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Institute Examinations 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, 1924, and May, 1925, have been prepared in response to request by The Journal of Accountancy. These answers have not been reviewed by the board of examiners and are entirely unofficial. They represent the personal opinions of the author.—*Editor*, The Journal of Accountancy.]

COMMERCIAL LAW

November 14, 1924, 9 A. M. to 12.30 P. M.

Maximum credit for each question answered is 10 points.

Give reasons for all answers.

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

No. 1:

Taylor held Thompson's note for $400. Taylor was indebted to Thompson on an open account for $400. Taylor transferred the note to King in the usual course of business for value. When due, King presented the note to Thompson, who refused payment on the ground that Taylor owed to him, Thompson, an amount equal to the note. Did Thompson, the maker, have a good defense?

Answer:

Thompson, the maker, did not have a good defense. The defense that Thompson had against the payee was cut off by the transfer to King for value in the usual course of business.

No. 2:

Styles made a note to Johnson dated January 1, 1924, and due April 1, 1924. The note contained no provision as to interest. The note was not paid by Styles when due but it was allowed to run until September 1, 1924, when Styles paid it. Could Johnson collect any interest?

Answer:

Johnson could collect interest from April 1, 1924, the date of maturity, to September 1, 1924. Where interest is not expressly reserved and the paper matures at a time certain, it will draw interest from its maturity by operation of law without prior demand. Interest before maturity, however, is recoverable only where the instrument expressly provides for interest, and inasmuch as there is no express provision for the payment of interest on this note no interest accrued before maturity.

No. 3:

McDonald becomes the holder in due course of a note purporting to have been made by Knapp and bearing endorsements in blank by Abbott, Perrin and Pringle. The maker's name was forged. When due the note was duly presented for payment, payment refused, and notice of dishonor given to all parties. Could McDonald collect and from whom?

Answer:

McDonald could recover from any one of the three endorsers. Each endorser warrants to all subsequent parties that the instrument is the genuine article it purports to be and he is therefore bound by his endorsement to all parties subsequent to him.

No. 4:

When should a draft be presented to the drawee for acceptance or payment?

Answer:

The negotiable-instruments law expressly provides that except as therein otherwise provided the holder of a bill required to be presented for acceptance must either present it for acceptance or negotiate it within a reasonable time, and if he fails to do so the drawer and all endorsers are discharged.

Presentment for payment, of course, can not be made until the instrument is due. In order to hold the endorser or drawer on a bill or note payable on a fixed day, the holder must present the same for payment on the day on which it is payable. Some few states allow three days of grace.

CONTRACTS

Answer two of the following three questions:

No. 5:

The A Company, a New York corporation, made a contract with the B Company in Norway for its yearly supply of Norwegian cod-liver oil of certain specifications. Payments for oil were to be made by drafts. A shipment of 200 barrels arrived in New York early in August, the A Company accepting a draft for the purchase price payable September 1st and took the oil from the steamer to its plant. The oil when tested (the testing process requiring about 10 days' time) proved to be of lower grade than required by the specifications. The A Company notified the B Company by cable of the defects, offered to return the oil to the B Company and refused to pay the draft on September 1st, (the draft being still held by the B Company). The B Company refused to accept a return of the oil and sued for the purchase price claiming that the A Company had accepted the oil. Did the A Company have a defense?

Answer:

The A Company has a good defense. The buyer is entitled to a reasonable time within which to inspect the goods. The acceptance of the draft, if regarded as an acceptance of the goods at all, is to be regarded as an acceptance on condition that the goods are as specified. Here the buyer inspected the goods within a reasonable time and found that they were not as specified in the contract. The failure of the seller to make delivery in accordance with the terms of the contract entitled the buyer to rescind the contract.

No. 6:

Jones and Chambers were both road-building contractors. Bids were called for by the state of New Jersey for the building of a certain state road in that state. Jones proposed to Chambers that Chambers refrain from bidding in consideration of Jones' refraining from bidding against Chambers on another road soon to be built and an agreement was entered into to that effect. Jones, however, entered a bid on both jobs and was awarded both contracts. Chambers sued Jones for the profits made under the second contract alleging breach of the agreement between them. Could Chambers recover?

Answer:

Chambers could not recover. The rule is well settled in the United States that agreements which in their necessary operation upon the occasion of contractors bidding for public work tend to restrain the natural rivalry and competition of the parties, and thus produce a result disadvantageous to the public, are against public policy and are void.

No. 7:

Wood contracted with Long, a shirt-maker, for 1000 shirts for men. Long manufactured and delivered 500 shirts which were paid for by Wood, who at the same time notified Long that he could not use or dispose of the other 500 shirts and directed Long not to manufacture any more under the contract. Long proceeded to make up the other 500 shirts, tendered them to Wood, who refused to accept, and Long then sued for the purchase price. Could he recover?

