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Experiences of the Southern Pacific Company In Non-Public Carrier Contracts

By RICHARD J. LATHROP[†]

The necessity of railroads competing actively for its business has pushed most railroads into fields far removed from railroading as it has been pictured in novels and motion pictures. Eager to secure any income from its properties, the railroad not only is willing to listen to any proposal, but has designated employees to seek out opportunities for the economic development of its properties, whether or not related to railroading. Since Southern Pacific Company, for example, owns some 3,800,000 acres of land not presently used for railroad purposes, the variety of activities in which it finds itself is amazing.

Meeting the Contingent Liabilities

In preparing the contracts to cover these varied activities, it is important that expenses which may arise from such uses be anticipated as accurately as possible, in order intelligently to determine whether the proposal should be accepted or rejected. The current tendency to litigate any claim, and the publicity given to substantial judgments awarded by generous juries, make the contingency of liability for bodily injury or property damage an expense to be anticipated in any commercial situation. Such contingent liability should, then, be considered by all parties to the transaction and agreement reached by them as to its apportionment between them. To peer into the crystal ball to predict what hazards will arise in connection with the enterprise, to ascertain the intentions of the parties as to assumption of such hazards, to apply the proper legal principles to the situation, and to calculate the probable interpretation which will be made by the courts of the

[*] This article deals primarily with indemnity clauses but necessarily will include some discussion of exculpatory clauses. It is based on experiences of the Southern Pacific Company and is intended to indicate some of the considerations, legal and practical, used by counsel in drafting such clauses. The article is limited to discussion of contracts of the Company in its activities other than those of a common carrier, so that the principles might be generally applicable and not subject to restrictions and circumstances peculiar to common carriers.

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agreement drawn—this is the role of the contract attorney. Since Southern Pacific Company enters into contracts at a rate somewhat in excess of 1000 per month, our experiences have been many and varied. In a large number of these contracts, the railroad company is not acting as a common carrier, and so the rules applicable to it are no different from those encountered in general commercial practice.

Factors Used in Contract Formulation

We have found that many factors enter into the formulation of our contracts, and that these are by no means limited to application of legal principles, but nevertheless control the preparation of the contract. Economic and psychological factors often have as much weight in the determination of the contract phraseology as do the rules of law which can be brought to bear. It would serve little purpose to draw a contract which would clearly set forth all of the rights of your client if the other party would not sign it. While it is necessary to recognize the legal principles applicable to any situation, the economics will generally control, and often a choice of wording will determine whether the contract will be acceptable, even though the legal results from either wording would be the same.

We will, therefore, consider these factors, even though they cannot be supported by case citations. As a matter of fact, extensive citation of supporting and contradictory cases has not been considered appropriate to this article, for to the contract draftsman it should make little difference whether the weight of authority is on one side or the other. The weight of authority will shift from year to year and from jurisdiction to jurisdiction; hence the matter should be so drafted as to avoid the necessity for interpretation or litigation. While easy to state in such pontifical fashion, this goal, of course, is difficult to reach, for the matter readily agreed upon today may become highly argumentative tomorrow. The point is that in preparation of the contract, it is not sufficient to choose the wording that will be supported in the event of litigation—the litigation should be avoided.

Turning then to that contractual situation most frequently encountered by the railroad company apart from its common carrier activities, and where it is most important that the liability attendant upon the situation be specified by contract, let us see some of the factors which have developed our form of contract. The most common situation and that with which we are now dealing is the commercial lease; that is, where properties of the railroad not currently required for railroad use are rented to another for his commercial endeavors. The only interest of the railroad is in securing a return from property which otherwise

would be idle until required for railroad purposes, and in the meantime would require payment of property taxes.

