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UNITED STATES BANKRUPTCY COURT

DISTRICT OF NEVADA (LAS VEGAS)

In re: SOUTH EDGE, LLC, Debtor.	Case No. 10-32968 Chapter 11 **REPLY OF FOCUS SOUTH GROUP, LLC TO THE OBJECTIONS OF JPMORGAN, THE BUILDERS AND THE TRUSTEE TO FOCUS'S MOTION FOR STANDING TO PURSUE CLAIMS AGAINST THE BUILDERS ON BEHALF OF THE ESTATE** **Hearing Date** Date: August 31, 2011 Time: 9:30 a.m.

INTRODUCTION

Focus South Group, LLC ("Focus"), a member of South Edge, LLC ("South Edge" or the "Debtor"), hereby files this Reply to the Objections of JPMorgan, the Builders, and the Trustee to Focus's Motion for Standing to Pursue Claims Against the Builders on Behalf of the Estate (the "Motion")[1] and respectfully represents as follows.

[1] The Motion is Docket No. 861 in the above-captioned bankruptcy case.

PRELIMINARY STATEMENT

On August 17, 2011, the Administrative Agent,[2] the Builders[3] and the Trustee each filed objections to the Motion. While the arguments vary from objection to objection, the purpose of the objections (other than Meritage's limited objection) is the same.[4] In short, the objections seek to protect the Builders from their breaches of the South Edge Operating Agreement, so that the "Settling Builders" and the Administrative Agent can attempt to confirm a plan of reorganization (the "Plan") that will release those very claims, essentially for no consideration, and before they are fully vetted by the Estate. In essence, the objections assume that the Plan is a *fait accompli* and will be confirmed. It is not and has not. The Administrative Agent and the Settling Builders will have a full and fair opportunity to confirm the Plan; however, until that occurs, it remains important for the Estate to pursue all of its assets, including its claims against the Builders, especially in a case such as this where Focus is prepared to do so at its own risk.

Through the Motion, Focus has offered to investigate and prosecute the Estate's claims against the Builders at its own cost and risk. Indeed and to be clear, Focus will pay all legal fees and costs incurred in connection with the prosecution of the Estate's claims against the Builders, and will receive no reimbursement on account of such costs, except from actual litigation recoveries to the Estate. Under these circumstances, Focus respectfully requests that the Court provide Focus with standing to prosecute the Estate's claims against the Builders, especially in light of the fact that the Trustee is prohibited from doing so at this time under the TIP Loan Agreement.

Importantly, and contrary to the various objections to the Motion, granting the Motion will not in any way derail the plan process. Focus is not requesting any stay of those proceedings and the Administrative Agent and the Settling Builders are free to aggressively

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[2] Capitalized terms used herein, but not defined herein, shall have the meanings ascribed to such terms in the Motion

[3] The "Settling Builders" filed an objection, and Meritage filed a separate limited objection. The Settling Builders are KB, Toll, Beazer and Pardee.

[4] Meritage's objection seeks to clarify that Meritage did not breach the South Edge Operating Agreement by failing to make its takedowns. What Meritage does not say is that the panel found that Meritage breached the South Edge Operating Agreement through is "failure to seek tender of financing interest and interest reserves into the appropriate account," and by voting to "terminate work" on the Inspirada project on March 10, 2008.

attempt to confirm the Plan. If anything, permitting Focus to actively pursue the Estate's claims against the Builders prior to the confirmation hearing will aid the confirmation process by fully vetting such claims prior to the Court's consideration of a plan that releases them forever. Nor will the Court's granting of the Motion somehow impair the Estate's "MI Deposit" litigation against Focus. The Builders are not a party to those proceedings (although the proceedings are clearly being brought for their benefit) and Focus also is not requesting that those proceedings be stayed as part of the Motion. Finally, the granting of the Motion will not cause any type of default under the Trustee's TIP Loan Agreement; rather, providing Focus with standing will assure that all of the assets of the Estate, including the claims against the Builders are vigorously pursued notwithstanding the onerous restrictions set forth therein.

