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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, 1929, 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 17, 1929, 9 A. M. to 12:30 P. M.

Answer only ten questions as directed, and give reasons for all answers.

(Each question counts 10 points)

GROUP I

Answer all the questions in this group.

No. 1.

The X Y Corporation is engaged in the real-estate business. It owns a building, the cost of which was $300,000. In July, 1928, it sells the building for a price which nets it $350,000. It then reinvests the proceeds of the sale in another building. Other than the profit on the sale it has only sufficient income to pay its operating expenses. Can the directors declare a dividend to the stockholders and, if so, by what means?

Answer:

The corporation has a surplus of $50,000 and can declare a dividend to that extent. This may be done in any of the following ways:

(a) In stock to the par value of $50,000. (But stock can not be issued in excess of amount authorized by charter.)

(b) In cash to the extent of $50,000. This cash may be obtained by borrowing on the new building.

(c) In scrip or notes of the corporation.

No. 2.

Royce becomes the holder of a negotiable promissory note in regular form made by A to B and bearing several full endorsements. He endorses the note to Church for value, but "without recourse." When Church endeavors to collect upon maturity of the note, it is discovered that A is an infant and refuses to pay. Church then sues the endorsers, including Royce. Has Royce any defense?

Answer:

No, Royce has no defense. Under the negotiable-instruments law even though he endorsed without recourse, nevertheless he warranted that all prior parties had capacity to contract.

No. 3.

A company enters into a contract with Y agreeing to manufacture and deliver to him, at an agreed price, 5,000 ladies' sweaters, deliveries to be made in equal quantities over a five-months' period. Before any deliveries can be made the company's employees go out on a strike which remains unsettled for a period of two or three months beyond the last delivery date. Y is compelled to buy his sweaters in the open market and brings suit to recover damages for the failure of the company to carry out its contract. Can he recover? If so, could the company have protected itself in the contract against such a liability?

Answer:

Y can recover. A would not be excused. While the strike might cause great difficulty of performance, it would not in law constitute impossibility of performance. A might have protected himself by inserting a clause in the contract that he would have additional time to the extent that he was delayed by a strike.

No. 4.

You are the owner of 500 shares of common stock of the Z Company. In 1928 it issued to its stockholders rights to subscribe for further stock at a specific price, one right for each share of stock held. You do not exercise your right to subscribe but you do sell the rights on the market. Under the 1928 federal income-tax law, how should the sale of the rights be treated on the tax return?

Answer:

Gain is recognized on the sale of the rights. In determining the gain or loss, the cost or other basis of the stock in respect of which the rights are issued, shall be apportioned between the rights and the stock in proportion to the respective values thereof at the time the rights are issued.

At the option of the taxpayer, he may dispense with the rather involved procedure of attempting to apportion costs, and he may include the entire proceeds from the sale of stock rights in gross income. In that event, the basis for determining gain or loss from the subsequent sale of the stock in respect of which the rights were issued, shall be the same as though the rights had not been issued.

No. 5.

"$500. January 1, 1928

"For value received I hereby agree to pay to A. C. Goodwin or order the sum of five hundred dollars ($500) in five instalments of one hundred dollars each, on the first day of each of the next following months of February, March, April, May and June, with interest on all unpaid principal at the rate of 6 per cent. per annum payable with each instalment, and in the event of any default in the payment of any instalment or interest, the whole balance of said principal sum and interest shall be and become immediately due and payable. All payments to be made at First National Bank.

"(Signed) John Smith."

Is this a negotiable promissory note?

Answer:

Yes. The provision for acceleration of the maturity of the note in case of default does not affect its negotiability. The negotiable-instruments law provides that the sum payable is a sum certain, within the meaning of the act, although it is to be paid by stated instalments, with a provision that, on default in the payment of any instalment, or of the interest, the whole shall become due.

GROUP II

Answer any five of the following questions, but no more than five.

No. 6.

You are in the employ of Jones & Co., a co-partnership engaged in the stock-brokerage business. Your employers offer to compensate you for your services by a share in the profits of the business. An agreement is submitted to you to carry out the offer. Before you sign the agreement, and for your protection,

what, if any, provisions should you insist upon including in the agreement other than those relating to your sharing in the profits?

