UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE FIFTH STREET FINANCE CORP. SECURITIES LITIGATION	:	**Case No. 15-cv-7759 (LAK)**
This Matter Relates To:	:	
All Actions	:	

DEFENDANTS' MEMORANDUM OF LAW
IN SUPPORT OF MOTION FOR
FINAL APPROVAL OF CLASS-ACTION SETTLEMENT

Ralph C. Ferrara
Jonathan E. Richman
Ann M. Ashton
Proskauer Rose LLP
Eleven Times Square
New York, NY 10036
T: (212) 969-3000
F: (212) 969-2900

Attorneys for Defendant
Fifth Street Asset Management Inc.
and the Individual Defendants

Allen W. Burton
Ross B. Galin
O'Melveny & Myers LLP
Times Square Tower
7 Times Square
New York, NY 10036
T: (212) 326-2000
F: (212) 326-2061

Attorneys for Defendant
Fifth Street Finance Corp.

January 12, 2017

TABLE OF CONTENTS

Page

INTRODUCTION 1

BACKGROUND AND PROCEDURAL HISTORY 2

A. Nature of Business-Development Companies 2

B. Valuation of BDC Assets 3

C. FSC's Asset Valuations and Disclosures 4

D. FSC's Dividends and Disclosures 7

E. The Complaint's Allegations 9

F. The Mediation and Settlement Process 11

G. The Proposed Settlement 12

H. Additional Discovery 14

ARGUMENT 14

I. THE COURT HAS JURISDICTION TO APPROVE THE SETTLEMENT. 15

II. THE CLASS NOTICE MET ALL APPLICABLE REQUIREMENTS. 15

A. Best Practicable Notice Methodology 17

B. Sufficient Content of the Notice 18

III. THE PROPOSED SETTLEMENT IS FAIR, REASONABLE, AND ADEQUATE. 20

A. Procedural Fairness 20

B. Substantive Fairness 22

1. Complexity, Expense, and Likely Duration of Litigation 23

2. Class's Reaction to Settlement 24

3. Stage of Proceedings and Amount of Discovery Completed 24

4. Risks of Establishing Liability and Damages 25

5. Risks of Maintaining Class Certification 28

6. Defendants' Ability to Withstand a Greater Judgment 28

7. Range of Reasonableness of Settlement Fund 29

CONCLUSION 31

TABLE OF AUTHORITIES

Page(s)

CASES:

City of Detroit v. Grinnell Corp.,
495 F.2d 448 (2d Cir. 1974),
abrogated on other grounds by Goldberger v. Integrated Res., Inc.,
209 F.3d 43 (2d Cir. 2000).. *passim*

City of Omaha, Neb. Civilian Emps.' Ret. Sys. v. CBS Corp.,
679 F.3d 64 (2d Cir. 2012)..27

City of Providence v. Aeropostale, Inc.,
2014 WL 1883494 (S.D.N.Y. May 9, 2014),
aff'd, 607 F. App'x 73 (2d Cir. 2015)..21

D'Amato v. Deutsche Bank,
236 F.3d 78 (2d Cir. 2001)..20, 21, 28

Destefano v. Zynga, Inc.,
2016 WL 537946 (N.D. Cal. Feb. 11, 2016) 30

Eisen v. Carlisle & Jacquelin,
417 U.S. 156, 94 S. Ct. 2140 (1974)..16, 17

Hicks v. Morgan Stanley,
2005 WL 2757792 (S.D.N.Y. Oct. 24, 2005) 22

In re Allied Capital Corp. Sec. Litig.,
2003 WL 1964184 (S.D.N.Y. Apr. 25, 2003)..3

In re Amer. Bus. Fin. Servs. Inc. Noteholders Litig.,
2008 WL 4974782 (E.D. Pa. Nov. 21, 2008) 30

In re Auction Houses Antitrust Litig.,
2001 WL 170792 (S.D.N.Y. Feb. 22, 2001),
aff'd, 42 F. App'x 511 (2d Cir. 2002)..20, 21

In re Bisys Sec. Litig.,
2007 WL 2049726 (S.D.N.Y. July 16, 2007) 30

In re Citigroup Inc. Bond Litig.,
296 F.R.D. 147 (S.D.N.Y. 2013) 23

In re Citigroup Inc. Sec. Litig.,
965 F. Supp. 2d 369 (S.D.N.Y. 2013)..23, 24, 25, 29, 30

In re Credit Default Swaps Antitrust Litig.,
2016 WL 2731524 (S.D.N.Y. Apr. 26, 2016)....................21

In re Flag Telecom Holdings, Ltd. Sec. Litig.,
2010 WL 4537550 (S.D.N.Y. Nov. 8, 2010)....................22

In re Giant Interactive Grp., Inc. Sec. Litig.,
279 F.R.D. 151 (S.D.N.Y. 2011)....................30

In re Global Crossing Sec. & ERISA Litig.,
225 F.R.D. 436 (S.D.N.Y. 2004).................... *passim*

In re Ikon Office Solutions, Inc. Sec. Litig.,
194 F.R.D. 166 (E.D. Pa. 2000)....................30

In re IMAX Sec. Litig.,
283 F.R.D. 178 (S.D.N.Y. 2012)....................16

In re Merrill Lynch & Co. Research Reports Sec. Litig.,
2007 WL 313474 (S.D.N.Y. Feb. 1, 2007)....................30

In re NFL Players Concussion Injury Litig.,
821 F.3d 410 (3d Cir. 2016),
cert. denied, 2016 U.S. Lexis 7559 & 7511 (U.S. Dec. 12, 2016)....................18

In re New Energy Sys. Sec. Litig.,
66 F. Supp. 3d 401, 405 (S.D.N.Y. 2014)....................27

In re PaineWebber Ltd. P'ships Litig.,
171 F.R.D. 104 (S.D.N.Y.),
aff'd, 117 F.3d 721 (2d Cir. 1997)....................28, 30

In re Prudential Ins. Co. of Am. Sales Practices Litig.,
148 F.3d 283 (3d Cir. 1998)....................15

In re Rite Aid Corp. Sec. Litig.,
146 F. Supp. 2d 706 (E.D. Pa. 2001)....................30

In re Telik, Inc. Sec. Litig.,
576 F. Supp. 2d 570 (S.D.N.Y. 2008)....................21

In re Viropharma Inc. Sec. Litig.,
2016 WL 312108 (E.D. Pa. Jan. 25, 2016)....................30

Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund,
135 S. Ct. 1318 (2015)....................24, 27

Tongue v. Sanofi,
816 F.3d 199 (2d Cir. 2016)....................24, 26, 27

Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.,
396 F.3d 96 (2d Cir. 2005)....................20, 24

Weinberger v. Kendrick,
698 F.2d 61 (2d Cir. 1982)....................18, 29

STATUTES AND RULES:

15 U.S.C. § 78aa(a)....................15

15 U.S.C. § 78u-4....................17

15 U.S.C. § 80a-1....................3

15 U.S.C. § 80a-2....................2, 3

15 U.S.C. § 80a-54....................2

26 U.S.C. § 852(a)....................7

28 U.S.C. § 1331....................15

17 C.F.R. § 230.175....................27

17 C.F.R. § 270.2a-46....................3

Fed. R. Civ. P. 23.................... *passim*

Fed. R. Civ. P. 23, 1966 Amendment Advisory Comm. Note to Subdiv.(d)(2)....................17

OTHER AUTHORITIES:

SEC Release Notice, Release No. AS-118, 1970 WL 5621 (Dec. 23, 1970)....................4

Accounting Standards Codification 820,
Fair Value Measurements and Disclosures, ASC 820-10-35-9A....................4, 5

INTRODUCTION

This putative securities class action challenges the financial statements issued by Fifth Street Finance Corp. ("FSC"), a business-development company (a "BDC") designed by statute to invest in nonpublic companies, small companies, and other non-investment-grade assets that do not have readily ascertainable market values or liquidity. Plaintiff alleges that FSC, its investment adviser Fifth Street Asset Management Inc. ("FSAM"), and several of FSC's directors and officers violated the Securities Exchange Act of 1934 (the "Exchange Act") in issuing statements that inflated FSC's financial condition by failing to properly value and timely write down certain of FSC's illiquid assets. The purpose of this supposed inflation of FSC's portfolio was to inflate FSAM's revenues – which derive in large part from the management fees that FSAM receives from FSC – so that FSAM could launch an initial public offering of its own shares (the "IPO").

