

Conveyancing and Collateralizing Utah Water Rights

by R.L. Knuth

It is a truism that in Utah, water rights are an important property interest. In point of fact, they are a downright obsession given our status as the second driest state in the Union. The law of water rights in Utah finds its roots in the mining and agricultural practices of the last century. The riparian system of water law inherited from the laws of England proved untenable in the arid west. Because Nature seldom put water where people want to use it, the practice arose under which the law protected the first person to divert water from the natural system and to apply it to a beneficial use. Water was simply too valuable for any individual to own in its natural state. This paper will address the way in which this most indispensable and potentially transitory of property interests can be conveyed and used to secure an obligation.

General Background

A. The Nature of Water Rights

In Utah, all natural waters are declared to be public property.¹ Under the Statutes of 1888 and by custom and practice prior to that time, water could be appropriated as a so-called "diligence right," simply by diverting it from a natural source and applying it to a beneficial use.² Under the current system, an application to appropriate must be filed with the State Engineer in order to create a new water right.³

An appropriation right gives an individual only a usufruct in water, that is, the right to use some maximum quantity of water from a specified source, at a specified point of diversion or withdrawal, for a specified use, and at a specified time.⁴ Each water right also has a particular "priority" in relation to other water rights in the same source. Priority is the order of ranking in which the owner of the right may take his or her entitlement; a senior appropriator may take his or her full measure of water before a junior appropriator may take any from the same source.⁵

B. The Classification of Water Rights

Generally, water rights are considered real property.⁶ The exception, however, is that shares in a mutual water company are personalty.⁷ But, all water rights—even shares in a mutual water company—can be appurtenant to land or can be severed from the land and transferred separately or reserved to the grantor.⁸

Utah water rights take a number of different forms which are transferred and encumbered variously:

Diligence Claims: Diligence claims are water rights arising from the diversion of water from a natural system and applied to a beneficial use. Surface rights were subject to appropriation by diligence prior to 1903 when filing an application for appropriation became the exclusive method of appropriating water, and groundwater rights prior to 1935.⁹ Thus, surface water rights established by diversion and use prior to 1903 are recognized as valid water rights, even though the State Engineer may have no record of them. Likewise, in 1935, groundwater rights were included for the first time in the State Engineer's appropriation application system; nevertheless, groundwater rights acquired by beneficial use alone prior to 1935 are valid, even though not of record.

In 1997, the Utah Legislature stiffened the requirements for filing diligence claims, and the new version of Utah Code section 73-5-13 applies to diligence claims made of record after May 4, 1997. The new statute requires a claimant to submit verification by a registered engineer or land surveyor quantifying the water diverted, attesting to its beneficial use, and providing a map showing the points of diversion and places of historical use. The State Engineer takes this information and must perform a field inspection of the claim and prepare a report. Although the State Engineer's acceptance of the filing and his inspection do not adjudicate the existence of a diligence right, this makes the diligence right of record.

Certificated Appropriations: As stated above, in 1903, (1935 for groundwater), the Legislature codified the application procedure, mandating applications with the State Engineer

R.L. KNUTH is an associate with the Salt Lake City firm Jones, Waldo, Holbrook & McDonough.



as the *sole* procedure for acquiring a water right in Utah.¹⁰ A certificate is granted by the State Engineer after his approval of the application and perfection of the right by actual diversion and application to a beneficial use. A certificate of appropriation is the appropriator's deed of title, good against the state and anyone else who cannot show a superior right.¹¹

Simply filing an application to appropriate, however, does not give the applicant the right to use the water applied for. Approval of the application only gives the applicant the right to perfect by actual diversion of the water and beneficial use.¹² Thus, until approval by the State Engineer and perfection by construction of the diversion works, diversion and application of the water to a beneficial use and the subsequent submission of proofs, the right is "inchoate."¹³

Mutual Water Company Shares: A mutual water company is a legal personality that holds legal title to water rights. The Utah Supreme Court recently held that "stock in a mutual irrigation corporation represents an interest in real property, . . ."¹⁴ Share ownership in the water company represents the right to use a proportionate share of the water the company diverts, and carries with it the obligation to pay a share of the company's expenses. The individual shareholders hold the beneficial ownership of the water rights and have the right to use their aliquot share of the water.¹⁵

Contract Rights: Many water users depend on water supply pursuant to contract. In most cases, the suppliers are public or quasi-public agencies operating pursuant to federal or state statutes. These suppliers hold appropriative rights allowing diversion of water that is subsequently supplied to users. In general terms, the terms of the contract define the users' rights. State, and even federal, law may apply in some such circumstances.

