

THE NEVADA SUPREME COURT CLARIFIES FREE ALIENABILITY OF WATER RIGHTS

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In *Adaven Mgt., Inc. v. Mt. Falls Acq. Corp.*, the Nevada Supreme Court provides guidance to borrowers and lenders by clarifying that water rights are freely alienable property interests separate from the land on which they may be used (i.e. appurtenant) and the ability of the transferee to put the water to beneficial use.¹

In *Adaven*, a development company purchased agricultural land and water rights in Nye County with the intent to build a residential community.² Subsequently, the development company pledged a portion of the land and the water rights to Commercial Federal Bank (CFB) as security for a loan.³ The CFB deed of trust included all water rights appurtenant to the real property, but the land on which the water rights could be placed to beneficial use was not offered as security for the loan.⁴ In Nevada, water rights are appurtenant to the benefited land (i.e. the land on which the water is placed to beneficial use) and are included with any conveyance of that land, unless expressly excluded.⁵ Thus, if a deed to real property includes the phrase, “together with all appurtenances,” then all water rights are included. In *Adaven*, however, the water rights were conveyed without the land on which they could be placed to beneficial use. Therefore, the CFB deed of trust severed ownership of the water rights from the land.

As required, the CFB deed of trust was recorded in Nye County.⁶ Subsequently, the development company defaulted on the loan and CFB foreclosed on the secured property and purchased it at the foreclosure sale.⁷ Because the CFB deed of trust did not encumber the land on which the water rights could be placed to a beneficial use, however, CFB could not



use the water rights on that land unless it sought permission from the landowner. Accordingly, to avoid losing the water rights because of non-use, CFB would have been required to obtain approval from the state engineer to change the place of use of the water rights, as permitted under NRS 533.040, or to obtain permission from the landowner to use the water rights on the current place of use.

Before CFB took any action regarding the water rights, however, the development company sold the land on which the water rights could be placed to beneficial use, and was not encumbered by the CFB deed of trust, to Adaven Management, Inc.⁸ The deed conveying the land to Adaven expressly included all appurtenant water rights and thus, purported to convey CFB’s water rights.⁹ And because Adaven apparently did not discover the CFB deed of trust or trustee’s deed, it believed that the development company still owned the appurtenant water rights. Accordingly, after the sale, Adaven filed a report of conveyance as required by NRS 533.382 with the Office of the State Engineer to complete the chain of title in the state engineer’s records from the development company to Adaven.¹⁰ Adaven also filed an application to change the manner of use of the water rights from agricultural to quasi-municipal.¹¹ Upon learning of Adaven’s asserted ownership in the water rights, CFB notified the state engineer’s office of the ownership dispute on behalf of its successor-in-title, Mountain Falls Acquisition



Corporation (MFAC).¹² The state engineer's office, however, stated that it would take no further action until the dispute was resolved and, thus, Adaven filed a quiet title action against MFAC and CFB.¹³

At the district court, MFAC was awarded summary judgment and Adaven appealed, arguing that transferring water rights separately from the land to which they are appurtenant was governed by NRS 533.040 and allowed only with approval of the state engineer.¹⁴ Accordingly, Adaven asserted that the water rights could not be conveyed as security to CFB without also conveying the underlying land. Additionally, Adaven argued that the anti-speculation doctrine prevented the developer from pledging the water rights as security without also pledging the land to which the water rights were appurtenant.¹⁵ The Supreme Court dismissed Adaven's arguments and concluded that neither NRS 533.040 nor the anti-speculation doctrine prevents a party from transferring water rights separately from the land to which they are appurtenant.¹⁶

First, the court held that NRS 533.040 does not prohibit a person from transferring water

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rights separately from the land to which they are appurtenant, either by conveying them in trust as security or selling them outright.¹⁷ The court concluded that transferring water rights separately from the land does not alter where the water rights could be placed to beneficial use, and, thus, does not require the state engineer's approval under NRS 533.040.¹⁸ Second, the court concluded that the anti-speculation doctrine, which "precludes speculative water right acquisitions without a showing of beneficial use," does not limit the ability of a party to acquire a security or ownership interest in water rights separately from the land to which they are placed to beneficial use.¹⁹

The *Adaven* decision is important because the Supreme Court clarified that water rights are separate and transferrable property interests that can be conveyed independently of the real property on which they are permitted to be used. The decision should create less uncertainty in water rights transactions and make it less difficult to secure project financing if water rights are involved. The *Adaven* decision should also provide some comfort to lenders who advance substantial sums of money for real estate development and water importation projects and provide much needed flexibility to borrowers who rely on these funds to complete such projects.

Although it has been the practice, in Nevada, to transfer ownership of water rights separately from the land to which they are appurtenant, the process requires several steps. First, as with real property, water rights must be transferred by deed.²⁰ The deed must be acknowledged and recorded in the office of the county recorder of each county in which the water is placed to beneficial use and diverted.²¹ The Nevada Supreme Court has previously held that water rights are a part of the attendant real property.²² Accordingly, water rights are usually incorporated in a deed to real property using the phrase, "together with all appurtenances." A "best practice" is to include a detailed list of the water rights as they are identified in the official records of the state engineer's office.