Answer:

Long could not recover the purchase price, for title to the shirts had not passed at the time of repudiation. Where, as here, the goods are still to be manufactured when the buyer repudiates the contract, the buyer cannot be held for any greater damages than the seller would have suffered if he had done nothing towards carrying out the contract of sale after receiving notice of the buyer's repudiation or countermand. The profit the seller would have made if the contract had been fully performed should be considered in estimating the damage suffered by the seller.

PARTNERSHIP

Answer one of the following two questions:

No. 8:

Barr and Nelson, co-partners, received in the course of business a note made by Nash. Barr endorsed the note in the firm name. The note not being paid at maturity was protested by the holder and notice given to Barr. In a suit against Barr and Nelson as endorsers, Nelson defended on the ground that he had not had notice. Was his defense good?

Answer:

Nelson's defense was not good. Notice to one of the partners is notice to all.

No. 9:

Bigelow engaged the services of Ely to manage a public garage owned by Bigelow. A written agreement was entered into under which Bigelow agreed to pay Ely a salary of $45 a week and 15% of the net profits of the business. Did the agreement constitute Bigelow and Ely as partners?

Answer:

The agreement did not make Bigelow and Ely partners. A contract for the remuneration of an agent or person engaged in a business by a share in the profits of the business does not of itself make the servant or agent a partner in the business.

CORPORATIONS

Answer one of the following two questions:

No. 10:

Explain the meaning of the words "ultra vires" as applied to corporations, illustrating by an example, actual or fictitious.

Answer:

The term "ultra vires" as applied to corporations means any act of a corporation which the corporation is not authorized to do either by its express or implied powers. For example, a corporation organized to carry on a general hardware business can not engage in a grocery business.

No. 11:

In what circumstances, if at all, has a corporation power to purchase its own stock?

Answer:

In the absence of constitutional, statutory or charter restriction, by the weight of authority in the United States a corporation may purchase and hold shares of its own stock provided that the corporation in making such purchase is acting in good faith and that the consideration paid is not unequal or disproportionate to the value of the stock, that the corporation is solvent and not contemplating or in process of dissolution, and that the rights of creditors and non-assenting stockholders are not adversely affected. To be valid against non-assenting parties the purchase must be by authority of the directors, although officers of the corporation may purchase without that authority so far as consenting parties are concerned.

BANKRUPTCY

Answer the following question:

No. 12:

Outline briefly the principal steps in a bankruptcy proceeding.

Answer:

The first step in a bankruptcy proceeding is the filing of either a voluntary or an involuntary petition. The next principal step is the adjudication. Upon the adjudication of the bankrupt a creditors' meeting is called, over which the referee presides. The bankrupt must appear at this meeting to be examined by any parties in interest who desire to examine him. The creditors present their claims to the referee. A trustee is elected by the creditors by a majority in numbers and amount of claims. He takes title to the bankrupt's assets and administers his estate. Within twelve months after the adjudication and not before one month after the adjudication, the bankrupt must file his application for a discharge. The court grants or refuses the discharge after hearing any objection that may be made thereto.

INCOME TAX

Answer both the following questions:

No. 13:

What is earned income as defined by the income-tax law of 1924 and what is its application under the law?

Answer:

Earned income means wages, salaries, professional fees and other amounts received as compensation for personal services actually rendered. If the taxpayer is engaged in business in which both personal services and capital are

material income-producing factors, a reasonable allowance as compensation for the personal services rendered by the taxpayer not in excess of 20 per cent. of his share of the profits of such business is considered earned income. In no case is more than $10,000 considered earned income. The tax is credited with 25 per cent. of the amount of the tax which would be payable if earned income constituted the entire income.

No. 14:

On January 10, 1923, A purchased stock of a certain corporation for $10,000. On August 15, 1923, he received dividends amounting to $1,200, all of which were paid out of earnings of the corporation accumulated prior to March 1, 1913. In December, 1923, A sold the stock for $8,000.

(A) Was the dividend of $1,200 taxable?

(B) What was A's deductible loss on the sale of the stock?

Answer:

(A) No, because out of earnings prior to March 1, 1913.

(B) Eight hundred dollars. The dividend is considered a return of so much principal.

COMMERCIAL LAW

MAY 15, 1925, 9 A. M. TO 12.30 P. M.

(Each satisfactory answer is entitled to 10 points)

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

No. 1:

A delivered to B the following instrument: "Jan. 5th, 1925. One month after date I promise to pay to B, seven hundred fifty dollars" (Signed) "A". B endorsed the instrument in blank before maturity and delivered it to C for value. When due, A refused to pay and C sued B. Could C recover?

