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## **Uniform CPA Examination/May 1979-November 1983 – Business Law, Selected Questions and Unofficial Answers Indexed to Content Specification Outline**

James D. Blum

Mark S. Goldstein

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CPA Examination/May 1979—November 1983

# business law

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Selected Questions  
And Unofficial Answers  
Indexed To  
Content Specification  
Outline

edited by James D. Blum and Mark S. Goldstein

**AICPA**

American Institute of Certified Public Accountants

business law

AICPA

Uniform CPA Examination/May 1979—November 1983

# **business law**

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**Selected Questions  
And Unofficial Answers  
Indexed To  
Content Specification  
Outline**

edited by  
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**AICPA**  
American Institute of Certified Public Accountants

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## FOREWORD

The Uniform CPA Examination is prepared by the Board of Examiners of the American Institute of Certified Public Accountants, and is used by the examining boards of all fifty states of the United States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands, as a prerequisite for issuance of CPA certificates.

This booklet contains selected questions and unofficial answers from the last ten Business Law sections of the Uniform Certified Public Accountant Examination. The questions and unofficial answers have been indexed in accordance with the Business Law Content Specification Outline for the Uniform Certified Public Accountant Examination.

All questions are identified by a boldface code indicating the month—May (**M**) or November (**N**)—the year (79 through 83), and the question number in the original examination. Within the content specification areas and groups, questions and answers have been arranged in reverse chronological order.

Each individual multiple choice question is indexed according to the area and group it tests. In some cases, a common fact pattern is used for two or more multiple choice questions. In such cases, where different areas and groups are being tested by questions referring to a common fact pattern, the fact pattern is repeated to accompany the questions indexed in each applicable area or group.

Where essay questions and their answers involve more than one part—for example, part a. and part b.—the essays have been separated and indexed according to areas and groups tested. Thus, all parts of a question and its answer may not appear in their original examination sequence.

Although the questions and unofficial answers may be used for many purposes, the principal reason for their publication is to aid candidates in preparing to take the examination. Candidates are also encouraged to read *Information for CPA Candidates*, which describes the content, grading, and other administrative aspects of the Uniform CPA Examination.

The unofficial answers were prepared by the staff of the Examinations Division and reviewed by the Board of Examiners but are not purported to be official positions of the American Institute of Certified Public Accountants.

William C. Bruschi, *Vice President—Examinations and Regulation*  
American Institute of Certified Public Accountants

March 1984



## TABLE OF CONTENTS

<b>Selected Questions</b>	<b>Pages</b>	
	<b>Multiple Choice Items</b>	<b>Essays</b>
I. The CPA and the Law	1	85†
A. Common Law Liability to Clients and Third Persons	1	
B. Federal Statutory Liability	1	
C. Workpapers, Privileged Communication, and Confidentiality	2	
II. Business Organizations	3	90†
A. Agency	3	
B. Partnerships	8	
C. Corporations	12	
D. Other Forms	17	
III. Contracts	17	95†
A. Nature and Classification of Contracts	17	
B. Offer and Acceptance	17	
C. Consideration	20	
D. Capacity, Legality, and Public Policy	21	
E. Other Defenses	22	
F. Parol Evidence Rule	23	
G. Third Party Rights	24	
H. Assignments	24	
I. Discharge, Breach, and Remedies	25	
IV. Debtor-Creditor Relationships and Consumer Protection	26	98†
A. Bankruptcy	26	
B. Suretyship	30	
C. Bulk Transfers	34	
D. Federal Consumer Protection Legislation	*	
V. Government Regulation of Business	35	100†
A. Administrative Law	35	
B. Antitrust Law	35	
C. Regulation of Employment	40	
D. Federal Securities Acts	43	
VI. Uniform Commercial Code	46	104†
A. Commercial Paper	46	
B. Documents of Title and Investment Securities	56	
C. Sales	58	
D. Secured Transactions	66	

\* No multiple choice items were indexed for this group.

† Questions in this area are not classified according to group.

	<u>Pages</u>	
	<u>Multiple Choice Items</u>	<u>Essays</u>
VII. Property, Estates, and Trusts	71	109†
A. Real and Personal Property	71	
B. Mortgages	73	
C. Administration of Estates and Trusts	75	
D. Fire and Casualty Insurance	77	
<b>Selected Multiple Choice Items — Unofficial Answers</b>		81
<b>Essays — Selected Questions</b>		85
<b>Selected Essays — Unofficial Answers</b>		113
<b>Suggested References</b>		141
<b>Appendix — Content Specification Outline</b>		143



## MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

### I. The CPA and the Law

#### A. Common Law Liability to Clients and Third Persons

**N83#1.** Locke, CPA, was engaged by Hall, Inc., to audit Willow Company. Hall purchased Willow after receiving Willow's audited financial statements, which included Locke's unqualified auditor's opinion. Locke was negligent in the performance of the Willow audit engagement. As a result of Locke's negligence, Hall suffered damages of \$75,000. Hall appears to have grounds to sue Locke for

	<u>Breach of contract</u>	<u>Negligence</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

**N83#2.** In which of the following statements concerning a CPA firm's action is scienter or its equivalent absent?

- Reckless disregard for the truth.
- Actual knowledge of fraud.
- Intent to gain monetarily by concealing fraud.
- Performance of substandard auditing procedures.

**N83#3.** Gleam is contemplating a common law action against Moore & Co., CPAs, based upon fraud. Gleam loaned money to Lilly & Company relying upon Lilly's financial statements which were audited by Moore. Gleam's action will fail if

- Gleam shows only that Moore failed to meticulously follow GAAP.
- Moore can establish that they fully complied with the Statute of Frauds.
- The alleged fraud was in part committed by oral misrepresentations and Moore pleads the parol evidence rule.
- Gleam is **not** a third party beneficiary in light of the absence of privity.

**N83#4.** In an action for negligence against a CPA, "the custom of the profession" standard is used at least to some extent in determining whether the CPA is neg-

ligent. Which of the following statements describes how this standard is applied?

- If the CPA proves he literally followed GAAP and GAAS, it will be conclusively presumed that the CPA was **not** negligent.
- The custom of the profession argument may only be raised by the defendant.
- Despite a CPA's adherence to the custom of the profession, negligence may nevertheless be present.
- Failure to satisfy the custom of the profession is equivalent to gross negligence.

**M81#1.** DMO Enterprises, Inc., engaged the accounting firm of Martin, Seals & Anderson to perform its annual audit. The firm performed the audit in a competent, nonnegligent manner and billed DMO for \$16,000, the agreed fee. Shortly after delivery of the audited financial statements, Hightower, the assistant controller, disappeared, taking with him \$28,000 of DMO's funds. It was then discovered that Hightower had been engaged in a highly sophisticated, novel defalcation scheme during the past year. He had previously embezzled \$35,000 of DMO funds. DMO has refused to pay the accounting firm's fee and is seeking to recover the \$63,000 that was stolen by Hightower. Which of the following is correct?

- The accountants can **not** recover their fee and are liable for \$63,000.
- The accountants are entitled to collect their fee and are **not** liable for \$63,000.
- DMO is entitled to rescind the audit contract and thus is **not** liable for the \$16,000 fee, but it can **not** recover damages.
- DMO is entitled to recover the \$28,000 defalcation, and is **not** liable for the \$16,000 fee.

#### B. Federal Statutory Liability

**N83#5.** Lewis & Clark, CPAs, rendered an unqualified opinion on the financial statements of a company that sold common stock in a public offering subject to the Securities Act of 1933. Based on a false statement in the financial statements, Lewis & Clark are being

sued by an investor who purchased shares of this public offering. Which of the following represents a viable defense?

- The investor has **not** met the burden of proving fraud or negligence by Lewis & Clark.
- The investor did **not** actually rely upon the false statement.
- Detection of the false statement by Lewis & Clark occurred after their examination date.
- The false statement is immaterial in the overall context of the financial statements.

**N83#6.** The Internal Revenue Code provisions dealing with tax return preparation

- Require tax return preparers who are neither attorneys nor CPAs to pass a basic qualifying examination.
- Apply to all tax return preparers whether they are compensated or uncompensated.
- Apply to a CPA who prepares the tax returns of the president of a corporation the CPA audits, without charging the president.
- Only apply to preparers of individual tax returns.

**N83#7.** Georges, a CPA, has prepared a tax return for his client, Arbor. The return was prepared in a fraudulent manner. Regarding Georges's potential liability to various parties, which of the following would be dismissed?

- A federal criminal action.
- A federal action for civil penalties.
- A federal action to revoke Georges's CPA certificate.
- A malpractice action by the client.

**N83#8.** Gibson is suing Simpson & Sloan, CPAs, to recover losses incurred in connection with Gibson's transactions in Zebra Corporation securities. Zebra's Annual Form 10-K Report contained material false and misleading statements in the financial statements audited by Simpson & Sloan. To recover under the Securities and Exchange Act of 1934, Gibson must, among other things, establish that

- All of his past transactions in Zebra securities, both before and after the auditors' report date, resulted in a net loss.
- The transaction in Zebra securities that resulted in a loss occurred within 90 days of the auditors' report date.
- He relied upon the financial statements in his decision to purchase or sell Zebra securities.
- The market price of the stock dropped significantly after corrected financial statements were issued by Zebra.

**M81#3.** Major, Major & Sharpe, CPAs, are the auditors of MacLain Industries. In connection with the public offering of \$10 million of MacLain securities, Major expressed an unqualified opinion as to the fi-

ancial statements. Subsequent to the offering, certain misstatements and omissions were revealed. Major has been sued by the purchasers of the stock offered pursuant to the registration statement which included the financial statements audited by Major. In the ensuing lawsuit by the MacLain investors, Major will be able to avoid liability if

- The errors and omissions were caused primarily by MacLain.
- It can be shown that at least some of the investors did **not** actually read the audited financial statements.
- It can prove due diligence in the audit of the financial statements of MacLain.
- MacLain had expressly assumed any liability in connection with the public offering.

**M81#4.** Donalds & Company, CPAs, audited the financial statements included in the annual report submitted by Markum Securities, Inc., to the Securities and Exchange Commission. The audit was improper in several respects. Markum is now insolvent and unable to satisfy the claims of its customers. The customers have instituted legal action against Donalds based upon section 10b and rule 10b-5 of the Securities Exchange Act of 1934. Which of the following is likely to be Donalds' best defense?

- They did **not** intentionally certify false financial statements.
- Section 10b does **not** apply to them.
- They were **not** in privity of contract with the creditors.
- Their engagement letter specifically disclaimed any liability to any party which resulted from Markum's fraudulent conduct.

**M81#6.** If a CPA firm is being sued for common law fraud by a third party based upon materially false financial statements, which of the following is the best defense which the accountants could assert?

- Lack of privity.
- Lack of reliance.
- A disclaimer contained in the engagement letter.
- Contributory negligence on the part of the client.

### C. Workpapers, Privileged Communication, and Confidentiality

**N83#9.** With respect to privileged communications of accountants, which of the following is correct?

- A state statutory privilege will be recognized in a case being tried in a federal court involving a federal question.
- Most courts recognize a common-law privilege between an accountant and the client.

## Selected Questions

- c. As a result of legislative enactment and court adoption, the client-accountant privilege is recognized in the majority of jurisdictions.
- d. The privilege will be lost if the party asserting the privilege voluntarily submits part of the privileged communications into evidence.

**N83#10.** Working papers prepared by a CPA in connection with an audit engagement are owned by the CPA, subject to certain limitations. The rationale for this rule is to

- a. Protect the working papers from being subpoenaed.
- b. Provide the basis for excluding admission of the working papers as evidence because of the privileged communication rule.
- c. Provide the CPA with evidence and documentation which may be helpful in the event of a lawsuit.
- d. Establish a continuity of relationship with the client whereby indiscriminate replacement of CPAs is discouraged.

**M81#2.** The CPA firm of Knox & Knox has been subpoenaed to testify and produce its correspondence and workpapers in connection with a lawsuit brought by a third party against one of their clients. Knox considers the subpoenaed documents to be privileged communication and therefore seeks to avoid admission of such evidence in the lawsuit. Which of the following is correct?

- a. Federal law recognizes such a privilege if the accountant is a Certified Public Accountant.
- b. The privilege is available regarding the working papers since the CPA is deemed to own them.
- c. The privileged communication rule as it applies to the CPA-client relationship is the same as that of attorney-client.
- d. In the absence of a specific statutory provision, the law does **not** recognize the existence of the privileged communication rule between a CPA and his client.

## II. Business Organizations

### A. Agency

**N83#11.** Dixon Sales, Inc., dismissed Crow as its general sales agent. Dixon notified all of Crow's known customers by letter. Hale Stores, a retail outlet located outside of Crow's previously assigned sales territory, had never dealt with Crow. However, Hale knew of Crow as a result of various business contacts. After his dismissal, Crow sold Hale goods, to be delivered by Dixon, and received from Hale a cash deposit for 20% of the purchase price. It was not unusual for an agent in Crow's previous position to receive cash deposits. In an action by Hale against Dixon on the sales contract, Hale will

- a. Lose, because Crow lacked any express or implied authority to make the contract.
- b. Lose, because Crow's conduct constituted a fraud for which Dixon is not liable.
- c. Win, because Dixon's notice was inadequate to terminate Crow's apparent authority.
- d. Win, because a principal is an insurer of an agent's acts.

**N83#12.** Ivy Corp. engaged Jones as a sales representative and assigned him to a route in southern Florida. Jones worked out of Ivy's main office and his duties, hours, and routes were carefully controlled. The employment contract contained a provision which stated: "I, Jones, do hereby promise to hold the corporation harmless from any and all tort liability to third

parties which may arise in carrying out my duties as an employee." On a sales call, Jones negligently dropped a case of hammers on the foot of Devlin, the owner of Devlin's Hardware. Which of the following statements is correct?

- a. Ivy has **no** liability to Devlin.
- b. Although the exculpatory clause may be valid between Ivy and Jones, it does **not** affect Devlin's rights.
- c. Ivy is **not** liable to Devlin in any event, since Jones is an independent contractor.
- d. The exculpatory clause is totally invalid since it is against public policy.

**N83#13.** Wall & Co. hired Carr to work as an agent in its collection department, reporting to the credit manager. Which of the following is correct?

- a. Carr does **not** owe a fiduciary duty to Wall since he does not compete with the company.
- b. Carr will be personally liable for any torts he commits even though they are committed in the course of his employment and pursuant to Wall's directions.
- c. Carr has the implied authority to engage counsel and commence legal action against Wall's debtors.
- d. Carr may commingle funds collected by him if this is convenient as long as he keeps proper records.

**N83#14.** Steel has been engaged by Lux to act as the agent for Lux, an undisclosed principal. As a result of this relationship

- a. Steel has the same implied powers as an agent engaged by a disclosed principal.
- b. Lux can **not** be held liable for any torts committed by Steel in the course of carrying out the engagement.
- c. Steel will be free from personal liability on authorized contracts for Lux when it is revealed that Steel was acting as an agent.
- d. Lux must file the appropriate form in the proper state office under the fictitious business name statute.

**M83#1.** Wallace, an agent for Lux, made a contract with Doolittle which exceeded Wallace's authority. If Lux wishes to hold Doolittle to the contract, Lux must prove that

- a. Lux ratified the contract before withdrawal from the contract by Doolittle.
- b. Wallace was acting in the capacity of an agent for an undisclosed principal.
- c. Wallace believed he was acting within the scope of his authority.
- d. Wallace was Lux's general agent even though Wallace exceeded his authority.

**M83#2.** Terrence has been Pauline's agent in the liquor business for ten years and has made numerous contracts on Pauline's behalf. Under which of the following situations could Terrence continue to have power to bind Pauline?

- a. The passage of a federal constitutional amendment making the sale or purchase of alcoholic beverages illegal.
- b. The death of Pauline without Terrence's knowledge.
- c. The bankruptcy of Pauline with Terrence's knowledge.
- d. The firing of Terrence by Pauline.

**N82#5.** The apparent authority of an agent would **not** be determined by reference to

- a. Prior dealings between the parties.
- b. The types of activity engaged in by the agent.
- c. An undisclosed limitation on the agent's usual power.
- d. Industry custom.

**N82#7.** Davidson is the agent of Myers, a fuel dealer. Myers is an undisclosed principal. Davidson contracts with Wallop to purchase 30,000 tons of coal at \$20 per ton. Which of the following is correct?

- a. If Davidson acts outside the scope of his authority in entering into this contract, Myers can **not** ratify the contract.
- b. Wallop is bound to this contract only if Davidson acts within the scope of his authority.

- c. If Davidson acts within the scope of his authority, Wallop can **not** hold Davidson personally liable on the contract.
- d. Should Davidson refuse to accept delivery of the coal, Wallop will become an agent of Myers by substitution.

**N82#34.** Downtown Disco, Inc., engaged Charleston as club manager in a written agreement providing for a \$20,000 salary, plus 2% of gross revenues, and exclusive management authority including entertainment bookings. The agreement is irrevocable by Downtown for three years but terminable by Charleston upon one month's written notice. The Downtown-Charleston arrangement is

- a. An agency coupled with an interest.
- b. A partnership between Downtown and Charleston.
- c. Terminable at any time by Downtown despite the three-year irrevocability clause.
- d. Enforceable by Charleston by an action for specific performance.

**M82#5.** The liability of a principal to a third party for the torts of his agent

- a. Can be effectively limited by agreement with the agent.
- b. Can **not** extend to the inclusion of a criminal act committed by the agent.
- c. Is less onerous if the agent is acting for an undisclosed principal.
- d. Is an example of the imposition of liability without fault upon the principal.

**M82#7.** Mathews is an agent for Sears with the express authority to solicit orders from customers in a geographic area assigned by Sears. Mathews has no authority to grant discounts nor to collect payment on orders solicited. Mathews secured an order from Davidson for \$1,000 less a 10% discount if Davidson makes immediate payment. Davidson had previously done business with Sears through Mathews but this was the first time that a discount-payment offer had been made. Davidson gave Mathews a check for \$900 and thereafter Mathews turned in both the check and the order to Sears. The order clearly indicated that a 10% discount had been given by Mathews. Sears shipped the order and cashed the check. Later Sears attempted to collect \$100 as the balance owed on the order from Davidson. Which of the following is correct?

- a. Sears can collect the \$100 from Davidson because Mathews contracted outside the scope of his express or implied authority.
- b. Sears can **not** collect the \$100 from Davidson because Mathews as an agent with express authority to solicit orders had implied authority to give discounts and collect.

Selected Questions

- c. Sears can **not** collect the \$100 from Davidson as Sears has ratified the discount granted and payment made to Mathews.
- d. Sears can **not** collect the \$100 from Davidson because although Mathews had **no** express or implied authority to grant a discount and collect, Mathews had apparent authority to do so.

**N81#12.** Which of the following is **not** an essential element of an agency relationship?

- a. It must be created by contract.
- b. The agent must be subject to the principal's control.
- c. The agent is a fiduciary in respect to the principal.
- d. The agent acts on behalf of another and **not** himself.

**N81#13.** To successfully invoke the doctrine of ratification

- a. The agent must have had the legal capacity to have so acted.
- b. The agent must in fact be the agent of the principal although the action taken was totally without authority.
- c. The ratification must have been stated expressly.
- d. The ratification must be made with knowledge of the material facts of the transaction.

**N81#14.** Kent works as a welder for Mighty Manufacturing, Inc. He was specially trained by Mighty in the procedures and safety precautions applicable to installing replacement mufflers on automobiles. One rule of which he was aware involved a prohibition against installing a muffler on any auto which had heavily congealed oil or grease or which had any leaks. Kent disregarded this rule, and, as a result, a customer's auto caught fire causing extensive property damage and injury to Kent. Which of the following is correct?

- a. Mighty is **not** liable to Kent under the worker's compensation laws.
- b. Mighty is **not** liable to the customer because Mighty's rule prohibited Kent from installing the muffler in question.
- c. Kent does **not** have any personal liability to the customer for the loss because Kent was acting for and on behalf of his employer.
- d. Mighty is liable to the customer irrespective of its efforts to prevent such an occurrence and the fact that it exercised reasonable care.

**N81#15.** The key characteristic of a servant is that

- a. His physical conduct is controlled or subject to the right of control by the employer.
- b. He is paid at an hourly rate as contrasted with the payment of a salary.
- c. He is precluded from making contracts for and on behalf of his employer.
- d. He lacks apparent authority to bind his employer.

**N81#16.** Brian purchased an automobile from Robinson Auto Sales under a written contract by which Robinson obtained a security interest to secure payment of the purchase price. Robinson reserved the right to repossess the automobile if Brian failed to make any of the required ten payments. Ambrose, an employee of Robinson, was instructed to repossess the automobile on the ground that Brian had defaulted in making the third payment. Ambrose took possession of the automobile and delivered it to Robinson. It was then discovered that Brian was not in default. Which of the following is **incorrect**?

- a. Brian has the right to regain possession of the automobile and to collect damages.
- b. Brian may sue and collect from either Robinson or Ambrose.
- c. If Ambrose must pay in damages, he will be entitled to indemnification from Robinson.
- d. Ambrose is **not** liable for the wrongful repossession of the automobile since he was obeying the direct order of Robinson.

**M81#29.** Barton, a wealthy art collector, orally engaged Deiter to obtain a rare and beautiful painting from Cumbers, a third party. Cumbers did not know that Barton had engaged Deiter to obtain the painting for Barton because, as Barton told Deiter, "that would cause the price to skyrocket." Regarding the liability of the parties if a contract is made or purported to be made, which of the following is correct?

- a. Since the appointment of Deiter was oral, **no** agency exists, and any contract made by Deiter on Barton's behalf is invalid.
- b. Because Barton specifically told Deiter **not** to reveal for whom he (Deiter) was buying the painting, Deiter can **not** be personally liable on the contract made on Barton's behalf.
- c. If Deiter makes a contract with Cumbers which Deiter breaches, Cumbers may, after learning of the agreement between Barton and Deiter, elect to recover from either Barton or Deiter.
- d. If Deiter makes a contract to purchase the painting, without revealing he is Barton's agent, Cumbers has entered into a contract which is voidable at his election.

**M81#30.** Moderne Fabrics, Inc., hired Franklin as an assistant vice president of sales at \$2,000 a month. The employment had no fixed duration. In light of their relationship to each other, which of the following is correct?

- a. Franklin has a legal duty to reveal any interest adverse to that of Moderne in matters concerning his employment.
- b. If Franklin voluntarily terminates his employment with Moderne after working for it for several years, he can **not** work for a competitor for a reasonable period after termination.
- c. Moderne can dismiss Franklin only for cause.
- d. The employment contract between the parties must be in writing.

**M81#31.** Sly was a general agent of the Cute Cosmetics Company with authority to sell, make collections, and adjust disputes. Sly was caught padding his monthly expense account by substantial amounts and was dismissed. Cute hired another general agent, Ready, to replace Sly. Ready was slowly but steadily calling upon Sly's accounts to make sales and was informing them that Sly's services had been terminated. Cute also published a notice in the appropriate trade journals and the local newspaper announcing the replacement of Sly with Ready. Sly, after he was let go, called on all the customers who had outstanding accounts payable and quickly made whatever collections he could in cash and absconded. Which of the following statements is correct regarding Cute's legal right against the customers?

- Cute can regain possession of the goods since title did **not** pass because Sly's actions constituted a fraud.
- Cute can obtain payment from the customers despite Sly's wrongful acts since it had published a notice of Sly's dismissal.
- Cute will have to absorb the loss since Sly had continuing implied authority to make collections.
- Cute will have to absorb the loss unless Cute can prove the customers had actual notice of Sly's dismissal.

**M81#32.** Marcross is an agent for Fashion Frocks, Ltd. As such, Marcross made a contract for, and on behalf of, Fashion Frocks with Sowinski Fabrics which was not authorized and upon which Fashion has disclaimed liability. Sowinski has sued Fashion on the contract asserting that Marcross had the apparent authority to make it. In considering the factors which will determine the scope of Marcross' apparent authority, which of the following would **not** be important?

- The custom and usages of the business.
- Previous acquiescence by the principal in similar contracts made by Marcross.
- The express limitations placed upon Marcross's authority which were **not** known by Sowinski.
- The status of Marcross's position in Fashion Frocks.

**M81#33.** Duval Manufacturing Industries, Inc., orally engaged Harris as one of its district sales managers for an 18-month period commencing April 1, 1980. Harris commenced work on that date and performed his duties in a highly competent manner for several months. On October 1, 1980, the company gave Harris a notice of termination as of November 1, 1980, citing a downturn in the market for its products. Harris sues seeking either specific performance or damages for breach of contract. Duval pleads the Statute of Frauds and/or a justified

dismissal due to the economic situation. What is the probable outcome of the lawsuit?

- Harris will prevail because he has partially performed under the terms of the contract.
- Harris will lose because his termination was caused by economic factors beyond Duval's control.
- Harris will lose because such a contract must be in writing and signed by a proper agent of Duval.
- Harris will prevail because the Statute of Frauds does **not** apply to contracts such as his.

**M81#34.** Jason Manufacturing Company wished to acquire a site for a warehouse. Knowing that if it negotiated directly for the purchase of the property the price would be substantially increased, it employed Kent, an agent, to secure lots without disclosing that he was acting for Jason. Kent's authority was evidenced by a writing signed by the proper officers of Jason. Kent entered into a contract in his own name to purchase Peter's lot, giving Peter a negotiable note for \$1,000 signed by Kent as first payment. Jason wrote Kent acknowledging the purchase. Jason also disclosed its identity as Kent's principal to Peter. In respect to the rights and liabilities of the parties, which of the following is a correct statement?

- Peter is **not** bound on the contract since Kent's failure to disclose he was Jason's agent was fraudulent.
- Jason, Kent and Peter are potentially liable on the contract.
- Unless Peter formally ratifies the substitution of Jason for Kent, he is **not** liable.
- Kent has **no** liability since he was acting for and on behalf of an existing principal.

**N80#25.** Wallers and Company has decided to expand the scope of its business. In this connection, it contemplates engaging several agents. Which of the following agency relationships is within the Statute of Frauds and thus should be contained in a signed writing?

- An irrevocable agency.
- A sales agency where the agent normally will sell goods which have a value in excess of \$500.
- An agency for the forthcoming calendar year which is entered into in mid-December of the prior year.
- An agency which is of indefinite duration but which is terminable upon one month's notice.

**N80#26.** A power of attorney is a useful method of creation of an agency relationship. The power of attorney

- Must be signed by both the principal and the agent.
- Exclusively determines the purpose and powers of the agent.
- Is the written authorization of the agent to act on the principal's behalf.
- Is used primarily in the creation of the attorney-client relationship.

Selected Questions

**N80#27.** Agents sometimes have liability to third parties for their actions taken for and on behalf of the principal. An agent will **not** be personally liable in which of the following circumstances?

- a. If he makes a contract which he had no authority to make but which the principal ratifies.
- b. If he commits a tort while engaged in the principal's business.
- c. If he acts for a principal which he knows is nonexistent and the third party is unaware of this.
- d. If he acts for an undisclosed principal as long as the principal is subsequently disclosed.

**N80#28.** Mayberry engaged Williams as her agent. It was mutually agreed that Williams would **not** disclose that he was acting as Mayberry's agent. Instead he was to deal with prospective customers as if he were a principal acting on his own behalf. This he did and made several contracts for Mayberry. Assuming Mayberry, Williams or the customer seeks to avoid liability on one of the contracts involved, which of the following statements is correct?

- a. Williams has **no** liability once he discloses that Mayberry was the real principal.
- b. Mayberry must ratify the Williams contracts in order to be held liable.
- c. The third party may choose to hold either Williams or Mayberry liable.
- d. The third party can avoid liability because he believed he was dealing with Williams as a principal.

**N80#29.** Park Manufacturing hired Stone as a traveling salesman to sell goods manufactured by Park. Stone also sold a line of products manufactured by a friend. He did **not** disclose this to Park. The relationship was unsatisfactory and Park finally fired Stone after learning of Stone's sales of the other manufacturer's goods. Stone, enraged at Park for firing him, continued to make contracts on Park's behalf with both new and old customers that were almost uniformly disadvantageous to Park. Park, upon learning of this, gave written notice of Stone's discharge to all parties with whom Stone had dealt. Which of the following statements is **incorrect**?

- a. Park can bring an action against Stone to have him account for any secret profits.
- b. Prior to notification, Stone retained some continued authority to bind Park despite termination of the agency relationship.
- c. New customers who contracted with Stone for the first time could enforce the contracts against Park if they knew that Stone had been Park's salesman but were unaware that Stone was fired.
- d. If Park had promptly published a notification of termination of Stone's employment in the local newspapers and in the trade publications, he would **not** be liable for any of Stone's contracts.

**N80#30.** Michaels appointed Fairfax as his agent. The appointment was in writing and clearly indicated the scope of Fairfax's authority and also that Fairfax was **not** to disclose that he was acting as an agent for Michaels. Under the circumstances

- a. Fairfax is an agent coupled with an interest.
- b. Michaels must ratify any contracts made by Fairfax on behalf of Michaels.
- c. Fairfax's appointment had to be in writing to be enforceable.
- d. Fairfax has the implied and apparent authority of an agent.

**N79#31.** Magnus Real Estate Developers, Inc., wanted to acquire certain tracts of land in Marshall Township in order to build a shopping center complex. To accomplish this goal, Magnus engaged Dexter, a sophisticated real estate dealer, to represent them in the purchase of the necessary land without revealing the existence of the agency. Dexter began to slowly but steadily acquire the requisite land. However, Dexter made the mistake of purchasing one tract outside the description of the land needed. Which of the following is correct under these circumstances?

- a. The use of an agent by Magnus, an undisclosed principal, is manifestly illegal.
- b. Either Magnus or Dexter may be held liable on the contracts for the land, including the land that was **not** within the scope of the proposed shopping center.
- c. An undisclosed principal such as Magnus can have **no** liability under the contract since the third party believed he was dealing with Dexter as a principal.
- d. An agent for an undisclosed principal assumes **no** liability as long as he registers his relationship to the principal with the clerk of the proper county having jurisdiction.

**N79#33.** Wanamaker, Inc., engaged Anderson as its agent to purchase original oil paintings for resale by Wanamaker. Anderson's express authority was specifically limited to a maximum purchase price of \$25,000 for any collection provided it contained a minimum of five oil paintings. Anderson purchased a seven-picture collection on Wanamaker's behalf for \$30,000. Based upon these facts, which of the following is a correct legal conclusion?

- a. The express limitation on Anderson's authority negates any apparent authority.
- b. Wanamaker can **not** ratify the contract since Anderson's actions were clearly in violation of his contract.
- c. If Wanamaker rightfully disaffirms the unauthorized contract, Anderson is personally **liable** to the seller.
- d. Neither Wanamaker **nor** Anderson is liable on the contract since the seller was obligated to ascertain Anderson's authority.

**N79#50.** Ozgood is a principal and Flood is his agent. Ozgood is totally dissatisfied with the agency relationship and wishes to terminate it. In which of the following situations does Ozgood **not** have the power to terminate the relationship?

- Ozgood and Flood have agreed that their agency is irrevocable.
- Flood has been appointed as Ozgood's agent pursuant to a power of attorney.
- Flood is an agent coupled with an interest.
- The agency agreement is in writing and provides for a specific duration which has **not** elapsed.

**M79#40.** Dolby was employed as an agent for the Ace Used Car Company to purchase newer model used cars. His authority was limited by a \$3,000 maximum price for any car. A wholesaler showed him a 1938 classic car which was selling for \$5,000. The wholesaler knew that Ace only dealt in newer model used cars and that Dolby had never paid more than \$3,000 for any car. Dolby bought the car for Ace, convinced that it was worth at least \$7,000. When he reported this to Williams, Ace's owner, Williams was furious but he nevertheless authorized processing of the automobile for resale. Williams also began pricing the car with antique car dealers who indicated that the current value of the car was \$4,800. Williams called the wholesaler, told him that Dolby had exceeded his authority, that he was returning the car, and that he was demanding repayment of the purchase price. What is the wholesaler's best defense in the event of a lawsuit?

- Dolby had apparent authority to purchase the car.
- Dolby's purchase was effectively ratified by Ace.
- Dolby had express authority to purchase the car.
- Dolby had implied authority to purchase the car.

**M79#45.** What fiduciary duty, if any, exists in an agency relationship?

- The agent owes a fiduciary duty to third parties he deals with for and on behalf of his principal.
- The principal owes a fiduciary duty to his agent.
- The agent owes a fiduciary duty to his principal.
- There is no fiduciary duty in an agency relationship.

## B. Partnerships

**N83#15.** Many states require partnerships to file the partnership name under laws which are generally known as fictitious name statutes. These statutes

- Require a proper filing as a condition precedent to the valid creation of a partnership.

- Are designed primarily to provide registration for tax purposes.
- Are designed to clarify the rights and duties of the members of the partnership.
- Have little effect on the creation or operation of a partnership other than the imposition of a fine for noncompliance.

**N83#16.** A general partner of a mercantile partnership

- Can by virtue of his acts, impose tort liability upon the other partners.
- Has **no** implied authority if the partnership agreement is contained in a formal and detailed signed writing.
- Can have his apparent authority effectively negated by express limitations in the partnership agreement.
- Can **not** be sued individually for a tort he has committed in carrying on partnership business until the partnership has been sued and a judgment returned unsatisfied.

**N83#17.** Which of the following is a correct statement concerning a partner's power to bind the partnership?

- A partner has **no** authority to bind the partnership after dissolution.
- A partner can **not** bind the partnership based upon apparent authority when the other party to the contract knows that the partner lacks actual authority.
- A partner has **no** authority in carrying on the regular business of the partnership to convey real property held in the partnership name.
- A partner, acting outside the scope of the partner's apparent authority, but with express authority to act, can **not** bind the partnership unless the third party knows of the express authority.

**N83#18.** Vast Ventures is a limited partnership. The partnership agreement does not contain provisions dealing with the assignment of a partnership interest. The rights of the general and limited partners regarding the assignment of their partnership interests are

- Determined according to the common law of partnerships as articulated by the courts.
- Basically the same with respect to both types of partners.
- Basically the same with the exception that the limited partner must give ten days notice prior to the assignment.
- Different in that the assignee of the general partnership interest does not become a substituted partner, whereas the assignee of a limited partnership interest automatically becomes a substituted limited partner.



*Selected Questions*

**M83#3.** For which of the following purposes is a general partnership recognized as an entity by the Uniform Partnership Act?

- a. Recognition of the partnership as the employer of its partners.
- b. Insulation of the partners from personal liability.
- c. Taking of title and ownership of property.
- d. Continuity of existence.

**M83#4.** Donovan, a partner of Monroe, Lincoln, and Washington, is considering selling or pledging all or part of his interest in the partnership. The partnership agreement is silent on the matter. Donovan can

- a. Sell part but not all of his partnership interest.
- b. Sell or pledge his entire partnership interest without causing a dissolution.
- c. Pledge his partnership interest, but only with the consent of his fellow partners.
- d. Sell his entire partnership interest and confer partner status upon the purchaser.

**M83#5.** In determining the liability of a partnership for the acts of a partner purporting to act for the partnership without the authorization of fellow partners, which of the following actions will bind the partnership?

- a. The renewal of an existing supply contract which the other partners had decided to terminate and which they had specifically voted against.
- b. An assignment of the partnership assets in trust for the benefit of creditors.
- c. A written admission of liability in a lawsuit brought against the partnership.
- d. Signing the partnership name as a surety on a note for the purchase of that partner's summer home.

**M82#1.** Three independent sole proprietors decided to pool their resources and form a partnership. The business assets and liabilities of each were transferred to the partnership. The partnership commenced business on September 1, 1981, but the parties did not execute a formal partnership agreement until October 15, 1981. Which of the following is correct?

- a. The existing creditors must consent to the transfer of the individual business assets to the partnership.
- b. The partnership began its existence on September 1, 1981.
- c. If the partnership's duration is indefinite, the partnership agreement must be in writing and signed.
- d. In the absence of a partnership agreement specifically covering division of losses among the partners, they will be deemed to share them in accordance with their capital contributions.

**M82#2.** A question has arisen in determining the partnership's liability for actions taken for and on behalf of a partnership, but which were in fact without express or implied authority. Which of the following actions taken by a general partner will bind the partnership?

- a. Renewing an existing supply contract which had previously been negotiated, but which the partners had specifically voted **not** to renew.
- b. Submitting a claim against the partnership to binding arbitration.
- c. Taking an action which was known by the party with whom he dealt to be in contravention of a restriction on his authority.
- d. Signing the firm name as an accommodation comaker on a promissory note not in furtherance of firm business.

**M82#3.** Stanley is a well-known retired movie personality who purchased a limited partnership interest in Terrific Movie Productions upon its initial syndication. Terrific has three general partners, who also purchased limited partnership interests, and 1,000 additional limited partners located throughout the United States. Which of the following is correct?

- a. If Stanley permits his name to be used in connection with the business and is held out as a participant in the management of the venture, he will be liable as a general partner.
- b. The sale of these limited partnership interests would **not** be subject to SEC registration.
- c. This limited partnership may be created with the same informality as a general partnership.
- d. The general partners are prohibited from also owning limited partnership interests.

**M82#4.** Cavendish is a limited partner of Custer Venture Capital. He is extremely dissatisfied with the performance of the general partners in making investments and managing the portfolio. He is contemplating taking whatever legal action may be appropriate against the general partners. Which of the following rights would Cavendish **not** be entitled to assert as a limited partner?

- a. To have a formal accounting of partnership affairs whenever the circumstances render it just and reasonable.
- b. To have the same rights as a general partner to a dissolution and winding up of the partnership.
- c. To have reasonable access to the partnership books and to inspect and copy them.
- d. To have himself elected as a general partner by a majority vote of the limited partners in number and amount.

**N81#17.** For which of the following does a partner have joint liability as contrasted with joint and several liability?

- The negligent injury of a third person by a partner while acting in the ordinary course of the firm's business.
- The misapplication of funds by a partner acting within the scope of his apparent authority.
- The intentional interference with an existing contractual relationship with the tacit approval of his fellow partners.
- The bond and mortgage on the partnership's office building.

**N81**

**Items 18 and 19** are based on the following information:

Daniels, Beal, and Wade agreed to form the DBW Partnership to engage in the import-export business. They had been lifelong friends and had engaged in numerous business dealings with each other. It was orally agreed that Daniels would contribute \$20,000, Beal \$15,000 and Wade \$5,000. It was also orally agreed that in the event the venture proved to be a financial disaster all losses above the amounts of capital contributed would be assumed by Daniels and that he would hold his fellow partners harmless from any additional amounts lost. The partnership was consummated with a handshake and the contribution of the agreed upon capital by the partners. There were no other express agreements.

**N81#18.** Under these circumstances, which of the following is correct?

- Profits are to be divided in accordance with the relative capital contributions of each partner.
- Profits are to be divided equally.
- The partnership is a nullity because the agreement is **not** contained in a signed writing.
- Profits are to be shared in accordance with the relative time each devotes to partnership business during the year.

**N81#19.** If the partnership becomes insolvent and the partnership debts exceed assets by \$15,000, which of the following is correct insofar as the rights of partnership creditors are concerned?

