cost recognition issues and the Company’s allowance for doubtful accounts, all of which ultimately became the subject of an SEC inquiry at the end of the Class Period.

12. Not only was the Company purposefully employing improper accounting manipulations to make its business look strong, the Company also misled the market about the level of care given at its hospitals, another key determinant of the Company’s financial success. As admitted by the Company in its fiscal year 2002 Form 10-K, the business of the Company could be adversely affected if its surgeons did not maintain the quality of medical care or did not follow required professional guidelines at the Company’s facilities, or if there was damage to the reputation of a key surgeon. Indeed, throughout the Class Period, Dynacq continuously represented to the investing public its “high quality healthcare services and facilities.” However, as a series of investigations and reports have uncovered, Dynacq’s hospitals are a disaster. To take just a few examples, the Houston Chronicle reported in February 2004 that a man who underwent surgery at one of Dynacq’s hospitals in 2002 suffered from brain damage and eventually died because no one could be found in the hospital to administer CPR. Additionally, as noted above, the license of Dr. Scheffey, who in 1986 had been put on a 10 year probation for abusing cocaine, was suspended in August 2003 by the TSBME because Scheffey constituted a “real and present danger” to the health of his patients. The Company initially brushed off the event as inconsequential to its business, but then admitted in December 2003 that it drastically affected business at its main hospital (Vista Medical Center in Pasadena, Texas). Scheffey, Defendant Baxter finally admitted, was a “prolific surgeon.” Scheffey, who had accounted for over 20% of Vista’s business, had been the frequent subject of discipline by the TSBME before his latest suspension, a fact that Defendants were aware of throughout the Class Period.
Moreover, as shown herein, Scheffey was so important to Vista and Dynacq that Dynacq’s CEO, Defendant Chiu Chan, knowingly allowed Scheffey to continue practicing medicine at Vista after Scheffey’s license was suspended. Moreover, in recent disclosures the Company revealed that between August 2003 and May 2004, Vista lost six of its key physicians (presumably including Scheffey) that accounted for 54% of the Company’s gross revenues for fiscal 2003.

13. During the weeks following the September 15, 2003 Barron’s article and the Company’s September 16, 2003 press release denying its allegations and minimizing the effect of Scheffey’s suspension, a string of developments belied the Company’s bullish statements regarding its financial performance and prospects. On December 2, 2003, Dynacq announced that it was requesting an automatic extension of up to 15 days to file its Form 10-K with the SEC for the fiscal year ended August 31, 2003. The Company stated that it was delaying the filing of the 2003 10-K and the release of its financial statements for the fiscal year 2003 until the SEC had completed a review of the Company’s periodic filings. The market reacted negatively to this news; Dynacq’s common stock closed at $15.94 per share on that day, approximately 12% below the previous day’s closing price of $18.05 per share.

14. On December 18, 2003, the Company announced that E&Y, which had been the Company’s independent auditor since mid-2002, had resigned, effective December 17, 2003, and that E&Y had advised the Company that its resignation was due to the Company’s “lack of internal controls necessary to develop reliable financial statements,” despite the fact that E&Y had issued a “clean” audit opinion for the Company’s fiscal year 2002 Form 10-K based on the same or worse controls, and had received $137,500 in non-audit consulting fees during the same period. The Company also announced that it was still unable to file its fiscal year 2003 Form 10-K. Dynacq blamed its inability to file a Form 10-K on E&Y’s resignation and failed to
provide a date certain for the filing. Instead it stated that it planned to file the Form 10-K “as soon as practicable” after a new auditor was retained and had completed “the audit of the Company’s financial statements for the fiscal year ended August 31, 2003, and after the SEC had completed its review of the Company’s periodic reports.”

15. On December 19, 2003, the Company announced that it had received a NASDAQ Staff Determination stating that because Dynacq had failed to comply with NASD Marketplace Rule 4310(c)(14) by its failure to file its fiscal year 2003 10-K in a timely manner, Dynacq common stock would be delisted from the NASDAQ on December 30, 2003, unless Dynacq requested a hearing before the NASDAQ Listings Qualification Panel, which the Company did.

16. Later that same day, the Company announced that it had received a notice from the SEC office in Fort Worth, Texas that the SEC was conducting an investigation into Dynacq’s reporting of its financial statements, revenue and cost recognition, allowances for doubtful accounts, and internal financial and accounting controls. Previously the Company had announced that the SEC’s division of corporate finance was commenting on its filings. The SEC’s Fort Worth office handles enforcement proceedings unlike the division of corporate finance, an article in the Houston Chronicle the next day noted. The Company is also the target of a probe by the Texas Attorney General into the way it solicits patients.

17. News of E&Y’s resignation, the SEC investigation, and the Company’s potential delisting drove the price of Dynacq shares even lower. On December 18, 2003, the day of the announcement of E&Y’s resignation, Dynacq’s common stock price fell approximately 11.5% from a high of $10.00 per share to close at $8.95 per share on extraordinarily high trading volume. On the following day, when Dynacq revealed the SEC’s Forth Worth office was
involved, Dynacq's share price continued to plummet, reaching a low of just $4.09 per share, again on extraordinarily high trading volume. During the Class Period, shares of Dynacq common stock traded as high as the artificially inflated price of $27.37 per share.

18. Finally, and no surprise to the marketplace based on the December 2003 revelations, the Company announced on April 6, 2004, that it would restate its financial statements for fiscal years ended 2001 and 2002. The Company announced that this restatement was necessary to “(i) reclassify certain accounts receivable to long-term status ... and (ii) correct an error in the application of an accounting principle related to the income tax effect of the exercise of stock options ...”

19. The Company’s stock was eventually delisted from the NASDAQ National Market on April 16, 2004. As a condition of NASDAQ’s potential reconsideration of Dynacq’s listing status, the Company was required to file a restatement of its 2001 and 2002 financials, as well as bring its other filing obligations current, by June 16, 2004. The Company failed to meet this deadline.

20. As Dynacq’s failure to file its financial statements in time to be eligible for reslisting shows, the financial statements that have been publicly filed during the Class Period were materially false and misleading in violation of Generally Accepted Accounting Principles ("GAAP") and portrayed an inaccurate picture of Dynacq’s financial performance.

21. Dynacq was finally able to file its Form 10-K for fiscal 2003 on July 31, 2004, including restatements for fiscal years 1999-2002. The restatements for fiscal years 2001 and 2002 included reductions in net income of $3.3 million and $0.61 million, respectively, due primarily to adjustments for the expensing of stock options issued to non-employees and the related income tax effects. The Company filed its Form 10-Q’s for the fiscal quarters ended
November 30, 2003, February 29, 2004, and May 31, 2004 on August 31, 2004. Not surprisingly (given the expected effect of the revelations about Vista’s doctors and the shoddy medicine being practiced there), for the nine months ended May 31, 2004, the Company reported net revenues of approximately $47.9 million and net income of approximately $1.1 million, compared to reported revenue of $64.7 million and net income of $15.2 million in the comparable period in fiscal 2003.

JURISDICTION AND VENUE

22. This Court has jurisdiction over the subject matter of this action pursuant to Section 27 of the Securities Exchange Act of 1934 (the “Exchange Act”), 15 U.S.C. §78aa and 28 U.S.C. §1331. The claims asserted herein arise under Sections 10(b), 20(a), and 20(A) of the Exchange Act, as amended, §78j(b), §78t(a), §78t-1 and Rule 10b-5, 17 C.F.R. § 240. 10b-5, promulgated thereunder by the SEC.

23. Venue is proper in this District pursuant to Section 27 of the Exchange Act, and 28 U.S.C. §1391(b). Many of the acts and transactions giving rise to the violations of law complained of herein, including the preparation and dissemination to the investing public of false and misleading information, occurred in this District. Defendant Dynacq has principal executive offices in Houston, Texas. Additionally, Defendant E&Y also has offices in Houston, Texas.

24. In connection with the acts, conduct and other wrongs alleged in this Complaint, the defendants, directly and indirectly, used the means and instrumentalities of interstate commerce, including the mails, telephone communications and the facilities of the NASDAQ.
THE PARTIES

25. Lead Plaintiffs purchased Dynacq common stock during the Class Period, as set forth in their certifications previously filed with this Court.

26. Defendant Dynacq is a Delaware corporation with principal executive offices located at 10304 Interstate 10 East, Suite 369, Houston, Texas 77029. Dynacq is a holding company with subsidiaries that provide surgical healthcare services and related ancillary services through hospital facilities and outpatient surgical centers.

27. (a) Defendant Chiu M. Chan ("Chiu Chan"), the founder of Dynacq, is and was at all relevant times Dynacq's Chief Executive Officer and the Chairman of the Board of Directors. Chiu Chan signed and certified Dynacq's Form 10-K filed with the SEC for fiscal year 2002 and certified Dynacq's Form 10-Qs filed with the SEC for the first, second and third quarters of fiscal year 2003. During the Class Period, Chiu Chan sold approximately 21,200 shares of personally-owned Company stock at inflated prices for gross proceeds of approximately $437,376.

(b) Defendant Philip S. Chan ("Philip Chan") is and was at all relevant times Dynacq's Chief Financial Officer, Treasurer, Vice President of Operations, and a director of the Company. Philip Chan reportedly holds advanced accounting degrees from the University of Houston, is a Certified Public Accountant in the State of Texas, and reportedly has over 25 years of experience in corporate accounting. Philip Chan signed and certified Dynacq's Form 10-K filed with the SEC for fiscal year 2002 and Form 10-Qs filed with the SEC for the first, second and third quarters of fiscal year 2003. During the Class Period, Philip Chan sold approximately 36,412 shares of personally-owned Company stock at inflated prices for gross proceeds of approximately $754,382.
(c) Defendant Sarah C. Garvin ("Garvin") was at all relevant times Dynaq’s Executive Vice-President and Chief Operating Officer. Garvin resigned from this position in February 2004. During the Class Period, Garvin sold approximately 28,879 shares of personally-owned Company stock at inflated prices for gross proceeds of approximately $500,286.

(d) Defendant Irvin T. Gregory ("Gregory") was at all relevant times Dynaq’s Executive Vice-President of Development. Gregory elected to leave his position on January 31, 2004. During the Class Period, Gregory sold approximately 53,413 shares of personally-owned Company stock at inflated prices for gross proceeds of approximately $1,001,046.

(e) Defendant James N. Baxter ("Baxter") is and since July 17, 2003 has been a Dynaq Executive Vice President. Previous to this, Baxter worked as an investor relations consultant for Dynaq.

28. Defendants Chiu Chan, Philip Chan, Garvin, Gregory, and Baxter are collectively referred to herein as the “Individual Defendants.” By virtue of their positions at Dynaq, the Individual Defendants had access to the adverse and undisclosed information about the financial results and performance of the Company, the accounting procedures and methods used by the Company, and the internal financial and accounting controls at Dynaq. The Individual Defendants also directly participated in the management of Dynaq, were directly involved in the financial operations of Dynaq at the highest levels, were privy to information concerning the financial results and performance of the Company, as well as the accounting procedures and methods and the internal accounting and financial controls used at the Company,
and were involved in the dissemination of the materially false and misleading statements and information on these subjects as alleged herein.

29. By reason of their positions as executive officers and/or directors of Dynacq, the Individual Defendants were at all relevant times controlling persons within the meaning of Section 20 of the Exchange Act. Because of their executive and/or directorial positions at Dynacq, the Individual Defendants had access to adverse, non-public and specific information about the Company’s financial results and performance, as well as its accounting procedures and methods and internal accounting and financial controls. Further, as particularized herein, the Individual Defendants were able to and did control the contents of various reports and public statements regarding Dynacq, its financial results and performance, and its accounting procedures and methods and the internal accounting and financial controls. Any acts attributed to Dynacq were caused and/or influenced by the Individual Defendants by virtue of their controlling-person positions at the Company.

30. As the senior officers and/or directors of a publicly-held company whose common stock was, at all relevant times, registered with the SEC pursuant to the Exchange Act, traded on the NASDAQ, and governed by the provisions of the federal securities laws, the Individual Defendants had a duty to promptly disseminate accurate and truthful information about Dynacq’s financial results and performance and its accounting procedures and methods and internal accounting and financial controls, so that the market price of Dynacq’s publicly-traded securities would be based upon truthful and accurate information. The Individual Defendants’ misrepresentations and omissions during the Class Period violated these specific requirements and obligations. By virtue of their positions of control and authority at Dynacq, the Individual Defendants had the power to and did control the content of the various public
statements concerning Dynacq, its financial results and performance, and its accounting procedures and methods and the internal accounting and financial controls made during the Class Period, and indeed made many of the challenged statements and representations described herein. Accordingly, the Individual Defendants were responsible for the accuracy of the public statements and releases detailed herein and are primarily liable for the misrepresentations contained therein.

31. Defendant E&Y is a certified public accounting firm with offices located nationwide, including a location at 5 Houston Center, Suite 1200, 1401 McKinney Street, Houston, Texas 77010. E&Y served as the Company’s auditor from June 4, 2002 until its resignation on December 17, 2003. E&Y purported to audit Dynacq’s financial statements for fiscal year 2002 in accordance with Generally Accepted Auditing Standards (“GAAS”) and issued a materially false and misleading unqualified audit opinion that those financial statements were prepared in accordance with Generally Accepted Accounting Principles (“GAAP”). Additionally, E&Y consented to the use of its unqualified opinion letter in Dynacq’s 2002 Form 10-K filed by the Company with the SEC and otherwise disseminated to the investing public during the Class Period.

32. As a result of E&Y’s knowing and/or reckless conduct and participation in Dynacq’s fraudulent scheme, E&Y is jointly and severally liable with the Dynacq Defendants to Lead Plaintiffs and the other members of the Class. E&Y knew that its audit report was being relied upon by investors, yet failed to comply with GAAS in the issuance of its false and misleading audit report.

CLASS ACTION ALLEGATIONS

33. Lead Plaintiffs bring this case as a class action pursuant to Rules 23 (a) and (b)(3) of the Federal Rules of Civil Procedure, on behalf of themselves and all other persons
who purchased or otherwise acquired Dynacq common stock between November 27, 2002 and December 19, 2003, inclusive (the "Class"). Excluded from the Class are Dynacq, its subsidiaries and affiliates, the Defendants, members of the immediate families of each of the Defendants, any entities in which any of the Defendants has a controlling interest, and the legal representatives, heirs, successors, affiliates or assigns of any of the foregoing excluded persons and entities.