Answer:

C could not recover as upon a negotiable instrument because it is not to the *order* of B.

No. 2:

Burns lent a sum of money to Atkins, but at a usurious rate of interest. He took a note payable to bearer for the amount of the loan and interest. Burns then sold the note to Wilson but endorsed "Without recourse". Wilson could not recover the face amount of the note from Atkins because of the usury and so attempted, by suit, to recover from Burns, the endorser. Could he recover?

Answer:

Yes, Wilson could recover from Burns, the endorser, even though Burns endorsed without recourse. One who endorses without recourse disclaims responsibility for ordinary failure to pay the note, but he does warrant that the note is genuine and in all respects what it purports to be. If the note is illegal because of usury it is not what it purports to be and the qualified endorser can be held.

No. 3:

A entered into an agreement to purchase certain shares of stock of the X Y Company, the agreement providing for the giving of a note for the amount of the deposit on the signing of the contract. The agreement further gave A the right to cancel his agreement to purchase on notice to the X Y Company. A gave the note. The X Y Company induced C to endorse the note as an accommodation and the note was thereupon discounted at a bank. A duly cancelled his purchase agreement but the note was not returned. On maturity, as neither A nor the X Y Company paid the note, C did so and the note, endorsed in blank, was turned over to him. C sued A on the note. Could he recover?

Answer:

C, the accommodation endorser, could recover from A.

The note was negotiable. The fact that by a separate agreement the note was not to be payable absolutely does not make the note non-negotiable. The bank by discounting the note became a holder in due course and therefore cut off the defense that A had because of his agreement with the corporation. When the endorser paid the note upon default of the maker, he stepped into the shoes of the holder in due course, whom he paid.

The fact that C became an endorser at the request of the corporation rather than at the request of the maker is immaterial here, for the maker by putting the note in circulation invited an endorsement thereof, and that invitation when accepted created a privity of contract between the maker and the endorser.

No. 4:

You are the holder of a negotiable promissory note endorsed in blank by John Jones. How would you transfer the note so as not to become liable as a party to it, as a guarantor of its genuineness or as to prior parties?

Answer:

In order to transfer a negotiable promissory note so as not to become liable as a party to it or as a guarantor of its genuineness and the contractual capacity of all parties, it would be necessary to do the following: Endorse the note without recourse and obtain from the purchaser an agreement to the effect that he takes the paper at his own risk absolutely. It would perhaps be best to have this agreement placed upon the instrument itself, although it has been held competent to show such an agreement by parol evidence where the endorsement is without recourse.

CONTRACTS

Answer two of the following three questions:

No. 5:

Hecht purchased from McCormick a team of horses for $650, a set of double harness for $185 and a wagon for $75. Before delivery the harness was stolen. McCormick tendered delivery of the team and wagon, but Hecht refused to accept and pay for them on the ground that McCormick could not deliver the harness also. Was Hecht correct in his position?

Answer:

Hecht was correct in his contention. The rule that a party who has failed fully to perform his contract can not recover for part performance applies only to entire and not to severable contracts which are in legal effect independent

agreements about different subjects, although made at the same time. In determining under which of the above two classes a contract falls the intention of the parties must govern.

Where, as here, the subject matter of the sale is regarded by the parties as being in the nature of one entire thing, the contract is entire although such goods consist of separate items and are priced separately.

The fact that the consideration was expressly apportioned among the three articles has been held sometimes to be indicative of an intention that the contract should be severable.

Here, however, it seems apparent from the very nature of the articles which were to be purchased that the contract was intended by the parties to be an entire one and not a severable one, and so it would seem that the position taken by Hecht is correct.

No. 6:

A entered into a contract to erect a house for B at a cost of $10,000. During construction, A notified B that the price of a certain material called for by the specifications had advanced so that it could not be used unless B would agree to pay $600 more. B agreed, but when the house was completed refused to pay the extra $600, so A brought suit. Did B have a defense?

Answer:

B has a defense. A was already legally bound by contract to erect the house for $10,000 and there was therefore no consideration to support the promise to build the house for $10,600.

No. 7:

Smith contracted to sell to Jones certain goods of specific quality to be delivered by truck to Jones' place of business on March 10, 1925. On that date Smith delivered the goods and Jones paid for them. At the date of delivery the goods were of considerably higher market value than the price under the contract. The next day Jones found the goods were not as specified. He, Jones, then returned the goods, notifying Smith that he rescinded the contract, and replaced them by purchasing other goods in the open market. Jones subsequently sued Smith to recover the amount he had paid to Smith and also the amount he had been compelled to pay above the contract price in order to purchase in the open market. What did Jones recover?