Defendants moved to dismiss this case in its entirety. However, while the motion was pending, the parties engaged in a lengthy mediation process with retired California Superior Court Judge Daniel Weinstein and reached an agreement to settle the action for $14,050,000, subject to the Court's approval.

On November 9, 2016, the Court certified the Class for settlement purposes, authorized the parties to send and publish notice to the Class, and scheduled a fairness hearing. Defendants now respectfully urge the Court to approve the proposed settlement embodied in the Stipulation of Settlement dated as of July 27, 2016 (the "Stipulation" or "Stip.") and to enter a final judgment dismissing this action with prejudice.[1]

---

[1] All capitalized terms not defined in this Memorandum have the meanings given to them in the Stipulation.

The proposed settlement represents a fair and reasonable compromise of the action: it would provide immediate cash benefits to the Class and enable Defendants to resolve a distracting litigation. According to Plaintiff's calculations, the proposed settlement represents an above-average recovery when measured against Plaintiff's estimate of the Class's likely provable damages. The fact that no Class Member to date has objected to or opted out of the proposed settlement further underscores the fairness of the compromise.

BACKGROUND AND PROCEDURAL HISTORY

FSC is a BDC under the Investment Company Act of 1940 (the "ICA"). [Consolidated Amended Complaint ("Complaint" or "FAC") (Dkt. No. 82), ¶ 27] It "primarily invests in illiquid assets." [*Id.* ¶ 3] This case concerns FSC's determinations of the fair value of those illiquid, non-investment-grade assets.

A. Nature of Business-Development Companies

A BDC is a company that is designed to allow retail investors to invest in securities of nonpublic companies, small companies, and other illiquid, non-investment-grade assets. Under ICA § 2(a)(48), a BDC must (*i*) be operated for the purpose of making investments in securities described in ICA §§ 54(a)(1)-(3) and (*ii*) make available "significant managerial assistance" to issuers of those securities. 15 U.S.C. § 80a-2(a)(48).

ICA § 55(a) requires a BDC to invest at least 70% of its assets in (*i*) privately issued securities purchased from issuers that are "eligible portfolio companies," (*ii*) securities of eligible portfolio companies that are controlled by a BDC, (*iii*) privately issued securities of companies subject to a bankruptcy proceeding or reorganization, (*iv*) cash, government securities, or high-quality debt securities maturing in one year or less, and (*v*) office furniture and equipment and interests in real estate and facilities needed to conduct the BDC's business. 15 U.S.C. § 80a-54. "Eligible portfolio companies" are domestic issuers that either (*i*) do not have any securities

listed on a national exchange or (*ii*) have listed equity securities, but have an aggregate market value of less than $250 million. *Id.* § 80a-2(a)(46); 17 C.F.R. § 270.2a-46.

BDC status can be desirable because the ICA and the Internal Revenue Code allow taxes on the BDC's income to be passed through to the BDC's shareholders, rather than be imposed on the entity. To qualify for this tax treatment, a BDC must distribute at least 90% of its taxable income to its shareholders as dividends. [FAC ¶ 27] Most BDCs – including FSC – choose to distribute at least 98% of their taxable income in order to obtain tax status as a regulated investment company (a "RIC") and avoid having to pay excise taxes. [*Id.*; *see also, e.g.*, 7/10/14 Prospectus at S-26 (Ex. E)][2]

B. <u>Valuation of BDC Assets</u>

The ICA requires BDCs to disclose the identity, cost basis, and fair value of their investments in their quarterly filings with the Securities and Exchange Commission (the "SEC"). 15 U.S.C. §§ 80a-1 *et seq.* BDCs must value their assets "at market value, if market quotations are available, and if no market for the securities exists, at 'fair value as determined in good faith by the board of directors.'" *In re Allied Capital Corp. Sec. Litig.*, 2003 WL 1964184, at *1 (S.D.N.Y. Apr. 25, 2003) (quoting 15 U.S.C. § 80a-2(a)(41)(A)).

A BDC with investments "composed of illiquid securities for which no market exists, and which [the BDC] does not intend to trade in the near future . . . must use the 'fair value' method of valuation . . . ." *Id.* "There is no one authoritative method of determining fair value, since valuing securities for which no current market exists involves the exercise of judgment, and is inherently imprecise." *Id.*

---

[2] Exhibits designated by letter refer to the exhibits submitted with the Declaration of Julia D. Alonzo (Dkt. No. 88), which was filed with Defendants' motion to dismiss.

Accounting Standards Codification ("ASC") 820, titled *Fair Value Measurements and Disclosures*, defines "fair value" as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique." ASC 820-10-35-9A. The SEC recognizes that "[n]o single standard for determining 'fair value' . . . can be laid down, since fair value depends upon the circumstances of each individual case." SEC Release Notice, Release No. AS-118, 1970 WL 5621, at *4 (Dec. 23, 1970).

C. <u>FSC's Asset Valuations and Disclosures</u>

At all times relevant to this case, FSC disclosed to investors that its assets consisted of "'securities that are rated below investment grade by rating agencies or that would be rated below investment grade if they were rated. Below investment grade securities, which are often referred to as "high yield" or "junk," have predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal.'" [FAC ¶ 48 (quoting 2014 10-K at 1)] FSC warned of the risks inherent in such securities, including (*i*) the issuers' "limited financial resources," (*ii*) the issuers' "shorter operating histories, narrower product lines, [and] smaller market shares," (*iii*) the issuers' "less predictable operating results," and (*iv*) "less publicly available information about [the issuers'] businesses, operations and financial condition." [7/10/14 Prospectus at 8-10, 32 (Ex. E); *see also* 2014 10-K at 33 (Ex. O)]

FSC therefore cautioned that "[t]he investments we make in accordance with our investment objective may result in a higher amount of risk than alternative investment options and a higher risk of volatility or loss of principal. Our investments in portfolio companies involve higher levels of risk, and therefore, an investment in our shares may not be suitable for someone with lower risk tolerance." [7/10/14 Prospectus at 32 (Ex. E)]

FSC also disclosed that virtually all of its assets were Level 3 assets, which ASC 820 defines as assets that have "unobservable" inputs and values that are "not corroborated by market data" [FAC ¶ 53(c)].[3] The assets therefore needed to be measured at fair value by FSC's Board. [2014 10-K at 9 (Ex. O) ("All of our investments are recorded at fair value as determined in good faith by our Board of Directors.")] FSC explained that, "[w]here observable prices or inputs are not available or reliable" – as they are not, for Level 3 assets – "valuation techniques are applied. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency for the investments or market and the investments' complexity." [*Id.* at 9]

FSC described its work to value each investment each quarter "on an individual basis, using bond yield, market and income approaches as appropriate." [7/10/14 Prospectus at S-15 (Ex. E)] That "multi-step valuation process" – which involved FSC's finance department, FSC's adviser, independent valuation firms, FSC's Audit Committee, and FSC's Board, among others – was fully disclosed in FSC's public filings. [*Id.* at S-15 to -16]

FSC also warned that determining the fair value of Level 3 investments "involves subjective judgments and estimates." [*Id.* at 89] In addition, FSC cautioned that the uncertainties involved in valuing Level 3 investments could result in overvaluing FSC's assets:

> Because such valuations, and particularly valuations of private securities and private companies, are inherently uncertain, may fluctuate over short periods of time and may be based on estimates, our determinations of fair value may differ materially from the values that would have been used if a ready market for these securities existed. . . . Due to these uncertainties, our fair value determinations may cause our net asset value on a given date to materially understate or overstate the value that we may ultimately realize upon the sale of one or more of our investments. As a result, investors purchasing our

