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Water Is Not Just for Diluting the Banker's Good Scotch: Lending on Water Dependent Collateral

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Grady B. Jolley is a native of Sweetwater, Texas, and graduated from Texas A&M University with a B.A. in History in 1978. In 1982, he received his J.D. from St. Mary's University School of Law in San Antonio. Following graduation from law school, Mr. Jolley practiced law in Abilene, Texas primarily in oil and gas and commercial law. In 1990, Mr. Jolley returned to the San Antonio area and set up a general law practice with an emphasis in real estate, banking, energy resources, business organizations and water rights. In 1996 he joined with Ken Nunley and Joe Davis to form the firm of Nunley & Jolley. Mr. Jolley joined the Branscomb|PC firm in 2014 as a shareholder. Mr. Jolley's practice focuses on real estate, water rights, banking, commercial law, regulation of real estate development and governmental entitlements for real property.

Mr. Jolley has served on the District 15-C Grievance committee and as President of the Medina County Bar Association and the Border District Bar Association and has been a member of the Texas Association of Bank Counsel for over 20 years. He is listed in the Best Lawyers in Texas and Best Lawyers in the United States in Real Estate and Banking law.

Mr. Jolley has lectured frequently on the topics of water rights, real estate development, financing water rights and laws and regulations regarding surface water use and groundwater rights. He serves on the planning committee for the State Bar of Texas' Changing Face of Water seminar and served as Co-chair in 2011 and 2012. He also serves on the Real Estate, Probate and Trust Law Section's Water Law Committee. Mr. Jolley is married to Rhonda Graff Jolley, a Branscomb|PC shareholder and frequent speaker on water and real property issues. Rhonda and Grady have four children and two grandchildren. He enjoys golf and is a music fan.

Previous Articles and Speeches:

How To Take A Lien Against Water Rights - Advanced Real Estate Drafting - 2004

Title Insurance For Water Marketing - University of Texas Water Law Institute - 2005

Forms And Transactional Issues In Private Sales Of Groundwater And Water Rights - Changing Face of Water Rights in Texas- 2007

Water – Can It Be Severed? - Advanced Real Estate Law - 2010

Water Reuse As A Tool In Real Estate Development - Opportunities And Challenges - Changing Face of Water Rights -2010

Water Resources For Your Client's Development- Advanced Real Estate Law Course – 2011

Water Amenities – Changing Face of Water -2011

Financing For Water Projects - Changing Face of Water -2012

How Do You Close A Water Sale - John Huffaker Agricultural Law Seminar – 2012

**Various Water Agreements - Forms of Some Common Transactions
(And Some Which May Soon Be) - - Changing Face of Water -2013**

**Water, Water Everywhere - But How Do We Get It? – University of Texas School of Law –
Mortgage Lending Institute – 2014**

Rural Water Issues – The Lender’s Perspective - Changing Face of Water -2014

**Environmental Due Diligence In Purchasing Groundwater Interests - Changing Face of Water -
2015**

**Drafting Tips For Water Transactions From Recent Case Law And The 84th Legislative Session -
Advanced Real Estate Drafting – 2015**

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Susana E. Canseco is a native of Del Rio, Texas, along the banks of the Rio Grande. She has advised clients on matters related to groundwater districts and permitting required by such entities, actions and applications before the Texas Commission on Environmental Quality and the Public Utility Commission, and other matters related to water law in Texas, as well as general real estate projects. Before joining Branscomb | PC, Susana operated a family business raising cattle and marketing grass-fed beef, an experience that gives her important perspective into her clients’ challenges and concerns in managing and using water in their businesses. After law school, Susana clerked for the Honorable Judge Lee Yeakel, federal district judge for the Western District of Texas, from 2007-2009.

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Ed McCarthy is a Partner in the Law Firm of Jackson, Sjoberg, McCarthy & Townsend, L.L.P., practicing primarily in water and water related matters, including wastewater and water reuse. Mr. McCarthy has significant experience representing both private landowners and municipalities, water supply corporations and other public entities, including water districts and river authorities operating pursuant to Article XVI, Section 59, of the Texas Constitution. His representation has included matters involving permitting, sales and transfers of groundwater and surface water rights, as well as wastewater, and regional water supply projects, including treatment plants and pipelines. He is a member of multiple TWCA Committees, including the Water Laws Committee of which he has served as Chair on several occasions.

Mr. McCarthy's background is rooted in property rights and land titles, including and the development of subsurface property rights, including mineral and groundwater rights. His experience includes substantial experience in permitting matters before the Texas Commission on Environmental Quality and, historically, the Railroad Commission of Texas, the Texas Department of Health, and Bureau of Radiation Control. He also represents clients in matters before the Texas Water Development Board and the Texas Legislature.

