BELOW THE TRACKS

California land grant case alters the scope of railroad subsurface rights

BY MICHAEL F. KERR AND NEIL M. SOLTMAN

When the United States Congress granted land to railroads in the 1800s, it was to encourage the building of the transcontinental railroads. In November 2014, a California appellate court held that railroad companies cannot charge rent for subsurface uses on rights of way where the title claimed by the railroad is derived from those 19th century land grants. The decision in Union Pacific Railroad Co. v. Santa Fe Pacific Pipelines, Inc., 231 Cal. App. 4th 134, 180 Cal. Rptr. 3d 173 (2014) (petition for California Supreme Court review denied January 21, 2015), has potentially far-reaching implications for both railroads and their tenants in the West.

Rent Determination

The case began with a trial to determine the fair market rent payable for the 10-year period beginning in January 2004, under an easement agreement between the railroad and the petroleum pipeline company. The suit involved an oil pipeline system more than 3,000 miles in length, which included about 1,850 miles of subsurface pipeline easements located within Union Pacific rights of way in six western states. The pipeline company moved for judgment on the grounds that the railroad had failed

> “On appeal, the Second District of the California Court of Appeal disagreed...and reversed the $100 million judgment for back rent.”

to prove that it owned the property through which the easements and pipeline ran, even though the easement agreement only required payment for easements within the “property of the railroad.” The trial court conceded that the railroad had not offered “direct evidence of its title,” but nevertheless concluded that the railroad’s ownership had “been adequately shown for purposes of this proceeding.”

The Appeal

On appeal, the Second District of the California Court of Appeal disagreed, based on a lengthy analysis of both federal and state case law discussing 19th century congressional land grants to railroads, and reversed the $100 million judgment for back rent. The court noted that public land had been “allocated to the railroads by the federal government for a specific purpose—to construct and operate a transcontinental railroad, in order to help protect the nation during civil strife, to expand its frontier, grow its economy, and develop its future.”

In this context, the court analyzed the General Railroad Right-of-Way Act of 1875 and concluded that “the railroad’s rights to the land underneath its rights of way granted by the 1875 Act were limited to what was necessary to support the railroad itself,” and that the right to rent the subsurface through which the pipeline ran was unnecessary to support the railroad and thus not a railroad purpose. It therefore was not considered the property of the railroad.

The court then reached the same result under congressional land grants prior to 1875, noting that “[r]enting out the subsurface to a third party from a different industry for private gain cannot reasonably be considered a railroad purpose” within the meaning of those earlier grants. The court ordered that the case be remanded so the trial court could identify those portions of the right of way where the railroad held a property interest sufficient to grant the pipeline an easement, and to calculate the fair market rent due just for those portions.

A Changed Relationship

This decision is likely to significantly affect the relationships between railroads and their subsurface tenants on rights of way that were originally granted by the federal government, particularly in the western part of the country. This is because, as the 20th century progressed and many railroads began to lose portions of their shipping business to other means of transportation, they sought to compensate for it by seeking other sources of revenue. For example, in the case under discussion, the predecessor railroad to Union Pacific had created the petroleum pipeline company in the 1950s as a means of competing with petroleum tanker trucks, the operating cost of which had decreased due to the new interstate highway system. (Union Pacific and the pipeline are no longer related entities, and the current appellate case stems from a rent determination proceeding called for by the settlement of a prior lawsuit.) The railroads were understandably concerned by the potential loss of revenue from such competitive developments and sought alternatives.

One such alternative was to rent out the subsurface of the railroad rights of way. As time went on and the density of urban development continued to increase (thus limiting the alternatives), the subsurface areas of many railroad rights of way began to fill up with pipelines, electric and gas utilities and other subterranean occupants that could afford to pay rent to the railroads. The rent is often not cheap and now forms a substantial part of the revenue of some railroads. Generally, the railroads calculate the rent by using an appraisal method that they developed known as across-the-fence (ATF).

The ATF methodology estimates fair market rental value for railroad rights of way based in part on the estimated value of the land. In making this estimate, the ATF appraisers working for the railroads have typically assumed that the railroads owned a full fee interest, or “fee equivalent,” in their rights of way, including on congressional grant lands. In addition, they have assigned an “enhancement factor” based on the supposed contiguity of the railroad’s right of way property, thereby increasing its appraised value. These assumptions of fee title and contiguity may no longer be justified in many locations in light of the Union Pacific case, which could call into question the usefulness of the entire ATF methodology.

The case assessed the scope of the rights granted to railroad companies by the U.S. Congress in the 19th century. The land grants, which were meant to encourage the building of transcontinental railroad lines, came with strings attached.

The Result

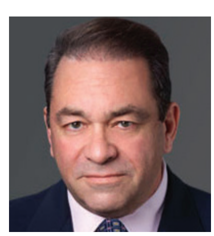
From the perspective of the railroads, at a minimum there will now be much greater scrutiny applied to the nature of a particular railroad's title in locations where the railroad is seeking to grant licenses or easements within its rights of way. This in turn may result in much lengthier and more complex rent negotiations with current and prospective subsurface tenants and/or lawsuits resembling the Union Pacific case itself. As mentioned previously, the efficacy of the railroads' preferred ATF appraisal methodology may also be called into question, since it is based on an assumption of full fee title. Of course, in many locations a particular railroad may indeed own a full fee interest in its right of way, allowing it to continue to do largely as it pleases with the subsurface.

For the subsurface tenants and prospective tenants, in addition to the potential effect on the fair market rental value of the subsurface, there is also the issue of whether they can obtain a sufficient property interest to withstand challenges to their right to occupy the property. This uncertainty raises several possible issues. One is that the subsurface tenant may wish to seek permission from the underlying landowner, meaning the owner of any remaining property interest that was not transferred to the railroad by the congressional grant. Another is that the tenant or prospective tenant may wish to explore whether it has a condemnation option, allowing it to establish a clear, permanent right to its presence in the right of way. A third consideration is that an entity contemplating a new longitudinal subsurface encroachment on a railroad right of way, such as a pipeline, may well find that there are now more attractive options that present fewer title problems. For example, even today railroad rights of way in many areas are surrounded by government land, such as the federal land overseen by the Bureau of Land Management. This alternative will present few if any title issues and is likely to be cheaper to rent than railroad land.

The one certainty that does exist is that this case is bound to have a profound effect on the relationships between the railroads and their subsurface tenants. ✪

A version of this article was originally published in the January 2015 issue of Law360.

Michael F. Kerr



Neil M. Soltman

The authors are partners at Mayer Brown LLP who handle complex civil trials and appeals. Both have 20 years of experience litigating issues pertaining to railroad rights of way and easements, both in trial and on appeal. They represented the pipeline company in the case described in this article.