Transfer of Water Rights

A. Transfer of Diligence Claims and Certificated Rights.

Utah Code section 73-1-10 provides that water rights may be transferred "by deed in substantially the same manner as real estate, . . ." Water rights can be severed from the land on which they were historically used and can be transferred independently of the land, or reserved to the grantor.¹⁶ Further, transfers of water rights are subject to the Statute of Frauds.¹⁷

The rules governing the construction of deeds generally apply to instruments conveying water rights.¹⁸ Warranty deeds should not be used to convey water rights, or water rights that are appur-

tenant to land being conveyed by warranty deed. Unlike other property rights, water rights must be used to persist. They can be forfeited if unused for five successive years.¹⁹ Water rights should be conveyed by separate instrument, without warranties. A deed of water rights should refer to the pertinent certificate number, diligence claim number, and change application number (if applicable). The water deed should also refer specifically to the nature and extent of use, the place of use and all diversion works and appurtenances, such as easements, wells and equipment, used in connection with the water right transferred.

Deeds of water rights must be recorded in the county where the water is used and, if different, the county where it is diverted.²⁰ Until this year, the law required the county recorder to send a certified copy of each such water rights deed to the State Engineer for filing;²¹ this requirement, however, has been honored more in the breach than the observance. In apparent recognition of this fact, in 1999 the Legislature amended section 73-1-10(c),²² loosening the requirement by requiring only that the county recorder forward a certified copy of a "deed or other

"The rules governing the construction of deeds generally apply to instruments conveying water rights."

conveyance which contains a reference to a water right number for a water right." Section 73-1-10(c) (iii) also empowers the State Engineer to "designate regional offices to receive copies of deeds or other conveyances transmitted pursuant to Subsection (1) (c) (i). A county recorder may not be required to transmit documents to more than one regional office." Obviously, this enactment has not moderated the perils of missing the recordation of a water conveyance.

Section 73-1-10(d) provides: "A recorded deed of a water right shall, from the time of its filing in the office of the county recorder constitute notice of its contents to subsequent purchasers, mortgagees, and lienholders."²³ Section 73-1-12 makes unrecorded deeds of water rights void as against subsequent purchasers only; the statute does *not* say that unrecorded deeds are void as against subsequent lienholders.

Inchoate water rights, that is appropriations applications that are unperfected, whether approved or unapproved, are "transferred or assigned by instruments in writing."²⁴

Shares in a mutual water company are transferred "in accordance with the procedures applicable to securities set forth in Title 70A Chapter 8, Utah Uniform Commercial Code."²⁵ Section 70A-8-304 requires endorsement and delivery of the certificate to the purchaser in order to effect a transfer of a certificated security.

B. Water Rights as an Appurtenance to Land

Although water rights are separate from land and can be separately transferred and encumbered, they can be an appurtenance to property for which they are acquired or on which the water has historically been used, and as such they may pass with the land. By statute, water rights are presumed appurtenant so that they pass to the grantee of land, unless specifically reserved.²⁶

The case law provides, generally, that water becomes appurtenant to land where it was historically used for a beneficial purpose at the time of the conveyance and previously.²⁷ For example, where certain water rights have historically been used to irrigate agricultural land and are necessary to its use and enjoyment, they will be considered appurtenant and, under section 73-1-11, will pass to the grantee, unless expressly reserved to the grantor.