34. This action is properly maintainable as a class action because:
   a. The members of the Class are so numerous that joinder of all members is impracticable. During the Class Period, millions of shares of Dynacq common stock were outstanding and actively traded on the NASDAQ. Upon information and belief, Lead Plaintiffs believe that there are, at a minimum, hundreds or thousands of Class members;
   b. Lead Plaintiffs’ claims are typical of the claims of the other members of the Class, as Lead Plaintiffs and the members of the Class purchased Dynacq shares and sustained damages as a result of Defendants’ wrongful conduct complained of herein;
   c. Lead Plaintiffs are representative parties who will fairly and adequately protect the interests of the other members of the Class and have retained counsel competent and experienced in class action securities litigation. Lead Plaintiffs have no interests antagonistic to, or in conflict with, the Class they seek to represent;
   d. A class action is superior to other available methods for the fair and efficient adjudication of the claims asserted herein. As the damages suffered by the individual Class members may be relatively small, the expense and burden of individual litigation make it virtually impossible for the Class members individually to redress the wrongs
done to them. The likelihood of individual Class members prosecuting separate claims is remote;

e. The questions of law and fact common to the members of the Class predominate over any questions affecting individual members of the Class. The questions of law and fact which are common to Lead Plaintiffs and the Class include, among others:

i. whether the federal securities laws were violated by Defendants’ acts as alleged herein;

ii. whether statements disseminated to the investing public and to Dynacq’s common stock holders during the Class Period misrepresented material facts about the financial results and performance of, and the internal financial and accounting controls at, the Company;

iii. whether Defendants acted with knowledge or with reckless disregard for the truth in misrepresenting and/or omitting to state material facts;

iv. whether, during the Class Period, the market price of Dynacq common stock was artificially inflated due to the material misrepresentations and non-disclosures complained of herein;

iv. whether the Defendants participated in and pursued the common course of conduct complained of herein; and

v. whether the members of the Class have sustained damages and, if so, the proper measure thereof.

35. Lead Plaintiffs anticipate no unusual difficulties in the management of this action as a class action.
The Company

36. Dynacq’s predecessor company, Ambulatory Infusion Therapy Specialists (AITS), was originally founded by Chiu Chan in 1986. In 1992, that Company became Dynacq Healthcare, Inc. In the fall of 2003, Dynacq Healthcare, Inc. merged with Dynacq International, Inc., and reincorporated in the State of Delaware. Dynacq’s stock began trading on the NASDAQ National Market System in April of 2000. Dynacq is a holding company with subsidiaries providing surgical healthcare services and related ancillary services through hospital facilities and outpatient surgical centers. Dynacq advertises itself as, inter alia, “focus[ing] on efficient, high-volume specialty surgical hospitals and ambulatory surgery centers.” At all relevant times, Dynacq’s common stock actively traded on the NASDAQ under the symbol “DYII.”

37. Dynacq has historically touted itself as a fast-growing company that owns and operates surgical hospitals and provides other healthcare-related services, but the vast majority of the Company’s business comes from its operation of one facility, Vista Medical Center, a 37-bed, eight-operating-room acute care hospital located in Pasadena, Texas. As reported in Dynacq’s financial statements, Vista Medical Center comprised as much as 90% of Dynacq’s business during the Class Period.

Defendants’ Fraudulent Scheme

38. Throughout the Class Period, Defendants engaged in an intentional, fraudulent scheme aimed at inflating the value of Dynacq’s stock. This scheme was comprised of three basic elements:

(1) Dynacq inflated its reported revenue by improperly recognizing net patient revenue that the Company and its senior management
had no reasonable basis to believe would be realized (and much of this revenue was in turn improperly reported as short-term accounts receivable, which misled investors about the risks associated with the accounts' collectibility);

(2) Senior management fostered an accounting environment severely lacking in internal controls, thereby rendering Dynacq's financial reporting subject to manipulation and inherently corrupt (which included the practices mentioned above at (1), as well as improper amortization of expenses related to stock options granted to non-employees, which had the effect of materially overstating reported earnings before and during the Class Period, and illegal, fraudulent billing and claims submission practices directed by CEO Chan);

and

(3) Dynacq consistently touted the quality of its health care services and of the doctors with which it partnered, while aware of myriad serious problems with its doctors and facilities. Dynacq also failed to disclose the concentration of risk associated with a large portion of its revenues being derived from a handful of "prolific" surgeons, at least one of whom had a history of professional discipline issues and was suspended from practice during the Class Period.

(1) **Dynacq's Improper Recognition of Revenue in Workers' Compensation Cases**

39. In its fiscal 2002 10-K, as well as other SEC filings, Dynacq describes its revenue recognition policy as follows:
Revenue from patient services are recognized as performed based on net realizable amounts from patients, third-party payors, and others for services rendered under reimbursement agreements. Allowances for discounts or services or adjustments for non-covered costs and expenses are recognized in the period in which the related revenues are provided.

Accordingly, Dynacq supposedly books and reports “patient service” revenue, the overwhelming majority of its revenue, as a “net” number, i.e., revenue is reported as already taking into account some portion of billings that will not be paid or “realized” because of contractual arrangements or discounts with insurance companies and/or HMO’s, as well as applicable regulations such as those promulgated by the Texas Workers’ Compensation Commission (TWCC).

40. Less than three months before the Company announced the delay in filing the 10-K, on September 15, 2003, Barron’s published an article by Rhonda Brammer entitled “Sizing Up Small Caps: Cloudy Prognosis,” which analyzed Dynacq’s remarkable reported growth and profitability through the first three quarters of 2003, and raised questions concerning whether the Company could sustain its business and financial prospects in the future.

41. Vista Medical Center is located near the Houston Ship Channel and Houston’s petrochemical industry, a highly industrial area east of the city. The nature of the work in these industries makes the employees especially prone to back injuries. These injuries are usually covered by workers’ compensation. The Barron’s article reported that in fiscal year 2002, 70% of Dynacq’s receivables were comprised of claims submitted to workers’ compensation carriers. The article also quotes a Dynacq spokesman as saying that “[w]e do as much workers’ compensation as any hospital in Texas.”

2 This figure is confirmed by the Company’s 2002 10-K at F-24. The workers’ compensation regulations in Texas, therefore, are of immense importance to the Company’s bottom line, because the regulations place a number of restrictions on medical billings putatively covered by workers’ compensation insurance, which materially affects the revenue of Dynacq.
42. The *Barron's* article questioned whether Dynacq was recognizing revenue on patient billings without adequate reserves for adjustment by private insurance companies and state agencies, specifically stating that Dynacq books "net patient service revenues" based on assumptions of what it is going to recover because of historical experience. Are those assumptions accurate, given this recent reluctance by [the largest workers' compensation insurance carrier in Texas] to pay more than a fraction of what [Dynacq-owned flagship hospital] Vista has demanded?

43. The importance of workers' compensation payments to Vista is brought home by the fact that in mid-February 2003 Vista brought suit against Texas Mutual Insurance for $2.9 million in uncollected "stop-loss bills." Ordinarily, Vista may only charge $1,118 per day for its workers' compensation patients. However, under the stop-loss rule, Vista may charge more than this amount under extraordinary circumstances. At issue in the Vista suit was the interpretation of the "stop-loss" method of payment. According to a person involved in the dispute between Vista and Texas Mutual, Vista was a predatory outfit that preyed on workers from the ship channel and petrochemical industry and then applied the stop-loss methodology as a rule to surgeries on these workers, and not as an exception, despite the rule's application only to extraordinary circumstances.

44. Pursuant to 28 TAC § 134.401 in the Texas Administrative Code, "Stop Loss is an independent reimbursement methodology established to ensure fair and reasonable compensation to the hospital for unusually costly services rendered during treatment to an injured worker." 28 TAC § 134.401(c)(6). Additionally: (i) To be eligible for stop-loss payment the audited charges for a hospital admission must exceed $40,000, the minimum stop-loss threshold; (ii) This stop-loss threshold is established to ensure compensation for unusually extensive services required during an admission; and (iii) If audited charges exceed the stop-loss
threshold, reimbursement for the entire admission shall be paid using a Stop-Loss Reimbursement Factor of 75%. 28 TAC § 134.401(c)(6)(A)(i)-(iii) (Emphasis added.) If the stop-loss method does not apply, the workers’ compensation per diem amount that is reimbursed to the hospital for surgical acute care inpatient services is $1,118. 28 TAC § 134.401(c)(1). This figure includes all charges, regardless of how much the hospital charges for everyday items such as tissues or basic pain relievers like Tylenol.

45. As the Barron’s article noted, the Company itself had declared that “Vista Medical Center Hospital is an institution that is particularly affected by the Stop Loss provisions as most of the surgery cases require intensive care and although the hospital stays are brief, a great deal of services are rendered within that time.” Additionally, the article reported the bill for the average patient at Vista Medical Center is more than $40,000. According to the Barron’s article, Defendant Chiu Chan explained in a 2002 conference call that “[e]very patient walking into this hospital is going to have a procedure, and the procedure is going to be expensive.... Our average bill going out to insurance companies is around $50,000.” For a patient who has a four day stay in the hospital and incurs a $50,000 bill, the Company would be paid $37,500 if the stop-loss method applies, but only $4,472 if it does not.

46. Vista’s lawsuit seeking stop-loss payments from Texas Mutual was nonsuited on February 24, 2004. The suit was never disclosed in any of the Company’s SEC filings.

47. Dynacq, through Vista, also admitted in other litigation that it was having trouble getting paid for workers’ compensation surgeries.3

48. Despite workers’ compensation carriers’ refusal to pay these stop-loss fees as a matter of routine4, Dynacq continued to incorporate into its recognized net patient

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3 See Complaint filed in Vista Medical Center Hospital, LLC v. J. Martin Barrash and John Does, in the District Court of Harris County, Texas, Case No. 2002-59058, at para. 25.
revenue payment expectations radically inconsistent with its historical experience. As noted, according to a source involved in the Texas Mutual litigation, Dynacq does not use the stop-loss method as the exception only for those cases requiring unusually extensive services during admission. Rather, Dynacq employs this method as the rule, which is why Texas Mutual and other third-party payors often decline to pay these bills. Even to the extent, if any, that Dynacq has created contractual allowances against patient revenue, the amounts are impossible to verify, because “net patient revenue” is a “top line” number, i.e., the contractual allowances supposedly established for billings that will be adjusted by workers’ compensation carriers, state agencies, and other insurers, are not separately reported. Indeed, a person involved with an administrative proceeding between Dynacq and Texas Mutual revealed that Dynacq refused to produce discovery concerning its contractual allowances.

49. The record of Dynacq’s workers’ compensation billings (via Vista) kept by the TWCC for the years 2000-2003 further underscores the unreasonable assumptions inherent in Dynacq’s reported net patient revenue. During this period, Vista hospital billed $17,136,099.66 for workers’ compensation cases, but actually received only $5,843,262.09, a realization rate of only 34%, and a far cry from the 75% expectation evidenced by Defendant Chan’s comments and the Texas Mutual litigation.\(^5\) Indeed, TWCC report shows that $10,517,251.60 was billed in 2003 alone, of which Vista only realized $3,428,633.01.

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\(^4\) Several of the cases at issue in the Texas Mutual litigation date back to 2000, indicating that Dynacq has long been on notice that its workers’ compensation billings are subject to a high degree of scrutiny and will not be paid in full as a matter of course.

\(^5\) The Texas Mutual litigation shows that on the numerous claims that were the subject of the suit, Texas Mutual had paid approximately 25% of the billings, and Vista was suing for 50% of the total billings, to net a 75% payment for Vista’s billings. Similarly, the payment history shown by records produced by the TWCC show that Vista collected on average only 34%. According to the TWCC, Vista was paid only $526,208.72 on $1,665,973.58 in workers’ compensation billings recorded by TWCC in 2000; only $835,551.17 on $1,822,349.36 in
50. Dynacq’s overstatement of net patient revenues is further evidenced by the fact that, for fiscal year 2002, Dynacq reported a soaring profit margin of 43%, drastically out of line with the 9.7% for for-profit specialty hospitals and 9.2% for for-profit general hospitals reported by the General Accounting Office in an October 2003 report. Given that Dr. Scheffey, the key physician at Vista for workers’ compensation cases during the relevant period, has a long history of administrative disciplinary actions and malpractice suits, including a 1995 suspension of his license and five years’ probation for “persistently and flagrantly overcharging patients[,]” and for performing unnecessary surgeries, among other things, the fact that Dynacq’s profit margins so grossly exceeded the norm for specialty hospitals should have put Defendants on notice that a problem with Dynacq’s internal controls and revenue recognition existed. That Dynacq’s profit margins and revenue per patient bed vastly exceeded the norm due to improper billings was corroborated by a former Vista analyst’s observation, after working at Vista for several months in 2003, that the doctors there “were doing surgeries they weren’t supposed to be doing; they were charging for stuff they didn’t even do.”

51. Vista’s improper billing practices are further corroborated by a former collections staff member at Vista Healthcare from November 2000 to January 2002. She relates that her direct supervisor was Jean Wincher (“Wincher”), head of collections for Vista, who reported directly to Defendant Philip Chan and worked closely with Defendant Chiu Chan. The former employee stated that it was Vista’s routine practice to maximize billings by intentionally failing to adjust a bill’s amount by the agreed upon contractual allowance. Instead, Wincher instructed the staff to modify the bill to reflect procedures that would allow for payment of the entire amount submitted, regardless of whether the procedures were actually performed. As an

billings in 2001; only $1,062,890.19 on $3,130,525.12 on billings in 2002; and only $3,428,633.01 on $10,517,251.60 in billings in 2003.
example, the former employee said she was instructed to always bill for the maximum number of views allowable for a CAT scan, regardless of how many were actually ordered and performed. As a matter of course, the former employee said she followed instructions and always submitted the highest number allowed in order to maximize payment from Medicare and other third party payers. The former employee related that Wincher’s explanation for this practice was that the doctors did not bring in enough money to Vista and the modifications were necessary in order to maximize profits for the hospital. The former employee also stated her belief that Wincher’s practices were directed by Defendant Chiu Chan, based on her observations of Chan’s involvement in the collections department. The employee also related that weekly meetings were held between Wincher and Defendants Chiu Chan, Philip Chan, and Sarah Garvin on Wednesday mornings.