[3] The precise percentages of reported Level 3 assets were 96.1%, 95.8%, 93.5%, and 92.3% as of March 31, June 30, September 30, and December 31, 2014, respectively. [3/31/14 10-Q at 66 (Ex. B); 6/30/14 10-Q at 68 (Ex. G); 9/30/14 10-K at 51 (Ex. O); 12/31/14 10-Q at 73 (Ex. Q)]

> common stock based on an overstated net asset value would pay a higher price than the realizable value of our investments might warrant. [*Id.* at 16]

FSC's public filings reported other financial metrics with subjective elements. For example, a portion of FSC's investments included original-issue discount ("OID") or payment-in-kind ("PIK") interest.[4] FSC warned that its decisions whether to apply OID or PIK interest to new or existing investments could result in "unreliable valuations because their continuing accruals require ongoing judgments about the collectability of their deferred payments and the value of their underlying collateral." [7/10/14 Prospectus at 16 (Ex. E)] In addition, FSC cautioned that assets with PIK interest could be overvalued if FSC's judgments about future collectability turned out to be incorrect: "if it is subsequently determined that we will not be able to collect any previously accrued PIK interest, the fair value of our loans or debt securities would decline by the amount of such previously accrued, but uncollectible, PIK interest." [*Id.* at S-17]

Each of FSC's quarterly SEC filings listed, and reported the status of and actions taken for, every investment in FSC's portfolio as of quarter end (and for quarter end in the prior year). Those disclosures included (*i*) the name of each issuer, (*ii*) the industry in which it operated, (*iii*) the specific securities that FSC held (*e.g.*, equity, debt tranche, etc.), (*iv*) the principal amount invested, (*v*) the cost of the investment, (*vi*) the fair value of the investment as of quarter end (thereby disclosing appreciation or depreciation over cost), (*vii*) adjustments to interest rates, (*viii*) cash interest, (*ix*) PIK interest, (*x*) the reason for any interest-rate adjustment, (*xi*) unfunded commitments (revolvers, term loans, limited partnership interests), (*xii*) realized gains or losses and net unrealized appreciation or depreciation, and (*xiii*) investments in and advances to affiliates. [*E.g.*, 6/30/14 10-Q at 5-27, 40-41, 51-54, 62-65, 75-78, 87-89 (Ex. G)]

---

[4] OID is a form of deferred interest on a debt instrument that results in the instrument's issuance at less than its value at maturity. [FAC ¶ 35 n.5] PIK interest is interest that is added to the loan principal and is due at the end of the loan term, rather than in monthly or other periodic installments. [*Id.* ¶ 35 n.6]

D. **FSC's Dividends and Disclosures**

FSC's status as a BDC and a RIC effectively required FSC to distribute at least 98% of its taxable income as dividends. [FAC ¶ 27] A BDC's taxable income consists of net investment income ("NII") plus realized net short-term capital gains over realized net long-term capital losses. 26 U.S.C. § 852(a). NII is the difference between (*i*) income from interest, dividends, fees, and other investment income and (*ii*) total expenses. [FAC ¶ 8 n.1]

FSC disclosed that it had to pay dividends on PIK interest even though it was not receiving – and might never receive – the interest in cash: "To maintain our status as a RIC, PIK income must be paid out to our stockholders in the form of dividends even though we have not yet collected the cash and may never collect the cash relating to the PIK interest." [7/10/14 Prospectus at S-17 (Ex. E)]

On July 7, 2014 – the first day of the putative Class Period – FSC announced that it would increase its monthly dividend by 10% for September through November 2014 . [FAC ¶¶ 123, 127; 7/7/14 8-K (Ex. D)] FSC "stated that the reason for the dividend increase was the 'confidence' the Company had in its future revenue streams, including investment income from the newly launched SLF JV1 fund" (a joint venture between FSC and an insurance company). [FAC ¶¶ 127, 125; 7/2/14 8-K (Ex. C)] FSC had announced five days earlier, on July 2, 2014, that SLF JV1 had $156.5 million in assets and that FSC "expect[ed]" it to reach $300 million in assets by September 30, 2014. [FAC ¶ 126; 7/2/14 8-K (Ex. C)]

Three months later, in October 2014, FSC reported that SLF JV1 was "generating a mid-teens return." FSC predicted that its plan to grow the joint venture "and other similar joint ventures [would] be a key component in driving future earnings growth." [10/8/14 News Release (Ex. L)] And FSC announced in November 2014 that it would maintain its dividend level through January 2015. [11/26/14 News Release (Ex. N); FAC ¶ 153]

Notwithstanding its optimism about generating sufficient income to pay the higher dividend, FSC repeatedly informed investors that its ability to meet its dividend projections could be affected by, among other things, a decline in asset performance. For example:

> We cannot assure you that we will achieve investment results that will allow us to sustain a specified level of cash distributions or periodic increases in cash distributions. Our ability to pay distributions might be adversely affected by, among other things, the impact of one or more of the risk factors described in the prospectus. In addition, the inability to satisfy the asset coverage test applicable to us as a business development company can limit our ability to pay distributions. All distributions will be paid at the discretion of our Board of Directors and will depend on our earnings, our financial condition, maintenance of our RIC status, compliance with applicable business development company regulations and such other factors as our Board of Directors may deem relevant from time to time. *We cannot assure you that we will continue to pay distributions to our stockholders*. [7/10/14 Prospectus at 24-25 (Ex. E) (emphasis added)]

FSC also warned that its use of leverage could affect its dividend payouts:

> ***Because we borrow money, the potential for loss on amounts invested in us will be magnified and may increase the risk of investing in us***. . . . If the value of our assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any decrease in our income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock distributions or scheduled debt payments. [*Id.* at 18-19]

Dividends could also be affected by the investments' payment terms, including changes to those terms over the life of the investment. Focusing investors' attention particularly on PIK, FSC warned that "modified terms" such as "increased PIK interest provisions and reduced cash interest rates . . . may limit the amount of interest income that we recognize from the modified investments, which may, in turn, limit our ability to make distributions to our shareholders." [*Id.* at S-20 to -21; 2014 10-K at 56 (Ex. O)] FSC flagged that it had already modified the payment terms of 17 of its investments as of March 31, 2014, with that number increasing to 19 by September 30, 2014. [7/10/14 Prospectus at S-20 (Ex. E); 2014 10-K at 56 (Ex. O)]

E. The Complaint's Allegations

The allegations in this case concern the relationship between FSC – the BDC whose shares Plaintiff purchased – and its investment adviser and manager, FSAM. Through operating subsidiaries, FSAM managed FSC's day-to-day operations and provided investment-advisory services under management and advisory agreements that FSC's Board of Directors reviewed and approved. [FAC ¶ 28; 2014 10-K at 12, 16-17 (Ex. O)]

FSC paid FSAM for those services through a base management fee and an incentive fee. The base fee was calculated at an annual rate of 2% of FSC's gross assets, excluding cash and cash equivalents. [FAC ¶ 29] The incentive fee was based on a combination of FSC's pre-incentive-fee NII and its capital gains. [*Id*; 7/10/14 Prospectus at 18 (Ex. E)]

Where a base fee depends on gross assets, a theoretical incentive exists – as Plaintiff alleges [FAC ¶¶ 29-30] – for a manager to make speculative and/or leveraged investments to increase the BDC's gross assets and, thus, the manager's fee. FSC disclosed that theoretical risk:

> The incentive fee payable by us to our investment adviser may create an incentive for it to make investments on our behalf that are risky or more speculative than would be the case in the absence of such compensation arrangement, which could result in higher investment losses, particularly during cyclical economic downturns. The way in which the incentive fee payable to our investment adviser is determined . . . may encourage our investment adviser to use leverage to increase the return on our investments or otherwise manipulate our income so as to recognize income in quarters where the hurdle rate is exceeded. Under certain circumstances, the use of leverage may increase the likelihood of default, which would disfavor the holders of our common stock. [7/10/14 Prospectus at 18 (Ex. E)]

