Title Fight—Avoiding a Water Right Conveyancing TKO

by Austin Hamre

This article examines apparently conflicting statutes and related case law bearing on how a practitioner determines title to water rights represented by shares in a mutual ditch company.

As a case study, imagine the following: A new client comes to see you for an initial consultation. She is really steamed. A bank she has never heard of sent her a letter saying if she does not pay $300,000, they are foreclosing on her water rights. She bought a farm, and associated water rights, eighteen months ago. Her attorney for the transaction (fortunately not you) told her there was nothing too concerning in the exceptions to the title commitment. She has since looked at the title policy, and indeed it does not show the encumbrance claimed by this bank. You tell her that is not very surprising (to you, at least), because title companies always except anything relating to water rights. As your conversation progresses, you learn that her water rights are shares in a mutual ditch company. Three years ago, the bank gave a loan to her predecessor in title and filed a notice of lien with the ditch company stating that the shares were pledged as collateral to secure the loan. The ditch company dutifully put the notice next to the stub of her predecessor’s stock certificate in their stock book. However, her attorney never researched the ditch company stock books, and the ditch company never mentioned it when she closed on the farm and they issued her new stock certificate. Her predecessor has stopped making payments on the loan and the bank has lost what little patience it had. What can you tell your new client? Who has the superior claim—your client or the bank?

The starting point for analyzing this question is that in Colorado, water rights are a form of real property, and a statute specifically addresses conveying water rights. CRS § 38-30-102(2) states:

In the conveyance of water rights in all cases, except where the ownership of stock in ditch companies or other companies constitutes the ownership of a water right, the same formalities shall be observed and complied with as in the conveyance of real estate.

Where the exception does not apply the intent of the statute is clear, but what happens when the water rights are represented by stock in a ditch or reservoir company? One would expect that CRS §§ 7-42-101 et seq., the special purpose corporation statute that specifically addresses mutual ditch and reservoir companies, would address this issue. However, it does not, in any direct way. Section 7-42-104(4) provides that “shares of stock shall be deemed personal property and transferable as such in the manner provided by the [ditch company’s] bylaws.” If the water rights are represented by the shares, this seems a clear statement that the company’s records regarding transfers of shares should be controlling. However, cases draw a distinction between the shares themselves and the water rights they represent.

The Jacobucci Opinion

The Jacobucci opinion—the Oracle regarding the relationship between mutual ditch companies, their shareholders, and the water rights decreed in the name of the ditch company—arose from the City of Thornton’s attempt to condemn the water rights held by the Farmers Highline Canal and Reservoir Company. Thornton was told by the Colorado Supreme Court that the interest held by the shareholders and represented by their shares, not the “naked title” to the rights held by the ditch company, was the interest that Thornton would have to condemn if it wanted ownership of the water rights decreed to the Farmers Highline. Jacobucci states that ditch company stock represents the shareholder’s pro rata interest in both the water rights and the infrastructure used by the company to deliver the water, and that “ownership of the shares of stock is merely incidental to the ownership of the water rights by the
shareholders." Jacobucci also makes clear that shares in a ditch company are not the same animal as shares in a business corporation. Instead, a mutual ditch company is "merely the vehicle by which its owners operate and manage its affairs," and "the unique character of these corporations mandates different treatment which is not fully in accord with the principles applicable to corporations in general." So far, it appears the bank may have the better argument.

The Mesa County Land Opinion

More recently, a similar issue was addressed by the Colorado Court of Appeals in *Mesa County Land Conservancy, Inc. v. Allen.* That case arose when the United States, as owner of a 140-acre parcel of land, granted a conservation easement to the Land Conservancy that included a restriction providing "all water rights held at the date of this conveyance shall remain with this land." At that time, the United States owned both the land and the water rights that historically had been used to irrigate it. The water rights were represented by nine shares of the Big Creek Reservoir Company. The United States granted the conservation easement in 1990, and the easement was recorded in the land title records of Mesa County, but apparently the United States did not seek a new share certificate from the ditch company that had a reference to the encumbrance printed on it, nor does it appear the federal government gave the ditch company any other notice of the encumbrance created by the easement. The United States sold the land and water rights to the Allens in 1993; the deed made specific reference to the Big Creek shares. In 2007, the Allens attempted to sell the Big Creek shares, severing them from the land, resulting in this litigation.

The *Mesa County Land* opinion focuses primarily on whether the conservation easement statute in 1990 was intended to allow such easements to apply water rights at all, and whether an amendment of the statute in 2003 was unconstitutionally retrospective. The Court of Appeals, understanding the nature of mutual ditch company shares, rejected Allen's assertion that the shares were securities and that a restriction on them was invalid without compliance with the Uniform Commercial Code's notice requirements.