We have mentioned that the first factor will be the intent of the parties and that ultimately this should govern. This oft-quoted aphorism is misleading in its simplicity. The lessor intends that he shall get a prescribed rental for use of his premises and that all else is the sole concern of the lessee; the lessee intends that for the rental he is paying he will receive premises guaranteed satisfactory for his intended use. There is nothing necessarily contradictory in these two intentions and they both may be preserved in the lease contract, but it is apparent that there is a considerable void here in which neither party has yet formulated any intention. If a customer of the lessee is injured and sues both lessor and lessee, should the lessee assume the entire expense incident to such injury? If so, then there must be some contractual provision shifting this expense from the lessor to the lessee, for in some cases the lessor will retain a responsibilty regardless of the fact that he has no longer any active control of the premises. If the lessor's employee is contributorily negligent, then the question arises as to what division of the responsibility should be made. If the lessor's employee is the sole cause of the injury, it is possible that the parties may intend a different allocation of the expenses. Seldom is any thought given to such detailed situations, yet in any specific instance the difference to either party may be measured in the hundreds of thousands of dollars. If the lessor is to be completely exonerated from expense incident to such accidents, then there must be a contractual provision shifting liability from one party to the other. It must be largely up to the attorney first to develop the intention of the parties, then to express the intent in the contract.

Exculpatory and Indemnity Clauses

If the lessee is to assume any of the liability which would be placed upon the lessor in the absence of agreement, the lease agreement should include an exculpatory and indemnity clause. For our contract purposes, it should be sufficient at this point to recognize the distinction between indemnification and exculpation, and consider that our indemnity clause will generally include exculpation. It has been stated that "the exculpatory clause deprives one of the contracting parties of his right to recover for damages suffered due to the negligent act of the other. The indemnity contract simply effects a change in the person who ultimately has to pay for the damages."[1] There would be some differences in the event of litigation, for different technicalities of interpreta-

[1] Annot., 175 A.L.R. 8, at 21 (1948).

tion might be applied. If the contractual provision is drawn to include the words "release and indemnify," the coverage should be sufficiently broad.

The matter of negligence and responsibility therefore is one of the most troublesome in negotiation of a contract which is intended to fix liability between the parties, shifting it from one to the other if this is necessary to meet their intentions. There is, of course, an instant reaction against the assumption of any responsibility for the negligence of another. From a practical standpoint there often should be no such objection.

Right-of-Way Contracts

The best example of this is in connection with another type of contract of which any railroad has hundreds. Extending through thousands of communities in the states through which it operates, the privately owned railroad right-of-way could easily become a Chinese wall blocking any movement across it. It therefore becomes necessary (often by statutory requirement) for the railroad to enter into agreements permitting, and to some extent controlling, the crossing of its right-of-way by other parties. Obviously such crossings are of no benefit to the railroad, but on the other hand constitute a real hazard to its normal operations. The other party has best control of the situation, for he may delay his crossing of the tracks with little or no difficulty, while it is manifestly impractical to bring a freight train to a stop in order to permit a farmer to drive across the tracks. It seems only equitable that the railroad in such a case should not be required to assume the risk for normal use of the crossing. Here is a situation in which a hazardous condition has been established upon railroad property (which was acquired partly to avoid just such hazard) entirely for the benefit of the other party and where such party has more control over the hazard than the railroad. It is to be anticipated in such a situation that if a lawsuit is based upon a crossing accident, negligence upon the part of the railroad will be alleged whether or not the other party has substantial evidence or any evidence at all to support such an allegation.

In order to provide any protection for the railroad company, then, the indemnification of the railroad company by the user should include any accidents even though there has been contributory negligence on the part of a railroad employee. In such cases, from a theoretical standpoint, it would be reasonable for the railroad to assume the risk of any accidents due to the sole negligence of its employees, but if such a provision were placed in the contract the net result would be a lease with no real contractual protection for the railroad company. The plaintiff

(or his insurance company) would in any such crossing case allege almost as a matter of course that the accident was solely caused by the negligence of the railroad employee in his failure to stop in time after becoming aware of the crossing user, or in failure to blow a whistle.

