



January 1951

Negotiable Instruments

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Recommended Citation

Rufus S. Garrett, *Negotiable Instruments*, 5 Sw L.J. 318 (1951)
<https://scholar.smu.edu/smulr/vol5/iss3/9>

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NEGOTIABLE INSTRUMENTS

GOOD FAITH UNDER THE UNIFORM WAREHOUSE
RECEIPTS ACT

Arkansas. A holder in due course of an instrument covered by the Negotiable Instruments Law must have taken that instrument in *good faith*.¹ Similarly, one to whom a warehouse receipt covered by the Uniform Warehouse Receipts Act has been duly negotiated acquires thereby such title to the goods as his transferor had ability to convey to a purchaser in *good faith*.² In determining what amounts to good faith the courts are not in accord.

Although the individual cases contain ramifications dealing with constructive notice and burden of proof, out of the tests the courts have proposed emerge two main theories, which may be considered as the *rule of negligence* and the *rule of honesty*. Apparently the conflict between them is bottomed upon the reluctance of the courts to depart from the common law test of a bona fide purchaser³ save in the field of commercial paper under the law merchant and the express provisions of modern statutes.

With respect to bills and notes, the test to determine what is good faith under the Negotiable Instruments Law is now plain. According to the vast majority rule, the test is one of honesty rather than negligence.⁴ Only two states retain the rule of negligence.⁵

¹ N. I. L. § 52(3); ARK. STAT. 1947 ANN. § 68-152(3); LA. GEN. STAT. (Dart, 1939) § 841; N. M. STAT. 1941 ANN. § 53-152; 48 OKLA. STAT. ANN. (Perm. Ed.) § 122; TEX. REV. CIV. STAT. (Vernon, 1948) art. 5935(52).

² U. W. R. A. § 41; ARK. STAT. 1947 ANN. § 68-1241; LA. GEN. STAT. (Dart, 1939) § 9899; N. M. STAT. 1941 ANN. § 53-841; 81 OKLA. STAT. ANN. (Perm. Ed.) § 341; TEX. REV. CIV. STAT. (Vernon, 1948) art. 5652.

³ The common law test of good faith in determining who is a bona fide purchaser of property or non-commercial paper contemplates the presence or lack of due diligence in the purchaser; that is to say, to charge him with constructive notice, the circumstances relied upon to put him on inquiry must be such as would naturally raise a suspicion in the mind of an ordinarily prudent man and necessitate an inquiry. 27 R. C. L., *Vendor and Purchaser*, § 475, p. 711.

⁴ *Holland Banking Co. v. Booth*, 121 Ark. 171, 180 S. W. 978 (1915); *Sharp v. Dunlap*, 176 Okla. 329, 55 P. 2d 971 (1936); *Quanah, A. & P. Ry. Co. v. Wichita State Bank & Trust Co.*, 127 Tex. 407, 93 S. W. 2d 701 (1936); see 10 C. J. S., *Bills and Notes*, § 324, p. 818; 6 TEX. JUR., *Bills and Notes*, § 93, p. 170.

⁵ *Bank of Commerce of Summerville v. Knowles*, 32 Ga. App. 800, 124 S. E. 910 (1924); *Boxell v. Bright Nat. Bank of Flora*, 184 Ind. 631, 112 N. E. 3 (1916).

On the other hand, the test under the more recent Uniform Warehouse Receipts Act is far from settled. One of the first cases determining good faith of a purchaser under this act made use of the rule of negligence.⁶ However, another case followed the rule of honesty, and while in that case the court admitted it could be said that defendant was negligent in taking the receipts without investigation, it was held there was no evidence that he acted dishonestly or in bad faith.⁷

In a recent decision the Supreme Court of Arkansas met the problem of which of the two tests should be applied. The case of *Grauman v. Jackson*⁸ involved a contest between the purchaser for value of a negotiable warehouse receipt for cotton and a landlord who asserted the statutory landlord's lien.