Moreover, the claims against the Builders are certainly not theoretical or subject to legitimate dispute. The Arbitration Panel expressly found the Builders in breach of the South Edge agreements, including the South Edge Operating Agreement. To be sure, the Builders will attempt various arguments and may make points around the edges of the damages that they have caused South Edge, but the fundamental legal and factual issues have already been conclusively decided after full litigation. Any argument, therefore, that the Estate's claims are merely speculative or subject to legitimate defenses is directly negated by the clear language of the Award. *See* Award, p. 57-58.

In short, the circumstances of this case strongly militate in favor of granting the Motion. Allowing Focus to pursue the Estate's claims against the Builders will have no negative consequences whatsoever for the Estate. It won't cost the Estate a penny unless the litigation is successful. It won't impair the ability of the Administrative Agent and the Builders to attempt to confirm the Plan. It won't prevent the Trustee from pursuing her misguided MI Deposit litigation against Focus, and it won't cause a default under the TIP Loan Agreement. On the other hand, the positive consequences will be substantial. One of the Estate's most important assets will be actively pursued at no cost to the Estate. Further, if Focus successfully prosecutes those claims (as it has done once before), the outcome for the Estate will be much better than the outcome under the Plan. The Plan resolves the claims of the Lenders. It does not result in the

completion of the Inspirada project or do anything to restructure or reorganize the LID or assure that the Project is responsibly restructured. A successful prosecution of the claims against the Builders, on the other hand, will not only satisfy the claims of the Administrative Agent and the Lenders, but it will result in the completion of the project for then benefit of South Edge and all of its various stake holders.

Finally, due to Section 15.10 of the South Edge Operating Agreement,[5] which provides for the quick resolution of disputes among the parties to the South Edge Operating Agreement through an expedited arbitration proceeding, any dispute with the Builders can be resolved in a short period of time, not in the "years" threatened by the Builders.

Put simply, the Motion should be granted.

ARGUMENT

A. Focus has met its burden to obtain standing

As an initial matter, it is important to note that Focus has more than satisfied its burden of proof in connection with the Motion. Focus has established that the Trustee is unable to assert the Estate's claims against the Builders at this time and, therefore, any demand that the Trustee pursue such claims would be futile and unnecessary. *See Official Comm. Of Unsecured Creditors of National Forge Co. v. Clark (In re Nat'l Forge Co.)*, 304 B.R. 214, 222 (Bankr.W.D. Pa. 2004) ("It cannot be said that a formal request, in order to obtain a formal refusal … should be required."). Indeed, there should be no dispute that the Trustee is prevented from prosecuting the Estate's claims against Builders at this time and will be unable to do so without eschewing further TIP loan funding, which she is unlikely to do in light of her decision to support the Plan.

Focus has established that the action against the Builders is "colorable." Indeed, even the Builders concede that the Award expressly states that they have breached the South Edge Operating Agreement.[6] Importantly, Focus has also presented more than enough evidence that

[5] The South Edge Operating Agreement has already been submitted to the Court. *See* Docket No. 8, Ex. D.

[6] The Builders note that the Award is on appeal, but fail to inform the Court that they did not appeal the panel's finding that they breached the South Edge Operating Agreement; rather, they claim (wrongly) that the damages awarded to Focus were too high. Accordingly, even if the Builders succeeded in their appeal,

