

## Why *Tulare Lake* Was Incorrectly Decided

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In December 2004, despite a good deal of inter-agency disagreement and public controversy,<sup>1</sup> the Bush administration settled the Tulare Lake water rights takings case by making a payment to the plaintiffs for \$16.7 million. The settlement agreement neither endorses nor repudiates the trial court's controversial finding of liability. At the same time, the decision has generated a good deal of interest and generated a mini-boomlet in similar takings cases. Ultimately, of course, the appellate courts will have to decide whether or not Tulare Lake was correctly decided. In my view, the question will not prove difficult: it was not, for a variety of different reasons.

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On April 31, 2001, the U.S. Court of Federal Claims ruled that the United States was liable for a taking based on restrictions on the operation of the California State Water Project mandated by the federal Endangered Species Act. See Tulare Lake Basin Water Storage Dist. v. United States, 49 Fed.Cl. 313 (2001). The restrictions served to protect several species of endangered fish, including Winter-Run Chinook Salmon and Delta Smelt, by providing higher water levels in the Sacramento-San Joaquin River Delta. At the same time, the restrictions reduced deliveries of water for irrigation to the claimant water users under their water supply contracts with the California Department of Water Resources. On December 31, 2003,

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<sup>1</sup> See, e.g., Dean E. Murphy, "In Fish vs. Farmers Cases, the Fish Loses its Edge," The New York Times, p. 15, February 22, 2005; Juliet Eilperin, "Water Rights Case Threatens Species Protection," The Washington Post, p. A18, December 17, 2004.

following a trial on the issue of damages, the claims court awarded just compensation of approximately \$14,000,000, plus prejudgment interest bringing the total judgment to over \$23,000,000. See 59 Fed. Cl. 246 (2003). Subsequently, in response to claimants' motion for reconsideration, the court issued a ruling increasing the rate for calculating prejudgment interest. See 2004 WL 1870073 (August 18, 2004).

Did the United States have strong grounds for appeal? Yes, unquestionably. . Specifically, the United States could and should have argued: (1) the court of claims erred in concluding that the water users' contracts with the Department created vested rights to the delivery of certain levels of irrigation water, given that (a) applicable background principles of California law limited the scope of the water rights claimants can claim pursuant to their contracts, and (b) the indemnity clauses in the contracts limited the rights conferred on claimants by the contracts; (2) even if the claimants had rights to certain quantities of water under the contracts, the court of claims erred in concluding that frustration of claimants' expectancies under the contracts as a result of enforcement of the ESA resulted in a taking; and (3) finally, in any event, the court of claims erred in concluding that the restrictions on the exercise of claimants' contract water rights effected a per se, physical-occupation type taking.

### Background

This takings case was based on the alleged taking of contract rights to the delivery and use of water. The California Department of Water Resources obtained appropriative rights to the water based on permits from the State Water Resources Control Board. The Department, in turn, contracted, either directly or indirectly, to deliver certain quantities of water, subject to various qualifications and conditions, to the claimant water users. The court of claims decided this case on the premise, which the parties apparently did not dispute, that claimants' property rights in the water, if any, were based on and embodied in their contracts with the Department.

It also was uncontested that claimants' rights under their contracts with the Department were derivative of, or dependent on, the rights the Department received under its water permits from the Board. As the court of claims said, "[T]he right to the water's use is transferred first by permits to DWR, and then by contract to end-users, such as the plaintiffs. Those contracts confer on plaintiffs a right to the exclusive use of prescribed quantities of water, consistent with the terms of the permits." 49 Fed.Cl. at 318 (emphasis added). See also Id. at 318 n.6 (stating that "plaintiffs' contracts are derivative of the permit issued to DWR"). Thus, claimants' rights under their contracts were subject to whatever limitations were placed on the Department's water rights under their permits.

Finally, it was common ground in this litigation that, generally speaking, private rights in water under California law are limited by various background legal principles, in particular the public trust and reasonable use doctrines. As the California Supreme Court explained in its landmark decision in National Audubon Society v. Superior Court of Alpine County, 33 Cal.3d 419, 425 (1983), "the core of the public trust doctrine is the state's authority as sovereign to exercise a continuous supervision and control over the navigable waters of the state and the lands

underlying these waters.” The Supreme Court explained that the legal effect of the public trust doctrine is to impose an obligation on state agencies and courts to “consider the effect of... diversions upon interests protected by the public trust.” Id. at 426. Public uses protected under the public trust doctrine include “navigation, commerce, fishing, recreation, or ecological use.” Id. Under the related reasonable use doctrine, “all California water rights are subject to the universal limitation that the use must be both reasonable and for a beneficial purpose.” Tulare, 49 Fed.Cl. at 321. “Included in that definition of reasonable use is the preservation of fish and wildlife.” Id.

### The Court of Claims Decision

Proceeding in a seemingly illogical sequence, the court of claims first addressed the government’s argument that implementation of the ESA did not result in a taking because it merely frustrated claimants’ private contract expectancies and therefore did not effect a compensable taking. Second, the court addressed the question whether the restrictions imposed under the ESA effected a taking under a per se physical-occupation theory. Finally, the court addressed whether the takings claims were barred because claimants could not demonstrate a threshold property interest, either because of the limitations imposed by background principles of California water law or because of the indemnity clause in the contracts.