Answer:

With full knowledge of all the facts, Jones made his election to rescind the contract, and he is bound by his election to rescind and can not thereafter affirm the contract and sue for its breach. Therefore he can not recover damages for the breach of contract.

The implied obligation of the parties to restore everything of value received under the contract remains and may be enforced after the rescission, however, so Jones could recover the amount paid under the contract.

PARTNERSHIP

Answer one of the following two questions:

No. 8:

State the rule for the marshaling of assets and payment of firm and individual debts where a copartnership becomes insolvent, the members thereof having personal assets and individual creditors.

Answer:

The general rule for the marshaling of assets and payment of firm and individual debts where a copartnership becomes insolvent, the members thereof having personal assets and individual creditors, is as follows: The firm assets are to be applied in the first instance to the payment of firm debts, and the assets of the individual partners to the payment of their individual debts.

No. 9:

To what extent is a partner liable to his copartners for losses incurred in his conduct of partnership transactions?

Answer:

The expenses and losses of a partnership are to be borne by the partners in the same proportion in which they are to share the profits unless they contract for a different proportion. Even where a partnership loss is occasioned by the conduct of one partner without the participation of the others, it will not be charged to him but will be borne by the firm in the absence of fraud, culpable negligence or bad faith on his part.

CORPORATIONS

Answer one of the following two questions:

No. 10:

A meeting of the board of directors of the Z corporation was called to consider the issuance of bonds. A, one of the directors, did not attend but gave a proxy to F authorizing F to attend in his place. Was this proper and could F attend and act at the meeting?

Answer:

F could not attend and act at the meeting for he was only a proxy. A director must attend the meetings of the board and act in person. The obvious reason for this is that he is obligated to use his individual judgment with respect to matters coming up before the meeting of the board in order to further the interests of the corporation. Such individual judgment can not be exercised by a proxy.

No. 11:

The Z corporation had a board consisting of fifteen directors. It adopted a by-law authorizing the board to appoint a committee of five of its members with authority to act whenever the board was not in session or could not be convened. This committee at one of its meetings authorized the sale of a bond and mortgage held by the corporation. Subsequently the assignment of the bond and mortgage, executed in accordance with the authorization, was attacked on the ground that it was not the act of the corporation, it not having been authorized by the whole board at a board meeting. Was the claim made correct?

Answer:

The claim made was not correct. In the final analysis the determination of the affairs of a corporation rests with its stockholders and arises from their power to choose a governing board of directors. Unless a local statute stands in the way, the stockholders may authorize the board of directors to delegate to an executive committee authority to act when the board is not in session and to do the acts that the board might do if the board were in session. The execu-

tive committee in this way derives the authority from the stockholders through the board of directors.

This is true even though the powers delegated by the board are discretionary powers.

BANKRUPTCY

Answer the following question:

No. 12:

Explain the difference between a trustee in bankruptcy and a receiver in bankruptcy.

Answer:

A receiver is a person appointed by the court upon application of parties in interest when the court finds it is absolutely necessary for the preservation of the estate to take charge of the property of the bankrupt after the filing of a petition and until it is dismissed or the trustee qualifies. The receiver does not take title to property or administer the estate of the bankrupt. The character of the function of a receiver is purely preservative.

The trustee is a person elected by the creditors after the adjudication to take title to the bankrupt's estate and to administer it. The function of the trustee is administrative as distinguished from the preservative character of the function of the receiver.

INCOME TAX

Answer both the following questions:

No. 13:

A purchased an apartment house in 1921. A never received any income from the property; in fact, it never produced sufficient revenue to pay for the cost of running it. He sold the property in 1924 at a price lower than that he paid for it. You are called upon to prepare A's income-tax return for 1924. Upon examining his returns for prior years, you find that no depreciation was ever deducted by A in regard to the apartment house property, A explaining that as there was no income from the property to serve as the basis of a reserve fund for depreciation, he had never taken any. How would you compute A's loss on the sale and should any action be taken with reference to the returns for prior years?

Answer:

Depreciation does not depend on income. Amended returns should be made for prior years taking depreciation as a deduction. In computing the loss the purchase price should first be reduced by depreciation from 1921 to 1924.

No. 14:

A was the owner of a majority of the capital stock of the M corporation; in fact, he held all the stock with the exception of a few shares. He was also the president of the corporation and the directors voted him a salary of $20,000 per annum. The corporation deducted the $20,000 from its 1922 return as compensation paid. Upon audit of the return the commissioner of internal revenue refused to allow the full $20,000 deduction and reduced it to $16,000. Has the commissioner such power and, if so, in what circumstances?

Answer:

The commissioner may disallow the salary of the president as a deduction to the corporation to the extent that such salary is unreasonable.