One exception exists, however, again in the case of water shares. There is a rebuttable presumption that mutual water company shares are *not* appurtenant.²⁸ The presumption may be rebutted by a clear and convincing showing that the water represented by the water company share was appurtenant and that the grantor intended to convey it with the land. Unless this showing is made, however, the grant of land will not convey with it the implied grant of water rights in the form of water shares.²⁹ For example, in *Brimm v. Cache Valley Banking Company*,³⁰ the water stock in question had been used to irrigate the land for sixty years and the land was worthless without the water represented by the stock. The Utah Supreme Court found that this was sufficient to overcome the presumption that water shares did not pass to the grantee.

The idea of appurtenance is related to the concept of beneficial use.³¹ The grantee is entitled to the amount of appurtenant water actually being used on the land by the grantor at the time of the transfer and for a reasonable time thereafter.³² Conversely, unless expressly reserved by the grantor, a vested water right is appurtenant to the land only to the extent it is used to benefit the land at the time of the conveyance.³³

But, not all of what are commonly thought of as "water rights" pass as an appurtenance. The Utah Supreme Court's decision in *Little v. Greene & Weed Investment Company*,³⁴ surprised many water law practitioners. In that case, the Supreme Court held that a water right does not become appurtenant to land until the State Engineer issues a certificate of appropriation. The

Court reasoned that two elements are necessary under the statute for a water right to become appurtenant to land. First, the water must be diverted and put to a beneficial use on the specific parcel of land. Second, all of the procedural steps required by the statute for appropriation must be completed, including the issuance of a certificate of appropriation. Thus, unperfected applications, that is, those that were still in the application process and not evidenced by a final certificate, could not be appurtenant to land. Accordingly, in that case the Supreme Court held that a grant of land and appurtenances was not effective to convey to the grantee an uncertificated appropriation application.³⁵

In 1998, the Legislature amended Utah Code section 73-1-11 to provide that in any land conveyance document executed on or after May 4, 1998, not only certificated water rights, but also water rights in the form of court decrees, diligence claims, and approved but unperfected applications for appropriations, permit changes and exchanges, pass as appurtenances to the grantee. In other words, after May 4, 1998, such uncertificated and unperfected water rights were also passed to the grantee under a "silent" advance.

"[W]ater rights evidenced by shares of stock are not deemed appurtenant to the land. . . ."

Section 73-1-11 also gives some guidance on the definition of appurtenance and clarifies a number of open questions concerning conveyance of water rights and water shares. For example, the statute provides that as to land conveyances executed before May 4, 1998:

If the water right has been exercised in irrigating different parcels of land at different times, it shall pass to the grantee of a parcel of land on which the water right was exercised the next preceding the time the land conveyance was executed.³⁶

The new version of the statute reiterates earlier law that water rights evidenced by shares of stock are not deemed appurtenant to the land, but provides that in any conveyance, the grantee assumes the obligation for any unpaid assessment on the shares.

Further, the new version of section 73-1-11 specifically defines that for purposes of land conveyances made on or after May 4, 1998, a water right evidenced by (1) a court decree; (2) a certificate of appropriation; (3) a diligence claim; (4) a water user's claim executed in a general determination of water rights; (5) an approval of an application to appropriate; (6) an approval of an application to permanently change the place of use of water; or, an approval of an exchange application issued

under section 73-3-20, is *appurtenant to land*. Accordingly, the statute implies that unperfected applications, such as unapproved applications to appropriate, change applications, or exchange applications, *do not* pass as an appurtenance to the land and must be expressly assigned to the grantee.

This new statute also clarifies, at least for conveyances executed on or after May 4, 1998, what happens when the grantor conveys only a part of a water right in a conveyance of land. In that case, the portion of the water right not conveyed is presumed to be reserved to the grantor.³⁷ If the land conveyed "constitutes only a portion of the authorized place of use for the water right, the amount of the appurtenant water right that passes to the grantee shall be proportionate to the conveyed portion of the authorized place of use."³⁸ Finally, for purposes of land conveyances only, and only for those executed on or after May 4, 1998, a water right is appurtenant to land that is the authorized place of use of the water as described in a court decree, a certificate of appropriation, a diligence claim, a water user's claim, or an approved appropriation application, change application, or exchange application.³⁹

Even if appurtenant, water rights can be severed from the land and either reserved or conveyed separately by the grantor. Whether a water right is actually appurtenant is a question of fact, peculiar to the facts of each case.⁴⁰

It is of paramount concern that if water shares are to be transferred along with land, that the deeds so recite, and that the share certificate be endorsed and delivered when closing the transaction.