On the contract expectancy issue, the United States contended that the claims were foreclosed by the U.S. Supreme Court decision in Omnia Commercial Co. v. United States, 261 U.S. 502 (1923). In Omnia, a private firm contracted with a steel manufacturer to receive a large quantity of steel plate at a favorable price. The United States subsequently requisitioned the entire output of the plant, making it impossible for the manufacturer to deliver steel pursuant to the contract. The frustrated purchaser sued under the Takings Clause, alleging that the government had “taken” the firm’s contractual rights to the steel. The Supreme Court rejected the claim on the ground that “the law affords no remedy” for “consequential loss or injury resulting from lawful government action.” Id. at 510. Without indicating that private contract rights can never be the subject of a successful taking claim, the court said this type of indirect effect on contract rights could not support a taking claim. “As a result of this lawful governmental action, the performance of the contract was rendered impossible. It was not appropriated, but ended.” Id. at 511.

Without disputing that Omnia remains good law, the court of claims ruled that Omnia was distinguishable and did not govern this case. In Omnia, the court said, the alleged contract right “remain[ed] separate and distinct from the property that [was] the subject of the contract,” in the sense that the plaintiff “could not claim ownership of the property since title had not yet passed to the party seeking compensation.” 49 Fed. Cl. at 317. By contrast, in this case, the court thought, the claimants could claim not only “a contract expectancy,” but also “an identifiable interest in a stipulated volume of water.” Id. at 318. The court characterized this interest as “a right to the exclusive use of prescribed quantities of water,” a right that was “superior to all competing interests.” Id. On this basis, the court termed claimants’ property interests “sufficiently matured to take [them] out of the realm of an Omnia analysis.” Id.

Second, the court concluded that the ESA-mandated restrictions effected a physical occupation of claimants' contract water rights and therefore resulted in a per se taking. Focusing on the limited, usufructuary nature of private rights in water, the court said that a restriction on the owner's ability to exercise such a right "completely eviscerates the right itself." Id. at 319. The court analogized this type of "invasion" of private water rights with the invasion of private air space by government aircraft held to effect a physical taking in Causby v. United States, 328 U.S. 256 (1946). Significantly, the court did not have the benefit of the U.S. Supreme Court's decision in Tahoe-Sierra Preservation League v. Tahoe Regional Planning Agency, 535 U.S. 302 (2002), decided the following year, in which the Court defined the physical-occupation takings theory in restrictive terms and drew a sharp distinction between physical occupation claims and regulatory takings claims. The court of claims also relied on a series of U.S. Supreme Court decisions in which the federal government acquired private interests in water in association with water development projects and was required to pay just compensation for such interests. See Dugan v. Rank, 372 U.S. 609 (1963); Ivanhoe Irrigation Dist. v. McCracken, 357 U.S. 275 (1958); United States v. Gerlach Live Stock Co., 339 U.S. 725 (1950); International Paper Co v. United States, 282 U.S. 399 (1931).

In the final section of its opinion, the court addressed the threshold question of whether the claimants had established a protected property interest sufficient to support their takings claims. First, the court rejected the United States' argument that the claimants could not claim an infringement of a protected property interest given the indemnity language in their contracts with the Department. The contracts state that the State cannot be held liable "for any damage, direct or indirect, arising from shortages in the amount of water to be made available for delivery... under this contract caused by drought, operation of area of origin statutes, or any other cause beyond their control." The court ruled that this language provided a defense available to the State only, and did not qualify the actual nature of claimants' rights. Therefore, the court said, the United States could not rely upon this indemnity language to defend against takings claims against the national government.

The court also ruled that, in the circumstances of this case, the United States could not rely on background principles of California law to defeat the claims. The court acknowledged, as a general proposition, that California background principles limit private water rights, and also acknowledged that the proper application of background principles can evolve based on new knowledge and information. Nonetheless, the court focused on the fact that the state water board, in Order D-1485, issued in 1978, had allocated available water to claimants subject to certain conditions. Given that the board has jurisdiction to enforce the public trust and reasonable use doctrines, the court believed that the order represented an authoritative application of California background principles, at least as of the date it was issued. Because the restrictions mandated by the ESA went beyond the conditions mandated by D-1485, the court reasoned, the ESA restrictions could not be consistent with background principles of California law. The court recognized that the board or the California courts might well have reached a new and different conclusion about how background principles should apply in the early 1990's, following the listing of the fish as endangered. But, the court ruled, unless and until the board or the state courts acted, D-1485 defined how the public trust and reasonable use doctrines affected

claimants' water rights. In the court's words, "Once an allocation has been made [by the board] – as was done in D-1485 – that determination defines the scope of plaintiffs' property rights." Id. at 322.

The court distinguished Rith Energy v. United States, 44 Fed. Cl. 108 (1999), in which the court of claims ruled that background principles of Tennessee nuisance law barred a taking claim, even though the federal court's interpretation of state nuisance law went beyond the application of state law adopted by any state agency or state court involved in the matter. The court reasoned that in Rith Energy, "the action taken by the federal government did not represent merely what the state could have done under its police power, but rather what the court believed the state was required to do in light of" the available evidence. Id. at 322 (emphasis in original). In other words, the federal court properly applied the state law definition of a nuisance in Rith because state law pointed "to a single, discrete resolution" of the issue. Id. at 323. On the other hand, when state law does not point to a single result, the court said, for a federal court to attempt to interpret and apply state law would compel it "to exercise... discretion for which [the] court is not suited and with which it is not charged." Id. at 323-24.

### The Issues on Which the United States Should Have Appealed

The court of claims decision is clearly wrong, as explained below. Adopting a more logical sequence in addressing the issues, I will first explain why claimants lack a protected property interest, then address why the court's attempt to distinguish Omnia was mistaken, and, finally, discuss why use of the per se physical-occupation theory was mistaken, especially in light of the landmark Supreme Court decision in Tahoe-Sierra.