The railroad would then have two alternatives: to proceed to trial with the necessity of establishing negligence on the part of the plaintiff, or to settle the claim on the best terms available. This might not be objectionable, for at least the railroad could defend itself by proving negligence on the part of the other party. The situation is much worse, however, if there is a guest in the car who cannot be charged with the driver's negligence. In such a case, the railroad must be able to establish complete absence of negligence on its part, an almost impossible task in any crossing case. Unless the contract shifts to the crossing user all liability in connection with use of the crossing, whether or not there was negligence on the part of the railroad, the crossing will be largely at the risk of the railroad, even though it in no way benefits from the presence of the crossing and has no realistic control over its use.

Commercial Leases

The same holds true in the commercial lease situation, except only that the railroad receives some rental to offset the tax burden on the land. The use is by the lessee who derives the principal benefit from the lease and has the control of such use. Having determined that the parties intend that all risk incident to his use of the premises should be placed upon the lessee, that it is necessary to shift the burden by contractual provision, and that the provision should extend to the lessor's negligence, let us proceed to some of the factors that will determine the contract phraseology.

Since our intention as a lessor is to place *all* of the risk upon the lessee, it would seem that the simplest approach would be to state categorically that all the risk is on the lessee. A contract placing upon the lessee responsibility for damages on the leased premises "from any cause whatsoever" should certainly be about as broad as could be drawn. This very breadth defeats such phraseology, for the courts have held that the intention of the parties in such cases did not include any negligence on the part of the lessor, or the parties would have so specified.[2] There are many cases reaching this conclusion, with quite an assortment of reasons for reaching it, and quite a few fine distinctions made, most by way of dicta. It has been stated, for instance, that such general wording does not extend to "affirmative negligence" as in the

[2] Barkett v. Brucato, 122 Cal. App. 2d 264, 264 P.2d 978 (1953).

cited case, or to "active negligence"[3] and "gross" and "wilful" negligence generally seem to be excluded.

Generally, public policy is cited as being against excusing one from his own negligent conduct, with many references to "inciting carelessness," "public duty," and "relative bargaining power." The Restatement of Contracts suggests that a bargain for exemption from liability should be valid except as to gross or wilful negligence, unless there is an employer-employee relationship or one of the parties is charged with a duty of public service.[4] The courts have not yet evolved a clear position in the matter, and so from a contract standpoint we must conclude that the indemnity clause must clearly include negligence on the part of the indemnitee.

California courts apparently will follow what they state is the general rule: "[i]ntent to indemnify a party from the consequences of its own negligence must be expressed in clear and explicit words."[5] It has been held, however, that it is not necessary to make specific reference to negligence if the contract is clear.[6] In Oregon, some distinction has been made in extending the indemnity to cases of joint negligence, but not to sole negligence.[7] We are not here concerned with what results might be expected in litigation of the matter; suffice it to note that there has been considerable discussion of the point in law reviews and in annotations.[8]

Possibility of Insurance

Here we should mention a factor which in most cases will overcome the lessee's objection to the indemnity clause in the lease agreement, and to a degree should overcome the objection of public policy asserted to be against such a clause. It is only realistic to recognize that there is hazard attached to use of real property for any purpose whatsoever, and prudent to provide for meeting expenses arising from such hazards. Good business practice would be to insure against all such expense, accepting the premium for such insurance as a normal business expense. This practice is common enough that a standard Owner's, Landlord's and Tenant's Liability Policy is issued by many insurance carriers, which standard policy at present includes the risk assumed by the

[3] Butt v. Bertola, 110 Cal. App. 2d 128, 242 P.2d 32 (1952).

[4] RESTATEMENT, CONTRACTS §§ 575, 576 (1932).

[5] County of Alameda v. So. Pac. Co., 4 Cal. Rptr. 807 (1960) [hearing on appeal pending before Supreme Court]; Vinnel Co. v. Pac. Elec. Ry., 52 Cal. 2d 411, 340 P.2d 604 (1959).

[6] Harvey Machine Co. v. Hatzel & Buehler, 54 Cal. 2d . . ., 353 P.2d 924, 6 Cal. Reptr. 284 (1960).

[7] Booth-Kelly Lumber Co. v. So. Pac. Co., 183 F.2d 902 (9th Cir. 1950).