South Edge has legitimate and "colorable" claims against the Builders, not only for failing to fund amounts due in respect of the Credit Agreement, but for failing to fund their ratable share of "Major Infrastructure" costs as well. Indeed, the panel found "[u]nder Section 2.3.6 of the Operating Agreement … each Member is required to … pre-fund South Edge development costs … These payments included funding for 'Major Infrastructure Costs …'" Award, p. 16. This is critical to the Motion. The Plan attempts to resolve the claims between the Administrative Agent and the Builders, but it does nothing to complete the Inspirada project or provide for the completion of Major Infrastructure, despite the Builders' clear obligation to do so under the South Edge Operating Agreement. Prosecuting the Estate's claims against the Builders would force the Builders to honor their commitments or pay damages for the benefit of the Estate and all its various constituents. The Plan simply ignores the Builders' obligation to complete Major Infrastructure and releases those claims without providing any commitments to complete Major Infrastructure.[7]

Finally, Focus has established that permitting Focus to prosecute the claims against the Builders would benefit the Estate. The Trustee and the Administrative Agent each concede that the Estate's claims against the Builders are valuable assets, and Focus merely proposes that it be allowed to prosecute those claims at its own risk—a clear benefit to the Estate.

B. The Objections are without merit

Unable to directly attack the merits of the Motion, the objectors raise a series of straw-man arguments that are without merit. The Administrative Agent argues that the Motion is a "thinly veiled effort" by Focus to "pre-judge" the merits of the Plan. Agent Objection 2:6-8. Nonsense. The Motion does nothing more than request standing to pursue an Estate asset on behalf of the Estate. It does not seek to stay any confirmation proceedings or otherwise

it would not overturn the finding that they breached (and continue to be in breach of) the South Edge Operating Agreement.

[7] The Trustee touts the settlement between the Settling Builders and the Administrative Agent as being in the best interests of the Estate, and that will be determined at confirmation. Focus, however, notes that almost all of the value flows from the Builders to the Administrative Agent and does nothing for South Edge and its Estate. Further, the Settling Builders are already committed to funding those amounts through their respective repayment guarantees. In essence, the Settling Builders want credit for doing what they have already agreed to do.

determine the merits of the Plan. To the contrary, Focus acknowledges in the Motion that, if the Plan is confirmed as currently drafted, the claims against the Builders will be released and it will no longer be able to pursue them.[8] Further, the Court's granting of the Motion will not in any way prevent the Administrative Agent or the Settling Builders from arguing that the releases set forth in the Plan should be approved. In any event, the Plan has not yet been confirmed and until it is the claims against the Builders remain viable and should be pursued by the Estate. The mere fact that the Builders and the Administrative Agent have proposed a plan that is to their liking does not mean that the Estate cannot pursue its assets and seek alternative and better solutions.

Interestingly, it is the Administrative Agent and not Focus that is attempting to "pre-judge" the Plan. Focus seeks to prosecute the claims against the Builders without limiting the Administrative Agent's efforts to confirm the Plan. The Administrative Agent, on the other hand, believes that Focus should be shut down merely because the Plan has been proposed and *might* be confirmed. In addition, Focus mentions the Plan in its Motion only to note that it provides for the release of the claims against the Builders and, therefore, those claims should be fully explored and vetted immediately. The Administrative Agent, on the other hand, devotes a substantial amount of time in its objection to extolling the virtues of its Plan. Focus, however, agrees that arguments for and against the Plan should be made at confirmation and not in the context of the Motion.

The Administrative Agent's assertion that the Motion should not be granted because South Edge's claims against the Builders constitute Lender collateral is also neither here nor there. As an initial matter, until the Administrative Agent is granted relief from the automatic stay (which it has not even sought), such claims belong to the Estate and they should be prosecuted for the Estate's benefit, not just the benefit of the Lenders. Further, due to the nature of the claims, there is clear "equity" for the Estate therein. As noted above, the South Edge Operating Agreement requires the Builders to fund their pro rata share of South Edge's obligations to the Lenders, but it does not stop there. As found by the panel, it also requires the

[8] Of course, Focus reserves all of its rights to object to the releases and will vigorously oppose them.