The landlord held his tenant's note for rent, money and supplies to be advanced for making a crop. The tenant was allowed to gin cotton in his own name and deposit it in a warehouse, where he took a negotiable bearer warehouse receipt, likewise in his own name. The purchaser of this receipt made no investigation of the tenant's title other than to inquire if any one else had an interest in the cotton. The reply was in the negative. The tenant left the state without paying his debt to the landlord.

After disposing of matters relating to the improper execution and filing of a deed of trust securing the tenant's note, and holding that the Uniform Warehouse Receipts Act changed in part pre-existing Arkansas law on the landlord's lien, the court arrived at the inquiry as to whether purchase of this receipt was made in good faith.

The court acknowledged that authority on the question was scant, and in examining two previous cases⁹ expressed approval of a Tennessee decision which stated that the test of notice imposed by the Uniform Warehouse Receipts Act is the same as that imposed by Section 56 of the Negotiable Instruments Law,¹⁰ *i.e.*, the rule of honesty.

⁶ *City Nat. Bank of Decatur v. Nelson*, 218 Ala. 90, 117 So. 681 (1928).

⁷ *Starkey v. Nixon*, 151 Tenn. 637, 270 S. W. 980 (1925).

⁸ 216 Ark. 362, 225 S. W. 2d 678 (1950).

⁹ Cited *supra* notes 6 and 7.

¹⁰ "To constitute notice of an infirmity in the instrument or defect in the title of

To sustain this view the court in the *Grauman* case pointed to the plain wording of the Uniform Warehouse Receipts Act: "A thing is done in good faith within the meaning of this act, when it is done honestly, whether it be done negligently or not."¹¹ In the opinion of the court, this language clearly indicates that the draftsmen of an act which made warehouse receipts negotiable must have intended to give the purchasers of such instruments the same protection that exists in the case of bills and notes. Also, heavy emphasis was placed upon the dissent of two justices in a contrary Alabama case,¹² wherein it is stated that the obvious purpose of Section 58¹³ of the Uniform Warehouse Receipts Act was to adopt the rule of negotiable instruments in general, that is to say, the rule of honesty as opposed to the rule of negligence.

It is suggested that the view taken by the Arkansas court will prevail, inasmuch as there appears no reason why under the two uniform laws the same rule to determine good faith of purchasers should not apply.

Jim Hambright.

OIL AND GAS

*Arkansas. Bodcaw Oil Co. v. Atlantic Refining Co.*¹ involved a dispute over the meaning and effect of an agreement by a lessor to allow a lessee to use an abandoned well on one tract in a field for injection of salt water to enhance production from adjacent tracts under lease from lessor to the same lessee. The agreement,

the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to bad faith." N. I. L. § 56; ARK. STAT. 1947 ANN. § 68-156; LA. GEN. STAT. (Dart, 1939) § 845; N. M. STAT. 1941 ANN. § 54-156; 48 OKLA. STAT. ANN. (Perm. Ed.) § 126; TEX. REV. CIV. STAT. (Vernon, 1948) art. 5935(56).

¹¹ U. W. R. A. § 58(2); ARK. STAT. 1947 ANN. § 68-1258(2); LA. GEN. STAT. (Dart, 1939) § 9916; N. M. STAT. 1941 ANN. § 53-858; 81 OKLA. STAT. ANN. (Perm. Ed.) § 383; TEX. REV. CIV. STAT. (Vernon, 1948) art. 5664.

¹² Cited *supra* note 6.

¹³ Statutes cited *supra* note 11.

¹Ark....., 228 S. W. 2d 626 (1950), noted, 20 Tex. L. Rev. 555 (1950).

made when the lease on the tract in question was about to expire, provided that the lease should remain in full force and effect so long as there was production from the adjacent tracts. This agreement was held to be supported by valid consideration (mutual benefit and mutual promises). The contention of plaintiff that there was an abandonment of the lease due to absence of further development, made despite language in the contract making unnecessary further development to keep the lease in force, was overruled by the court. The court looked to the purpose of the agreement and, finding that the activities of defendant were in conformance with it, refused to give effect to contentions by plaintiff contrary to the evident intent of the parties at the time the contract was made. The court did not pass on the interesting contention that the owner of the mineral estate only had no authority to grant the right to inject salt water through an abandoned well, disposing of this argument on other grounds.