Plaintiff contends that, during the putative Class Period (July 7, 2014 through February 6, 2015), Defendants "engaged in a fraudulent scheme . . . to artificially inflate FSC's assets and investment income in order to increase FSAM's revenue." [FAC ¶¶ 1, 4] Defendants purportedly "pushed FSC into increasingly risky, speculative investments at unsustainable leverage levels, delayed writing down impaired investments . . . , disregarded or abandoned

underwriting guidelines when making investments, and improperly accelerated the recognition of fee income in clear violation of applicable accounting rules." [*Id.* ¶ 6]

The purpose of this supposed "scheme" was to "maintain the illusion of sustainable performance in FSC's investment portfolio" so that FSAM – whose "future expected cash flows are tied directly to the long-term viability of FSC and its business" – could complete a successful IPO, and its principals could sell stock and obtain other benefits. [*Id.* ¶¶ 5-6] FSAM filed its preliminary Registration Statement for the IPO on September 5, 2014, and the offering went effective on October 29, 2014. [FSAM S-1 (Ex. K); Notice of Effectiveness (Ex. M)]

Several months after FSAM's IPO, FSC announced on February 9, 2015 that it was writing down the value of four of its assets: CCCG, LLC; JTC Education, Inc.; Phoenix Brands Merger Sub LLC; and TransTrade Operators, Inc. [FAC ¶¶ 62-101, 119, 162] Plaintiff contends that FSC intentionally delayed those write-downs until after FSAM's IPO. [*Id.* ¶ 6]

The Complaint also charges that Defendants knew that FSC's 10% dividend increase was unsustainable from the date it was announced (July 7, 2014) because of the inflated valuation of FSC's assets. [*Id.* ¶¶ 128, 138(f)] In addition, Plaintiff contends that FSC's general statements about the financial strength of its portfolio were false because Defendants knew that FSC's investments were increasingly "speculative" and "high risk" (hardly surprising for a BDC portfolio consisting almost entirely of Level 3 assets). [*Id.* ¶ 137(c)]

Plaintiff attributes all of these alleged problems to Defendants' valuation and impairment decisions. The Complaint pleads that, "*[a]s a result*" of Defendants' failure to write down assets before FSAM's IPO, "FSC's financial statements metrics, such as investments at fair value, net unrealized appreciation on investments, net assets, and net asset value, and FSC's income statement metrics, such as its interest income, PIK interest income, fee income, total investment

income, expenses such as the base management fee, net investment income, unrealized appreciation on investments, net increase in net assets resulting from operations, and earnings per share, were materially overstated by Defendants." [*Id.* ¶ 60 (emphasis added)]

Defendants moved to dismiss the Complaint on May 31, 2016 for failure to state a claim. [Dkt. Nos. 86-88] While that motion was pending, the parties and Defendants' insurers engaged in lengthy pre-mediation and mediation processes.

F. <u>The Mediation and Settlement Process</u>

As Lead Counsel explained in its prior Declaration to the Court, the parties initiated the settlement process because Defendants had only limited insurance assets potentially available to resolve the claims in this case as well as those in a class action filed by FSAM's shareholders (*Linde v. Fifth Street Asset Management Inc.*, No. 1:16-cv-01941 (LAK) (S.D.N.Y.)) and in several derivative actions filed by FSC shareholders in federal and state courts. [Declaration of Joel H. Bernstein, filed Sept. 23, 2016, ¶ 5 (Dkt. No. 93) (the "Bernstein Decl.").] The parties understood that, "[i]f the cases proceeded along a traditional route, it was likely that those [insurance] proceeds would diminish . . . to the point where they would be insufficient to satisfy all the claims against the Defendants." [*Id.*] Plaintiff believed that, "if available insurance proceeds were sufficient to obtain a fair settlement for the Class, an early resolution would be preferable to prolonged proceedings." [*Id.*] But Plaintiff "advised Defendants that it could not agree to resolve the Class' claims without sufficiently developing the knowledge of the strengths and weaknesses of the claims." [*Id.*]

The parties therefore agreed to retain retired Judge Daniel Weinstein as mediator, and they developed a three-step settlement process.

First, despite the pendency of the statutory stay of discovery under the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), Defendants provided to Plaintiff (and to all other

plaintiffs participating in the mediation process) approximately 5,300 pages of internal FSC and FSAM documents and all potentially applicable insurance policies. [*Id.* ¶ 7]

Second, on June 6 and 7, 2016, Defendants' counsel gave a two-day Pre-Mediation Presentation to Lead Counsel (and Plaintiff's forensic accounting expert), the counsel for the plaintiffs in the FSAM class action and the FSC derivative actions, and Judge Weinstein (and his two assistant mediators). The presentation consisted of almost 1,000 PowerPoint slides addressing the facts and issues relating to the principal allegations in the various plaintiffs' complaints, as developed from Defendants' counsel's review of internal FSC and FSAM documents and records, such as internal emails, Board of Directors and Audit Committee materials, analyses prepared by independent third-party valuation firms, and analyses of insurance and indemnity issues. [*Id.* ¶¶ 8-9] Following this presentation, Plaintiff decided to move forward to the third stage: the mediation itself. [*Id.* ¶ 10]

The mediation lasted three full days (June 15-17, 2016) and involved Lead Counsel, a representative of Plaintiff, Defendants' counsel, Defendants' insurers, and the mediators. At the end of the third day, the parties still had not reached an agreement, so Judge Weinstein made a mediator's proposal for the parties to consider. Several days later, the parties signed an agreement in principle accepting that proposal for the $14,050,000 settlement. [*Id.* ¶ 11]

The proposed settlement terms were subject to various conditions, including execution of a formal Stipulation of Settlement and completion of additional discovery. [*Id.*] Those processes took place on parallel tracks.

G. <u>The Proposed Settlement</u>

The parties' counsel executed the Stipulation of Settlement as of July 27, 2016. [Dkt. No. 93-1] That agreement, which is subject to the Court's approval, provides for a cash payment of $14,050,000 (the "Settlement Amount") to resolve all claims in the action. The

Settlement Amount has been paid into an escrow account in accordance with the terms of the Stipulation. [*Id.* § II.A.I, at 25]

The Stipulation states that notice and administrative costs, as well as Lead Counsel's fees and expenses, will be paid from the settlement fund. [*Id.* §§ III.C, IV.D, IX, at 34, 35, 41-42] The remainder of the fund will be distributed to eligible Class Members.

On September 23, 2016, Plaintiff filed a motion asking the Court to certify the Class for settlement purposes and to authorization dissemination of notice to the potential Class Members. The Court issued its Notice Order on November 9, 2016. [Dkt. No. 103] The Notice Order certified the putative Class for settlement purposes, approved the form and content of the proposed notice materials, authorized the mailing and publication of the notice materials, and scheduled a Fairness Hearing for February 16, 2017.