Builders to fund their pro rata share of "Major Infrastructure Costs" in connection with Inspirada. Indeed, Section 2.3.6 of the South Edge Operating Agreement states that:

> Each Member shall be responsible for payment of that portion (the "Member Costs") of the "Major Infrastructure Cost" ... as set forth in Section 3 of the Acquisition Agreement, which obligations shall survive any Phase Close of Escrow ... and continue for each Member notwithstanding the termination of the Acquisition Agreement or such Member or the rights of such Member thereunder.

Put simply, the Builders have an obligation to fund South Edge's obligations to the Lenders, but they are also required to fund their share of "Major Infrastructure," which is a separate obligation requiring the Builders to fund more than what is owed to the Lenders. There is no question that the Estate is entitled to receive such funding after the Administrative Agent has been paid and the Estate is entitled to attempt to realize those recoveries.

The Administrative Agent's argument that it is entitled to "adequate protection" of its liens is also unavailing. The Administrative Agent will be adequately protected as a result of Focus's efforts to collect the amounts due from the Builders. The Administrative Agent cannot attempt to prevent the realization of the Estate's asset, while also demanding adequate protection. Further, as noted in the Motion, Focus is intimately familiar with the Estate's claims and uniquely positioned to vigorously prosecute them.

The Trustee's objections are also misguided. The Trustee argues that Focus cannot act as a fiduciary because it is "conflicted." This is simply not true. Focus may not agree with the Trustee's handling of South Edge's bankruptcy case, and it certainly does not support the Plan; however, its interests are perfectly aligned with those of the Estate when it comes to maximizing the value of the claims against the Builders. Focus's primary motivation in asserting claims against the Builders has been and will continue to be to fund the completion of the Inspirada project for the benefit of all parties in interest.

Importantly, although the Trustee has attempted to paint Focus in a negative light, the fact remains that Focus is the *only* member of South Edge that has made all of its take downs, posted its entire MI Deposit, and performed all of its other obligations to South Edge. The Builders did not. Further, Focus is the only member that has consistently pushed for the

completion of the Inspirada project since the Builders voted to stop construction in March of 2008. And, as a land owner in South Edge, it has a clear interest in assuring that the Major Infrastructure required to sustain Inspirada is completed, which necessarily benefits South Edge, all of its creditors, the City of Henderson and the holders of LID bonds. The Estate's interest is not materially different. There is simply no conflict. Further, Focus is keenly aware that, if the Motion is granted, it will be required to act for the benefit of the Estate and believes that it can unequivocally meet those obligations.

In any event, the various "conflicts" listed in the Trustee's opposition are not conflicts at all. The Trustee notes that Focus opposes the Plan. That certainly does not mean that Focus will not vigorously prosecute the claims against the Builders for the benefit of the Estate. The Trustee argues that the litigation concerning the MI Deposit somehow creates a conflict. Once again, not true. Although the MI Deposit litigation is being run for the benefit of Builders, the Builders are simply not parties thereto. Further, nothing in Focus's position in the MI Deposit litigation is inconsistent with the full and vigorous prosecution of the Estate's claims against the Builders, and the Trustee does not contend otherwise. Instead, the Trustee asserts that Focus is conflicted merely because she has sued Focus and intends to object to Focus's claims. This simply does not compromise Focus's ability to effectively prosecute the claims against the Builders. To the contrary, it is quite common in chapter 11 proceedings for parties to be aligned on some matters and not others.

The Trustee's argument that Focus's arbitration proceeding against the Builders somehow creates a conflict is also unavailing. Indeed, the opposite is true. It is precisely Focus's participation in the arbitration that provides it with the knowledge and experience to efficiently prosecute the Estate's claims, and the Estate's claims against the Builders are completely consistent with the arbitration.

Next, the Trustee argues that the Motion must fail because she has made a justifiable decision to defer prosecution of the claims at this time. This argument also misses the point. The Trustee has done more than "defer" prosecution of the Estate's claims against the Builders. She has consented to the Plan, which, if confirmed, will release those claims forever without

any in-depth investigation and without any real consideration for the Estate. In short, this is not a case where the Trustee is deferring prosecution in order to deal with more pressing matters or to properly investigate the claims prior to their prosecution. This is a case where the Trustee has agreed not to prosecute the claims at all pending the confirmation of a plan that will release them forever.