Second, even though ownership of water rights is transferred by deed and subject to the records of the county recorder, a report of conveyance must be filed with the state engineer's office to complete the "chain of title" to the water right with that agency.²³ Filing the report of conveyance is an important step because the state engineer is charged with notice of only those documents in his official records and he is not required to search the county recorder's records to determine the true owner of the water right.²⁴ Accordingly, if the state engineer's records are not updated to reflect the current ownership of the water rights, then the owner may not be aware of any conditions or deadlines that may affect their water rights, and risks losing them to

cancellation, abandonment or forfeiture. Additionally, until the state engineer is aware of any change in ownership, he may prohibit the new owner from changing the point of diversion, place of use, or manner of use of the water rights as permitted under NRS 533.040. Lastly, if the chain of title is not complete in the state engineer's office, then the owner may not be able to sell, lease or use its water rights.

With real property, any transfer is customarily preceded by a title search performed by a title company. The title company then insures the transferee's title. Currently, it is not possible to obtain a title policy for water rights in Nevada and any real property title policy usually excludes any coverage for water rights; therefore, the prospective purchaser must review the records of the appropriate county recorder and the state engineer, to determine if the buyer has marketable title to the water rights.

Obtaining a deed of trust to real property has been the most reliable way to secure a loan in Nevada. Unfortunately, the recent decrease in real estate values may make the real property security less reliable. Unlike real property, water rights are a somewhat more flexible property interest because they may be severed from the land to which they are appurtenant and applied to a beneficial use on other land. Taking a deed of trust in water rights requires preparation of the underlying debt instrument and a deed of trust. Through a deed of trust, the debtor, who owns the water right and is called the "trustor," grants the water right to a "trustee," usually a title company, in trust for the benefit of the lender, the "beneficiary," for the purpose of securing the obligation contained in the underlying debt instrument. The deed of trust must be recorded in the office of the county recorder of each county in which the water is placed to beneficial use *and* diverted. In addition, the practitioner should file the deed of trust or a notice of pledge with the state engineer's office, to inhibit the debtor from changing the place of use of the water rights without notice to the lender. This practice is used to provide additional notice to the lender and to alert prospective water rights buyers of the encumbrance on the water rights. Lastly, the lender should review the state engineer's records periodically to determine if the borrower is (1) complying with any conditions imposed by the state engineer and (2) not attempting to transfer the water rights to land not covered by the deed of trust.

When the obligation is satisfied, the deed of trust is revoked and reconveyed through a "request for reconveyance," signed by the beneficiary. If the debtor defaults prior to obtaining the reconveyance – by failing to make payments, for example – then the trustee may, through foreclosure, be able to sell the water rights to satisfy the debt.

Water rights in Nevada have decreased in value somewhat from record highs of \$40,000 to \$50,000 per acre-foot a few years ago. Nevertheless, water rights remain an extremely valuable and necessary property interest and will likely become more valuable over time, given Nevada's arid climate. Although much of the water in some areas, such as the Las Vegas Valley, is owned or distributed by municipal water providers, a substantial volume of water remains to be transferred privately. Consequently, the court's decision in *Adaven* provides needed guidance concerning how lenders and borrowers can secure water rights to enable financing of future ventures.

Lastly, the court has noted that the system of documenting water rights transfers could be greatly improved. Until such time as the legislature acts, however, the difficulty of searching for transfers of water rights, separate from the land to which they are appurtenant, remains a significant issue. **NL**

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1 124 Nev. Adv. Op. 67, 191 P.3d 1189 (Sept. 11, 2008).
 2 *Id.* at p. 3, 1191.
 3 *Id.*
 4 *Id.*
 5 NRS 533.040; *Dermody v. City of Reno*, 113 Nev. 207, 931 P.2d 1354 (1997).
 6 *Adaven*, 124 Nev. Adv. Op. 67, at p. 12, 191 P.3d at 1194.
 7 *Id.* at p. 3, 1191.
 8 *Id.* at p. 4, 1191.
 9 *Id.*
 10 *Id.*
 11 *Id.* at p. 5, 1191.
 12 *Id.*
 13 *Id.*
 14 *Id.* at p. 6, 1192.
 15 *Id.*
 16 *Id.*
 17 *Id.* at p. 18, 1196.
 18 *Id.* at p. 8, 1193.
 19 *Id.* at p. 11, 1194, *Bacher v. State Engineer*, 122 Nev. 1110, 1119, 146 P.3d 793, 799 (2006).
 20 NRS 533.382.
 21 *Id.*

22 *Dermody*, 113 Nev. at 212, 931 P.2d at 1358.

23 NRS 533.384. The failure to file the report of conveyance, however, has no effect on a subsequent purchaser's notice of the transfer and, thus, does not prevent a subsequent purchaser for value from obtaining title to the water rights if the subsequent purchaser's deed is recorded first in the proper county recorder's office.

24 See, *State, Dept. of Conservation and Nat. Resources v. Foley*, 121 Nev. 77, 109 P.3d 760 (2005).