#### I. The Court of Federal Claims Erred in Finding That Claimants Possessed a Protected Property Right to the Delivery of Certain Quantities of Irrigation Water.

The threshold issue in the case, as in any takings case, was whether claimants possessed property interests sufficient to support their takings claims. The United States argued before the claims court that any rights claimants acquired under their contracts with the Department were subject to background principles of California law, including in particular the public trust and reasonable use doctrines, and that the ESA restrictions simply paralleled the limitations on the scope of private water rights imposed by these background principles.<sup>2</sup> Accordingly, the United States argued, claimants' taking claims should have been rejected on this ground alone. The United States also argued that the indemnity clause in the claimants' contracts with the Department barred them from claiming a protected right under the contracts and also defeated their takings claims. The court of claims erred twice in rejecting these independent arguments.

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<sup>2</sup> The United States also raised the argument that claimants' rights were limited under California nuisance law. The court acknowledged this argument, but did not separately address it. See generally People v. Truckee Lumber Co., 116 Cal. 397 (1897) (private activities that harm public fisheries constitute a nuisance)

A. Background Principles of California Law Bar The Claims.

The court of claims erred in concluding that the claims were not barred under background principles of California law, including in particular the public trust and reasonable use doctrines. The court's erroneous handling of the background principles issue actually reflects two separate legal mistakes. First, the court of claims misinterpreted the public trust and reasonable use doctrines as defined by the California courts, and therefore incorrectly concluded that claimants had a vested property right under California law to the delivery of water notwithstanding the evidence of adverse effects of water diversions on endangered fish. Second, the court of claims made a separate error by concluding that it could and should apply background principles of California law differently than the California courts would apply them in a comparable case in state court. For both of these reasons, the court of claims' conclusion that claimants established a protected property right sufficient to support their takings claims was mistaken and should be reversed on appeal.

1. Misinterpretation of California Law. First, the court misconstrued the California public trust and reasonable use doctrines and the nature of the limitations they place on private rights in water. The court of claims stated that D-1485 "define[d] the scope of plaintiff's property rights." This statement is simply mistaken. It confuses the question of the range of authority vested in the water board (and California courts) to interpret and apply the public trust and reasonable use doctrines in particular cases, and the nature of the limitations on private rights in water created by the existence if the public trust and reasonable use doctrines.

In National Audubon, the California Supreme Court emphasized that the public trust doctrine does not impose an absolute prohibition on private exploitation of trust resources. See 33 Cal.3d at 425. The court said, "The prosperity and habitability of much of this state requires the diversion of great quantities of water from its streams for purposes unconnected to any navigation, commerce, fishing, recreation, or ecological use relating to the source stream." Id. Rather than prohibiting destruction or harm to public trust resources, the doctrine merely establishes, at least in the first instance, a requirement that government officials consider public trust values in their decisions affecting public trust resources.

On the other hand, National Audubon recognized that the public trust doctrine places far-reaching limitations on the kinds of private property rights that can be claimed to the exploitation of trust resources. The court said, "The state must have the power to grant nonvested usufructary rights to appropriate water even if such diversions harm public trust uses." 33 Cal.3d. at 426 (emphasis added). As this language indicates, the board may be able to allocate water to a particular private use that harms trust values. But it does not thereby create vested private property rights in that use. In other words, what uses of trust resources state courts and agencies may allow do not define the scope of private rights in those resources.

Thus, National Audubon makes clear that, with one minor exception,<sup>3</sup> a private party cannot acquire a vested property right to exploit trust resources in a fashion that is harmful to trust values. “One consequence” of the doctrine, the Supreme Court explained, “in this and many other cases, is that parties acquiring rights in trust property generally hold those rights subject to the trust, and can assert no vested right to use those rights in a manner harmful to the trust.” Id. at 437. See also Id. at 445 (stating that the public trust doctrine “prevents any party from acquiring a vested right to appropriate water in a manner harmful to the interests protected by the public trust”); Id. at 452 (“The public trust doctrine... precludes anyone from acquiring a vested right to harm the public trust...”). Under this interpretation, regardless of whether or how the board has allocated public trust resources to private parties in any particular proceeding, such parties can never acquire property rights to exploit trust resources in a fashion that harms trust values.

The court of claims erred because it believed that the board, by authorizing the use of certain quantities of water in D-1485, thereby granted the Department, and in turn the claimants, a vested right to exploit water up to that amount, at least until the order was formally modified by the board itself. However, for the reasons discussed, no private party can ever acquire a vested property right to use water in a way that harms public trust resources. In concluding otherwise, the court of claims misinterpreted governing California law.

If the California public trust and reasonable use doctrines had properly been applied by the court of claims, it is clear that claimants could not have claimed an infringement of a protected property interest. It is not disputed that over-exploitation of the water in the Sacramento-San Joaquin River Delta, including diversions of water for use by claimants, contributed to the endangerment of the fish and threatened their future existence. Fish are obviously a resource protected under California’s background principles. Because creating a risk of extinction certainly harms fish, claimants could claim no protected right to the benefit of continued excessive water diversions in the circumstances of this case. Accordingly, by restricting claimants’ use of their contract water rights, the Endangered Species Act infringed no protected right that claimants could claim as their own.<sup>4</sup>

2. Abdication of Federal Court Duty to Apply State Law. The court’s conclusion that California background principles did not bar these claims was also mistaken for a second reason. According to the court of claims, a California court (or the state water board), faced with the same evidence about threats to endangered species, would have had an obligation to consider whether protection of the public trust and the reasonable use doctrine required additional

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<sup>3</sup> The exception mentioned, private rights in improvements lawfully constructed in public trust areas, see id. at 440 n.22, has no application in this case,

<sup>4</sup> In general, the court of claims’ discussion of California water law is muddled and confusing. While the conclusion that D-1485 created vested rights to exploit water in derogation of public trust values is the most obvious error of state law in the opinion, the opinion may well contain other errors of state law.

restrictions above those imposed by the board in D-1485. See 49 Fed.Cl. at 322. However, in the court of claims' view, it, qua federal court, could not apply state law doctrines in the same fashion as a state court. In the court's terse words, "That we cannot do." 49 Fed.Cl. at 323.