Defendants understand that, on November 23, 2016, the Claims Administrator (A.B. Data, Ltd.) mailed copies of the Court-approved cover letter, Individual Notice, and Claim Form by first-class mail to 68 potential Class Members for whom address information was available from FSC's transfer agent. [Declaration of Adam Walter (the "Walter Decl."), ¶ 3] A.B. Data also mailed the notice materials to another 5,292 custodial banks and other institutions identified from its proprietary databases. [*Id.* ¶ 4] A.B. Data later mailed the notice materials to an additional 37,398 potential Class Members identified by nominees or other individuals. [*Id.* ¶ 7] A.B. Data sent a total of 43,177 sets of notice materials to potential Class Members and Nominees. [*Id.* ¶ 9] In addition, A.B. Data sent the cover letter, Individual Notice and Claim Form to the Depository Trust Company for publication on the Legal Notice System. [*Id.* ¶ 5]

A.B. Data caused the Court-approved Publication Notice to be published once in each of *The Wall Street Journal* and *Investor's Business Daily*, as well as on PR Newswire. [*Id.* ¶ 10]

A.B. Data also posted information and documents about the proposed settlement on its website. [*Id.* ¶ 12]

H. Additional Discovery

The Stipulation was conditioned on Plaintiff's ability to conduct additional discovery to determine whether the underlying facts were consistent with Plaintiff's original understanding that the proposed settlement is fair, reasonable, and adequate. [Dkt. No. 93-1, §§ I.C, XIV, at 23-24, 52] Defendants therefore made available to Lead Counsel more than 90,000 documents, consisting of more than 2.4 million pages. [Bernstein Decl., ¶ 11]

The production consisted of (*i*) all documents referenced in the Pre-Mediation Presentation, (*ii*) additional documents used in creating the Pre-Mediation Presentation, including the list of search terms used while the presentation was being created, (*iii*) FSC's Credit Files for the four FSC investments that Plaintiff had alleged were significantly impaired during the Class Period (the files consisted of documents relating to the origination, valuation, and management of those investments), and (*iv*) the full set of documents that Defendants' counsel had produced to the SEC in connection with an investigation that covered certain allegations in the Complaint. In addition, Plaintiff conducted five day-long interviews of key FSC and FSAM executives. [*Id.*]

After reviewing all of this discovery and consulting with Plaintiff's accounting expert (who also had examined relevant documents), Plaintiff and Lead Counsel decided to proceed with the proposed settlement, because they continued to believe that it "is fair, reasonable, and adequate, and represents an excellent result for the Class." [*Id.* ¶ 12]

ARGUMENT

The Court should approve the proposed settlement as fair, reasonable, and adequate. Lead Counsel and Defendants' counsel engaged in extensive, arm's-length settlement

negotiations with the assistance of a respected, experienced mediator. The parties' counsel are skilled in securities class-action litigation and were involved in each step of the settlement negotiations. The settlement would provide the Class with immediate financial benefits that are well within the range of settlements in similar types of actions, and no Class Member has objected to or opted out of the settlement at this time. Accordingly, the Court should grant final approval and should dismiss the action pursuant to the proposed final Judgment.

I. THE COURT HAS JURISDICTION TO APPROVE THE SETTLEMENT.

The Court has the requisite subject-matter and personal jurisdiction to approve the proposed settlement.

The Complaint alleges that Defendants violated provisions of the Exchange Act. The Court therefore has subject-matter jurisdiction under § 27(a) of the Exchange Act, 15 U.S.C. § 78aa(a), as well as under the general federal-question statute, 28 U.S.C. § 1331.

The Court has personal jurisdiction over Plaintiff and all other Class Members. "In the class action context, the district court obtains personal jurisdiction over the absentee class members by providing proper notice of the impending class action and providing the absentees with the opportunity to be heard or the opportunity to exclude themselves from the class." *In re Prudential Ins. Co. of Am. Sales Practices Litig.*, 148 F.3d 283, 306 (3d Cir. 1998). As discussed below, and as the Court concluded in the Notice Order, those conditions were satisfied here.

II. THE CLASS NOTICE MET ALL APPLICABLE REQUIREMENTS.

The Court ruled in the Notice Order that the class-notice materials and the proposed method of dissemination (by first-class mail and publication) met the requirements of due process, Rule 23 of the Federal Rules of Civil Procedure, and the PSLRA, "constitute[d] the best notice practicable under the circumstances, and constitute[d] due and sufficient notice to all persons entitled to such notice." [Notice Order ¶ 9 (Dkt. No. 103)] Now that notice has been

provided to the Class, the Court can and should reaffirm its earlier findings concerning the adequacy of the Notice Program (including the Individual Notice and the Publication Notice, as well as the manner of delivering and publishing those notices).

"Where, as here, the parties [have sought] simultaneously to certify a settlement class and to settle a class action, the elements of Rule 23(c) notice . . . are combined with the elements of Rule 23(e) notice . . . because Rule 23(e)'s notice requirements are less specific than that of Rule 23(c)'s . . . ." *In re IMAX Sec. Litig.*, 283 F.R.D. 178, 185 (S.D.N.Y. 2012) (internal quotations omitted).

For classes certified under Fed. R. Civ. P. 23(b)(3), such as the Class in this action, Rule 23(c)(2)(B) requires "the best notice that is practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort." The Rule also prescribes that the notice state "(i) the nature of the action; (ii) the definition of the class certified; (iii) the class claims, issues, or defenses; (iv) that a class member may enter an appearance through an attorney if the member so desires; (v) that the court will exclude from the class any member who requests exclusion; (vi) the time and manner for requesting exclusion; and (vii) the binding effect of a class judgment on class members under Rule 23(c)(3)." *Id.*

Rule 23(e) is less specific, requiring only that notice of a proposed settlement be given "in a reasonable manner." Thus, if the notice satisfies Rule 23(c), it will also satisfy Rule 23(e). *See, e.g., In re Global Crossing Sec. & ERISA Litig.,* 225 F.R.D. 436, 448 (S.D.N.Y. 2004).

The Constitution's Due Process Clause also imposes certain minimum notice requirements. As the Supreme Court has observed, however, the "'mandatory notice pursuant to [Rule 23(c)(2)] . . . is designed to fulfill requirements of due process to which the class action procedure is of course subject.'" *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 173-74, 94 S. Ct.

2140, 2150-51 (1974) (quoting Fed. R. Civ. P. 23, 1966 Amendment Advisory Comm. Note to Subdiv. (d)(2)). Due-process considerations are therefore satisfied if the notice conforms to Rule 23(c)(2).

The Exchange Act, in provisions added by the PSLRA, imposes certain notice requirements specifically for settlements of securities class actions. *See* 15 U.S.C. § 78u-4. The PSLRA requires that the notice contain the following information:

- Statement of recovery – "[t]he amount of the settlement proposed to be distributed to the parties to the action, determined in the aggregate and on an average per share basis";
- Statement of potential outcome of case – the amount of damages per share recoverable if the plaintiffs were to prevail on every claim, but, if the parties are unable to agree on damages, "a statement from each settling party concerning the issue or issues on which the parties disagree";
- Statement of attorneys' fees – a statement of fees and costs to be applied for in the aggregate and on an average per-share basis;
- Identification of lawyers' representatives – the name, telephone number, and address of counsel available to answer questions; and
- Reasons for settlement – "[a] brief statement explaining the reasons why the parties are proposing the settlement."

Id. The notice must also include a cover page summarizing all of these topics. *Id.*

A. <u>Best Practicable Notice Methodology</u>

The means by which notice was provided to potential Class Members met all applicable requirements for adequacy of notice and due process. The Individual Notice was sent by first-class mail to all potential Class Members who could be identified through reasonable efforts – meaning all potential Class Members for whom names and addresses were available.

In addition to mailing the Individual Notices to all potential Class Members for whom it had names and addresses, the Claims Administrator mailed the Individual Notices to thousands of nominees and other institutions that might have purchased FSC common stock beneficially

owned by potential Class Members. [Walter Decl. ¶¶ 3-9] The Claims Administrator also posted the Individual Notice (as well as other documents relating to the lawsuit and the settlement) on its website. [*Id.* ¶ 12] The website and the notice materials provided telephone numbers (including a toll-free number) that potential Class Members could call if they had questions. [*Id.* ¶¶ 11-12]

The Claims Administrator also arranged for publication of the Court-approved Publication Notice in *The Wall Street Journal* and *Investor's Business Daily* as well as on wire services. [*Id.* ¶ 10] The Publication Notice contained pertinent information about the class action and settlement required by Rules 23(c)(2) and 23(e) and by principles of due process.

These procedures fully satisfied Rule 23(c)(2)'s requirement of individual notice "to all members who can be identified through reasonable effort." *See, e.g.*, *In re Global Crossing,* 225 F.R.D. at 449 (notice by first-class mail, publication of summary notice, posting on website, and toll-free number collectively satisfied Rule 23(c)(2)'s requirements).