- Daniels is a surety insofar as partnership debts in excess of \$40,000 are concerned.
- Those creditors who were aware of the oral agreement among the partners regarding partnership liability are bound by it.
- Partnership creditors must first proceed against Daniels and have a judgment returned unsatisfied before proceeding against Beal or Wade.
- Each partner may be held jointly liable to firm creditors.

**N81#20.** For which of the following is a partnership recognized as a separate legal entity?

- The liability for and payment of taxes on partnership gains from the sale of capital assets.
- In respect to contributions and advances made by partners to the partnership.
- The recognition of net operating losses.
- The status of the partnership as an employer for worker's compensation purposes.

**N81#21.** Donaldson reached the mandatory retirement age as a partner of the Malcomb and Black partnership. Edwards was chosen by the remaining partners to succeed Donaldson. The remaining partners agreed to assume all of Donaldson's partnership liability and released Donaldson from such liability. Additionally, Edwards expressly assumed full liability for Donaldson's partnership liability incurred prior to retirement. Which of the following is correct?

- Edwards's assumption of Donaldson's liability was a matter of form since as an incoming partner he was liable as a matter of law.
- Firm creditors are **not** precluded from asserting rights against Donaldson for debts incurred while she was a partner, the agreements of Donaldson and the remaining partners notwithstanding.
- Donaldson has **no** continuing potential liability to firm creditors as a result of the agreements contained in the retirement plan.
- Since Donaldson obtained a release from firm debts she has **no** liability for debts incurred while she was a partner.

**N81#22.** Which of the following may a partner **not** do without the express unanimous assent of the remaining partners?

- Assign his entire partnership interest to an outsider.
- Dismiss the accounting firm engaged to audit the partnership's accounts.
- Submit a long-standing dispute regarding a partnership claim against a recalcitrant customer to arbitration.
- Obtain a short-term loan from the partnership's banker to increase the partnership's working capital.

**N81#23.** Wichita Properties is a limited partnership created in accordance with the provisions of the Uniform Limited Partnership Act. The partners have voted to dissolve and settle the partnership's accounts. Which of the following will be the last to be paid?

- General partners in respect to profits.
- Limited partners in respect to capital.
- Limited partners in respect to their share of the profits.
- General partners in respect to capital.

*Selected Questions*

**N80#19.** Perone was a member of Cass, Hack & Perone, a general trading partnership. He died on August 2, 1980. The partnership is insolvent, but Perone's estate is substantial. The creditors of the partnership are seeking to collect on their claims from Perone's estate. Which of the following statements is correct insofar as their claims are concerned?

- a. The death of Perone caused a dissolution of the firm, thereby freeing his estate from personal liability.
- b. If the existing obligations to Perone's personal creditors are **all** satisfied, then the remaining estate assets are available to satisfy partnership debts.
- c. The creditors must first proceed against the remaining partners before Perone's estate can be held liable for the partnership's debts.
- d. The liability of Perone's estate can **not** exceed his capital contribution plus that percentage of the deficit attributable to his capital contribution.

**N80#20.** The partnership agreement of one of your clients provides that upon death or withdrawal, a partner shall be entitled to the book value of his or her partnership interest as of the close of the year preceding such death or withdrawal and nothing more. It also provides that the partnership shall continue. Regarding this partnership provision, which of the following is a correct statement?

- a. It is unconscionable on its face.
- b. It has the legal effect of preventing a dissolution upon the death or withdrawal of a partner.
- c. It effectively eliminates the legal necessity of a winding up of the partnership upon the death or withdrawal of a partner.
- d. It is **not** binding upon the spouse of a deceased partner if the book value figure is less than the fair market value at the date of death.

**N80#21.** Watson decided to withdraw from the Sterling Enterprises Partnership. Watson found Holmes as a prospective purchaser and his successor as a partner in the partnership. The other partners agreed to admit Holmes as a general partner in Watson's place. As a part of the agreement between Watson and Holmes, Holmes promised to satisfy any prior partnership debts for which Watson might be liable. What potential liability does Holmes or Watson have to firm creditors?

- a. Holmes has no liability for the obligations arising before he entered the partnership.
- b. Holmes is liable for the obligations arising before he entered the partnership, but only to the extent of partnership property.
- c. Holmes is fully liable to firm creditors for liabilities occurring before and after his entry into the partnership.
- d. Watson's liability to firm creditors has been extinguished.

**N80#22.** One of your audit clients, Major Supply, Inc., is seeking a judgment against Danforth on the basis of a representation made by one Coleman, in Danforth's presence, that they were in partnership together doing business as the D & C Trading Partnership. Major Supply received an order from Coleman on behalf of D & C and shipped \$800 worth of goods to Coleman. Coleman has defaulted on payment of the bill and is insolvent. Danforth denies he is Coleman's partner and that he has any liability for the goods. Insofar as Danforth's liability is concerned, which of the following is correct?

- a. Danforth is **not** liable if he is **not** in fact Coleman's partner.
- b. Since Danforth did **not** make the statement about being Coleman's partner, he is **not** liable.
- c. If Major Supply gave credit in reliance upon the misrepresentation made by Coleman, Danforth is a partner by estoppel.
- d. Since the "partnership" is operating under a fictitious name (the D & C Partnership) a filing is required and Major Supply's failure to ascertain whether there was in fact such a partnership precludes it from recovering.

**N80#23.** In the course of your audit of James Fine, doing business as Fine's Apparels, sole proprietorship, you discovered that in the past year Fine had regularly joined with Charles Walters in the marketing of bathing suits and beach accessories. You are concerned whether Fine and Walters have created a partnership relationship. Which of the following factors is the **most** important in ascertaining this status?

- a. The fact that a partnership agreement is **not** in existence.
- b. The fact that each has a separate business of his own which he operates independently.
- c. The fact that Fine and Walters divide the net profits equally **on** a quarterly basis.
- d. The fact that Fine and Walters did **not** intend to be partners.

**N80#24.** Ms. Walls is a limited partner of the Amalgamated Limited Partnership. She is insolvent and her debts exceed her assets by \$28,000. Goldsmith, one of Walls's largest creditors, is resorting to legal process to obtain the payment of Walls's debt to him. Goldsmith has obtained a charging order against Walls's limited partnership interest for the unsatisfied amount of the debt. As a result of Goldsmith's action, which of the following will happen?

- a. The partnership will be dissolved.
- b. Walls's partnership interest must be redeemed with partnership property.
- c. Goldsmith automatically becomes a substituted limited partner.
- d. Goldsmith becomes in effect an assignee of Walls's partnership interest.

**N79#14.** Dowling is a promoter and has decided to use a limited partnership for conducting a securities investment venture. Which of the following is **unnecessary** in order to validly create such a limited partnership?

- a. All limited partners' capital contributions must be paid in cash.
- b. There must be a state statute which permits the creation of such a limited partnership.
- c. A limited partnership certificate must be signed and sworn to by the participants and filed in the proper office in the state.
- d. There must be one or more general partners and one or more limited partners.

**N79#15.** Jon and Frank Clarke are equal partners in the partnership of Clarke & Clarke. Both Jon Clarke and the partnership are bankrupt. Jon Clarke personally has \$150,000 of liabilities and \$100,000 of assets. The partnership's liabilities are \$450,000 and its assets total \$250,000. Frank Clarke, the other partner, is solvent with \$800,000 of assets and \$150,000 of liabilities. What are the rights of the various creditors of Jon Clarke, Frank Clarke, and the partnership?

- a. Jon Clarke must divide his assets equally among his personal creditors and firm creditors.
- b. Frank Clarke will be liable in full for the \$200,000 partnership deficit.
- c. Jon Clarke's personal creditors can recover the \$50,000 deficit owed to them from Frank Clarke.
- d. Frank Clarke is liable only for \$100,000, his equal share of the partnership deficit.

**N79#16.** King, Kline and Fox were partners in a wholesale business. Kline died and left to his wife his share of the business. Kline's wife is entitled to

- a. The value of Kline's interest in the partnership.
- b. Kline's share of specific property of the partnership.
- c. Continue the partnership as a partner with King and Fox.
- d. Kline's share of the partnership profits until her death.

**N79#17.** Which of the following will **not** result in a dissolution of a partnership?

- a. The bankruptcy of a partner as long as the partnership itself remains solvent.
- b. The death of a partner as long as his will provides that his executor shall become a partner in his place.
- c. The wrongful withdrawal of a partner in contravention of the agreement between the partners.
- d. The assignment by a partner of his entire partnership interest.

**N79**

**Items 18 and 19** are based on the following information:

Teal and Olvera were partners of the T & O Real Estate Investment Company. They decided to seek more capital in order to expand their participation in the booming real estate business in the area. They obtained five individuals to invest \$100,000 each in their venture as limited partners.

**N79#18.** Assuming the limited partnership agreement is silent on the point, which of the following acts may Teal and Olvera engage in without the written consent of all limited partners?

- a. Admit an additional person as a general partner.
- b. Continue the partnership business upon the death or retirement of a general partner.
- c. Invest the entire amount (\$500,000) of contributions by the limited partners in a single venture.
- d. Admit additional limited partners from time to time in order to obtain additional working capital.

**N79#19.** Which of the following rights would the limited partners **not** have?

- a. The right to have a dissolution and winding up by court decree where such is appropriate.
- b. The right to remove a general partner by a majority vote if the limited partners determine that a general partner is not managing the partnership affairs properly.
- c. The right upon dissolution to receive their share of profits and capital contributions before any payment is made to the general partners.
- d. The right to have the partnership books kept at the principal place of business and to have access to them.

### C. Corporations

**N83#19.** At their annual meeting, shareholders of the Bones Corp. approved several proposals made by the board of directors. Among them was the ratification of the salaries of the executives of the corporation. In this connection, which of the following is correct?

- a. The salaries ratified are automatically valid for federal income tax purposes.
- b. Such ratification by the shareholders is required as a matter of law.
- c. The action by the shareholders serves the purpose of confirming the board's action.
- d. The shareholders can **not** legally ratify the compensation paid to director-officers.

**N83#20.** King Corp. and Queen Corp. have decided to merge pursuant to the merger provisions of the

Selected Questions

Model Business Corporation Act, which is the law of their jurisdiction. The statutory merger

- a. Is one type of tax-free reorganization recognized by the Internal Revenue Code.
- b. Is subject to clearly defined rules regarding the percentage and types of securities which may be used to consummate the merger.
- c. May cut off the rights of creditors of the merged corporation.
- d. Requires the approval of the secretary of state or the attorney general at least 90 days prior to consummation of a merger or consolidation.

**N83#23.** Which of the following statements is correct regarding the fiduciary duty?

- a. A majority shareholder as such may owe a fiduciary duty to fellow shareholders.
- b. A director's fiduciary duty to the corporation may be discharged by merely disclosing his self-interest.
- c. A director owes a fiduciary duty to the shareholders but **not** to the corporation.
- d. A promoter of a corporation to be formed owes no fiduciary duty to anyone, unless the contract engaging the promoter so provides.

**N83#24.** Ambrose purchased 400 shares of \$100 par value original issue common stock from Minor Corporation for \$25 a share. Ambrose subsequently sold 200 of the shares to Harris at \$25 a share. Harris did not have knowledge or notice that Ambrose had not paid par. Ambrose also sold 100 shares of this stock to Gable for \$25 a share. At the time of this sale, Gable knew that Ambrose had not paid par for the stock. Minor Corporation became insolvent and the creditors sought to hold all the above parties liable for the \$75 unpaid on each of the 400 shares. Under these circumstances

- a. The creditors can hold Ambrose liable for \$30,000.
- b. If \$25 a share was a fair value for the stock at the time of issuance, Ambrose will have no liability to the creditors.
- c. Since Harris acquired the shares by purchase, he is not liable to the creditors, and his lack of knowledge or notice that Ambrose paid less than par is immaterial.
- d. Since Gable acquired the shares by purchase, he is not liable to the creditors, and the fact that he knew Ambrose paid less than par is immaterial.

**N83#25.** Decanter Corporation declared a 10% stock dividend on its common stock. The dividend

- a. Must be registered with the SEC pursuant to the Securities Act of 1933.
- b. Requires a vote of the shareholders of Decanter.
- c. Has no effect on the earnings and profits for federal income tax purposes.
- d. Is includable in the gross income of the recipient taxpayers in the year of receipt.

**M82#8.** A court is most likely to disregard the corporate entity and hold shareholders personally liable when

- a. The owner-officers of the corporation do **not** treat it as a separate entity.
- b. A parent corporation creates a wholly owned subsidiary in order to isolate the high risk portion of its business in the subsidiary.
- c. A sole proprietor incorporates his business to limit his liability.
- d. The corporation has elected, under Subchapter S, **not** to pay any corporate tax on its income but, instead, to have the shareholders pay tax on it.

**M82#9.** Phillips was the principal promoter of the Waterloo Corporation, a corporation which was to have been incorporated not later than July 31, 1981. Among the many things to be accomplished prior to incorporation were the obtaining of capital, the hiring of key executives and the securing of adequate office space. In this connection, Phillips obtained written subscriptions for \$1.4 million of common stock from 17 individuals. He hired himself as the chief executive officer of Waterloo at \$200,000 for five years and leased three floors of office space from Downtown Office Space, Inc. The contract with Downtown was made in the name of the corporation. Phillips had indicated orally that the corporation would be coming into existence shortly. The corporation did not come into existence through no fault of Phillips. Which of the following is correct?

- a. The subscribers have a recognized right to sue for and recover damages.
- b. Phillips is personally liable on the lease with Downtown.
- c. Phillips has the right to recover the fair value of his services rendered to the proposed corporation.
- d. The subscribers were **not** bound by their subscriptions until the corporation came into existence.

**M82#10.** Fairwell is executive vice president and treasurer of Wonder Corporation. He was named as a party in a shareholder derivative action in connection with certain activities he engaged in as a corporate officer. In the lawsuit, it was determined that he was liable for negligence in performance of his duties. Fairwell seeks indemnity from the corporation for his liability. The board would like to indemnify him. The articles of incorporation do not contain any provisions regarding indemnification of officers and directors. Indemnification

- a. Is **not** permitted since the articles of incorporation do **not** so provide.
- b. Is permitted only if he is found **not** to have been grossly negligent.
- c. Can **not** include attorney's fees since he was found to have been negligent.
- d. May be permitted by court order despite the fact that Fairwell was found to be negligent.

**M82#11.** Sandy McBride, president of the Cranston Corporation, inquired about the proper method of handling the expenditures incurred in connection with the recent incorporation of the business and sale of its shares to the public. In explaining the legal or tax treatment of these expenditures, which of the following is correct?

- a. The expenditures may be paid out of the consideration received in payment for the shares without rendering such shares not fully paid or assessable.
- b. The expenditures are comparable to goodwill and are treated accordingly for nontax and tax purposes.
- c. The expenditures must be capitalized and are nondeductible for federal income tax purposes since the life of the corporation is perpetual.
- d. The expenditures may be deducted for federal income tax purposes in the year incurred or amortized at the election of the corporation over a five-year period.

**M82#17.** Skipper was for several years the principal stockholder, director, and chief executive officer of the Canarsie Grocery Corporation. Canarsie had financial difficulties and an order of relief was filed against it, and subsequently discharged. Several creditors are seeking to hold Skipper personally liable as a result of his stock ownership and as a result of his being an officer-director. Skipper in turn filed with the bankruptcy judge a claim for \$1,400 salary due him. Which of the following is correct?

- a. Skipper's salary claim will be allowed and he will be entitled to a priority.
- b. Skipper has **no** personal liability to the creditors as long as Canarsie is recognized as a separate legal entity.
- c. Skipper can **not** personally file a petition in bankruptcy for seven years.
- d. Skipper is personally liable to the creditors for Canarsie's losses.

**M81#21.** Universal Joint Corporation has approached Minor Enterprises, Inc., about a tax-free statutory merger of Minor into Universal. The stock of both corporations is listed on the NYSE. Which of the following requirements or procedures need **not** be complied with in order to qualify as a statutory merger pursuant to state and federal law?

- a. The boards of directors of both corporations must approve the plan of merger.
- b. Universal, the surviving corporation, must apply for and obtain a favorable revenue ruling from the Treasury Department.
- c. The boards of both corporations must submit the plan of merger to their respective shareholders for approval.
- d. The securities issued and exchanged by Universal for the shares of Minor must be registered since they are considered to be "offered" and "sold" for purposes of the Securities Act of 1933.

**M81#22.** The consideration for the issuance of shares by a corporation may **not** be paid in

- a. Tangible property.
- b. Intangible property.
- c. Services to be performed for the corporation.
- d. Services actually performed for the corporation.

**M81#23.** Bixler obtained an option on a building he believed was suitable for use by a corporation he and two other men were organizing. After the corporation was successfully promoted, Bixler met with the Board of Directors who agreed to acquire the property for \$200,000. Bixler deeded the building to the corporation and the corporation began business in it. Bixler's option contract called for the payment of only \$155,000 for the building and he purchased it for that price. When the directors later learned that Bixler paid only \$155,000, they demanded the return of Bixler's \$45,000 profit. Bixler refused, claiming the building was worth far more than \$200,000 both when he secured the option and when he deeded it to the corporation. Which of the following statements correctly applies to Bixler's conduct?

- a. It was improper for Bixler to contract for the option without first having secured the assent of the Board of Directors.
- b. If, as Bixler claimed, the building was fairly worth more than \$200,000, Bixler is entitled to retain the entire price.
- c. Even if, as Bixler claimed, the building was fairly worth more than \$200,000, Bixler nevertheless must return the \$45,000 to the corporation.
- d. In order for Bixler to be obligated to return any amount to the corporation, the Board of Directors must establish that the building was worth less than \$200,000.

**M81#24.** Delta Corporation has decided to purchase \$2,000,000 of its own outstanding shares. In connection with this acquisition, which of the following is a correct statement?

- a. The shares may **not** be acquired out of capital surplus.
- b. The shares in question must be classified as treasury shares if **not** cancelled.
- c. A subsequent offering of the acquired shares to the public in interstate commerce would be exempt from SEC registration.
- d. If the shares are acquired at a price less than the original offering price, the corporation has realized a taxable capital gain.

**M81#25.** The stock of Crandall Corporation is regularly traded over the counter. However, 75% is owned by the founding family and a few of the key executive officers. It has had a cash dividend record of paying out annually less than 5% of its earnings and profits over the past 10 years. It has, however, declared a 10% stock dividend during each of these years. Its accumulated

*Selected Questions*

earnings and profits are beyond the reasonable current and anticipated needs of the business. Which of the following is correct?

- a. The shareholders can compel the declaration of a dividend only if the directors' dividend policy is fraudulent.
- b. The Internal Revenue Service can **not** attack the accumulation of earnings and profits since the Code exempts publicly held corporations from the accumulations provisions.
- c. The fact that the corporation was paying a 10% stock dividend, apparently in lieu of a cash distribution, is irrelevant insofar as the ability of the Internal Revenue Service to successfully attack the accumulation.
- d. Either the Internal Revenue Service or the shareholders could successfully obtain a court order to compel the distribution of earnings and profits unreasonably accumulated.

**M81#26.** Global Trucking Corporation has in its corporate treasury a substantial block of its own common stock, which it acquired several years previously. The stock had been publicly offered at \$25 a share and had been reacquired at \$15. The board is considering using it in the current year for various purposes. For which of the following purposes may it validly use the treasury stock?

- a. To pay a stock dividend to its shareholders.
- b. To sell it to the public without the necessity of a registration under the Securities Act of 1933, since it had been previously registered.
- c. To vote it at the annual meeting of shareholders.
- d. To acquire the shares of another publicly held company without the necessity of a registration under the Securities Act of 1933.

**M81#27.** The Larkin Corporation is contemplating a two-for-one stock split of its common stock. Its \$4 par value common stock will be reduced to \$2 after the split. It has 2 million shares issued and outstanding out of a total of 3 million authorized. In considering the legal or tax consequences of such action, which of the following is a correct statement?

- a. The transaction will require both authorization by the Board of Directors and approval by the shareholders.
- b. The distribution of the additional shares to the shareholders will be taxed as a dividend to the recipients.
- c. Surplus equal to the par value of the existing number of shares issued and outstanding must be transferred to the stated capital account.
- d. The trustees of trust recipients of the additional shares must allocate them ratably between income and corpus.

**M80#6.** Barton Corporation and Clagg Corporation have decided to combine their separate companies pursuant to the provisions of their state corporation laws. After much discussion and negotiation, they decided that a consolidation was the appropriate procedure to be followed. Which of the following is an **incorrect** statement with respect to the contemplated statutory consolidation?

- a. A statutory consolidation pursuant to state law is recognized by the Internal Revenue Code as a type of tax-free reorganization.
- b. The larger of the two corporations will emerge as the surviving corporation.
- c. Creditors of Barton and Clagg will have their claims protected despite the consolidation.
- d. The shareholders of both Barton and Clagg must approve the plan of consolidation.

**M80#7.** Mark Corporation is a moderate-sized closely held corporation which is 80% owned by Joseph Mark. The remaining 20% of stock is owned by Mark's wife, sons, daughter, and parents. One son, David Mark, who recently graduated from business school, has been hired by the corporation as financial vice president at a salary of \$60,000 per year. Other members of the family are either officers or directors of the corporation and are all generously compensated. Joseph Mark is paid \$300,000 as Chairman of the Board and Chief Executive Officer. The corporation is profitable, solvent, and meeting all claims as they become due. Who of the following would have standing to attack the reasonableness of the salary payments?

- a. The creditors of the corporation.
- b. The attorney general of the state in which Mark is incorporated.
- c. The Internal Revenue Service.
- d. The Securities and Exchange Commission.

**M80#8.** The Board of Directors of Wilcox Manufacturing Corporation, a publicly held corporation, has noted a significant drop in the stock market price of its 7% preferred stock and proposes to purchase some of the stock. The proposed purchase price is substantially below the redemption price of the stock. The Board has decided to acquire 100,000 shares of said preferred stock and either place it in the treasury or retire it. Under these circumstances, which of the following is a correct statement?

- a. The corporation will realize a taxable gain as a result of the transaction.
- b. The preferred stock so acquired must be retired and may **not** be held as treasury stock.
- c. The corporation may **not** acquire its own shares unless the articles of incorporation so provide.
- d. Such shares may be purchased by the corporation to the extent of unreserved and unrestricted earned surplus available therefor.

**M80#9.** A major characteristic of the corporation is its recognition as a separate legal entity. As such it is capable of withstanding attacks upon its valid existence by various parties who would wish to disregard its existence or "pierce the corporate veil" for their own purposes. The corporation will normally be able to successfully resist such attempts **except** when

- a. The corporation was created with tax savings in mind.
- b. The corporation was created in order to insulate the assets of its owners from personal liability.
- c. The corporation being attacked is a wholly owned subsidiary of its parent corporation.
- d. The creation of and transfer of property to the corporation amounts to a fraud upon creditors.

**M80#12.** Golden Enterprises, Inc., entered into a contract with Hidalgo Corporation for the sale of its mineral holdings. The transaction proved to be *ultra vires*. Which of the following parties, for the reason stated, may properly assert the *ultra vires* doctrine?

- a. Golden Enterprises to avoid performance.
- b. A shareholder of Golden Enterprises to enjoin the sale.
- c. Hidalgo Corporation to avoid performance.
- d. Golden Enterprises to rescind the consummated sale.

**M80#13.** Grandiose secured an option to purchase a tract of land for \$100,000. He then organized the Dunbar Corporation and subscribed to 51% of the shares of stock of the corporation for \$100,000, which was issued to him in exchange for his three-month promissory note for \$100,000. Controlling the board of directors through his share ownership, he had the corporation authorize the purchase of the land from him for \$200,000. He made no disclosure to the board or to other shareholders that he was making a \$100,000 profit. He promptly paid the corporation for his shares and redeemed his promissory note. A disgruntled shareholder subsequently learned the full details of the transaction and brought suit against Grandiose on the corporation's behalf. Which of the following is a correct statement?

- a. Grandiose breached his fiduciary duty to the corporation and must account for the profit he made.
- b. The judgment of the board of directors was conclusive under the circumstances.
- c. Grandiose is entitled to retain the profit since he controlled the corporation as a result of his share ownership.
- d. The giving of the promissory note in exchange for the stock constituted payment for the shares.

**M80#14.** Destiny Manufacturing, Inc., is incorporated under the laws of Nevada. Its principal place of business is in California and it has permanent sales offices in several other states. Under the circumstances, which of the following is correct?

- a. California may validly demand that Destiny incorporate under the laws of the state of California.
- b. Destiny must obtain a certificate of authority to transact business in California and the other states in which it does business.
- c. Destiny is a foreign corporation in California, but **not** in the other states.
- d. California may prevent Destiny from operating as a corporation if the laws of California differ regarding organization and conduct of the corporation's internal affairs.

**M80#16.** Plimpton subscribed to 1,000 shares of \$1 par value common stock of the Billiard Ball Corporation at \$10 a share. Plimpton paid \$1,000 upon the incorporation of Billiard and paid in additional \$4,000 at a later time. The corporation subsequently became insolvent and is now in bankruptcy. The creditors of the corporation are seeking to hold Plimpton personally liable. Which of the following is a correct statement?

- a. Plimpton has **no** liability directly or indirectly to the creditors of the corporation since he paid the corporation the full par value of the shares.
- b. As a result of his failure to pay the full subscription price, Plimpton has unlimited joint and several liability for corporate debts.
- c. Plimpton is liable for the remainder of the unpaid subscription price.
- d. Had Plimpton transferred his shares to an innocent third party, neither he nor the third party would be liable.

**N79#30.** Which of the following is a correct statement concerning the similarities of a limited partnership and a corporation?

- a. Shareholders and limited partners may both participate in the management of the business and retain limited liability.
- b. Both are recognized for federal income tax purposes as taxable entities.
- c. Both can only be created pursuant to a statute and each must file a copy of their respective certificates with the proper state authorities.
- d. Both provide insulation from personal liability for all of the owners of the business.



## Selected Questions

### D. Other Forms

**N83#21.** Lamay Associates, a general partnership, and Delray Corporation are contemplating entering into a joint venture. Such a joint venture

- Will be treated as an association for federal income tax purposes and taxed at the prevailing corporate rates.
- Must incorporate in the state in which the joint venture has its principal place of business.
- Will be treated as a partnership in most important legal respects.
- Must be dissolved upon completion of a single undertaking.

**M82#57.** Martins created an irrevocable fifteen-year trust for the benefit of his minor children. At the end of the fifteen years, the principal reverts to Martins. Martins named the Bloom Trust Company as trustee and provided that Bloom would serve without the necessity of posting a bond. In understanding the trust and rules applicable to it, which of the following is correct?

- If Martins dies ten years after creation of the trust, it is automatically revoked and the property is distributed to the beneficiaries of his trust upon their attaining age 21.
- Martins may revoke the trust after eleven years, since he created it, and the principal reverts to him at the expiration of the fifteen years.

- The facts indicate that the trust is a separate legal entity for both tax and non-tax purposes.
- The trust is **not** a separate legal entity for federal tax purposes.

**N80#45.** The Marquis Trust has been properly created and it qualifies as a real estate investment trust (REIT) for federal income tax purposes. As such, it will

- Be taxed as any other trust for income tax purposes.
- Have been created under the Federal Trust Indenture Act.
- Provide limited liability for the parties investing in the trust.
- Be exempt from the Securities Act of 1933.

**N80#51.** Larson is considering the creation of either a lifetime (inter vivos) or testamentary (by his will) trust. In deciding what to do, which of the following statements is correct?

- If the trust is an inter vivos trust, the trustee must file papers in the appropriate state office roughly similar to those required to be filed by a corporation to qualify.
- An inter vivos trust must meet the same legal requirements as one created by a will.
- Property transferred to a testamentary trust upon the grantor's (creator's) death is **not** included in the decedent's gross estate for federal tax purposes.
- Larson can retain the power to revoke an inter vivos trust.

## III. Contracts

### A. Nature and Classification of Contracts

**N83#26.** In general, which of the following requirements must be satisfied in order to have a valid contract?

- A writing.
- Consideration.
- Mutual promises.
- Signatures of all parties.

**M83#6.** In determining whether a bilateral contract has been created, the courts look primarily at

- The fairness to the parties.
- The objective intent of the parties.
- The subjective intent of the parties.
- The subjective intent of the offeror.

**N81#11.** Where a client accepts the services of an accountant without an agreement concerning payment there is

- An implied in fact contract.
- An implied in law contract.
- An express contract.
- No contract.

**N79#5.** Which of the following represents the basic distinction between a bilateral contract and a unilateral contract?

- Specific performance is available if the contract is unilateral whereas it is **not** if the contract is bilateral.
- There is only one promise involved if the contract is unilateral whereas there are two promises if the contract is bilateral.
- The statute of frauds applies to a bilateral contract but **not** to a unilateral contract.
- The rights under a bilateral contract are assignable whereas rights under a unilateral contract are **not** assignable.

### B. Offer and Acceptance

**N83#27.** Flaxx, a sales representative of Dome Home Sites, Inc., escorted Mr. and Mrs. Grand through several acres of Dome's proposed subdivision and showed the Grands various one-acre lots for sale at \$27,000

each. Upon conclusion of the tour, the Grands expressed interest in purchasing a lot in the near future. Flaxx urged them to show their good faith and sign a letter of intent, which stated: "We, the undersigned, having decided to purchase a lot from Dome Home Sites in the future, deliver to the corporation's agent one hundred dollars (\$100) earnest money." This was signed by the Grands at the bottom of the form and the \$100 was delivered to Flaxx by the Grands. Under the circumstances

- a. The Grands have made an offer to buy a lot from Dome.
- b. If all the lots are sold by Dome, the Grands have a cause of action for breach of contract.
- c. If no deal is ever consummated, the Grands have the right to the return of the \$100.
- d. The \$100 constitutes liquidated damages and will be forfeited in the event the Grands do not purchase a lot.

**M83#29.** West sent a letter to Baker on October 18, 1983, offering to sell a tract of land for \$70,000. The offer stated that it would expire on November 1, 1983. Baker sent a letter on October 25, indicating the price was too high and that he would be willing to pay \$62,500. On the morning of October 26, upon learning that a comparable property had sold for \$72,500, Baker telephoned West and made an unconditional acceptance of the offer at \$70,000. West indicated that the price was not \$73,000. Baker's letter offering \$62,500 arrived the afternoon of October 26. Under the circumstances

- a. West's letter was a firm offer as defined under the Uniform Commercial Code.
- b. Baker validly accepted on the morning of October 26.
- c. There is **no** contract since Baker's acceptance was not in a signed writing.
- d. The parol evidence rule will preclude Baker from contradicting his written statements with oral testimony contra to his letter of October 25.

**M83#8.** Justin made an offer to pay Benson \$1,000 if Benson would perform a certain act. Acceptance of Justin's offer occurs when Benson

- a. Promises to complete the act.
- b. Prepares to perform the act.
- c. Promises to perform and begins preliminary performance.
- d. Completes the act.

**M83#9.** Luxor wrote Harmon offering to sell Harmon Luxor's real estate business for \$200,000. Harmon sent a telegram accepting the offer at \$190,000. Later, learning that several other parties were interested in purchasing the business, Harmon telephoned Luxor and

made an unqualified acceptance on Luxor's terms. The telegram arrived an hour after the phone call. Under the circumstances

- a. Harmon's telegram effectively terminated the offer.
- b. Harmon's oral acceptance is voidable, because real estate is involved.
- c. The offer was revoked as a result of Harmon's learning that others were interested in purchasing the business.
- d. Harmon has made a valid contract at \$200,000.

**N82#1.** On October 1, 1982, Arthur mailed to Madison an offer to sell a tract of land located in Summer-ville for \$13,000. Acceptance was to be not later than October 10. Madison posted his acceptance on the 6th of October. The acceptance arrived on October 7th. On October 4th, Arthur sold the tract in question to Larson and mailed to Madison notice of the sale. That letter arrived on the 6th of October, but after Madison had dispatched his letter of acceptance. Which of the following is correct?

- a. There was a valid acceptance of the Arthur offer on the day Madison posted his acceptance.
- b. Arthur's offer was effectively revoked by the sale of the tract of land to Larson on the 4th of October.
- c. Arthur could **not** revoke the offer to sell the land until after October 10th.
- d. Madison's acceptance was **not** valid since he was deemed to have notice of revocation prior to the acceptance.

**N82#3.** Starbuck Corporation sent Crane Company an offer by a telegram to buy its patent on a calculator. The Starbuck telegram indicated that the offer would expire in ten days. The telegram was sent on February 1, 1982, and received on February 2, 1982, by Crane. On February 8, 1982, Starbuck telephoned Crane and indicated it was withdrawing the offer. Crane telegraphed an acceptance on the 11th of February. Which of the following is correct?

- a. Starbuck's withdrawal of the offer was ineffective because it was **not** in writing.
- b. The offer was an irrevocable offer, but Crane's acceptance was too late.
- c. No contract arose since Starbuck effectively revoked the offer on February 8, 1982.
- d. Since Crane used the same means of communication, acceptance was both timely and effective.

*Selected Questions*

**N82#44.** Lee Motors sold an oral option to Hall, Inc., for \$50. The option was to purchase any late model used automobiles received by Lee as trade-ins on new cars for the next 100 days. Hall paid the \$50 and promptly sent Lee a signed memorandum which correctly described the agreement and its terms. Lee did not respond until after 30 days had elapsed and it had discovered it had made a very bad bargain. Therefore, it notified Hall that it would no longer perform under the terms of the option, which it alleged was invalid, and it enclosed a check for \$50 to Hall's order. Which of the following is correct?

- The oral option is invalid for lack of consideration.
- The Statute of Frauds can be validly asserted by Lee to avoid liability.
- Lee has entered into a valid contract with Hall.
- Options for a duration of more than three months are unenforceable.

**M82#15.** On May 1st, Perry Boat Sales sent a letter to James offering to sell James a boat for \$4,000. James received the offer the morning of May 3rd. That afternoon, James delivered an acceptance to the telegraph office. Due to an error by the telegraph company, the acceptance was never received by Perry. Which of the following is correct?

- Perry is bound to a contract even though the telegram of acceptance was never received.
- Perry is **not** bound to a contract because the telegraph company's error excused him of any responsibility.
- Perry would be bound to a contract only if James had sent his acceptance by mail.
- If Perry had sold the boat to Evans, without James's knowledge, before James delivered his acceptance to the telegraph office, Perry would **not** be bound in contract to James.

**N81#1.** Dustin received a telephone call on Monday from his oil supplier. The supplier offered him 1,000 barrels of heating oil at \$48 a barrel, the current price in a rapidly changing market. Dustin said he would take the offer under advisement. The next day, the market price rose to \$50 a barrel and Dustin sent the supplier a letter late that afternoon accepting the offer at \$48 a barrel. The letter arrived in the usual course on Thursday morning, by which time the market price had moved to \$56 a barrel. The supplier called Dustin and said it would not accept his order. Dustin insisted that he had a contract. Which of the following is correct?

- Acceptance took place on dispatch of Dustin's letter.
- Acceptance did **not** take place upon dispatch as the offer had already expired.
- Acceptance did **not** take place because the only means of acceptance Dustin could use was the phone.
- Acceptance could only be made by a signed writing.

**N81#4.** Which of the following offers for the sale of the Lazy L Ranch is enforceable?

- Owner tells buyer she will sell the ranch for \$35,000 and that the offer will be irrevocable for ten days.
- Owner writes buyer offering to sell the ranch for \$35,000 and stating that the offer will remain open for ten days.
- Owner telegraphs buyer offering to sell the ranch for \$35,000 and promises to hold the offer open for ten days.
- Owner writes buyer offering to sell the ranch for \$35,000 and stating that the offer will be irrevocable for ten days if buyer will pay \$1.00. Buyer pays.

**N81#7.** Water Works had a long-standing policy of offering employees \$100 for suggestions actually used. Due to inflation and a decline in the level and quality of suggestions received, Water Works decided to increase the award to \$500. Several suggestions were under consideration at that time. Two days prior to the public announcement of the increase to \$500, a suggestion by Farber was accepted and put into use. Farber is seeking to collect \$500. Farber is entitled to

- \$500 because Water Works had decided to pay that amount.
- \$500 because the suggestion submitted will be used during the period that Water Works indicated it would pay \$500.
- \$100 in accordance with the original offer.
- Nothing if Water Works chooses **not** to pay since the offer was gratuitous.

**N81#8.** Nichols wrote Dilk and offered to sell Dilk a building for \$50,000. The offer stated it would expire 30 days from July 1, 1981. Nichols changed his mind and does not wish to be bound by his offer. If a legal dispute arises between the parties regarding whether there has been a valid acceptance of the offer, which of the following is correct?

- The offer will **not** expire prior to the 30 days even if Nichols sells the property to a third person and notifies Dilk.
- If Dilk categorically rejects the offer on July 10th, Dilk can **not** validly accept within the remaining stated period of time.
- If Dilk phoned Nichols on August 1 and unequivocally accepted the offer, it would create a contract, provided he had **no** notice of withdrawal of the offer.
- The offer can **not** be legally withdrawn for the stated period of time.

**M81#8.** Harper is opening a small retailing business in Hometown, U.S.A. To announce her grand opening, Harper places an advertisement in the newspaper quoting sale prices on certain items in stock. Many local residents come in and make purchases. Harper's grand opening is such a huge success that she is unable to totally satisfy the demand of the customers. Which of the following correctly applies to the situation?

- Harper has made an offer to the people reading the advertisement.
- Harper has made a contract with the people reading the advertisement.
- Harper has made an invitation seeking offers.
- Any customer who demands the goods advertised and tenders the money is entitled to them.

**M81#9.** Martin sent Dobbs the following offer by mail:

I offer you 150 fantastic television sets, model J-1, at \$65 per set, F.O.B. your truck at my warehouse, terms 2/10, net/30. I am closing out this model, hence the substantial discount. Accept all or none. (signed) Martin

Dobbs immediately wired back:

I accept your offer re the fantastic television sets, but will use Blue Express Company for the pickup, at my expense of course. In addition, if possible, could you have the shipment ready by Tuesday at 10:00 AM because of the holidays? (signed) Dobbs

Based on the above correspondence, what is the status of Dobbs' acceptance?

- It is valid upon dispatch despite the fact it states both additional and different terms than those contained in the offer.
- It is valid but will **not** be effective until received by Martin.
- It represents a counteroffer which will become a valid acceptance if **not** negated by Martin within ten days.
- It is **not** a valid acceptance because it states both additional and different terms than those contained in the offer.

**M81#10.** On March 1, Wilkins wrote Conner a letter and offered to sell him his factory for \$150,000. The offer stated that the acceptance must be received by him by April 1. Under the circumstances, Wilkins's offer

- Will be validly accepted if Conner posts an acceptance on April 1.
- May be withdrawn at any time prior to acceptance.
- May **not** be withdrawn prior to April 1.
- Could **not** be validly accepted since Wilkins could assert the Statute of Frauds.