In *Dobson v. Arkansas Oil and Gas Commission*² the court held that compulsory unitization of a petroleum reservoir (the McKemie-Patton field) by order of the Oil and Gas Commission was not authorized by Arkansas law. However, persons at whose suit the unitization was declared invalid were not permitted to recover royalties on the full amount of production from their tracts, where these tracts had been given increased allowables for the wells thereon due to the unitization. The absence of statutory authority for compulsory unitization was remedied by the Arkansas Legislature soon after this case was decided.³

In *Johnson v. Lion Oil Co.*⁴ joint adventurers were held to owe each other the duty of the finest loyalty. Plaintiffs agreed to drill oil wells on a certain tract in return for a one-half interest in the leasehold estate. Plaintiffs and defendants then entered into a joint venture, defendants undertaking half the responsibility for drilling the wells in return for a one-fourth interest in the leasehold. Production was obtained, and defendants, without notice to

² _____ Ark. _____, 235 S. W. 2d 33 (1950), noted in 14 Tex. B. J. 235 (1951) and 29 Tex. L. Rev. 852 (1951).

³ Ark. Acts 1951, No. 134.

⁴ 216 Ark. 736, 227 S. W. 2d 162 (1950).

plaintiffs, purchased the outstanding one-half leasehold interest. In holding that plaintiffs were entitled to participate in the purchase and that failure to afford them the opportunity was a breach of duty by their joint adventurers, the court adopted the following language of Justice Cardozo in *Meinhard v. Salmon*:⁵

“Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”

Temporary cessation of production is not sufficient ground for declaring that an oil and gas lease has terminated under the rule announced in *Reynolds v. McNeill*.⁶ Under a lease for a term of six months and as long thereafter as oil or gas was produced in paying quantities, lessee drilled a well which the court found to have been a commercial producer. Production declined to the extent that it was no longer in paying quantities, and lessee began reworking operations. The chancery court refused to declare a termination of the lease at the suit of the lessor but granted lessee an additional sixty days of grace in which to resume production in paying quantities. The rule applied in the case is in accord with that in most other jurisdictions.⁷

Louisiana. A survey of 1950 Louisiana legislation and of important decisions concerning oil and gas may be found in an article in the *Louisiana Law Review*.⁸

The case of *McMurrey v. Gray*,⁹ which concerns the interrup-

⁵ 249 N. Y. 458, 164 N. E. 545, 546 (1928).

⁶ Ark., 236 S. W. 2d 723 (1951).

⁷ *Wilson v. Holm*, 164 Kan. 229, 188 P. 2d 899 (1948); *Scarborough v. New Domain Oil & Gas Co.*, 276 S. W. 331 (Tex. Civ. App. 1925); 2 SUMMERS, *THE LAW OF OIL AND GAS* (Perm. Ed. 1938) § 305.

⁸ Dagggett, *Work of the Supreme Court—Mineral Rights*, 11 La. L. Rev. 157 (1951). Cases discussed in this article include *Union Sulphur Company v. Andrau*, 217 La. 662, 47 So. 2d 38 (1950); *Hunter Company v. Vaughn*, 217 La. 459, 46 So. 2d 735 (1950); *Liberty Farms Inc. v. Miller*, 216 La. 1023, 45 So. 2d 610 (1950); *Wier v. Glassell*, 216 La. 828, 44 So. 2d 882 (1950); *Davidson v. Bolton*, 216 La. 677, 44 So. 2d 700 (1950).

⁹ 216 La. 904, 45 So. 2d 73 (1949).

tion of prescription *liberandi causa* of a mineral estate by drilling operations, is discussed in a Note in 11 *Louisiana Law Review* 378 (1951).

In *Atlantic Refining Co. v. Shell Oil Co.*¹⁰ an oil and gas lease was held to have terminated where the lessee mistakenly paid one-half of the delay rentals to an assignee of half of the minerals under the land who was not, under the terms of his assignment from the lessor, entitled to participate in such payments. The case involves the interesting question of the effect of a deletion in a printed form where the abstract relied on fails to show the deletion.