52. On September 16, 2003, Dynacq responded dismissively to the September 15, 2003 Barron’s article by branding it as a “slanted and mistaken account of Dynacq’s current and future business,” which the company expected to be “welcomed by the short sellers” of Dynacq stock. Defendant Baxter said in response to the Barron’s article that “[t]he short sellers must be heaving a sigh of relief to have some negative ‘news’ to pen-nit some covering positions before the Company reports its results for the fiscal year ended August 31, 2003.” The response then went on to purportedly “set the record straight” by providing a list of what it claimed to be some of the real “reasons for Dynacq’s remarkable growth and profitability.” In the article, Dynacq stated that it “expects insurers to pay Dynacq subsidiary hospitals the amounts which are due in accordance with existing regulations[,]” i.e., the 75% putatively available under the stop-loss provisions.
53. As detailed herein, however, despite this intentional effort to misrepresent Dynacq’s recent financial success, barely three months later Dynacq (a) had still not filed its financial report for the fiscal year 2003, and had requested an extension to file said report; (b) had suffered the abrupt resignation of its fourth external auditor precisely because the Company “lack[ed] internal controls necessary to develop reliable financial statements”; (c) faced delisting from the NASDAQ as a result of its failure to file its 2003 fiscal year-end report with the SEC; and (d) was informed that it was facing an SEC investigation of its financial statements, revenue and cost recognition, allowances for doubtful accounts, and internal financial and accounting controls, as well as a probe by the Texas Attorney General into alleged improper patient solicitation.

54. Prior to the recent filing of Dynacq’s Form 10-K on July 31, 2004, the Company had never disclosed that a very significant portion of its accounts receivable are more often than not disputed as to their legitimacy in terms of the necessity of the services rendered and the amount of the billing (which is unsurprising given Dynacq’s highly questionable billing practices and the quality of medical care reportedly given at its Vista facility, discussed both supra and infra). In its most recent 10-K, the Company disclosed that:

Because our business is different from virtually all other healthcare facility companies, our accounts receivable look different from most healthcare companies. Our accounts receivable are larger than and older than those of typical healthcare companies. We are normally not a party to managed care contracts and do not have significant Medicare/Medicaid cases, which assure relatively quick payment of relatively small amounts of facility reimbursement. The focus of our business is relatively complex cases with corresponding large facility reimbursements. Our 2003 net patient service revenue came 52% from service to injured Texas workers (Worker’s Compensation) . . . .

Collections for services provided to injured workers in Texas may take up to three years or longer to be completely adjudicated. Because the Company has in recent years focused on providing services to injured workers in Texas, accounts
receivable in the workers compensation and MDR [medical dispute resolution] financial classes have increased.

55. The 10-K also discloses that, of the Company's reported balance of $46,544,023 of accounts receivable for fiscal year 2002, $36,624,610 are classified as "long-term," meaning that these accounts were not expected to be collected within one year. Under SEC Regulation S-X, § 210.5-02, registrants are required to disclose the portion of its receivables that are expected to be collected after one year, because there is a markedly greater risk of uncollectibility for such receivables. By not disclosing that the overwhelming majority of its receivables were of this category in its Class Period financial statements, Dynacq misrepresented the risks associated with receiving payment for services it (allegedly) provided in worker's compensation cases.

56. The fact that the Company now admits that most of its revenues are derived from worker's compensation claims that are subject to protracted adjudication processes (which implies that most if not all of these claims are disputed, as alleged supra) further corroborates the allegation that the Company's contractual allowances, i.e., the amount it subtracts from gross revenues in order to reflect the amount it actually expects to be paid, are based on unrealistic expectations. Indeed, the Company admits in its most recent 10-K that its assumptions are based on experiences from the previous twelve months to a given reporting period, even though, by the Company's own admission, worker's compensation claims often take as long as three years or more to settle. Under the heading "Limited Operating History of

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6 The Company admits as much in its most recent 10-K: "When the Company is required to pursue reimbursement through the MDR process, any such reimbursement therefrom often involves delays and compromises, due to the subjective nature of the administrative process and the lack of established timeframes in which the reimbursement disputes are to be resolved. This results in the aging of our receivables which can affect our liquidity and, in some instances, actual recoveries."
Current Business Strategy,” the Company effectively admits that the bases for its assumptions about the collectibility of its receivables (and therefore the realizability of its revenues in the first instance) have not been on firm footing:

Any changes in the estimates applied in evaluating the collectibility of outstanding receivables could materially impact the Company’s reported revenues and profitability. Due to our limited operating history in this healthcare segment, we have limited data upon which to base this evaluation. As our business in this healthcare segment matures, additional data with respect to historical cash collections and the collectibility of outstanding receivables will become available. As the additional collection data becomes available in the future, management may change its estimate of the collectibility of then outstanding receivables which could affect reported net patient revenues and profitability.

(2) **Defendants’ Lack of Internal Controls**

57. The American Institute of Certified Public Accountants ("AICPA") defines “internal control” in AU § 319:

Internal control is a process—effected by an entity’s board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. Internal control consists of five interrelated components:

a. Control Environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

b. Risk Assessment is the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

c. Control Activities are the policies and procedures that help ensure that management directives are carried out.

d. Information and Communication Systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

e. Monitoring is a process that assesses the quality of internal control performance over time.

The total lack of internal controls at Dynacq makes clear that the Company’s accounting disaster was not the result of mere mismanagement. Rather, this accounting fraud was part and parcel of Defendants’ effort to deceive the market in order to inflate the price of Dynacq’s stock.
58. The Company’s lack of internal accounting controls throughout the Class Period rendered Dynacq’s financial reporting inherently corrupt, subject to manipulation and unreliable, and resulted in materially false and misleading financial statements. Rather than reveal this information, however, Defendants repeatedly manipulated Dynacq’s accounting in order to inflate revenues, net income, and earnings per share throughout the Class Period.

59. In March 2002, a shareholder derivative action was brought in the Judicial District Court of Harris County, Texas against Dynacq International and certain of its officers, alleging improprieties in Dynacq International’s finances. According to Dynacq’s 2002 Form 10-K, the suit specifically alleged that Dynacq failed to “implement and maintain an adequate internal control system.”

60. On October 1, 2003, the Company issued a press release announcing that it had settled the Texas shareholder derivative action. In connection with the final settlement hearing on November 10, 2003, Dynacq announced that it had “implemented and/or agreed to implement certain procedures relating to its Audit Committee and its accounting for uncollectible accounts and contractual allowances.” The Company also represented that “the Settlement does not require any changes in previously reported financial statements.” As shown below, however, the Company was subsequently forced to announce a pending restatement of its fiscal year 2001 and 2002 financial statements.

61. The Stipulation of Settlement, dated September 11, 2003, details the changes that the Company was required to implement with regard to its business practices. The poor state of Dynacq’s accounting practices are well evidenced by the following changes that the Company was required to make in accordance with the Settlement:
a. The Audit Committee agreed to review its Charter at least once every three years;

b. The Audit Committee elected its first Chair;

c. Dynacq adopted a policy whereby its CFO and Controller will attend continuing education courses regarding accounting developments in the hospital and/or healthcare industries;

d. Dynacq adopted a policy whereby its Controller will periodically review, and, if appropriate, write off uncollectible accounts receivable balances on the system that are not in the medical dispute resolution process [an administrative process to determine, \textit{inter alia}, propriety of billing for certain procedures arguably covered by workers’ compensation] at set intervals such as every one or two years;

e. Dynacq adopted a policy whereby it will utilize the “balance sheet” approach in addition to the “income sheet” approach in order to check the value of the contractual allowances charged against net patient revenue;

f. Dynacq instituted an improved system to estimate: (i) contractual adjustments; and (ii) bad debt. The new system requires two individuals to be involved in making estimates. The Controller shall make written recommendations on a quarterly basis concerning these two estimates for each 10-Q and the annual 10-K and show the basis for the recommendations. The CFO shall then analyze both estimates and make a final written decision on the appropriate amount. If the CFO disagrees with the Controller’s estimates, the CFO shall write a memo to the Audit Committee and the CEO explaining the basis for the disagreement and the CFO’s recommendations. If the CEO agrees, the CFO shall write a memo reporting his
agreement to the Audit Committee and should provide the Audit Committee with a copy of the Controller’s recommendations; and

   g. Dynacq adopted a policy whereby the Company will be required to retain documentation showing the calculations for contractual adjustments for at least five years.

62. Despite agreeing to make these changes as part of the settlement, Dynacq’s internal accounting controls were still so inadequate and unreliable that the Company was forced to announce on December 2, 2003 that it was requesting an automatic extension of up to 15 days to file its 2003 10-K. The Company then announced on December 18, 2003, in connection with the resignation of E&Y as Dynacq’s auditors, that the Company was still unable to file its 10-K and would do so as soon as practicable. As a result of its delinquency in making required filings with the SEC, the NASDAQ Listing Qualifications Panel delisted Dynacq’s common stock from the NASDAQ National Market as of the opening of business on April 16, 2004, and Dynacq failed to meet NASDAQ’s June 16, 2004 deadline to file its delinquent statements in order to be eligible for relisting.

63. In the Company’s most recent 10-K, Dynacq communicated its past and current auditors’ opinions that the control environment at the Company was and continues to be deficient:

   In conjunction with Ernst & Young’s resignation, Ernst & Young advised us that it had identified material weaknesses relating to our internal controls. In a letter dated December 23, 2003, Ernst & Young advised us that a material weakness existed as a result of inadequate communication lines and internal controls relating to authorization, recognition, capture and review of transactions, facts, circumstances and events that may have a material impact on the Company’s financial reporting process.

   ...
Further, our current independent auditors have orally advised the audit committee that they have identified what they consider to be material weaknesses in our internal controls with respect to:

- the non-compliance by various departments in submitting information in accordance with procedures to ensure proper and timely recording of accounts payable;
- family relationships among certain of our officers and employees;
- the failure to properly utilize the inventory software to track and report our inventory quantities on a real time basis;
- the failure to properly account for stock options issued to non-employees; and
- a lack of supervision, review, and quality control related to the accounting for income taxes.

64. Dynacq's lack of internal controls is further corroborated by the Company's recognition of medical supplies costs in the first three quarters of fiscal year 2003. In the 10-Q for the second quarter 2003, the Company reported a 6-month medical supplies expense of $6,403,848. The second quarter expense is reported as $3,244,483. Subtracting the second quarter expense from the six-month total yields a first quarter expense of $3,159,365; however, the first quarter expense was originally reported as $3,739,794. Similarly, the third quarter 9-month expense is reported in the third quarter 10-Q as $11,006,201, with the third quarter expense reported as $4,021,744. Subtracting the third quarter expense from the nine-month total yields a six-month total of $6,984,277; however, the six-month total was reported three months prior as $6,403,848. It appears that Dynacq later reversed the second quarter understatement of supplies costs (approximately $580,000) without any notice or reason given.  

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7 Defendants' reclassification of approximately $580,000 of their expenses from the first to the second quarter in fiscal year 2003, and then back again in the third quarter 2003, involves such a material amount that this flip-flopping reclassification is, at a minimum, suspect and suggests a lack of internal controls. As noted, issues concerning the Company's cost recognition were a subject of the SEC inquiry. Moreover, although the Company disclosed that it had reclassified certain expenses from the prior year's presentation to conform to the current presentation, Defendants never specifically disclosed the back and forth reclassifications between the second and third quarters of 2003 beyond disclosing the numbers set forth above and left it to the investors to "do the math".

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65. In addition, as a result of Defendants’ accounting violations, Dynacq failed to meet NASDAQ’s June 16, 2004 deadline.

66. The severely deficient control environment at Dynacq is further evidenced by the fraudulent billing and claims submission practices described above at ¶¶ 50-51. In addition to the fraudulent billing practices, the former employee in the collections department also related that it was Vista’s practice to repeatedly submit rejected claims to insurance carriers until the claims were eventually paid. The former employee stated that she was instructed to modify billing and procedure codes in order to render the claims covered and payable, and this process was often repeated several times until a particular claim was paid. This practice often resulted in a great deal of variance between submitted claims and the medical records associated with the procedures for which reimbursement was sought. Moreover, the collections employee stated that members of the staff were given collections quotas by Jean Wincher at the direction of Defendants, and that failure to meet one’s quota could result in discipline or firing.

(a) Dynacq’s Auditors, Ernst & Young, Were Participants in the Accounting Fraud

67. E&Y was hired as the Company’s auditor on June 4, 2002 at a time when Dynacq was already facing at least two lawsuits about the Company’s highly questionable accounting practices (the derivative suit previously mentioned and a securities fraud class action). Accordingly, E&Y was well aware of the questions surrounding the internal control environment at Dynacq. In fact, E&Y was the fourth auditor to work for Dynacq since 1995, as the Company had suffered from a large turnover of its auditors. E&Y served as the Company’s auditors until December 17, 2003, when it resigned “due to the Company’s lack of internal controls necessary to develop reliable financial statements.”

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68. The state of the Company's internal controls, however, did not change during the Class Period. The Company's 10-K for fiscal 2002 contained an unqualified audit opinion issued by E&Y which stated that its audit was performed in accordance with GAAS and Dynacq's financial statements were presented in conformity with GAAP. There were no changes to management, however, from the time of this audit opinion until the end of the Class Period. The Company was therefore acting under the same internal controls (or lack thereof) at the beginning of the Class Period (when E&Y gave Dynacq a clean bill of financial health) as they were when E&Y resigned.

69. Indeed, if anything, as a result of the derivative litigation settlement, the internal controls should have been better at the time E&Y resigned than they were at the time of the fiscal 2002 audit opinion; however, it does not appear that the Company made any material changes to its internal controls after the settlement—in a February 4, 2004 earnings press release, the Company stated that:

The earnings estimates announced today are preliminary and may change based upon the outcome of pending discussions between the Company and the Securities Exchange Commission. The financial statements from which Dynacq's preliminary earnings estimates are derived have not been reviewed by our independent auditor, which has only recently been appointed, but have been prepared based upon the same accounting policies underlying our prior reported financial statements. Reports and financial statements previously filed by the Company are being reviewed by the Securities and Exchange Commission. (emphasis added).

70. Additionally, when resigning, E&Y did not state that anything had changed at the Company in regard to its internal controls. In any event, during 2002 E&Y had earned $135,700 in non-audit fees, and was well-aware of the Company's internal accounting
controls or lack thereof, or was at the very least severely reckless in not knowing. Moreover, the fact that E&Y resigned in late December 2003, weeks after the Form 10-K was due, is highly suspicious.