Further, allowing Focus to pursue the claims against the Builders is clearly beneficial to the Estate, and that consideration should trump all others. As noted above, allowing Focus to pursue such claims does not prevent the Trustee from consenting to the Plan. It does not impair the ability of the Builders and the Administrative Agent to pursue the Plan. It does not affect the Trustee's ability to prosecute her MI Deposit claims against Focus. It does not cost the Estate a single penny unless there are recoveries, and it does not result in a default under the TIP Loan Agreement. Moreover, the objections fail to articulate any legitimate harm that might befall the Estate if the Motion is granted. Granting the Motion, on the other hand, would permit one of the Estate's most important assets to be investigated and explored in a full and fair manner at Focus's risk and before it can be released without serious vetting in the Plan.

Finally, in their objection, the Builders inappropriately argue that the Motion should not be granted because the Focus may have difficulty enforcing the claims against the Builders. That is simply not the standard that Focus has to meet in order to obtain standing. Focus need only show that South Edge has "colorable" claims. The Award makes it absolutely clear that it does. The arbitration panel in the Focus arbitration found that:

> [The Builders], except Meritage, breached the Operating Agreement in connection with their duties to fund financing interest and interest reserves when the Members, voting their interests as Managers of South Edge, either refused to propose or approve capital calls for such expenditures. Meritage breached these duties under the Operating Agreement by failure to seek tender of financing interest and interest reserves into the appropriate account.

Award, p. 57. The panel also found:

> Likewise, [the Builders], except Meritage, breached their obligations under the Operating Agreement to effect their April 2008 Takedowns as scheduled, or during and following expiration of the Forbearance

> Agreement on June 31, 2008, by unilaterally extending Takedown dates without the approval of . . . JPMorgan. . . .

Id. at 58. And, the panel expressly held that the Builders breached the Operating Agreement by ceasing construction of the Inspirada project, noting that:

> The [Builders] also breached Section 7.03(o) of the Credit Agreement, which prohibits cessation of construction of improvements for a continuous period. Such in turn constituted an "Event of Default" under [Operating] Agreement Section 11.1.12. This breach became effective upon the Management Committee vote to terminate work taken on March 10, 2008.

Id. In short, there is no question that the Builders breached the South Edge Operating Agreement and that South Edge has colorable claims as a result of those breaches. The Court's inquiry should end there.

In any event, the Builders' attacks upon the merits of the litigation are misleading and disingenuous. First, the Builders note that Focus only received $36.8 million in damages as a result of the Builders' breaches and that is far less than the value purportedly provided by the Plan. This argument ignores the fact that Focus is seeking standing to assert *South Edge's* claims against the Builders, not those of Focus. South Edge is entitled to significantly more damages than Focus. At the very least, it is entitled to collect the capital contributions required by the South Edge Operating Agreement that the Builders refused to make, including capital contributions required to repay the Lenders *and* fund the "Major Infrastructure." These damages are not "speculative," but standard direct contractual damages and, as was presented in great detail in the arbitration, total close to $200 million.[9]

Next, the Builders claim that Focus cannot be successful because the panel found that South Edge cannot obtain specific performance of the Builders' take down obligations. This argument is another red herring. South Edge need not obtain specific performance to successfully prosecute the Estate's claims against the Builders. If the Builders do not wish to perform under the South Edge Operating Agreement, they must pay damages to South Edge on account of their breaches. Those damages *(i.e.*, the amounts needed to satisfy the Lender's

[9] Larry Bross also testified in connection with the Focus's objections to the TIP Loan Agreement that the Builders have failed to fund close to $200 million in "Major Infrastructure" costs.

claims and fund Major Infrastructure) will permit South Edge to satisfy the claims of the Lenders and complete the Inspriada project in some reasonable form whether or not there is any specific performace. This, in turn, will result in a much better outcome for South Edge than the Plan, which simply provides no guarantee that any "Major Infrastructure" will ever be built.