B. <u>Sufficient Content of the Notice</u>

The potential Class Members will have received the "best notice that is practicable under the circumstances," as required by Rule 23(c)(2), if the notice "contain[s] sufficient information to enable class members to make informed decisions on whether they should take steps to protect their rights, including objecting to the settlement or, when relevant, opting out of the class." *In re NFL Players Concussion Injury Litig.*, 821 F.3d 410, 435 (3d Cir. 2016) (internal quotations omitted), *cert. denied*, 2016 U.S. Lexis 7559 & 7511 (U.S. Dec. 12, 2016); *accord, e.g., Weinberger v. Kendrick,* 698 F.2d 61, 70 (2d Cir. 1982) (settlement notice must "fairly apprise the prospective members of the class of the terms of the proposed settlement and of the options that are open to them in connection with the proceedings"). The notice in this case met that standard.

The notice materials informed potential Class Members of the relevant aspects of the claims in the Complaint and the terms of the proposed settlement, including:

- The nature of the case, a statement of the claims and defenses, and a statement about how the settlement fund will be allocated among eligible Class Members if the proposed settlement is approved;

- The right of potential Class Members to exclude themselves from the Class, to object to any aspect of the proposed settlement, or to appear at the Fairness Hearing – and the processes and deadlines for doing so;

- The date of the Fairness Hearing;

- The terms of the release of claims; and

- The binding effect of any judgment – whether favorable or not – on all persons who do not exclude themselves from the Class, and the impact on Class Members if the proposed settlement is approved.

The content of the notice thus complied with Rule 23(c)(2).

In addition, consistent with the requirements of the PSLRA, the Individual Notice:

- Set out the amount of the settlement on an aggregate and a per-share basis, as well as the proposed plan of distribution;

- Informed potential Class Members of the parties' disagreement regarding damages and explained each party's position on that issue;

- Stated the amount of attorneys' fees and expenses sought on an aggregate and a per-share basis;

- Provided potential Class Members with the name, address, and telephone number of Lead Counsel; and

- Explained why the parties proposed the settlement.

The Individual Notice thus met the PSLRA's requirements.

Accordingly, the notice procedures and the contents of the Individual Notice and the Publication Notice satisfied all applicable requirements, including those of Rules 23(c)(2) and 23(e), the PSLRA, and the U.S. Constitution. The Court should therefore reaffirm the finding in its Notice Order that the notices and notice methodology were the best practicable under the

circumstances and met all applicable requirements. The Court should also confirm that the Notice Program was implemented as required by the Notice Order.

III. THE PROPOSED SETTLEMENT IS FAIR, REASONABLE, AND ADEQUATE.

"The judgment a court confronted with a class action settlement is called upon to make is whether the settlement is fair, adequate, and reasonable to the class members, a standard that includes both procedural and substantive components." *In re Auction Houses Antitrust Litig.*, 2001 WL 170792, at *5 (S.D.N.Y. Feb. 22, 2001) (internal quotations omitted), *aff'd*, 42 F. App'x 511 (2d Cir. 2002). Courts examine procedural and substantive fairness in light of the "strong judicial policy in favor of settlements, particularly in the class action context." *Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.*, 396 F.3d 96, 116-17 (2d Cir. 2005).

"Assessing procedural fairness requires attention to such matters as the negotiation history and adequacy of class representation. Factors pertinent to substantive fairness are included among those set out in" the Second Circuit's decision in *City of Detroit v. Grinnell Corp.*, 495 F.2d 448 (2d Cir. 1974), *abrogated on other grounds by Goldberger v. Integrated Res., Inc.*, 209 F.3d 43 (2d Cir. 2000). *In re Auction Houses*, 2001 WL 170792, at *5. The proposed settlement here is both procedurally and substantively fair to the Class.

A. <u>Procedural Fairness</u>

To assess procedural fairness, the Court must examine the negotiating process that led to the proposed settlement. *Wal-Mart Stores, Inc.*, 396 F.3d at 116; *D'Amato v. Deutsche Bank*, 236 F.3d 78, 85 (2d Cir. 2001). "A presumption of fairness, adequacy, and reasonableness may attach to a class settlement reached in arm's-length negotiations between experienced, capable counsel after meaningful discovery." *Wal-Mart Stores,* 396 F.3d at 116.

The proposed settlement here was negotiated by experienced, informed counsel. Lead Counsel is one of the premier plaintiffs'-side securities firms in the country, with vast experience

in litigating securities class actions and with deep understanding of the factual and legal issues presented. Lead Counsel was also assisted by seasoned experts and had access to extensive documents and testimony before entering into the Stipulation. Moreover, neither the parties' agreement in principle nor the final Stipulation addressed the fees that Lead Counsel might seek, so the negotiating process was not affected by fee considerations. *See, e.g., In re Auction Houses*, 2001 WL 170792, at *6 (finding "no doubt" about procedural fairness where "[t]he settlement was reached among exceptionally able counsel, experienced in litigation of this sort," and "the negotiations that produced this proposed settlement could not have been influenced adversely by considerations of counsel's compensation").

Courts have also recognized that the participation of an experienced, respected mediator is a factor that weighs in favor of a proposed settlement's procedural fairness. *See, e.g., D'Amato*, 236 F.3d at 85 ("mediator's involvement in . . . settlement negotiations helps to ensure that the proceedings were free of collusion and undue pressure").

Many District Judges in this District (and elsewhere) have cited Judge Weinstein as a respected, experienced mediator whose involvement in settlement negotiations has helped to guarantee procedural fairness. *See, e.g., City of Providence v. Aeropostale, Inc.*, 2014 WL 1883494, at *4 (S.D.N.Y. May 9, 2014) (approving class-action settlement mediated by Judge Weinstein, "one of the nation's premier mediators in complex, multi-party, high stakes litigation, and one in whom this court reposes considerable confidence as a result of past experience"), *aff'd*, 607 F. App'x 73 (2d Cir. 2015); *In re Telik, Inc. Sec. Litig.*, 576 F. Supp. 2d 570, 576 (S.D.N.Y. 2008) ("Judge Weinstein's role in the settlement negotiations strongly supports a finding that they were conducted at arm's length and without collusion.").[5]

[5] *See also, e.g., In re Credit Default Swaps Antitrust Litig.*, 2016 WL 2731524, at *2, *7 (S.D.N.Y. Apr. 26, 2016) (noting that settlement was negotiated with "a renowned mediator, Daniel Weinstein," and that the parties

Judge Weinstein has signed a Declaration (submitted with Plaintiff's motion papers) attesting to the integrity of the mediation process and recommending the proposed settlement as "reasonable, hard-fought, arm's length, and accurately reflective of the risks and potential rewards of the claims being settled." [Weinstein Decl., ¶ 8] Judge Weinstein's involvement in the mediation should give the Court additional comfort about the proposed settlement's fairness and, in particular, about the professional, noncollusive nature of the negotiation process.

B. <u>Substantive Fairness</u>

The *Grinnell* factors for evaluating the substantive fairness of a proposed settlement are:

> (1) the complexity, expense and likely duration of the litigation; (2) the reaction of the class to the settlement; (3) the stage of the proceedings and the amount of discovery completed; (4) the risks of establishing liability; (5) the risks of establishing damages; (6) the risks of maintaining the class action through the trial; (7) the ability of the defendants to withstand a greater judgment; (8) the range of reasonableness of the settlement fund in light of the best possible recovery; [and] (9) the range of reasonableness of the settlement fund to a possible recovery in light of all the attendant risks of litigation.

Grinnell Corp., 495 F.2d at 463 (citations omitted). While the Court "must give comprehensive consideration to all relevant factors . . . , it must stop short of the detailed and thorough investigation that it would undertake if it were actually trying the case." *Id.* at 462.

Moreover, "[i]n finding that a settlement is fair, not every factor must weigh in favor of settlement, rather the court should consider the totality of these factors in light of the particular circumstances." *In re Global Crossing*, 225 F.R.D. at 456 (internal quotations omitted).

The *Grinnell* factors as a whole here weigh heavily in favor of approving the proposed settlement.