71. E&Y, therefore, knew or severely recklessly disregarded that: (i) E&Y had not audited Dynacq's 2002 financial statements in accordance with GAAS; and (ii) the 2002 financial statements had not been prepared in conformity with GAAP and did not present fairly, in all material respects, the financial position of Dynacq and the results of its operations and cash flows.

(3) **Atrocious Conditions at Dynacq’s Flagship Hospital, Vista Medical Center**

72. Throughout the Class Period, Dynacq continuously touted itself as a company that “provides surgical healthcare services and related ancillary services through surgical hospital facilities and outpatient surgical centers. Dynacq specializes in creating surgical facilities that are models of quality patient care, efficiency, technology, clinical skills and profitability.” Dynacq emphasized that:

> The business of the Company depends upon the efforts and success of the surgeon partners who perform surgical procedures at the Company’s facilities and the strength of its relationship with these surgeons. The Company’s business could be adversely affected if these surgeons do not maintain the quality of medical care or do not follow required professional guidelines at the Company’s facilities, if

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8 Dynacq’s 2002 Proxy Statement makes the unusual affirmative claim that the non-audit services performed by E&Y were not for information technology services relating to financial information systems design and implementation. However, a report by Institutional Shareholder Services dated February 12, 2003 (the “ISS Report”) states that E&Y received $135,700, or 37% of its fees from Dynacq in fiscal year 2002, for financial information systems design and implementation. In addition, as the ISS Report noted, payments to an allegedly independent auditor for non-audit work creates “potential conflicts that might interfere with the auditor’s independent judgment.”

9 Queried about E&Y’s resignation, a former federal prosecutor and SEC lawyer was quoted in a December 19, 2003 *Houston Chronicle* article, commenting that “[a]nytime an independent auditor resigns, particularly over such a central issue to financial reporting as internal controls, that is a major event.”
there is damage to the reputation of a key surgeon or group of surgeons, or if the relationship with a key surgeon partner or group of surgeon partners is impaired.

73. Despite the Company’s touting of its “model” facilities, Dynacq’s hospitals provided substandard healthcare, at best, by incompetent surgeons. For instance, on February 15, 2004, the Houston Chronicle reported a story about a man named Nathan Young, who underwent neck surgery in Dynacq’s Vista Medical Center Hospital in May 2002.

[H]e soon developed breathing problems. Over the next seven hours, doctors and nurses dismissed his increasingly anxious complaints, court documents show, advising him to suck on ice. Finally, he stopped breathing altogether and fell to the floor outside the nurses’ lounge in a desperate bid for help. **Precious minutes ticked by because staff couldn’t find emergency resuscitation equipment or immediately locate anyone who knew CPR,** according to a nurse’s deposition. His brain profoundly damaged from oxygen deprivation, Young died in a nursing home in October [2003]. (Emphasis added.)

74. Dynacq continued to tout its “model” facilities, despite the fact that a patient died at its “flagship” hospital because no one could be found to perform CPR, one of the most basic, yet important, medical procedures which many non-health professionals are trained to give.

75. The incident involving Nathan Young was not an isolated one at Vista Medical Center. It is consistent with a pattern of unacceptable conditions and events that have continuously plagued the hospital. A February 15, 2004 article in the Houston Chronicle details this pattern:

a. From the time that Vista opened in May 1999 until January 2004, “state inspectors conducted eight investigations into more than a dozen incidents.” On three occasions, state investigators recommended that Vista’s Medicare funding be terminated, which the article called “one of the harshest penalties possible for a hospital.”
b. In the previous three years, Vista or its outpatient clinic has been named in “at least 14 medical malpractice lawsuits, including at least two cases involving patients who died.”

c. In August 2003, a man named Nicolas Moreno Perez had spinal surgery at Vista for a back injury. During the operation, the “oxygen and EKG monitors malfunctioned according to the suit, and medical personnel ignored physical signs of distress in the patient.” This led to the patient’s heart stopping during the surgery. Mr. Perez remains severely impaired today.

d. Inspectors repeatedly found serious problems with Vista’s “emergency room and with transfers of patients to other facilities, as well as poor record keeping and unreliable lists for on-call physicians.” For example, in December 2000, a post-surgical patient at Vista who developed alcohol-withdrawal symptoms “was abandoned on the ambulance deck of Ben Taub Hospital…. The disoriented man wore only a hospital gown and one sock and had no paperwork from Vista or other information to indicate why he was there.”

e. In October 2001, “state inspectors found 14 out of 19 nursing personnel files contained no verification from the Board of Nurse Examiners of valid and current licenses. Inspectors found “prescribed drugs and blood-sugar tests for diabetic patients were given hours late.” Additionally, inspectors found that emergency life saving equipment had not been checked for two months, even though the law requires them to be examined every month.

f. In February 2002, state inspectors learned that Vista “had no physicians on call to treat people who came into the emergency room or Vista’s own post-surgery patients who got into trouble during the night. Four out of nine doctors contacted from a
list provided by Vista stated they were unaware of the on-call list and didn’t know their names were on it.”

g. In June 2002, a patient named Rudy Faupel almost died due to “nursing inattention and an equipment malfunction.” This patient had had surgery at Vista and repeatedly complained to the nursing staff that his self-administered pain-medication pump was not working. A nurse discovered that the pump was blocked and unblocked it. Then, “[p]ain medication that had built up in the clogged line rushed into Faupel’s body and stopped his heart.” The patient survived, but lost several teeth as a result of the effort to save his life.

h. In October 2002, state inspectors found that eight patients (most of them small children) had been turned away from Vista’s emergency room “without even perfunctory evaluations or stabilizing treatments required by law.” In one of these incidents a 14-month old who had swallowed Tilex was “sent away by a physician who later wrote, “We were not equipped to evaluate. Recommended the parents take the patient to another facility.””

i. There are numerous lawsuits alleging that “doctors at Vista provided unnecessary treatments and surgery, that equipment didn’t work, and staff either ignored patients’ complaints or made serious mistakes....” For example, one patient claimed that “his doctor operated on the wrong knee, then operated on the other knee the same day, disabling him.”

76. After many of these incidents, Vista promised to fix the problems and escaped punishment, according to February 15, 2004 article in the Houston Chronicle. In fact, Texas rarely penalizes hospitals for violations. The state has imposed penalties on hospitals for regulation violations only 20 times since November 2000. A state official has admitted,
however, that there are problems with his inspections leading to proper actions taken against violators:

    Upon reviewing a Houston Chronicle summary of state-documented problems at Vista, the Texas Department of Health’s associate commissioner for consumer health protection admitted his inspectors had fallen short. “In hindsight … I think the surveyor and/or program administrator may have made some judgment errors,” said TDH’s Richard Bays, who oversees hospital licensing and compliance. “I’m not out to ‘get’ any facility. My interest is patient care and safety. But yes, I will have a discussion with our compliance staff.”

77. Further evidence of the horrifying conditions at Vista Hospital is the temporary suspension of Scheffey’s medical license by TSBME in August 2003. According to the Barron’s September 15, 2003 article, the TSBME “characterized Scheffey as ‘a continuing threat to the public welfare,’ arguing that he has ‘failed to practice medicine in an acceptable professional manner,’ that he ‘billed for surgeries and procedures that were unnecessary,’ and that he constituted ‘a real and present danger’ to the health of his patients.”

78. Moreover, according to Barron’s, Scheffey had his first run-in with the TSBME in 1986, when he was put on a 10-year probation for using cocaine. In May 1995, Scheffey was placed on probation for 5 years for performing unnecessary operations on four patients and over-billing. In September 2001, he was put on probation for one year for failing to document adequate explanations for surgeries on two patients. Barron’s also reported that the TSBME alleged that Scheffey had been sued for malpractice no fewer than 78 times and was forced to make payments in 45 cases totaling more than $13.3 million.10

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10 Don Holt, senior vice president for Vista, told a reporter from the Pasadena Citizen that the hospital conducts extensive background checks before granting privileges to physicians and surgeons. The hospital, Holt said, verifies the physician’s degree, Texas license and standing, liability insurance, and past claim history, among other things.
79. The day after the Barron’s article, on September 16, 2003, the Company issued a press release stating, in pertinent part, that:

The temporary suspension of the medical license of a nonemployee physician practicing at any Dynacq hospital is of course a concern, and Vista Medical Center promptly suspended Dr. Scheffey’s hospital privileges, in accordance with the hospital’s policies. But this concern does not affect Dynacq’s overall business, which is far greater than the status of a particular doctor’s license at a particular subsidiary hospital.

80. Scheffey’s importance to the hospital’s business, however, was far greater than the Company initially admitted. In fact, Scheffey was one of only a few of the key surgeons at Vista Hospital, which accounted for almost 90% of Dynacq’s revenue in the relevant period. According to a source familiar with Vista’s billings, Scheffey accounted for 25% of the revenue produced by Vista. On December 6, 2003, the Houston Chronicle quoted Defendant Baxter as stating that Scheffey was “a prolific surgeon” and “when he lost his license, we had empty operating rooms for quite a bit of time.”

81. Another Vista doctor who worked closely with Dr. Scheffey was also the subject of discipline. On December 5, 2003, the TSBME issued a press release announcing the suspension of the medical license of Dr. Floyd O. Hardimon (“Hardimon”), another surgeon who practiced at Vista. The press release stated, in pertinent part, that the TSBME took action to temporarily suspend Hardimon’s license because his “continuation in the practice of medicine presents a continuing threat to the public welfare.”

The panel, composed of one physician and two public members, based its decision on allegations that Dr. Hardimon employed Dr. Eric Scheffey in the practice of medicine when Dr. Scheffey was under an Order of Temporary Suspension entered by the Board on August 29. The panel found that employing or associating with a physician who has been found to be a continuing
threat to the public welfare constitutes a real danger to the health of patients or to the public. [Emphasis added]  

82. According to a December 6, 2003 article in the *Houston Chronicle*, a patient went to see Scheffey in his office for a follow-up after surgery. According to the article, the patient filed a written statement alleging that Scheffey winked his eye at him and said “I need him [Hardimon] in the room because the Texas State Board temporarily took away my license. But don’t worry, I’m getting it back at my next hearing.” The patient stated that “Dr. Hardimon didn’t say a word and seemed to be dozing off comfortably in the corner.” After examining the patient, Scheffey instructed Hardimon to prescribe medications for the patient, including a narcotic pain reliever, a tranquilizer, an anti-inflammatory drug, and a muscle relaxer.

83. According to a December 20, 2003 article in the *Houston Chronicle*, a member of the TSBME “quizzed Hardimon about the latest advances in spinal surgery and about protocols for prescribing powerful drugs to relieve pain and anxiety.” The article reported that Hardimon could not name the leading professional organization for spine surgeons and admitted having no good reason for refilling [the patient’s] prescriptions.

84. The Company’s accounting improprieties and its inability to provide quality healthcare have led to inquiries by a prominent Texas official. According to a December 17, 2003 article in the *Houston Chronicle*, Texas State Representative Ron Wilson launched an investigation that month into allegations of “shoddy medicine and questionable business practices” at the Vista Hospital.

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11 A former Vista employee who worked closely with the senior managers of the operating room corroborated TSBME’s contention that Scheffey continued to practice medicine while suspended by having Dr. Hardimon present. In fact, this witness explained that Defendant Chia Chan told the Director of Surgery to “keep it quiet” regarding Dr. Scheffey because Scheffey was bringing in so many patients. This witness also explained that Vista overcharged for “back cages” used in surgeries (tripling the price) and their medical vendors often had problems getting paid. Vendors that were not being paid included: Stryker, Depuy, and Accramed.
85. Not only did the Company fail to disclose the horrific medical care being given at Vista Hospital, the Company also failed to disclose that the vast majority of the hospital’s revenues were derived from the activities of a handful of doctors, and the attendant risks associated with revenues being derived from such a concentration. In its most recent filings, the Company reports that revenues for the nine months ended May 31, 2004 have sharply declined over the same period in fiscal 2003, almost exclusively because of a “loss of key physicians.” According to the Company in its most recent 10-K, “During the period August 2003 to May 2004 six physicians who had accounted for 54% of our gross revenues in fiscal 2003 departed from the Pasadena Facility [Vista] or substantially reduced their surgeries for various reasons.” The financial impact allegedly due to the exit of “key physicians” can be summarized thus:

[See chart on next page]
## DYNACQ'S DECREASE IN REVENUE AND OPERATING PROFIT
(000'S)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross billed charges</strong></td>
<td>$90,755</td>
<td>$117,551</td>
<td>$27,386</td>
<td>$46,392</td>
</tr>
<tr>
<td><strong>Decrease</strong></td>
<td>($26,796)</td>
<td></td>
<td>($19,006)</td>
<td></td>
</tr>
<tr>
<td><strong>Percentage decrease</strong></td>
<td>-22.80%</td>
<td></td>
<td>-40.97%</td>
<td></td>
</tr>
<tr>
<td><strong>Net revenue</strong></td>
<td>$47,921</td>
<td>$64,668</td>
<td>$12,955</td>
<td>$25,606</td>
</tr>
<tr>
<td><strong>Decrease</strong></td>
<td>($16,747)</td>
<td></td>
<td>($12,651)</td>
<td></td>
</tr>
<tr>
<td><strong>Percentage decrease</strong></td>
<td>-25.90%</td>
<td></td>
<td>-49.41%</td>
<td></td>
</tr>
<tr>
<td><strong>Cost and expenses</strong></td>
<td>$45,656</td>
<td>$38,134</td>
<td>$14,876</td>
<td>$14,487</td>
</tr>
<tr>
<td><strong>Percentage increase</strong></td>
<td>19.73%</td>
<td></td>
<td>2.69%</td>
<td></td>
</tr>
<tr>
<td><strong>Income (loss) from operations</strong></td>
<td>$2,265</td>
<td>$26,534</td>
<td>($1,921)</td>
<td>$11,19</td>
</tr>
<tr>
<td><strong>Percentage decrease</strong></td>
<td>91.46%</td>
<td></td>
<td>117.28%</td>
<td></td>
</tr>
<tr>
<td><strong>Operating profit margin</strong></td>
<td>4.73%</td>
<td>41.03%</td>
<td>-14.83%</td>
<td>43.42%</td>
</tr>
<tr>
<td><strong>Percentage decrease</strong></td>
<td>88.48%</td>
<td></td>
<td>134.15%</td>
<td></td>
</tr>
<tr>
<td><strong>Total procedures</strong></td>
<td>3,808</td>
<td>3,340</td>
<td>1,515</td>
<td>1,276</td>
</tr>
<tr>
<td><strong>Percentage Increase</strong></td>
<td>14.01%</td>
<td></td>
<td>18.73%</td>
<td></td>
</tr>
<tr>
<td><strong>Gross billed charges per procedure</strong></td>
<td>$23,833</td>
<td>$35,195</td>
<td>$18,077</td>
<td>$36,357</td>
</tr>
<tr>
<td><strong>Percentage decrease</strong></td>
<td>32.28%</td>
<td></td>
<td>50.28%</td>
<td></td>
</tr>
</tbody>
</table>

86. Although the Company suggests that the drastic decline in revenue is due to a much lower volume of activity caused by the exit of six of its key surgeons, a comparison of the first nine months of fiscal years 2003 and 2004 shows that in fact the number of procedures performed in the 2004 period actually increased. As the chart shows, the drastic difference in revenues and profitability is actually attributable to a disparity between the gross billed charges per procedure compared period over period. This strongly suggests that the loss of the key...
physicians is associated with heightened scrutiny of their medical practices (a la Scheffey) and the legitimacy of their billings during and after the Class Period. In other words, the aforementioned investigations and heightened scrutiny of Vista’s fraudulent billing and other business practices affected the way in which the Company conducted its business, leading to more appropriate practices, which in turn had the effect of reducing per procedure revenues. Failure to disclose the grave risks associated with Vista’s questionable business practices during the Class Period was highly misleading to investors. Indeed, the Company actively misled investors on these issues in its September 16, 2003 press release, as alleged supra.