Answer:

The contract should be definite as to what your duties are to be, as to the length of your employment, and as to the share of profits that you are to receive. You should be careful to have it clearly stated that the profits that you are to receive are to be compensation to you for services, that you are not required to contribute capital, and that you are not a partner and do not share in any losses. You should endeavor to have a provision that you are to receive a fixed sum as salary in any event whether your share in the profits equals that amount or not. (After you have "insisted" on all these provisions the offer will probably be withdrawn.)

No. 7.

The X Y Corporation has outstanding $250,000 in 6 per cent. non-cumulative preferred stock and 2,500 shares of no-par-value common stock. During each of the years 1926, 1927 and 1928, the corporation made net profits of $25,000. No dividends were declared in 1926 or 1927, the directors allowing the profits to remain in surplus. Late in 1928, the directors declared a dividend of 6 per cent. on the non-cumulative preferred stock and $23 per share on the no-par-value common stock. The preferred stockholders objected to the dividend on the common stock, claiming that they were entitled to receive 18 per cent. of the then existing surplus before any of it could be available for common-stock dividends. Was the objection valid?

Answer:

In my opinion the objection is valid. In the ordinary case where dividends are not declared on non-cumulative preferred stock there is no right to have back dividends paid before dividends are declared on common stock. But the courts are careful to protect stockholders against fraud. In this case only $15,000 annually would have been required to pay the dividend on the preferred stock. The dividend could have been paid in each year, and there would have been $10,000 remaining for dividend on common stock. But the directors withheld payments on the preferred stock for two years, and only paid the preferred dividend in the third year when it was necessary to pay a dividend on the preferred in order to pay a dividend on the common. The directors then used up practically the entire profits of the three years in paying one dividend on the common stock. I do not think that any court would allow this.

No. 8.

B, a violin expert, ascertained that A owned an old violin of famous make, worth many thousands of dollars. In talking with A, B found that the violin had been in A's family for many years, but that A had no knowledge of its true value. B, after some persuasion and by offering what to A seemed an excessive price ($350), succeeded in buying the instrument. Later A heard of the true facts and, tendering a return of the purchase price, sued to recover the violin. What, in your opinion, would be the result?

Answer:

A would not recover. A contract may be rescinded for fraud but there is no fraud in this case. B owed A no duty to disclose his special knowledge of the value of the violin. The parties were dealing at arm's length with one another and the seller could readily have protected himself by securing an appraisal.

No. 9.
Explain the difference between personal defenses and absolute defenses in an action on a negotiable instrument, and name some instances of each kind.

Answer:

A personal defense in an action on a negotiable instrument is one that can be made only as against a party not a holder in due course and which is "cut off" by a transfer to a holder in due course. Examples of such defenses are fraud, duress, illegality, want or failure of consideration, release or payment and discharge of party primarily liable.

An absolute defense is one that is not "cut off" by a transfer to a holder in due course. Examples of such defenses are forgery, infancy, insanity, lack of authority of agent to sign.

No. 10.
Goods shipped to you by railroad, while in the railroad's warehouse awaiting delivery to you, are destroyed by a fire which is not due to any negligence on the part of the railroad. What are the important facts to be determined in order to establish upon whom the loss falls?

Answer:

(a) In what state the warehouse is located. (The law differs as to whether or not the railroad is liable as an insurer.)

(b) How long the goods were in the warehouse, and if and when notice of receipt was sent to consignee. (Even where railroad may be insurer, liability may end in some states after notice and in others after reasonable time.)

(c) (If railroad not liable.) Terms of contract between seller and buyer, also terms of bill of lading, and any facts as to relationship between parties which may throw light on legal title and beneficial ownership at time of destruction. Where contract was made and to be performed. (Generally at common law loss follows legal title. Under uniform-sales act in some states loss follows beneficial interest.)