Mr. McCarthy has written numerous articles and contributed to publications on the subject of water rights and mining activities in Texas. He is the Co-Author of a Chapter in the book "The Essentials of Texas Water Resources" entitled "Surface Water Rights Transactions;" and Co-Author of Chapters 3 and 26 in Volumes 45-46 of the Texas Practice Series on Environmental Law relating to Administrative Practice and Mining issues in Texas. Mr. McCarthy is currently participating on the State Bar Committee updating the Real Estate Forms Manual.

Water Is Not Just for Diluting the Banker's Good Scotch: Mortgage Lending on Collateral Dependent on Water

This paper is intended for lender's counsel when financing real estate where the use of water is material to the value of the collateral. If your collateral includes water sources used for municipal supply, irrigation, recreation, or other amenities, your due diligence should focus on the water rights as well as the physical attributes and environmental status of the project. While all improved real estate is somewhat dependent on an adequate supply of water, our focus in this paper is on the project where the supply of water is not only critical to the success of the venture but where the value of the water supply is part of the appraised value of the collateral.

Section I gives examples of scenarios where the water rights are not just included in the real property collateral, but where the water rights are critical to the operation of the property. Examples include a golf course, a subdivision based on a recreation or amenity lake, a development that will use the water right for public water supply for its own system, a water right used to irrigate farmland, and water for a rural residential estate. The rest of the paper can then be read with those examples in mind.

I. Collateral Dependent on Water Supply for Value

A. Golf Courses

No one wants to play golf on bare dirt. The economics of a golf course will suffer, and the value of the golf-course development will therefore suffer, if it cannot be irrigated. It is therefore in the lender's interest to do careful due diligence on the adequacy and legal intricacies of the water rights allowing that irrigation to assure the water will be reliable for the life of the loan. The lender will want to perform due diligence on any surface or groundwater permits allowing a golf course to irrigate as well as the adequacy of the water source, whether surface or groundwater. And as discussed below, any existing stock ponds the developer wants to repurpose for use on the golf course will require special attention.

Keep in mind the water demand for a golf course is dependent on a variety of factors:

1. The most important is the number of irrigated acres. Modern golf courses designed to be more water efficient have fewer acres of irrigated fairways, smaller greens, and fewer tee boxes which require more water than fairways.
2. Different varieties of grass have different irrigation requirements.
3. Local climate, temperature, humidity.
4. Tree cover
5. Soil type

B. Subdivision Development

1. Water Supply

The need arises for water-rights due diligence regarding water supply to new subdivisions in a few contexts. For example, in a development outside of a municipality, a lender should verify the adequacy and reliability of the water supply to a development that will be secured by a loan. Another example would be land on which a field of wells will be developed as a water supply for human consumption or an industrial use.

2. Existing Ponds

Some developers will try to re-purpose existing stock ponds as amenity ponds for golf courses or water-dependent subdivisions such as fishing subdivisions. However, just because the raw land included livestock ponds does not mean that a developer can convert them into amenity ponds for a golf course or development. This is true because small reservoirs that are exempt from TCEQ permitting for domestic or livestock use lose that exemption when the surrounding property is developed. If the value of the development is dependent on the water in the existing pond, careful due diligence is warranted on the status of that pond.

C. Irrigation

The value of irrigated farmland is inherently tied to the availability and reliability of its source of irrigation water. If something goes wrong with that water supply, whether because of water-availability problems or regulatory concerns, it could seriously damage the value of your collateral. Due diligence on this type of project should include review of all aspects of water availability and reliability.

For example, lenders lost dramatic amounts on loans secured by irrigated farm land dependent on the Ogallala aquifer in the 1980's. The Ogallala is slow to recharge and poorly regulated withdrawals led to a dramatic drop in aquifer levels. Combined with higher energy costs and lower commodity prices, the cost of lifting the water and applying it to crops became a money-losing proposition for many farmers. Lenders quickly discovered that their collateral had changed from \$2,500 per acre irrigated land to \$650 per acre dry farm or pasture land. Through forced workouts and bankruptcy valuations a great deal of secured debt became unsecured debt in a short amount of time. It could happen again. You can hedge energy supply costs and commodity prices to address some of the uncertainty, but how does the lender reduce the risk of the loss of the water supply?

D. The Rural Residential Estate

We have all seen the large acreage rural residences with beautiful entry features and concrete driveways stretching into the distance through an immaculately manicured pasture filled with exotic game, cattle, or horses of some rare and unfamiliar variety grazing peacefully in a beautiful sunset - it looks like a painting. When I see this setting I immediately think that the owner of this land did not make his living in agriculture. There is often an impressive home on the property occupying several thousand square feet with numerous related structures (in the end, the one with most toys wins). Somewhere there is probably a banker with multi-million dollar

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