**DEFENDANTS’ FINANCIAL STATEMENTS DURING THE CLASS PERIOD WERE MATERIALLY FALSE AND MISLEADING AND VIOLATED GAAP**

87. At all relevant times during the Class Period, Defendants represented that Dynacq’s financial statements, when issued, were prepared in conformity with GAAP, which are recognized by the accounting profession and the SEC as the uniform rules, conventions and procedures necessary to define accepted accounting practices at a particular time. However, the Company used improper accounting practices in violation of GAAP, SEC reporting requirements and its own publicly stated policies to falsely inflate Dynacq’s reported revenues, net income and earnings per share during the Class Period.

88. Dynacq’s materially false and misleading financial statements resulted from a series of deliberate senior management decisions designed to conceal the truth regarding Dynacq’s actual operating results. Specifically as discussed in ¶¶37-59, Defendants caused the Company to violate GAAP by, among other things:

a. Improperly recognizing patient service revenues; and
b. Failing to establish and maintain adequate internal accounting controls.

89. As set forth in Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Concepts ("Concepts Statement") No. 1, Objectives of Financial Reporting by Business Enterprises (November 1978), one of the fundamental objectives of financial reporting is that it provide accurate and reliable information concerning an entity’s financial performance during the period being presented. Concepts Statement No. 1, paragraph 42, states:

Financial reporting should provide information about an enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' and creditors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance.

90. According to SEC Rule 4-01(a) of SEC Regulation S-X, "[f]inancial statements filed with the [SEC] which are not prepared in accordance with [GAAP] will be presumed to be misleading or inaccurate." 17 C.F.R. § 210.4-01(a) (1). Management is responsible for preparing financial statements that conform to GAAP. As noted by the American Institute of Certified Public Accountants ("AICPA") Codification of Statements on Auditing Standards § 110.03:

The financial statements are management's responsibility . . . . Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities and equity are within the direct knowledge and control of management . . . . Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility.
**Improper Recognition of Patient Service Revenue**

91. Dynacq’s financial statements during the Class Period were materially false and misleading because Defendants materially overstated the Company’s revenues in violation of GAAP, SEC regulations and its own revenue recognition policy. Defendants knowingly or recklessly disregarded the manipulation of its workers’ compensation billings to workers’ compensation carriers in order to materially inflate the operating results of the Company. Specifically, Dynacq recognized unearned revenue by abusing the provisions of the Texas Workers’ Compensation Stop Loss Rules. This revenue was not a result of Dynacq providing “unusually costly services,” but rather a manipulation of its workers’ compensation billings so that it sought payment under the stop-loss provision on a regular basis.

92. GAAP provides that revenue should not be recognized until it is realized or realizable, earned. The conditions for revenue recognition ordinarily are met when persuasive evidence of an arrangement exists, services have been rendered, the seller price to the buyer is fixed or determinable, collectibility is reasonably assured, and the seller has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Revenues are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. If collectibility is not reasonably assured, revenues should be recognized on the basis of cash received. If payment is subject to a significant contingency, revenue recognition is improper. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (December 1984), ¶83-84; Accounting Research Bulletin (“ARB”) No. 43, *Restatement and Revision of Accounting Research Bulletins* (June 1953) Chapter 1A ¶1; Accounting Principles Board Opinion (“APB”) No. 10 *Omnibus Opinion*, (December 1966) ¶12; Staff Accounting Bulletin No. 101 *Revenue Recognition in Financial Statements* (“SAB 101”) (December 1999); Statement of Financial
Accounting Standard No. 5, *Accounting for Contingencies* (March 1975). Dynacq also had an affirmative duty to recognize revenue in interim periods in accordance with APB Opinion No. 28, *Interim Financial Reporting* (December 1973) ¶ 22, “[r]evenue from products sold or services rendered should be recognized as earned during an interim period on the same basis as followed for the full year.”

93. Dyancq’s financial statements during the Class Period disclosed the following with respect to the Company’s policy of accounting for revenue recognition:

Revenue from patient services are recognized as performed based on net realizable amounts from patients, third-party payors, and others for services rendered under reimbursement agreements.

94. Defendants’ representations concerning the operating results during the Class Period were materially false and misleading because Dynacq, in violation of GAAP and its publicly stated revenue recognition policy, improperly recognized revenues by using the workers’ compensation stop loss provisions not as an exception but as a rule, thereby rendering collectibility from workers’ compensation carriers highly questionable. As a result, the Company’s reported revenues, earnings and earnings per share, were materially inflated during the Class Period.

**Failure to Maintain an Adequate System of Internal Controls**

95. In addition to the foregoing accounting impropriety, Dynacq also suffered from a serious lack of internal accounting controls throughout the Class Period, which rendered the Company’s financial reporting inherently corrupt, subject to manipulation and unreliable, resulting in materially false and misleading financial statements. Contrary to GAAP and SEC requirements, the Dynacq Defendants either failed to implement and maintain an adequate internal accounting control system, or knowingly and/or recklessly tolerated the failure to use existing accounting controls in a manner that would ensure compliance with GAAP.
96. In this regard, the Company disclosed in its Form 8-K/A filed on April 6, 2004:

On December 15, 2003, E&Y orally communicated to certain officers of the Company E&Y’s concerns relating to the Company’s disclosure controls, accounting controls and controls over safeguarding of assets. E&Y’s concerns arose as a result of a transaction related to the sale of certain Company receivables to a foreign entity which is not a financial institution; the transaction did not appear to E&Y to be in the ordinary course of the Company’s business.

On December 17, 2003, E&Y orally informed the Company that the Company lacked the internal controls necessary to develop reliable financial statements. By letter dated December 23, 2003, E&Y advised the Board of Directors of its conclusion that material weaknesses in internal control had come to its attention during the course of performing its audit of the Company’s financial statements for the year ended August 31, 2003, specifically noting (a) “inadequate communication lines and internal controls relating to the authorization, recognition, capture and review of transactions, facts, circumstances and events that may have a material impact on the Company’s financial reporting process and (b) a lack of supervision, review and quality control related to the accounting for income taxes, including the preparation of the federal income tax provision in accordance with SFAS No. 109, Accounting for Income Taxes.”

97. Section 13(b)(2) of the Exchange Act states, in pertinent part, that every reporting company must: (A) make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer; and (B) devise and maintain a system of internal controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. These provisions require an issuer to employ and supervise reliable personnel, to maintain reasonable assurances that transactions are executed as authorized, to properly record transactions on an issuer’s books and, at reasonable intervals, to compare accounting records with physical assets.
Indeed, in its Form 8-K/A filed on April 6, 2004, the Company has admitted:

Specifically in November 2003, the Company’s Chief Executive Officer negotiated a significant transaction to sell certain accounts receivable to another entity. This transaction was not disclosed to the Company’s Chief Financial Officer, the Company’s independent auditors nor the Company’s Board of Directors prior to its execution and represents significant deficiencies in the Company’s disclosure controls, accounting controls and controls over the safeguarding of its assets.

98. In addition, as described above in ¶61, a Stipulation of Settlement dated September 11, 2003, as a result of a previous derivative action, required the Company to adopt numerous changes to its business practices. Several of these changes relate directly to the implementation of fundamental internal accounting controls.

99. Dynacq disclosed in its 2003 10-K that the Company still suffers from inadequate internal controls. As discussed in ¶63 above, its current auditors identified several deficiencies in Dynacq’s internal controls that are considered to be material weaknesses.

100. Furthermore, Dynacq misrepresented in each of its Forms 10-K and 10-Q filed during the Class Period that:

[T]he Company’s disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Exchange Act) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in [United States] Securities and Exchange Commission rules and forms. There were no significant changes in the Company’s internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weaknesses. . . .

101. Dynacq thus violated Section 13(b)(2) of the 1934 Exchange Act and its own disclosed policy by failing to establish an appropriate control environment resulting in significant failures in the Company’s internal accounting controls and procedures. The
Company's lack of adequate internal controls throughout the Class Period rendered Dynaq's Class Period financial reporting inaccurate, unreliable and subject to manipulation resulting in the issuance of materially false and misleading financial statements. Nonetheless, throughout the Class Period, the Company issued annual and quarterly financial statements, without ever disclosing the existence of the significant and material deficiencies in its internal accounting controls and falsely asserted that its financial statements complied with GAAP.

**Violations of SEC Regulations**

102. Item 7 of Form 10-K and Item 2 of Form 10-Q, Management’s Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") require the issuer to furnish information required by Item 303 of Regulation S-K [17 C.F.R. 229.303]. In discussing results of operations, Item 303 of Regulation S-K requires the registrant to:

Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

The instructions to Paragraph 303(a) further state:

The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results . . . .

103. In addition, the SEC, in its May 18, 1989 Interpretive Release No. 34-26831, has indicated that registrants should employ the following two-step analysis in determining when a known trend or uncertainty is required to be included in the MD&A disclosure pursuant to Item 303 of Regulation S-K:

A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and is reasonably likely to have a material effect on the registrant’s financial condition or results of operations.
104. Nonetheless, Dynacq's Class Period Forms 10-K and 10-Q failed to disclose that the increases in revenues during the Class Period were a result of improper revenue recognition and its internal control system deficiencies, which were reasonably likely to have a material adverse effect on Dynacq's operating results, and the disclosure of such was necessary for a proper understanding and evaluation of the Company's operating performance and an informed investment decision.

Additional GAAP Violations

105. As a result of the foregoing, the Defendants caused Dynacq's reported financial results to violate, among other things, the following provisions of GAAP for which each Defendant is necessarily responsible:

a) The principle that interim financial reporting should be based upon the same accounting principles and practices used to prepare annual financial statements (APB No. 28, Interim Financial Reporting ¶ 10 (May 1973));

b) The principle that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions (FASB Concepts Statement No. 1, ¶ 34);

c) The principle that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and effects of transactions, events and circumstances that change resources and claims to those resources (FASB Concepts Statement No. 1, ¶ 40);

d) The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it. To the extent that management offers securities of the enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective investors and to the public in general (FASB Concepts Statement No. 1, ¶ 50);

e) The principle that financial reporting should be reliable in that it represents what it purports to represent. That information should be reliable as well as relevant is a notion that is central to accounting
(FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* ¶¶ 58-59 (May 1980));

f) The principle of completeness, which means that nothing is left out of the information that may be necessary to insure that it validly represents underlying events and conditions (FASB Concepts Statement No. 2, ¶ 79); and

g) The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. The best way to avoid injury to investors is to try to ensure that what is reported represents what it purports to represent (FASB Concepts Statement No. 2, ¶¶ 95, 97).

**E&Y'S KNOWING OR RECKLESS PARTICIPATION IN THE FRAUD**

106. Defendant E&Y is a worldwide firm of certified public accountants, auditors, and consultants. Through its Houston Texas office, E&Y served as Dynaq’s auditor from June 5, 2002 until its resignation on December 17, 2003.

107. An audit conducted in accordance with GAAS requires that an auditor consider the effectiveness of the audited company’s internal controls systems before issuing an audit opinion on financial statements derived from such systems. Dynaq’s misstatements and violations of GAAP, resulting in a restatement, were masked, in large part, by the Company’s lack of internal controls and accounting systems, which E&Y intentionally or with severe recklessness disregarded. E&Y could not have opined that the Company’s 2002 financial statements were fairly stated when those statements were prepared by fundamentally flawed accounting systems because lack of internal controls “could adversely affect the organization’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.” AU § 325.02.

108. Furthermore, Dynaq disclosed in Item 14 of its 2002 Form 10-K and Item 4 of its subsequent 10-Qs issued throughout the Class Period that:
[The Company's disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Exchange Act) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in [United States] Securities and Exchange Commission rules and forms. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weaknesses . . . .

109. It is inconceivable that E&Y could have issued an unqualified opinion on Dynacq's 2002 financial statements and then resigned "due to the Company's lack of internal controls necessary to develop reliable financial statements" a mere five months later, especially given that E&Y was well-aware of the public's concern about Dynacq's internal controls as evinced by prior securities and derivative litigation, and the fact that Dynacq had agreed to reform its internal controls pursuant to the derivative suit settlement.

110. E&Y was required to audit Dynacq's financial statements in accordance with GAAS\textsuperscript{12}, and to report the audit results to Dynacq, its Board of Directors and Audit Committee, and the members of the investing public, including plaintiffs and other members of the Class. The auditor's report must express an opinion on the financial statements taken as a whole and must contain a clear indication of the character of the auditor's work. The auditor can determine that it is able to express an unqualified opinion only if it has performed an audit in accordance with GAAS. AU § 508.07.

111. During the Class Period, E&Y audited Dynacq's fiscal 2002 financial statements, performed quarterly reviews in fiscal years 2001 and 2002, and provided other non-

\textsuperscript{12} GAAS, as approved and adopted by the American Institute of Public Accountants ("AICPA"), relate to the conduct of individual audit engagements. Statements on Auditing Standards (codified and referred to as AU §) are recognized by the AICPA as the interpretation of GAAS.
audit services. According to Dynacq's Proxy Statement, over the one and a half years E&Y served as Dynacq's outside auditors, E&Y earned almost $228,000, of which 37% was for non-audit services.