**M81#11.** Maurice sent Schmit Company a telegram offering to sell him a one-acre tract of commercial property located adjacent to Schmit's warehouse for \$8,000. Maurice stated that Schmit had three days to consider the offer and in the meantime the offer would be irrevocable. The next day Maurice received a better offer from another party, and he telephoned Schmit informing him that he was revoking the offer. The offer was

- Irrevocable for three days upon receipt by Schmit.
- Effectively revoked by telephone.
- Never valid, since the Statute of Frauds applies.
- Not effectively revoked because Maurice did **not** use the same means of communication.

**M81#13.** Wilcox mailed Norriss an unsigned contract for the purchase of a tract of real property. The contract represented the oral understanding of the parties as to the purchase price, closing date, type of deed, and other details. It called for payment in full in cash or certified check at the closing. Norriss signed the contract, but added above his signature the following:

This contract is subject to my (Norriss) being able to obtain conventional mortgage financing of \$100,000 at 13% or less interest for a period of not less than 25 years.

Which of the following is correct?

- The parties had already made an enforceable contract prior to Wilcox's mailing of the formalized contract.
- Norriss would **not** be liable on the contract under the circumstances even if he had **not** added the "conventional mortgage" language since Wilcox had **not** signed it.
- By adding the "conventional mortgage" language above his signature, Norriss created a condition precedent to his contractual obligation and made a counteroffer.
- The addition of the "conventional mortgage" language has **no** legal effect upon the contractual relationship of the parties since it was an implied condition in any event.

### C. Consideration

**N83#28.** Love granted Nelson a written option to buy a tract of land in an industrial park. The option stated that it was irrevocable for 11 days and was given for \$20 and other valuable consideration. The \$20 was not paid and there was no other valuable consideration. Which of the following is a correct statement regarding the option in question?

- Since real property is involved, Nelson's acceptance must be contained in a signed writing if Nelson is to enforce it against Love.
- It is an option contract enforceable for the 11-day period.

Selected Questions

- c. Acceptance must be received at Love's place of business before expiration of the 11 days.
- d. It is unenforceable because it lacks consideration.

**M83#7.** Dougal is seeking to avoid performing a promise to pay Clark \$500. Dougal is relying upon lack of consideration on Clark's part sufficient to support his promise. Dougal will prevail if he can establish that

- a. The contract is executory.
- b. Clark's asserted consideration is worth only \$100.
- c. Prior to Dougal's promise, Clark had already performed the requested act.
- d. Clark's only claim of consideration was the relinquishment of a legal right.

**M82#12.** Bunker's son, Michael, was seeking an account executive position with Harrison, Inc., the largest brokerage firm in the United States. Michael was very independent and wished no interference by his father. The firm, after several weeks deliberation, decided to hire Michael. They made him an offer on April 12, 1982, and Michael readily accepted. Bunker feared that his son would not be hired. Unaware of the fact that his son had been hired, Bunker mailed a letter to Harrison on April 13 in which he promised to give the brokerage firm \$50,000 in commission business if the firm would hire his son. The letter was duly received by Harrison and they wish to enforce it against Bunker. Which of the following is correct?

- a. Harrison will prevail since the promise is contained in a signed writing.
- b. Past consideration is **no** consideration, hence there is **no** contract.
- c. Harrison will prevail based upon promissory estoppel.
- d. The preexisting legal duty rule applies and makes the promise unenforceable.

**M82#16.** Montrose sent Bilbo a written offer to sell this tract of land located in Majorsville for \$50,000. The parties were engaged in a separate dispute. The offer stated that it would be irrevocable for 30 days if Bilbo would promise to refrain from suing Montrose during this time. Bilbo promptly delivered a promise not to sue during the term of the offer and to forego suit if she accepted the offer. Montrose subsequently decided that the possible suit by Bilbo was groundless and therefore phoned Bilbo and revoked the offer ten days after making it. Bilbo mailed an acceptance on the 30th day. Montrose did not reply. Under the circumstances

- a. Montrose's offer was supported by consideration, and was irrevocable when accepted.
- b. Bilbo's promise was accepted by Montrose by his silence.
- c. Montrose's revocation, **not** being in writing, was invalid.
- d. Montrose's written offer would be irrevocable even without consideration.

**N79#3.** Which of the following will **not** be sufficient to satisfy the consideration requirement for a contract?

- a. The offeree expends both time and money in studying and analyzing the offer.
- b. The offeree makes a promise which is a legal detriment to him.
- c. The offeree performs the act requested by the offeror.
- d. The offeree makes a promise which benefits the offeror.

**D. Capacity, Legality, and Public Policy**

**M83#10.** Fairbanks, an author, was approached by Nickle Corporation to ghostwrite the history of Nickle for \$15,000. Larson, the president of Nickle, told Fairbanks the job was his if he would agree to cleverly defame its leading competitor, Mogul Corporation, using sly innuendo and clever distortion of the facts. Fairbanks wrote the history. It turned out that the Mogul passages were neither sly nor clever and Mogul obtained a judgment against Nickle. Fairbanks is seeking to collect the final \$5,000 installment on the contract. Nickle refuses to pay and seeks to recover the \$10,000 it has already paid. In the event of a lawsuit

- a. Fairbanks will recover \$5,000.
- b. The court will deny relief to either party.
- c. Nickle will recover \$10,000.
- d. Fairbanks will recover in quantum meruit for the value of his services.

**N82#8.** Patton is a partner in an accounting firm. His partnership contract contains a clause which states that should Patton leave the firm, he agrees not to compete with the firm for one year, either as an individual or as a member of another accounting firm, anywhere within the city limits of New York City. The accounting firm does most of its business with clients in the states of New York, Pennsylvania and New Jersey. The clause would be held

- a. Legally enforceable in most states.
- b. An illegal restraint of trade under federal antitrust statutes.
- c. Illegal, thereby invalidating the entire contract.
- d. Unconscionable under the Uniform Commercial Code.

**M79#12.** Philpot purchased the King Pharmacy from Golden. The contract contained a promise by Golden that he would **not** engage in the practice of pharmacy for one year from the date of the sale within one mile of the location of King Pharmacy. Six months later Golden opened the Queen Pharmacy within less than

a mile of King Pharmacy. Which of the following is a correct statement?

- a. Golden has **not** breached the above covenant since he did **not** use his own name or the name King in connection with the new pharmacy.
- b. The covenant is reasonable and enforceable.
- c. The contract is an illegal restraint of trade and illegal under federal antitrust laws.
- d. The covenant is contrary to public policy and is illegal and void.

#### E. Other Defenses

**M83#12.** The Statute of Frauds

- a. Codified common law rules of fraud.
- b. Requires that formal contracts be in writing and signed by the parties to the contract.
- c. Does **not** apply if the parties waive its application in the contract.
- d. Sometimes results in a contract being enforceable by only one party.

**M83#13.** Certain oral contracts fall outside the Statute of Frauds. An example would be a contract between

- a. A creditor and a friend of the debtor, providing for the friend's guaranty of the debt in exchange for the creditor's binding extension of time for payment of the debt.
- b. A landlord and a tenant for the lease of land for ten years.
- c. A school board and a teacher entered into on January 1, for nine months of service to begin on September 1.
- d. A retail seller of television sets and a buyer for the sale of a TV set for \$399 C.O.D.

**M83#14.** Silvers entered into a contract which contains a substantial arithmetical error. Silvers asserts mistake as a defense to his performance. Silvers will prevail

- a. Only if the mistake was a mutual mistake.
- b. Only if the error was **not** due to his negligence.
- c. If the error was unilateral and the other party knew of it.
- d. If the contract was written by the other party.

**M83#15.** Smith, an executive of Apex Corporation, became emotionally involved with Jones. At the urging of Jones, and fearing that Jones would sever their relationship, Smith reluctantly signed a contract which was grossly unfair to Apex. Apex's best basis to rescind the contract would be

- a. Lack of express authority.
- b. Duress.
- c. Undue influence.
- d. Lack of consideration.

**N82#9.** In order to establish a common law action for fraud, the aggrieved party must establish that

- a. Although the defendant did **not** in fact know that his statements were false, he made the false statements with a reckless disregard for the truth.
- b. The contract entered into is within the Statute of Frauds.
- c. There was a written misrepresentation of fact by the defendant.
- d. The plaintiff acted as a reasonably prudent businessman in relying upon the misrepresentation.

**N82#10.** Which of the following is **not** required in order for the plaintiff to prevail in an action for innocent misrepresentation?

- a. That the misrepresentation was intended to induce reliance.
- b. That the misrepresentation amounted to gross negligence.
- c. That the plaintiff acted promptly and offered to restore what was received.
- d. That the plaintiff relied upon the misrepresentation.

**M82#14.** Paul filed a \$20,000 fire loss claim with the Williams Fire Insurance Company. Dickerson, Williams's adjuster, called Paul on the phone and invited him to come to his hotel room to settle the claim. Upon Paul's entry to the room, Dickerson locked the door and placed the key in his pocket. He then accused Paul of having set the building on fire and of having been involved in several previous suspicious fire claims. Dickerson concluded by telling Paul that unless he signed a release in exchange for \$500, he would personally see to it that Paul was prosecuted by the company for arson. Visibly shaken by all this, Paul signed the release. Paul has subsequently repudiated the release. The release is **not** binding because of

- a. Fraud.
- b. Lack of consideration.
- c. Undue influence.
- d. Duress.

**N81#2.** When a lengthy delay has occurred between the breach of a contract and the commencement of the lawsuit, the statute of limitations defense may be raised. The statute

- a. Is three years irrespective of the type of legal action the plaintiff is bringing.
- b. Does **not** apply to an action brought in a court of equity.
- c. Is a defense to recovery if the requisite period of time has elapsed.
- d. Fixes a period of time in which the plaintiff must commence the action or be barred from recovery, regardless of the defendant's conduct during the period.

Selected Questions

**N81#3.** Madison advertised for the submission of bids on the construction of a parking lot. Kilroy submitted a bid of \$112,000. There were nine other bids. Kilroy's bid was \$45,000 less than the next lowest bid. The discrepancy was due to the omission of a \$46,000 item on the part of Kilroy's staff. Madison accepted the bid and demands either performance or damages from Kilroy. Kilroy is

- Bound by the acceptance at \$112,000.
- Not bound by the acceptance but only if Madison knew of the mistake.
- Not bound by the acceptance if the mistake should have been known by Madison.
- Not bound by the bid submitted because there was **no** subjective meeting of the minds.

**N81#9.** The element which makes fraud or deceit an intentional tort is

- The materiality of the misrepresentation.
- Detrimental reliance.
- Actual reliance by the aggrieved party upon the misrepresentation.
- Scienter or knowledge of falsity.

**N79#2.** In the process of negotiating the sale of his manufacturing business to Grand, Sterling made certain untrue statements which Grand relied upon. Grand was induced to purchase the business for \$10,000 more than its true value. Grand is **not** sure whether he should seek relief based upon misrepresentation or fraud. Which of the following is a correct statement?

- If Grand merely wishes to rescind the contract and get his money back, misrepresentation is his **best** recourse.
- In order to prevail under the fraud theory, Grand must show that Sterling intended for him to rely on the untrue statements; whereas he need **not** do so if he bases his action on misrepresentation.
- Both fraud and misrepresentation require Grand to prove that Sterling knew the statements were false.
- If Grand chooses fraud as his basis for relief, the statute of fraud applies.

**M79#9.** Williams purchased a heating system from Radiant Heating, Inc., for his factory. Williams insisted that a clause be included in the contract calling for service on the heating system to begin **not** later than the next business day after Williams informed Radiant of a problem. This service was to be rendered free of charge during the first year of the contract and for a flat fee of \$200 per year for the next two years thereafter. During the winter of the second year, the heating system broke down and Williams promptly notified Radiant of the situation. Due to other commitments, Radiant did **not** send a man over the next day. Williams phoned Radiant and was told that the \$200 per year service charge was uneconomical and they could **not** get a man over there for several days. Williams in desperation promised to pay an additional \$100 if Radiant

would send a man over that day. Radiant did so and sent a bill for \$100 to Williams. Is Williams legally required to pay this bill and why?

- No, because the pre-existing legal duty rule applies to this situation.
- No, because the statute of frauds will defeat Radiant's claim.
- Yes, because Williams made the offer to pay the additional amount.
- Yes, because the fact that it was uneconomical for Radiant to perform constitutes economic duress which freed Radiant from its obligation to provide the agreed-upon service.

**M79#13.** Keats Publishing Company shipped textbooks and other books for sale at retail to Campus Bookstore. An honest dispute arose over Campus's right to return certain books. Keats maintained that the books in question could **not** be returned and demanded payment of the full amount. Campus relied upon trade custom which indicated that many publishers accepted the return of such books. Campus returned the books in question and paid for the balance with a check marked "Account Paid in Full to Date." Keats cashed the check. Which of the following is a correct statement?

- Keats is entitled to recover damages.
- Keats' cashing of the check constituted an accord and satisfaction.
- The pre-existing legal duty rule applies and Keats is entitled to full payment for all the books.
- The custom of the industry argument would have no merit in a court of law.

**F. Parol Evidence Rule**

**M83#16.** Elrod is attempting to introduce oral evidence in court to explain or modify a written contract he made with Weaver. Weaver has pleaded the parol evidence rule. In which of the following circumstances will Elrod **not** be able to introduce the oral evidence?

- The modification asserted was made several days after the written contract had been executed.
- The contract indicates that it was intended as the "entire contract" between the parties, and the point is covered in detail.
- There was a mutual mistake of fact by the parties regarding the subject matter of the contract.
- The contract contains an obvious ambiguity on the point at issue.

**M83#41.** With respect to written contracts, the parol evidence rule applies

- Exclusively to the purchase or sale of goods.
- To subsequent oral modifications.
- Only to prior or contemporaneous oral modifications.
- To modifications by prior written or oral agreements.

**M81#12.** Martin agreed to purchase a two-acre home site from Foxworth. The contract was drafted with great care and meticulously set forth the alleged agreement between the parties. It was signed by both parties. Subsequently, Martin claimed that the contract did not embody all of the agreements that the parties had reached in the course of their negotiations. Foxworth had asserted that the parol evidence rule applies. As such, the rule

- a. Applies to both written and oral agreements relating to the contract made prior to the signing of the contract.
- b. Does **not** apply to oral agreements made at the time of the signing of the contract.
- c. Applies exclusively to written contracts signed by both parties.
- d. Is **not** applicable if the Statute of Frauds applies.

**N79#4.** Marsh and Lennon entered into an all inclusive written contract involving the purchase of a tract of land. Lennon claims that there was a contemporaneous oral agreement between the parties which called for the removal by Marsh of several large rocks on the land. Marsh relies upon the parol evidence rule to avoid having to remove the rocks. Which of the following is correct?

- a. The parol evidence rule does **not** apply to contemporaneous oral agreements.
- b. Since the statute of frauds was satisfied in respect to the contract for the purchase of the land, the parol evidence rule does **not** apply.
- c. Since the oral agreement does not contradict the terms of the written contract, the oral agreement is valid despite the parol evidence rule.
- d. The parol evidence rule applies and Lennon will be precluded from proving the oral promise in the absence of fraud.

### G. Third Party Rights

**M83#17.** Nancy is asserting rights as a third party donee beneficiary on a contract made by Johnson and Harding. In order to prevail, Nancy must prove that

- a. The contract specifically named her as the beneficiary.
- b. She gave consideration for the donative promise.
- c. She is related by blood or marriage to the promisee.
- d. The terms of the contract and surrounding circumstances manifest a clear intent to benefit her.

**N82#11.** A common law duty is delegable even though the

- a. Contract provides that the duty is nondelegable.
- b. Duty delegated is the payment of money and the delegatee is **not** of as equal credit-worthiness as the delegator.
- c. Delegation will result in a material variance in performance by the delegatee.
- d. Duty to be performed involves personal services.

**N82#12.** Wilson sold his factory to Glenn. As part of the contract, Glenn assumed the existing mortgage on the property which was held by Security Bank. Regarding the rights and duties of the parties, which of the following is correct?

- a. The promise by Glenn need **not** be in writing to be enforceable by Security.
- b. Security is a creditor beneficiary of Glenn's promise and can recover against him personally in the event of default.
- c. Security is a mere incidental beneficiary since it was **not** a party to the assignment.
- d. Wilson has **no** further liability to Security.

### H. Assignments

**M83#18.** The assignment of a contract right

- a. Will **not** be enforceable if it materially varies the obligor's promise.
- b. Is invalid unless supported by consideration.
- c. Gives the assignee better rights against the obligor than the assignor had.
- d. Does not create any rights in the assignee against the assignor until notice is given to the obligor.

**N82#13.** Walton owed \$10,000 to Grant. Grant assigned his claim against Walton to the Line Finance Company for value on October 15, 1982. On October 25, 1982, Hayes assigned his matured claim for \$2,000 against Grant to Walton for value. On October 30, 1982, Line notified Walton of the assignment to them of the \$10,000 debt owed by Walton to Grant. Line has demanded payment in full. Insofar as the rights of the various parties are concerned

- a. Walton has the right of a \$2,000 set-off against the debt which he owed Grant.
- b. Walton must pay Line in full, but has the right to obtain a \$2,000 reimbursement from Grant.
- c. Line is a creditor beneficiary of the debt owed by Walton.
- d. The claimed set-off of the Hayes claim for \$2,000 is invalid since it is for an amount which is less than the principal debt.



Selected Questions

**N81#5.** Fennell and McLeod entered into a binding contract whereby McLeod was to perform routine construction services according to Fennell's blueprints. McLeod assigned the contract to Conerly. After the assignment

- a. Fennell can bring suit under the doctrine of anticipatory breach.
- b. McLeod extinguishes all his rights and duties under the contract.
- c. McLeod extinguishes all his rights but is **not** relieved of his duties under the contract.
- d. McLeod still has all his rights but is relieved of his duties under the contract.

**N81#10.** Marglow Supplies Inc., mailed a letter to Wilson Distributors on September 15, 1981, offering a three-year franchise dealership. The offer stated the terms in detail and at the bottom stated that the offer would not be withdrawn prior to October 1, 1981. Which of the following is correct?

- a. The statute of frauds would **not** apply to the proposed contract.
- b. The offer is an irrevocable option which can **not** be withdrawn prior to October 1, 1981.
- c. The offer can **not** be assigned to another party by Wilson if Wilson chooses **not** to accept.
- d. A letter of acceptance from Wilson to Marglow sent on October 1, 1981, but **not** received until October 2, 1981, would **not** create a valid contract.

**M80#20.** Monrad is contemplating making a contract for the purchase of certain real property. Which of the following is **incorrect** insofar as such a contract is concerned?

- a. It must meet the requirements of the statute of frauds.
- b. If the agreement is legally consummated, Monrad could obtain specific performance.
- c. The contract is nonassignable as a matter of law.
- d. An implied covenant of marketability applies to the contract.

**I. Discharge, Breach, and Remedies**

**N83#22.** Smith, CPA, contracted to perform certain services for Jones for \$500. Jones claimed that the services were not fully performed and therefore disputed the amount of his obligation. As a result, Jones sent Smith a check for only \$425 and marked clearly on the check it was "payment in full." Smith crossed out the words "payment in full" and cashed the check. The majority of courts would hold that the debt is

- a. Liquidated and Smith can collect the remaining \$75.
- b. Liquidated, but Jones by adding the words "payment in full" cancelled the balance of the debt owed.

- c. Unliquidated and the cashing of the check by Smith completely discharged the debt.
- d. Unliquidated, but the crossing out of the words "payment in full" by Smith revives the balance of \$75 owed.

**N83#30.** Stone engaged Parker to perform personal services for \$1,000 a month for a period of three months. The contract was entered into orally on August 1, 1983, and performance was to commence January 1, 1984. On September 15, Parker anticipatorily repudiated the contract. As a result, Stone can

- a. Obtain specific performance.
- b. Not assign her rights to damages under the contract to a third party.
- c. Immediately sue for breach of contract.
- d. Not enforce the contract against Parker since the contract is oral.

**M83#20.** Myers entered into a contract to purchase a valuable rare coin from Eisen. Myers tendered payment which was refused by Eisen. Upon Eisen's breach, Myers brought suit to obtain the coin. The court will grant Myers

- a. Compensatory damages.
- b. Specific performance.
- c. Reformation.
- d. Restitution.

**N82#14.** Conrad is seeking to avoid liability on a contract with Fuld. Conrad can avoid liability on the contract if

- a. A third party has agreed to perform his duty and has for a valuable consideration promised to hold Conrad harmless on the obligation to Fuld.
- b. The entire contract has been assigned.
- c. There has been a subsequent unexecuted accord between Fuld and himself.
- d. He has been discharged by a novation.

**N82#21.** On August 1, 1982, Fields & Boss, CPAs, made a contract with Gil Manufacturing to audit Gil's financial statements for calendar year 1982 and to render an opinion thereon. Gil agreed to an estimated fee of \$7,500 for the services. Gil changed its mind and on September 2, 1982, before any services had been performed, notified Fields & Boss that it was repudiating the contract. Which of the following is correct?

- a. The CPA firm may sue for breach of contract immediately and need **not** wait until after performance is due and refused.
- b. The CPA firm is no longer bound on the contract but can **not** sue until after January 1, 1983.
- c. The CPA firm remains bound by the contract until January 1, 1983.
- d. There has been a present breach of the contract.

**M82#13.** Foster offered to sell Lebow his garage for \$27,000. The offer was in writing and signed by Foster. Foster gave Lebow five days to decide. On the fourth day Foster accepted a better offer from Dilby, who was unaware of the offer to Lebow. Foster subsequently conveyed the property to Dilby. Unaware of the sale to Dilby, Lebow telephoned Foster on the fifth day and unconditionally accepted the offer. Under the circumstances, Lebow

- a. Is entitled to specific performance by Foster.
- b. Has **no** rights against Foster.
- c. Is entitled to damages.
- d. Can obtain specific performance by Dilby upon depositing in court the \$27,000 he agreed to pay.

**N81#6.** Monroe purchased a ten-acre land site from Acme Land Developers, Inc. He paid 10% at the closing and gave his note for the balance secured by a 20-year mortgage. Three years later, Monroe found it increasingly difficult to make payments on the note and finally defaulted. Acme Land threatened to accelerate the loan and foreclose if he continued in default. It told him either to get the money or obtain an acceptable third party to assume the obligation. Monroe offered the land to Thompson for \$1,000 less than the equity he had in the property. This was acceptable to Acme and at the closing Thompson paid the arrearage, executed a new mortgage and note, and had title transferred to his name. Acme surrendered Monroe's note and mortgage to him. The transaction in question is a (an)

- a. Assignment and delegation.
- b. Third party beneficiary contract.
- c. Novation.
- d. Purchase of land subject to a mortgage.

**M81#7.** Smith contracted to perform for \$500 certain services for Jones. Jones claimed that the services had been performed poorly. Because of this, Jones sent Smith a check for only \$425. Marked clearly on the check was "payment in full". Smith crossed out the words "payment in full" and cashed the check. Assuming that there was a bona fide dispute as to whether Smith had in fact performed the services poorly, the majority of courts would hold that

- a. The debt is liquidated, and Smith can collect the remaining \$75.
- b. The debt is liquidated, but Jones by adding the words "payment in full" cancelled the balance of the debt owed.
- c. The debt is unliquidated and the cashing of the check by Smith completely discharged the debt.
- d. The debt is unliquidated, but the crossing out of the words "payment in full" by Smith revives the balance of \$75 owed.

**M79#8.** Arthur sold his house to Michael. Michael agreed to pay the existing mortgage on the house. The Safety Bank, which held the mortgage, released Arthur from liability on the debt. The above declared transaction (relating to the mortgage debt) is

- a. A delegation.
- b. A novation.
- c. Invalid in that the bank did **not** receive any additional consideration from Arthur.
- d. **Not** a release of Arthur if Michael defaults, and the proceeds from the sale of the mortgaged house are insufficient to satisfy the debt.

#### IV. Debtor-Creditor Relationships and Consumer Protection

##### A. Bankruptcy

**M83#21.** A voluntary bankruptcy proceeding is available to

- a. All debtors provided they are insolvent.
- b. Debtors only if the overwhelming preponderance of creditors have **not** petitioned for and obtained a receivership pursuant to state law.
- c. Corporations only if a reorganization has been attempted and failed.
- d. Most debtors even if they are **not** insolvent.

**M83#22.** An involuntary petition in bankruptcy

- a. Will be denied if a majority of creditors in amount and in number have agreed to a common law composition agreement.
- b. Can be filed by creditors only once in a seven-year period.

- c. May be successfully opposed by the debtor by proof that the debtor is solvent in the bankruptcy sense.
- d. If **not** contested will result in the entry of an order for relief by the bankruptcy judge.

**M83#23.** A bankrupt who has voluntarily filed for and received a discharge in bankruptcy

- a. Will receive a discharge of any and all debts owed by him as long as he has **not** committed a bankruptcy offense.
- b. Can obtain another voluntary discharge in bankruptcy after five years have elapsed from the date of the prior discharge.
- c. Must surrender for distribution to the creditors amounts received as an inheritance if the receipt occurs within 180 days after filing of the petition.
- d. Is precluded from owning or operating a similar business for two years.

Selected Questions

**M83#24.** Hard Times, Inc., is insolvent. Its liabilities exceed its assets by \$13 million. Hard Times is owned by its president, Waters, and members of his family. Waters, whose assets are estimated at less than a million dollars, guaranteed the loans of the corporation. A consortium of banks is the principal creditor of Hard Times having loaned it \$8 million, the bulk of which is unsecured. The banks decided to seek reorganization of Hard Times and Waters has agreed to cooperate. Regarding the proposed reorganization

- a. Waters' cooperation is necessary since he must sign the petition for a reorganization.
- b. If a petition in bankruptcy is filed against Hard Times, Waters will also have his personal bankruptcy status resolved and relief granted.
- c. Only a duly constituted creditors committee may file a plan of reorganization of Hard Times.
- d. Hard Times will remain in possession unless a request is made to the court for the appointment of a trustee.

**N82#16.** An otherwise valid petition for involuntary bankruptcy has been filed against Mohawk Corporation. This will be sufficient to obtain an order for relief against Mohawk provided

- a. Mohawk is generally not paying debts as they become due.
- b. A custodian has been appointed to take charge of substantially all of Mohawk's debts within four months of filing.
- c. The creditor or creditors can establish that Mohawk is bankrupt in the bankruptcy sense.
- d. The majority of creditors join in the filing if there are more than two creditors involved.

**N82#17.** The Bankruptcy Reform Act of 1978 distinguishes between an exception to discharge of a debt or debts and a denial of discharge. Which of the following types of conduct will result in a denial of discharge?

- a. Obtaining of money or credit by resort to actual fraud.
- b. Fraud or defalcation while acting in a fiduciary capacity.
- c. Transfer by the debtor, with an intent to hinder a creditor, of property within one year before the date of filing of the petition.
- d. Willful and malicious injury by the debtor to another entity or its property.

**N82#18.** Since the passage of the Bankruptcy Reform Act of 1978, voluntary bankruptcy proceedings have become increasingly popular with debtors. The new law

- a. Increases availability and eases filing.
- b. Increases the amount of property which is exempt.
- c. Reduces the number of creditors necessary for filing.
- d. Accepts solvency in the equity sense as the criterion for determining bankruptcy status.

**N82#19.** Chapter 11 of the Bankruptcy Reform Act of 1978 deals with reorganizations. This Chapter

- a. Is exclusively available to corporations.
- b. Permits the debtor-in-possession to continue to operate the business in the same manner as a Chapter 11 trustee.
- c. Provides for filing of voluntary petitions but prohibits the filing of involuntary petitions.
- d. Provides separate procedures for corporations with publicly held securities.

**M82#18.** Mac, doing business as Mac's Restaurant, has an involuntary petition in bankruptcy filed against him. Which of the following is a correct legal statement regarding such a filing?

- a. Mac has the right to controvert the validity of the petition and if Mac is successful, the petition will be dismissed and Mac may recover his costs including a reasonable attorney's fee.
- b. The filing of the petition by a majority of the creditors creates a binding presumption that Mac is insolvent.
- c. A single creditor may file the petition regardless of the number of creditors if its provable claim exceeds \$7,500.
- d. A trustee is appointed upon the filing of the petition and is vested by operation of law with the bankrupt's title as of the date of the filing.

**M82#19.** An audit client is in serious financial trouble. On November 1, 1981, several creditors filed an involuntary petition in bankruptcy. Which of the following is correct?

- a. As long as the client generally can meet current debts as they mature, the court will deny relief against the client in a bankruptcy proceeding.
- b. If the client creates a new corporation and transfers most of its assets to the newly created corporation, it can avoid bankruptcy.
- c. As long as the client's assets, at fair value, exceed its liabilities, the creditors' petition will be denied.
- d. Unless the client commits an act of bankruptcy, the creditors can **not** force the client into bankruptcy.

**M82#20.** The Bankruptcy Reform Act of 1978 provides that certain allowed expenses and claims are entitled to a priority. Which of the following is **not** entitled to such a priority?

- a. Claims of governmental units for taxes.
- b. Wage claims, but to a limited extent.
- c. Rents payable within the four months preceding bankruptcy, but to a limited extent.
- d. Unsecured claims for contributions to employee benefit plans, but to a limited extent.

**M82#21.** Which of the following was a significant reform made in the reorganization provisions of the Bankruptcy Reform Act of 1978?

- a. Separate treatment of publicly held corporations under its provisions.
- b. Elimination of the separate and competing procedures contained in the various chapters of the prior Bankruptcy Act.
- c. Elimination of participation in bankruptcy reorganizations by the Securities and Exchange Commission.
- d. The exclusion from its jurisdiction of partnerships and other noncorporate entities.

**M82#22.** Clark is a surety on a \$100,000 obligation owed by Thompson to Owens. The debt is also secured by \$50,000 mortgage to Owens on Thompson's factory. Thompson is in bankruptcy. Clark has satisfied the debt. Clark is

- a. Only entitled to the standing of a general creditor in bankruptcy.
- b. A secured creditor to the extent of the \$50,000 mortgage and a general creditor for the balance.
- c. Entitled to nothing in bankruptcy since this was a risk he assumed.
- d. Not entitled to a priority in bankruptcy, even though Owens could validly claim it.

**M81#40.** A client has joined other creditors of the Martin Construction Company in a composition agreement seeking to avoid the necessity of a bankruptcy proceeding against Martin. Which statement describes the composition agreement?

- a. It provides a temporary delay, **not** to exceed six months, insofar as the debtor's obligation to repay the debts included in the composition.
- b. It does **not** discharge any of the debts included until performance by the debtor has taken place.
- c. It provides for the appointment of a receiver to take over and operate the debtor's business.
- d. It must be approved by all creditors.

**M81#41.** In a bankruptcy proceeding, the trustee

- a. Must be an attorney admitted to practice in the federal district in which the bankrupt is located.
- b. Will receive a fee based upon the time and fair value of the services rendered, regardless of the size of the estate.
- c. May **not** have had any dealings with the bankrupt within the past year.
- d. Is the representative of the bankrupt's estate and as such has the capacity to sue and be sued on its behalf.

**M81#42.** Haplow engaged Turnbow as his attorney when threatened by several creditors with a bankruptcy proceeding. Haplow's assets consisted of \$85,000 and his debts were \$125,000. A petition was subsequently filed and was uncontested. Several of the creditors are concerned that the suspected large legal fees charged by Turnbow will diminish the size of the distributable estate. What are the rules or limitations which apply to such fees?

- a. None, since it is within the attorney-client privileged relationship.
- b. The fee is presumptively valid as long as arrived at in an arm's-length negotiation.
- c. Turnbow must file with the court a statement of compensation paid or agreed to for review as to its reasonableness.
- d. The trustee must approve the fee.

**M81#43.** If a secured party's claim exceeds the value of the collateral of a bankrupt, he will be paid the total amount realized from the sale of the security and will

- a. Not have any claim for the balance.
- b. Become a general creditor for the balance.
- c. Retain a secured creditor status for the balance.
- d. Be paid the balance only after all general creditors are paid.

**M81#44.** In order to establish a preference under the federal bankruptcy act, which of the following is the trustee required to show where the preferred party is **not** an insider?

- a. That the preferred party had reasonable cause to believe that the debtor was insolvent.
- b. That the debtor committed an act of bankruptcy.
- c. That the transfer was for an antecedent debt.
- d. That the transfer was made within 60 days of the filing of the petition.

**M80#3.** The federal bankruptcy act contains several important terms. One such term is "insider." The term is used in connection with preferences and preferential transfers. Which among the following is **not** an "insider"?

- a. A secured creditor having a security interest in at least 25% or more of the debtor's property.
- b. A partnership in which the debtor is a general partner.
- c. A corporation of which the debtor is a director.
- d. A close blood relative of the debtor.

Selected Questions

**M80#10.** Bunker Industries, Inc., ceased doing business and is in bankruptcy. Among the claimants are employees seeking unpaid wages. The following statements describe the possible status of such claims in a bankruptcy proceeding or legal limitations placed upon them. Which one is an **incorrect** statement?

- a. They are entitled to a priority.
- b. If a priority is afforded such claims, it **cannot** exceed \$2,000 per wage earner.
- c. Such claims **cannot** include vacation, severance, or sick-leave pay.
- d. The amounts of excess wages **not** entitled to a priority are mere unsecured claims.

**M80#31.** Merchant is in serious financial difficulty and is unable to meet current unsecured obligations of \$25,000 to some 15 creditors who are demanding immediate payment. Merchant owes Flintheart \$5,000 and Flintheart has decided to file an involuntary petition against Merchant. Which of the following is necessary in order for Flintheart to validly file?

- a. Flintheart must be joined by at least two other creditors.
- b. Merchant must have committed an act of bankruptcy within 120 days of the filing.
- c. Flintheart must allege and subsequently establish that Merchant's liabilities exceed Merchant's assets upon fair valuation.
- d. Flintheart must be a secured creditor.

**M80#35.** Hapless is a bankrupt. In connection with a debt owed to the Suburban Finance Company, he used a false financial statement to induce it to loan him \$500. Hapless is seeking a discharge in bankruptcy. Which of the following is a correct statement?

- a. Hapless will be denied a discharge of any of his debts.
- b. Even if it can be proved that Suburban did **not** rely upon the financial statement, Hapless will be denied a discharge either in whole or part.
- c. Hapless will be denied a discharge of the Suburban debt.
- d. Hapless will be totally discharged despite the false financial statement.

**M79#50.** Jane Sabine was doing business as Sabine Fashions, a sole proprietorship. Sabine suffered financial reverses and began to use social security and income taxes withheld from her employees to finance the business. Sabine finally filed a voluntary petition in bankruptcy. Which of the following would **not** apply to her as a result of her actions?

- a. She would remain liable for the taxes due.
- b. She is personally liable for fines and imprisonment.

- c. She could justify her actions by showing that the use of the tax money was vital to continuation of the business.
- d. She may be assessed penalties up to the amount of taxes due.

**M79#19.** Marigold, Inc., was in extreme financial difficulty. Hargrove, one of its persistent creditors, insisted upon payment of the entire amount due on the shipments of goods to Marigold over the past four months or it would sue Marigold and obtain a judgment against it. In order to dissuade Hargrove from taking such action, Marigold persuaded Hargrove to accept its note which was secured by a second mortgage on Marigold's warehouse. Hargrove filed the mortgage on November 1, 1978, the same day that the note and mortgage were executed. On February 1, 1979, Marigold concluded that things were hopeless and filed a voluntary petition in bankruptcy. The trustee in bankruptcy is attacking the validity of the mortgage as a voidable preference. Which of the following is correct?

- a. The mortgage is **not** a voidable preference since it was filed the same day it was obtained.
- b. The fact that Marigold was delinquent on its payment to Hargrove establishes that Hargrove knew that Marigold was insolvent in the bankruptcy sense.
- c. The antecedent indebtedness requirement necessary to establish a voidable preference has **not** been satisfied under the facts given.
- d. Whether Hargrove knew of the fact that Marigold was insolvent in the bankruptcy sense is irrelevant insofar as deciding whether the mortgage constitutes a preference as contrasted with a voidable preference.

**M79#22.** Robert Cunningham owns a shop in which he repairs electrical appliances. Three months ago Electrical Supply Company sold Cunningham, on credit, a machine for testing electrical appliances and obtained a perfected security interest at the time as security for payment of the unpaid balance. Cunningham's creditors have now filed an involuntary petition in bankruptcy against him. What is the status of Electrical in the bankruptcy proceeding?

- a. Electrical is a secured creditor and has the right against the trustee if **not** paid to assert a claim to the electrical testing machine it sold to Cunningham.
- b. Electrical must surrender its perfected security interest to the trustee in bankruptcy and share as a general creditor of the bankrupt's estate.
- c. Electrical's perfected security interest constitutes a preference and is voidable.
- d. Electrical must elect to resort exclusively to its secured interest or to relinquish it and obtain the same share as a general creditor.

**M79#24.** Markson is a general creditor of Black. Black filed a voluntary petition in bankruptcy. Markson is irate and wishes to have the bankruptcy court either deny Black a general discharge or at least **not** have his debt discharged. The discharge will be granted and it will include Markson's debt even if

- a. It is unscheduled.
- b. Markson extended the credit based upon a fraudulent financial statement.
- c. Markson was a secured creditor who was **not** fully satisfied from the proceeds obtained upon disposition of the collateral.
- d. Black had received a previous discharge in bankruptcy within six years.

## B. Suretyship

**M83#25.** A distinction between a surety and a cosurety is that only one is entitled to

- a. Compensation.
- b. Subrogation.
- c. Contribution.
- d. Notice upon default.

**M83#26.** A release of a cosurety by the creditor

- a. Will have **no** effect on the obligation of the other cosurety.
- b. Will release the other cosurety entirely.
- c. Will release the other cosurety to the extent that his right to contribution has been adversely affected.
- d. Need **not** be a binding release in order to affect the rights of the parties.

**M83#27.** The right of subrogation

- a. May permit the surety to assert rights he otherwise could **not** assert.
- b. Is denied in bankruptcy.
- c. Arises only to the extent that it is provided in the surety agreement.
- d. Can **not** be asserted by a cosurety unless he includes all other cosureties.

**N82#15.** Markum contacted the Variable Loan Company for a business loan. Variable refused to make the loan unless adequate security or an acceptable surety could be provided. Markum asked Duffy, one of his trade customers, to act as surety on the loan. In order to induce Duffy to sign, Markum made certain fraudulent representations and submitted a materially false financial statement. He also promised Duffy favorable treatment if Duffy would agree to act as surety for him. Markum is now insolvent and Variable seeks to hold Duffy liable. Duffy may avoid liability

- a. Since the surety undertaking was void at the inception.
- b. Based upon fraud if Duffy can show Variable was aware of the fraud.

- c. Because Variable had a duty to warn Duffy about Markum's financial condition and did **not** do so.
- d. Because the law of suretyship favors the surety where neither the surety nor the creditor is at fault.

**N82#20.** Gray and Far are cosureties on a loan of \$100,000 made by the Durham Bank to Wilson Fabric, Inc. Gray guaranteed the loan in full and Far guaranteed \$50,000 of the loan. Each was aware of the cosurety relationship. Gray received \$50,000 of collateral from Wilson as a condition precedent to his serving as cosurety. Wilson has defaulted on the loan. With respect to their ultimate liabilities

- a. Gray is liable for \$50,000 but has the exclusive benefit of resort to the collateral to repay his loss.
- b. Gray and Far will each be liable for \$50,000.
- c. Since Gray received collateral and Far did not, the relationship is actually one of subsuretyship with Gray being liable for the entire amount.
- d. In the final settlement between the sureties, Far will be liable for a net amount of \$16,667.