Creating Security Interests in Water Rights

Generally, security interests in water rights are created and perfected in the same manner as mortgages in land. A mortgage of land encumbers all appurtenant water rights, as well.⁴¹

The exception to this general rule is with shares in a mutual water company, the ostensible reason being that water shares are not necessarily tied to specific land, but represent the right to use water within an area served by the company's distribution system. The issue of collateralization of water shares was brought into sharp focus in 1989, when the Utah Court of Appeals decided the case of *Associates Financial Services Company of Utah v. Sevy*.⁴² There, the sellers sold land and water rights in the form of water stock, and took back a trust deed covering both the land and the shares. But, the stock was

certificated in the buyers' name and the buyer later pledged them to a creditor who took actual possession of the stock certificates.

As between the seller (who took a trust deed on the land), and the buyers' pledgee (who took actual possession of the share certificates), the Court of Appeals held for the pledgee of the stock, reasoning that shares in a mutual water company fell within the definition of a "security" which is, in turn, an "instrument" within the meaning of section 70A-8-102(1)(a). Under Article 9, chapter 8 of the Utah Uniform Commercial Code, a "security" is an instrument

- (i) . . . issued in bearer or registered form; and (ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in a medium for investment; and (iii) is either one of a class or a series or by its terms is divisible into a class or series of instruments; and (iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.⁴³

"It is of paramount concern that if water shares are to be transferred along with land, that the deeds so recite, and that the share certificate be endorsed and delivered when closing the transaction."

Since the shares were certificated securities, the only way a security interest could be perfected in them was by physical possession of the certificates themselves, and the Court of Appeals held for the pledgee of the stock.

In its 1994 decision in *Salt Lake City Corporation v. Caboon & Maxfield Irrigation Company*,⁴⁴ the Utah Supreme Court expressly rejected the Court of Appeals's holding in *Associates Financial Services v. Sevy*,⁴⁵ and observed:

Stock of a mutual irrigation corporation is different from, and should not be treated like, stock of other types of corporations. Instead, such stock is more akin to a contract between the shareholders for the pooling and distribution of water.

* * *

Accordingly, we hold that stock in a mutual irrigation corporation represents an interest in real property and is therefore not a certificated security under Section 70A-8-102(1)(a).⁴⁶

The Supreme Court rejected as "faulty"⁴⁷ the notion that shares in a mutual water company qualify as a "medium for investment," observing that such entities are organized primarily as a vehicle to allocate water contributed by the shareholders, and

not to make a profit or pay a dividend.⁴⁸

In 1996, in apparent response to the *Caboon* decision, the Utah Legislature amended Utah Code section 73-1-10(2) to provide that transfers of the "right to the use of water evidenced by shares of stock in a corporation" are to be consistent with the procedures applicable to securities in chapter 8 of Article 9 of the Utah Uniform Commercial Code, Title 70A, that is, by the indorsement of the share certificate and delivery to the transferee. To make the provisions parallel, the Legislature also added section 70A-8-409 to the Commercial Code, providing: "The procedures of this chapter shall apply to shares of stock in a water company, irrigation company, canal company, reservoir company, or other similar water corporation." Accordingly, practitioners should treat the transfer or collateralization of water shares the same as any other certificated security.

Utah Code section 57-1-30 provides that where shares of stock evidencing water rights are "used, intended to be used, or suitable for use" on property subject to a trust deed, and which were made subject to the trust deed, can be sold by the trustee at the trustee's sale upon foreclosure. Presumably, given the Supreme Court's reversal of *Sevy*, endorsement and actual possession of the share certificates would not be necessary to perfect a security interest in water shares. This leaves open the question of how the Supreme Court would treat the facts of the *Sevy* case, where one creditor has possession of the share certificates, and the other has a recorded trust deed covering appurtenant water rights.