**E&Y Failed To Render an Accurate Audit Report**

112. E&Y did not render an accurate audit report and thus did not exercise due professional care, because Dynacq's financial statements were not in conformity with GAAP, and because E&Y failed to perform sufficient procedures to audit Dynacq's financial statements as of August 31, 2002, in accordance with GAAS.

113. On November 22, 2002 E&Y issued an unqualified audit opinion on Dynacq's financial statements for fiscal year 2002, in which E&Y stated that its audit was performed in accordance with GAAS and Dynacq's financial statements were presented in conformity with GAAP. Specifically, in its unqualified audit opinion issued during the Class Period, E&Y represented that:

> We have audited the accompanying consolidated balance sheet of Dynacq International, Inc. (the "Company"), as of August 31, 2002, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. Our audit also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audit.

> We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Dynacq International, Inc. at August 31, 2002, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

114. In issuing its audit opinion, E&Y turned a blind eye to Dynacq's systemic and pervasive GAAP and SEC violations described in detail above and issued an unqualified audit opinion on its fiscal 2002 financial statements, even though E&Y knew or with severe recklessness disregarded that: (i) E&Y had not audited Dynacq's financial statements in accordance with GAAS; and (ii) the financial statements had not been prepared in conformity with GAAP and did not present fairly, in all material respects, the financial position of Dynacq and the results of its operations and cash flows.

**E&Y Knew or With Severe Recklessness Disregarded That Dynacq’s Internal Controls Were Materially Deficient**

115. The second GAAS standard of fieldwork provides that "sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." As detailed above, E&Y either (1) intentionally ignored Dynacq's lack of internal controls, or (2) failed to gain an understanding of Dynacq's internal control structure and control risk. As a result, E&Y failed to obtain reasonable assurance that the financial statements were free of material misstatements.

116. Indeed, the fiscal 2002 financial statements audited by E&Y were not free of material misstatements, evidenced by Dynacq's restatement. GAAP allows for restatements due to "mathematical mistakes, mistakes in the application of accounting principles, or oversight
or misuse of facts that existed at the time the financial statements were prepared.” Accounting Principles Board No. 20: *Accounting Changes* §13 (July 1971).

117. At all times relevant hereto, Dynacq exhibited significant internal control weaknesses including, among other things, the lack of appropriate policies and procedures related to allowances for bad debt and contractual allowances, improperly trained financial staff, and the myriad deficiencies noted in ¶63 above. In fact, not until the Stipulation of Settlement as noted in ¶61 above, did the Company begin to implement adequate internal accounting controls to correct its weaknesses. Because of the pervasiveness of these problems and the utter lack of internal controls evident at the Company, E&Y knew of, or recklessly disregarded, the Company’s improper financial reporting practices complained of herein, but, nevertheless, proceeded to issue a materially false and misleading unqualified audit opinion during the Class Period.

118. The myriad investigations into Dynacq’s business practices by the SEC, NASDAQ, the Texas Attorney General, Texas State Representative Ron Wilson, and the Texas State Board of Medical Examiners, as well as the fact that E&Y was Dynacq’s fourth auditor in only eight years, should have provided notice to E&Y as to Dynacq’s questionable practices.

119. Indeed, when management fails to display and communicate an appropriate attitude regarding internal control, such as, ineffectively communicating and supporting a company’s values or ethics, or communication of inappropriate values or ethics, the auditor must be cognizant that although “such risk factors do not necessarily indicate the existence of fraud, they often have been observed in circumstances where fraud has occurred.” AU 316.11.
120. E&Y violated SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, in that it failed to adequately consider the risk that the audited financial statements of Dynacq were free of material misstatement, whether caused by error or fraud. In this regard, E&Y knew or recklessly disregarded numerous circumstances that occurred or existed at Dynacq during the Class Period that are specifically identified in SAS No. 82 as being “risk factors relating to misstatements arising from fraudulent financial reporting.” These risk factors include, but are not limited to:

a. A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process such as inadequate monitoring of significant controls;

b. Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee;

c. Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws;\(^\text{13}\) and

d. Unusually rapid growth or profitability especially compared with that of other companies in the same industry.

121. E&Y’s unqualified audit opinion, which represented that Dynacq’s 2002 financial statements were presented in conformity with GAAP, were materially false and misleading because E&Y knew or was reckless in not knowing that Dynacq’s financial statements violated principles of fair reporting and GAAP. In the course of rendering its unqualified audit opinion on Dynacq’s financial statements, E&Y knew it was required to adhere

\(^{13}\) Dynacq was sued by investors for securities fraud in 2002. *In re Dynacq International, Inc. Securities Litigation*, (S.D. Tex.), H-02-0377.
to, among other things, each of the herein described standards and principles of GAAS, including
the requirement that the financial statements comply in all material respects with GAAP. E&Y,
in issuing its unqualified opinion, knew or with severe recklessness disregarded that by doing so
it was engaging in gross departures from GAAS, thus making its opinion materially false.

122. Accordingly, in certifying Dynacq’s Class Period financial statements, E&Y falsely represented that its audit was conducted in accordance with GAAS. The audit E&Y conducted was knowingly or recklessly not performed in accordance with GAAS in the following respects:

a. E&Y violated GAAS Standard of Reporting No. 1 that requires the audit report to state whether the financial statements are presented in accordance with GAAP. E&Y’s opinion falsely represented that Dynacq’s financial statements were presented in conformity with GAAP when they were not for the reasons alleged above in detail.

b. E&Y violated GAAS Standard of Reporting No. 4 which requires that, when an opinion on the financial statements as a whole cannot be expressed, the reasons therefore must be stated. AU § 504.01. E&Y should have stated that no opinion could be issued by it on Dynacq’s fiscal 2002 financial statements or issued an adverse opinion stating that the financial statements were not fairly presented. E&Y also failed to require Dynacq to restate its 2001 financial statements for an error in the application of an accounting principle related to the income tax effect of stock options. According to Dynacq’s 2003 10-K, fiscal 2001 and 2002 were restated to correct for errors in accounting for stock options. The failure to make such a qualification, correction, modification and/or withdrawal was a violation of GAAS, including the Fourth Standard of Reporting.
c. E&Y violated GAAS Standard of Field Work No. 2, which requires that in all audits, the auditor must make a proper study of an entity’s existing internal controls, including accounting, financial and managerial controls, to determine whether reliance thereon was justified, and if such controls are not reliable, to expand the nature and scope of the auditing procedures to be applied. The standard provides that a sufficient understanding of an entity’s internal control structure must be obtained to adequately plan the audit and to determine the nature, timing and extent of tests to be performed. AU § 150.02. In all audits, the auditor should perform procedures to obtain a sufficient understanding of three elements of an entity’s internal control structure: the control environment, the accounting system, and control procedures. AU § 319.02. The control environment, which includes management’s integrity and ethical values, is the foundation of internal control and provides discipline, structure and sets the tone of the organization. After obtaining an understanding of an entity’s internal control structure, the auditor then assesses the entity’s control risk. AU § 319.02. Control risk is the risk that a material misstatement in an assertion by management contained in a company’s financial statements will not be prevented or detected on a timely basis by an entity’s internal control structure policies or procedures. AU § 319.63. The ultimate purpose of assessing control risk is to aid the auditor in evaluating the effectiveness of an entity’s internal control in preventing or detecting material misstatements in the financial statements. AU § 319.62. In the course of auditing Dynaqc’s fiscal 2002 financial statements, E&Y either knew or recklessly disregarded facts that indicated it either failed to sufficiently understand Dynaqc’s internal control structure and/or it disregarded the now admitted significant weaknesses and deficiencies in Dynaqc’s internal control structure.
d. E&Y violated Standard of Field Work No. 3, which requires an auditor to obtain "sufficient competent evidential matter through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit" as to the "fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles." AU §§ 110.01, 326.01. The risk associated with an audit determines the nature and extent of evidentiary matter that must be obtained to assure the auditor that the financial statements are free from material error. As described above, E&Y knew, or recklessly disregarded that due to Dynacq's internal control deficiencies, E&Y could not obtain sufficient competent evidential matter to afford a reasonable basis for issuing an opinion that Dynacq's fiscal year end 2002 financial statements were fairly presented in all material respects in accordance with GAAP.

e. E&Y violated GAAS General Standard No. 2, which requires that independence in mental attitude be maintained by the auditor in all matters related to the assignment. AU § 220.01.

f. E&Y violated GAAS General Standard No. 3, which requires that due professional care must be exercised by the auditor in the performance of the audit and the preparation of the report. AU § 230.01.


[T]he capital formation depends in large part on the confidence of investors in financial reporting. An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding
the corporations in which he has invested or proposes to invest. The quality of information disseminated in the securities markets and the continuing conviction of individual investors that such information is reliable are thus key to the formation and effective allocation of capital. Accordingly, the audit function must be meaningfully performed and the accountants’ independence not compromised. The auditor must be free to decide questions against his client’s interests if his independent judgment compels that result.

124. Furthermore, in accordance with SAS No. 71, Interim Financial Information (May 1992) and the SEC, E&Y was required to perform quarterly reviews of Dynacq’s financial statements. SAS No. 71 requires that procedures for conducting a review of interim financial information should include, among others:

a. Inquiries concerning internal controls, especially changes in internal control since the most recent financial statement audit or review;

b. Reading the interim financial information for conformity with generally accepted accounting principles; and

c. Inquiry of officers and other executives having responsibility for financial and accounting matters concerning whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied.

125. E&Y’s unqualified audit opinion, which represented that Dynacq’s 2002 financial statements were presented in conformity with GAAP, was materially false and misleading because E&Y knew or was severely reckless in not knowing that Dynacq’s financial statements violated principles of fair reporting and GAAP. In the course of rendering its unqualified audit opinion on Dynacq’s financial statements, E&Y knew it was required to adhere to, among other things, each of the herein described standards and principles of GAAS, including the requirement that the financial statements comply in all material respects with GAAP. E&Y,
in issuing its unqualified opinion, knew or with severe recklessness disregarded that by doing so it was engaging in gross departures from GAAS, thus making its opinion materially false.

126. Thus, against the backdrop of Dynaq’s massive fraud, E&Y was supposedly acting as the public’s “watch dog,” with a duty to ensure that the Company’s Class Period financial statements were fairly stated in accordance with GAAP before certifying them as such to the investing public. Indeed, E&Y had a heightened duty to be especially vigilant of its independence given its dual role as a non-audit consultant during the relevant period. E&Y knowingly or recklessly failed in its role as an auditor as defined by the SEC. As a result, E&Y furthered the fraud through its issuance of a “clean” audit opinion on Dynaq’s financial statements that were ultimately restated.

DEFENDANTS’ OTHER MATERIALLY FALSE AND MISLEADING STATEMENTS DURING THE CLASS PERIOD

127. The Class Period begins on November 27, 2002, when Dynaq issued a press release announcing financial results for fiscal year 2002, ended on August 31, 2002. The press release, which was entitled “Dynaq International Continues Record Earnings Growth,” reported net income of $15,439,179, an increase of 39.58% over the previous year. Additionally, the press release reported net revenue of $64,883,235, an increase of 48.12% over the previous year and diluted earnings per share of $1.03, an increase of 38.16%. Defendant Chiu Chan was quoted in the press release as stating, in pertinent part, that “[t]his outstanding performance reflects the hard work of our clinical support teams, managers and employees to provide high quality healthcare services and facilities for patients and surgeons…. We are committed to continuing Dynaq’s performance for shareholders in the current fiscal year by combining strong operating results from the Houston marketplace with the start-up of hospital operations in Baton Rouge in January.” (Emphasis added.)
128. On November 29, 2002, Dynacq filed a Form 10-K with the SEC which reported the Company’s results for the fiscal year 2002. The 10-K was signed by Defendants Chiu Chan and Philip Chan and reiterated the results reported in the November 27, 2002 press release.

129. Additionally, the Form 10-K contained an unqualified audit opinion issued by Defendant E&Y which represented that:

We have audited the accompanying consolidated balance sheet of Dynacq International, Inc. (the "Company"), as of August 31, 2002, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. Our audit also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Dynacq International, Inc. at August 31, 2002, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

130. Defendants knew or recklessly disregarded that the statements referenced in ¶¶127-129 above were materially false and misleading when made, and were made without a
reasonable basis, because they misrepresented and/or omitted the following adverse facts discussed in detail above, that then existed, the disclosure of which was necessary to make the statements made not materially misleading:

a. As set forth in ¶¶87-105 above, the Company’s reported revenues, income and earnings per share were materially inflated because the Company used improper accounting practices in violation of GAAP, SEC reporting requirements, and its own publicly stated policies;

b. As set forth in ¶¶57-66 above, the Company lacked adequate internal controls, and as a result, statements concerning Dynacq’s financial results were inaccurate, unreliable, and subject to manipulation;

c. As set forth in ¶¶39-56 above, the Company had been improperly reporting net patient revenue that Vista Hospital billed to workers’ compensation carriers even though the carriers were on average were paying only a small fraction of the billed amount;

d. As set forth in ¶¶72-86 above, Dynacq did not provide high quality healthcare and facilities for patients and surgeons; and

e. As set forth in ¶¶106-126 above, E&Y knew or was reckless in not knowing that it had not conducted its audits in accordance with GAAS and that the Company’s financial statements were not prepared in accordance with GAAP.

131. On January 14, 2003, Dynacq issued a press release reporting “continued strong growth in overall financial performance in the first quarter ending November 30, 2002 for fiscal year 2003.” That news release announced net revenue of $17,933,926, representing a 30% increase over the corresponding prior year quarter, net income of $4,185,666 (before cumulative effects of changes in accounting principles), representing a 24% increase over the corresponding
prior year quarter, and basic and diluted earnings per share of $0.28 and $0.27 respectively (before cumulative effects of changes in accounting principles), representing 22% and 17% increases over the corresponding prior year quarter. Defendant Chiu Chan was quoted in this press release as stating that the Company's first quarter 2003 growth "reflect[s] Dynacq's goal in providing high quality healthcare services and facilities for our patients and medical professionals" and touting the "success of [Dynacq's] management and business model."