This conclusion was mistaken because it ignores the responsibility of a federal court, in addressing a state law issue in a case properly before it, to faithfully apply state law. In justifying its ruling, the court of claims indicated that it was avoiding the "displacement of the state regulatory regime" in California by declining to address matters "for which this court is not suited and with which it is not charged." Id. at 323. In reality, by declining to address the state law issue on the same basis that the California courts would, the federal court effectively arrogated to itself the power to contradict substantive state law. Thus, far from reflecting respect for the principle of federalism, the court's approach offends that principle.

Since the landmark decision in Erie Railroad v. Tompkins, 304 U.S. 64 (1938), the Supreme Court has recognized the principle that, except in matters governed by the Constitution or Acts of Congress, the law to be applied by federal courts is state law. While Erie involved federal diversity jurisdiction, the same principle applies in any federal court case. See Wright & Miller, Federal Practice and Procedure, § 4520, at 635 ("[T]he Erie doctrine applies, whatever the ground for federal jurisdiction, to any issue or claim which has its source in state law."). In a takings case under the Takings Clause, of course, the threshold property interest is not defined by the Constitution itself, but by state law or some other independent source of law. Thus, the principle of Erie is fully applicable in takings cases filed in federal court. See Id. at 639-40 ("Thus state law has been applied to determine the character of property... in federal condemnation actions to determine what property interests are compensable.").

The Supreme Court justified the Erie doctrine, in part, based on the desirability of avoiding divergent legal results based on whether a federal or state court is addressing a state legal issue. 304 U.S. at 820-21. At bottom, however, the Erie decision reflects the fundamental constitutional principle of federalism:

"Erie ultimately rests on the principle that the federal government as a whole, including Congress and the federal courts, has no more authority than that given it by the Constitution. This fundamental principle, which is inherent in the political theory underlying the very concept and structure of the federal government, is reinforced by the Tenth Amendment, which reserves to the states or to the people those powers 'not delegated to the federal government by the Constitution.'"

Wright & Miller, Federal Practice & Procedure, §4505, at 60.

In carrying out its duties under Erie, a federal court applying state law is, "in substance 'only another court of the State.'" Bernhardt v. Polygraphic Co., 350 U.S. 190 203 (1956), quoting Guaranty Trust Co. v. York, 326 U.S. 99, 108 (1945). In other words, a federal court addressing a substantive state law issue "functions as a proxy for the entire state court system, and therefore must apply the substantive law that it conscientiously believes would have been applied in the state court system." Wright & Miller, Federal Practice & Procedure, §4507, at 126.

In accord with these teachings, federal courts addressing takings claims must seek to decide state law issues in the case in the same fashion as the relevant state courts would. For example, in Phillips v. Washington Legal Foundation, 524 U.S. 156 (1998), the Supreme Court addressed whether the claimant possessed a protected property interest under Texas law by attempting to faithfully apply Texas precedents. See also Esplanade Properties, LLC v. City of Seattle, 307 F.3d 978 (9th Cir. 2002), cert. denied, 123 S.Ct. 2574 (2003) (rejecting taking claim based on application of Washington precedent defining the scope of the Washington public trust doctrine). Cf. Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1032 n. 18 (1992) (“We stress that an affirmative decree eliminating all economically beneficial uses may be defended only if an objectively reasonable application of relevant [state law] precedents would exclude those beneficial uses in the circumstances in which the land is presently found.”) (emphasis added).

Significantly, in National Audubon itself, the California Supreme Court specifically recognized the possibility that federal courts would have occasion to interpret and apply the California public trust doctrine. See 33 Cal3d at 451. The court gave no indication that the federal courts could or should apply the California public trust doctrine differently than the California courts. For the reasons discussed, any such suggestion would be inconsistent with Erie.

In failing to attempt to duplicate how the state courts would apply California background principles, the court of claims abdicated its responsibility to faithfully apply state law. The court, without any citation to relevant supporting authority, concluded that it had an obligation to follow state law only so long as state law pointed to “a single, discrete resolution” of the issue, distinguishing the court’s earlier decision in Rith. But state law commonly requires the exercise of judicial judgment, as when a court is required to decide whether an action is “negligent” or a contract “unconscionable.” There is no exception to the federal court duty to faithfully apply state law for cases requiring the exercise of judicial judgment.

Accordingly, even if the court of claims were correct in thinking that D-1485 fixed private rights in water unless and until the order was reexamined, the court of federal claims had the same authority, indeed obligation, as the state courts to conduct a reexamination of how the public trust and reasonable use doctrines applied in then current circumstances. In failing to approach this issue on the same basis that the state courts would, the court of claims failed in its obligation to faithfully apply state law. For this second, independent reason, the court of claims’ resolution of the background principles issue was mistaken and should be reversed.

#### B. The Indemnity Clause Bars These Claims.

There is a second reason the court of claims erred in concluding that claimants had a vested property right to receive a certain quantity of water. As discussed, the claimants’ contracts with the Department provide that neither the state nor its agents may be held liable “for any damage, direct or indirect, arising from shortages in the amount of water to be made available for delivery... under this contract caused by drought, operation of area of origin

statutes, or any other cause beyond their control.” Relying on O’Neill v. United States, 50 F.3d 677 (9<sup>th</sup> Cir. 1995), the United States contended that this indemnity provision barred claimants from claiming an entitlement to water that might prove undeliverable “for any other cause” beyond the Department’s control, including enforcement of the Endangered Species Act by the federal government. The court should have accepted this defense.