*Romero v. Humble Oil & Refining Co.*¹¹ involved an attempt by a lessor to have a lease terminated for failure by the lessee to fulfill his implied covenant of reasonable development.¹² In this case the lessor found an operator who was ready to drill a well on the lease while the lessee and sublessee consistently refused to conduct further drilling operations. Despite the fact that there was considerable doubt as to the advisability of conducting further drilling operations in view of past failures,¹³ the willingness of another operator to drill apparently convinced the court that the usual test of reasonable development—whether or not a reasonable and prudent operator would have carried on drilling operations¹⁴—should not be applied. The court apparently based its decision on a “public policy” that potential oil property should not remain undeveloped, and held that the lease would be cancelled unless the lessee commenced additional development within a reasonable time.

¹⁰ 217 La. 576, 46 So. 2d 907 (1950), noted, 13 Tex. B. J. 564 (1950).

¹¹ 93 F. Supp. 117 (E. D. La. 1950), noted, 29 Tex. L. Rev. 851 (1951).

¹² *Morley v. Berg*,Ark....., 235 S. W. 2d 873 (1951), includes a statement of the rule that an oil and gas lessor may declare a forfeiture if the lessee fails to develop the leasehold with a view to the best interests of both parties. A majority of the states hold that forfeiture of the leasehold is a proper remedy for breach of this implied covenant. See MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES (2d Ed. 1940) § 160.

¹³ Two dry holes and one gas condensate had been drilled on the 876-acre tract involved. Defendant relied on testimony of three experienced geologists, who were familiar with the field, that a reasonably prudent operator would not drill.

¹⁴ *Senter v. Shanafelt*, 233 S. W. 2d 202 (Tex. Civ. App. 1950); see 2 SUMMERS, THE LAW OF OIL AND GAS (Perm. Ed. 1938) § 416.

In *Texas Co. v. State Mineral Board*¹⁵ it was held that the obligation to pay delay rentals on tidelands leased from the State of Louisiana was not suspended by the controversy over ownership of the lands between the State and the Federal Government.

New Mexico. The definition of royalty by the Texas courts¹⁶ was adopted by the New Mexico Supreme Court in *Duvall v. Stone*.¹⁷ The court held that royalty retained by a grantor of lands is perpetual unless clearly and expressly limited. A retention of "one-half of the one-eighth royalty interest" covered only a non-participating royalty interest, and the grantee was held to own the exclusive leasing rights and the exclusive right to bonuses and delay rentals. However, the court indicated that no lease by the grantee could deprive grantor of his right to the one-half of one-eighth royalty interest reserved.

Oklahoma. In the case of *Champlin Refining Co. v. United States*¹⁸ it was held that a pipeline company that carries only its own petroleum products is not a common carrier and hence is not subject to federal regulations¹⁹ requiring common carriers to construct receiving and delivery facilities and to carry petroleum products of others for hire.

In *Cities Service Gas Co. v. Peerless Oil and Gas Co.*²⁰ the Supreme Court of the United States upheld an order of the Oklahoma Corporation Commission requiring pipeline owners to pay a minimum price for gas produced in a field (to prevent physical and economic waste of gas due to extremely low field prices) and to take ratably from its own wells and those of producers without pipeline outlets. The Supreme Court held that the slight impact of the State regulation on interstate commerce was insufficient ground for declaring it invalid and that there was no harm to the national interest. The order was within the State's police power

¹⁵ 216 La. 742, 44 So. 2d 841 (1949), noted, 13 Tex. B. J. 295 (1950).

¹⁶ Schlittler v. Smith, 128 Tex. 628, 101 S. W. 2d 543, 544 (1937).

¹⁷ 54 N. M. 27, 213 P. 2d 212 (1949).

¹⁸ 95 F. Supp. 170 (W. D. Okla. 1950), noted, 13 Tex. B. J. 463 (1950), *modified and aff'd*, 341 U. S. 290 (1951).