132. Also on January 14, 2003, Dynacq filed its quarterly report for the first quarter of fiscal year 2003 ended November 30, 2002, reiterating the financial results reported in the Company's press release dated the same day. This Form 10-Q also represented, in a section titled "Controls and Procedures", that

Based on their evaluation as of a date within 90 days of the filing date of this Quarterly Report on Form 10-Q, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Exchange Act) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weakness, and therefore there were no corrective actions taken. [Emphasis added.]

133. The Form 10-Q for the first quarter of fiscal year 2003 was signed by Defendant Philip Chan and certified by both Defendant Philip Chan and Chiu Chan. By signing and certifying this Form 10-Q, Defendants Chui Chan and Philip Chan represented, inter alia, that the quality and accuracy of the information being reported therein concerning Dynacq's financial condition and performance was safeguarded by internal financial and accounting controls in place at the Company, which were designed to foster the development of reliable
financial statements. Those internal controls were, in truth, at a minimum, seriously deficient and thus unable to accomplish their purpose.

134. Defendants knew or recklessly disregarded that the statements referenced in ¶¶131-133 above were materially false and misleading when made, and were made without a reasonable basis, because they misrepresented and/or omitted the following adverse facts discussed in detail above, that then existed, the disclosure of which was necessary to make the statements made not materially misleading:

a. As set forth in ¶¶87-105 above, the Company’s reported revenues, income and earnings per share were materially inflated because the Company used improper accounting practices in violation of GAAP, SEC reporting requirements, and its own publicly stated policies;

b. As set forth in ¶¶57-66 above, the Company lacked adequate internal controls, and as a result, statements concerning Dynacq’s financial results were inaccurate, unreliable, and subject to manipulation;

c. As set forth in ¶¶39-56 above, the Company had been improperly reporting net patient revenue that Vista Hospital billed to worker’s compensation carriers even though the carriers were paying only a small fraction of the billed amount; and

d. As set forth in ¶¶72-86 above, Dynacq did not provide high quality healthcare and facilities for patients and surgeons.

135. On April 14, 2003, the Company issued a press release announcing Dynacq’s financial results for the second quarter of fiscal year 2003, ended February 28, 2003. In this press release, in which Dynacq touted its “Continued Strong Growth,” Dynacq reported net revenues of $21,128,000, representing a 41% increase over the corresponding prior year quarter,
and basic earnings per share and diluted earnings per share of $0.28 and $0.27 respectively, representing 17% and 13% increases over the corresponding prior year quarter. Dynaq also reported net income of $4,181,495.

136. Dynaq also filed a Form 10-Q with the SEC on April 14, 2003 for the second quarter of fiscal year 2003 ended February 28, 2003, reiterating the financial results reported in the Company’s press release dated the same day. This Form 10-Q also represented, in a section titled “Controls and Procedures”, that

Based on their evaluation as of a date within 90 days of the filing date of this Quarterly Report on Form 10-Q, the Company’s principal executive officer and principal financial officer have concluded that the Company’s disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Exchange Act) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms. There were no significant changes in the Company’s internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weakness and therefore there were no corrective actions taken. [Emphasis added.]

137. This Form 10-Q was signed by Defendant Philip Chan and certified by both Defendant Philip Chan and Chiu Chan. By signing and certifying this Form 10-Q, Defendants Chui Chan and Philip Chan represented, inter alia, that the quality and accuracy of the information being reported therein concerning Dynaq’s financial condition and performance was safeguarded by internal financial and accounting controls in place at the Company, which were designed to foster the development of reliable financial statements. Those internal controls were in truth, at a minimum, seriously deficient and thus unable to accomplish their purpose.

138. Dynaq’s over-hyped claims of financial success in 2003 caused it to draw undeserved praise from the business news media. For instance, Dynaq was ranked eighth by
Fortune Small Business magazine on the “TSB 100, American’s Fastest Growing Small Companies” list, which was based upon an averaging of the rankings of the public companies on major exchanges with less than $200 million in revenue growth rates regarding earnings, revenue and stock data.

139. Defendants knew or recklessly disregarded that the statements referenced in ¶¶135-138 above were materially false and misleading when made, and were made without a reasonable basis, because they misrepresented and/or omitted the following adverse facts discussed in detail above, that then existed, the disclosure of which was necessary to make the statements made not materially misleading:

a. As set forth in ¶¶87-105 above, the Company’s reported revenues, income and earnings per share were materially inflated because the Company used improper accounting practices in violation of GAAP, SEC reporting requirements, and its own publicly stated policies;

b. As set forth in ¶¶57-66 above, the Company lacked adequate internal controls, and as a result, statements concerning Dynacq’s financial results were inaccurate, unreliable, and subject to manipulation; and

c. As set forth in ¶¶39-56 above, the Company had been improperly reporting net patient revenue that Vista Hospital billed to workers’ compensation carriers even though the carriers were on average paying only a small fraction of the billed amount.

140. On July 14, 2003, the Company issued a press release entitled “Dynacq Reports 52% Increase in Third Quarter Net Income to $6.3 Million.” In that press release, Dynacq reported net patient service revenues of $25,606,000, representing a 31% increase over the corresponding prior year quarter, net income of $6,277,000, representing a 52% increase over
the corresponding prior year quarter, and diluted earnings per share of $0.40, representing a 48% increase over the corresponding prior year quarter. The press release quoted Defendant Chiu Chan, in pertinent part, as stating: “I am especially pleased that the continued success of the Houston facilities has permitted the Company to achieve such strong net earnings growth, even with the expected initial earnings drag from the start-up of the new hospital in Baton Rouge, La. As the Baton Rouge facility begins to achieve profitability, the ongoing success of the management and clinical teams in implementing our strategic growth plan should accelerate.”

141. Dynacq also filed a Form 10-Q with the SEC on July 14, 2003 for the third quarter of fiscal year 2003, ended May 31, 2003, reiterating the financial results reported in the Company’s press release dated the same day. This Form 10-Q also represented, in a section titled “Controls and Procedures”, that

Based on their evaluation as of a date within 90 days of the filing date of this Quarterly Report on Form 10-Q, the Company’s principal executive officer and principal financial officer have concluded that the Company’s disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Exchange Act) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms. There were no significant changes in the Company’s internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weakness, and therefore there were no corrective actions taken. [Emphasis added.]

142. This Form 10-Q was signed by Defendant Philip Chan and certified by both Defendant Philip Chan and Chiu Chan. By signing and certifying this Form 10-Q, Defendants Chui Chan and Philip Chan represented, inter alia, that the quality and accuracy of the information being reported therein concerning Dynacq’s financial condition and performance was safeguarded by internal financial and accounting controls in place at the Company which
were designed to foster the development of reliable financial statements, which internal controls were in truth, at a minimum, seriously deficient and thus unable to accomplish their purpose.

143. Defendants knew or recklessly disregarded that the statements referenced in ¶140-142 above were materially false and misleading when made, and were made without a reasonable basis, because they misrepresented and/or omitted the following adverse facts discussed in detail above, that then existed, the disclosure of which was necessary to make the statements made not materially misleading:

a. As set forth in ¶87-105 above, the Company’s reported revenues, income and earnings per share were materially inflated because the Company used improper accounting practices in violation of GAAP, SEC reporting requirements, and its own publicly stated policies;

b. As set forth in ¶57-66 above, the Company lacked adequate internal controls, and as a result, statements concerning Dynacq’s financial results were inaccurate, unreliable, and subject to manipulation; and

c. As set forth in ¶39-56 above, the Company had been improperly reporting net patient revenue that Vista Hospital billed to workers’ compensation carriers even though the carriers were on average paying only a small fraction of the billed amount.

144. On August 18, 2003, Dynacq issued a press release announcing that one of its affiliates had completed the purchase of a 113 bed hospital located in the Dallas-Ft. Worth area. The press release quoted Dynacq Chief Operating Officer, Sarah Garvin, in pertinent part, as stating: “Our affiliate plans to retrofit the hospital to fit Dynacq’s model of a progressive, efficient facility for providing surgical healthcare which focuses on compassionate high tech health care in a family atmosphere. As at the Houston and Baton Rouge facilities, the new
hospital will be designed to accommodate laparoscopic, spine, bariatric, orthopedic and plastic surgeries.” (Emphasis added.)

145. Defendants knew or recklessly disregarded that the statements referenced in ¶144 above were materially false and misleading when made, and were made without a reasonable basis, because they misrepresented and/or omitted the following adverse facts discussed in detail above, that then existed, the disclosure of which was necessary to make the statements made not materially misleading:

a. As set forth in ¶72-86 above, Dynacq’s hospitals did not provide a “progressive more efficient facility for providing surgical healthcare which focuses on compassionate high tech health care.” Rather, Dynacq’s hospitals were operating under poor conditions.

146. Following the release of the September 15, 2003 Barron’s article detailed above in ¶40-42, relating to Dynacq’s improper revenue recognition practices in light of Texas insurance regulations, Dynacq issued a press release on September 16, 2003 responding to the article. The press release stated, in pertinent part, that “[t]he Company believes that the Barron’s article provided a slanted and mistaken account of Dynacq’s current and future business and dredged up some old news regarding reimbursement disputes with one of the Texas insurers and a regulatory proceeding involving a surgeon who used to have staff privileges at a subsidiary hospital.” The press release continued:

The former litigation with Texas Mutual is a normal part of Dynacq’s business strategy of providing first class medical facilities for complex surgeries and refusing to accept payments from insurers which are less than the amounts scheduled by the Texas Workers Compensation Commission. Texas Mutual is only one of the workers comp insurance payers in Texas and it cannot dictate what it is required to reimburse. Whatever Texas Mutual may assert, only the Texas Workers Compensation Commission
can ultimately determine the reimbursements. In any event, all of the underpayments by Texas Mutual which were detailed in the Barron’s article have long since been fully accounted for and will have no adverse effect on Dynacq’s financials. In addition, the hospitals involved are still pursuing certain of these claims in administrative appeals.

(Emphasis added.) The Company made these misleading claims in spite of the fact that historically the TWCC itself only authorized reimbursement of 34% of Vista’s workers’ compensation billings. As to the allegations concerning Dr. Scheffey, the press release stated that “[t]he temporary suspension of the medical license of a nonemployee physician practicing at any Dynacq hospital is of course a concern, and Vista Medical Center promptly suspended Dr. Scheffey’s hospital privileges, in accordance with the hospital’s policies. But this concern does not affect Dynacq’s overall business, which is far greater than the status of a particular doctor’s license at a particular subsidiary hospital.” (Emphasis added.)

147. Defendants knew or recklessly disregarded that the statements referenced in ¶146 above were materially false and misleading when made, and were made without a reasonable basis, because they misrepresented and/or omitted the following adverse facts discussed in detail above, that then existed, the disclosure of which was necessary to make the statements made not materially misleading:

a. As set forth in ¶¶39-56 above, the Company had been improperly reporting net patient revenue that Vista Hospital billed to workers’ compensation carriers even though the carriers were on average paying only a small fraction of the billed amount;

b. As set forth in ¶¶72-86 above, Dynacq’s hospitals did not provide “first class medical facilities for complex surgeries.” Rather, Dynacq’s hospitals were operating under poor conditions; and
c. As set forth in ¶80 above, Dr. Scheffey brought in a large percentage of Dynacq's business and the loss of his services had a negative and material effect on Dynacq's business.

The Truth Emerges\textsuperscript{14}

148. In early December of 2003, the truth about Dynacq's purported financial success as well as the actual state of its internal financial and accounting controls, began to be revealed. On December 2, 2003, Dynacq announced that it was requesting an automatic extension of up to 15 days to file its Form 10-K with the SEC for the fiscal year ended August 31, 2003. The Company stated that it was delaying the filing of the 2003 10K and the release of its financial statements for the fiscal year 2003 until the SEC had completed a review of the Company's periodic filings.

149. Then, on December 18, 2003, the Company announced that E&Y had resigned as the Company's outside auditor effective immediately on December 17, 2003. The Company admitted that in connection with its resignation, E&Y had "verbally advised" Dynacq that it was resigning due to the Company's "lack of internal controls necessary to develop reliable financial statements." Dynacq stated that, as a result of E&Y's resignation, the Company "continues to be unable to file its annual report on Form 10-K," and only planned to do so "as soon as practicable" after a new auditor had been retained, completed the audit of the Company's financial statements for the year ended August 31, 2003, and after the SEC had completed its review of the Company's periodic reports.

150. On December 19, 2003, the Company announced that it had received a NASDAQ Staff Determination stating that because it had failed to comply with NASD

\textsuperscript{14} The stock market also reacted negatively to the Barron's article but, as noted above, defendants stemmed the decline by denying the article's allegations.
Marketplace Rule 4310(c)(14) by failing to file its fiscal year 2003 10-K with the SEC in a timely manner, Dynacq common stock would be delisted from the NASDAQ National Market on December 30, 2003, unless Dynacq requested a hearing before the NASDAQ Listings Qualification Panel.

151. Finally, on December 19, 2003, the Company announced that it had received a notice from the SEC office in Fort Worth, Texas, that the SEC was conducting an investigation into Dynacq's reporting of its financial statements, revenue and cost recognition, allowances for doubtful accounts, and its internal accounting controls.

152. The market reacted negatively to the news on December 2, 2003 that Dynacq was requesting an automatic 15 day extension to file its fiscal year 2003 Form 10-K. Dynacq's common stock closed at $15.94 per share on that day, approximately 12% below the previous day's closing price of $18.05 per share.

153. The market price of Dynacq's stock plunged even further following the Company's disclosures that its independent auditor was resigning, that it was being threatened with delisting from the NASDAQ National Market, and that the SEC was investigating its accounting practices and controls. On December 18, 2003, the date these announcements were made, Dynacq's common stock price fell approximately 11.5% from a high of $10.00 per share to close at $8.95 per share on extraordinarily high trading volume of about 1.14 million shares, nearly three times the trading volume of approximately 400,000 shares just a day earlier on December 17, 2003. On the following day, December 19, 2003, Dynacq's share price continued to plummet, reaching a low of just $4.09 per share, again on extraordinarily high trading volume. During the Class Period, shares of Dynacq common stock traded as high as the artificially inflated price of $27.37 per share.
ADDITIONAL SCIENTER ALLEGATIONS & INSIDER TRADING

154. As alleged herein, Defendants acted with scienter in that Defendants knew or recklessly disregarded that the public documents and statements issued or disseminated in the name of the Company, as set forth herein, were materially false and misleading when made. Defendants knew that such statements or documents would be issued or disseminated to the investing public and they knowingly and substantially participated or acquiesced in the issuance or dissemination of such statements or documents as primary violators of the federal securities laws. As set forth elsewhere herein in detail, Defendants, by virtue of their receipt of information reflecting the true facts regarding Dynacq and its business, their control over Dynacq’s allegedly materially misleading statements, and/or their associations with the Company, which made them privy to confidential proprietary information concerning Dynacq, were active and culpable participants in the fraudulent scheme alleged herein.