Bankruptcy Issues

The so-called "strong-arm" powers of a bankruptcy trustee can raise serious issues if the security interest in water rights is not properly perfected. Under section 544(a) of the United States Bankruptcy Code,⁴⁹ the trustee has the rights and status, as of the date of the order for relief in the bankruptcy, of: (1) a judicial lien creditor on all property of the debtor on which a creditor of the debtor on a simple contract could have obtained such a simple lien on that date; (2) a creditor holding an execution returned unsatisfied; and (3) a bona fide purchaser of real property of the debtor.⁵⁰ The trustee's knowledge, or the knowledge of any creditor, is irrelevant to the trustee's status. Nevertheless, constructive notice, such as possession by a third-party, is also binding on the trustee.⁵¹ Likewise, the trustee is bound by any express or constructive trust to which estate property is subject.⁵²

The extent of the bankruptcy trustee's avoidance powers, in the first instance, depends on the *state* law of perfection and

attachments of security interests.⁵³ Under Uniform Commercial Code section 9-301(1)(b), Utah Code section 78-9-301(1)(b), a judicial lien creditor has priority over an unperfected security interest. Also, a bona fide purchaser of real property for value takes free of unrecorded interests.⁵⁴ Accordingly, the bankruptcy trustee can, using his or her status as a hypothetical creditor with a judgment lien, avoid any security interest or transfer of property by the debtor, which was not properly perfected as of the date the bankruptcy was filed (except where the Uniform Commercial Code permits automatic perfection). Thus, a bankruptcy trustee could avoid unrecorded water deeds or assignments of unperfected water rights. Where the water rights are shares in a water company and where a security interest in the shares has not been perfected, the trustee can avoid any transfers or encumbrances that could be successfully set aside in favor of a good faith purchaser for value and without notice. In all of these instances, the debtor's own knowledge is irrelevant.

Conclusion

Many changes to the law, both legislative and judicial, have occurred over the last several years, and these create as many questions as answers. And if anything, practitioners face even greater risk in documenting a transfer or a collateralization of water rights than they did before.

¹UTAH CODE ANN. § 73-1-1(1953).

²Revised Statutes of Utah 1898, Title 33, Sections 1261-62; *Bishop v. Duck Creek Irrigation Co.*, 241 P.2d 162, 164 (Utah 1952).

³UTAH CODE ANN. § 73-3-1.

⁴*See J.J.N.P. Co. v. State*, 655 P.2d 1133, 1136 (Utah 1982).

⁵UTAH CODE ANN. § 73-3-21.

⁶UTAH CODE ANN. § 57-1-1(3) (1994); *In re Bear River Drainage Area*, 271 P.2d 846, 848 (Utah 1954).

⁷*See* UTAH CODE ANN. § 73-1-11(4) (Supp. 1998); *East Jordan Irrigation Co. v. Morgan*, 860 P.2d 310, 313, n. 9 (Utah 1993).

⁸UTAH CODE ANN. § 73-1-11(1) (Supp. 1998); *Brimm v. Cache Valley Banking Co.*, 269 P.2d 259, 864 (Utah 1954).

⁹*See Bishop v. Duck Creek Irrigation Co.*, 241 P.2d 162, 164 (Utah 1952).

¹⁰UTAH CODE ANN. § 73-3-1.

¹¹*Lake Shore Duck Club v. Lake View Duck Club*, 166 Pac. 309, 311 (Utah 1917).

¹²*Rocky Ford Irrigation Co. v. Kents Lake Reservoir Co.*, 35 P.2d 108, 113 (Utah 1943).

¹³*See Mosby Irrigation Co. v. Criddle*, 354 P.2d 848, 852 (Utah 1960); *Duchesne County v. Humphries*, 148 P.2d 338, 339 (Utah 1944).

¹⁴*Salt Lake City Corp. v. Caboon & Maxfield Irrigation Co.*, 879 P.2d 248, 252, n. 8 (Utah 1994).

¹⁵*Genola Town v. Santaquin City*, 80 P.2d 930, 936 (Utah 1938).