¹⁹ 49 U. S. C. 1946 ed. §§ 1, 6, 20 (¶s 1-4, 8).

²⁰ 340 U. S. 179 (1950), noted, 14 Tex. B. J. (1951), *aff'g*Okla....., 220 P. 2d 279 (1950).

since it had a reasonable relation to a legitimate end—the elimination of waste entailed by the existing low field prices.

In the companion case of *Phillips Petroleum Co. v. State of Oklahoma*²¹ the same order of the Corporation Commission was upheld in its application to a pipeline company that was not purchasing from other producers in the field. Basis for the decision was that the order would have been ineffective unless the Commission had been able to regulate all operations in the common reservoir.

Texas. In *Big Three Welding Equipment Co. v. Crutcher, Rolfs, Cummings, Inc.*,²² it was held that the dismantling of part of a pipeline, hauling the pipe to storage yards, reconditioning it and loading it aboard cars was not “operation or maintenance” as those terms are used in the statutes²³ providing for liens of contractors and subcontractors for certain services performed on mineral property.

A lot across the street from a tract described in an oil and gas lease was held to be contiguous and covered by the “Mother Hubbard” clause in the lease in the case of *Gardner v. Amerada Petroleum Corp.*²⁴

One of the most interesting cases decided during 1950 by the Texas courts was that of *Hastings Oil Co. v. Texas Company*.²⁵ In this case adjacent lessees were involved in a dispute over the possibility that there was a subsurface trespass by one on the lease of the other due to possible deviation of an offsetting well from the vertical. Plaintiff claimed that defendant’s well was bot-tomed on the lease of plaintiff. It was held that the trial court had authority to grant a temporary injunction and to order a directional survey of defendant’s well by a qualified impartial expert. The trial court also had the authority to require defendant to co-operate with the expert and allow him to use defendant’s rig and

²¹ 340 U. S. 190 (1950).

²² Tex., 229 S. W. 2d 600 (1950), noted in 13 Tex. B. J. 514 (1950) and 29 Tex. L. Rev. 266 (1950).

²³ TEX. REV. CIV. STAT. (Vernon, 1948) arts. 5473, 5474.

²⁴ 91 F. Supp. 134 (S. D. Tex. 1950).

²⁵ Tex., 234 S. W. 2d 389 (1950), noted, 14 Tex. B. J. 27 (1951), *aff'g* 227 S. W. 2d 317 (Tex. Civ. App. 1950), noted, 13 Tex. B. J. 154 (1950).

other equipment, which would be necessary in making the survey. The supreme court justified this action under the discovery rule. While it was stated that Texas courts have no power to originate new methods of enabling parties to secure evidence, provision in Rule 737, Texas Rules of Civil Procedure, for relief by bill of discovery "in accordance with the usages of courts of equity" was held to authorize the action taken by the trial court. Because the case was unusual on its facts, the court drew analogy to other cases in which the courts had allowed inspection of real property, or appointed surveyors to go upon premises involved in trespass to try title suits. The injunction was justified, despite alleged violations of Article 4644, *Texas Revised Civil Statutes* (Vernon; 1948), on the ground that there was a claim of subsurface trespass rather than injury due to wrongful drainage or surface nuisance.

Liability for payment of delay rentals to the State during the pendency of the controversy with the Federal Government over ownership of the tidelands was found not to exist as to lessees of the lands involved.²⁶

In *West v. Continental Oil Co.*²⁷ it was held that continued production from a well drilled under an old oil and gas lease which had been cancelled was sufficient to keep a new lease in force without other drilling or payment of delay rentals. This conclusion was reached despite the fact that the new lease contained the usual "unless" clause providing for termination of the lease in the absence of drilling within one year or payment of delay rentals.

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²⁶ *Ohio Oil Co. v. Giles*,Tex....., 235 S. W. 2d 630 (1950), noted, 15 Tex. B. J. 85 (1951).

²⁷ 91 F. Supp. 505 (S. D. Tex. 1950), noted, 13 Tex. B. J. 564 (1950).