

**BALCOMB & GREEN, P.C.**  
**ATTORNEYS AT LAW**

EDWARD MULHALL, JR.

SCOTT BALCOMB  
LAWRENCE R. GREEN  
TIMOTHY A. THULSON  
DAVID C. HALLFORD  
CHRISTOPHER L. COYLE  
THOMAS J. HARTERT  
CHRISTOPHER L. GEIGER  
SARA M. DUNN

DANIEL C. WENNOGLE  
SCOTT GROSSCUP  
CHAD J. LEE  
NICHOLAS B. NELSON

**P. O. DRAWER 790**  
**818 COLORADO AVENUE**  
**GLENWOOD SPRINGS, COLORADO 81602**

**TELEPHONE: 970.945.6546**  
**FACSIMILE: 970.945.8902**

[www.balcombgreen.com](http://www.balcombgreen.com)

KENNETH BALCOMB  
(1920-2005)

OF COUNSEL:

JOHN A. THULSON

March 19, 2009

## MEMORANDUM

To: Eric Klein  
Tom Kennedy

From: David Hallford

Re: PLEASANT VALLEY DITCH INCORPORATION

Dear Eric and Tom:

I did not find much in the way of detailed written communications about the Pleasant Valley Ditch incorporation that was proposed and discussed last year. Draft articles of incorporation and bylaws were exchanged, and we made some suggested revisions to those documents.

Tom requested a "pros and cons" list. This is a summary response to that request.

I recall that we discussed this matter on the phone, and Tom then attended a meeting of the PVD water right owners after which the deal fell apart. Tom and I have an email dated April 11, 2008 from Tom Kinney, representing Lizard Head Wilderness Ranch (f/k/a Faraway Ranch), indicating that Lizard Head had determined not to join the ditch company. The stated reasons were the proposed assessment of O&M costs on a proportionate basis, proposed company control over changes of water rights, and the loss of owner control over ditch take outs and their maintenance and repair.

I have attached a March 17, 2008 memo from Jeff Houpt to Janie Goldberg outlining issues regarding a mutual ditch company organization as well as a list of reputed owners provided to us in approximately March 2008. Obviously, some of the owner names have changed. I recall that Jeff Houpt was representing Wilson Mesa Ranch HOA.

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There are some advantages to a formal ditch company. Significantly, it provides some assurance of the annual budgeting and collection of funds for operation and maintenance. A related downside was pointed out by Tom Kinney, that costs are shared on a percentage basis rather than on the portions of the ditch actually used by the individual users. Thus, a user at the front end of the ditch (i.e. Lizard Head) would incur greater O&M assessments under a ditch company structure than under the unincorporated ownership structure. In an unincorporated ditch situation, the owners are only responsible for the costs of O&M on the ditch from the headgate to their point of take out.

The relative advantage or disadvantage is determined by the location of your takeout. Sound of Music Ranch is better positioned on the ditch to gain from a percentage O&M cost allocation than Lizard Head Ranch is.

There is considerable hyperbole in the March 18 email from Janie Goldberg. There are many unincorporated ditches in Colorado, probably more unincorporated than incorporated ditches. The state water officials do not decline to deal with unincorporated ditch owners. Water rights that are used through an unincorporated ditch generally are not at greater risk than if they were diverted through an incorporated ditch.

Major advantages of the ditch company structure are: (1) effective budgeting and funding for O&M; (2) more cost-effective acquisition of liability insurance; (3) efficient collective defense against any threats to the ditch water rights, such as water right applications by other users; and (4) a more formal framework for sharing water. The advantages need to be weighed against the loss of control over individual water rights, particularly in situations where the incorporation includes a requirement for company approval of any changes of the water rights to new uses or to different places of use.

The bylaws proposed last year included a requirement for company approval of such changes. Users who have no intent to change their rights could support such a provision, but users wanting to maintain flexibility to make changes (by a sale of their rights, for example) would oppose such a provision. Last year, I never got a sense of how wedded any of the owners were to the approval provision.

Let me know if this gives you enough information to engage in discussions with Janie Goldberg or others. Recall that in the context of the BBR Water Court case that was recently opposed, BBR's attorney mentioned their hope that WMRH will participate in an incorporation.

Attachments

**BEATTIE, CHADWICK & HOUP, LLP**  
ATTORNEYS AND COUNSELORS AT LAW  
932 COOPER AVENUE  
GLENWOOD SPRINGS, CO 81601

STEVEN M. BEATTIE  
GLENN D. CHADWICK  
JEFFERSON V. HOUP  
JULIE S. HANSON  
JAMIE J. ROTH

TELEPHONE (970) 945-8659  
FAX (970) 945-8671

JHOUP@BEATTIECHADWICK.COM

**MEMORANDUM**

**TO:** Janie Goldberg  
**FROM:** Jefferson V. Houpt, Esq.  
**DATE:** March 17, 2008  
**RE:** Organization of Pleasant Valley Ditch

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At the last meeting of the owners of the Pleasant Valley Ditch, it was agreed that management of the ditch should be formalized, and I was asked to prepare documentation toward that end. I have prepared the enclosed draft Articles of Incorporation and Bylaws for the proposed Pleasant Valley Ditch Mutual Ditch Company. While there are other mechanisms for organizing multiple owners of a single ditch and the water rights exercised through that ditch, the mutual ditch company has several advantages:

- A mutual ditch company is a comprehensive management entity that recognizes common ownership interests in both the ditch and the water rights that are exercised through the ditch (other types of management structures often address only one portion of these interests, typically maintenance of the ditch). It provides a flexible organizational structure that can adapt to changing circumstances.
- Mutual ditch companies have been recognized in Colorado for over 100 years, and are the most common type of organization used for this purpose. A substantial body of law has developed around mutual ditch companies. This reduces the uncertainty that can accompany the dealings of other, less common, types of organizations.
- Stock certificates in a mutual ditch company represent the ownership of an interest in all aspects of a ditch, including the ditch structure, the water rights that are exercised through the ditch, easements and rights of way, *et cetera*.
- A mutual ditch company provides decision-making structure for management of the ditch, including issues regarding the operation and maintenance of the ditch, distribution of water among the owners, annual accounting to the Division of Water Resources, *et cetera*.