**N82#22.** Which of the following transactions does **not** establish Samp as a surety?

- a. Samp says: "Ship goods to my son and I will pay for them."
- b. Samp signs commercial paper as an accommodation indorser for one of his suppliers.
- c. Samp guarantees a debt of a corporation he controls.
- d. Samp sells an office building to Park, and, as a part of the consideration, Park assumes Samp's mortgage on the property.

**N82#24.** Knott obtained a loan of \$10,000 from Charles on January 1, 1982, payable on April 15, 1982. At the time of the loan, Beck became a noncompensated surety thereon by written agreement. On April 15, 1982, Knott was unable to pay and wrote to Charles requesting an extension of time. Charles made no reply, but did not take any immediate action to recover. On May 30, 1982, Charles demanded payment from Knott and, failing to collect from him, proceeded against Beck. Based upon the facts stated

- a. Charles was obligated to obtain a judgment against Knott returned unsatisfied before he could collect from Beck.
- b. Beck is released from his surety obligation because Charles granted Knott an extension of time.
- c. Charles may recover against Beck despite the fact Beck was a noncompensated surety.
- d. Beck is released because Charles delayed in proceeding against Knott.

Selected Questions

**N82#25.** Which of the following will release a surety from liability?

- Release of the principal debtor from liability with the consent of the surety.
- Delegation of the debtor's obligation to another party with the acquiescence of the creditor.
- Lack of capacity because the debtor is a minor.
- Discharge of the debtor in bankruptcy.

**M82#23.** Which of the following defenses by a surety will be effective to avoid liability?

- Lack of consideration to support the surety undertaking.
- Insolvency in the bankruptcy sense by the debtor.
- Incompetency of the debtor to make the contract in question.
- Fraudulent statements by the principal-debtor which induced the surety to assume the obligation and which were unknown to the creditor.

**M82#24.** Dinsmore & Company was a compensated surety on the construction contract between Victor (the owner) and Gilmore Construction. Gilmore has defaulted and Victor has released Dinsmore for a partial payment and other consideration. The legal effect of the release of Dinsmore is

- To release Gilmore as well.
- Contingent on recovery from Gilmore.
- Binding upon Victor.
- To partially release Gilmore to the extent that Dinsmore's right of subrogation has been diminished.

**M82#25.** In relation to the principal debtor, the creditor and a fellow cosurety, the cosurety is **not** entitled to

- Exoneration against the debtor under any circumstances.
- A pro rata contribution by his fellow surety or sureties if he pays the full amount.
- Be subrogated to the rights of the creditor upon satisfaction of the debt.
- Avoid performance because his cosurety refuses to perform.

**M80#41.** Simpson and Thomas made separate contracts of suretyship with Allan to guarantee repayment of a \$12,000 loan Allan made to Parker. Simpson's guarantee was for \$12,000 and Thomas's for \$8,000. In the event Simpson pays the full amount (\$12,000), what may he recover from Thomas?

- Nothing since their contracts were separate.
- \$4,800.
- \$6,000.
- \$8,000.

**N81#24.** Dustin is a very cautious lender. When approached by Lanier regarding a \$2,000 loan, he not only demanded an acceptable surety but also collateral equal to 50% of the loan. Lanier obtained King Surety Company as his surety and pledged rare coins worth \$1,000 with Dustin. Dustin was assured by Lanier one week before the due date of the loan that he would have no difficulty in making payment. He persuaded Dustin to return the coins since they had increased in value and he had a prospective buyer. What is the legal effect of the release of the collateral upon King Surety?

- It totally releases King Surety.
- It does **not** release King Surety if the collateral was obtained after its promise.
- It releases King Surety to the extent of the value of the security.
- It does **not** release King Surety unless the collateral was given to Dustin with the express understanding that it was for the benefit of King Surety as well as Dustin.

**N81#25.** When the debtor has defaulted on its obligation, the creditor is entitled to recover from the surety, unless which of the following is present?

- The surety is in the process of exercising its right of exoneration against the debtor.
- The debtor has died or become insolvent.
- The creditor could collect the entire debt from the debtor's collateral in his possession.
- The surety is a guarantor of collection and the creditor failed to exercise due diligence in enforcing his remedies against the debtor.

**N81#26.** Dependable Surety Company, Inc., issued a surety bond for value received which guaranteed: (1) completion of a construction contract Mason had made with Lund and (2) payment by Mason of his workmen. Mason defaulted and did not complete the contract. The workers were not paid for their last week's work. Mason had in fact become insolvent, and a petition in bankruptcy was filed two months after the issuance of the bond. What is the effect upon Dependable as a result of the above events?

- If Dependable pays damages to Lund as a result of the default on the contract, Dependable is entitled to recover in the bankruptcy proceedings the entire amount it paid prior to the payment of the general creditors of Mason.
- If Dependable pays the workers in **full**, it is entitled to the same priority in the bankruptcy proceedings that the workers would have had.
- If Dependable has another separate claim against Lund, Dependable may **not** set it off against any rights Lund may have under this contract.
- As a compensated surety, Dependable would be discharged from its surety obligation by Mason's bankruptcy.

**N81#27.** Marbury Surety, Inc., agreed to act as a guarantor of collection of Madison's trade accounts for one year beginning on April 30, 1980, and was compensated for same. Madison's trade debtors are in default in payment of \$3,853, as of May 1, 1981. As a result

- a. Marbury is liable to Madison without any action on Madison's part to collect the amounts due.
- b. Madison can enforce the guarantee even if it is **not** in writing since Marbury is a *del credere* agent.
- c. The relationship between the parties must be filed in the appropriate county office since it is a continuing security transaction.
- d. Marbury is liable for those debts for which a judgment is obtained and returned unsatisfied.

**N81#28.** Hargrove borrowed \$40,000 as additional working capital for her business from the Old Town Bank. Old Town required that the loan be collateralized to the extent of 60%, and an acceptable surety for the entire amount be obtained. Prudent Surety Company agreed to act as surety on the loan and Hargrove pledged \$24,000 of bearer negotiable bonds, which belonged to her husband, with Old Town. Hargrove has defaulted. Which of the following is correct?

- a. As a result of the default, Prudent and Hargrove's husband are cosureties.
- b. Old Town must first proceed against Hargrove and obtain a judgment for payment before it can proceed against the collateral.
- c. Old Town must first liquidate the collateral before it can proceed against Prudent.
- d. Prudent is liable in full immediately upon default by Hargrove, but will upon satisfaction of the debt be entitled to the collateral.

**N81#29.** Allen was the surety for the payment of rent by Lear under a lease from Rosenthal Rentals. The lease was for two years. A clause in the lease stated that at the expiration of the lease, the lessee had the privilege to renew upon thirty days' prior written notice or, if the lessee remained in possession after its expiration, it was agreed that the lease was to continue for two years more. There was a default in the payment of rent during the extended term of the lease and Rosenthal is suing Allen for the rent due based upon the guarantee. Allen contends that he is liable only for the initial term of the lease and not for the extended term. Allen is

- a. Not liable since it does **not** appear that a judgment against Lear has been returned unsatisfied.
- b. Not liable because there has been a material alteration of the surety undertaking.
- c. Not liable because there was a binding extension of time.
- d. Liable on the surety undertaking which would include the additional two years.

**M81#35.** Doral is the surety on a loan made by Nelson to Gordon. Which statement describes Doral's legal relationship or status among the respective parties?

- a. As between Gordon and Doral, Doral has the ultimate liability.
- b. Upon default by Gordon and payment by Doral, Doral is entitled to subrogation to the rights of Nelson or to obtain reimbursement from Gordon.
- c. Doral is a fiduciary insofar as Nelson is concerned.
- d. Doral is **not** liable immediately upon default by Gordon, unless the agreement so provides.

**M81#36.** Don loaned \$10,000 to Jon, and Robert agreed to act as surety. Robert's agreement to act as surety was induced by (1) fraudulent misrepresentations made by Don concerning Jon's financial status and (2) a bogus unaudited financial statement of which Don had no knowledge, and which was independently submitted by Jon to Robert. Which of the following is correct?

- a. Don's fraudulent misrepresentations will **not** provide Robert with a valid defense unless they were contained in a signed writing.
- b. Robert will be liable on his surety undertaking despite the facts since the defenses are personal defenses.
- c. Robert's reliance upon Jon's financial statements makes Robert's surety undertaking voidable.
- d. Don's fraudulent misrepresentations provide Robert with a defense which will prevent Don from enforcing the surety undertaking.

**M81#37.** Welch is a surety on Stanton's contract to build an office building for Brent. Stanton intentionally abandoned the project after it was 85% completed because of personal animosity which developed toward Brent. Which of the following is a correct statement concerning the rights or responsibilities of the various parties?

- a. Any modification of the contract, however slight and even if beneficial to Welch, will release Welch.
- b. Welch would be ordered to specifically perform the completion of the building if Brent sought this remedy.
- c. Neither Stanton's failure to give Welch prior notice of its intention to abandon the project **nor** its actual abandonment of the project will release Welch.
- d. Welch can **not** engage a contractor to finish the job and obtain from Brent the balance due on the contract.



Selected Questions

**M81#38.** Reginald, who is insolvent, defaulted on a loan upon which Jayne was the surety. Edward, the creditor, demanded payment from Jayne of the amount owed by Reginald. The loan was also secured by a mortgage which Edward has the right to foreclose. Which of the following is Jayne's best legal course of action?

- a. Seek specific performance by Reginald.
- b. Refuse to pay until Reginald has been petitioned into bankruptcy and the matter has been decided by the trustee in bankruptcy.
- c. Pay Edward and resort to the subrogation rights to the collateral.
- d. Refuse to pay because Edward must first resort to the collateral.

**M81#39.** Overall, Inc., owns 100% of the stock of Controlled Corporation, each being a separate entity. Overall telephoned the Factory Supply Company and ordered \$400 of miscellaneous merchandise. Overall told Factory to ship the supplies to Controlled and Overall would pay for them. Factory did so and now seeks recovery of the price or damages. Which of the following is correct?

- a. Overall is a surety.
- b. The Statute of Frauds will **not** bar Factory from recovering from Overall.
- c. Controlled is the principal debtor.
- d. Overall and Controlled are jointly and severally liable on the contract.

**M80#36.** Dilworth provided collateral to Maxim to secure Dilworth's performance of an obligation owed to Maxim. Maxim also obtained the Protection Surety Company as a surety for Dilworth's performance. Dilworth has defaulted and Protection has discharged the obligation in full. Which of the following is the correct legal basis for Protection's assertion of rights to the collateral?

- a. Promissory estoppel.
- b. Exoneration.
- c. Indemnification.
- d. Subrogation.

**M80#39.** Nolan Surety Company has agreed to serve as a guarantor of collection (a form of conditional guaranty) of the accounts receivable of the Dunbar Sales Corporation. The duration of the guarantee is one year and the maximum liability assumed is \$3,000. Nolan charged the appropriate fee for acting in this capacity. Which of the following statements **best** describes the difference between a guarantor of collection and the typical surety relationship?

- a. A guaranty need **not** be in writing provided the duration is less than a year.
- b. The guarantor is **not** immediately liable upon default; the creditor must first proceed against the debtor.

- c. A guaranty is only available from a surety who is a compensated surety.
- d. A guaranty is only used in connection with the sale of goods which have been guaranteed by the seller.

**M80#44.** Cornwith agreed to serve as a surety on a loan by Super Credit Corporation to Fairfax, one of Cornwith's major customers. The relationship between Fairfax and Super deteriorated to a point of hatred as a result of several late payments on the loan. On the due date of the final payment, Fairfax appeared 15 minutes before closing and tendered payment of the entire amount owing to Super. The office manager of Super told Fairfax that he was too late and would have to pay the next day with additional interest and penalties. Fairfax again tendered the payment, which was again refused. It is now several months later and Super is seeking to collect from either Cornwith or Fairfax or both. What are Super's rights under the circumstances?

- a. It cannot collect anything from either party.
- b. The tender of performances released Cornwith from his obligation.
- c. The tender of performance was too late and rightfully refused.
- d. Cornwith is released only to the extent that the refusal to accept the tender harmed him.

**M79#1.** Martinson borrowed \$50,000 from Wisdom Finance Company. The loan was evidenced by a non-negotiable promissory note secured by a first mortgage on Martinson's ranch. One of the terms of the note required acceleration of repayment in the event that Wisdom "deemed itself insecure." When the value of the property declined, Wisdom notified Martinson that pursuant to the terms of the note, it "deemed itself insecure" and demanded that either additional collateral or an acceptable surety be provided. Martinson arranged for Clark, a personal friend, to act as surety on the loan. Clark signed the note as an indorser and Wisdom agreed in writing **not** to accelerate repayment of the loan during the life of the debt. Martinson has defaulted. Which of the following is a correct statement?

- a. Clark's promise is **not** supported by consideration, hence it is unenforceable.
- b. Clark is a guarantor of collection and his obligation is conditioned upon Wisdom's first proceeding against Martinson.
- c. Release of the mortgage by Wisdom would release Clark to the extent of the value of the property.
- d. Wisdom must first foreclose the mortgage before it can proceed against Clark.

**M79#5.** Dunlop loaned Barkum \$20,000 which was secured by a security agreement covering Barkum's machinery and equipment. A financing statement was properly filed covering the machinery and equipment. In addition, Delson was a surety on the Barkum loan. Barkum is now insolvent and a petition in bankruptcy has been filed against him. Delson paid the amount owed (\$17,000) to Dunlop. The property was sold for \$12,000. Which of the following is correct?

- Delson has the right of a secured creditor to the \$12,000 via subrogation to Dunlop's rights and the standing of general creditor for the balance.
- To the extent Delson is **not** fully satisfied for the \$17,000 he paid Dunlop, his claim against Barkum will **not** be discharged in bankruptcy.
- Delson's **best** strategy would have been to proceed against Barkum in his own right for reimbursement.
- Delson should have asserted his right of exoneration.

**M79#6.** Quinn was the sole owner of Sunnydale Farms, Inc. The business was in dire need of additional working capital in order to survive. Click Company was willing to loan Sunnydale \$12,000, but only if Click obtained a security interest in Sunnydale's machinery and equipment and a promise from Quinn to guarantee repayment of the loan. Click obtained both. Sunnydale was subsequently adjudged bankrupt. Click filed a reclamation claim for the machinery and equipment which was denied by the trustee in bankruptcy. The property was sold at public auction for \$10,500. Click negotiated a settlement with the trustee whereby it received the \$10,500 proceeds on the sale in full settlement of its claim against the bankrupt. Which of the following is a correct statement?

- Where a surety is the sole owner of the stock of the corporation whose debt he guarantees, he is a compensated surety.
- Click first had to exhaust his remedies against the property before he could sue Quinn.
- Quinn must pay Click the \$1,500 difference, plus interest.
- The settlement released Quinn from his surety obligation.

**M79#7.** Crawford and Blackwell separately agreed to act as sureties on a loan of \$25,000 by Lux to Factor. Each promised to pay the full \$25,000 upon default of Factor. Lux subsequently released Blackwell from his surety undertaking. Which of the following is a correct statement?

- The release has **no** effect upon Crawford's right to contribution if he is obligated to pay.
- The release of Blackwell had no effect upon Crawford's liability.
- The release of Blackwell also totally released Crawford.
- The release of Blackwell also released Crawford to the extent of \$12,500.

### C. Bulk Transfers

**M83#28.** Prior to a bulk transfer, the creditors of the transferor are entitled to

- Examine the books and records of the transferee in order to determine creditworthiness.
- Require that the transferee post an adequate surety bond guaranteeing proper performance.
- Prevent the proposed bulk transfer from taking place if the creditors will meet the terms offered by the transferee in the transfer agreement.
- Notice at least 10 days before the transferee takes possession of the goods or pays for them, whichever occurs first.

**M83#29.** Johnstone purchased all the inventory, machinery, and fixtures of Lomax. Johnstone failed to comply with the requirements of the Bulk Transfers Article of the Uniform Commercial Code. Dark subsequently purchased some of the used machinery from Johnstone. Dark

- Must give notice to Lomax's creditors who sold the machinery to Lomax.
- Will take free of the claims of Lomax's creditors irrespective of Dark's good faith or notice since the creditors must seek recourse from Johnstone exclusively.
- Will have a voidable title even if he took in good faith and without notice.
- Takes subject to any title defect if he had notice of Johnstone's failure to comply.

**M83#30.** Which of the following transfers by a transferor is subject to the Bulk Transfers Article of the Uniform Commercial Code?

- The transfer of property to creditors to provide security for performance of an obligation.
- The transfer to a buyer of some equipment used in the business along with the major part of the inventories, materials, and supplies.
- A transfer made to a vendor in settlement of a security interest.
- A transfer made to a creditor pursuant to settlement of a judicial lien.

**M82#23.** An insolvent debtor made transfers of approximately 70% of inventory to secured creditors in satisfaction of debts. The debts were secured by the inventory. Under the circumstances

- Secured creditors must give notice to the other creditors of the debtor.
- Transfers in settlement of the security interest are excepted from the bulk sales provisions.
- Inventory must be held for one month to enable the creditors to file their claims for any surplus which may arise from its sale.
- Failure of the secured creditors to demand and obtain a list of the other creditors of the debtor will invalidate the transfer.

## Selected Questions

**N82#26.** The Bulk Transfers Article of the Uniform Commercial Code applies to

- a. A general assignment for the benefit of creditors.

- b. A sale of substantially all assets by auction.
- c. A transfer of the bulk of the inventory to settle a lien or other security interest.
- d. A transfer of assets to a receiver.

## V. Government Regulation of Business

### A. Administrative Law

**N83#31.** Able Corporation was charged with a violation of the Federal Trade Commission Act. Harp, a FTC examiner, concluded that Able had violated the Act and made adverse determinations on several issues. Able believes Harp has been not only arbitrary in several of the determinations, but also clearly incorrect in others. Harp has reached his decision and submitted his opinion. Able has decided not to accept the determinations in the opinion. Assuming Able's allegations are correct, Able

- a. Must accept the determination unless it was denied due process.
- b. Should immediately proceed in the local state court to obtain injunctive relief ordering Harp to reopen the case and redetermine his conclusions.
- c. Should appeal immediately to the local federal district court to overturn the determination.
- d. Must exhaust the available administrative remedies before relief in court can be sought.

**N83#32.** In general, federal administrative agencies may exercise

- a. Judicial power only.
- b. Executive power only.
- c. Both judicial and executive power, but **not** legislative power.
- d. Executive, judicial, and legislative power.

### B. Antitrust Law

**N83#33.** Loop Corp. has made a major breakthrough in the development of a micropencil. Loop has patented the product and is seeking to maximize the profit potential. In this effort, Loop can legally

- a. Require its retailers to sell only Loop's products, including the micropencils, and **not** sell similar competing products.
- b. Require its retailers to take stipulated quantities of its other products in addition to the micropencils.
- c. Sell the product at whatever price the traffic will bear even though Loop has a monopoly.
- d. Sell the product to its retailers upon condition that they do **not** sell the micropencils to the public for less than a stated price.

**N83#34.** Certain members of the Tri-State Railway Construction Association decided that something must be done about the disastrous competition, which, when coupled with the depressed status of the industry and economy, was causing financial chaos for many of its members. They met privately after one of the association meetings and decided to allocate construction projects among themselves based upon an historical share of the market. Under the arrangement, a certain designated company would submit the low bid, thereby ensuring that the company would obtain the job. Such an arrangement is

- a. Illegal per se, and a criminal violation of the antitrust law.
- b. Illegal under the rule of reason, but **not** a criminal violation of the antitrust law.
- c. Legally justifiable due to the economic conditions in the marketplace.
- d. Legal under antitrust law since it does **not** fix prices.

**N83#35.** In a pure conglomerate merger

- a. The government must establish an actual restraint on competition in the marketplace in order to prevent the merger.
- b. The acquiring corporation **neither** competes with **nor** sells to or buys from the acquired corporation.
- c. The merger is prima facie valid unless the government can prove the acquiring corporation had an intent to monopolize.
- d. Some form of additional anticompetitive behavior must be established (e.g., price fixing) in order to provide the basis for the government's obtaining of injunctive relief.

**N83#36.** In contesting the validity of a previously consummated vertical merger

- a. The Justice Department must proceed within five years of the consummation of the merger.
- b. The fact that the acquiring corporation deliberately failed to apply for a ruling is presumptive evidence of bad faith.
- c. The Justice Department must show the likelihood that competition may be foreclosed in a substantial share of that market.
- d. Only a showing of actual substantial lessening of competition will be sufficient to establish illegality.

**M83#37.** If a defendant is charged with an unfair method of competition under the Federal Trade Commission Act

- a. The FTC may prevail despite the fact that the conduct alleged to be illegal did **not** violate either the Sherman or Clayton Act.
- b. Criminal sanctions can generally be imposed against a defendant even though the defendant has **not** violated an FTC order to cease and desist.
- c. There can be **no** violation of the Act unless one or more of the specifically enumerated unfair methods of competition are established.
- d. The complaint must be based upon the purchase or sale of goods, wares, or commodities in interstate commerce.

**M83#38.** The Justice Department is proceeding criminally against RSV Corp. and Knox, its president and chief operating officer, for conspiring to fix prices in the greeting card industry. If found guilty

- a. RSV could be fined a maximum of \$500,000.
- b. Knox could be fined a maximum of \$50,000 or be given a prison term, but not both.
- c. Knox would be guilty of a felony and could be sentenced to a prison term not exceeding three years.
- d. RSV may deduct the amount of any fine imposed against it on its federal income tax return.

**M83#31.** Grubar is a troublesome appliance price-cutter. The other retail appliance dealers dislike Grubar's price cutting and he is equally unpopular with the appliance manufacturers. Grubar's appliance sales constitute less than .001% of the market. The marketplace has an abundance of retailers, and competition is vigorous. The manufacturers and the retailers jointly decided to boycott Grubar, thereby significantly limiting the availability of appliances to him, and thus hoping to drive him out of business. Grubar has commenced legal action against the various parties based upon a violation of the Sherman Act. He is seeking injunctive relief and damages. Under the circumstances

- a. Grubar is entitled to the relief requested since the facts indicate a per se violation.
- b. Grubar's complaint should be dismissed since it alleges only a private wrong as contrasted with a public wrong.
- c. Grubar is entitled to the relief requested against the interstate commerce manufacturers, but not the intrastate retailers.
- d. Grubar is **not** entitled to injunctive relief since only the Department of Justice is entitled to obtain such relief.

**M83#32.** Pratt Company manufactures and sells distinctive clocks. Its best selling item is a reproduction of a rare antique grandfather clock. Taylor Co. purchased 100 of the clocks from Pratt at \$99 each. Much to Taylor's chagrin, it discovered that Stewart, one of its competitors, had purchased the same clock from

Pratt at \$94 per clock. Taylor has complained and threatened legal action. In the event the issue is litigated

- a. Taylor has a presumption in its favor that it has been harmed by price discrimination.
- b. Pratt will prevail if it can show it did **not** intend to harm Taylor.
- c. Pratt will prevail if it can show that it sold the clocks at the lower price to all customers such as Stewart who had been doing business with it continuously for ten years or more.
- d. Pratt will prevail if it can establish that there were several other clock companies with which Taylor could deal if Taylor were dissatisfied.

**M83#33.** Section 7 of the Clayton Act is the primary statutory provision used by the Department of Justice in controlling anticompetitive mergers and acquisitions. In general, the Clayton Act is invoked because

- a. It provides for harsher criminal penalties than does the Sherman Act.
- b. It enables the Department of Justice to proscribe mergers and acquisitions in their incipency.
- c. It provides for exclusive jurisdiction over such activities.
- d. The Sherman Act applies to asset mergers or acquisitions only and **not** to stock mergers or acquisitions.

**M82#27.** The United States Department of Justice has alleged that Variable Resources, Inc., the largest manufacturer and seller of variable speed drive motors, is a monopolist. It is seeking an injunction ordering divestiture by Variable of a significant portion of its manufacturing facilities. Variable denies it has monopolized the variable speed drive motor market. Which of the following statements is correct insofar as the government's action against Variable is concerned?

- a. The government must prove that Variable is the sole source of a significant portion of the market.
- b. In order to establish monopolization, the government must prove that Variable has at least 75% of the market.
- c. If Variable has the power to control prices or exclude competition, it has monopoly power.
- d. As long as Variable has not been a party to a contract, combination, or conspiracy in restraint of trade, it can not be found to be guilty of monopolization.

**M82#28.** The Federal Trade Commission Act sets forth a legislative yardstick or standard to be applied with respect to anti-competitive practices. Which of the following is an **incorrect** statement with respect to the Act's scope and application?

- a. The Act's legislative yardstick provides the basis under which the Federal Trade Commission proceeds against violators of the other antitrust laws.
- b. The Act applies not only to goods and wares

Selected Questions

- in interstate commerce, but to services as well.
- The Act provides the basis for an action for treble damages by a private party who is adversely affected by a violation of the Act.
  - The Act permits the Federal Trade Commission to reach violations which are in their incipiency, but which have not yet reached the threshold level of illegality under the Sherman or Clayton Acts.

**M82#29.** City Utility Company and Suburban Electric Company merged with the permission of the Federal Power Commission. The Department of Justice was apprised of the proposed merger from the beginning. Two years after the consummation of the merger the Department of Justice commenced an action under Section 7 of the Clayton Act and Section 1 of the Sherman Act seeking divestiture. Which of the following is correct?

- Public utilities are exempt from the antitrust laws.
- The fact that the Department of Justice was aware of the proposed merger and did nothing precludes it from obtaining an injunction at this late date.
- A merger can **not** be illegal under both the Sherman and Clayton Acts.
- Injunctive relief ordering divestiture is a proper form of relief for the Department of Justice to seek.

**M82#30.** Jackson Corporation is engaging in a widespread price fixing arrangement with several of its leading competitors. Which of the following is correct?

- Only the federal government can obtain injunctive relief.
- The agreement will **not** be found to be illegal if the parties can show they are merely meeting competition.
- If one of the parties to the price fixing arrangement sues Jackson for treble damages for certain breaches of the agreement, relief will be denied.
- The officers of Jackson can **not** be prosecuted and found guilty of violating the antitrust law as long as they are acting solely for and on behalf of the corporation.

**M82#31.** Gould Machinery builds bulldozers. Prior to 1981, it sold on credit a substantial amount of equipment to Mace Contractors. Mace went into bankruptcy in 1981. In order to protect its investment, Gould took over the business of Mace. Erhart Contractors now complains that the acquisition harms its business, on the ground that its business would have improved had not Gould entered the market as a competitor. Erhart can

- Not recover damages under the antitrust laws.
- Recover treble damages.
- Recover only its actual damages.
- Obtain injunctive relief ordering divestiture.

**M82#32.** Darby Corporation manufactures a patented and trademarked, high quality, expensive product. It has discovered that certain disreputable discount stores have been using it as a loss leader. Darby has commenced a rigorous enforcement of its suggested minimum resale price in order to protect its product. Under the circumstances, Darby is

- Guilty of price discrimination.
- Guilty of per se illegal price fixing.
- Not guilty of any violation of the antitrust laws since retail price maintenance is legal.
- Not guilty since Darby may validly set a minimum price beneath which a patented product may not be sold.

**M82#33.** The Marvel Tire Company entered into agreements with its retailers whereby they agreed not to sell Marvel tires beneath the minimum prices determined by Marvel. In exchange for this agreement, Marvel promised not to sell tires at retail in the retailers' respective territories. The agreement did not preclude the retailers from selling competing brands of tires. The agreement is

- An exception to the price fixing provision of the Sherman Act because Marvel has given up the right to sell in the various territories.
- Illegal even though the minimum prices are reasonable.
- Legal since the retailers are permitted to sell the competing brands at any price they choose.
- Legal if the tires are sold under Marvel's exclusive trademark.

**N81#31.** Sunrise Company has a distribution system comprised of distributors and retailers. Each distributor has a defined geographic area in which it has the exclusive right to sell to retailers and to which sales are restricted. Franchised retailers are authorized to sell Sunrise's products only within specified locations. Both distributors and retailers are forbidden to sell to non-franchised retailers. Under present law this marketing arrangement will be

- Judged under the rule of reason, whether or not title passes.
- Illegal *per se* if title passes to the distributor or retailers, but judged under the rule of reason if title does **not** pass (as under an agency or consignment).
- Illegal *per se*, whether or not title passes.
- Illegal *per se* if title does **not** pass, but judged under the rule of reason if title passes.

**N81#32.** Which of the following is a *per se* violation of the federal antitrust laws?

- a. Exclusive territorial rights to sell and corresponding limitations on selling outside the allocated territory by a manufacturer and its distributors.
- b. Unilateral refusal to deal with a troublesome wholesaler.
- c. Tacit agreement with several leading competitors to respect established customer relationships of each other.
- d. Sale of a patented product at an unreasonably high price.

**N81#33.** The United States Justice Department has promulgated the Merger Guidelines in order to inform the public of its views on the factors and considerations to be taken into account in ascertaining whether a merger is potentially illegal. The Merger Guidelines are

- a. Strongly influenced by the factor of size, stated in percentage shares of the market of the parties to the proposed merger.
- b. Based exclusively upon the decisions of the Supreme Court of the United States.
- c. Binding on all parties affected by them subsequent to the date of their promulgation.
- d. Not of great importance, since they are too indefinite and uncertain to have any meaning in respect to an actual merger.

**N81#34.** Robinson's pricing policies have come under attack by several of its retailers. In fact, one of those retailers, Patman, has instigated legal action against Robinson alleging that Robinson charges other favored retailers prices for its products which are lower than those charged to it. Patman's legal action against Robinson

- a. Will fail unless Patman can show that there has been an injury to competition.
- b. Will be sufficient if the complaint alleges that Robinson charged different prices to different customers and there is a reasonable possibility that competition may be adversely affected.
- c. Is groundless since one has the legal right to sell at whatever price one wishes as long as the price is determined unilaterally.
- d. Is to be tested under the rule of reason and if the different prices charged are found to be reasonable, the complaint will be dismissed.

**M81#55.** The Aden Corporation entered into its standard dealership contract with the Downtown Corporation. The contract provided Downtown with an exclusive right to sell Aden's products in Columbia County. Which of the following provisions, if included as a part of the contract, will **not** create a potential antitrust problem?

- a. Aden retains all rights, title, and interest to the goods shipped to Downtown.
- b. Downtown agrees to certain resale price ranges stipulated by Aden.

- c. Downtown may **not** sell any product which Aden Corporation designates as being competitive with its products.
- d. Downtown agrees **not** to sell to certain retailers designated by Aden as price cutters.

**M81#56.** The Radiant Furnace Company entered into agreements with retail merchants whereby they agreed not to sell beneath Radiant's minimum "suggested" retail price of \$850 in exchange for Radiant's agreeing not to sell its furnaces at retail in their respective territories. The agreement does not preclude the retail merchants from selling competing furnaces. What is the legal status of the agreement?

- a. It is illegal even though the price fixed is reasonable.
- b. It is legal if the product is a trade name or trademarked item.
- c. It is legal if the power to fix maximum prices is **not** relinquished.
- d. It is illegal unless it can be shown that the parties to the agreement were preventing cut-throat competition.

**M81#57.** Global Reproductions, Inc., makes and sells high quality, expensive lithographs of the works of famous artists. It sells to art wholesalers throughout the United States. It requires that its wholesalers not purchase lithographs of competing companies during the three-year duration of the contract. They may sell all other types of pictures, including oil, watercolor and charcoal. The Federal Trade Commission has attacked the legality of this exclusive dealing arrangement. This exclusive dealing arrangement

- a. Is legal *per se* since its duration is less than five years.
- b. Could be found to be illegal under the Sherman, Clayton, and Federal Trade Commission Acts.
- c. Will be tested under the rule of reason, and only if found to be unreasonable, will be declared illegal.
- d. Is legal since the wholesalers are permitted to sell all other types of pictures.

**N80#18.** Divco Corporation manufactured and sold a high quality line of distinctive calculators. In order to fully realize the potential of the products, it decided to engage in a franchising arrangement with selected outlets throughout the country. Its basic arrangement was to grant to each dealer the exclusive right to sell in a designated area and each dealer agreed not to sell outside its allotted geographic area. Which of the following best describes the status of the law?

- a. Such arrangements are *per se* illegal.
- b. Divco **must** sell on consignment, thereby retaining title, in order to avoid illegality.
- c. Such franchising arrangements will be tested under the rule of reason and as long as they are found to be reasonable they are legal.
- d. Such arrangements are specifically declared to be illegal under existing antitrust statutes.

## Selected Questions

**M80#1.** Jay Manufacturing Company sells high quality, high-priced lawn mowers to retailers throughout the United States. Jay unilaterally announced suggested retail prices in its advertisements. Jay also informed retailers that its products would not be sold to them if the retailers used them as “loss leaders” or “come-ons.” There was no requirement that any retailer agree to sell at the suggested prices or refrain from selling at whatever price they wished. Monroe Sales, Inc., a large home supply discounter, persistently engaged in loss-leading selling of the Jay mower. Jay has terminated sales to Monroe and declined to do any further business with it. Monroe claims that Jay has violated the antitrust laws. Under the circumstances, which is a correct statement?

- The arrangement in question is an illegal joint boycott.
- The arrangement in question amounts to price fixing and is illegal per se.
- The mere unilateral refusal to deal with Monroe is **not** illegal under antitrust laws.
- Even if it were found that in fact the overwhelming preponderance of retailers had willingly agreed to follow the suggested prices, Jay would **not** have violated antitrust laws.

**M80#2.** Congress recently amended the antitrust laws to provide stiffer penalties and increased sanctions for violation of the various acts’ provisions. Which of the following represents an **incorrect** statement of the changed provisions?

- The maximum fine for corporations was increased to one million dollars.
- Violations of the Sherman Act are now classified as felonies with a maximum prison term of 3 years.
- Punitive damages obtainable in private antitrust actions have been increased from 3 times to 5 times actual damages.
- The maximum fine for individuals has been increased to \$100,000.

**M80#4.** Marble Manufacturing, Inc., produces a high quality, trademarked line of distinctive clocks which it sells to selected wholesalers and retailers. The clocks are sold in free and open competition with the clocks of many other manufacturers. The selection of the wholesalers and retailers is dependent upon their agreeing to the pricing policies of Marble. Several other manufacturers also have similar marketing arrangements. The above-described marketing arrangement is

- Legal, in that Marble is merely “meeting the competition” of other clock manufacturers.
- Legal, since it is a permissible resale price maintenance agreement.
- Fully subject to the general antitrust prohibitions against price fixing.
- To be tested under the rule of reason, since the agreement is not among competitors but rather between a supplier and its customers.

**M80#5.** The Duplex Corporation has been charged by the United States Justice Department with an “attempt to monopolize” the duplex industry. In defending itself against such a charge, Duplex will prevail if it can establish

- It had **no** intent to monopolize the duplex industry.
- Its percentage share of the relevant market was less than 50%.
- Its activities do **not** constitute an unreasonable restraint of trade.
- It does **not** have monopoly power.

**N79#6.** The Flick Corporation sold various interrelated products that it manufactured. One of the items was manufactured almost exclusively by Flick and sold throughout the United States. Flick realized the importance of this product to its purchasers and decided to capitalize on the situation by requiring all purchasers to take at least two other products in order to obtain the item over which it has almost complete market control. At Flick’s spring sales meeting, its president informed the entire sales force that they were to henceforth sell only to those customers who agreed to take the additional products. As a result of this plan, gross sales of the additional items increased by more than \$1 million. Which of the following **best** describes the legality of the above situation?

- It is illegal only if the products are patented products.
- It is an illegal tying arrangement.
- It is legal as long as the price charged to retailers for the other products is competitive.
- It is legal if the retailers do **not** complain about purchasing the other products.

**N79#21.** Wanton Corporation, its president, and several other officers of the corporation are found guilty of conspiring with its major competitor to fix prices. Which of the following sanctions would **not** be applicable under federal antitrust laws?

- Suspension of corporate right to engage in interstate commerce for **not** more than one year.
- Treble damages.
- Seizure of Wanton’s property illegally shipped in interstate commerce.
- Fines against Wanton and fines and imprisonment of its president and officers.

**N79#34.** Which of the following activities engaged in by a corporation will **not** be deemed illegal under the antitrust law?

- A price-fixing agreement with competitors aimed at lowering prices to a reasonable level.
- The charging of a price aimed at maximizing its profits based upon economic analysis of supply and demand for its products.
- Participating in a plan suggested by the trade association aimed at territorial allocations of markets to cut costs.
- The payment of brokerage commissions to the purchasers of goods.

**N79#35.** The Donner Corporation has obtained a patent on a revolutionary coin-operated washing machine. It is far superior to the existing machines currently in use. Which of the following actions taken by Donner will **not** result in a violation of federal antitrust law?

- a. Maintaining the resale price for machines it sells to distributors.
- b. Obtaining a near total monopolization of the market as a result of the patent.
- c. Requiring the purchasers of the machines to buy from Donner all their other commonplace supplies connected with the use of the machine.
- d. Joining in a boycott with other appliance manufacturers to eliminate a troublesome discount distributor.

**N79#36.** Expansion Corporation is an aggressive, large-sized conglomerate. It is seeking to obtain control of several additional corporations including Resistance Corporation. Expansion does **not** currently buy from, sell to, or compete with Resistance. Which of the following statements applies to this proposed takeover?

- a. Since Expansion does **not** buy from, sell to, or compete with Resistance, antitrust laws do **not** apply.
- b. If Expansion can consummate the acquisition before there is an objection to it, the acquisition can **not** subsequently be set aside.
- c. The acquisition is likely to be declared illegal if there will be reciprocal buying and there is a likelihood that other entrants into the market would be precluded.
- d. The acquisition is legal on its face if there will be cost efficiency resulting from combined marketing and advertising.

**N79#37.** The Justice Department is contemplating commencing an action against Lion Corporation for monopolizing the off-shore oil drilling business in violation of Section 2 of the Sherman Act. Which of the following would be Lion's **best** defense against such an action?

- a. Since the drilling is off-shore, interstate commerce is not involved.
- b. The monopoly was originally the result of a long since expired patent.
- c. Lion had **no** specific wrongful intent to monopolize.
- d. Lion's market share is such that it does **not** have the power to fix prices or to exclude competitors.

**N79#42.** Nicks is a troublesome chain store furniture dealer. He constantly engaged in price cutting on widely advertised name products in order to lure customers to his store so that he could sell them other products. The "big three" manufacturers agreed that Nicks could no longer sell their products unless he ceased and desisted

from such practices. Nicks refused and the three manufacturers promptly cut off his supply of their branded products. Which of the following is a correct statement?

- a. Since a businessman has the freedom to choose with whom he will deal, the conduct in question is **not** illegal under the antitrust laws.
- b. If the harm to the public was minor, and the products were readily available from other furniture dealers in a market marked by free and open competition, there would be **no** violation of the law.
- c. The conduct described is a joint boycott, and as such is illegal per se.
- d. Since the conduct described was unilateral, and Nicks did **not** agree to stop his price cutting, the manufacturers' conduct is legal.