---

were "assisted by an able mediator"); *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 2010 WL 4537550, at *14 (S.D.N.Y. Nov. 8, 2010) ("The presumption in favor of the negotiated settlement in this case is strengthened by the fact that the settlement was reached in an extended mediation supervised by Judge Weinstein."); *Hicks v. Morgan Stanley*, 2005 WL 2757792, at *5 (S.D.N.Y. Oct. 24, 2005) (noting Judge Weinstein's involvement as mediator, and observing that "[t]he participation of a respected and neutral mediator gives [the court] confidence that [the negotiations] were conducted in an arms-length, non-collusive manner") (internal quotations omitted).

1. Complexity, Expense, and Likely Duration of Litigation

"[C]ourts in this district have long recognized that securities class action litigation, in particular, is notably difficult and notoriously uncertain." *In re Citigroup Inc. Bond Litig.*, 296 F.R.D. 147, 155 (S.D.N.Y. 2013) (internal quotations omitted). In these circumstances, "the more complex, expensive, and time consuming the future litigation, the more beneficial settlement becomes as a matter of efficiency to the parties and to the Court." *In re Citigroup Inc. Sec. Litig.*, 965 F. Supp. 2d 369, 381-82 (S.D.N.Y. 2013) (internal quotations omitted).

This case is no exception to the general view that securities class actions are complex, expensive, and time-consuming to litigate. For example, continued litigation and trial of this action would require the parties to investigate and the Court to adjudicate numerous complicated factual issues, including:

- The origination of investments for FSC's portfolio, including the due diligence conducted in making the initial investments;
- The monitoring and management of investments in FSC's portfolio;
- Waivers, amendments, and loan modifications effected regarding FSC's investments;
- The quarterly valuation of FSC's investments, almost all of which were Level 3 assets whose valuation depended on exercises of judgment;
- The accounting treatment for FSC's investments;
- FSC's leverage, including the aggregate amount of FSC's indebtedness and the terms and structure of its various financing arrangements;
- FSC's projections about future dividends, including its projections about the sources of funds to pay those dividends and the success of the SLF JV1 joint venture;
- FSC's judgments about whether and, if so, when and in what amount to write down or record an impairment of any of its assets; and
- FSC's public statements relating to all of the above matters.

The parties would also need to litigate and the Court would need to adjudicate various legal and damages issues, many of which would involve complex expert testimony, including:

- The extent to which the matters of judgment and opinion at issue in this case could be actionable after the recent decisions in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), and *Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016);

- Whether Plaintiff and the Class could satisfy the Exchange Act's reliance requirement in light of the fact that all of the allegations concerning FSC's valuations, projections, and other judgments were publicly disclosed and should therefore have been incorporated into FSC's stock price; and

- Whether Plaintiff and the Class could satisfy the Exchange Act's loss-causation requirement where FSC's supposedly "true" financial condition was known to the market – and whether the decline in FSC's stock price resulted from the dividend reduction and/or other factors, rather than from the write-downs of the four investments at issue in the Complaint.

Continued litigation of this case would therefore be complex, expensive, and lengthy.

2. Class's Reaction to Settlement

"If only a small number of objections are received, that fact can be viewed as indicative of the adequacy of the settlement." *Wal-Mart Stores*, 396 F.3d at 118. Although the period for filing objections and exclusion requests has not yet closed, no objections or exclusion requests have yet been filed. [Walter Decl. ¶ 13] This "favorable reception by the class constitutes 'strong evidence' that [the] proposed settlement is fair." *In re Citigroup Inc. Sec. Litig.*, 965 F. Supp. 2d at 382 (quoting *Grinnell*, 495 F.2d at 462).

3. Stage of Proceedings and Amount of Discovery Completed

This factor "is intended to assure the Court that counsel for plaintiffs have weighed their position based on a full consideration of the possibilities facing them. . . . Formal discovery is not a prerequisite; the question is whether the parties had adequate information about their claims." *In re Global Crossing*, 225 F.R.D. at 458 (internal quotations omitted).

Plaintiff and its counsel here had more than sufficient information to conclude that the proposed settlement is fair, reasonable, and adequate. Before participating in the three-day mediation that led to the settlement, Lead Counsel and its forensic accounting expert received approximately 5,300 pages of internal FSC and FSAM documents and then attended a two-day Pre-Mediation Presentation consisting of almost 1,000 PowerPoint slides. Then, after signing the Stipulation, Lead Counsel received additional discovery, consisting of more than 90,000 documents (comprising more than 2.4 million pages) and five day-long interviews of key FSC and FSAM executives.

These efforts enabled Plaintiff and its attorneys to explore the facts and circumstances underlying their claims and to assess the potential risks and rewards of litigating versus settling. Accordingly, the adequacy of the discovery conducted to date favors approval of the settlement. *See, e.g., In re Global Crossing*, 225 F.R.D. at 458-59 (approving settlement and finding that plaintiffs' attorneys "had the requisite information to make informed decisions about the relative benefits of litigating or settling" where they had received documents during settlement discussions and then had obtained many more documents after signing settlement agreement).

4. Risks of Establishing Liability and Damages

These two *Grinnell* factors "concern the obstacles plaintiffs [would] face[] in pursuing a final judgment in their favor." *In re Citigroup Inc. Sec. Litig.*, 965 F. Supp. 2d at 382. These factors "do[] not require the Court to adjudicate the disputed issues or decide unsettled questions; rather, the Court need only assess the risks of litigation against the certainty of recovery under the proposed settlement." *In re Global Crossing*, 225 F.R.D. at 459.

Plaintiff here would face significant hurdles in proving its case if the litigation were to proceed. As Defendants showed in the memorandum supporting their motion to dismiss ("Br.") [Dkt. No. 87], Plaintiff's allegations suffer from multiple deficiencies, including the following:

First, Plaintiff would not be able to prove that FSC made any actionable material misstatement or omission as to its assets and valuations. The thrust of the Complaint is that FSC overvalued its assets and therefore inflated its financial condition. But the valuations that FSC ascribed to its Level 3 assets – illiquid, non-investment-grade assets that lacked ascertainable market values – were not "facts" that can be determined true or false. Rather, those valuations reflected judgments, opinions, and estimates, which cannot be actionable as false or misleading statements unless FSC either (*i*) actually disbelieved those judgments or (*ii*) omitted information whose omission made the statements misleading to a reasonable investor. *Sanofi*, 816 F.3d at 210. Plaintiff would not be able to establish either of those bases for liability. The Complaint does not plead any facts suggesting that FSC actually doubted its reported valuations. And FSC's financial statements disclosed extensive details about valuations, including FSC's valuation policies, the various valuation methodologies, the inputs applied to each, the multiple levels of review, the inherent subjectivity in making valuation decisions, and the valuation ascribed to each asset as of the end of each quarter. Moreover, if this case were to survive the pleading stage, Defendants would introduce evidence about the reasonable bases for their asset-management and valuation decisions and about the valuations performed by the independent third-party valuation firms that conducted quarterly reviews of FSC's portfolio.

Second, FSC's challenged valuations and related judgments not only were neither false nor misleading, they also were not material. As FSC explained in its motion to dismiss [Dkt. No. 87, at 21-23], the challenged items had little actual impact on FSC's financial position.

Third, Plaintiff would not be able to prove that FSC's dividend projections were actionable, because (*i*) FSC never failed to pay any of the projected dividends and (*ii*) the projections of future dividends were protected judgments and opinions and are therefore

insulated from liability under *Omnicare* and *Sanofi*, SEC Rule 175, and the bespeaks-caution doctrine.

Fourth, FSC's general statements about its portfolio performance and investments were inactionable puffery.

Fifth, as Defendants explained in their motion to dismiss [*id.* at 34-38], Plaintiff would not be able to prove that Defendants acted with scienter.

