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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 May, 1936, 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

May 15, 1936, 9 A. M. to 12:30 P. M.

Reasons must be stated for each answer. Whenever practicable give the answer first and then state reasons. Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question rather than on his conclusions.

Group I

Answer all questions in this group.

No. 1 (10 points):

Parker, a certified public accountant, made an audit of Thornton's books of account and rendered a financial report which Thornton used in obtaining credit. Answer each of the following questions, giving legal arguments or reasons for each answer:

(a) If Thornton is sued by a creditor who had not seen Parker's report, can Parker, as a duly subpoenaed witness, decline to disclose business information procured by him during the conduct of his audit but not incorporated in his report?

(b) If Thornton is arrested and tried in a criminal proceeding, can Parker, as a duly subpoenaed witness, decline to disclose such information?

(c) Can Thornton compel Parker to turn over to him an analysis (in pencil) of an asset account made at Parker's request and for his assistance by Thornton's bookkeeper during the conduct of Parker's audit?

(d) Can Thornton compel Parker to turn over to him an analysis in (pencil) of the asset account referred to in question (c) made by one of Parker's assistants during the conduct of his audit?

(e) Can Parker by his last will and testament bequeath all of his working papers to a legatee?

Answer:

(a) Statements made to accountants do not constitute privileged communications. As Parker has in his possession knowledge of facts which are material to the vindication of the rights of the creditor, he may be compelled by judicial process to produce such evidence at the trial on behalf of the creditor. The foregoing is according to common law. In Colorado, Florida, Illinois, Iowa, Maryland, New Mexico, and perhaps in other states communications to accountants are made privileged by statute and may not be divulged.

(b) A witness is protected against self-incrimination in criminal cases, but this protection only applies to the witness when his testimony would be against himself. No such protection exists when the testimony sought would affect another person. Parker, therefore, can not decline to disclose non-privileged

information in his possession which is relevant and material on the ground that it would incriminate Thornton.

(c) It was within the scope of Thornton's bookkeeper's employment to make the analysis of the asset account requested by Parker, and the pencil analysis given Parker by the bookkeeper became Parker's property just as would a letter from Thornton to Parker. Thornton, therefore, can not compel Parker to turn it over to him. Thornton could compel Parker to give him a copy of this analysis, however.

(d) An analysis made by one of Parker's assistants was Parker's property from the time it was made, and Thornton can not compel Parker to turn it over. Parker as a professional man did not contract to give Thornton this information but merely contracted to give Parker his final certificate. As in the answer to (c), Thornton can compel Parker to give him a copy.

(e) The papers are the property of Parker and therefore are part of his estate and as such pass to his legal representatives. There is, however, a confidential relationship between Thornton and Parker, and Thornton may properly object to have the papers examined by third persons to any greater extent than is necessary to insure the collection of any fees which may be due from Thornton to Parker. If Thornton makes no objection, Parker may bequeath the papers to one legatee rather than to another, but if Parker has been paid in full by Thornton, Thornton could probably enjoin the delivery of the papers to a legatee on the ground that they contained confidential information which he did not wish to have disclosed to the particular legatee.

No. 2 (10 points):

The certificate of incorporation and the by-laws of a corporation provided that management of it was vested in its board of seven directors. A deed to land owned by the corporation was prepared in the name of the corporation and was signed by each director, but no two directors signed at the same time or place and no meeting was held or resolution passed. There were several hundred stockholders and three of the directors were not stockholders. Was the deed effective to pass title?

Answer:

The deed was not effective to pass title. The directors of a corporation must act at a meeting where opportunity is given for an interchange of views, and they can not act by signing a document separately. If there had been no stockholders other than the directors, this defect would have been immaterial, because the deed could not have been questioned by any of the stockholders, but in this case, as there were stockholders other than the directors, the deed was ineffective.

No. 3 (10 points):

What elements or factors must exist in order to constitute a fraud sufficient to vitiate a contract?

Answer:

The essential element which must always be present in any action of fraud or suit to rescind a contract because of fraud is the misrepresentation of a material fact (perhaps by concealment) by one who knows the representation is

false or by one who makes it in reckless disregard of what the truth may be with the intention to have another act thereon. The elements usually mentioned are:

1. A false representation of material facts.
2. Knowledge of the falsity of the representations by the person making them, or reckless disregard of what the truth may be.
3. Ignorance of their falsity by the person to whom they are made.
4. Intent or reason to believe that they will be acted upon.
5. Action by the person, to his damage.