**M79#41.** Zebra Acquisitions, Inc., has been steadily acquiring the assets and stock of various corporations manufacturing brass. It also has been purchasing the stock of its customers and others who purchase substantial quantities of brass. It now has 8% of the brass manufacturing facilities in the United States and 22% in the tri-state area in which it is located. Which of the following claims is the United States Department of Justice likely to assert?

- a. The relevant market in question is the entire United States.
- b. It is illegal per se to purchase the stock of competitors.
- c. It is illegal per se to purchase the stock of customers and other potential buyers.
- d. The most recent acquisition substantially lessens competition in the tri-state area.

### C. Regulation of Employment

**N83#39.** Hicks is employed as executive sales manager by Foster Fabrics. She received a salary of \$30,000 in 1982. In addition, she earned \$15,000 net in 1982 as a free lance photographer. As a result of the above earnings for 1982 and the application of the provisions of the Federal Insurance Contributions Act, Hicks

- a. Owed nothing since her salary was fully subjected to withholding of FICA tax by Foster.
- b. Was required to pay a self-employment tax on the difference between the FICA tax base amount and \$30,000.
- c. Was required to pay both an employer and employee FICA tax on the \$15,000.
- d. Was required to ascertain the gross amount of income from the free lance photography and compute the FICA tax owed on that amount.



Selected Questions

**N83#40.** The Equal Employment Opportunity Commission

- a. Has authority to impose criminal penalties under the Equal Employment Opportunity Act.
- b. Has the power to file a civil suit in federal district court and to represent a person charging a violation of the act.
- c. Has **no** jurisdiction over the Civil Rights Act.
- d. Has authority to issue cease and desist orders in those cases where there have been repeated violations.

**N83#41.** There are federal and state unemployment taxes. Regarding the Federal Unemployment Tax Act

- a. Payment of the tax is shared equally by the employer and the employee.
- b. Employees who earn less than \$7,000 are exempt from coverage.
- c. Benefits to an employee can **not** exceed the amount contributed to his account.
- d. A credit is generally available for contributions made by the employer to state unemployment funds.

**M83#34.** Fairfax was employed by Wexford Manufacturing Company as a salaried salesman. While Fairfax was driving a company car on a sales call, a truck owned and operated by Red Van Lines ran a stop light and collided with Fairfax's car. Fairfax applied for and received worker's compensation for the injuries sustained. As a result of receiving worker's compensation, Fairfax

- a. Must assign any negligence cause of action to Wexford pursuant to the doctrine of respondeat superior.
- b. Is precluded from suing Red for negligence because of the worker's compensation award.
- c. Can recover in full against Red for negligence, but must return any duplication of the worker's compensation award.
- d. Can recover in full against Red for negligence and retain the full amounts awarded under worker's compensation.

**M83#35.** Which of the following is a part of the Social Security law?

- a. A self-employed person must contribute an annual amount which is less than the combined contributions of an employee and his or her employer.
- b. Upon the death of an employee prior to his retirement, his estate is entitled to receive the amount attributable to his contributions as a death benefit.
- c. Social Security benefits must be fully funded and payments, current and future, must constitutionally come only from Social Security taxes.
- d. Social Security benefits are taxable as income when they exceed the individual's total contributions.

**N82#26.** Which of the following regarding workers' compensation is correct?

- a. A purpose of workers' compensation is for the employer to assume a definite liability in exchange for the employee giving up his common law rights.
- b. It applies to workers engaged in or affecting interstate commerce only.
- c. It is optional in most jurisdictions.
- d. Once workers' compensation has been adopted by the employer, the amount of damages recoverable is based upon comparative negligence.

**N82#27.** Which of the following would be the employer's best defense to a claim for workers' compensation by an injured route salesman?

- a. A route salesman is automatically deemed to be an independent contractor, and therefore excluded from workers' compensation coverage.
- b. The salesman was grossly negligent in carrying out the employment.
- c. The salesman's injury was caused primarily by the negligence of an employee.
- d. The salesman's injury did **not** arise out of and in the course of employment.

**N82#28.** Which of the following employees are exempt from the minimum and maximum hour provisions of the Fair Labor Standards Act?

- a. Children.
- b. Railroad and airline employees.
- c. Members of a union recognized as the bargaining agent by the National Labor Relations Board.
- d. Office workers.

**N82#29.** Under the Fair Labor Standards Act the Secretary of Labor does **not** have the power to

- a. Issue subpoenas compelling attendance by a witness and the production of records by an employer.
- b. Conduct investigations regarding practices subject to the Act.
- c. Issue a wage order which requires an employer to pay wages found to be due and owing under the Act.
- d. Issue injunctions to restrain obvious violations of the Act.

**M82#34.** Under the Fair Labor Standards Act, certain employment of children is considered oppressive and is prohibited. Which of the following is **not** a legal exception to the Act?

- a. Employment in agriculture outside of school hours.
- b. Employment of children under sixteen by a parent.
- c. Newspaper delivery.
- d. After school part-time work in the fast-food industry.

**N81#30.** The social security tax does **not** apply to which of the following?

- a. Payments on account of sickness including medical and hospital expenses paid by the employer.
- b. Compensation paid in forms other than cash.
- c. Self-employment income of \$1,000.
- d. Bonuses and vacation time pay.

**M81#58.** Stephens is an employee of the Jensen Manufacturing Company, a multi-state manufacturer of roller skates. The plant in which he works is unionized and Stephens is a dues paying union member. Which statement is correct insofar as the Federal Fair Labor Standards Act is concerned?

- a. The Act allows a piece-rate method to be employed in lieu of the hourly-rate method where appropriate.
- b. Jensen is permitted to pay less than the minimum wage to employees since they are represented by a bona fide union.
- c. The Act sets the maximum number of hours that an employee can work in a given day or week.
- d. The Act excludes from its coverage the employees of a labor union.

**M81#59.** The Social Security Act provides for the imposition of taxes and the disbursement of benefits. Which of the following is a correct statement regarding these taxes and disbursements?

- a. Only those who have contributed to Social Security are eligible for benefits.
- b. As between an employer and its employee, the tax rates are the same.
- c. A deduction for federal income tax purposes is allowed the employee for Social Security taxes paid.
- d. Social Security payments are includable in gross income for federal income tax purposes unless they are paid for disability.

**M81#60.** Musgrove Manufacturing Enterprises is subject to compulsory worker's compensation laws in the state in which it does business. It has complied with the state's worker's compensation provisions. State law provides that where there has been compliance, worker's compensation is normally an exclusive remedy. However, the remedy will **not** be exclusive if

- a. The employee has been intentionally injured by the employer personally.
- b. The employee dies as a result of his injuries.
- c. The accident was entirely the fault of a fellow-servant of the employee.
- d. The employer was only slightly negligent and the employee's conduct was grossly negligent.

**N80#58.** Ichi Ban Mopeds, Inc., is a Japanese manufacturer which has a manufacturing facility in the United States. United States business comprises ten percent (10%) of the sales of Ichi Ban of which four percent (4%) is manufactured at its United States facility. Under these circumstances

- a. Ichi Ban is exempt from state workmen's compensation laws.
- b. Ichi Ban is exempt from the Fair Labor Standards Act provided it is governed by comparable Japanese law.
- c. Ichi Ban is subject to generally prevailing federal and state laws applicable to American employees with respect to its employees at the United States facility.
- d. Ichi Ban could legally institute a policy which limited promotions to Japanese-Americans.

**N80#60.** Which of the following is a correct statement regarding the federal income tax treatment of Social Security tax payments and retirement benefits?

- a. The employer's Social Security tax payments are **not** deductible from its gross income.
- b. Social Security retirement benefits are fully includable in the gross income of the retiree if he earns an amount in excess of certain established ceilings.
- c. Social Security retirement benefits are excludable from the retiree's gross income even if the retiree has recouped all he has contributed.
- d. The employee's Social Security tax payments are deductible from the employee's gross income.

**M80#18.** At age 66, Jonstone retired as a general partner of Gordon & Co. He no longer participates in the affairs of the partnership but does receive a distributive share of the partnership profits as a result of becoming a limited partner upon retirement. Jonstone has accepted a part-time consulting position with a corporation near his retirement home. Which of the following is correct regarding Jonstone's Social Security situation?

- a. Jonstone's limited partner distributive share will be considered self-employment income for Social Security purposes up to a maximum of \$10,000.
- b. There is **no** limitation on the amount Jonstone may earn in the first year of retirement.
- c. Jonstone will lose \$1 of Social Security benefits for each \$1 of earnings in excess of a statutorily permitted amount.
- d. Jonstone will be subject to an annual earnings limitation until he attains a stated age which, if exceeded, will reduce the amount of Social Security benefits.

## Selected Questions

**N79#48.** Yeats Manufacturing is engaged in the manufacture and sale of convertible furniture in interstate commerce. Yeats's manufacturing facilities are located in a jurisdiction which has a compulsory workmen's compensation act. Hardwood, Yeats's president, decided that the company should, in light of its safety record, choose to ignore the requirement of providing workmen's compensation insurance. Instead, Hardwood indicated that a special account should be created to provide for such contingencies. Basset was severely injured as a result of his negligent operation of a lathe which accelerated and cut off his right arm. In assessing the potential liability of Yeats, which of the following is a correct answer?

- Federal law applies since Yeats is engaged in interstate commerce.
- Yeats has **no** liability, since Basset negligently operated the lathe.
- Since Yeats did **not** provide workmen's compensation insurance, it can be sued by Basset and cannot resort to the usual common law defenses.
- Yeats is a self-insurer, hence it has **no** liability beyond the amount of the money in the insurance fund.

**N79#49.** The federal Social Security Act applies in general to both employers and employees. Hexter Manufacturing is a small business as defined by the Small Business Administration. Regarding Hexter's relationship to the requirements of the Social Security Act, which of the following is correct?

- Since Hexter is a small business, it is exempt from the Social Security Act.
- Social Security payments made by Hexter's employees are tax deductible for federal income tax purposes.
- Hexter has the option to be covered or excluded from the provisions of the Social Security Act.
- The Social Security Act applies to both Hexter and its employees.

**M79#47.** Wilton was grossly negligent in the operation of a drill press. As a result he suffered permanent disability. His claim for workmen's compensation will be

- Reduced by the percentage-share attributable to his own fault.
- Limited to medical benefits.
- Denied.
- Paid in full.

### D. Federal Securities Acts

**N83#42.** The Securities Exchange Act of 1934 holds certain insiders liable for short-swing profits under section 16(b) of the Act. Which of the following individuals would **not** be an insider in relation to the corporation in which he or she owns securities?

- A major debenture holder.
- An executive vice president.

- A director who owns less than 10% of the shares of stock of the corporation.
- A 13% owner, 9% of which is held in the owner's name and 4% in an irrevocable trust for his or her benefit for life.

**N83#43.** Although the Securities and Exchange Commission has broad powers in conducting a formal investigative proceeding, the SEC can **not**

- Impose monetary penalties without court proceedings.
- Compel a witness to appear.
- Subpoena records.
- Conduct its investigations secretly.

**N83#44.** The president of XK Corporation has been charged by the Securities and Exchange Commission with a criminal violation of the Securities Exchange Act of 1934. Under these circumstances

- The SEC may elect to prosecute the case itself or turn the case over to the Justice Department.
- It is irrelevant whether the president had knowledge of his wrongdoing in determining whether to impose a fine or prison term.
- The SEC must elect between civil and criminal action but may **not** pursue both.
- A fine or prison term or both may be imposed.

**N83#45.** Which of the following corporations are subject to the accounting requirements of the Foreign Corrupt Practices Act?

- All corporations engaged in interstate commerce.
- All domestic corporations engaged in international trade.
- All corporations which have made a public offering under the Securities Act of 1933.
- All corporations whose securities are registered pursuant to the Securities Exchange Act of 1934.

**N82#30.** Under the Foreign Corrupt Practices Act, an action may be brought which seeks

- Treble damages by a private party.
- Injunctive relief by a private party.
- Criminal sanctions against both the corporation and its officers by the Department of Justice.
- Damages and injunctive relief by the Securities and Exchange Commission.

**N82#31.** Which of the following securities or security transactions is automatically exempt under the Securities Act of 1933 from the Act's registration requirements?

- An offering of \$3,000,000 or less of stock to 25 or fewer persons.
- A \$10 million offering of first mortgage bonds to the public.
- An exchange by a corporation of its own securities with existing shareholders without payment of brokerage commissions.
- Sale by a director of her shares of stock providing that she owns less than 10% of the corporation's stock and that the sale is on a registered stock exchange.

**N82#32.** Which of the following is required under the Securities Exchange Act of 1934 or the SEC's reporting requirements issued pursuant thereto?

- Current reporting by issuers of registered securities of certain specified corporate and financial events within ten days after the close of the month in which they occur.
- Quarterly audited financial reports and statements by those corporations listed on a national exchange.
- Reporting by issuers of securities which are traded over-the-counter, but only if the securities are actively traded.
- Annual filing of audited financial reports by all corporations engaged in interstate commerce.

**N82#33.** Insofar as the Securities Act of 1933 and the Securities Exchange Act of 1934 are concerned with fraud

- The Acts are identical with respect to proscribing fraudulent transactions.
- The antifraud provisions are contained exclusively in the 1934 Act.
- The 1933 Act does not require proof of scienter in all circumstances whereas the 1934 Act does.
- Only the 1933 Act contains criminal sanctions against those found to be guilty of fraud.

**N82#59.** Nick owns 200 shares of stock of Sylvester Manufacturing Company. Sylvester is listed on a national stock exchange and has in excess of one million shares outstanding. Nick claims that Abner, a Sylvester director, has purchased and sold shares in violation of the insider trading provisions of the Securities Exchange Act of 1934. Nick has threatened legal action. Which of the following is correct?

- Abner will have a valid defense if he can show he did **not** have any insider information which influenced his purchases or sales.

- Since Nick's stock ownership is less than 1%, his only recourse is to file a complaint with the SEC or obtain a sufficient number of other shareholders to join him so that the 1% requirement is met.
- In order to prevail, Nick must sue for and on behalf of the corporation and establish that the transactions in question occurred within less than six months of each other and at a profit to Abner.
- Nick can sue Abner personally, but his recovery will be limited to his proportionate share of Abner's profits plus legal expenses.

**N80#39.** The Securities Exchange Act of 1934 requires that certain persons register and that the securities of certain issuers be registered. In respect to such registration under the 1934 Act, which of the following statements is **incorrect**?

- All securities offered under the Securities Act of 1933 also must be registered under the 1934 Act.
- National securities exchanges must register.
- The equity securities of issuers, which are traded on a national securities exchange, must be registered.
- The equity securities of issuers having in excess of \$1 million in assets and 500 or more stockholders which are traded in interstate commerce must be registered.

**N80#40.** Theobold Construction Company, Inc., is considering a public stock offering for the first time. It wishes to raise \$1.2 million by a common stock offering and do this in the least expensive manner. In this connection, it is considering making an offering pursuant to Regulation A. Which of the following statements is correct regarding such an offering?

- Such an offering can **not** be made to more than 250 people.
- The maximum amount of securities permitted to be offered under Regulation A is \$1 million.
- Only those corporations which have had an initial registration under the Securities Act of 1933 are eligible.
- Even if Regulation A applies, Theobold is required to distribute an offering circular.

**N80#41.** Shariff is a citizen of a foreign country. He has just purchased six percent (6%) of the outstanding common shares of Stratosphere Metals, Inc., a company listed on a national stock exchange. He has instructed the brokerage firm that quietly and efficiently handled the execution of the purchase order that he wants the securities to be held in street name. What are the legal implications of the above transactions? Shariff must

- Immediately have the securities registered in his own name and take delivery of them.

*Selected Questions*

- b. Sell the securities because he has violated the anti-fraud provisions of the Securities Exchange Act of 1934.
- c. Notify Stratosphere Metals, Inc., of his acquisition and file certain information as to his identity and background with the SEC.
- d. Notify the SEC and Stratosphere Metals, Inc., only if he acquires ten percent (10%) or more of Stratosphere's common shares.

**N80#42.** Which of the following statements concerning the scope of Section 10(b) of the Securities Exchange Act of 1934 is correct?

- a. In order to come within its scope, a transaction must have taken place on a national stock exchange.
- b. It applies exclusively to securities of corporations registered under the Securities Exchange Act of 1934.
- c. There is an exemption from its application for securities registered under the Securities Act of 1933.
- d. It applies to purchases as well as sales of securities in interstate commerce.

**N80#43.** Which of the following statements is correct regarding qualification for the private placement exemption from registration under the Securities Act of 1933?

- a. The instrumentalities of interstate commerce must **not** be used.
- b. The securities must be offered to **not** more than 35 persons.
- c. The minimum amount of securities purchased by each offeree must **not** be less than \$100,000.
- d. The offerees **must** have access to or be furnished with the kind of information that would be available in a registration statement.

**N80#44.** The Foreign Corrupt Practices Act of 1977 prohibits bribery of foreign officials. Which of the following statements correctly describes the Act's application to corporations engaging in such practices?

- a. It only applies to multinational corporations.
- b. It applies to all domestic corporations engaged in interstate commerce.
- c. It only applies to corporations whose securities are registered under the Securities Exchange Act of 1934.
- d. It applies only to corporations engaged in foreign commerce.

**N79#27.** Taylor is the executive vice president for marketing of Reflex Corporation and a member of the Board of Directors. Based on information obtained during the course of his duties, Taylor concluded that Reflex's profits would fall by 50% for the quarter and 30% for the year. He quietly contacted his broker and disposed of 10,000 shares of his Reflex stock at a profit, some of which he had acquired within 6 months of the sale. In fact, Reflex's profits did **not** fall, but its stock

price declined for unrelated reasons. Taylor had also advised a friend to sell her shares and repurchase the stock later. She followed Taylor's advice, sold for \$21, and subsequently repurchased an equal number of shares at \$11. A shareholder has commenced a shareholder derivative action against Taylor and the friend for violation of the Securities Exchange Act of 1934. Under these circumstances, which of the following is correct?

- a. Taylor is **not** an insider in relation to Reflex.
- b. Taylor must account to the corporation for his short-swing profit.
- c. Taylor and the friend must both account to the corporation for their short-swing profits.
- d. Neither Taylor nor the friend has incurred any liability under the 1934 act.

**N79#28.** Which of the following is exempt from registration under the Securities Act of 1933?

- a. First mortgage bonds.
- b. The usual annuity contract issued by an insurer.
- c. Convertible preferred stock.
- d. Limited partnership interests.

**N79#29.** Under the Securities Act of 1933, an accountant may be held liable for any materially false or misleading financial statements, including an omission of a material fact therefrom, provided the purchaser

- a. Proves reliance on the registration statement or prospectus.
- b. Proves negligence or fraud on the part of the accountant.
- c. Brings suit within four years after the security is offered to the public.
- d. Proves a false statement or omission existed and the specific securities were the ones offered through the registration statement.

**N79#32.** Whitworth has been charged by Bonanza Corporation with violating the Securities Exchange Act of 1934. Whitworth was formerly the president of Bonanza, but he was ousted as a result of a proxy battle. Bonanza seeks to recover from Whitworth any and all of his short-swing profits. Which of the following would be a valid defense to the charges?

- a. Whitworth is a New York resident, Bonanza was incorporated in New York, and the transactions were all made through the New York Stock Exchange; therefore, interstate commerce was **not** involved.
- b. Whitworth did **not** actually make use of any insider information in connection with the various stock transactions in question.
- c. All the transactions alleged to be in violation of the 1934 act were purchases made during February 1979 with the corresponding sales made in September 1979.
- d. Whitworth's motivation in selling the stock was solely a result of the likelihood that he would be ousted as president of Bonanza.

**M79#43.** Tweed Manufacturing, Inc., plans to issue \$5 million of common stock to the public in interstate commerce after its registration statement with the SEC becomes effective. What, if anything, must Tweed do in respect to those states in which the securities are to be sold?

- a. Nothing, since approval by the SEC automatically constitutes satisfaction of any state requirements.
- b. Make a filing in those states which have laws governing such offerings and obtain their approval.
- c. Simultaneously apply to the SEC for permission to market the securities in the various states without further clearance.
- d. File in the appropriate state office of the state in which it maintains its principal office of business, obtain clearance, and forward a certified copy of that state's clearance to all other states.

**M79#48.** Harvey Wilson is a senior vice president, 15% shareholder and a member of the Board of Directors of Winslow, Inc. Wilson has decided to sell 10% of his stock in the company. Which of the following methods of disposition would subject him to SEC registration requirements?

- a. A redemption of the stock by the corporation.
- b. The sale by several brokerage houses of the stock in the ordinary course of business.
- c. The sale of the stock to an insurance company which will hold the stock for long-term investment purposes.
- d. The sale to a corporate officer who currently owns 5% of the stock of Winslow and who will hold the purchased stock for long-term investment.

## VI. Uniform Commercial Code

### A. Commercial Paper

**N83#49.** Weber had a negotiable instrument in his possession which he had received in payment of certain equipment he had sold to Roth Merchandising. The instrument was originally payable to the order of Martin Burns or bearer. It was endorsed specially by Burns to Roth who in turn negotiated it to Weber via a blank endorsement. The instrument in question, along with some cash and other negotiable instruments, was stolen from Weber on October 1, 1983. Which of the following is correct?

- a. The theft constitutes a common law conversion which prevents anyone from obtaining a better title to the instrument than the owner.
- b. A holder in due course will prevail against Weber's claim to the instrument.
- c. Once an instrument is bearer paper it is always bearer paper.
- d. Weber's signature was necessary in order to further negotiate the instrument.

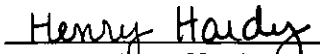
### N82

**Items 35 through 37** all concern instruments which Alex & Co. has in its possession:

### N82#35.

September 2, 1982

I, Henry Hardy, do hereby acknowledge my debt to Walker Corporation arising out of my purchase of soybeans and promise to pay to Walker or to its order, SIX HUNDRED DOLLARS, thirty days after presentment of this instrument to me at my principal place of business.

  
Henry Hardy

Re: \$600.00 - Soybean purchase

The above instrument is

- a. Nonnegotiable.
- b. A negotiable promissory note.
- c. A trade acceptance.
- d. A negotiable bill of lading.

Selected Questions

N82#36.

No. 003	
Nov. 1, 1982	62-105
	251
Pay to the order of <u>Alex &amp; Co.</u> \$1,000.00	
<u>One Thousand and 00/100</u>	Dollars
<u>Ten days after presentment</u>	
Security Trust Company Austin, Texas Memo: For purchases of securities	
<u>Herbert Stein</u> Herbert Stein	

The above instrument is

- a. Nonnegotiable.
- b. A draft.
- c. A trade acceptance.
- d. A check.

N82#37.

October 5, 1982
To: Henry Futterman Suppliers 281 Cascade Boulevard Spokane, Washington 99208
<u>\$950.00</u>
Pay to the order of Alex & Co. Nine hundred fifty and 00/100 dollars one month after acceptance.
Alex & Co. By <u>Charles Alex</u> Managing Partner
Alex & Co. 264 Liberty Avenue Philadelphia, Pa. 19117
Accepted by: <u>Laura Futterman, Treasurer</u> Henry Futterman Suppliers
Date: <u>October 15, 1982</u>

The above instrument is

- a. Nonnegotiable since the payee is also the drawer.

- b. A time promissory note.
- c. A trade acceptance which imposes primary liability upon Henry Futterman Suppliers after acceptance.
- d. A negotiable investment security under the Uniform Commercial Code.

**N82#38.** Kirk made a check payable to Haskin's order for a debt she owed on open account. Haskin negotiated the check by a blank indorsement to Carlson who deposited it in his checking account. The bank returned the check with the notation that payment was refused due to insufficient funds. Kirk is insolvent. Under the circumstances

- a. Kirk has a real defense assertable against all parties including Carlson, a holder in due course.
- b. If Kirk files for bankruptcy, Haskin or Carlson could successfully assert that there had been an assignment of whatever funds were in Kirk's checking account.
- c. If there is a proper presentment, and notice is properly given by Carlson to Haskin, Carlson may recover the amount of the check from Haskin.
- d. Haskin or Carlson can correctly assert the standing of a secured creditor.

**N82#39.** An instrument complies with the requirements for negotiability contained in the Commercial Paper Article of the Uniform Commercial Code. The instrument contains language expressly acknowledging the receipt of \$10,000 by the First Bank of Grand Rapids and an agreement to repay principal with interest at 15% one year from date. This instrument is

- a. Nonnegotiable because of the additional language.
- b. A negotiable certificate of deposit.
- c. A banker's draft.
- d. A banker's acceptance.

**N82#40.** Below is a note which your client, Robinson Real Estate, Inc., obtained from Grant in connection with Grant's purchase of a homesite located in Bangor, Maine. The note was given for the balance due on the purchase and was secured by a first mortgage on the homesite.

\$17,000.00                      Bangor, Maine  
    November 1, 1982

For value received, five years after date, I promise to pay to the order of Robinson Real Estate, Inc., SEVENTEEN THOUSAND and 00/100 DOLLARS with interest at 15% compounded annually until fully paid. This instrument arises out of the sale of land located in Maine and the law of Maine is to be applied to any question which may arise. It is secured by a first mortgage on the land conveyed. It is further agreed that:

1. Purchaser will pay the costs of collection including attorney's fees upon default.
2. Purchaser may repay the amount outstanding on any anniversary date of this note.
3. This note is subject to such implied conditions as are applicable to such notes.

Robert Grant  
 Robert Grant

This note is

- a. Not commercial paper, but instead a negotiable investment security.
- b. A negotiable promissory note since it is payable to Smalley's order and contains an unconditional promise to pay \$1,000 if the holder so elects.
- c. Nonnegotiable since it gives Smalley the option to take stock instead of cash.
- d. Nontransferable.

**N82#42.** The following three indorsements appear on the back of a negotiable promissory note made payable to Harold Dawson. The note is in the possession of Maxim Company.

Pay to James Edwards  
 Harold Dawson

Without Recourse  
 James Edwards

Gilbert Olsen

This note is a

- a. Nonnegotiable promissory note since it is secured by a first mortgage.
- b. Nonnegotiable promissory note since it permits prepayment and requires the maker's payment of the costs of collection and attorney's fees.
- c. Negotiable promissory note.
- d. Negotiable investment security under the Uniform Commercial Code.

**N82#41.** Ash Company has in its possession the following note:

October 15, 1982

I, Joseph Gorman, promise to pay or deliver to Harold Smalley or to his order ONE THOUSAND DOLLARS (\$1,000) or at his option to deliver an amount of stock in the Sunrise Corporation which, on the due date of this instrument, is worth not less than ONE THOUSAND DOLLARS (\$1,000). This note is due and payable on the 1st of November, 1982.

Joseph Gorman  
 Joseph Gorman

The instrument has been dishonored after due presentment by Maxim. Proper notice of dishonor has been given to all parties. Which of the following is correct?

- a. James Edwards's signature on the instrument was **not** necessary.
- b. James Edwards has effectively negated all warranty liability to any subsequent party except Gilbert Olsen.
- c. James Edwards has neither contractual nor warranty liability as a result of his indorsing without recourse.
- d. Gilbert Olsen's signature was **not** necessary to effectively negotiate to Maxim.

**N82#43.** Dodger fraudulently induced Tell to issue a check to his order for \$900 in payment for some nearly worthless securities. Dodger took the check and artfully raised the amount from \$900 to \$1,900. He promptly negotiated the check to Bay who took it in good faith and for value. Tell, upon learning of the fraud, issued a stop order to its bank. Which of the following is correct?

- a. Dodger has a real defense which will prevent any of the parties from collecting anything.



Selected Questions

- b. The stop order was ineffective against Bay since it was issued after the negotiation to Bay.
- c. Bay as a holder in due course will prevail against Tell but only to the extent of \$900.
- d. Had there been no raising of the amount by Dodger, the bank would be obligated to pay Bay despite the stop order.


**N82#51.** A holder in due course will take an instrument free from which of the following defenses?

- a. Discharge in insolvency proceedings.
- b. Infancy of the maker or drawer.
- c. Claims of ownership on the part of other persons.
- d. The forged signature of the maker or drawer.

**N82#60.** Drummond broke into the Apex Drug Store and took all of the cash and checks which were in the cash register. The checks reflect payments made to Apex for goods sold. Drummond disposed of the checks and has disappeared. Apex is worried about its ability to recover the checks from those now in possession of them. Which of the following is correct?

- a. Apex will prevail as long as its signature was necessary to negotiate the checks in question.
- b. Since there was no valid transfer by Apex to Drummond, subsequent parties have no better rights than the thief had.
- c. Apex will prevail only if the checks were payable to cash.
- d. Apex will not prevail on any of the checks since it was the only party that could have prevented the theft.

**M82#35.** The following instrument has been received by your client:

October 15, 1981
To: Bill Souther Rural Route 1 Waverly, Iowa
Pay to the order of James Olson six hundred dollars.
 Robert Smythe

Which of the following is correct?

- a. The instrument is payable on demand.
- b. The instrument is a negotiable note.
- c. As Bill Souther is the drawer, he is primarily liable on the instrument.
- d. As Bill Souther is the drawee, he is secondarily liable on the instrument.

**M82#36.** Industrial Factors, Inc., discounted a \$4,000 promissory note, payable in two years, for \$3,000. It paid \$1,000 initially and promised to pay the balance (\$2,000) within 30 days. Industrial paid the balance within the 30 days, but before doing so learned that the note had been obtained originally by fraudulent misrepresentation in connection with the sale of land which induced the maker to issue the note. For what amount will Industrial qualify as a holder in due course?

- a. None because the 25% discount is presumptive or prima facie evidence that Industrial is **not** a holder in due course.
- b. \$1,000.
- c. \$3,000.
- d. \$4,000.

**M82#37.** Although the scope of the Uniform Commercial Code is broad insofar as inclusion of instruments within the definition of commercial paper, it excludes certain instruments from its coverage. Which of the following is **not** commercial paper?

- a. A promissory note payable 30 days after presentment for payment.
- b. A draft which is an order to pay.
- c. A negotiable certificate of deposit issued by a bank.
- d. An investment security which is payable to bearer.

**M82#38.** Cindy Lake is a holder in due course of a negotiable promissory note for \$1,000. Which of the following defenses of the maker may be validly asserted against her?

- a. A total failure of consideration on the part of the party to whom it was issued.
- b. A wrongful filling in of the amount on the instrument by the party to whom it was issued.
- c. Nonperformance of a condition precedent to its transfer by the party to whom it was issued.
- d. Infancy of the maker to the extent that it is a defense to a simple contract.

**M82#39.** Franklin sold her grain business to Hobson for \$150,000 and received a check drawn on Farmer's Bank for that amount. In addition, she entered into a contract for the purchase of a ranch for the same amount. The closing on the ranch is to take place in five days. The sales contract regarding the ranch requires payment by cash, by buyer's certified check, or by certified check payable to the buyer's order and indorsed to the seller. Franklin intends to have Hobson's check certified by Farmer's Bank and use it as payment. Which of the following is correct?

- a. If the bank refuses to certify the check it has been dishonored.
- b. If Hobson's account has sufficient funds to honor the check, Franklin has the right to have it certified.
- c. Certification by the bank will discharge Hobson from liability as the drawer.
- d. Only Hobson can obtain certification of the check.

**M82#40.** Hoover is a holder in due course of a check which was originally payable to the order of Nelson or bearer and has the following indorsements on its back:

*Nelson*  
 Pay to the order of Maxwell  
*Duffy*  
 Without Recourse  
*Maxwell*  
*Howard*

Which of the following statements about the check is correct?

- a. It was originally order paper.
- b. It was order paper in Howard's hands.
- c. Maxwell's signature was **not** necessary for it to be negotiated.
- d. Presentment for payment must be made within seven days after indorsement to hold an indorser liable.

**M82#41.** Your client, Ensign Factors Corporation, has purchased the trade acceptance shown below from Mason Art Productions, Inc. It has been properly indorsed in blank on the back by Mason.

October 15, 1981

Adams Wholesalers, Inc.  
 49 Buena Vista Avenue  
 Santa Monica, California

Pay to the order of Mason Art Productions, Inc., ten thousand and 00/100 dollars (\$10,000.00).

*Gilda Loucksi*  
 \_\_\_\_\_  
 Gilda Loucksi, President  
 Mason Art Productions, Inc.

Accepted *October 24, 1981*  
 Adams Wholesalers, Inc.

By *Charles Lurch, President*

As to the rights of Ensign, which of the following is correct?

- a. The instrument is nonnegotiable, hence Ensign is an assignee.
- b. Until acceptance, Mason had primary liability on the instrument.
- c. After acceptance by Adams Wholesalers, Adams is primarily liable and Mason is secondarily liable.
- d. After acceptance by Adams, Mason is primarily liable, and Adams is secondarily liable.

**M82#42.** Balquist sold a negotiable instrument payable to her order to Farley. In transferring the instrument to Farley, she forgot to indorse it. Accordingly

- a. Farley qualifies as a holder in due course.
- b. Farley has a specifically enforceable right to obtain Balquist's unqualified indorsement.
- c. Farley obtains a better right to payment of the instrument than Balquist had.
- d. Once the signature of Balquist is obtained, Farley's rights as a holder in due course relate back to the time of transfer.

**M82#43.** Which of the following provisions contained in an otherwise negotiable instrument will cause it to be nonnegotiable?

- a. It is payable in Mexican pesos.
- b. It contains an unrestricted acceleration clause.
- c. It grants to the holder an option to purchase land.
- d. It is limited to payment out of the entire assets of a partnership.

Selected Questions

N81

Items 35 and 36 are based on the following information:

Howard Corporation has the following instrument which it purchased in good faith and for value from Luft Manufacturing, Inc.

July 2, 1981
McHugh Wholesalers, Inc. Pullman, Washington
Pay to the order of Luft Manufacturing, Inc., one thousand seven hundred dollars (\$1,700) three months after acceptance.
<i>Peter Crandall, President</i> Peter Crandall, President Luft Manufacturing, Inc.
Accepted <i>July 12, 1981</i> McHugh Wholesalers, Inc.
By <i>Charles Towne, President</i>

Crandall indorsed the instrument on the back in his capacity as president of Luft when it was transferred to Howard on July 15, 1981.

N81#35. This instrument

- Would be treated as a promissory note since the drawee is **not** a bank.
- Is a negotiable draft and Howard is a holder in due course.
- Is **not** negotiable under Article 3 (commercial paper) of the Uniform Commercial Code, although it may be negotiable under another Article.
- Is **not** negotiable since the drawer and the payee are the same person.

N81#36. What liability do McHugh and Luft have to Howard?

- McHugh has primary liability and Luft has secondary liability.
- Luft has primary liability and McHugh has no liability.
- Luft has primary liability and McHugh has secondary liability.
- McHugh has primary liability and Luft has no liability.

N81#37. Calhoun has in his possession a negotiable instrument which was originally payable to the order of Bannister. It was transferred to Calhoun by a mere delivery by Travis, who took it from Bannister in good faith in satisfaction of an antecedent debt. The back of the instrument read as follows, "Pay to the order of Travis in satisfaction of my prior purchase of a used IBM typewriter, signed Bannister." Which of the following is correct?

- Travis's taking the instrument for an antecedent debt prevents him from qualifying as a holder in due course.

- Calhoun is a holder in due course.
- Calhoun has the right to assert Travis's rights, including his standing as holder in due course and also has the right to obtain Travis's signature.
- Bannister's indorsement was a special indorsement; thus Travis's signature was **not** required in order to negotiate it.

N81#38. Clarkson received a check from Shipley which was incomplete as to the amount. The check was given as payment in advance on the purchase of 100 CB radios. The amount was left blank because Clarkson had the right to substitute other CB models if available for those ordered, which would change the price. It was agreed that in no event would the purchase price exceed \$1,800. Desperate for cash, Clarkson wrongfully substituted much more expensive CB radios thereby increasing the purchase price to \$2,200. Clarkson then negotiated the check to Marshall, one of his suppliers. Clarkson filled in the \$2,200 in Marshall's presence showing him the shipping order and invoice applicable to the sale to Shipley. Marshall accepted the check in payment of \$1,400 overdue debts and \$800 in cash. Under the circumstances, Marshall is

- A holder in due course but only to the extent of the \$800 in cash.
- A holder in due course and entitled to recover the full amount.
- Not a holder in due course because the amount filled in was greater than authorized.
- Not a holder in due course because the instrument was completed in his presence.

N81#40. A client has in its possession the instrument below.

<p>I, Margaret Dunlop, hereby promise to pay to the order of Caldwell Motors five thousand dollars (\$5,000) upon the receipt of the final distribution from the estate of my deceased uncle, Carlton Dunlop. This negotiable instrument is given by me as the down payment on my purchase of a 1981 Lincoln Continental to be delivered in two weeks.</p> <p style="text-align: right;"><i>Margaret Dunlop</i> Margaret Dunlop</p>
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The instrument is

- Negotiable.
- Not negotiable as it is undated.
- Not negotiable in that it is subject to the two-week delivery term regarding the purchase of the Lincoln Continental.
- Not negotiable because it is **not** payable at a definite time.

**N81#41.** Dunbar is the holder and payee of a check. He takes it to the Federal Bank upon which it was drawn and has it certified. Which of the following is correct?

- a. Prior to certification of the check, Federal is only secondarily liable on the check.
- b. Federal is obligated to certify the check so long as there are adequate funds in the account.
- c. After certification of the check, Federal is primarily liable and the drawer is discharged on the check.
- d. If Federal refuses to certify the check, the check will be dishonored.

**N81#42.** Dilworth, an employee of Excelsior Super Markets, Inc., stole his payroll check from the cashier before it was completed. The check was properly made out to his order but the amount payable had not been filled in because Dilworth's final time sheet had not yet been received. Dilworth filled in an amount which was \$300 in excess of his proper pay and cashed it at the Good Luck Tavern. Good Luck took the check in good faith and without suspecting that the instrument had been improperly completed. Excelsior's bank paid the instrument in due course. Excelsior is demanding that the bank credit its account for the \$300 or that it be paid by Good Luck. Which of the following is correct?

- a. Good Luck has **no** liability for the return of the \$300.
- b. Excelsior's bank must credit Excelsior's account for the \$300.
- c. A theft defense would be good against all parties including Good Luck.
- d. Only in the event that negligence on Excelsior's part can be shown will Excelsior bear the loss.

**N81#43.** Wilbur executed and delivered a check for \$80 payable to the order of Muldowney. Muldowney raised the amount to \$800, and negotiated it to Lester, who took the check in good faith and for value without notice of the alteration. When Lester presented it for payment to the bank, the bank refused to honor it due to insufficient funds in Wilbur's account. Lester is seeking to collect the \$800 from Wilbur. Which of the following is correct?

- a. Lester is a holder in due course, but is only entitled to collect \$80 from Wilbur unless Wilbur's negligence facilitated the alteration.
- b. The bank's dishonor of the instrument was wrongful.
- c. Wilbur is liable for \$800 since Lester is a holder in due course and the defense is a personal defense.
- d. The material alteration of the check by Muldowney released Wilbur from all liability to subsequent parties.