Without disputing that O’Neill was correctly decided, the court rejected this defense, observing that the indemnity provision in O’Neill explicitly ran in favor of the United States. By contrast, in this case, the court reasoned, the United States seeks to rely on an indemnity clause that, by its terms, runs in favor of the State. The court concluded that the indemnity language did not render claimants’ rights “contingent,” but merely created a defense to a claim for monetary compensation, available to the State only, in the event the State failed or was unable to deliver water under the contract. Therefore, the court concluded, the United States could not rely on this indemnity language to demonstrate that claimants lacked a sufficient property interest to support their claims against the United States.

While the court of claims’ reasoning was superficially plausible, the United States’ position is the correct one. The Ninth Circuit decision in O’Neill effectively recognized that the indemnity language did not merely create a defense, but also qualified the nature of the claimants’ contract rights themselves. See also United States v. State Water Resources Control Board, 182 Cal.App.3d 82, 142 (1986) (stating that immunity provision in contract establishes, “both substantively and conceptually,” that “the contractors cannot justify any reasonable expectation of a certain or guaranteed water supply for delivery”). Because the indemnity provision qualifies the scope of the property right itself, it is irrelevant for the purpose of takings analysis whether the challenged action was by the federal government or by the State. Accordingly, the indemnity provision establishes that claimants lacked vested rights sufficient to support their takings claims. Thus, the court of claims erred in failing to reject the claims based on this language.

## II. The Court of Federal Claims Erred in Concluding that Claimants Could Assert a Taking of Their Alleged Contract Rights to Water.

The United States contended before the court of claims, principally relying on the Supreme Court decision in Omnia Commercial Co v. United States, 261 U.S. 502 (1923), that the Takings Clause does not provide a remedy for consequential injury or loss resulting from general federal legislation impairing the value of private contract rights. The government’s position was supported by Omnia, as well as other relevant Supreme Court and Federal Circuit precedent.

Omnia stands for the broad proposition that the United States has broad latitude to take actions to advance the general welfare even when such actions may have the incidental effect of limiting or even destroying the value of private contract rights. As a unanimous Supreme Court said in Concrete Pipe & Prods. v. Construction Laborers Pension Trust, 508 U.S. 602 (1993): “Contracts, however express, cannot fetter the constitutional authority of Congress.

Contracts may create rights of property, but when contracts deal with a subject matter which lies within the control of Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them.”

Id. at 642, quoting Norman v. Baltimore & Ohio R. Co., 294 U.S. 240, 307-08 (1935), in turn citing Hudson County Water Co. v. McCarter, 209 U.S. 349, 357 (1908) (“One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the state by making a contract about them.”)

Accordingly, the Supreme Court and lower federal courts have repeatedly rejected takings claims based on the argument that federal legislation has impaired private property rights grounded in contract. This principle applies regardless of whether federal legislation imposes obligations beyond those which a party has agreed to pursuant to contract, see, e.g., Connolly v. Pension Benefit Guaranty Corp., 475 U.S. at 223 (“[a]ppellants’ claim of an illegal taking gains nothing from the fact that the employer in the present litigation was protected by the terms of its contract from any liability beyond the specified contributions to which it had agreed”), or deprives private parties of the expected benefits of a contract. See, e.g., Omnia Commercial Co v. United States, 261 U.S. 502 (1923); PVM Redwood Co. v. United States, 686 F.2d 1327 (9<sup>th</sup> Cir. 1982) (denial of supply of lumber to sawmill operator due to passage of Redwood Park Expansion Act merely a noncompensable frustration of a contract expectancy).

“This is not to say that contractual rights are never property rights or that the Government may [never] take them” within the meaning of the Takings Clause. Connolly v. Pension Benefit Guaranty Corp., 475 U.S. at 224. For example, the Supreme Court indicated that a taking claim might lie if the government has appropriated contract rights for its “own use;” by contrast, the Court has said, no taking results if the United States “only has nullified a contractual provision... by imposing an additional obligation that is otherwise within the power of Congress to impose.” Id. This is not a case in which the government has appropriated contract rights for its own use. In the same vein, in Cienega Gardens v. United States, 331 F.3d 1319, 1335 (Fed.Cir. 2003), the Federal Circuit stated that a taking does not result from “legislation targeted at some public benefit, which incidentally affects contracts,” but contrasted that type of case with a case involving “legislation aimed at the contract rights themselves in order to nullify them,” which the court thought could support a taking claim. Because this case involves a taking claim arising from the application of general legislation (the Endangered Species Act) designed to achieve a general benefit, it does not fall within the scope of the exception identified in Cienega.<sup>5</sup>

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<sup>5</sup> It is debatable whether federal legislation that specifically targets a private contract for destruction should automatically trigger liability under the Takings Clause. While Cienega Gardens states that legislation targeting a specific contractual relationship can effect a taking, the Supreme Court has said that even targeted legislation does not necessarily raise a constitutional problem:

The principle [that Congress can pass legislation abrogating private contract rights] is not limited to the incidental effect of the exercise by Congress of its constitutional authority. There is no constitutional ground for denying to the Congress the power expressly to