Sixth, Plaintiff has not attempted to plead that it actually relied on any of the alleged misstatements or omissions, and Plaintiff would not be able to establish this element of its cause of action by invoking the fraud-on-the-market presumption of reliance. Every alleged fact that the Complaint cites to challenge FSC's valuations, projections, and other judgments came from FSC's financial disclosures. Thus, according to Plaintiff's own allegations, FSC's stock price should have incorporated all of that publicly disclosed information. Where "all of the information alleged to constitute 'red flags' calling for . . . impairment testing . . . were matters of public knowledge," a plaintiff cannot "sufficiently allege reliance upon a fraudulently inflated price." *City of Omaha, Neb. Civilian Emps.' Ret. Sys. v. CBS Corp.*, 679 F.3d 64, 69 (2d Cir. 2012).

Seventh, for related reasons, Plaintiff would not be able to establish loss causation. "[W]hen elements of the alleged concealed risk were exposed to the market" *before* the price drop at issue, those disclosed elements could not have caused the alleged loss. *In re New Energy Sys. Sec. Litig.*, 66 F. Supp. 3d 401, 405 (S.D.N.Y. 2014) (internal quotations omitted). Here, all of the facts that the Complaint cites to support its allegations of fraud were revealed to the market each quarter, in FSC's public filings. Every cash infusion into the four allegedly inflated assets, every restructuring of PIK interest, and every change of loan terms was disclosed long

before the write-downs were announced in February 2015. Plaintiff thus cannot contend that that announcement revealed a previously concealed risk that caused the alleged loss.

For all of these reasons – and others that would emerge if the case were to survive the pleading stage – Plaintiff would face fatal challenges to its ability to establish liability and damages.

5. Risks of Maintaining Class Certification

The parties reached the proposed settlement before Plaintiff moved to certify a class for litigation purposes, so the Court did not need to address the appropriateness of certifying a litigation class. However, "[w]ere [this case] not to settle, defendants might contest class certification on various grounds, thereby creating appreciable risk to the class members' potential for recovery." *In re Global Crossing*, 225 F.R.D. at 460. "And even if plaintiffs could obtain class certification, there could be a risk of decertification at a later stage." *Id*. This factor therefore weighs in favor of approval of the proposed settlement.

6. Defendants' Ability to Withstand a Greater Judgment

This *Grinnell* factor addresses whether the defendant could withstand a judgment greater than the settlement amount. However, while "[t]he ability of the defendant to pay a judgment greater than the settlement amount can be relevant to the Court's determination of the Settlement's fairness . . . , the converse is not necessarily true; i.e., the fact that a defendant is able to pay more than it offers in settlement does not, standing alone, indicate that the settlement is unreasonable or inadequate." *In re PaineWebber Ltd. P'ships Litig.*, 171 F.R.D. 104, 129 (S.D.N.Y.), *aff'd*, 117 F.3d 721 (2d Cir. 1997); *see also, e.g., D'Amato*, 236 F.3d at 86 (affirming approval of settlement because other *Grinnell* factors weighed in favor of settlement despite District Court's express finding that defendants could withstand higher judgment).

In this case, FSC's and FSAM's financial situations were publicly available from the companies' quarterly and annual financial statements. Plaintiff's counsel also received information about FSC's and FSAM's limited insurance coverage before the mediation, and counsel for the insurers participated in the mediation. Plaintiff understood the practical reality that, "[i]f the cases proceeded along a traditional route, it was likely that those [insurance] proceeds would diminish (as a result of the obligation of the involved insurers to pay for the defense of multiple lawsuits) to the point where they would be insufficient to satisfy all the claims against the Defendants." [Bernstein Decl., ¶ 5] Plaintiff thus was aware of the limited available financial resources when it agreed to the Settlement Amount and decided that "an early resolution would be preferable to prolonged proceedings." [*Id.*]

7. <u>Range of Reasonableness of Settlement Fund</u>

The last two *Grinnell* factors "'compare the terms of the compromise with the likely rewards of litigation.'" *In re Citigroup*, 965 F. Supp. 2d at 384 (quoting *Weinberger*, 698 F.2d at 73). "[T]he question for the Court is not whether the settlement represents the highest possible recovery . . . but whether it represents a reasonable one in light of the many uncertainties the class faces . . . ." *Id.*

"[T]he settlement amount's ratio to the maximum potential recovery need not be the sole, or even the dominant, consideration when assessing the settlement's fairness. '[T]he fact that a proposed settlement may only amount to a fraction of the potential recovery does not, in and of itself, mean that the proposed settlement is grossly inadequate and should be disapproved.'" *In re Global Crossing*, 225 F.R.D. at 460-61 (quoting *Grinnell*, 495 F.2d at 455).

For the reasons described above and in Defendants' motion to dismiss, Defendants believe that this settlement represents a fair and good value for a weak case. Defendants do not

believe that this case would survive the pending motion to dismiss – or that Plaintiff would prevail at trial if the case were to proceed that far.

Defendants understand that, according to Plaintiff's calculations, the proposed settlement amount represents a recovery of between approximately 15% and 20% of Plaintiff's claimed damages. Courts throughout the country have routinely approved settlements providing such percentages – and even far smaller percentages – of recovery. *See, e.g., Destefano v. Zynga, Inc.*, 2016 WL 537946, at *11 (N.D. Cal. Feb. 11, 2016) (reporting that median recovery in securities class-action settlements between 2013 and 2015 was 2.2% of claimed damages); *In re Viropharma Inc. Sec. Litig.*, 2016 WL 312108, at *14 (E.D. Pa. Jan. 25, 2016) (approving settlement of 9% to 10% of maximum estimated loss, and noting that, between 1996 and 2014, median settlement amount was 4.8% of projected investor losses ranging between $50 million and $99 million); *In re Citigroup*, 965 F. Supp. 2d at 384 (noting mean recovery of 2.2% and median recovery of 1.1% in securities cases, and approving settlement for 9.4% of potential damages).[6]

This *Grinnell* factor therefore also supports approval of the proposed settlement.

[6] *See also, e.g., In re Giant Interactive Grp., Inc. Sec. Litig.*, 279 F.R.D. 151, 163 (S.D.N.Y. 2011) ("the average settlement in securities class actions ranges from 3% to 7% of the class' total estimated losses"); *In re Amer. Bus. Fin. Servs. Inc. Noteholders Litig.*, 2008 WL 4974782, at *3, *9, *13 (E.D. Pa. Nov. 21, 2008) (approving settlement for 2.5% of damages); *In re Bisys Sec. Litig.*, 2007 WL 2049726, at *3 (S.D.N.Y. July 16, 2007) ("the more typical recovery rate in class actions is between 5% and 6%"); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 2007 WL 313474, at *10 (S.D.N.Y. Feb. 1, 2007) (recovery of approximately 6.25% of estimated damages is "at the higher end of the range of reasonableness of recovery in class actions securities litigation"); *In re Rite Aid Corp. Sec. Litig.*, 146 F. Supp. 2d 706, 714-15 (E.D. Pa. 2001) (noting that securities class actions that settled between 1995 and 1999 recovered between 5.5% and 6.2% of estimated losses); *In re Ikon Office Solutions, Inc. Sec. Litig.*, 194 F.R.D. 166, 183-84 (E.D. Pa. 2000) (approving settlement for 5.2% to 8.7% of claimed damages); *In re PaineWebber*, 171 F.R.D. at 131 (approving settlement for 4% to 12.5% of damages).

CONCLUSION

For the foregoing reasons, the Court should approve the proposed settlement of this action and enter the proposed Final Order and Judgment.

Dated: January 12, 2017

Respectfully submitted,

/s/ Ralph C. Ferrara
Ralph C. Ferrara
Jonathan E. Richman
Ann M. Ashton
Proskauer Rose LLP
Eleven Times Square
New York, NY 10036
T: (212) 969-3000
F: (212) 969-2900

Attorneys for Defendant
Fifth Street Asset Management Inc.
and Individual Defendants

/s/ Allen W. Burton
Allen W. Burton
Ross B. Galin
O'Melveny & Myers LLP
Times Square Tower
7 Times Square
New York, NY 10036
T: (212) 326-2000
F: (212) 326-2061

Attorneys for Defendant
Fifth Street Finance Corp.