¹⁶UTAH CODE ANN. § 73-1-11(1) (Supp. 1998).

¹⁷UTAH CODE ANN. § 25-5-1 (1995).

¹⁸*See Cornish Town v. Koller*, 758 P.2d 919, 921, *appeal after remand*, 798 P.2d 753 (Utah 1988).

- 19 UTAH CODE ANN. § 73-1-4.
 20 UTAH CODE ANN. § 73-1-10(1)(b).
 21 UTAH CODE ANN. § 73-1-10(1)(c).
 22 S.B. 154, 1999 General Session.
 23 UTAH CODE ANN. § 73-1-10(1)(d).
 24 UTAH CODE ANN. § 73-3-18; *Loosle v. First Fed. Sav. & Loan Ass'n*, 858 P.2d 999, 1003 (Utah 1993).
 25 UTAH CODE ANN. § 73-1-10(2).
 26 "[W]ater appurtenant to land shall pass to the grantee of such land . . ." UTAH CODE ANN. § 73-1-11.
 27 *Roberts v. Roberts*, 584 P.2d 378, 379-80 (Utah 1978); *Stebbens v. Burton*, 546 P.2d 240 (Utah 1976); *Conant v. Deep Creek & Curlew Valley Irrigation Co.*, 66 Pac. 188, 189 (Utah 1901).
 28 UTAH CODE ANN. § 73-1-11(4).
 29 *Brimm v. Cache Valley Banking Co.*, 269 P.2d 259, 864 (Utah 1954).
 30 269 P.2d 259, 864 (Utah 1954).
 31 "Beneficial use shall be the basis, the measure and the limit of all rights to the use of water in this state." UTAH CODE ANN. § 73-1-3.
 32 *Stebbens v. Burton*, 546 P.2d 240, 242 (Utah 1976).
 33 *Little v. Greene & Weed Inv. Co.*, 839 P.2d 791, 792 (Utah 1992).
 34 839 P.2d 791 (Utah 1992).
 35 *Id.* at 796.
 36 UTAH CODE ANN. § 73-1-11(2)(a).
 37 UTAH CODE ANN. § 73-1-11(5)(d).
 38 UTAH CODE ANN. § 73-1-11(5)(e).
 39 UTAH CODE ANN. § 73-1-11(5)(c).
 40 *Cortella v. Salt Lake City*, 72 P.2d 630, 641 (Utah 1937).
 41 *Thompson v. McKinney*, 63 P.2d 1056, 1058 (Utah 1937).
 42 776 P.2d 650 (Utah Ct. App. 1989).
 43 *Id.* at 652.
 44 879 P.2d 248 (Utah 1994).
 45 776 P.2d 650 (Utah Ct. App. 1989).
 46 *Id.* at 252.
 47 *Id.* at 251.
 48 *Id.* at 252.
 49 U.S. Code, Title 11.
 50 11 U.S.C. § 544(a).
 51 *In re Richardson*, 23 BR 434, 439-40 (Bankr. D. Utah 1982).
 52 *In re First Capital Mortgage Loan Corp.*, 60 B.R. 915, 916-17 (Bankr. D. Utah 1986).
 53 *Matter of Raceway, Inc.*, 113 B.R. 527, 529 (Bankr. D. Iowa 1990).
 54 UTAH CODE ANN. § 57-3-103.



A
Not-for-profit
Community
Mediation
Service

Upcoming Training Seminars

◆◆◆
4 Hour Advanced Mediation Training
Family, Divorce, Visitation
December 13-15, 1999

Fee: \$450 early registration (by Dec 1st)
 \$500 after December 1st

◆◆◆
32 Hour Basic Mediation Training
February 10, 11, 14, & 15, 2000

Fee: \$500 early registration (by Jan 28th)
 \$550 after Jan 28th

◆◆◆
32 Hour Basic Mediation Training
May 4, 5, 8 & 9, 2000

Fee: \$500 early registration (by April 21st)
 \$550 after April 21st

Law & Justice Center, 645 South 200 East, SLC, UT 84111
 (801) 532-4841



Happy Holidays!

from the Utah State Bar