As the United States correctly argued before the court of federal claims, Omnia was on all fours with this case and required rejection of the taking claims. In Omnia, the court of claims said, the plaintiff had only a “contract expectancy” to receive a certain quantity of steel plate. By contrast, according to the court of claims, the claimants in this case could claim “an identifiable interest in a stipulated volume of water.” But this purported distinction is illusory. Both in Omnia and in this case, the contracts were executory as of the date of the alleged taking. Water is no less fungible, and arguably a good deal more fungible, than the steel plate in Omnia. In addition, claimants’ rights to delivery of water under the contracts in the future were no more vested than the plaintiffs’ contract rights to the delivery of the steel plates in Omnia. Claimants’ characterization of their contract water rights certainly draws no support from California water law, under which ownership of the water itself always remains with the State, as trustee for the public, and private parties obtain, at most, a right to the use of a certain quantity of water during a certain period of time. See page 14, infra. Lastly, in both cases, the frustration of the contract expectancy was not the result of some government action targeted at the contract itself, but rather the indirect consequence of general government action designed to serve legitimate public purposes. If anything, the government action in Omnia was more targeted than the Endangered Species Act in this case, and therefore a finding of no taking in this case should have followed a fortiori from Omnia.

In several relatively recent cases, the Federal Circuit has relied upon and followed Omnia, confirming that Omnia is recognized as governing precedent in the Federal Circuit. In 767 Third Avenue Associates v. United States, 48 F.3d 1575 (Fed.Cir. 1995), the court affirmed rejection of a claim that the United States effected a taking of a lessor’s property rights under its lease by ordering closure of the foreign government offices that occupied the space. In the court’s words, “no taking occurs when, as occurred in this case, expectations under a contract are merely frustrated by lawful government action not directed against the takings claimant.” Id. at 1581. Similarly, in NL Industries Inc. v. United States, 839 F.2d 1578 (Fed Cir.), cert. denied, 488 U.S.820 (1988), the court rejected a taking claim alleging frustration of a private contract to transport nuclear wastes to a reprocessing facility based on the United States’ decision to defer action on an application to operate the facility. See also Cienega Gardens (treating Omnia as binding precedent, but distinguishing the decision based on its facts).

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prohibit and invalidate contracts although previously made, and valid when made, when they interfere with the carrying out of the policy it is free to adopt....The power of the Congress in regulating interstate commerce [is] not fettered by the necessity of maintaining existing arrangements and stipulations which would conflict with the execution of its policy. The reason is manifest. To subordinate the exercise of the federal authority to the continuing operation of previous contracts would be to place to this extent the regulation of interstate commerce in the hands of private individuals and to withdraw from the control of the Congress so much of the field as they might choose by ‘prophetic discernment’ to bring within the range of their agreements. The Constitution recognizes no such limitation.”

Norman v. Baltimore & O.R. Co., 294 U.S. 240, 309-10 (1935). The Cienega Gardens court did not cite nor discuss the Supreme Court decision in Norman.

Importantly, in 767 Third Avenue, the Federal Circuit ruled that the fact that a taking claim is based on consequential injuries to private contract rights represents a stand-alone basis for rejecting a taking claim. The plaintiff contended that Omnia and NL Industries did not represent sufficient authority, by themselves, to justify rejection of the taking claim, and argued that the Federal Circuit “must [also] perform the ad hoc regulatory takings analysis outlined in Penn Central for any claim that government regulation is contrary to a property owner’s reasonable expectations.” Id. at 1583 (emphasis in original). The court’s succinct response: “We disagree.” Id. The numerous regulatory takings cases applying traditional takings analysis, the court said, “are not inconsistent with the principle that no interest is taken when a contract expectation is merely frustrated by a regulation directed toward a different party or property interest.” Id. In short, the Omnia issue represented a separate, freestanding basis for reversing the court of claims’ liability ruling.

### III. The Court Erred in Applying a Per Se Physical-Occupation Takings Test to Restrictions on the Exercise of Claimants’ Water Rights.

Based on the premise that claimants had a vested property interest in the delivery of a certain quantity of water, and having concluded that claimants did not suffer a mere consequential injury to their contract rights, the court proceeded to evaluate the claimants’ takings claims as per se physical-occupation takings. On that theory, the court concluded that the claimants had indeed suffered a compensable taking. This too was error.

As the court itself recognized, the critical feature of the physical occupation takings test is that the parcel as a whole rule does not apply, and compensation is due “no matter how minute the intrusion.” 49 Fed.Cl. at 318, quoting Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1115 (1992). On the other hand, as the court also recognized, if the case had been considered under traditional regulatory takings analysis, thereby triggering an assessment of economic impact using the “parcel as a whole” rule, the taking claim would certainly have failed. As the court said, “the economic loss asserted here - a fraction of the master contract’s overall value - was de minimis.” 49 Fed.Cl. at 318-19. See also Melinda Harm Benson, “The Tulare Case: Water Rights, the Endangered Species Act, and the Fifth Amendment,” 32 Envtl. Law 551, 560 (2002) (“[t]he restrictions resulted in an overall reduction in water availability of approximately 0.115 and 2.92%” for the two lead plaintiff irrigation districts). The critical question, therefore, is whether the court erred in applying the physical occupation doctrine (thus barring application of the parcel as whole rule) as opposed to traditional regulatory takings doctrine (requiring application of the parcel as a whole rule).

Upon analysis, it is clear that the court of claims should have applied a traditional regulatory takings analysis and that it erred in applying a physical occupation test. The court’s error is especially apparent in light of the Supreme Court’s teachings on the distinctions between these two types of takings claims in Tahoe-Sierra Preservation League v. Tahoe Regional Planning Agency, 535 U.S. 302 (2002). Unfortunately, the court of claims did not have the benefit of the 2002 Tahoe-Sierra decision when it issued its 2001 ruling on liability.