**N80#1.** Who among the following can personally qualify as a holder in due course?

- a. A payee.
- b. A reacquirer who was not initially a holder in due course.
- c. A holder to whom the instrument was negotiated as a gift.
- d. A holder who had notice of a defect but who took from a prior holder in due course.

**N80#2.** The Mechanics Bank refused to pay a check drawn upon it by Clyde, one of its depositors. Which of the reasons listed below is **not** a proper defense for the bank to assert when it refused to pay?

- a. The bank believed the check to be an overdraft as a result of its misdirecting a deposit made by Clyde.
- b. The required indorsement of an intermediary transferee was missing.
- c. Clyde had orally stopped payment on the check.
- d. The party attempting to cash the check did not have proper identification.

**N80#3.** Your client, Globe, Inc., has in its possession an undated instrument which is payable 30 days after date. It is believed that the instrument was issued on or about August 10, 1980, by Dixie Manufacturing, Inc., to Harding Enterprises in payment of goods purchased. On August 13, 1980, it was negotiated to Desert Products, Inc., and thereafter to Globe on the 15th. Globe took for value, in good faith and without notice of any defense. It has been learned that the goods shipped by Harding to Dixie are defective. Which of the following is correct?

- a. Since the time of payment is indefinite, the instrument is non-negotiable and Globe can **not** qualify as a holder in due course.
- b. By issuing an undated instrument payable 30 days after date, Dixie was reserving the right to avoid liability on it until it filled in or authorized the filling in of the date.
- c. Since the defense involves a rightful rejection of the goods delivered, it is valid against Globe.
- d. Globe can validly fill in the date and will qualify as a holder in due course.

**N80#4.** A CPA's client has an instrument which contains certain ambiguities or deficiencies. In construing the instrument, which of the following is **incorrect**?

- a. Where there is doubt whether the instrument is a draft or a note, the holder may treat it as either.
- b. Handwritten terms control typewritten and printed terms, and typewritten terms control printed terms.

Selected Questions

- c. An instrument which is payable only upon the happening of an event that is uncertain as to the time of its occurrence is payable at a definite time if the event has occurred.
- d. The fact that the instrument is antedated will not affect the instrument's negotiability.

**N80#5.** Smith buys a TV set from the ABC Appliance Store and pays for the set with a check. Later in the day Smith finds a better model for the same price at another store. Smith immediately calls ABC trying to cancel the sale. ABC tells Smith that they are holding him to the sale and have negotiated the check to their wholesaler, Glenn Company, as a partial payment on inventory purchases. Smith telephones his bank, the Union Trust Bank, and orders the bank to stop payment on the check. Which of the following statements is correct?

- a. If Glenn can prove it is a holder in due course, the drawee bank, Union Trust, must honor Smith's check.
- b. Union Trust is **not** bound or liable for Smith's stop payment order unless the order is placed in writing.
- c. If Union Trust mistakenly pays Smith's check two days after receiving the stop order, the bank will **not** be liable.
- d. Glenn can **not** hold Smith liable on the check.

**N80#6.** Marshall Franks purchased \$1,050 worth of inventory for his business from Micro Enterprises. Micro insisted on the signature of Franks's former partner, Hobart, before credit would be extended. Hobart reluctantly signed. Franks delivered the following instrument to Micro:

January 15, 1980

We, the undersigned, do hereby promise to pay to the order of Micro Enterprises, Inc., One Thousand and Fifty Dollars (\$1,050.00) on the 15th of April, 1980.

Marshall Franks  
Marshall Franks

Norman Hobart  
Norman Hobart

Memo:  
N. Hobart signed as an accommodation for Franks

Franks defaulted on the due date. Which of the following is correct?

- a. The instrument is nonnegotiable.
- b. Hobart is liable on the instrument but only for \$525.
- c. Since it was known to Micro that Hobart signed as an accommodation party, Micro must first proceed against Franks.

- d. Hobart is liable on the instrument for the full amount and is obligated to satisfy it immediately upon default.

**N80#7.** Rapid Delivery, Inc., has in its possession the following instrument which it purchased for value.

March 1, 1980

Thirty days from date, I, Harold Kales, do hereby promise to pay Ronald Green four hundred dollars and no cents (\$400.00). This note is given for value received.

Harold Kales  
Harold Kales

Which of the following is correct?

- a. The instrument is negotiable.
- b. The instrument is nonnegotiable, and therefore Rapid has obtained no rights on the instrument.
- c. Rapid is an assignee of the instrument and has the same rights as the assignor had on it.
- d. The instrument is nontransferable on its face.

**N80#8.** Harrison obtained from Bristow his \$11,500 check drawn on the Union National Bank in payment for bogus uranium stock. He immediately negotiated it by a blank indorsement to Dunlop in return for \$1,000 in cash and her check for \$10,400. Dunlop qualified as a holder in due course. She deposited the check in her checking account in the Oceanside Bank. Upon discovering that the stock was bogus, Bristow notified Union National to stop payment on his check, which it did. The check was returned to Oceanside Bank, which in turn debited Dunlop's account and returned the check to her. Which of the following statements is correct?

- a. Dunlop can collect from Union National Bank since Bristow's stop payment order was invalid in that the defense was only a personal defense.
- b. Oceanside's debiting of Dunlop's account was improper since she qualified as a holder in due course.
- c. Dunlop can recover \$11,500 from Bristow despite the stop order, since she qualified as a holder in due course.
- d. Dunlop will be entitled to collect only \$1,000.

**N80#9.** An otherwise valid negotiable bearer note is signed with the forged signature of Darby. Archer, who believed he knew Darby's signature, bought the note in good faith from Harding, the forger. Archer transferred the note without indorsement to Barker, in partial payment of a debt. Barker then sold the note to Chase for 80% of its face amount and delivered it without indorsement. When Chase presented the note for payment at maturity, Darby refused to honor it, pleading forgery. Chase gave proper notice of dishonor to Barker and to Archer. Which of the following statements **best** describes the situation from Chase's standpoint?

- a. Chase can **not** qualify as a holder in due course for the reason that he did **not** pay face value for the note.
- b. Chase can hold Barker liable on the ground that Barker warranted to Chase that neither Darby nor Archer had any defense valid against Barker.
- c. Chase can hold Archer liable on the ground that Archer warranted to Chase that Darby's signature was genuine.
- d. Chase can **not** hold Harding, the forger, liable on the note because his signature does **not** appear on it and thus, he made no warranties to Chase.

**N80#46.** Anderson agreed to purchase Parker's real property. Anderson's purchase was dependent upon his being able to sell certain real property that he owned. Anderson gave Parker an instrument for the purchase price. Assuming the instrument is otherwise negotiable, which one of the statements below, written on the face of the instrument, will render it nonnegotiable?

- a. A statement that Parker's cashing or indorsing the instrument acknowledges full satisfaction of Anderson's obligation.
- b. A statement that payment of the instrument is contingent upon Anderson's sale of his real property.
- c. A statement that the instrument is secured by a first mortgage on Parker's property and that upon default in payment the entire amount of the instrument is due.
- d. A statement that the instrument is subject to the usual implied and constructive conditions applicable to such transactions.

**M80#15.** Mask stole one of Bloom's checks. The check was already signed by Bloom and made payable to Duval. The check was drawn on United Trust Company. Mask forged Duval's signature on the back of the check and cashed the check at the Corner Check Cashing Company which in turn deposited it with its bank, Town National Bank of Toka. Town National proceeded to collect on the check from United. None of the parties mentioned was negligent. Who will bear the loss assuming the amount **cannot** be recovered from Mask?

- a. Bloom.
- b. Duval.

- c. United Trust Company.
- d. Corner Check Cashing Company.

**M80#19.** Gomer developed a fraudulent system whereby he could obtain checks payable to the order of certain repairmen who serviced various large corporations. Gomer observed the delivery trucks of repairmen who did business with the corporations, and then he submitted bills on the bogus letterhead of the repairmen to the selected large corporations. The return envelope for payment indicated a local post office box. When the checks arrived, Gomer would forge the payees' signatures and cash the checks. The parties cashing the checks are holders in due course. Who will bear the loss assuming the amount **cannot** be recovered from Gomer?

- a. The defrauded corporations.
- b. The drawee banks.
- c. Intermediate parties who endorsed the instruments for collection.
- d. The ultimate recipients of the proceeds of the checks even though they are holders in due course.

**M80#21.** An instrument is order paper when it is

- a. Payable to the order of cash on its face.
- b. Indorsed to John Smith by Marvin Frank, the payee.
- c. Payable to the order of Marvin Frank and indorsed in blank.
- d. Payable to a specified person or bearer.

**M80#22.** Barber has in his possession a negotiable instrument which he purchased in good faith and for value. The drawer of the instrument stopped payment on it and has asserted that Barber does **not** qualify as a holder in due course since the instrument is overdue. In determining whether the instrument is overdue, which of the following is **incorrect**?

- a. A reasonable time for a check drawn and payable in the United States is presumed to be 30 days after issue.
- b. A reasonable time for a check drawn and payable in the United States is presumed to be 20 days after the last negotiation.
- c. All demand instruments, other than checks, are **not** overdue until a reasonable time after their issue has elapsed.
- d. The instrument will be deemed to be overdue if a demand for payment had been made and Barber knew this.

**M80#23.** A formal protest of dishonor must be made in order to hold the drawer or indorsers liable for all of the following **foreign** instruments **except**

- a. Drafts.
- b. Promissory notes.
- c. Trade acceptances.
- d. Checks.

Selected Questions

**M80#24.** Dodson drew a check to the order of Swanson for services which were partially rendered. The check was left blank because the exact amount was **not** known at the time of issue. The understanding between Dodson and Swanson was that Swanson would complete the job, fill in the check for the exact amount due which was estimated as \$650, but which would in no event exceed \$700. Swanson failed to complete the work as agreed, but filled in the amount of the check for \$1,000. He then negotiated it to Irwin in satisfaction of a \$500 debt, with the balance paid to Swanson in cash. Swanson has disappeared, Dodson stopped payment and Irwin is seeking to collect the \$1,000 from Dodson. What will Irwin be able to collect?

- a. Nothing.
- b. \$500.
- c. \$700.
- d. \$1,000.

**M80#30.** Robb stole one of Markum's blank checks, made it payable to himself, and forged Markum's signature to it. The check was drawn on the Unity Trust Company. Robb cashed the check at the Friendly Check Cashing Company which in turn deposited it with its bank, the Farmer's National. Farmer's National proceeded to collect on the check from Unity Trust. The theft and forgery were quickly discovered by Markum who promptly notified Unity. None of the parties mentioned was negligent. Who will bear the loss, assuming the amount **cannot** be recovered from Robb?

- a. Markum.
- b. Unity Trust Company.
- c. Friendly Check Cashing Company.
- d. Farmer's National.

**M79#25.** Martindale Retail Fish Stores, Inc., purchased a large quantity of fish from the Seashore Fish Wholesalers. The exact amount was **not** ascertainable at the moment, and Martindale, rather than waiting for the exact amount, gave Seashore a check which was blank as to the amount. Seashore promised **not** to fill in any amount until it had talked to Martindale's purchasing agent and had the amount approved. Seashore disregarded this agreement and filled in an amount that was \$300 in excess of the correct price. The instrument was promptly negotiated to Clambake & Company, one of Seashore's persistent creditors, in payment of an account due. Martindale promptly stopped payment. For what amount will Martindale be liable to Clambake? Why?

- a. Nothing because Martindale can assert the real defense of material alteration.
- b. Nothing because Clambake did not give value and the stop order is effective against it.
- c. Only the correct amount because the wrongful filling in of the check for the \$300 excess amount was illegal.
- d. The full amount because the check is in the hands of a holder in due course.

**M79#26.** Filbert Corporation has in its possession an instrument which Groves, the maker, assured Filbert was negotiable. The instrument contains several clauses which are **not** typically contained in such an instrument and Filbert is **not** familiar with their legal effect. Which of the following will adversely affect the negotiability of the instrument?

- a. A promise to maintain collateral and to provide additional collateral if the value of existing collateral decreases.
- b. A term authorizing the confession of judgment on the instrument if **not** paid when due.
- c. A statement to the effect that the instrument arises out of the November 1, 1978, sale of goods by Filbert to Groves.
- d. A statement that it is payable only out of the proceeds from the resale of the goods sold by Filbert to Groves on November 1, 1978.

**M79#27.** Mitchell sold his ranch to Campbell. Campbell tendered his uncertified check for \$35,000 at the closing. Mitchell objected and asserted that the check had to be certified. An examination of the contract revealed that the usual certification requirement had been omitted. Mitchell begrudgingly accepted the check after a phone call to the bank confirmed that "the check is good." He promptly proceeded to Campbell's bank and requested that it be certified in that he needed a certified check for a closing the following day in connection with the purchase of another property. Regarding Mitchell's request for certification, which of the following is correct?

- a. The bank is legally obligated to certify the check.
- b. If the bank did certify the check, it constituted an acceptance and released Campbell.
- c. The bank's oral statement that "the check is good" constituted an implied certification.
- d. Once a check has been properly certified, further negotiation is prohibited.

**M79#28.** Johnson lost a check that he had received for professional services rendered. The instrument on its face was payable to Johnson's order. He had indorsed it on the back by signing his name and printing "for deposit only" above his name. Assuming the check is found by Alcatraz, a dishonest person who attempts to cash it, which of the following is correct?

- a. Any transferee of the instrument must pay or apply any value given by him for the instrument consistent with the indorsement.
- b. The indorsement is a blank indorsement and a holder in due course who cashed it for Alcatraz would prevail.
- c. The indorsement prevents further transfer or negotiation by anyone.
- d. If Alcatraz simply signs his name beneath Johnson's indorsement, he can convert it into bearer paper and a holder in due course would take free of the restriction.

**M79#29.** Archer has in his possession a bearer negotiable instrument. He took it by negotiation from Perth who had stolen it from Cox's office along with cash and other property. The robbery of Cox's office had received appropriate coverage in the local papers in the area in which both Archer and Cox reside. Archer did **not** know that Perth had stolen the instrument when he purchased it at a 20% discount. Cox refuses to pay and Archer has commenced legal action asserting that he is a holder in due course. Which of the following statements is correct?

- a. Even if all other requisites are satisfied, Archer's title is defective in that there was **no** delivery by Cox of the instrument.
- b. Archer is a holder in due course and will prevail.
- c. Archer is prevented from qualifying as a holder in due course because there had been general notice published in the community about the robbery.
- d. The discount in and of itself prevents Archer from qualifying as a holder in due course or at least prevents him from so qualifying as to the 20%.

**M79#30.** Path stole a check made out to the order of Marks. Path forged the name of Marks on the back and made the instrument payable to himself. He then negotiated the check to Harrison for cash by signing his own name on the back of the instrument in Harrison's presence. Harrison was unaware of any of the facts surrounding the theft or forged indorsement and presented the check for payment. Central County Bank, the drawee bank, paid it. Disregarding Path, which of the following will bear the loss?

- a. The drawer of the check payable to Marks.
- b. Central County Bank.
- c. Marks.
- d. Harrison.

**M79#31.** Troy fraudulently induced Casper to make a negotiable instrument payable to the order of Troy in exchange for goods he never intended to deliver. Troy negotiated it to Gorden, who took with notice of the fraud. Gorden in turn negotiated it to Wagner, a holder in due course. Wagner presented it for payment to Casper, who refused to honor it. Wagner contacted Gorden who agreed to reacquire the instrument by negotiation from Wagner. Which of the following statements is correct?

- a. Casper would have been liable if Wagner had pursued his rights on the negotiable instrument.
- b. Gorden was initially a holder in due course as a result of the negotiation to him from Troy.
- c. Casper is liable to all parties except Troy in that it was his fault that the instrument was issued to Troy.
- d. Gorden can assert the rights of his prior holder in due course, Wagner, as a result of the repurchase.

**M79#32.** Franco & Sons, Inc., was engaged in the furniture manufacturing business. One of its bi-weekly paychecks was payable to Stein, who negotiated it to White in payment of a gambling debt. White proceeded to raise the amount of the check from \$300 to \$800 and negotiated it to Carson, a holder in due course, for cash. Upon presentment by Carson at the drawee bank, the teller detected the raising of the amount and contacted Franco who stopped payment on the check. Franco refuses to pay Carson. Carson is seeking to recover the \$800. Under the circumstances, which of the following is a correct statement?

- a. Franco is liable, but only for \$300.
- b. Franco is liable for the \$800.
- c. Stein is liable for the \$800.
- d. Franco has **no** liability to Carson.

## B. Documents of Title and Investment Securities

**N83#46.** Hack Company owned 100 tires which it deposited in a public warehouse on April 25, receiving a negotiable warehouse receipt in its name. Hack sold the tires to Fast Freight Co. On which of the following dates did the risk of loss transfer from Hack to Fast?

- a. May 1 — Fast signed a contract to buy the tires from Hack for \$15,000. Delivery was to be at the warehouse.
- b. May 2 — Fast paid for the tires.
- c. May 3 — Hack negotiated the warehouse receipt to Fast.
- d. May 4 — Fast received delivery of the tires at the warehouse.

**N83#47.** Thieves broke into the warehouse of Monogram Airways and stole a shipment of computer parts belonging to Valley Instruments. Valley had in its possession a negotiable bill of lading covering the shipment. The thieves transported the stolen parts to another state and placed the parts in a bonded warehouse. The thieves received a negotiable warehouse receipt which they used to secure a loan of \$20,000 from Reliable Finance. These facts were revealed upon apprehension of the thieves. Regarding the rights of the parties

- a. Reliable is entitled to a \$20,000 payment before relinquishment of the parts.
- b. Monogram will be the ultimate loser of the \$20,000.
- c. Valley is entitled to recover the parts free of Reliable's \$20,000 claim.
- d. Valley is **not** entitled to the parts but may obtain damages from Monogram.



Selected Questions

**M83#48.** In order to qualify as an investment security under the Uniform Commercial Code, an instrument must be

- Issued in registered form, and **not** bearer form.
- Of a long-term nature not intended to be disposed of within one year.
- Only an equity security or debenture security, and **not** a secured obligation.
- In a form that evidences a share, participation or other interest in property or in an enterprise, or evidences an obligation of the issuer.

**M83#43.** The Uniform Commercial Code deals differently with negotiable documents of title than with commercial paper. Which of the following will prevent a due negotiation of a negotiable document of title?

- The transfer by delivery alone of a title document which has been endorsed in blank.
- The receipt of the instrument in payment of an antecedent money obligation.
- The taking of a bearer document of title from one who lacks title thereto.
- The fact that the document of title is more than one month old.

**M83#44.** Under the Uniform Commercial Code's rule, a warehouseman

- Is liable as an insurer.
- Will **not** be liable for the nonreceipt or misdescription of the goods stored even to a good faith purchaser for value of a warehouse receipt.
- Can **not** limit its liability in respect to loss or damage to goods while in its possession.
- Is liable for damages which could have been avoided through the exercise of due care.

**M83#45.** A negotiable bill of lading

- Is one type of commercial paper as defined by the Uniform Commercial Code.
- Can give certain good faith purchasers greater rights to the bill of lading or the goods than the transferor had.
- Can **not** result in a loss to the owner if lost or stolen, provided prompt notice is given to the carrier in possession of the goods.
- Does **not** give the rightful possessor the ownership of the goods.

**M83#46.** Dwight Corporation purchased the following instrument in good faith from John Q. Billings:

No. 7200 ●●● REGISTERED ●●● \$10,000  
Magnum Cum Laude Corporation

Ten year 14% Debenture, Due May 15, 1990

Magnum Cum Laude Corporation, a Delaware Corporation, for value received, hereby promises to pay the sum of TEN THOUSAND

DOLLARS (\$10,000) to JOHN Q. BILLINGS, or registered assigns, at the principal office or agency of the Corporation in Wilmington, Delaware.

On the reverse side of the instrument, the following appeared:

"For value received, the undersigned sells, assigns, and transfers unto DWIGHT CORPORATION, (signed) JOHN Q. BILLINGS." Billings's signature was guaranteed by Capital Trust Company.

Magnum's 14% debentures are listed on the Pacific Coast Exchange. The instrument is

- A registered negotiable investment security which Dwight took free of adverse title claims.
- Nonnegotiable since the instrument must be registered with Magnum to be validly transferred.
- Negotiable commercial paper.
- A nonnegotiable investment security since the instrument lacks the words of negotiability, "to the order of or bearer."

**M82#46.** A negotiable bill of lading is duly negotiated even though

- The negotiation is **not** in the ordinary course of business.
- It is received by the transferee in payment of a money obligation.
- It is **not** negotiable upon issuance, but is subsequently indorsed in blank and transferred.
- It is initially payable to the order of a named person, who signs in blank and delivers it to the transferee.

**M82#44.** While auditing the common stock ledger of Sims Corporation a CPA uncovers the following situation. An investor has purchased a certificate representing 500 shares of common stock of the corporation. It was the duty of the clerk to prepare stock certificates from a supply of blanks for signature of the corporate secretary. The clerk forged the corporate secretary's signature on a bearer certificate and delivered the certificate for value to the investor who did not have notice of the forgery and who now demands a reissued certificate in the investor's name from the corporation. The corporation asserts that it has no liability to reissue a certificate in the name of the investor and that the investor's bearer certificate is null and void. Which of the following is correct?

- The certificate is valid and the investor is entitled to a reissued certificate.
- The certificate issued is invalid and the corporation has **no** liability to reissue.
- An appropriate recourse of the investor is to sue the corporation and clerk for dollar damages and to sue the clerk for the crime of forgery.
- The corporation is required to reissue a certificate only if appropriately compensated by the investor.

**M82#45.** Wilberforce & Company has in its possession certain securities which it took in good faith and for value from Dunlop. An adverse claim or defense has been asserted against the securities. Which of the following warranties may Wilberforce validly assert against Dunlop, its prior transferor?

- a. There is **no** defect in the prior chain of title.
- b. The securities are genuine and have **not** been materially altered.
- c. There is **no** defect which might impair the validity of the securities.
- d. Dunlop will defend the purchasers' title from adverse claim or defects which would impair the validity of the securities.

**N81#47.** Boyd Corporation owned 100 cases of canned fish and stored them in a public warehouse. It asked for and received from the bailee a negotiable warehouse receipt payable to bearer. It sold the document in the ordinary course of business for cash to the Payton Corporation. Boyd delivered the document and indorsed it "Deliver to order of Payton Corporation, signed Boyd Corporation." A thief then stole the document and forged the signature of the Payton Corporation. The thief sold and delivered the document to Slate Corporation who bought it for cash in good faith and in the ordinary course of business. Which of the following is correct?

- a. Slate has legal title to the document.
- b. Payton has legal title to the document.
- c. Boyd has legal title to the document.
- d. Payton can recover the document from Slate but must reimburse Slate for the resultant damages.

**N80#10.** Hargrove lost some stock certificates of the Apex Corporation which were registered in his name, but which he had indorsed in blank. Flagg found the securities and sold them through a brokerage house to Waldorf. Apex, unaware of Hargrove's problem, transferred them to Waldorf. Hargrove is seeking to recover the securities or damages for their value. Which of the following is correct?

- a. The stock in question is transferable but Waldorf takes subject to Hargrove's claim of title.
- b. Waldorf is a holder in due course of a negotiable instrument and therefore will prevail.
- c. Apex is liable for wrongfully transferring Hargrove's stock to Waldorf.
- d. Waldorf qualifies as a bona fide purchaser and acquires the stock free of Hargrove's adverse claim.

### C. Sales

**N83#50.** Which of the following requirements must be met for modification of a sales contract under the Uniform Commercial Code?

- a. The modification must satisfy the Statute of Frauds if the contract as modified is within its provisions.
- b. There must be consideration present if the contract is between merchants.
- c. The parol evidence rule applies and thus a writing is required.
- d. There must be a writing if the original sales contract is in writing.

**N83#51.** In order to have an irrevocable offer under the Uniform Commercial Code, the offer must

- a. Be made by a merchant to a merchant.
- b. Be contained in a signed writing which gives assurance that the offer will be held open.
- c. State the period of time for which it is irrevocable.
- d. Not be contained in a form supplied by the offeror.

**N83#52.** Gold sold Sable ten fur coats. The contract contained no specific provision regarding title warranties. It did, however, contain a provision which indicated that the coats were sold "with all faults and defects." Two of the coats sold to Sable had been stolen and were reclaimed by the rightful owner. Which of the following is a correct statement?

- a. The implied warranty of title is eliminated by the parol evidence rule.
- b. The contract automatically contained a warranty that the title conveyed is good and can only be excluded by specific language.
- c. Since there was **no** express title warranty, Sable assumed the risk.
- d. The disclaimer "with all faults and defects" effectively negates any and all warranties.

**N83#53.** On October 1, Baker, a wholesaler, sent Clark, a retailer, a written signed offer to sell 200 pink-ing shears at \$9 each. The terms were F.O.B. Baker's warehouse, net 30, late payment subject to a 15% per annum interest charge. The offer indicated that it must be accepted no later than October 10, that acceptance would be effective upon receipt, and that the terms were not to be varied by the offeree. Clark sent a telegram which arrived on October 6, and accepted the offer expressly subject to a change of the payment terms to 2/10, net/30. Baker phoned Clark on October 7, rejecting the change of payment terms. Clark then indicated it would accept the October 1 offer in all respects, and expected delivery within 10 days. Baker did not accept Clark's oral acceptance of the original offer. Which of the following is a correct statement?

- a. Baker's original offer is a firm offer, hence irrevocable.
- b. There is **no** contract since Clark's modifications effectively rejected the October 1 offer,

Selected Questions

- and Baker never accepted either of Clark's proposals.
- c. Clark actually created a contract on October 6, since the modifications were merely proposals and did **not** preclude acceptance.
  - d. The statute of frauds would preclude the formation of a contract in any event.

**N83#54.** The Uniform Commercial Code implies a warranty of merchantability to protect buyers of goods. To be subject to this warranty the goods need **not** be

- a. Fit for all of the purposes for which the buyer intends to use the goods.
- b. Adequately packaged and labeled.
- c. Sold by a merchant.
- d. In conformity with any promises or affirmations of fact made on the container or label.

**N83#55.** Donaldson suffered an injury due to a malfunction of a power tool he had purchased from Malloy Hardware. The tool was manufactured by Superior Tool Company. Donaldson has commenced an action against Malloy and Superior based upon strict liability. Which of the following is a correct statement?

- a. Donaldson's suit against Malloy will be dismissed since Malloy was **not** at fault.
- b. Privity will **not** be a valid defense against Donaldson's suit.
- c. Superior will **not** be liable if it manufactured the tool in a nonnegligent manner.
- d. The lawsuit will be dismissed since strict liability has **not** been applied in product liability cases in the majority of jurisdictions.

**N83#56.** In deciding a controversy involving the question of who has the risk of loss, the court will look primarily to

- a. The intent of the parties manifested in the contract.
- b. The shipping terms used by the parties.
- c. Whether title has passed.
- d. The insurance coverage of the parties.

**N83#57.** Dey ordered 100 cases of Fancy Brand carrots at list price from Ned Wholesaler. Immediately upon receipt of Dey's order, Ned sent Dey an acceptance which was received by Dey. The acceptance indicated that shipment would be made within seven days. On the seventh day Ned discovered that all of its supply of Fancy Brand carrots had been sold. Instead it shipped 100 cases of Rabbit Brand, stating clearly on the invoice that the shipment was sent only as an accommodation. Which of the following is correct?

- a. Ned's note of accommodation cancels the contract between Ned and Dey.
- b. Dey's order is a unilateral offer, and can only be accepted by Ned's shipment of the goods ordered.

- c. Ned's shipment of Rabbit Brand constitutes a breach of contract.
- d. Ned's shipment of Rabbit Brand is a counter-offer, thus **no** contract exists between Dey and Ned.

**N83#58.** Marvin contracted to purchase goods from Ling. Subsequently, Marvin breached the contract and Ling is seeking to recover the contract price. Ling can recover the price if

- a. Ling does **not** seek to recover any damages in addition to the price.
- b. The goods have been destroyed and Ling's insurance coverage is inadequate, regardless of risk of loss.
- c. Ling has identified the goods to the contract and the circumstances indicate that a reasonable effort to resell the goods at a reasonable price would be to no avail.
- d. Marvin anticipatorily repudiated the contract and specific performance is **not** available.

**N83#59.** Dodd Company sold Barney & Company 10,000 ball point pens. The shipment, upon inspection, was found to be nonconforming and Barney rejected the pens. Barney purchased the pens elsewhere at a price which was \$525 more than the contract price. The Dodd sales contract contained a clause which purported to reduce the statute of limitations provision of the Uniform Commercial Code to one year. Barney has done nothing about the breach except to return the pens and demand payment of the \$525 damages. Dodd has totally ignored Barney's claim. The statute of limitations

- a. Is four years according to the Uniform Commercial Code and can **not** be reduced by the original agreement.
- b. Will totally bar recovery unless suit is commenced within the time specified in the contract.
- c. May be extended by the parties but **not** beyond five years.
- d. Can **not** be reduced by the parties to a period less than two years.

**N83#60.** Hall is suing the manufacturer, the wholesaler, and the retailer for bodily injuries caused by a lawnmower Hall purchased. Under the theory of strict liability

- a. Privity will be a bar insofar as the wholesaler is concerned if the wholesaler did **not** have a reasonable opportunity to inspect.
- b. Contributory negligence on Hall's part will always be a bar to recovery.
- c. The manufacturer will avoid liability if it can show it followed the custom of the industry.
- d. Hall may recover despite the fact that he can **not** show that any negligence was involved.

**M83#11.** Glass Co. telephoned Hourly Company and ordered 2,000 watches at \$2 each. Glass agreed to pay 10% immediately and the balance within ten days after receipt of the entire shipment. Glass forwarded a check for \$400 and Hourly shipped 1,000 watches the next day, intending to ship the balance by the end of the week. Glass decided that the contract was a bad bargain and repudiated it, asserting the Statute of Frauds. Hourly sued Glass. Which of the following will allow Hourly to enforce the contract in its entirety despite the Statute of Frauds?

- Glass admitted in court that it made the contract in question.
- Hourly shipped 1,000 watches.
- Glass paid 10% down.
- The contract is **not** within requirements of the Statute.

**M83#38.** A merchant's irrevocable written offer (firm offer) to sell goods

- Must be separately signed if the offeree supplies a form contract containing the offer.
- Is valid for three months unless otherwise provided.
- Is nonassignable.
- Can **not** exceed a three-month duration even if consideration is given.

**M83#39.** In general, disclaimers of implied warranty protection are

- Permitted if they are explicit and understandable and the buyer is aware of their existence.
- Not binding on remote purchasers with notice thereof.
- Void because they are against public policy.
- Invalid unless in writing and signed by the buyer.

**M83#40.** The Uniform Commercial Code's position on privity of warranty as to personal injuries

- Resulted in a single uniform rule being adopted throughout most of the United States.
- Prohibits the exclusion on privity grounds of third parties from the warranty protection it has granted.
- Applies exclusively to manufacturers.
- Allows the buyer's family the right to sue only the party from whom the buyer purchased the product.

**M83#42.** On February 1, 1983, Nugent Manufacturing, Inc. contracted with Costello Wholesalers to supply Costello with 1,000 integrated circuits. Delivery was called for on May 1, 1983. On March 15, 1983, Nugent notified Costello that it would not perform and that Costello should look elsewhere. Nugent had received a larger and more lucrative contract on February 27, 1983, and its capacity was such that it could not fulfill both orders. The facts

- Are **not** sufficient to clearly establish an anticipatory repudiation.

- Will prevent Nugent from retracting its repudiation of the Costello contract.
- Will permit Costello to sue immediately after March 15, 1983, even though the performance called for under the contract was not until May 1, 1983.
- Will permit Costello to sue only after May 1, 1983, the latest performance date.

**N82#4.** Calvin Poultry Co. offered to sell Chickenshop 20,000 pounds of chicken at 40 cents per pound under specified delivery terms. Chickenshop accepted the offer as follows:

"We accept your offer for 20,000 pounds of chicken at 40 cents per pound per city scale weight certificate."

Which of the following is correct?

- A contract was formed on Calvin's terms.
- Chickenshop's reply constitutes a conditional acceptance, but **not** a counteroffer.
- Chickenshop's reply constitutes a counteroffer and **no** contract was formed.
- A contract was formed on Chickenshop's terms.

**N82#6.** In which of the following situations would an oral agreement without any consideration be binding under the Uniform Commercial Code?

- A renunciation of a claim or right arising out of an alleged breach.
- A firm offer by a merchant to sell or buy goods which gives assurance that it will be held open.
- An agreement which is a requirements contract.
- An agreement which modifies an existing sales contract.

**N82#45.** Stand Glue Corp. offered to sell Macal, Inc., all of the glue it would need in the manufacture of its furniture for one year at the rate of \$25 per barrel, f.o.b. seller's city. Macal accepted Stand's offer. Four months later, due to inflation, Stand wrote to Macal advising Macal that Stand could no longer supply the glue at \$25 per barrel, but offering to fulfill the contract at \$28 per barrel instead. Macal, in need of the glue, sent Stand a letter agreeing to pay the price increase. Macal is

- Legally obligated to pay only \$25 per barrel under the contract with Stand.
- Legally obligated to pay \$28 per barrel under the contract with Stand.
- Not** legally obligated to purchase any glue henceforth from Stand since Stand has breached the contract.
- Legally obligated to pay \$28 per barrel due to the fact inflation represents an unforeseen hardship.

*Selected Questions*

**N82#47.** Webster purchased a drill press for \$475 from Martinson Hardware, Inc. The press has proved to be defective and Webster wishes to rescind the purchase based upon a breach of implied warranty. Which of the following will preclude Webster's recovery from Martinson?

- a. The press sold to Webster was a demonstration model and sold at a substantial discount; hence, Webster received no implied warranties.
- b. Webster examined the press carefully, but as regards the defects, they were hidden defects which a reasonable examination would **not** have revealed.
- c. Martinson informed Webster that they were closing out the model at a loss due to certain deficiencies and that it was sold "with all faults."
- d. The fact that it was the negligence of the manufacturer which caused the trouble and that the defect could **not** have been discovered by Martinson without actually taking the press apart.

**N82#48.** Falcon, by telegram to Southern Wool, Inc., ordered 30 bolts of cloth, first quality, 60% wool and 40% dacron. The shipping terms were F.O.B. Falcon's factory in Norwalk, Connecticut. Southern accepted the order and packed the bolts of cloth for shipment. In the process it discovered that one half of the bolts packed had been commingled with cloth which was 50% wool and 50% dacron. Since Southern did not have any additional 60% wool cloth, it decided to send the shipment to Falcon as an accommodation. The goods were shipped and later the same day Southern wired Falcon its apology informing Falcon of the facts and indicating that the 15 bolts of 50% wool would be priced at \$15 a bolt less. The carrier delivering the goods was hijacked on the way to Norwalk. Under the circumstances, who bears the risk of loss?

- a. Southern, since they shipped goods which failed to conform to the contract.
- b. Falcon, since the shipping terms were F.O.B. Falcon's place of business.
- c. Southern, because the order was **not** a signed writing.
- d. Falcon, since Falcon has title to the goods.

**N82#49.** Filmore purchased a Miracle color television set from Allison Appliances, an authorized dealer, for \$499. The written contract contained the usual one-year warranty as to parts and labor as long as the set was returned to the manufacturer or one of its authorized dealers. The contract also contained an effective disclaimer of any express warranty protection, other than that which was included in the contract. It further pro-

vided that the contract represented the entire agreement and understanding of the parties. Filmore claims that during the bargaining process Surry, Allison's agent, orally promised to service the set at Filmore's residence if anything went wrong within the year. Allison has offered to repair the set if it is brought to the service department, but denies any liability under the alleged oral express agreement. Which of the following would be the best defense for Allison to rely upon in the event Filmore sues?

- a. The Statute of Frauds.
- b. The parol evidence rule.
- c. The fact that all warranty protection was disclaimed other than the express warranty contained in the contract.
- d. The fact that Surry, Allison's agent, did **not** have express authority to make such a promise.

**N82#50.** Sanders Hardware Company received an order for \$900 of assorted hardware from Richards & Company. The shipping terms were F.O.B. Lester Freight Line, seller's place of business, 2/10, net/30. Sanders packed and crated the hardware for shipment and it was loaded upon Lester's truck. While the goods were in transit to Richards, Sanders learned that Richards was insolvent in the equity sense (unable to pay its debts in the ordinary course of business). Sanders promptly wired Lester's office in Denver, Colorado, and instructed them to stop shipment of the goods to Richards and to store them until further instructions. Lester complied with these instructions. Regarding the rights, duties, and liabilities of the parties, which of the following is correct?

- a. Sanders's stoppage in transit was improper if Richards's assets exceeded its liabilities.
- b. Richards is entitled to the hardware if it pays cash.
- c. Once Sanders correctly learned of Richards's insolvency, it had no further duty or obligation to Richards.
- d. The fact that Richards became insolvent in no way affects the rights, duties, and obligations of the parties.

**N82#47.** A claim has been made by Donnegal to certain goods in your client's possession. Donnegal will be entitled to the goods if it can be shown that Variance, the party from whom your client purchased the goods, obtained them by

- a. Deceiving Donnegal as to his identity at the time of the purchase.
- b. Giving Donnegal his check which was later dishonored.
- c. Obtaining the goods from Donnegal by fraud, punishable as larceny under criminal law.
- d. Purchasing goods which had been previously stolen from Donnegal.

**M81#14.** The Uniform Commercial Code provides for a warranty against infringement. Its primary purpose is to protect the buyer of goods from infringement of the rights of third parties. This warranty

- a. Only applies if the sale is between merchants.
- b. Must be expressly stated in the contract or the Statute of Frauds will prevent its enforceability.
- c. Protects the seller if the buyer furnishes specifications which result in an infringement.
- d. Can **not** be disclaimed.

**M81#16.** Ace Auto Sales, Inc., sold Williams a secondhand car for \$9,000. One day Williams parked the car in a shopping center parking lot. When Williams returned to the car, Montrose and several policemen were waiting. It turned out that the car had been stolen from Montrose who was rightfully claiming ownership. Subsequently, the car was returned by Williams to Montrose. Williams seeks recourse against Ace Auto Sales who had sold him the car with the usual disclaimer of warranty. Which of the following is correct?

- a. Since Ace Auto Sales' contract of sale disclaimed "any and all warranties" arising in connection with its sale to Williams, Williams must bear the loss.
- b. Since Ace Auto and Williams were both innocent of any wrongdoing in connection with the theft of the auto, the loss will rest upon the party ultimately in possession.
- c. Had Williams litigated the question of Montrose's ownership to the auto, he would have won since possession is nine-tenths of the law.
- d. Ace Auto will bear the loss since a warranty of title in Williams's favor arose upon the sale of the auto.

**M81#17.** A dispute has arisen between two merchants over the question of who has the risk of loss in a given sales transaction. The contract does not specifically cover the point. The goods were shipped to the buyer who rightfully rejected them. Which of the following factors will be the most important factor in resolving their dispute?

- a. Who has title to the goods.
- b. The shipping terms.
- c. The credit terms.
- d. The fact that a breach has occurred.