In the end, the court of appeals determined the conservation easement was valid and, because it conveyed an interest in real property, the federal government's compliance with the land title recording statute provided all the notice to which the Allens were legally entitled. Specifically, the court said: "Because mutual ditch shares are water rights, which are real property interests, they are subject to notice and recording requirements provided by sections 38-35-106(1) and 38-35-109, C.R.S. 2011."

Under the court's reasoning, there would be no material difference between on one hand, the creation of an easement that forever vests the water rights represented by the shares to the land they historically irrigated, and on the other hand, creating a lien against such water rights that, if foreclosed, can divest a subsequent owner of his or her interest in the mutual ditch company shares and the water rights they represent. Importantly, however, there is
no suggestion in the *Mesa County Land* opinion that the exception for ditch company shares in CRS § 38-30-102(2) was ever brought to the court of appeals’ attention, or that any party argued that the chain of title reflected by the ditch company’s stock book might be controlling over the county’s land title records.

Unrecorded Instruments

*Mesa County Land* might provide a glimmer of hope to this client, but interpreting the court of appeals’ statements to mean that county title records always win would be too simplistic. The recording statute cited in *Mesa County Land* says the following regarding unrecorded instruments:

No such unrecorded instrument or document shall be valid against any person with any kind of rights in or to such real property who first records and those holding rights under such person, except between the parties thereto and against those having notice thereof prior to acquisition of such rights. This is a race–notice recording statute.\(^\text{10}\)

Any attorney familiar with real property knows that a document properly recorded provides constructive notice, regardless of whether the buyer actually found the recorded document. In this case study, the client’s attorney did search the county real property records, and had no actual knowledge of the lien against the shares. The question then becomes: What is required for constructive notice? According to *Jaramillo v. McIloy*,\(^\text{11}\) a federal district court opinion: “Notice may be constructive or implied from the fact that there existed means of knowledge which the party did not use.”\(^\text{12}\) It goes on to say that if a purchaser

has knowledge of circumstances which, in the exercise of common reason and prudence, ought to put a man upon particular inquiry, he will be presumed to have made that inquiry, and will be charged with notice of every fact which would in all probability have been revealed had such investigation been undertaken.\(^\text{13}\)

Is the existence of a parallel chain of title—the ditch company’s stock books—such a circumstance, even if there was no indication of any encumbrance or competing claim? *Jaramillo* relied on several earlier Colorado cases, and was later relied on by the Colorado Supreme Court in *Page v. Fees–Krey, Inc.*,\(^\text{14}\) which involved a dispute over the enforceability of an unrecorded overriding royalty interest in an oil and gas lease on federal land. In *Page*, the Court noted that the U.S. Bureau of Land Management maintained its own set of records of interests in federal oil and gas leases, and those records reflected Page’s overriding royalty interest. The Court then said:

The BLM records provided a ready source of possible information with respect to title history and status of the lease. Under the facts of this case it is only reasonable to hold Fees to a duty of inquiry as to the matters reflected in those records and to hold it to be on notice of all matters which such inquiry would have disclosed.\(^\text{15}\)

There is no material distinction between the BLM lease records and the share transfer books of a ditch company.

Conclusion

In this case study, you conclude that the question you began with—whether a county’s real property title records or a ditch company’s title records should “win” on the rare occasions when the two title chains conflict—is the wrong question. The real question is: What is the complete picture of the title to the water right represented by mutual company shares before purchase, and how do you get it? You cannot get that complete picture without considering both of these sources of title information.

You tell your client she has options, but none of them are pretty. Trying to fight the bank on the basis that it failed to record its lien is not likely to be successful in this circumstance. She can sue her predecessor in title, but if that were likely to succeed the bank would probably be doing it—perhaps it has already tried. The ditch company had no duty to do more than make its share transfer records available for a purchaser’s inspection, and here that request was never made. She could sue her former attorney. She may not want to—perhaps because he had done a decent job for her for years or decades and, after all, he was not the one who stiffed the bank. Even so, in the search for funds to get the bank paid, his malpractice policy is a very likely target. While the statutes pertaining to conveyancing of water rights in this context could be clearer, one thing that is absolutely clear is that you never want to find yourself in the shoes of your client’s former attorney.

Notes

2. *Id.* at 673–74.
3. *Id.* at 672.
4. *Id.*
6. *Id.* at 49.
7. *Id.*
8. *Id.* at 55–56.
9. *Id.* (citation omitted).
10. CRS § 38-35-109(1).
12. *Id.* at 876.
13. *Id.*
15. *Id.* at 1194 (citation omitted).