General Considerations. In the first place, the court's use of the physical occupation theory runs counter to the Supreme Court's statements that this categorical test is disfavored and should be applied only in narrow circumstances. In Tahoe-Sierra, the Court stated that "[t]he temptation to adopt what amount to per se rules" must be resisted, id. at 321, and use of the per se test must be tightly cabined to avoid "transform[ing] government regulation into a luxury few governments could afford." Id. at 324. The Court said, this test must be reserved for "relatively rare" cases in which the physical occupation can be "easily identified." Id. The Court also stressed the need to maintain clear analytical lines between these two test; it is "inappropriate to treat cases involving physical occupations as controlling precedents for the evaluation of a claim that there has been a 'regulatory taking,' and vice versa." Id. The court of claims' ruling on liability evinced no awareness that it was applying a distinct test that is properly confined to the "relatively rare" case.

Second, the court of claims' physical-occupation takings theory is inconsistent with the character of private rights in water. Under California law, title to water always remains with the State, and a water user, whether it holds its right by virtue of a permit or under a contract, holds merely a usufructary right in the water. See Eddy v. Simpson, 3 Cal. 249, 252-53 (1853) ("The right of property in water is usufructary, and consists not so much of fluid itself as the advantage of its use....The right is not in the corpus of the water, and only continues with its possession."). The physical occupation doctrine logically can apply in the context of real property, for example, when the government or those authorized by government can actually be said to physically invade private property, see, e.g., Dolan v. City of Tigard, 512 U.S. 374 (1994), or perhaps where government action appropriates an identified monetary fund. See Brown v. Legal Foundation of Washington, 538 U.S. 216 (2003) (assuming arguendo that the case involved a physical occupation of a fund of money). But the physical occupation theory cannot logically be applied to a water right, because there is no property that the government or third parties can occupy. There is merely a right of use. A use right can be restricted, even obliterated, but it cannot be physically occupied.

Finally, the court of claims's physical occupation theory, which would give property rights in water greater protection than any other type of property known to the law, is inconsistent with the traditionally limited and contingent nature of private rights in water. Certainly, at a minimum, private property rights in water "have no higher or protected status than any other sort of property." Joseph Sax, "The Constitution, Property Rights, and the Future of Water Law," 61 U.Colo.L. Rev. 257, 260 (1990). If anything, private rights in water are subject to greater demands on behalf of the public welfare, and therefore are less appropriate for treatment using a per se takings rule than other types of property rights. As discussed, unlike with real property, the State owns title to the water itself, and holders of private rights in water have only use rights. Furthermore, these limited use rights are cabined by a variety of doctrines, including the public trust doctrine, the reasonable use doctrine, and nuisance law (as well as the federal navigational servitude). It would be anomalous, in light of the legal traditions supporting broad public authority to restrict private rights in water, to conclude that private water rights actually hold a special, elevated place in takings law.

One ironic consequence of the court of claims's theory is that water rights holders subject to the requirements of the Endangered Species Act would have far greater protection under the Takings Clause than real property owners subject to ESA constraints. For example, in Seiber v. United States, 364 F.3d 1356 (Fed.Cir. 2004), the appeals court recently affirmed a court of claims decision rejecting a claim that ESA restrictions on logging on 40 acres of property effected a taking. Applying the parcel as a whole rule, the court said the taking claim had to be evaluated in light of the claimants' entire 200-acre property. Yet, under the reasoning of the court of claims, water rights holders could recover under the physical occupation theory, no matter how modest the economic impact of the restriction on the property as a whole. In this case, the court of claims found a taking by focusing on restrictions imposed for limited periods over the span of three years, ignoring the fact that the ESA did not impose a permanent restriction on the exercise of these rights. Cf. Tahoe-Sierra Preservation League v. Tahoe Regional Planning Agency, 535 U.S. 302, 331 (2002) (emphasizing that the parcel as a whole rule applies in the temporal as well as the geographical dimension). Claimants' segmentation theory is patently unfair because it would grant special privileges to water rights holders under the Takings Clause. There is no support in the law for this type of special treatment.

Flawed Analysis. In addition, the specific analysis that led the court of claims to apply a physical-occupation takings test in this case was fundamentally mistaken. The court's basic reasoning was that the ESA restrictions on the exercise of claimants' water rights accomplished "a complete extinction of all value," 49 Fed.Cl. at 319, and for that reason "amount[ed] to a physical occupation" of the property. Id. at 320.

The court erred, first, in concluding that because the regulation ostensibly "deprived [claimants] of the entire value of their contract right," id. at 318, it effected a physical occupation of claimants' asserted water rights. Contrary to the court's reasoning, a regulatory restriction that destroys all economically viable use is not the same thing as a physical occupation of private property. For example, Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992), involved a regulation that had been found to make the property valueless. But the Supreme Court did not conclude from this finding that the claim in Lucas involved a physical occupation. To the contrary, the Lucas Court said there are "two discrete categories" of government action for the purpose of the Takings Clause, id. at 1025 (emphasis added), physical occupations and regulatory use restrictions. The Court said the "total taking" claim in Lucas fell into the regulatory taking category, not the physical occupation category.

The court in Tulare Lake believed that its theory that a total destruction of value results in a per se physical-occupation taking was supported by the decision in United States v. Causby, 328 U.S. 256 (1946). But that belief was mistaken. Causby addressed a taking claim based on the government's frequent operation of low-flying aircraft through plaintiff's privately owned airspace. The government action in Causby may well have destroyed the owner's property value (or nearly so), but the action was found to effect a physical taking because the government's airplanes actually physically invaded plaintiff's property. See Tahoe-Sierra, 535 U.S. at 322 (placing Causby on the physical-occupation side of the divide between regulatory restrictions and physical occupations). Because Causby involved an actual physical occupation, it does not

support the theory that a regulation eliminating economically viable use can be equated with a physical occupation.