**M81#18.** Doral Inc., wished to obtain an adequate supply of lumber for its factory extension which was to be constructed in the spring. It contacted Ace Lumber Company and obtained a 75-day written option (firm offer) to buy its estimated needs for the building. Doral supplied a form contract which included the option. Ace Lumber signed at the physical end of the contract but did not sign elsewhere. The price of lumber has risen drastically and Ace wishes to avoid its obligation.

Which of the following is Ace's best defense against Doral's assertion that Ace is legally bound by the option?

- a. Such an option is invalid if its duration is for more than two months.
- b. The option is **not** supported by any consideration on Doral's part.
- c. Doral is **not** a merchant.
- d. The promise of irrevocability was contained in a form supplied by Doral and was **not** separately signed by Ace.

**M81#20.** Darrow purchased 100 sets of bookends from Benson Manufacturing, Inc. Darrow made substantial prepayments of the purchase price. Benson is insolvent and the goods have not been delivered as promised. Darrow wants the bookends. Under the circumstances, which of the following will prevent Darrow from obtaining the bookends?

- a. The fact that he did **not** pay the full price at the time of the purchase even though he has made a tender of the balance and holds it available to Benson upon delivery.
- b. The fact that he can obtain a judgment for damages.
- c. The fact that he was **not** aware of Benson's insolvency at the time he purchased the bookends.
- d. The fact that the goods have **not** been identified to his contract.

**N80#11.** Base Electric Co. has entered an agreement to buy its actual requirements of copper wiring for six months from the Seymour Metal Wire Company and Seymour Metal has agreed to sell all the copper wiring Base will require for six months. The agreement between the two companies is

- a. Unenforceable because it is too indefinite.
- b. Unenforceable because it lacks mutuality of obligation.
- c. Unenforceable because of lack of consideration.
- d. Valid and enforceable.

**N80#12.** Gibbeon Manufacturing shipped 300 designer navy blue blazers to Custom Clothing Emporium. The blazers arrived on Friday, earlier than Custom had anticipated and on an exceptionally busy day for its receiving department. They were perfunctorily examined and sent to a nearby warehouse for storage until needed. On Monday of the following week, upon closer examination, it was discovered that the quality of the linings of the blazers was inferior to that specified in the sales contract. Which of the following is correct insofar as Custom's rights are concerned?

- a. Custom can reject the blazers upon subsequent discovery of the defects.
- b. Custom must retain the blazers since it accepted them and had an opportunity to inspect them upon delivery.

Selected Questions

- c. Custom's only course of action is rescission.
- d. Custom had no rights if the linings were of merchantable quality.

**N80#13.** The Balboa Custom Furniture Company sells fine custom furniture. It has been encountering difficulties lately with some customers who have breached their contracts after the furniture they have selected has been customized to their order or the fabric they have selected has been cut or actually installed on the piece of furniture purchased. The company therefore wishes to resort to a liquidated damages clause in its sales contract to encourage performance or provide an acceptable amount of damages. Regarding Balboa's contemplated resort to a liquidated damages clause, which of the following is correct?

- a. Balboa may not use a liquidated damages clause since it is a merchant and is the preparer of the contract.
- b. Balboa can simply take a very large deposit which will be forfeited if performance by a customer is not made for any reason.
- c. The amount of the liquidated damages stipulated in the contract must be reasonable in light of the anticipated or actual harm caused by the breach.
- d. Even if Balboa uses a liquidated damages clause in its sales contract, it will nevertheless have to establish that the liquidated damages claimed did not exceed actual damages by more than 10%.

**N80#14.** Fernandez is planning to attend an auction of the assets of Cross & Black, one of his major competitors who is liquidating. In the conduct of the auction, which of the following rules applies?

- a. Such a sale is without reserve unless the goods are explicitly put up with reserve.
- b. A bidder may retract his bid at any time until the falling of the hammer.
- c. The retraction of a bid by a bidder revives the previous bid.
- d. If the auction is without reserve, the auctioneer can withdraw the article at any time prior to the fall of the hammer.

**N80#15.** Joseph Manufacturing, Inc., received an order from Raulings Supply Company for certain valves it manufactured. The order called for prompt shipment. In respect to Joseph's options as to the manner of acceptance, which of the following is **incorrect**?

- a. Joseph can accept only by prompt shipment since this was the manner indicated in the order.
- b. The order is construed as an offer to enter into either a unilateral or bilateral contract and Joseph may accept by a promise of or prompt shipment.

- c. If Joseph promptly ships the goods, Raulings must be notified within a reasonable time.
- d. Joseph may accept by mail, but he must make prompt shipment.

**M80#27.** Ford bought a used typewriter for \$625 from Jem Typewriters. The contract provided that the typewriter was sold "with all faults, as is, and at the buyer's risk." The typewriter broke down within a month. Ford took it back to Jem, and after prolonged arguing and negotiating, Jem orally agreed to reduce the price by \$50 and refund that amount. Jem has reconsidered his rights and duties and decided **not** to refund the money. Under the circumstances, which of the following is correct?

- a. The disclaimer of the implied warranties of merchantability and fitness is invalid.
- b. The agreement to reduce the price is valid and binding.
- c. Jem's promise is unenforceable since Ford gave no new consideration.
- d. Since the contract as modified is subject to the statute of frauds, the modification must be in writing.

**M80#29.** Marblehead Manufacturing, Inc., contracted with Wellfleet Oil Company in June to provide its regular supply of fuel oil from November 1 through March 31. The written contract required Marblehead to take all of its oil requirements exclusively from Wellfleet at a fixed price subject to an additional amount **not** to exceed 10% of the contract price and only if the market price increases during the term of the contract. By the time performance was due on the contract, the market price had already risen 20%. Wellfleet seeks to avoid performance. Which of the following will be Wellfleet's **best** argument?

- a. There is **no** contract since Marblehead was **not** required to take any oil.
- b. The contract fails because of lack of definiteness and certainty.
- c. The contract is unconscionable.
- d. Marblehead has ordered amounts of oil unreasonably disproportionate to its normal requirements.

**M80#32.** Target Company, Inc., ordered a generator from Maximum Voltage Corporation. A dispute has arisen over the effect of a provision in the specifications that the generator have a 5,000 kilowatt capacity. The specifications were attached to the contract and were incorporated by reference in the main body of the contract. The generator did **not** have this capacity but instead had a maximum capacity of 4,800 kilowatts. The contract had a disclaimer clause which effectively negated both of the implied warranties of quality. Target

is seeking to avoid the contract based upon breach of warranty and Maximum is relying on its disclaimer. Which of the following is a correct statement?

- a. The 5,000 kilowatt term contained in the specifications does **not** constitute a warranty.
- b. The disclaimer effectively negated any and all warranty protection claimed by Target.
- c. The description language (5,000 kilowatt) contained in the specifications is an express warranty and has **not** been effectively disclaimed.
- d. The parol evidence rule will prevent Target from asserting the 5,000 kilowatt term as a warranty.

**M80#33.** Buyer ordered goods from Seller. The contract required Seller to deliver them f.o.b. Buyer's place of business. Buyer inspected the goods, discovered they failed to conform to the contract, and rightfully rejected them. In the event of loss of the goods, which of the following is a correct statement?

- a. Seller initially had the risk of loss and it remains with him after delivery.
- b. Risk of loss passes to Buyer upon tender of the goods f.o.b. Buyer's place of business.
- c. Buyer initially had the risk of loss, but it is shifted to Seller upon rightful rejection.
- d. If Seller used a public carrier to transport the goods to Buyer, risk of loss is on Buyer during transit.

**M80#34.** Milgore, the vice president of Deluxe Restaurants, telephoned Specialty Restaurant Suppliers and ordered a made-to-order dishwashing unit for one of its restaurants. Due to the specifications, the machine was **not** adaptable for use by other restaurateurs. The agreed price was \$2,500. The machine was constructed as agreed but Deluxe has refused to pay for it. Which of the following is correct?

- a. Milgore obviously lacked the authority to make such a contract.
- b. The statute of frauds applies and will bar recovery by Specialty.
- c. Specialty can successfully maintain an action for the price.
- d. Specialty must resell the machine and recover damages based upon the resale price.

**M80#37.** Pure Food Company packed and sold quality food products to wholesalers and fancy food retailers. One of its most popular items was "southern style" baked beans. Charleston purchased a large can of the beans from the Superior Quality Grocery. Charleston's mother bit into a heaping spoonful of the beans at a family outing and fractured her jaw. The evidence revealed that the beans contained a brown stone, the size of a marble. In a subsequent lawsuit by Mrs. Charleston, which of the following is correct?

- a. Mrs. Charleston can collect against Superior Quality for negligence.

- b. Privity will **not** be a bar in a lawsuit against either Pure Food or Superior Quality.
- c. The various sellers involved could have effectively excluded or limited the rights of third parties to sue them.
- d. Privity is a bar to recovery by Mrs. Charleston, although her son may sue Superior Quality.

**M80#38.** Martha Supermarkets ordered 1,000 cases of giant pitted olives from Grove Packers and Wholesalers. The olives were to be packed, labelled and shipped in 30 days. The payment terms were 2/10, net/30 upon delivery. After the order was nearly ready for shipment, Grove learned that Martha was **not** paying its debts as they became due. Martha insisted on delivery according to the terms of the contract. Which of the following is correct?

- a. Upon discovery of Martha's financial condition, Grove was relieved from any duty under the contract.
- b. Martha has the right of performance since it was **not** insolvent in the bankruptcy sense.
- c. Grove must perform but it is entitled to demand cash.
- d. The terms of the contract provided credit to Martha and Grove is bound by it.

**N79#1.** Cox Manufacturing repudiated its contract to sell 300 televisions to Ruddy Stores, Inc. What recourse does Ruddy Stores have?

- a. It can obtain specific performance by the seller.
- b. It can recover punitive damages.
- c. It must await the seller's performance for a commercially reasonable time after repudiation if it wishes to recover anything.
- d. It can "cover," that is, procure the goods elsewhere and recover any damages.

**N79#9.** Lally sent Queen Supply Company, Inc., a telegram ordering \$700 of general merchandise. Lally's telegram indicated that immediate shipment was necessary. That same day Queen delivered the goods to the Red Freight Company. The shipment was delayed due to a breakdown of the truck which was transporting the goods. When the merchandise did **not** arrive as promptly as expected, Lally notified Queen that it revoked the offer and was purchasing the goods elsewhere. Queen indicated to Lally that the merchandise had been shipped the same day Lally had ordered it and Lally's revocation was **not** good. Which of the following statements **best** describes the transaction?

- a. The statute of frauds will be a defense on any action by Queen to enforce the contract.
- b. Prompt shipment of the merchandise by Queen constituted an acceptance.
- c. Lally's revocation of the offer was effective since Lally had **not** received a notice of acceptance.
- d. Lally's order was an offer to Queen to enter into a bilateral contract which could be accepted only by a promise.



*Selected Questions*

**N79#11.** Which of the following omissions will prevent a writing from satisfying the statute of frauds with respect to the sale of goods?

- a. It does **not** indicate that a sale has occurred.
- b. It is **not** signed by both the buyer and seller.
- c. The time and place of delivery are **not** indicated.
- d. The payment terms are **not** contained in the writing.

**N79#13.** On March 11, Vizar Sales Corporation telegraphed Watson Company:

“Will sell 1,000 cases of coffee for \$28 a case for delivery at our place of business on April 15. You may pick them up at our loading platform.”

Watson telegraphed its acceptance on March 12. On March 20, coffee prices rose to \$30 a case. Vizar telegraphed Watson on March 21 that it repudiated the sale and would **not** make delivery. The telegram was received by Watson on March 22 when the price was \$32; Watson could have covered at that price but chose not to do so. On April 15 the coffee was selling at \$35 a case. Watson tendered \$28,000 to Vizar and indicated it was ready to take delivery. Vizar refused to deliver. What relief, if any, is Watson entitled to?

- a. Specific performance, because it made a valid tender of performance.
- b. Nothing, because it failed to cover.
- c. Damages of \$4,000 (the difference between the contract price and the fair market value at the time Watson learned of the breach).
- d. Damages of \$7,000 (the difference between the contract price and the fair market value at the time delivery should have been made).

**M79#7.** Master Corporation, a radio and television manufacturer, invited Darling Discount Chain to examine several odd lots of discontinued models and make an offer for the entire lot. The odd lots were segregated from the regular inventory but inadvertently included 15 current models. Darling was unaware that Master did not intend to include the 15 current models in the group. Darling made Master an offer of \$9,000 for the entire lot, which represented a large discount from the normal sales price. Unaware of the error, Master accepted the offer. Master would **not** have accepted had it known of the inclusion of the 15 current models. Upon learning of the error, Master alleged mistake as a defense and refused to perform. Darling sued for breach of contract. Under the circumstances, what is the status of the contract?

- a. There is **no** contract since Master did not intend to include the 15 current models in the group of radios to be sold.
- b. The contract is voidable because of a unilateral mistake.

- c. The contract is voidable because of a mutual mistake.
- d. There is a valid and binding contract which includes the 15 current-model radios.

**N79#8.** A salesman for A & C Company called upon the purchasing agent for Major Enterprises, Inc., and offered to sell Major 1,500 screwdriver sets at \$1.60 each. Major's purchasing agent accepted and the following day sent A & C a purchase order which bore Major's name and address at the top and also had the purchasing agent's name and title stamped at the bottom with his initials. The purchase order recited the agreement reached orally the prior day. Subsequently, Major decided it did **not** want the screwdriver sets since it was overstocked in that item. Major thereupon repudiated the contract and asserted the statute of frauds as a defense. Under the circumstances, which of the following is correct?

- a. The statute of frauds does **not** apply to this transaction since performance is to be completed within one year from the date of the making of the contract.
- b. Major will lose but only if its purchasing agent's authority to make the contract was in writing.
- c. The fact that an authorized agent of A & C did **not** sign the purchase order prevents its use by A & C against Major to satisfy the statute of frauds.
- d. The purchase order is sufficient to satisfy the statute of frauds even though the purchasing agent never signed it in full.

**M79#33.** Stratford Theaters made a contract with Avon, Inc., for the purchase of \$450 worth of theater supplies. Delivery was to take place in one month. One week after accepting the order, the price of materials and labor increased sharply. In fact, to break even on the contract, Avon would have to charge an additional \$600. Avon phoned Stratford and informed them of the situation. Stratford was sympathetic and said they were sorry to hear about the situation but that the best they would be willing to do was split the rise in price with Avon. Avon accepted the modification of Stratford's terms. As a result of the above modification, which of the following is correct?

- a. Avon's continuing to perform the contract after informing Stratford of the price difficulty constitutes consideration for the modification of the price.
- b. The oral modification is **not** effective since there was **no** consideration.
- c. The statute of frauds applies to the contract as modified.
- d. The contract contained an implied promise that it was subject to price rises.

**M79#34.** Mara Oil, Inc., had a contract with Gotham Apartments to supply it with its fuel oil needs for the year, approximately 10,000 gallons. The price was fixed at ten cents above the price per gallon that Mara paid for its oil. Due to an exceptionally cold winter, Mara found that its capacity to fulfill this contract was doubtful. Therefore, it contacted Sands Oil Company and offered to assign the contract to it for \$100. Sands agreed. Which of the following is correct as a result of the above assignment?

- The contract with Gotham was neither assignable nor delegable.
- Mara is now released from any further obligation to perform the Gotham contract.
- Mara has effectively assigned to Sands its rights and delegated its duties under the terms of the contract with Gotham.
- In the event Sands breaches the contract with Gotham, Mara has **no** liability.

**M79#37.** Marco Auto Inc., made many untrue statements in the course of inducing Rockford to purchase a used auto for \$3,500. The car in question turned out to have some serious faults. Which of the following untrue statements made by Marco should Rockford use in seeking recovery from Marco for breach of warranty?

- "I refused a \$3,800 offer for this very same auto from another buyer last week."
- "This auto is one of the best autos we have for sale."
- "At this price the auto is a real steal."
- "I can guarantee that you will never regret this purchase."

**M79#38.** If a seller repudiates his contract with a buyer for the sale of 100 radios, what recourse does the buyer have?

- He can "cover," i.e., procure the goods elsewhere and recover the difference.
- He must await the seller's performance for a commercially reasonable time after repudiation.
- He can obtain specific performance by the seller.
- He can recover punitive damages.

**M79#39.** Duval Liquor Wholesales, Inc., stored its inventory of goods in the Reliable Warehouse Company. Duval's shipments would arrive by truck and be deposited with Reliable who would in turn issue negotiable warehouse receipts to Duval. Duval would resell the liquor by transferring the negotiable warehouse receipts to the buyer who was responsible for transporting it to his place of business. In one of the sales of liquor to a retailer, the liquor was badly damaged and a question has arisen as to who has the risk of loss, Duval or the retailer. If the contract is silent on this point, when did the risk of loss pass to the retailer?

- When the goods have been placed on the warehouseman's delivery dock awaiting pick up by the retailer.

- When the goods have been identified to the contract.
- On his receipt of the negotiable warehouse receipts covering the goods.
- When the goods have been properly loaded upon the retailer's carrier.

**M79#44.** Major Steel Manufacturing, Inc., signed a contract on October 2, 1978, with the Hard Coal & Coke Company for its annual supply of coal for three years commencing on June 1, 1979, at a price to be determined by taking the average monthly retail price per ton, less a ten cent per ton quantity discount. On March 15, 1979, Major discovered that it had made a bad bargain and that it could readily fulfill its requirements elsewhere at a much greater discount. Major is seeking to avoid its obligation. Which of the following is correct?

- The pricing term is too indefinite and uncertain hence there is **no** contract.
- Since the amount of coal required is unknown at the time of the making of the contract, the contract is too indefinite and uncertain to be valid.
- Major is obligated to take its normal annual coal requirements from Hard or respond in damages.
- There is **no** contract since Major could conceivably require **no** coal during the years in question.

#### D. Secured Transactions

**M83#47.** Attachment and perfection will occur simultaneously when

- The security agreement so provides.
- There is a purchase money security interest taken in inventory.
- Attachment is by possession.
- The goods are sold on consignment.

**M83#48.** Perfection of a security interest by a creditor provides added protection against other parties in the event the debtor does not pay his debts. Which of the following is **not** affected by perfection of a security interest?

- A buyer in the ordinary course of business.
- A subsequent personal injury judgment creditor.
- The trustee in a bankruptcy proceeding.
- Other prospective creditors of the debtor.

**M83#49.** On November 10, 1982, Cutter, a dealer, purchased 100 lawnmowers. This comprised Cutter's entire inventory and was financed under an agreement with Town Bank which gave the bank a security interest in all lawnmowers on the premises, all future acquired lawnmowers, and the proceeds of sales. On November 15, 1982, Town Bank filed a financing statement that adequately identified the collateral. On December 20, 1982, Cutter sold one lawnmower to Wills for family

Selected Questions

use and five lawnmowers to Black for its gardening business. Which of the following is correct?

- a. The security interest may not cover after-acquired property even if the parties so agree.
- b. The lawnmower sold to Wills would **not** ordinarily continue to be subject to the security interest.
- c. The lawnmowers sold to Black would ordinarily continue to be subject to the security interest.
- d. The security interest does **not** include the proceeds from the sale of the lawnmowers to Black.

**M83#50.** Attachment under Article 9 of the Uniform Commercial Code applies primarily to the rights of

- a. Third party creditors.
- b. Parties to secured transactions.
- c. Holders in due course.
- d. Warehousemen.

**M83#52.** Gilbert borrowed \$10,000 from Merchant National Bank and signed a negotiable promissory note which contained an acceleration clause. In addition, securities valued at \$11,000 at the time of the loan were pledged as collateral. Gilbert has defaulted on the loan repayments. At the time of default, \$9,250, plus interest of \$450, was due, and the securities had a value of \$8,000. Merchant

- a. Must first proceed against the collateral before proceeding against Gilbert personally on the note.
- b. Can **not** invoke the acceleration clause in the note until ten days after the notice of default is given to Gilbert.
- c. Must give Gilbert 30 days after default in which to refinance the loan.
- d. Is entitled to proceed against Gilbert on either the note or the collateral or both.

**N82#52.** Lombard, Inc., manufactures exclusive designer apparel. It sells through franchised clothing stores on consignment, retaining a security interest in the goods. Gifford is one of Lombard's franchisees pursuant to a detailed contract signed by both Lombard and Gifford. In order for the security interest to be valid against Gifford with respect to the designer apparel in Gifford's possession, Lombard

- a. Must retain title to the goods.
- b. Does not have to do anything further.
- c. Must file a financing statement.
- d. Must perfect its security interest against Gifford's creditors.

**N82#53.** Hathaway purchased from Rustic Hardware a new lathe for his home workshop for cash. Two weeks later, Hathaway was called by the Shuster Loan Company. Shuster explained to Hathaway that it had been financing Rustic's purchases from the manufacturers and that to protect its interest it had obtained a perfected security interest in Rustic's entire inventory of hardware and power tools, including the lathe which

Hathaway bought. Shuster further explained that Rustic had defaulted on a payment due to Shuster, and Shuster intended to assert its security interest in the lathe and repossess it unless Hathaway was willing to make payment of \$220 for a release of Shuster's security interest. If Hathaway refuses to make the payment, which of the following is correct?

- a. Shuster's security interest in the lathe in question is invalid against all parties unless its filing specifically described and designated the particular lathe Hathaway purchased.
- b. Hathaway must pay the \$220 or the lathe can be validly repossessed and sold to satisfy the amount Rustic owes Shuster and any excess paid to Hathaway.
- c. Hathaway will **not** take free of Shuster's security interest if he was aware of said interest at the time he purchased the lathe.
- d. Even if Hathaway had both actual notice and constructive notice via recordation of Shuster's interest, he will prevail if Shuster seeks to repossess the lathe.

**N82#54.** Two Uniform Commercial Code concepts relating to secured transactions are "attachment" and "perfection." Which of the following is correct in connection with the similarities and differences between these two concepts?

- a. They are mutually exclusive and wholly independent of each other.
- b. Attachment relates primarily to the rights against the debtor and perfection relates primarily to the rights against third parties.
- c. Satisfaction of one automatically satisfies the other.
- d. It is **not** possible to have a simultaneous attachment and perfection.

**N82#55.** Tawney Manufacturing approached Worldwide Lenders for a loan of \$50,000 to purchase vital components it used in its manufacturing process. Worldwide decided to grant the loan but only if Tawney would agree to a field warehousing arrangement. Pursuant to their understanding, Worldwide paid for the purchase of the components, took a negotiable bill of lading for them, and surrendered the bill of lading in exchange for negotiable warehouse receipts issued by the bonded warehouse company that had established a field warehouse in Tawney's storage facility. Worldwide did not file a financing statement. Under the circumstances, Worldwide

- a. Has a security interest in the goods which has attached and is perfected.
- b. Does **not** have a security interest which has attached since Tawney has not signed a security agreement.
- c. Must file an executed financing statement in order to perfect its security interest.
- d. Must **not** relinquish control over any of the components to Tawney for whatever purpose, unless it is paid in cash for those released.

**N82#56.** On October 1, 1982, Winslow Corporation obtained a loan commitment of \$250,000 from Liberty National Bank. Liberty filed a financing statement on October 2, 1982. On October 5, 1982, the \$250,000 loan was consummated and Winslow signed a security agreement granting the bank a security interest in inventory, accounts receivable, and proceeds from the sale of the inventory and collection of the accounts receivable. Liberty's security interest was perfected

- a. On October 1.
- b. On October 2.
- c. On October 5.
- d. By attachment.

**N82#57.** Thrush, a wholesaler of television sets, contracted to sell 100 sets to Kelly, a retailer. Kelly signed a security agreement with the 100 sets as collateral. The security agreement provided that Thrush's security interest extended to the inventory, to any proceeds therefrom, and to the after-acquired inventory of Kelly. Thrush filed his security interest centrally. Later, Kelly sold one of the sets to Haynes who purchased with knowledge of Thrush's perfected security interest. Haynes gave a note for the purchase price and signed a security agreement using the set as collateral. Kelly is now in default. Thrush can

- a. Not repossess the set from Haynes, but is entitled to any payments Haynes makes to Kelly on his note.
- b. Repossess the set from Haynes as he has a purchase money security interest.
- c. Repossess the set as his perfection is first, and first in time is first in right.
- d. Repossess the set in Haynes's possession because Haynes knew of Thrush's perfected security interest at the time of purchase.

**N82#58.** Clearview Manufacturing, Inc., sells golf equipment to wholesale distributors, who sell to retailers, who in turn sell to golfers. In most instances, the golf equipment is sold on credit with a security interest in the goods taken by each of the respective sellers. With respect to the above described transactions

- a. The only parties who qualify as purchase money secured parties are the retailers.
- b. The security interests of all of the parties remain valid even against good faith purchasers despite the fact that resale was contemplated.
- c. Except for the retailers, all of the sellers must file or have possession of the goods in order to perfect their security interests.
- d. The golf equipment is inventory in the hands of all the parties involved.

**M82#46.** Mansfield Financial lends money on the strength of negotiable warehouse receipts. Its policy is always to obtain a perfected security interest in the receipts against the creditors of the borrowers and to maintain it until the loan has been satisfied. Insofar as this policy is concerned, which of the following is correct?

- a. Mansfield can **not** transfer the warehouse receipts to another lending institution without the debtor's consent.
- b. Relinquishment of the receipts is **not** permitted under any circumstances without the loss of the perfected security interest in them.
- c. Mansfield has a perfected security interest in goods which the receipts represent.
- d. If the receipts are somehow wrongfully duly negotiated to a holder, Mansfield's perfected security interest will **not** be prejudiced.

**M82#48.** Johnstone Hardware Company sold a \$450 drill press to Markum for use in his home workshop. Markum paid 20% initially and promised to pay the balance in monthly installments over a period of one year. Johnstone took a purchase money security interest in the drill press to secure payment. Markum promised not to sell or otherwise transfer the drill press without Johnstone's consent. Johnstone did not file a financing statement in connection with the transaction. Markum subsequently found himself hard pressed to make the payments and defaulted. He then sold the drill press to his neighbor Harper for \$250 without disclosing Johnstone's interest and without Johnstone's consent. Under the circumstances

- a. The security agreement need not be in writing and signed in order to be valid since the purchase price of the drill press is less than \$500.
- b. No one can obtain superior rights to the drill press in that transfer of the press was prohibited without Johnstone's consent.
- c. Johnstone's security interest is perfected against the other creditors of Markum, but not against Harper.
- d. Harper would take the drill press free of Johnstone's security interest even if Johnstone had filed.

**M82#49.** The Uniform Commercial Code contains numerous provisions relating to the rights and remedies of the parties upon default. With respect to a buyer, these provisions may

- a. Not be varied even with the agreement of the buyer.
- b. Only be varied if the buyer is apprised of the fact and initials the variances in the agreement.
- c. Not be varied insofar as they require the secured party to account for any surplus realized on the disposition of collateral securing the obligation.
- d. All be varied by agreement as long as the variances are not manifestly unreasonable.

Selected Questions

**M82#50.** Dix Laboratories, Ltd., manufactures medical equipment for sale to medical institutions and retailers. Dix also sells directly to consumers in its wholly-owned retail outlets. Dix has created a subsidiary, Dix Finance Corporation, for the purpose of financing the purchase of its products by the various customers. In which of the following situations does Dix Finance **not** have to file a financing statement to perfect its security interest against competing creditors in the equipment sold by Dix?

- a. Sales made to consumers who purchase for their own personal use.
- b. Sales made to retailers who in turn sell to buyers in the ordinary course of business.
- c. Sales made to any buyer when the equipment becomes a fixture.
- d. Sales made to medical institutions.

**N81#44.** Macho Financial loans money on the strength of negotiable warehouse receipts. Its policy is always to obtain a perfected security interest in the receipts and to maintain it until the loan has been satisfied. Insofar as this policy is concerned, which of the following is correct?

- a. Macho can **not** perfect a security interest by filing.
- b. Relinquishment of the receipts is **not** permitted under any circumstances without the loss of the perfected security interest in them.
- c. Macho has a perfected security interest in goods which the receipts represent.
- d. If the receipts are wrongfully but duly negotiated to a holder, Macho's perfected security interest will **not** be prejudiced.

**N81#46.** A purchase money security interest

- a. May be taken or retained only the seller of collateral.
- b. Is exempt from the Uniform Commercial Code's filing requirements.
- c. Entitles the person who is the original purchase money lender to certain additional rights and advantages, which are nontransferable.
- d. Entitles the purchase money lender to a priority through a ten-day grace period for filing.

**N81#48.** Futuristic Appliances, Inc., sells various brand name appliances at discount prices. Futuristic maintains a large inventory which it obtains from various manufacturers on credit. These manufacturer-creditors have all filed and taken secured interests in the appliances and proceeds therefrom which they have sold to Futuristic on credit. Futuristic in turn sells to hundreds of ultimate consumers; some pay cash but most buy on credit. Futuristic takes a security interest but does not file a financing statement for credit sales. Which of the following is correct?

- a. The appliance manufacturers can enforce their secured interests against the appliances in the hands of the purchasers who paid cash for them.

- b. A subsequent sale by one of Futuristic's customers to a bona fide purchaser will be subject to Futuristic's secured interest.
- c. The appliances in Futuristic's hands are consumer goods.
- d. Since Futuristic takes a purchase money security interest in the consumer goods sold, its security interest is perfected upon attachment.

**N81#49.** Which of the following requirements is **not** necessary in order to have a security interest attach?

- a. The debtor must have rights in the collateral.
- b. There must be a proper filing.
- c. Value must be given by the creditor.
- d. Either the creditor must take possession or the debtor must sign a security agreement which describes the collateral.

**N81#50.** A filing requirement applies to which of the following transactions under Article 9 (Secured Transactions) of the Uniform Commercial Code?

- a. The factoring of accounts receivable.
- b. A collateralized bank loan, with securities serving as the collateral.
- c. The transfer of an interest in an insurance policy to secure a loan.
- d. The retention of title by a seller of land to secure payment under the terms of a land contract.

**N80#31.** In the course of an examination of the financial statements of Control Finance Company for the year ended September 30, 1980, the auditors learned that the company has just taken possession of certain heavy industrial equipment from Arrow Manufacturing Company, a debtor in default. Arrow had previously borrowed \$60,000 from Control secured by a security interest in the heavy industrial equipment. The amount of the loan outstanding is \$30,000. Which of the following is correct regarding the rights of Control and Arrow?

- a. Control is **not** permitted to sell the repossessed equipment at private sale.
- b. Arrow has **no** right to redeem the collateral at any time once possession has been taken.
- c. Control is **not** entitled to retain the collateral it has repossessed in satisfaction of the debt even though it has given written notice to the debtor and he consents.
- d. Arrow is **not** entitled to a compulsory disposition of the collateral.

**N80#32.** The Jolly Finance Company provides the financing for Triple J Appliance Company's inventory. As a part of its sales promotion and public relations campaign, Jolly Finance placed posters in Triple J's stores indicating that Triple J is another satisfied customer of Jolly and that the goods purchased at Triple J are available through the financing by Jolly. Jolly also files a financing statement which covers the financed inventory. Victor Restaurants purchased four hi-fi sets for use in its restaurants and had read one of the Jolly

posters. Triple J has defaulted on its loan and Jolly Finance is seeking to repossess the hi-fi sets. Which of the following is correct?

- a. Jolly has perfected security interest in the hi-fi sets which is good against Victor.
- b. Victor's knowledge of the financing arrangement between Jolly and Triple J does **not** affect its rights to the hi-fi sets.
- c. Jolly's filing was unnecessary to perfect its security interest in Triple J's inventory since it was perfected upon attachment.
- d. The hi-fi sets are consumer goods in Victor's hands.

**N80#33.** The Gordon Manufacturing Company manufactures various types of lathes. It sold on credit 25 general-use lathes to Hardware City, a large retail outlet. Hardware City sold one of the lathes to Johnson for use in his home repair business, reserving a security interest for the unpaid balance. However, Hardware City did **not** file a financing statement. Johnson's creditors are asserting rights against the lathe. Which of the following statements is correct?

- a. The lathe is a consumer good in Johnson's hands.
- b. No filing was necessary to perfect a security interest in the lathe against Johnson's creditors.
- c. Gordon Manufacturing could assert rights against the lathe sold to Johnson in the event Hardware City defaults in its payments.
- d. The lathe was inventory in both Gordon and Hardware's hands and is equipment in Johnson's, and both Gordon and Hardware City must file to perfect their interests.

**N80#34.** The Town Bank makes collateralized loans to its customers at 1% above prime on securities owned by the customer, subject to existing margin requirements. In doing so, which of the following is correct?

- a. Notification of the issuer is necessary in order to perfect a security interest.
- b. Filing is a permissible method of perfecting a security interest in the securities if the circumstances dictate.
- c. Any dividend or interest distributions during the term of the loan belong to the bank.
- d. A perfected security interest in the securities can only be obtained by possession.

**N80#36.** Retailer Corp. was in need of financing. To secure a loan, it made an oral assignment of its accounts receivable to J. Roe, a local investor, under which Roe loaned Retailer on a continuing basis, 90% of the face value of the assigned accounts receivable. Retailer collected from the account debtors and remitted to Roe at intervals. Before the debt was paid, Retailer filed a petition in bankruptcy. Which of the following is correct?

- a. As between the account debtors and Roe, the assignment is **not** an enforceable security interest.

- b. Roe is a secured creditor to the extent of the unpaid debt.
- c. Other unpaid creditors of Retailer Corp. who knew of the assignment are bound by its terms.
- d. An assignment of accounts, to be valid, requires the debtors owing the accounts to be notified.

**N80#37.** The Secured Transactions Article of the Code recognizes various methods of perfecting a security interest in collateral. Which of the following is **not** recognized by the Code?

- a. Filing.
- b. Possession.
- c. Consent.
- d. Attachment.

**N80#38.** Which of the following is included within the scope of the Secured Transactions Article of the Code?

- a. The outright sale of accounts receivable.
- b. A landlord's lien.
- c. The assignment of a claim for wages.
- d. The sale of chattel paper as a part of the sale of a business out of which it arose.

**N79#25.** In respect to obtaining a purchase money security interest, which of the following requirements must be met?

- a. The property sold may only be consumer goods.
- b. Only a seller may obtain a purchase money security interest.
- c. Such a security interest must be filed in all cases to be perfected.
- d. Credit advanced to the buyer must be used to obtain the property which serves as the collateral.

**N79#26.** Vista Motor Sales, a corporation engaged in selling motor vehicles at retail, borrowed money from Sunshine Finance Company and gave Sunshine a properly executed security agreement in its present and future inventory and in the proceeds therefrom to secure the loan. Sunshine's security interest was duly perfected under the laws of the state where Vista does business and maintains its entire inventory. Thereafter, Vista sold a new pickup truck from its inventory to Archer and received Archer's certified check in payment of the full price. Under the circumstances, which of the following is correct?

- a. Sunshine must file an amendment to the financing statement every time Vista receives a substantial number of additional vehicles from the manufacturer if Sunshine is to obtain a valid security interest in subsequently delivered inventory.
- b. Sunshine's security interest in the certified check Vista received is perfected against Vista's other creditors.

## Selected Questions

- c. Unless Sunshine specifically included proceeds in the financing statement it filed, it has **no** rights to them.
- d. The term “proceeds” does **not** include used cars received by Vista since they will be resold.

**M79#18.** Migrane Financial does a wide variety of lending. It provides funds to manufacturers, middlemen, retailers, consumers, and home owners. In all instances it intends to create a security interest in the loan transactions it enters into. To which of the following will Article 9 (Secured Transactions) of the Uniform Commercial Code **not** apply?

- a. A second mortgage on the borrower’s home.
- b. An equipment lease.
- c. The sale of accounts.
- d. Field warehousing.

**M79#20.** Bigelow manufactures mopeds and sells them through franchised dealers who are authorized to resell them to the ultimate consumer or return them. Bigelow delivers the mopeds on consignment to these retailers. The consignment agreement clearly states that the agreement is intended to create a security interest for Bigelow in the mopeds delivered on consignment.

ment. Bigelow wishes to protect itself against the other creditors of and purchasers from the retailers who might assert rights against the mopeds. Under the circumstances, Bigelow

- a. Must file a financing statement and give notice to certain creditors in order to perfect his security interest.
- b. Will have rights against purchasers in the ordinary course of business who were aware of the fact that Bigelow had filed.
- c. Need take **no** further action to protect himself, since the consignment is a sale or return and title is reserved in Bigelow.
- d. Will have a perfected security interest in the mopeds upon attachment.

**M79#21.** Johnson loaned money to Visual, Inc., a struggling growth company, and sought to obtain a security interest in negotiable stock certificates which are traded on a local exchange. To perfect his interest against Visual’s other creditors, Johnson

- a. Need do nothing further in that his security interest was perfected upon attachment.
- b. May file or take possession of the stock certificates.
- c. Must take possession of the stock certificates.
- d. Must file and give the other creditors notice of his contemplated security interest.

## VII. Property, Estates, and Trusts

### A. Real and Personal Property

**M83#53.** Wilmont owned a tract of waterfront property on Big Lake. During Wilmont’s ownership of the land, several frame bungalows were placed on the land by tenants who rented the land from Wilmont. In addition to paying rent, the tenants paid for the maintenance and insurance of the bungalows, repaired, altered and sold them, without permission or hindrance from Wilmont. The bungalows rested on surface cinderblock and were not bolted to the ground. The buildings could be removed without injury to either the buildings or the land. Wilmont sold the land to Marsh. The deed to Marsh recited that Wilmont sold the land, with buildings thereon, “subject to the rights of tenants, if any, . . .” When the tenants attempted to remove the bungalows, Marsh claimed ownership of them. In deciding who owns the bungalows, which of the following is **least** significant?

- a. The leasehold agreement itself, to the extent it manifested the intent of the parties.
- b. The mode and degree of annexation of the buildings to the land.
- c. The degree to which removal would cause injury to the buildings or the land.
- d. The fact that the deed included a general clause relating to the buildings.

**M83#54.** Fosdick’s land adjoins Tracy’s land and Tracy has been using a trail across Fosdick’s land for a number of years. The trail is the shortest route to a roadway which leads into town. Tracy is asserting a right to continue to use the trail despite Fosdick’s objections. In order to establish an easement by prescription, Tracy must show

- a. Implied consent by Fosdick.
- b. Use of the trail for the applicable statutory period.
- c. His use of the trail with an intent to assert ownership to the underlying land.
- d. Prompt recordation of the easement upon its coming into existence.

**M83#56.** Purdy purchased real property from Hart and received a warranty deed with full covenants. Recordation of this deed is

- a. Not necessary if the deed provides that recordation is **not** required.
- b. Necessary to vest the purchaser’s legal title to the property conveyed.
- c. Required primarily for the purpose of providing the local taxing authorities with the information necessary to assess taxes.
- d. Irrelevant if the subsequent party claiming superior title had actual notice of the unrecorded deed.

**M82#51.** A condition in a contract for the purchase of real property which makes the purchaser's obligation dependent upon his obtaining a given dollar amount of conventional mortgage financing

- a. Can be satisfied by the seller if the seller offers the buyer a demand loan for the amount.
- b. Is a condition subsequent.
- c. Is implied as a matter of law.
- d. Requires the purchaser to use reasonable efforts to obtain the financing.

