

Client Advisory

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KMZ Rosenman Wins Dismissal for Company That Restated 3½ Years of Financials

When a company restates its financials, it can expect an onslaught of securities class action complaints. The plaintiffs' bar has repeatedly challenged a company's admission that there were material errors contained in the financials subject to restatement. Despite the heightened pleading standards enacted in the Private Securities Litigation Reform Act of 1995 (PSLRA), only a handful of restatement complaints have been dismissed. Given a desire to protect the public, a reluctance to dismiss cases arising from admitted errors in a company's public statements is not surprising. Not many judges have strictly applied all of the PSLRA's requirements, even where plaintiffs have not tied the errors to any fraud.

Nonetheless, on October 5, 2001, the Honorable Gary A. Fenner, United States District Court Judge for the Western District of Missouri, dismissed a consolidated amended complaint alleging violations of Section 10(b) of the Securities Exchange Act against Katten Muchin Zavis Rosenman's client, DT Industries, Inc. and certain of its former officers and directors. The complaint arose out of DT Industries' allegedly "massive" restatement of prior financials over a 3½ year period, and it related to two different subsidiaries of the company. The court's dismissal was entered in record time, a mere 18 days after briefing had concluded.

As is typical in securities cases, the allegations against DT Industries and the individual defendants were based on plaintiffs' "information and belief" rather than personal knowledge, and the source of that belief and information was unidentified former employees of the company's subsidiaries. These sources were described in vague terms, such as an "employee in the accounting department." Plaintiffs rarely provide much detail in their descriptions of sources, viewing these individuals as confidential informants in need of protection, despite the fact that the PSLRA requires that complaints based on information and belief state "all facts" on which that belief is formed. Despite the PSLRA's plain language, the courts that have interpreted this section are split on whether "all facts" includes the identification of plaintiffs' sources. Nonetheless, the district court in the DT Industries case agreed with KMZ Rosenman's argument that the identity of plaintiffs' sources is a fact and must be included. The court, therefore, disregarded and struck all allegations based on information and belief, which were virtually all of the allegations of the complaint.

The court also regarded allegations of the defendants' motives — to keep their jobs and please Wall Street — as insufficient under the PSLRA. In this regard, the court joined the majority in concluding that motives held by most corporate executives are insufficient to plead a defendant's scienter under any of the prevailing standards.

While the securities plaintiffs will surely continue to target companies announcing restated financials, the DT Industries decision can now be counted by the defense bar as authority for a just result.

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