[8] See, *e.g.*, Annot. 175 A.L.R. 12 (1948).

indemnity clause we would include in the lease agreement. The practice of including the indemnity clause in the lease and taking out insurance against expense incurred thereby permits both parties to calculate their expenses in the transaction accurately. The premium may be adjusted to fit the hazards presented by the proposed use, and possible liabilities which would make the proposition unattractive to one party or the other are eliminated.

It is apparent that it is to the benefit of both parties that this insurance should be taken out by the lessee, with premiums paid by him directly. If the lessor should assume such expense, either through payment of the premium or through assumption of the risk directly by elimination of the indemnity clause, it would be necessary to increase the rent by enough to cover the premium, plus lessor's overhead in carrying this, plus taxes on the added amount. It is unfortunate that this insurance approach is so unfamiliar and so little used. A word of caution is in order as to the insurance policy itself. In many standard forms, the insurance is against damage arising from defined hazards and "caused by accident." Such wording excludes coverage for damage caused by improper operations of the tenant, which may or may not be acceptable. It generally is not difficult to secure an endorsement placing coverage on an "occurrence" basis rather than the "accident" basis. The broader coverage is desirable if there is little or no added premium cost.

Contracts With Governmental Bodies

In view of the increasing activity of all levels of governmental bodies, and their entry into more and more fields, it is not surprising that a large corporation should have a great number of contracts of various sorts with different governmental bodies. It is, however, somewhat surprising that, under our political philosophy which tends to deny or restrict special privileges to government, that there should be such a distinction between the terms expected by governmental bodies from others and those they are willing to grant to others.

This is most noticeable with respect to the use of indemnity clauses. It has become common practice to include an indemnity clause in a lease agreement, the lessee indemnifying the landlord against hazards arising from his tenancy. Most governmental agencies conform happily to this custom when they are in the landlord's position, but feel constrained to refuse any indemnification clause at all when they are the lessee.

We have been presented with what must surely be considered an extreme case in such dealings with a state agency—not in California. In this case the state agency desired to rent space to operate a liquor

store. The printed form submitted by the state not only required the lessor to guarantee that the proposed use would not be contrary to any property restrictions, which would be reasonable, but required the lessor to warrant that the operations of the lessee would not be in violation of any ordinance or statute, and further required the lessor to indemnify the lessee against any loss resulting from the existence of any such ordinances or statutes which might be violated by the lessee's operations. When we declined thus to indemnify the state against its own illegal acts, there was considerable consternation, since this was their lease form in general use for years, and it had never before been questioned. It should come as no surprise that when leasing its properties, that state requires that the lessee fully indemnify the state.

Claim of Legal Inability to Indemnify

The point here made is that in dealings with any governmental body, it is to be expected that it will claim a legal inability to make any indemnification. Generally, it is claimed that such a clause would be a gift of public money, or a loaning of public credit. For example, the California Constitution provides:[9]

> The Legislature shall have no power to give or to lend, or to authorize the giving or lending, of the credit of the state, or of any county, city and county, city, township or other political corporation or subdivision of the state now existing, or that may hereafter be established in aid of or to any person, association or corporation, whether municipal or otherwise, or to pledge the credit thereof, in any manner whatever. . . .

Also article XII, section 13, provides: "the state shall not in any manner loan its credit . . . ." And section 23007 of the Government Code provides that "except as specified in this article, a county shall not, in any manner, give or loan its credit to or in aid of any person or corporation. An indebtedness or liability incurred contrary to this article is void." Reference generally is made to the opinion expressed by the Attorney General where it was declared that a county could not execute an indemnity clause as it would be a loan of the county's credit.[10]

There has been considerable litigation on the validity of indemnity clauses executed by governmental agencies, with some divergence of opinion both in the results and in the reasoning by which the results were reached. As we above pointed out, from a contract standpoint, this is sufficient to dictate that the contract should be drawn without relying on the validity of such a clause, and we need not here consider what may be the majority rule, or the probable result in California. We

[9] CAL. CONST. art. IV, § 31.