155. At all relevant times, Defendants had actual knowledge of, or recklessly disregarded, Dynacq’s (1) total failure to maintain an adequate system of internal controls; (2) violations of SEC regulations; (3) violations of GAAP; and (4) declining financial performance due to loss of Scheffey’s services as particularized in ¶¶39-105 above. Nevertheless, Defendants issued the materially false and misleading statements above, which were contradicted by internal evidence, which was known to or recklessly disregarded by Defendants during the Class Period.

156. As Chief Financial Officer of Dynacq, defendant Philip Chan, in conjunction with Defendant Chiu Chan, was responsible for the preparation of Dynacq’s financial statements and for ensuring that the periodic reports filed with the SEC containing such financial statements complied fully with the disclosure requirements of the federal securities laws. Defendants Chiu Chan and Philip Chan reviewed and signed and/or certified Dynacq’s
SEC filings containing the Company’s financial results, as alleged herein. Moreover, given the pervasiveness of the accounting irregularities and the substantial lack of internal financial and accounting controls at the Company, the Individual Defendants, as senior executive officers and directors of the Company, knew of, approved or with severe recklessness ignored the improper conduct complained of herein.

157. Defendant E&Y knew or was reckless in not knowing that the financial information it was seeing was false. E&Y admitted, when it resigned on December 17, 2003, that the Company lacked internal controls to develop reliable financial statements. However, the Company’s lack of internal controls was constant during the Class Period. Furthermore, when resigning, E&Y never said that there was any deterioration in regard to the Company’s internal controls — only that the Company lacked them.

158. Defendants were further motivated to engage in the fraudulent scheme alleged herein in order to enable the Individual Defendants to sell their personally held Dynacq common stock to the unsuspecting public at artificially inflated prices while they were in the possession of material non-public information about the Company. The following chart sets forth the substantial selling by the Individual Defendants during the Class Period:

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15 Among other things, Defendants Chiu Chan and Philip Chan both certified in these filings that: “[b]ased on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this . . . report[,]” as well as that “all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant’s ability to record, process, summarize and report financial data” have been disclosed. Having attested to these circumstances, Defendants were at a minimum severely reckless in not knowing that Dynacq’s internal controls were seriously deficient and that the Company’s financials did not fairly present the condition of the Company.
Defendant Chiu Chan, Chief Executive Officer and Chairman of the Board of Directors:

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Defendant Philip Chan, Chief Financial Officer, Treasurer, Vice President of Operations, and Director:

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<td>$21.00</td>
<td>$52,500.00</td>
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<td>32,862</td>
<td>$20.94</td>
<td>$688,130.28</td>
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<td>Total</td>
<td>36,412</td>
<td></td>
<td>$754,382.78</td>
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Defendant Sarah Garvin, Executive Vice President and Chief Operating Officer:

<table>
<thead>
<tr>
<th>DATE</th>
<th># OF SHARES</th>
<th>PRICE PER SHARE</th>
<th>TOTAL VALUE</th>
</tr>
</thead>
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<tr>
<td>12/4/2002</td>
<td>5,000</td>
<td>$15.73</td>
<td>$78,650.00</td>
</tr>
<tr>
<td>12/5/2002</td>
<td>5,000</td>
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<td>$76,200.00</td>
</tr>
<tr>
<td>12/9/2002</td>
<td>3,000</td>
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<td>$45,450.00</td>
</tr>
<tr>
<td>12/10/2002</td>
<td>3,000</td>
<td>$15.08</td>
<td>$45,240.00</td>
</tr>
</tbody>
</table>
Defendant Irvin Gregory, Executive Vice-President of Development:

<table>
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<tr>
<th>DATE</th>
<th># OF SHARES</th>
<th>PRICE PER SHARE</th>
<th>TOTAL VALUE</th>
</tr>
</thead>
<tbody>
<tr>
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<td>$15.75</td>
<td>$78,750.00</td>
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<tr>
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<td>5,000</td>
<td>$15.24</td>
<td>$76,200.00</td>
</tr>
<tr>
<td>12/9/2002</td>
<td>3,000</td>
<td>$15.15</td>
<td>$45,450.00</td>
</tr>
<tr>
<td>12/10/2002</td>
<td>3,000</td>
<td>$15.08</td>
<td>$45,240.00</td>
</tr>
<tr>
<td>12/11/2002</td>
<td>3,000</td>
<td>$15.27</td>
<td>$45,810.00</td>
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<tr>
<td>7/21/2003</td>
<td>34,413</td>
<td>$20.62</td>
<td>$709,596.06</td>
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<tr>
<td>Total</td>
<td>53,413</td>
<td></td>
<td>$1,001,046.06</td>
</tr>
</tbody>
</table>

159. These sales are suspicious and unusual in the fact that Defendants Philip Chan, Garvin, and Gregory sold much higher volumes of shares than usual immediately following the release of Dynacq's financial results for the third quarter of fiscal year 2003. Defendant Philip Chan's largest sale of stock between the beginning of 2001 and his July 18, 2003 sale of 32,862 shares, was 9,800 shares, in June 2001. Defendant Garvin made no sales of stock between the beginning of 2001 and the beginning of the Class Period. Defendant Gregory made only two sales between the beginning of 2001 and the beginning of the Class Period. Both occurred in April 2002 and totaled 20,000 shares together, over 14,000 shares less than his July 21, 2003 sale of 34,413 shares. Additionally, Defendant Chiu Chan's sales in late July 2003 were the first sales he had made in over a year and a half. The Form 10-Q filed by the Company
with the SEC on July 14, 2003, which immediately preceded the unusual sales by Defendants Chiu Chan, Philip Chan, Garvin, and Gregory as detailed above, was, in fact, the last time Dynacq filed financial results for any quarter or fiscal year.

APPLICABILITY OF PRESUMPTION OF RELIANCE:
FRAUD-ON-THE-MARKET DOCTRINE

160. At all relevant times, the market for Dynacq common stock was an efficient market for the following reasons, among others:

a. Dynacq common stock met the requirements for listing, and was listed, on the NASDAQ, an efficient and automated market;

b. During the Class Period, millions of shares of Dynacq common stock were traded on the open market; and

c. As a regulated issuer, Dynacq filed periodic public reports with the SEC and the NASDAQ.

161. As a result, the market for Dynacq common stock promptly digested current information regarding the Company from all publicly available sources and reflected such information in Dynacq’s common stock price. Under these circumstances, all purchasers of the Company’s common shares during the Class Period suffered similar injury through their purchase of shares at artificially inflated prices and a presumption of reliance applies.

INAPPLICABILITY OF STATUTORY SAFE HARBOR

162. The statutory safe harbor provided for forward-looking statements under certain circumstances does not apply to any of the allegedly false statements pleaded in this Complaint. The statements alleged to be false and misleading herein all relate to then-existing facts and conditions. In addition, to the extent certain of the statements alleged to be false may
be characterized as forward-looking, they were not identified as “forward-looking statements” when made, there was no statement made with respect to any of those representations forming the basis of this Complaint that actual results “could differ materially from those projected,” and there were no meaningful cautionary statements identifying relevant important factors that could cause actual results to differ materially from those in the purportedly forward-looking statements. Alternatively, to the extent that the statutory safe harbor does apply to any forward-looking statements pleaded herein, Defendants are liable for those false forward-looking statements because at the time each of those forward-looking statements was made, the Defendants had actual knowledge that the particular forward-looking statement was false.

163. The statutory safe harbor provided for forward-looking statements under certain circumstances, moreover, does not apply to false statements or material omissions of existing facts.

COUNT I

VIOLATION OF SECTION 10(B) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 THEREUNDER

164. Lead Plaintiffs repeat and reallege each and every allegation above, as if set forth in full herein.

Throughout the Class Period, Defendants, individually and in concert, directly or indirectly, engaged in a common plan, scheme and course of conduct described herein, pursuant to which they knowingly or recklessly engaged in acts, transactions, practices and a course of business and conduct which operated as a fraud upon Lead Plaintiffs and the other members of the Class; made various false statements of material facts and omitted to state material facts to make the statements made not misleading to Lead Plaintiffs and the other members of the Class; and employed manipulative or deceptive devices and contrivances in connection with the purchase
and sale of Dynacq stock. The purpose and effect of Defendants' plan, scheme and course of conduct was to artificially inflate the price of Dynacq's stock and to artificially maintain the market price of Dynacq securities.

165. The Individual Defendants, who are the top officers and are directors of the Company, had actual knowledge of the material omissions and/or the falsity of the material statements set forth above, and intended to deceive Lead Plaintiffs and the other members of the Class, or, in the alternative, acted with reckless disregard for the truth when they failed to ascertain and disclose the true facts in the statements made by them or other Dynacq personnel to members of the investing public, including Lead Plaintiffs and the Class, and the securities analysts.

166. As a result of the foregoing, the market price of Dynacq securities was artificially inflated during the Class Period. In ignorance of the falsity of the Defendants' statements and representations concerning the financial results and performance of Dynacq, and the true state of the internal accounting and financial controls at the Company, Lead Plaintiffs and the other members of the Class relied, to their damage, on the statements and representations described above and the integrity of the market price of Dynacq stock during the Class Period in purchasing Dynacq common stock at prices which were artificially inflated as a result of Defendants' false and misleading statements and representations.

167. Had Lead Plaintiffs and the other members of the Class known of the material adverse information which Defendants did not disclose, they would not have purchased Dynacq common stock at the artificially inflated prices that they did.

168. Defendants' concealment of this material information served only to harm Lead Plaintiffs and the other members of the Class who purchased Dynacq common stock in
ignorance of the financial risk to them as a result of such nondisclosures. Moreover, the Individual Defendants’ Class Period sales of Dynacq stock, while in possession of material, adverse, non-public information, was in derogation of their duties to shareholders trading contemporaneously therewith to either disclose the information or abstain from trading pursuant to Rule 10b-5.

169. As a result of the wrongful conduct alleged herein, Lead Plaintiffs and other members of the Class have suffered damages in an amount to be established at trial. By reason of the foregoing, Defendants have violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, and are liable to Lead Plaintiffs and the other members of the Class for substantial damages which they suffered in connection with their purchase of Dynacq common stock during the Class Period.

COUNT II

VIOLATION OF SECTION 20(a)
OF THE SECURITIES EXCHANGE ACT

170. Lead Plaintiffs repeat and reallege each and every allegation above, as if set forth in full herein.

171. During the Class Period, each of the Individual Defendants, by virtue of their offices at, and directorship of, Dynacq, and their specific acts, were controlling persons of Dynacq within the meaning of Section 20(a) of the Exchange Act.

172. The Individual Defendants’ positions made them privy to, and provided them with actual knowledge of, the material facts which the Individual Defendants and Dynacq concealed from Lead Plaintiffs and the other members of the Class during the Class Period.
Each of the Individual Defendants had the power and influence, and exercised same, to engage in the unlawful conduct and practices complained of herein by causing Dynacq to disseminate the false and misleading information referred to above.

173. By virtue of the foregoing, the Individual Defendants have violated Section 20(a) of the Exchange Act.

174. By virtue of the conduct alleged above, the Individual Defendants are liable to the Lead Plaintiffs and the other members of the Class for the substantial damages that they suffered in connection with their purchases of Dynacq's common stock during the Class Period.

COUNT III

VIOLATION OF SECTION 20(A) OF THE EXCHANGE ACT

175. Plaintiff Harkness hereby incorporates and alleges the foregoing paragraphs as if alleged fully herein.

176. Individual Defendants collectively sold 139,904 shares of Dynacq common stock during the Class Period, reaping total proceeds in excess of $2,680,000, while in possession of material non-public information as set forth above.

177. As detailed above, Individual Defendants sold Dynacq common stock while in possession of material, adverse, non-public information. These sales were contemporaneous with purchases by Plaintiff Harkness: (1) on July 21, 2003, Defendant Chiu Chan sold 10,200 shares; (2) on July 22, 2003, Defendant Chiu Chan sold 1000 shares; (3) on July 18, 2003 Defendant Philip Chan sold 32,862 shares; (4) on July 22, 2003 Defendant Garvin sold 12,879 shares; (5) on July 21, 2003 Defendant Gregory sold 34,413 shares; and (6) on July 25, 2003 Plaintiff Harkness purchased 100 shares.
178. By reason of Plaintiff's purchases of Dynacq common stock contemporaneously with certain of the Defendants' sales of stock, Plaintiff suffered recoverable damages. Under Section 20(A) of the Exchange Act, Defendants are liable to Plaintiff and all members of the Class for all profits gained and losses avoided by them as a result of these contemporaneous transactions.

WHEREFORE, Lead Plaintiffs, on their own behalf and on behalf of the other members of the Class, demand judgment against the Defendants as follows:

A. Determining that this action is properly maintainable as a class action pursuant to Rule 23 of the Federal Rules of Civil Procedure;

B. Certifying Lead Plaintiffs as the Class Representatives and their counsel as Class Counsel;

C. Declaring and determining that Defendants violated the federal securities laws by reason of their conduct as alleged herein;

D. Awarding monetary damages against all Defendants, jointly and severally, in favor of Lead Plaintiffs and the other members of the Class for all losses and damages suffered as a result of the acts and transactions complained of herein, together with prejudgment interest from the date of the wrongs to the date of the judgment herein;

E. Awarding Lead Plaintiffs the costs, expenses, and disbursements incurred in this action, including reasonable attorneys' and experts' fees; and

F. Awarding Lead Plaintiffs and the other members of the Class such other and further relief as the Court may deem just and proper in light of all the circumstances of this case.
JURY DEMAND

Lead Plaintiffs demand a trial by jury.

Dated: Houston, Texas
June 7, 2004

Respectfully submitted,

CUNNINGHAM, WELSH, DARLOW, ZOOK
& CHAPOTON, LLP

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Additional Plaintiffs’ Counsel
CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been forwarded to counsel of record by facsimile and regular mail, on September 30, 2004.

[Signature]

Tom Alan Cunningham