



Not Perfect:

Perfecting Security Interests in W

Recent developments require banks to take extra precautions in attempting to perfect security interests in shares of stock held in water companies. Water is essential in Utah's arid climate. Not surprising, Utah water rights carry a hefty price tag. For decades, Utah lenders have used borrowers' valuable water rights to collateralize loans. Borrowers commonly pledge their shares of stock in water companies as collateral for loans. Most banks willingly accept such pledges, but many misunderstand how to perfect their security interest in the shares, and a recent decision by the United States Bankruptcy Court for the District of Utah (Bankruptcy Court) further complicates perfection.¹

Water shares in Utah do not automatically run appurtenant (i.e., tied) to land.² An owner of water shares, therefore, does not convey ownership of water shares by deed, but, rather, by transferring possession of the water shares in accordance with Article 8 of the Utah Uniform Commercial

Code (UCC).³ For the past few decades, the law on how to perfect a security interest in water shares has been somewhat fluid (pun intended). As a result, lenders have made their best guess on how to perfect.

The issue arose in 1989 when the Utah Court of Appeals held that water shares qualify as an "instrument" under Article 9 of the UCC, and, therefore, perfection is accomplished by possession.⁴ Five years later, in the *Cahoon* case, the Utah Supreme Court overruled the Utah Court of Appeals and held that a share of stock in a water company "represents an interest in real property and is therefore not a certificated security under [Article 9 of the UCC]."⁵ In 1996, the Utah Legislature responded to *Cahoon* and amended the Utah Code to clarify that "the right to the use of water evidenced by shares of stock in a corporation shall be transferred in accordance with the procedures applicable to securities set forth in [Article 8 of the UCC]."⁶

After these amendments, it was understood that water shares were real property rights that could be transferred like certificated securities in accordance with Article 8 of the UCC. From this, lenders logically concluded that a security interest in water shares could (and should) be perfected by taking possession of stock certificates pursuant to Article 9. Despite this, in addition to possession, many lenders also included a description of the water shares in a recorded deed of trust.

In January 2014, perfection of water shares was brought back into the spotlight. The Bankruptcy Court analyzed "the proper method to perfect a security interest in water shares."⁷ Acknowledging that the Utah Supreme Court had not addressed the impact of the 1996 amendments on *Cahoon*, the Bankruptcy Court attempted "to predict how the Utah Supreme Court would rule on that question."⁸ After a thorough analysis, the Bankruptcy Court held that the 1996 amendments require

¹See *West v. Lee (In re Anderson)*, Adv. Proc. No. 12-2348, 2014 WL 172222 (Bankr. D. Utah Jan. 15, 2014).

²Utah Code Ann. § 73-1-11(4).

³*Id.* at §§ 73-1-10(2), 70A-8-301.

⁴*Associates Fin. Servs. Co. of Utah v. Sevy*, 776 P.2d 650, 652 (Utah Ct. App. 1989).

⁵*Salt Lake City Corp. v. Cahoon and Maxfield Irrig. Co.*, 879 P.2d 248, 252 (Utah 1994).

⁶Utah Code Ann. § 73-1-10; see also Utah Code Ann. § 70A-8-409 (explaining that Article 8 of the UCC applies to shares of stock in a water company).

⁷*West*, 2014 WL 172222, at *8.

⁸*Id.*

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water shares to be transferred pursuant to Article 8 but that the 1996 amendments did not overturn *Cahoon* and did “not transform water shares from real property to personal property, nor do they require the result that inclusion in a trust deed is no longer a valid method to perfect a security interest in water shares.”⁹ In other words, the Bankruptcy Court held that (i) *Cahoon* is still good law; (ii) water shares are not certificated securities as defined under Article 9; (iii) water shares are real property rights; (iv) the 1996 amendments apply to the transfer of water shares but not perfection of security interests in water shares; and, accordingly, (v) the Utah Supreme Court would rule that 70A-9a-313 does not require possession to perfect a security interest in water shares.¹⁰ Accordingly, the Bankruptcy Court determined that a security interest in water shares may be perfected by including the shares in a recorded deed of trust.”

While not binding precedent for Utah Courts, banks should seriously consider the Bankruptcy Court’s decision. Importantly, the Bankruptcy Court did not

predict that the Utah Supreme Court would rule that possession of water shares is not perfection of a security interest, but its reasoning calls this method into serious question. The court predicted that the Utah Supreme Court would hold that perfection of a security interest in water shares can be accomplished by including the shares in a recorded deed of trust.¹¹

The Bankruptcy Court’s decision poses several challenges for banks. For example, if a borrower owned several parcels of real property within the service area of a water company, how would a potential lender be able to determine whether another lender already had a properly perfected security interest in water shares that are still in the possession of the borrower? The potential lender would essentially have to run a title report on all of the parcels owned by the borrower within the service area of the water company to determine whether another lender already had recorded a deed of trust against one of the borrower’s parcels and whether that deed of trust described the water stock still in the possession of the borrower. This process would be burdensome, expensive, inefficient, and is ripe for errors. Possession, on the other hand, provides the lender with some assurance that the water shares have not been pledged to another lender. And perfection by possession (not just transfer by possession) appears to be what the Utah Legislature had in mind in 1996.

In light of the recent Bankruptcy Court decision, it would be wise for lenders to review their loan files for loans secured by water shares and to review their protocols for originating loans secured by water shares. In an abundance of caution, if a lender has taken water shares as collateral, the lender should possess both the water stock certificates and a recorded deed of trust properly identifying the water shares. If the lender does not have possession of the stock certificates, it should take immediate steps to obtain possession. If the lender does not hold a recorded deed of trust identifying the shares, the lender should consider approaching the borrower about recording a modified deed of trust while the borrower is willing to work with the lender (i.e., before a default). If a lender accepts water shares as collateral for new loans, it should do the following: (i)

conduct a title search on all lands served by the water company for recorded deeds of trust that include the borrower’s water shares; (ii) properly describe the water stock certificates in a deed of trust recorded against real property served by the water shares (note that the land may not be collateral for the loan in some instances); (iii) take possession of the water stock certificates; and (iv) provide written notice to the water company that the lender has possession of and a security interest in the borrower’s water stock certificates.

While there is room for clarity in the law, wise lenders should take steps to review their loan portfolios and change their origination protocols to ensure that they properly perfect valuable security interests in water shares. Lenders also should consider consolidating resources to lobby the Utah Legislature to clarify that security interests in water shares are perfected by possession, just as certificated securities under Article 9. ■



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⁹*Id.* at *9

¹⁰*Id.* at *9.

¹¹*Id.* at *10.