- This structure allows all owners of the water rights currently decreed to the Pleasant Valley Ditch to speak with a single voice when confronted with actions by third parties that may adversely affect the ditch and its water rights.
- Stock in a mutual ditch company provides a simple means of demonstrating the ownership of water rights and of conveying that ownership interest, by eliminating the need for a buyer to conduct an independent evaluation of the seller's title, the reliability and yield of the seller's interest, and the terms for exercising those rights through a common structure.
- Stock in a mutual ditch company also provides a convenient, reliable means of allocating the costs of operation and maintenance of the ditch by providing for pro-rata assessments. The amount of such assessments is determined by the shareholders, and the participation of all shareholders is ensured.

The enclosed Articles and Bylaws would create the Pleasant Valley Ditch Mutual Ditch Company. While these documents should be read thoroughly by all prospective shareholders, the following summarizes several important features:

- The Articles of Incorporation establish the basic structure of the entity; the Bylaws provide additional detail concerning the operation of the Company.
- All existing owners of interests in the water rights decreed to the Pleasant Valley Ditch will become shareholders in the Company. After the Articles of Incorporation are filed and the Company is established, the owners will convey their respective interests in the Pleasant Valley Ditch and its water rights to the Company; in exchange, they will receive shares of stock in the Company that correspond to the amount of their current interest in the Pleasant Valley Ditch water rights.
- Thereafter, the Company will own and operate the ditch and water rights on behalf of its shareholders, and will distribute water to the shareholders in accordance with the number of shares they own. The Company will own, operate and maintain the Pleasant Valley Ditch up to and including the device that measures and delivers water into each individual shareholder's lateral ditch. The individual shareholder will be responsible for his own ditch from that point on.
- The shareholders will hold an annual meeting at which they will elect a Board of Directors (initially three members) to oversee the operation of the Company. The Company may hire a Ditch Manager who will be responsible for day-to-day operations of the ditch, the distribution of water, maintenance of the ditch, *et cetera*.

- Revenue to pay for the cost of ditch operations, maintenance and repair will be raised by assessment of the shares. Annual costs will be estimated and assessments will be levied on the shares at a rate designed to produce the revenue necessary to meet those costs. The shareholders will approve the assessments by majority vote. If additional funds are required to meet the Company's expenses within any given year, the Board can make supplemental assessments. The Bylaws include procedures for the collection of assessments and remedies where the assessments are not timely paid.
- The Bylaws include provisions that permit the shareholders to lend water to each other temporarily, and to use the unused water of other shareholders, so long as it does not interfere with deliveries to all shareholders that intend to use their water. However, no shareholder can in this manner gain a permanent ownership interest in the water of another shareholder.

Certain issues tend to arise as land uses change and lands served by the ditch are divided into smaller parcels. I have attempted to include provisions in these documents to address some of those issues:

- Although ownership of the water rights decreed to the Pleasant Valley Ditch is currently divided into 15 "shares," the Articles of Incorporation provide for the issuance of 150 shares of Company stock. This will simplify the division of existing interests in the ditch into smaller increments.
- Some shareholders may desire to change a portion of their interest in the water rights to serve a new purpose, such as augmentation of pond evaporation. The Bylaws include provisions that allow such changes to occur, but with limitations to ensure that the rights of other shareholders are not injured. In this way, the other shareholders can evaluate and react to the proposed change collectively, rather than on an individual basis, as was required on several previous occasions. This provision is also applicable to changes of shares for use outside the Company's System.
- Some shareholders may desire to sell their interests to third parties for use beyond the current service area of the ditch; for example, to a rancher or developer located further downstream on Big Bear Creek or on the San Miguel River. Water rights are valuable property rights, and while Colorado law allows the ditch company to restrict the use of water to lands served by the ditch, some owners of the Pleasant Valley Ditch may not want their shares to be so restricted. To accommodate differing view points, I have included a Right of First Refusal that would allow either the Company or individual shareholders to purchase any shares that may be sold for use beyond the Company's system. If no one elects to exercise that right, the shares may be sold for use outside the System, subject to the provisions relating to changes of shares discussed in the preceding paragraph.

*Janie Goldberg*  
*March 17, 2008*  
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I understand that a meeting of the current ditch owners is scheduled for April 3, 2008; hopefully, the group will be in a position to take action on these documents at that time.

To: Scott  
Erickson

FAX: 369-6664

**Pleasant Valley Ditch Association**

Manager: John Nelson of Buckskin Ranch  
PO Box 3222  
Telluride, CO 81435  
728-0389

-6984  
728-6785 FAX

Faraway Foundation  
PO Box 2314  
Telluride, CO 81435

5 shares

**Sound of Music**

SOM - C  
PO Box 2220  
Telluride, CO 81435

3 shares

SOM - A  
PO Box 2220  
Telluride, CO 81435

1 share

Buckskin Ranch  
PO Box 3022  
Telluride, CO 81435

2 shares

Wilson Mesa Ranch Homeowners Association  
PO Box 215  
Placerville, CO 81430

2 shares

M.J. Cadgene  
PO Box 21  
Redvale, CO 81431

1 share

El Prado  
7710 Mockingbird  
San Antonio, TX 78229

1 share

Scott,  
This should be everything you asked for  
to create the LLC except for the map which  
I am working on.  
Thanks Cheryl