Further, the Builders' mischaracterize the Award when they argue that South Edge's damages would be limited to the "liquidated damages" amount set forth in the Acquisition Agreement. They are not and the panel never limited South Edge's damages in that fashion. Section 2.3.3 of the South Edge Operating Agreement requires each member to contribute the capital required for South Edge to satisfy its obligations to the Lenders, whether or not such member makes its takedowns, and the panel clearly found that this was the case when it held that the Builders breached Section 2.3.3 of the Operating Agreement. The panel noted that "[the Builders], except Meritage, breached the Operating Agreement in connection with their duties to fund financing interest and interest reserve when the Members, voting their interests as Managers of South Edge, either refused to propose or approve capital calls for such expenditures." Award, p. 57-58. And, Section 2.3.6 of the Operating Agreement also obligates the Builders to pay development costs whether or not their takedowns are made. Put simply, South Edge's claims against the Builders are more than colorable, they are meritorious.

Finally, the Builders claim that the Motion should not be granted because it will result in years of additional litigation. Once again, this argument should be unpersuasive. In fact, Focus believes that the claims against the Builders can be litigated in a quick and efficient manner and without undue delay. The Award has already established that the Builders breached the South Edge Operating Agreement. Award, p. 57-58. As a result, any litigation against the Builders will simply determine how much is owed. And, the South Edge Operating Agreement provides that all disputes among the parties must be settled by binding arbitration in an expedited fashion. Indeed, Section 15.10 of the South Edge Operating Agreement provides, in part, that:

> The Arbitration Proceedings shall be expedited to the maximum extent practicable. To the extent possible, the arbitration proceeding shall be conducted on consecutive days, excluding Saturdays, Sundays, and holidays until hearings are concluded. All discovery and hearings shall be

> completed within 30 days from the day the Arbitrator is selected or appointed.
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> * * * *
>
> The Arbitration Proceeding shall be completed and the written decision delivered to the parties no later than the earlier to occur of (i) 60 days after the last hearing date or (ii) 120 days after delivery of the notice of the dispute to the opposing party.

Contrary to the arguments of the Builders, the South Edge Operating Agreement does not contemplate a drawn out and long litigation. It contemplates a quick dispute resolution procedure that can liquidate the Estate's claims against the Builders in an efficient manner and without undue delay. That is particularly true in a case such as this where liability is a given and the sole issue before the arbitration panel will be the amount of damages to award. In essence, all that is required is a "prove-up hearing" to consider the proper level of damages to award South Edge.

CONCLUSION

To conclude, there is little question that the Estate will benefit if the Motion is granted. Granting the Motion will not harm the Estate. It will not prevent the Administrative Agent and the Builders from attempting to confirm the Plan. It will not prevent the Trustee from litigating against Focus. It will not cause a default under the TIP Loan Agreement and it won't cost the Estate a single penny unless Focus succeeds.

On the other hand, allowing Focus to prosecute the Estate's claims against the Builders will undoubtedly benefit the Estate. Among other things, Focus will investigate and prosecute one of the Estate's most valuable claims for the benefit of the Estate at Focus's own risk. In addition, one of the Estate's most important claims will be fully vetted prior to the confirmation of a Plan that attempts to release those very claims.

Further, Focus is fully capable of vigorously prosecuting the Estate's claims against the Builders and has no conflicts that would prevent it from doing so. Finally, warnings regarding years of litigations are overstated and misleading.

Under these circumstances, the Motion should be granted and the Court should grant such other relief as is just and proper.

Dated: August 24, 2011

Respectfully submitted,

By: */s/ I. Scott Bogatz*

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