[10] 6 OPS CAL. ATT'Y GEN. 41 (1945).

may note in passing, however, that the courts have often placed considerable weight on whether or not the clause could be extended to cover negligence on the part of the indemnitee, and if it could be so extended, it would be considered invalid. Courts have also given considerable weight to the fact that any recovery would be limited in amount or recovered only from a certain fund.

The safest course must be to consider that in the event of litigation, the indemnification clause would be no guarantee of success. Here again let us note that other factors may dictate the inclusion of such a clause, for it can do no harm to the indemnitee in the event of litigation, cases could be cited supporting the validity of such clauses, and presence of such a clause would probably be given much weight by a city council or other administrative body in determining the settlement of any claim against it.

Nature of Transaction

The distinction most often made in indemnity clauses executed by governmental bodies is based on the nature of the transaction in connection with which it was given. If the agency was acting in a governmental capacity, it is said, the constitutional proscriptions apply and the clause is invalid; but if the agency was acting in a proprietary capacity, then it is no better off than any other businessman.

The distinction between governmental and proprietary activities is so wavy in many cases as to make reliance upon this distinction somewhat hazardous. A more serious hazard, it would seem, is that no such distinction is made either in the constitutional provision or applicable statute. The constitutional proscription [11] is particularly strong, forbidding the giving or lending of the credit of the state or any county, city, township or other political subdivision in any manner whatever. If this is wrong because it may be a threat to the solvency of the public body, the threat is no less great because the threat was incurred in a business transaction. If anything, it would seem more reasonable for the political subdivision to stake its credit in support of its governmental actions. If the objection is that this may be a gift of public money, as forbidden by the second part of the constitutional provision, it would seem that value should be demanded just as much in connection with business activities as with governmental functions. In either case, public monies are to be affected.

Apparently, the conclusion to be reached from a contractual standpoint is that indemnification from a governmental body cannot conclusively be relied upon in the event of litigation, but nevertheless may

[11] See note 9 *supra.*

have some value short of litigation and even in the event of litigation could be supported by case citation. Application of appropriate technicalities of interpretation could well justify sustaining the validity of the indemnification. Insurance coverage would be the practical solution.

Psychology and the Wording of Clauses

In determining the precise wording to be included in an indemnity clause, the psychological factors may be even more important than the applicable rules of law. In the course of the development of indemnity clauses to be used in lease forms, we at one time concluded the clause with the words "regardless of any negligence on the part of the railroad." This wording met with such serious resistance that it seemed necessary to revise the clause.

Reviewing other forms that contained indemnity clauses, we found one that had been in use for several years which concluded with the words "regardless of any negligence or alleged negligence on the part of Railroad employees." Investigation developed that no objections had been received to this wording. As a matter of interest, we submitted this wording to several of those who had objected to the first phraseology, and it was accepted without protest. It would be difficult, if not impossible, to explain the reasoning which would lead anyone to accept the one wording and reject the other, for certainly there is no difference in the legal effect when the party to be exculpated from the consequences of its negligence is a corporation that can act only through its employees.

Since it is desirable to make it clear that the indemnity clause does include negligence on the part of the indemnitee, and use of the word "negligence" in the clause may make it objectionable despite its probable insurability, we presently are using in some such cases the wording "regardless of any act or omission on the part of Railroad employees." This seems clearly to include negligent acts or omissions, and does not seem to meet with the objections to which the other wording is subject.

In shifting the expenses of a tenancy from the landlord to the tenant, the principal concern is the cost and expense which the landlord may incur incident to the tenancy. This has led to the typical wording of the indemnity clause, covering "cost and expense" incurred by the indemnitee. Under such a clause, it is necessary for the indemnitee to pay the cost and expense before he can require the indemnitor to reimburse him. This is not as effective protection as it would be to have the indemnitor make the payment initially. In most cases, this can be accomplished by extending the indemnity clause to include liability incurred by the indemnitee. The indemnification will then be against

"liability, cost and expense" incurred by the indemnitee and arising from the transaction between the parties. This position seems to be rather generally established and accepted in most jurisdictions.[12]