If these factors exist there is usually a fraud sufficient to vitiate the contract. If, however, there is no intent to defraud or wilful indifference on the part of the person making the statement, there is misrepresentation but not fraud.

No. 4 (10 points):

Hawkes and Andrews were public accountants practising under the firm name of Hawkes and Andrews. Without the knowledge of Hawkes, Andrews borrowed money on a promissory note signed and endorsed by him individually and then endorsed by him with the firm name. He used the money thus borrowed for regular and ordinary expenses of the firm. In an action on the note, by the payee, can judgment be obtained against Hawkes?

Answer:

Judgment can not be obtained against Hawkes. If the partnership is a non-trading one, there is no implied power in a partner to bind the partnership by making, accepting or endorsing commercial paper in its name, and third persons are on notice of the character of the business and that no such authority exists on the part of any individual partner. Even though, as in this case, the money was used for the benefit of the partnership itself, the weight of authority is to the effect that such action is not binding on the partnership nor upon other members thereof. A firm of accountants is a professional, non-trading partnership and in the absence of any general custom or special authority one member may not bind the others by his endorsement of commercial paper, even though the money is used for the firm business.

No. 5 (10 points):

What is the difference between a sale and a contract to sell and of what importance is the distinction?

Answer:

A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price; while a contract to sell goods is a contract whereby the seller agrees to transfer the property in goods to the buyer for a consideration called the price. The distinction is often expressed by the terms "executory" and "executed" sales. The distinguishing feature is whether or not the property in the goods has been transferred. If it has, there is a sale, regardless of whether the price is paid or not. If it has not, there is a contract to sell, even though the price is paid. The distinction is important because the risk of loss will lie with the holder of title in the absence of an agreement to the contrary.

GROUP II

Answer any five questions in this group. No credit will be given for additional answers, and if more are submitted only the first five will be considered.

No. 6 (10 points):

Eight men signed, acknowledged, filed, and recorded a paper purporting to be a certificate of incorporation under a state statute. They then issued capital stock to themselves, elected directors and officers, adopted by-laws and began to do business. The purposes of the corporation stated in the paper so executed and filed were not authorized by the statute under which incorporation was attempted and the place where the business was to be conducted was not stated therein as required by the statute, but these errors were not detected in the office of the secretary of state until after the organization had been completed and some business had been transacted.

(a) Can the state successfully question the legality of the corporation?

(b) Can the eight men be sued as partners by a person dealing with the alleged corporation prior to any action by the state?

Answer:

A corporation de jure is one created in strict or substantial conformity to the governing corporation statutes, whose right to exist and act as such can not be successfully attacked in a direct proceeding for that purpose by the state. A de-facto corporation is one so defectively created as not to be a de-jure corporation, but nevertheless the result of a bona-fide attempt to incorporate under existing statutory authority, coupled with the exercise of corporate powers. It is recognized by the courts as a de-facto corporation upon the ground of public policy in all proceedings except a direct attack by the state questioning its corporate existence. In the case put I doubt whether the absence of the statement of the place where the business was to be conducted would have prevented the corporation from being a de-jure corporation. Certainly that failure would not have prevented the corporation from being a de-facto corporation. But the first essential according to the great weight of authority in order that there may be a corporation de facto is the existence of a charter or law under which a corporation of its character and for the objects and purposes for which it is organized might exist, and there may be no corporation de facto where a corporation is formed with purposes not permitted by the governing statutes. I conclude therefore:

(a) The state can successfully question the legality of the corporation.

(b) The eight men may be sued as partners as in all cases where there is no de-jure or de-facto corporation.

No. 7 (10 points):

A young man 20 years and 11 months of age who looked 25 years of age misrepresented himself to be over the age of 21 and made a contract for the purchase of and did purchase an article which was not a "necessary" for which he would be liable. Has the vendor any remedy in a civil (not a criminal) action?

Answer:

The vendor may sue the infant in tort for deceit. The English rule is that an infant is not liable in tort for deceit when, by false statements or fraudulent representations, he obtains goods or credit from another. This doctrine was first broken away from in this country in 1819 by a Massachusetts court. Since then, the rule in this country, though by no means uniform, has constantly

grown away from the English rule, and today we may safely say that the weight of authority in the United States is that an infant may be proceeded against in a tort action for deceit when he misrepresents himself to be of age and thereby secures goods or money, etc. If it is obvious that the infant is not over twenty-one, the vendor's reliance upon the infant's representation as to age can not be treated as justifiable and hence the vendor could not recover for deceit.

