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Institute Examination in Law

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[The following answers to the questions set by the board of examiners of the American Institute of Accountants at the examinations of November, 1927, have been prepared at the request of The Journal of Accountancy. These answers have not been reviewed by the board of examiners and are in no way official. They represent merely the personal opinions of the author.—*Editor*, The Journal of Accountancy.]

EXAMINATION IN COMMERCIAL LAW

November 18, 1927, 9 A. M. to 12:30 P. M.

Answer no more than ten questions as directed
Give reasons for all answers

NEGOTIABLE INSTRUMENTS

Answer three questions

No. 1.

Boston, Mass.
January 2, 1927.

Ninety days after date I promise to pay to the order of X. Y. five hundred dollars with interest.

(Signed) John Doe
by A. B.
Attorney-in-fact.

Endorsed in blank "without recourse," X. Y.

The above note passes in due course to William Smith. The note being unpaid at maturity Smith sues. John Doe is not liable as maker because A. B. had no authority to sign as agent or attorney-in-fact. X. Y. interposes the defense that he is not liable as he endorsed "without recourse." Is such defense good?

Answer:

The negotiable-instruments act provides that every person negotiating an instrument by qualified endorsement warrants that the instrument is genuine and in all respects what it purports to be. It would appear that this instrument is not what it purports to be in that it is not signed by John Doe through an attorney who had authority to sign, so that X. Y. could be held on the warranty even though he endorsed "without recourse." It appears, therefore, that the defense is not good. The writer, however, has found no decisions precisely in point under the negotiable-instruments act.

No. 2. On December 1, 1910, A gives to B the following instrument:

January 30, 1911, after date I promise to pay to B four hundred dollars at 25 Broad St., New York, N. Y.

(Signed) A.

B endorsed the instrument to X before maturity for value. A, the maker, did not pay on the due date and defended suit by X on the ground of lack of consideration. Could X recover?

Answer:

X could not recover if there was no consideration. The note is not negotiable because not payable to order or to bearer. Therefore X is only an assignee and the defense of lack of consideration may be made as it might against B.

No. 3. Jones, a farmer, owed Smith a sum of money for feed and seeds purchased. Jones, together with his wife, gave a promissory note to Smith for the amount of the debt. In a suit by Smith, the note having been dishonored at maturity, Mrs. Jones defended on the ground that as she was not liable for the goods, the note was without consideration as to her. Was the defense good?

Answer:

In jurisdictions where the disability of a wife to become an accommodation party to a note given by the husband for his debt has been removed by statute the wife would be liable as an accommodation party in spite of the fact that the note was without consideration as to her. Under the negotiable-instruments law Smith would be a holder for value, and an accommodation party is under that law made liable to such a party even though the holder for value knew the accommodation party to be such at the time he took the instrument.

No. 4. By whom must payment of a negotiable instrument be made in order to extinguish it?

Answer:

The negotiable-instruments law provides that a negotiabl einstrument is discharged by payment in due course by or on behalf of the principal debtor, or by payment in due course by the party accommodated, where the instrument is made or accepted for accommodation.

CONTRACTS

Answer two questions

No. 5. A hires an automobile from the Drive-Yur-Self Auto Co. at $1.00 an hour. Through no fault of A the car is damaged in collision with B. Is A liable to the renting corporation? Is B liable to A or to the corporation?

Answer:

A is not liable to the renting corporation. A bailee is not liable for damage to the object of bailment unless he has been negligent. It can not be told from the question whether B is liable to A or to the corporation, because there is no statement as to whether or not B is negligent.

No. 6. Doran, by a written contract, agreed to sell to Best 200 drums of acid of certain specifications, at the rate of 2 drums per diem, title to pass upon delivery. After delivery the acid was to be sampled and tested and the price fixed according to daily market quotations. Best sold his business, including the contract with Doran, to Trimble, but Doran refused to make deliveries to Trimble who thereupon sued Doran for damages. Is Doran liable?

Answer:

This contract is sufficiently certain to be valid since a means is provided for fixing the contract price by reference to the market price. The contract right to receive the acid is assignable and Doran is liable to Trimble for breach of the contract. As the damages would ordinarily be the difference between the contract price and market price and they are the same in this case, it is hard to see how any damages could be recovered.

No. 7. What are general damages and what are special damages for breach of contract of sale?

Answer:

General damages recoverable by the buyer for breach of a contract of sale if the price has not been paid is the market value of the subject matter less the price agreed to be paid, and if the price has been paid in advance its market value, because by reasonable diligence the subject matter may be obtained by the buyer in the market at its market value.

Where the contract is for the sale of a commodity or article which can not be obtained in the general market, a different rule is applied. In such case the buyer can recover special damages which are based on the value of the article to the buyer. Where material or supplies are purchased by the buyer to be used for the purpose of running his manufacturing plant, and such fact is known to the seller, and on account of the non-delivery the buyer is unable to run his plant, the value of the use of the plant while it necessarily remains idle has been held recoverable as special damages. If the seller has knowledge that the purchase is made by the buyer to enable him to fill contracts of resale with third persons, the loss of profits on the resale because of the seller's failure to deliver is recoverable by the buyer as special damages.