The Insupportable Clause

Just as we have found that some contracts may be acceptable or objectionable depending sometimes upon the choice made between words having the same legal effect, so also do we often find it desirable to include in a contract some provisions which might not be supported by a court following the current weight of authority. It is obvious that case law will change from year to year, just as statutory law will, and it may well be that a controversial provision will develop into the deciding factor in settlement of a contract dispute. More important, it should be remembered that in all probability the contract will not be subjected to the interpretation of a court, but will serve as a reminder to both parties of what their intention was at the time the contract was entered into.

We are not, of course, speaking of any agreement which would be illegal or contrary to the intent of the parties, but rather a provision that expresses their intent within the law. Thus we may secure a full indemnification from a governmental body, realizing that in the event of litigation the court in applying the technicalities of public policy, pledging of public credit, and distinguishing between governmental and proprietary functions, may not give full force to the indemnification. Usually, the parties will arrive at a settlement without resorting to litigation, and the matter will be disposed of as the parties intended. The hazard here is not so much that litigation will be lost as that the client may rely fully on the contractual protection without any realization that there is a possibility of losing. This, of course, makes him no different from any other client, all of whom expect to prevail in any lawsuit.

Reflections and Conclusions

We have seen, then, that in the preparation of a contract which is designed to shift some liability from one of the contracting parties to the other, it will be necessary to include the indemnitee's sole and contributory negligence by clear reference, preferably with a requirement that the contractual liability be insured, and with a recognition that in view of the many technicalities involved there may be difficulty in sustaining some provisions in the event litigation makes it necessary

[12] 27 AM. JUR. *Indemnity* § 20 *et seq.* (1939).

for a court to interpret the intentions of the parties.

The contract draftsman will, of course, realize that in many cases the parties will not agree upon the complete indemnification we have discussed, and that for any of the economic, psychological or legal reasons we have mentioned they will prefer to stop short of that coverage. The most frequent modification we have encountered relates to negligence, and is required by the refusal of the indemnitor to assume any responsibility for the sole negligence of the indemnitee. In such a case, we have found the most acceptable phrasing to be to conclude the indemnity clause with the words "except when due to the sole negligence of" the indemnitee. The only reference to negligence being in the exclusion, the question may be raised whether the parties intended to include any negligence by the indemnitee, but it would seem clearly indicated that the parties were contemplating the effects of negligence and intentionally excluded only *sole* negligence, thus necessarily retaining coverage for joint negligence. We know of no judicial interpretation of this precise point, but feel it should be upheld. At any rate, it has been found acceptable from the standpoint of negotiations, and attorneys on both sides have agreed in our interpretation.

Other modifications may be required by individual factual situations. It may be, also, that the circumstances will dictate use of an exculpatory clause only, without full indemnification. This coverage will be rather restricted, limited as it is to a release of one of the parties by the other.

In this particular field of the law, we must conclude that it is necessary to be as specific as is possible in dealing with future situations, keeping abreast of the constantly changing rules of interpretation developed by our courts.

As a matter of interest, we set out in conclusion the indemnity clause presently used in our commercial leases. This is by no means a model contractual provision, for its development has been influenced greatly by some of the factors other than legal to which reference has been made. Further changes will be made, and in fact some are now being contemplated. Like the government, a large corporation must move through established channels, with the obvious delays resulting.

The clause reads:

> Lessee agrees to release and indemnify Railroad from and against all liability, cost and expense for loss of or damage to property and for injury to or deaths of persons (including, but not limited to the propperty and employees of each party hereto), when arising or resulting from:
>
> (a) The use of said premises by Lessee, its agents, employees or invitees, or

(b) breach of the provisions of this lease by Lessee

whether or not caused or contributed to by any act or omission of Railroad, its employees, agents, contractors, subcontractors or their employees or agents, or any other person.

Lessee, upon request, will provide Railroad with certified copies of insurance in form and amounts satisfactory to Railroad, insuring the liability of Lessee under this agreement.