No. 8 (10 points):

Martin, a licensed insurance broker, procured a new policy from an insurance company, delivered it to the assured, and collected the premium. He then notified the company that he had collected the premium and the company sent him a bill for the premium payable in 60 days. The policy contained a provision to the effect that the broker was an agent of the assured and not of the insurance company. Martin failed to pay the amount of the premium to the company and thereupon the company sent a notice to the assured cancelling the policy for non-payment of the premium. Must the assured again pay the premium to avoid cancellation of the policy?

Answer:

The insured would have to pay the premium a second time. When a company puts a clause in a contract of insurance, similar to the one in the instant case, it may rely upon it, unless there is a statute which makes all insurance brokers the agents of the company notwithstanding such clauses or unless the facts constitute a waiver of the clause. In this case, I think that the fact that the company sent the broker a bill payable in sixty days would not be sufficient to waive the provision. The result might be otherwise if the broker had acted for the company in other cases and had an open account with the company.

No. 9 (10 points):

Formal notice of presentment and dishonor of a promissory note was not mailed or otherwise given to an indorser. Upon the trial of an action brought against him, the testimony showed that the indorser had said to at least one witness that the maker "is having trouble with his creditors and I don't believe he will be able to meet this note at maturity." It further appeared that the indorser had arranged with the maker a plan whereby the maker could pay the note in instalments. Is the defense of lack of notice an effective bar to the action against the indorser?

Answer:

The defense is effective. Upon maturity of a note the holder must give formal notice of presentment and dishonor to an endorser before the endorser's liability attaches, and failure to do so will discharge the liability of the endorser in the absence of an express or implied waiver. There is no indication from the question that the endorser made any statement to the holder or that the holder relied on any statement made by the endorser or any action of the endorser when he failed to give the notice. The testimony merely goes to show that the endorser had knowledge that the maker would not pay the note. This is not sufficient to constitute a waiver.

No. 10 (10 points):

What are the legal requirements in your state as to witnesses and other formalities for the proper execution of a last will and testament? (Name the state to which your answer relates.)

Answer:

A will and testament shall be in writing and signed by the testator or by some other person in his presence and by his express directions, and shall be attested and subscribed in the presence of the testator by at least two credible witnesses or else it shall be utterly void and of no effect. (District of Columbia.)

No. 11 (10 points):

Give a general description of the plan provided in section 74 of the National Bankruptcy Act which makes it possible for a person, other than a corporation, in financial difficulty to petition for a composition with creditors or for an extension of time in which to pay his debts.

Answer:

Section 74 gives any person except a corporation the right to file a petition or, in an involuntary case, an answer seeking to obtain a composition or an extension of time within which to pay his debts, if the petitioner is insolvent or can not meet his debts as they mature. Secured debts may not be reduced nor their security impaired, but they may be extended if the security is in the possession of the debtor or receiver. If the petition appears to be a proper one, the court (that is, the referee), after notice to creditors, appoints a receiver for the petitioner's property. The receiver calls a creditor's meeting, the bankrupt is examined, a trustee is appointed and the bankrupt submits his composition or extension proposal. This proposal, when accepted by a majority in number and amount of creditors, including those whose claims would not otherwise be provable in bankruptcy, is submitted to the court for confirmation. Upon approval by the court, the petitioner makes payments as provided in the agreement, and, upon satisfactory completion of his obligations, the case is dismissed. If, however, the petitioner fails to live up to his agreement or to secure the consent of the requisite number of creditors, the estate is liquidated as in ordinary bankruptcy proceedings.

No. 12 (10 points):

Colley, who was a promoter, announced that he was organizing a new corporation. He made a contract in the name of the corporation prior to its incorporation by which the corporation agreed to purchase merchandise from Russell. After the corporation was duly organized, Colley was unable to convince its directors and officers that it should purchase this merchandise and the corporation refused to accept it when it was duly tendered. Can Russell recover damages from Colley, or from the corporation, or from both of them?

Answer:

Russell may not recover damages from the corporation. Colley had no authority to act as agent for the corporation before it was organized, and as the contract was not ratified or entered into in any way by the corporation itself, it did not become the contract of the corporation. Russell can, however, probably recover from Colley on the facts stated. There is a strong inference that a promoter is bound by a contract made in the name of a non-existent corporation, which can only be overcome by proof that the other party was to look to the corporation alone.