No. 11.
On March 1, 1913, the A Company had an earned surplus of $500,000. Between that date and January 1, 1928, it added $1,000,000 to the earned surplus. On January 5, 1928, the directors adopted resolutions declaring two cash dividends, one of $500,000 declared as payable out of surplus earned prior to March 1, 1913, and one of $500,000 declared as payable out of the later accumulated surplus. A stockholder claims that the first dividend is not taxable for surtax under the federal income-tax law, because it is paid out of earnings made prior to March 1, 1913. The examining agent for the internal-revenue bureau disputes this, claiming that the directors had no power, so far as the income-tax law is concerned, so to allocate the dividend payments. Who is correct?

Answer:

The examining agent is correct. According to section 115 (b) of the revenue act of 1928 as interpreted by article 623 of *Regulations 74*, a corporation can not distribute earnings or profits accumulated prior to March 1, 1913, exempt from tax, unless and until all earnings or profits accumulated since February 28, 1913, have been distributed.

No. 12.
What is a statute of limitations and what is its object?

Answer:

A statute of limitations is a legislative enactment which prescribes a certain period within which actions may be brought upon certain claims or within which certain rights may be enforced. The object of the statute is to suppress fraudulent and stale claims from springing up after a long lapse of time, and surprising the parties or their representatives when all the proper vouchers and evidence are lost, or the facts have become obscure from the lapse of time, or the defective memory, or death, or removal of witnesses.

No. 13.

Explain what is meant by each of the following: act of bankruptcy, voluntary bankruptcy, involuntary bankruptcy, composition.

Answer:

The theory of the bankruptcy law is that if a person becomes insolvent he may be adjudicated bankrupt and such adjudication discharges him from his obligations so that he can start to work again with a clean slate. The assets are collected by a trustee and distributed among the bankrupt's creditors. A person may become bankrupt voluntarily or involuntarily.

As to who may become a voluntary bankrupt the bankruptcy law provides that any person, except a municipal, railroad, insurance or banking corporation shall be entitled to the benefits of the law relating to voluntary bankrupts.

As to who may become an involuntary bankrupt the law provides that any natural person, except a wage earner or a person engaged chiefly in farming or the tillage of soil, any unincorporated company, and any moneyed, business or commercial corporation, except a municipal, railroad, insurance or banking corporation, owing debts to the amount of $1,000 or over, may be adjudged an involuntary bankrupt upon default or impartial trial and shall be subject to the provisions and entitled to the benefits of the law.

The bankrupt himself may initiate the proceedings for voluntary bankruptcy by filing a petition to be adjudged such. Initiation of an involuntary bankruptcy proceeding is had by the filing of a petition by three or more creditors who have provable claims against the bankrupt which amount in the aggregate in excess of the value of securities held by them, if any, to $500, or over; or if all of the creditors of such person are less than twelve in number, then one of such creditors whose claim equals such amount may file a petition to have him adjudged a bankrupt.

A composition in bankruptcy is a proceeding voluntary on both sides, by which the debtor of his own motion offers to pay his creditors a certain percentage of their claims in exchange for a release from his liabilities. The amount offered may be less or more than would be realized through distribution in bankruptcy by the trustee. The creditors may accept this offer or they may refuse it. For the purposes of the composition all the creditors are treated as a class, and the will of the majority is enforced upon the minority, provided the decision of the majority is approved by the court. In the ordinary case of distribution by a trustee, the debtor's whole property, save that which is exempt is applicable to the payment of his debts and belongs to his creditors, and not to him, until their claims have been satisfied. After adjudication there is no voluntary offer to pay by the bankrupt, and no bargained release by the creditor. The creditor takes all his debtors property whether the debtor likes

it or not. In a composition case the creditor gets, not his share of the bankrupt's estate, but only what he bargained for. The effect of the composition proceeding is to substitute composition for bankruptcy proceedings in a certain sense, and in a measure to supersede the latter proceeding and to reinvest the bankrupt with all his property free from the claims of his creditors.

No. 14.

Give an example of a contract on which, in the event of a breach, specific performance would be granted by the courts.

Answer:

A valid contract for the sale of land may be specifically enforced by the vendor or the purchaser.