CORPORATIONS

Answer both questions

No. 8. A banking corporation had a charter giving its board of directors power to alter or to amend its by-laws. One by-law provided that no interest should be paid on certificates of deposit payable on demand. Interest was, however, paid upon such a certificate to X, whom the bank later sued for return of interest. X proved at the trial that he had obtained the written consent of a majority of the directors, one at a time, to such payment. What, in your opinion, should the trial judge have decided?

Answer:

If X had notice of the by-law the bank could recover. The by-laws could only be amended by the board of directors in meeting. The directors are elected to meet and confer and to act after an opportunity for an interchange of ideas. For this reason the independent consent of all directors does not take the place of action at a meeting.

No. 9. For the purpose of financing a proposed new corporation, what would be the advantage, from the viewpoint of the corporation, of issuing 6 per cent. cumulative preferred stock (redeemable), instead of 6 per cent. twenty-year gold bonds?

Answer:

In the absence of fraud if the directors do not believe that the corporation has made a sufficient amount to justify paying dividends on the cumulative preferred stock, the dividends may be omitted, the only penalty ordinarily being that there can be no dividends on the common stock until back dividends on the preferred stock have been paid (but ordinarily these deferred dividends do not bear any interest). If the rate of interest should fall and the corporation not wish to pay the 6 per cent., it can redeem the preferred stock. If the interest on the bonds is not paid this constitutes an indebtedness from the corporation to the bondholders. The bondholders can ordinarily foreclose on any property

securing the bonds and can take any other steps to collect that creditors could. The bonds can not be redeemed after they run for twenty years, so that if the interest rate falls the corporation can not be relieved.

PARTNERSHIP

Answer one question

No. 10. Define dormant partner, limited partnership, general partner, trading partnership, ostensible partner.

Answer:

A dormant partner is one whose connection with the parnership business is concealed and who does not take any active part in it. Such a partner is held responsible to third persons although he may not be so chargeable to the other partners. A limited partnership is one formed under a statute permitting an individual to contribute a specified sum to the capital of a firm and then limiting his liability for losses to that amount on the parties complying with certain established requirements. A general partner is one whose liability is at common law unlimited. It is usually required by statutes creating special or limited partnerships that there must be at least one general partner. A trading partnership is one whose business according to the usual mode of conducting it imports, in its nature, the necessity of buying and selling. A person who is held out to the public as a partner, though not actually a partner, is held liable as a partner and is known as an ostensible partner.

No. 11. A partner without consent of any of the other partners executed and delivered a mortgage on firm real estate using the proceeds to pay certain firm debts. Was the mortgage binding?

Answer:

This question does not state in whom the legal title to the firm real estate was vested and for the purpose of answering the question we shall assume that title was in the partner who executed the mortgage. If the mortgagee did not know of the equitable rights of the other partners to the realty either by actual knowledge or by the record, the mortgage is valid.

FEDERAL INCOME TAX

Answer question No. 12 and one other

No. 12. The copartnership of Jones & Smith was declared bankrupt, and copartnership assets were administered by a duly elected trustee. Just prior to distribution of the final dividend to creditors, the internal-revenue department filed proofs of claim against the individual partners for unpaid income tax for prior years, claiming rights to priority of payment under the income-tax-law provision that the bankruptcy court shall order payment of all taxes legally due and owing by the bankrupt to the United States before payment of dividends to creditors. Could the revenue department succeed in its claim?

Answer:

In proceedings in bankruptcy against a partnership, the partnership assets must first be applied to the payment of the partnership debts, and the United States is not entitled to any priority of payment out of such assets for a tax due it from an individual partner except to the extent of the share of such partner, if any, in the surplus remaining after the payment of the partnership debts. The bureau of internal revenue therefore could not succeed in its claim.

No. 13. Under the 1926 revenue act, are affiliated corporations required to file consolidated returns? Summarize the provisions of the 1926 act as to returns by affiliated corporations.

Answer:

Under the revenue act of 1926 affiliated corporations may make consolidated returns but are not required to do so. If a return is made on any basis, all returns thereafter made shall be upon the same basis unless permission to change is granted by the commissioner. For provisions relating to returns by affiliated corporations see section 240.

No. 14. You are employed as accountant and auditor for a corporation about to engage in an extensive retail business, which will, necessarily, extend credit to a large number of customers. Under the income-tax law, in what way could you treat bad debts?

Answer:

Instead of charging off particular debts as they are ascertained to be worthless, a reasonable addition may be made each year to a reserve for bad debts upon obtaining permission from the commissioner. In the case of a corporation engaging in extensive retail business that would be the best way to treat the item.