Second, the court of claims simply begged the critical question of the impact of the regulation in determining that the ESA restrictions rendered claimants' water rights valueless. The court concluded that the ESA rendered claimants' water rights valueless because it assumed, without ever explaining why, that the parcel as a whole rule did not apply. But the parcel rule could properly have been disregarded only if the case involved a physical occupation. The court of claims characterized the ESA restrictions as a physical occupation, but its basis for doing so was that the regulation ostensibly rendered the property valueless. That conclusion necessarily rested on the premise that the parcel rule did not apply, an assumption that would have been appropriate only if the case actually involved a physical invasion. In other words, the court concluded that ESA restrictions made the claimants' water rights valueless because it assumed that the parcel rule did not apply. As the Supreme Court explained in Concrete Pipe & Products of California, Inc. v. Construction Laborers Pension Trust for Southern California, 508 U.S. 602, 644 (1993), "[t]o the extent that any portion of property is taken, that portion is always taken in its entirety; the relevant question, however, is whether the property taken is all, or only a portion of, the parcel in question." In other words, the court's reasoning was perfectly, and fatally, circular.

Instead of assuming the answer to its question, the court of claims should have addressed, at the outset of its analysis, whether this case involved a regulatory restriction or a physical occupation. If the court had followed the proper approach, and in particular if it had had the benefit of the guidance provided in Tahoe-Sierra, it would have recognized that this case involves a regulatory restriction, not a physical occupation. Based on that conclusion it would have been required to apply the parcel as a whole rule. Because, under the parcel rule, the economic impact of the ESA regulations on claimants was, in the court's words, "de minimis," the basis for the court's finding of a taking would have evaporated.

Applying the governing standards, it is plain that this case involved a restriction on the use of private property, not a physical taking. First, the Court in Tahoe-Sierra described the distinction between physical occupations and regulatory restrictions by way of example. Thus, the Court said compensation is due under a physical occupation theory "when a leasehold is taken and the government occupies it for its own purposes." *Id.* at 1478-79, citing e.g., United States v. General Motors Corp., 323 U.S. 373 (1945). "Similarly," the Court said, "when the government appropriates part of a rooftop in order to provide cable TV access for apartment tenants, Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982), or when its planes use private airspace to approach a government airport, United States v. Causby, 328 U.S. 256 (1946)," physical-occupation theory applies. *Id.* at 1479. On the other hand, regulatory takings analysis applies, the Court said, to "a government regulation that merely prohibits landlords from evicting tenants unwilling to pay a higher rent, Block v. Hirsh, 256 U.S. 135 (1921); that bans certain private uses of a portion of an owner's property, Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926); Keystone Bituminous Coal Assn. v. DeBenedictis, 480 U.S. 470 (1987); or that forbids the private use of certain airspace, Penn Central Transp. Co. v.

New York City, 438 U.S. 104 (1978).” Id.

The ESA restrictions in this case were akin to the land use regulations in Keystone or the air space restrictions in Penn Central. The government regulation had the effect of barring the claimants from exploiting or using their water rights for their private economic benefit. On the other hand, the government action in this case was unlike the actual physical invasions of real property in Loretto and Causby. Neither government officials or agents of the government could reasonably be said to have “physically invaded” either the claimants’ alleged rights or the molecules of water to which they relate.

Other, more general considerations confirm the conclusion that this case involved a use restriction rather than a physical occupation. First, it makes no sense, given the usufructary nature of private rights in water, to think that restrictions on the exercise of such rights can effect a physical occupation. Use rights might conceivably be taken but they cannot be physically occupied.

Second, the Supreme Court said in Tahoe-Sierra that the physical occupation theory should be reserved for “easily identified” instances of physical occupation. The alleged taking in this case cannot, at a minimum, be easily identified as a physical taking. So this consideration too weighs in favor of treating this case as a traditional regulatory takings case.

Finally, the court of claims erred in relying on the Supreme Court decisions in International Paper Co v. United States, 282 U.S. 399 (1931), and other similar cases, such as Dugan v. Rank, 372 U.S. 609 (1963), United States v. Gerlach Live Stock Co., 339 U.S. 725 (1950), and Ivanhoe Irrigation Dist. v. McCracken, 357 U.S. 275 (1958), to support its per se physical occupation theory. See 49 Fed. Cl. at 319. These cases are all distinguishable from this case because they do not involve regulatory restrictions on the exercise of water rights. Rather, they involve the acquisition of water rights in connection with government water development projects, or the direct expropriation of rights in water by government. Thus, all of these cases “present [a] classi[c] taking in which the government appropriates property for its own use...., instead [of an] interference with property rights aris[ing] from some public program adjusting the benefits and burdens of economic life to promote the common good.” Tahoe-Sierra, 535 U.S. at 324-25.

In sum, the court of claims was plainly wrong to conclude that this case involved a physical occupation of private property appropriate for per se treatment under the Takings Clause.

## CONCLUSION

For a number of independent reasons, the liability ruling in Tulare Lake was wrong as a matter of law. If the court of claims had had the benefit of the Supreme Court’s guidance in Tahoe-Sierra when it made its decision, it almost certainly would have arrived at a different conclusion. The court of claims’ decision should have been reversed, not only to correct the

errors in this case, but to remove an erroneous and misleading precedent from the body of takings law. While the Bush administration's decision to settle the case postpones the day of reckoning, it cannot change the eventual outcome.