**M82#52.** Park purchased Marshall's department store. At the closing, Park delivered a certified check for the balance due and Marshall gave Park a warranty deed with full covenants to the property. The deed

- a. Must be recorded to be valid between the parties.
- b. Must recite the actual consideration given by Park
- c. Must be in writing and contain the signature of both parties duly witnessed.
- d. Usually represents an exclusive integration of the duties of the seller.

**M82#53.** Fulcrum Enterprises, Inc., contracted to purchase a four-acre tract of land from Devlin as a site for its proposed factory. The contract of sale is silent on the type of deed to be received by Fulcrum and does not contain any title exceptions. The title search revealed that there are 51 zoning laws which affect Fulcrum's use of the land and that back taxes are due. A survey revealed a stone wall encroaching upon a portion of the land Devlin is purporting to convey. A survey made 23 years ago also had revealed the wall. Regarding the rights and duties of Fulcrum, which of the following is correct?

- a. Fulcrum is entitled to a warranty deed with full covenants from Devlin at the closing.
- b. The existence of the zoning laws above will permit Fulcrum to avoid the contract.
- c. Fulcrum must take the land subject to the back taxes.
- d. The wall results in a potential breach of the implied warranty of marketability.

**M81#52.** Glover Manufacturing, Inc., purchased a four-acre tract of commercially zoned land. A survey of the tract was made prior to the closing, and it revealed an unpaved road which passed across the northeast corner of the land. The title search revealed a mortgage held by Peoples National Bank, which was satisfied at the closing by the seller out of the funds received from Glover. The title search did not indicate the existence of any other adverse interest which would constitute a defect in title. There was no recordation made in connection with the unpaved road. Which of the following statements is correct regarding Glover's title and rights to the land against the claims of adverse parties?

- a. The unpaved road poses **no** potential problem if Glover promptly fences off the property and puts up "no trespassing" signs.
- b. Glover does **not** have to be concerned with the unpaved road since whatever rights the users might claim were negated by failing to record.
- c. The mere use of the unpaved road as contrasted with the occupancy of the land can **not** create any interest adverse to Glover.
- d. The unpaved road revealed by the survey may prove to be a valid easement created by prescription.

**N80#47.** Gilgo has entered into a contract for the purchase of land from the Wicklow Land Company. A title search reveals certain defects in the title to the land to be conveyed by Wicklow. Wicklow has demanded that Gilgo accept the deed and pay the balance of the purchase price. Furthermore, Wicklow has informed Gilgo that unless Gilgo proceeds with the closing, Wicklow will hold Gilgo liable for breach of contract. Wicklow has pointed out to Gilgo that the contract says nothing about defects and that he must take the property "as is." Which of the following is correct?

- a. Gilgo can rely on the implied warranty of merchantability.
- b. Wicklow is right in that if there is **no** express warranty against title defects, none exists.
- c. Gilgo will prevail because he is entitled to a perfect title from Wicklow.
- d. Gilgo will win if the title is **not** marketable.

**N80#48.** Marks is a commercial tenant of Tudor Buildings, Inc. The term of the lease is five years and two years have elapsed. The lease prohibits subletting, but does **not** contain any provision relating to assignment. Marks approached Tudor and asked whether Tudor could release him from the balance of the term of the lease for \$500. Tudor refused unless Marks would agree to pay \$2,000. Marks located Flint who was interested in renting in Tudor's building and transferred the entire balance of the lease to Flint in consideration of his promise to pay Tudor the monthly rental and otherwise perform Marks's obligations under the lease. Tudor objects. Which of the following statements is correct?

- a. A prohibition of the right to sublet contained in the lease completely prohibits an assignment.
- b. The assignment need **not** be in writing.
- c. The assignment does **not** extinguish Marks's obligation to pay the rent if Flint defaults.
- d. The assignment is invalid without Tudor's consent.



## Selected Questions

**N80#50.** Paul Good's will left all of his commercial real property to his wife Dorothy for life and the remainder to his two daughters, Joan and Doris, as tenants in common. All beneficiaries are alive and over 21 years of age. Regarding the rights of the parties, which of the following is a correct statement?

- a. Dorothy may **not** elect to take against the will and receive a statutory share instead.
- b. The daughters **must** survive Dorothy in order to receive any interest in the property.
- c. Either of the daughters may sell her interest in the property without the consent of their mother or the other daughter.
- d. If only one daughter is alive upon the death of Dorothy, she is entitled to the entire property.

**M80#11.** Carr owns 100 acres of undeveloped land on the outskirts of New Town. He bought the land several years ago to build an industrial park in the event New Town grew and prospered. The land was formerly used for grazing and truck gardening. A subsequent inspection revealed that several adjacent landowners recently had been using a shortcut across his land in order to reach a newly constructed highway. Which of the following is a correct statement?

- a. There is a danger that the adjacent landowners will obtain title by adverse possession.
- b. Since Carr has properly recorded his deed, the facts do **not** pose a problem for him.
- c. There is a danger that an easement may be created.
- d. Since the adjacent landowners are trespassers, Carr has nothing to fear.

**M80#26.** Dombres is considering purchasing Black-acre. The title search revealed that the property was willed by Adams jointly to his children, Donald and Martha. The language contained in the will is unclear as to whether a joint tenancy or a tenancy in common was intended. Donald is dead and Martha has agreed to convey her entire interest by quit-claim deed to Dombres. The purchase price is equal to the full fair market price of the property. Dombres is **not** interested in anything less than the entire title to the tract. Under the circumstances, which of the following is correct?

- a. There is a statutory preference which favors the finding of a joint tenancy.
- b. Whether the will created a joint tenancy or a tenancy in common is irrelevant since Martha is the only survivor.
- c. Dombres will **not** obtain title to the entire tract of land by Martha's conveyance.
- d. There is **no** way or means whereby Dombres may obtain a clear title under the circumstances.

**N79#10.** Marcross and two business associates own real property as tenants in common that they have invested in as a speculation. The speculation proved to be highly successful, and the land is now worth substantially more than their investment. Which of the following is a correct legal incident of ownership of the property?

- a. Upon the death of any of the other tenants, the deceased's interest passes to the survivor(s) unless there is a will.
- b. Each of the co-tenants owns an undivided interest in the whole.
- c. A co-tenant can **not** sell his interest in the property without the consent of the other tenants.
- d. Upon the death of a co-tenant, his estate is entitled to the amount of the original investment, but **not** the appreciation.

**N79#41.** Dunbar Dairy Farms, Inc., pursuant to an expansion of its operations in Tuberville, purchased from Moncrief a 140-acre farm strategically located in the general area in which Dunbar wishes to expand. Unknown to Dunbar, Cranston, an adjoining landowner, had fenced off approximately five acres of the land in question. Cranston installed a well, constructed a storage shed and garage on the fenced-off land, and continuously farmed and occupied the five acres for approximately 22 years prior to Dunbar's purchase. Cranston did this under the mistaken belief that the five acres of land belonged to him. Which of the following is a correct answer in regard to the five acres occupied by Cranston?

- a. Under the circumstances Cranston has title to the five acres.
- b. As long as Moncreif had properly recorded a deed which includes the five acres in dispute, Moncrief had good title to the five acres.
- c. At best, the only right that Cranston could obtain is an easement.
- d. If Dunbar is unaware of Cranston's presence and Cranston has failed to record, Dunbar can oust him as a trespasser.

## B. Mortgages

**M83#57.** Which of the following is an **incorrect** statement regarding a real property mortgage?

- a. It transfers title to the real property to the mortgagee.
- b. It is invariably accompanied by a negotiable promissory note which refers to the mortgage.
- c. It creates an interest in real property and is therefore subject to the Statute of Frauds.
- d. It creates a nonpossessory security interest in the mortgagee.

**M83#58.** Recordation of a real property mortgage

- a. Is required to validate the rights of the parties to the mortgage.
- b. Will **not** be effective if improperly filed even if the party claiming superior title had actual notice of its existence.
- c. Perfects the interest of the mortgagee against subsequent bona fide purchasers for value.
- d. Must be filed in the recordation office where the mortgagee's principal place of business is located.

**M83#59.** Moch sold her farm to Watkins and took back a purchase money mortgage on the farm. Moch failed to record the mortgage. Moch's mortgage will be valid against all of the following parties **except**

- a. The heirs or estate of Watkins.
- b. A subsequent mortgagee who took a second mortgage since he had heard there was a prior mortgage.
- c. A subsequent bona fide purchaser from Watkins
- d. A friend of Watkins to whom the farm was given as a gift and who took without knowledge of the mortgage.

**M83#60.** Peters defaulted on a purchase money mortgage held by Fairmont Realty. Fairmont's attempts to obtain payment have been futile and the mortgage payments are several months in arrears. Consequently, Fairmont decided to resort to its rights against the property. Fairmont foreclosed on the mortgage. Peters has all of the following rights **except**

- a. To remain in possession as long as his equity in the property exceeds the amount of debt.
- b. An equity of redemption.
- c. To refinance the mortgage with another lender and repay the original mortgage.
- d. A statutory right of redemption.

**M82#54.** Linderman purchased a tract of land from Noteworthy for \$250,000. Noteworthy revealed the fact that there was an existing first mortgage of \$100,000 on the property which would be satisfied out of the proceeds of the sale. Effective Title Company's title search and policy revealed only the first mortgage. Noteworthy did not reveal that there was a \$50,000 unrecorded second mortgage on the property held by his father, Vincent. The first mortgage was satisfied at the closing and Linderman presumed he had clear title to the property. A month after the closing, Vincent appeared and claimed that Linderman was obligated to pay the principal and interest on the mortgage he held. Noteworthy has fled the jurisdiction. As among Linderman, Vincent, and Effective, which of the following is correct?

- a. Vincent will prevail since he had a valid second mortgage.
- b. Effective must pay on its title policy since it is an insurer.

- c. Linderman's failure to obtain an affidavit from Noteworthy representing that there was no other mortgage outstanding will result in his taking subject to the Vincent mortgage.
- d. Linderman will take free of the Vincent mortgage.

**M81#53.** Golden sold his moving and warehouse business, including all the personal and real property used therein, to Clark Van Lines, Inc. The real property was encumbered by a duly-recorded \$300,000 first mortgage upon which Golden was personally liable. Clark acquired the property subject to the mortgage but did not assume the mortgage. Two years later, when the outstanding mortgage was \$260,000, Clark decided to abandon the business location because it had become unprofitable and the value of the real property was less than the outstanding mortgage. Clark moved to another location and refused to pay the installments due on the mortgage. What is the legal status of the parties in regard to the mortgage?

- a. Clark took the real property free of the mortgage.
- b. Clark breached its contract with Golden when it abandoned the location and defaulted on the mortgage.
- c. Golden must satisfy the mortgage debt in the event that foreclosure yields an amount less than the unpaid balance.
- d. If Golden pays off the mortgage, he will be able to successfully sue Clark because Golden is subrogated to the mortgagee's rights against Clark.

**M81#54.** Tremont Enterprises, Inc., needed some additional working capital to develop a new product line. It decided to obtain intermediate term financing by giving a second mortgage on its plant and warehouse. Which of the following is true with respect to the mortgages?

- a. If Tremont defaults on both mortgages and a bankruptcy proceeding is initiated, the second mortgagee has the status of general creditor.
- b. If the second mortgagee proceeds to foreclose on its mortgage, the first mortgagee must be satisfied completely before the second mortgagee is entitled to repayment.
- c. Default on payment to the second mortgagee will constitute default on the first mortgage.
- d. Tremont can **not** prepay the second mortgage prior to its maturity without the consent of the first mortgagee.

**N79#40.** Carter wished to obtain additional working capital for his construction company. His bankers indicated that they would be willing to lend the company \$50,000 if the bank could obtain a first mortgage on the real property belonging to the business. Carter reluctantly acquiesced and mortgaged all his real property to secure repayment of the loan. Unknown to the bank one portion of the real property was already mortgaged to Johnson for \$30,000, but Johnson had neglected to

Selected Questions

record the mortgage. The bank promptly recorded its mortgage. Which of the following is correct regarding the rights of the parties?

- Johnson's failure to record makes the mortgage invalid against Carter.
- The bank's mortgage will have a priority over Johnson's mortgage.
- Both mortgagees would share the proceeds from any foreclosure on a pro rata basis.
- The bank will be deemed to have notice of Johnson's mortgage and will take subject to the mortgage.

C. Administration of Estates and Trusts

**M82#55.** Assuming that a given trust indenture is silent on the point, the trustee has certain rights and duties as a matter of law. The trustee

- Has a fiduciary duty to the trust but **not** to the beneficiaries.
- Is **not** entitled to commissions unless so provided.
- Can elect to terminate the trust as long as the beneficiaries unanimously concur.
- Must act in a competent, nonnegligent manner, or he may face removal.

**M82#56.** Wayne & Company, CPAs, was engaged by Harding, the trustee of the Timmons Testamentary Trust. The will creating the Timmons Trust gave Harding wide discretion with respect to the investment of the trust principal but was silent on the question of the allocation of receipts and charges to principal or income. Among the assets invested in by Harding is a \$500,000 annuity and a \$50,000 limited partnership interest in an offshore investment limited partnership. The partnership has reported a \$40,000 loss for the year. Regarding the trust in general and the limited partnership loss allocation in particular, which of the following is correct?

- It is against public policy to permit the investment by the trustee in the offshore investment limited partnership.
- Since the trust is silent on the allocation question, Harding has wide discretion in making allocations.
- The loss attributable to the offshore partnership is allocable equally to principal and income.
- The receipts from the \$500,000 annuity must be apportioned between principal and income.

**M81#51.** The Martin Trust consisted primarily of various income-producing real estate properties. During the year, the trustee incurred various charges. Among the charges were the following: depreciation, principal payments on various mortgages, and a street assessment. Which of the following would be a proper allocation of these items?

- All to income, except the street assessment.

- All are to be allocated equally between principal and income.
- All to principal.
- All to principal, except depreciation.

**N81#54.** Harper died and his will was admitted to probate. It named his son Harris and his daughter Jean as co-executors. Under the terms of the will, he left 60% of his estate outright to his wife, Martha, after all expenses, taxes, and fees were paid. The balance was equally divided among his children, Harris, Jean, Tobey, and Lydia. The value of the gross estate is \$400,000. Which of the following is correct?

- Martha would be better off electing to take under the interstate succession laws.
- The estate will be able to take a \$250,000 statutory marital deduction.
- Tobey and Lydia are also entitled to qualify as executors since Harris and Jean are residuary takers as well as executors.
- All the property bequeathed to Martha will be deducted from Harper's estate for federal estate tax purposes.

**M81#49.** With respect to trusts, which of the following states an **invalid** legal conclusion?

- The trustee must obtain the consent of the majority of the beneficiaries if a major change in the investment portfolio of the trust is to be made.
- For federal income tax purposes, a trust is entitled to an exemption similar to that of an individual although **not** equal in amount.
- Both the life beneficiaries of a trust and the ultimate takers have rights against the trustee, and the trustee is accountable to them.
- A trust is a separate taxable entity for federal income tax purposes.

**M81#51.** Shepard created an inter vivos trust for the benefit of his children with the remainder to his grandchildren upon the death of his last surviving child. The trust consists of both real and personal property. One of the assets is an apartment building. In administering the trust and allocating the receipts and disbursements, which of the following would be **improper**?

- The allocation of forfeited rental security deposits to income.
- The allocation to principal of the annual service fee of the rental collection agency.
- The allocation to income of the interest on the mortgage on the apartment building.
- The allocation to income of the payment of the insurance premiums on the apartment building.

**N80#49.** James Gordon decided to create an inter vivos trust for the benefit of his grandchildren. Gordon wished to bypass his own children and to provide an independent income for his grandchildren. He did not, however, wish to completely part with the assets he would transfer to the trust. Therefore, he transferred the assets to the York Trust Company in trust for the benefit of his grandchildren irrevocably for a period of 21 years. In relation to the Gordon trust and the rights and duties of the parties in respect to it

- a. Such a trust is quite useful in skipping generations and tying up the ownership of property, since its duration can be potentially infinite.
- b. The trust is **not** recognized as a legal entity for tax purposes, thus Gordon must include the trust income with his own.
- c. York has legal title to the trust property, the grandchildren have equitable title, and Gordon has a reversionary interest.
- d. If the trust deed is silent on the point, York must **not** sell or otherwise dispose of the trust assets without Gordon's advice and consent.

**N80#52.** An executor named in a decedent's will

- a. Must consent to serve, have read the will, and be present at the execution of the will.
- b. Need **not** serve if he does **not** wish to do so.
- c. Must serve without compensation unless the will provides otherwise.
- d. Can **not** be the principal beneficiary of the will.

**M80#28.** The Astor Bank and Trust Company is the trustee of the Wayne Trust. A significant portion of the trust principal has been invested in AAA rated public utility bonds. Some of the bonds have been purchased at face value, some at a discount, and others at a premium. Which of the following is a proper allocation of the various items to income?

- a. The income beneficiary is entitled to the entire interest without dilution for the premium paid but is **not** entitled to the proceeds attributable to the discount upon collection.
- b. The income beneficiary is entitled to the entire interest without dilution and to the proceeds attributable to the discount.
- c. The income beneficiary is only entitled to the interest less the amount of the premium amortized over the life of the bond.
- d. The income beneficiary is entitled to the full interest and to an allocable share of the gain resulting from the discount.

**M80#40.** Waldorf's last will and testament named Franklin as the executor of the will. In respect to Franklin's serving as executor, which of the following is correct?

- a. He serves without compensation unless the will provides otherwise.

- b. He is at liberty to purchase the estate's property the same as any other person dealing at arm's length.
- c. Waldorf must have obtained Franklin's consent in writing to serve as executor.
- d. Upon appointment by the court, he serves as the legal representative of the estate.

**M80#49.** A group of real estate dealers has decided to form a Real Estate Investment Trust (REIT) which will invest in diversified real estate holdings. A public offering of \$10,000,000 of trust certificates is contemplated. Which of the following is an **incorrect** statement?

- a. Those investing in the venture will **not** be insulated from personal liability.
- b. The entity will be considered to be an "association" for tax purposes.
- c. The offering must be registered under the Securities Act of 1933.
- d. If the trust qualifies as a REIT and distributes all its income to the investors, it will **not** be subject to federal income tax.

**M80#50.** Mullins created a trust pursuant to her last will and testament which named her husband as the life income beneficiary and her children as the remaindermen. She is dead. Which of the following does **not** apply to the above-described trust?

- a. It is a testamentary trust.
- b. The husband has the right to appoint the ultimate beneficiaries.
- c. The children have a vested interest in the trust.
- d. The trustee owes a fiduciary duty to both the husband and the children.

**N79#20.** Woodrow died and left a will that named as co-executors the Fundamental Trust Company and Harlow, who is one of the residuary legatees. The will was silent on various points indicated below. Which of the following is correct?

- a. If Woodrow's will was **not** properly executed, it will **not** be admitted to probate and his property will be distributed according to the intestate succession laws even though this is contrary to Woodrow's wishes as stated in the will.
- b. Since Harlow is one of the residuary legatees, Harlow can **not** serve as executor since this would represent a conflict of interest and also would violate Harlow's fiduciary duty.
- c. All taxes paid will be allocated to the residuary estate and **not** apportioned.
- d. The executors have complete discretion insofar as investing the estate's assets during the term of their administration.

Selected Questions

**N79#43.** Gail Monet has decided to make certain gifts to her family. Her goal is to reduce her estate and income taxes. Which of the following need **not** be present in order for Monet to make valid gifts?

- Monet must be competent to make the gifts in question.
- Monet must have some purpose or motive other than, or in addition to, the mere saving of taxes.
- There must be delivery of the gifts to the donees.
- The gifts must be made voluntarily and with the requisite donative intent.

**N79#44.** James Gordon decided to create an inter vivos trust for the benefit of his grandchildren. He wished to bypass his own children, and to provide an independent income for his grandchildren. He did **not**, however, wish to completely part with the assets he would transfer to the trust. Therefore, he transferred the assets to the York Trust Company, in trust for the benefit of his grandchildren irrevocably for a period of 12 years. Which of the following is correct regarding the trust?

- The trust will fail for want of a proper purpose.
- The trust income will **not** be taxable to Gordon during its existence.
- Gordon retains beneficial title to the property transferred to the trust.
- If Gordon demands the return of the trust assets prior to the 12 years, York must return them to him since he created the trust and the assets will eventually be his again.

**N79**

**Items 46 and 47** are based on the following information:

Martin is the trustee of the Baker Trust which has assets in excess of \$1 million. Martin has engaged the CPA firm of Hardy & Fox to prepare the annual accounting statement for the allocation of receipts and expenditures between income and principal. The trust indenture provides that "receipts and expenses are to be allocated to income or principal according to law."

**N79#46.** Which of the following receipts should be allocated to income?

- Rights to subscribe to shares of the distributing corporation.
- Sale of rights to subscribe to shares of the distributing corporation.
- A 2% stock dividend.
- Rights to subscribe to shares of another corporation.

**N79#47.** Which of the following receipts from real property should be allocated to principal?

- An unexpected payment of nine months arrears in rental payments.

- A six-month prepayment of rent.
- Insurance proceeds for the destruction of a garage on one of the properties.
- Interest on a purchase money mortgage arising from the sale of a parcel of the trust's real property.

**D. Fire and Casualty Insurance**

**M83#36.** The insurable interest in property

- Can be waived by consent of the parties.
- Is subject to the incontestability clause.
- Must be present at the time the loss occurs.
- Is only available to owners, occupiers, or users of the property.

**M83#37.** The underlying rationale which justifies the use of the coinsurance clause in fire insurance is

- It provides an insurable interest in the insured if this is **not** already present.
- To require certain minimum coverage in order to obtain full recovery on losses.
- It prevents arson by the owner.
- It makes the insured more careful in preventing fires since the insured is partially at risk in the event of loss.

**M82#58.** The coinsurance feature of property insurance

- Is fixed at a minimum of 80% by law.
- Prevents the insured from insuring for a minimal amount and recovering in full for such losses.
- Precludes the insured from insuring for less than the coinsurance percentage.
- Is an additional refinement of the insurable interest requirement.

**M82#59.** Tedland Trading Corporation insured its 17 automobiles for both liability and collision. Milsap, one of its salesmen, was in an automobile accident while driving a company car on a sales trip. The facts clearly reveal that the accident was solely the fault of Williams, the driver of the other car. Milsap was seriously injured, and the automobile was declared a total loss. The value of the auto was \$3,000. Which of the following is an **incorrect** statement regarding the rights and liabilities of Tedland, its insurer, Milsap and Williams?

- Tedland's insurer must defend Tedland against any claims by Milsap or Williams.
- Tedland's insurer has **no** liability whatsoever since the accident was the result of Williams's negligence.
- Milsap has an independent action against Williams for the injuries caused by Williams's negligence.
- Tedland's insurer is liable for \$3,000, less any deductible, on the collision policy, but will be subrogated to Tedland's rights.

**M82#60.** Which of the following is an **incorrect** statement regarding the insurable interest requirement as it applies to property insurance?

- It is used to determine the amount of recovery to be awarded the insured.
- It need **not** necessarily be present at the inception of the policy so long as it is present at the time of the loss.
- One of its functions is to prevent recovery by those who have **no** economic interest in the property insured.
- It can be waived by the parties so long as both are fully competent to contract.

**N81#55.** Jerry's House of Jewelry, Inc., took out an insurance policy with the Old Time Insurance Company which covered the stock of jewelry displayed in the store's windows. Old Time agreed to indemnify Jerry's House for losses due to window smashing and theft of the jewels displayed. The application contained the following provision: "It is hereby warranted that the maximum value of the jewelry displayed shall not exceed \$10,000." The insurance policy's coverage was for \$8,000. The application was initialed alongside the warranty and attached to the policy. Subsequently, thieves smashed the store window and stole \$4,000 worth of jewels. The total value of the display during that week, including the day of the robbery, was \$12,000. Which of the following is correct?

- Jerry's House will recover nothing.
- Jerry's House will recover \$2,000, the loss less the amount in excess of the \$10,000 display limitation.
- Jerry's House will recover the full \$4,000 since the warranty will be construed as a mere representation.
- Jerry's House will recover the full \$4,000 since attaching the application to the policy is insufficient to make it a part thereof.

**N81#56.** Carter, Wallace, and Jones are partners. Title to the partnership's office building was in Carter's name. The Carter, Wallace, and Jones partnership procured a \$150,000 fire insurance policy on the building from the Amalgamated Insurance Company. The policy contained an 80% coinsurance clause. Subsequently, the building was totally destroyed by fire. The value of the building was \$200,000 at the time the policy was issued, and \$160,000 at the time of the fire. Under the fire insurance policy, how much can the partnership recover?

- Nothing, since it did **not** have legal title to the building.
- The face value of the policy (\$150,000).
- Eight percent of the loss (\$128,000).
- The value at the time of the loss (\$160,000).

**N81#58.** Mammoth Furniture, Inc., is in the retail furniture business and has stores located in principal cities in the United States. Its designers created a unique coffee table. After obtaining prices and schedules, Mammoth ordered 2,000 tables to be made to its design and specifications for sale as a part of its annual spring sales promotion campaign. Which of the following represents the earliest time Mammoth will have an insurable interest in the tables?

- Upon shipment of conforming goods by the seller.
- When the goods are marked or otherwise designated by the seller as the goods to which the contract refers.
- At the time the contract is made.
- At the time the goods are in Mammoth's possession.

**N81#59.** A fire insurance policy is one common type of contract. As such it must meet the general requirements necessary to establish a binding contract. In a dispute between the insured and the insurance company, which of the following is correct?

- The contract is always unilateral.
- Insurance contracts are specifically included within the general Statute of Frauds.
- The insured must satisfy the insurable interest requirement.
- The actual delivery of the policy to the insured is a prerequisite to the creation of the insurance contract.

**N81#60.** Fuller Corporation insured its factory and warehouse against fire with the Safety First Insurance Company. As a part of the bargaining process, in connection with obtaining the policy Fuller was required by Safety First to give in writing certain warranties regarding the insured risk. Fuller did so and they were incorporated into the policy. Which of the following correctly describes the law applicable to such warranties?

- The warranties given by Fuller will be treated as representations.
- It was **not** necessary that the warranties given by Fuller be in writing to be effective.
- In the event that Fuller does **not** strictly comply with the warranties it has given, it will be denied recovery in a substantial number of states.
- In deciding whether the language contained in a policy constitutes a warranty, the courts usually construe ambiguous language in a way which favors the insurance company.

**N81#48.** Burt owns an office building which is leased to Hansen Corporation under the terms of a long-term lease. Both Burt and Hansen have procured fire insurance covering the building. Which of the following is correct?

- Both Burt and Hansen have separate insurable interests.

Selected Questions

- b. Burt's insurable interest is limited to the book value of the property.
  - c. Hansen has an insurable interest in the building, but only to the extent of the value of any additions or modifications it has made.
  - d. Since Burt has legal title to the building, he is the only party who can insure the building.
- c. When she has received possession of the goods.
  - d. At the time the contract is made whether or not the goods are identified.

**N80#53.** Bernard Manufacturing, Inc., owns a three-story building which it recently purchased. The purchase price was \$200,000 of which \$160,000 was financed by the proceeds of a mortgage loan from the Cattleman Savings and Loan Association. Bernard immediately procured a standard fire insurance policy on the premises for \$200,000 from the Magnificent Insurance Company. Cattleman also took out fire insurance of \$160,000 on the property from the Reliable Insurance Company of America. The property was subsequently totally destroyed as a result of a fire which started in an adjacent loft and spread to Bernard's building. Insofar as the rights and duties of Bernard, Cattleman, and the insurers are concerned, which of the following is a correct statement?

- a. Cattleman Savings and Loan lacks the requisite insurable interest to collect on its policy.
- b. Bernard Manufacturing can only collect \$40,000.
- c. Reliable Insurance Company is subrogated to Cattleman's rights against Bernard upon payment of Cattleman's insurance claim.
- d. The maximum amount that Bernard Manufacturing can collect from Magnificent is \$40,000, the value of its insurable interest.

**N80#55.** Morse is seeking to collect on a property insurance policy covering certain described property which was destroyed. The insurer has denied recovery based upon Morse's alleged lack of an insurable interest in the property. In which of the situations described below will the insurance company prevail?

- a. The property has been willed to Morse's father for life and, upon his father's death, to Morse as the remainderman.
- b. The insured property does **not** belong to Morse, but instead to a corporation which he controls.
- c. Morse is **not** the owner of the insured property but a mere long-term lessee.
- d. The insured property belongs to a general trade debtor of Morse and the debt is unsecured.

**M80#46.** Dupree buys and sells merchandise at wholesale. She is concerned with her insurance coverage on her purchases. Her desire is to insure the property at the earliest possible time legally permitted. Which of the following times or circumstances correctly indicates the earliest time permissible?

- a. At the time the goods are identified to the contract.
- b. When title to the goods has passed to her.

**M80#48.** Hazard & Company was the owner of a building valued at \$100,000. Since Hazard did not believe that a fire would result in a total loss, it procured two standard fire insurance policies on the property. One was for \$24,000 with the Asbestos Fire Insurance Company and the other was for \$16,000 with the Safety Fire Insurance Company. Both policies contained standard pro rata and 80% coinsurance clauses. Six months later, at which time the building was still valued at \$100,000, a fire occurred which resulted in a loss of \$40,000. What is the total amount Hazard can recover on both policies and the respective amount to be paid by Asbestos?

- a. \$0 and \$0.
- b. \$20,000 and \$10,000.
- c. \$20,000 and \$12,000.
- d. \$40,000 and \$20,000.

**M79#2.** Wilson obtained a fire insurance policy on his dairy farm from the Columbus Insurance Company. The policy was for \$80,000 which was the value of the property. The policy was the standard fire insurance policy sold throughout the United States. A fire occurred late one night and caused a \$10,000 loss. Which of the following will prevent Wilson from recovering the full amount of his loss from Columbus Insurance?

- a. The coinsurance clause.
- b. Wilson had a similar policy with another insurance company for \$40,000.
- c. The fact that 50% of the loss was caused by smoke and water damage.
- d. The fact that his negligence was the primary cause of the fire.

**N79#12.** Charleston, Inc., had its warehouse destroyed by fire. Charleston's property was insured against fire loss by the Conglomerate Insurance Company. An investigation by Conglomerate revealed that the fire had been caused by a disgruntled employee whom Charleston had suspended for one month due to insubordination. Charleston seeks to hold its insurer liable for the \$200,000 loss of its warehouse. Which of the following is correct insofar as the dispute between Charleston and the Conglomerate Insurance Company?

- a. Since the loss was due to the deliberate destruction by one of Charleston's employees, recovery will be denied.
- b. Conglomerate must pay Charleston, but it will be subrogated to Conglomerate's rights against the wrongdoing employee.
- c. The fact that the employee has been suspended for one month precludes recovery against Conglomerate.
- d. Arson is excluded from the coverage of most fire insurance policies, and therefore Conglomerate is **not** liable.

*Business Law*

**N79#38.** Glick was the owner of a factory valued at \$100,000. He procured a fire insurance policy on the building for \$40,000 from Safety Insurance Company, Inc. The policy contained an 80% coinsurance clause. The property was totally destroyed by fire. How much will Glick recover from the insurance company?

- \$20,000.
- \$32,000.
- \$40,000.
- Glick will recover nothing because he did **not** meet the coinsurance requirements.

**N79#45.** The usual fire insurance policy does **not**

- Have to meet the insurable interest test if this requirement is waived by the parties.
- Provide for subrogation of the insurer to the insured's rights upon payment of the amount of the loss covered by the policy.
- Cover losses caused by the negligence of the insured's agent.
- Permit assignment of the policy prior to loss without the consent of the insurer.



**SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS**

**I. The CPA and the Law**

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|--|---|--|---|
| <p><b>A. Common Law Liability to Clients and Third Persons</b></p> <p>N83# 1 a<br/>N83# 2 d<br/>N83# 3 a</p> | <p>N83# 4 c<br/>M81# 1 b</p> <p><b>B. Federal Statutory Liability</b></p> <p>N83# 5 d</p> | <p>N83# 6 c<br/>N83# 7 c<br/>N83# 8 c<br/>M81# 3 c<br/>M81# 4 a<br/>M81# 6 b</p> | <p><b>C. Workpapers, Privileged Communication, and Confidentiality</b></p> <p>N83# 9 d<br/>N83# 10 c<br/>M81# 2 d</p> |
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**II. Business Organizations**

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|--|--|---|--|
| <p><b>A. Agency</b></p> <p>N83# 11 c<br/>N83# 12 b<br/>N83# 13 b<br/>N83# 14 a<br/>M83# 1 a<br/>M83# 2 d<br/>N82# 5 c<br/>N82# 7 a<br/>N82# 34 c<br/>M82# 5 d<br/>M82# 7 c<br/>N81# 12 a<br/>N81# 13 d<br/>N81# 14 d<br/>N81# 15 a<br/>N81# 16 d<br/>M81# 29 c<br/>M81# 30 a<br/>M81# 31 d<br/>M81# 32 c<br/>M81# 33 c<br/>M81# 34 b<br/>N80# 25 c<br/>N80# 26 c</p> | <p>N80# 27 a<br/>N80# 28 c<br/>N80# 29 d<br/>N80# 30 d<br/>N79# 31 b<br/>N79# 33 c<br/>N79# 50 c<br/>M79# 40 b<br/>M79# 45 c</p> <p><b>B. Partnerships</b></p> <p>N83# 15 d<br/>N83# 16 a<br/>N83# 17 b<br/>N83# 18 b<br/>M83# 3 c<br/>M83# 4 b<br/>M83# 5 a<br/>M82# 1 b<br/>M82# 2 a<br/>M82# 3 a<br/>M82# 4 d<br/>N81# 17 d<br/>N81# 18 b<br/>N81# 19 d</p> | <p>N81# 20 d<br/>N81# 21 b<br/>N81# 22 c<br/>N81# 23 d<br/>N80# 19 b<br/>N80# 20 c<br/>N80# 21 c<br/>N80# 22 c<br/>N80# 23 c<br/>N80# 24 d<br/>N79# 14 a<br/>N79# 15 b<br/>N79# 16 a<br/>N79# 17 d<br/>N79# 18 c<br/>N79# 19 b</p> <p><b>C. Corporations</b></p> <p>N83# 19 c<br/>N83# 20 a<br/>N83# 23 a<br/>N83# 24 a<br/>N83# 25 c<br/>M82# 8 a<br/>M82# 9 b</p> | <p>M82# 10 d<br/>M82# 11 a<br/>M82# 17 b<br/>M81# 21 b<br/>M81# 22 c<br/>M81# 23 c<br/>M81# 24 b<br/>M81# 25 c<br/>M81# 26 a<br/>M81# 27 a<br/>M80# 6 b<br/>M80# 7 c<br/>M80# 8 d<br/>M80# 9 d<br/>M80# 12 b<br/>M80# 13 a<br/>M80# 14 b<br/>M80# 16 c<br/>N79# 30 c</p> <p><b>D. Other Forms</b></p> <p>N83# 21 c<br/>M82# 57 c<br/>N80# 45 c<br/>N80# 51 d</p> |
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**III. Contracts**

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|--|--|--|---|
| <p><b>A. Nature and Classification of Contracts</b></p> <p>N83# 26 b<br/>M83# 6 b<br/>N81# 11 a<br/>N79# 5 b</p> | <p><b>B. Offer and Acceptance</b></p> <p>N83# 27 c<br/>N83# 29 b<br/>M83# 8 d<br/>M83# 9 d<br/>N82# 1 a<br/>N82# 3 c<br/>N82# 44 c</p> | <p>M82# 15 a<br/>N81# 1 b<br/>N81# 4 d<br/>N81# 7 c<br/>N81# 8 b<br/>M81# 8 c<br/>M81# 9 a<br/>M81# 10 b<br/>M81# 11 b<br/>M81# 13 c</p> | <p><b>C. Consideration</b></p> <p>N83# 28 d<br/>M83# 7 c<br/>M82# 12 b<br/>M82# 16 a<br/>N79# 3 a</p> |
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*Business Law*

**D. Capacity, Legality, and Public Policy**

M83#10 b  
N82# 8 a  
M79#12 b

N82# 9 a  
N82# 10 b  
M82#14 d  
N81# 2 c  
N81# 3 c  
N81# 9 d  
N79# 2 a  
M79# 9 a  
M79#13 b

M81#12 a  
N79# 4 d

**G. Third Party Rights**

M83#17 d  
N82# 11 b  
N82# 12 b

**I. Discharge, Breach, and Remedies**

N83# 22 c  
N83# 30 c  
M83#20 b  
N82# 14 d  
N82# 21 a  
M82#13 c  
N81# 6 c  
M81# 7 c  
M79# 8 b

**E. Other Defenses**

M83#12 d  
M83#13 d  
M83#14 c  
M83#15 c

**F. Parol Evidence Rule**

M83#16 b  
M83#41 d

**H. Assignments**

M83#18 a  
N82# 13 a  
N81# 5 c

**IV. Debtor-Creditor Relationships and Consumer Protection**

**A. Bankruptcy**

M83#21 d  
M83#22 d  
M83#23 c  
M83#24 d  
N82# 16 a  
N82# 17 c  
N82# 18 b  
N82# 19 b  
M82#18 a  
M82#19 a  
M82#20 c  
M82#21 b  
M82#22 b  
M81#40 b  
M81#41 d

M81#42 c  
M81#43 b  
M81#44 c  
M80# 3 a  
M80#10 c  
M80#31 a  
M80#35 c  
M79#50 c  
M79#19 d  
M79#22 a  
M79#24 c

N82# 15 b  
N82# 20 d  
N82# 22 a  
N82# 24 c  
N82# 25 b  
M82#23 a  
M82#24 c  
M82#25 d  
M80#41 b  
N81# 24 c  
N81# 25 d  
N81# 26 b  
N81# 27 d  
N81# 28 d  
N81# 29 d  
M81#35 b  
M81#36 d  
M81#37 c

M81#38 c  
M81#39 b  
M80#36 d  
M80#39 b  
M80#44 b  
M79# 1 c  
M79# 5 a  
M79# 6 d  
M79# 7 d

**B. Suretyship**

M83#25 c  
M83#26 c  
M83#27 a

**C. Bulk Transfers**

M83#28 d  
M83#29 d  
M83#30 b  
N82# 23 b  
M82#26 b

**V. Government Regulation of Business**

**A. Administrative Law**

N83# 31 d  
N83# 32 d

M82#32 b  
M82#33 b  
N81# 31 a  
N81# 32 c  
N81# 33 a  
N81# 34 b  
M81#55 a  
M81#56 a  
M81#57 b  
N80# 18 c  
M80# 1 c  
M80# 2 c  
M80# 4 c  
M80# 5 a  
N79# 6 b  
N79# 21 a  
N79# 34 b  
N79# 35 b  
N79# 36 c  
N79# 37 d  
N79# 42 c  
M79#41 d

**C. Regulation of Employment**

N83# 39 b  
N83# 40 b  
N83# 41 d  
M83#34 c  
M83#35 a  
N82# 26 a  
N82# 27 d  
N82# 28 b  
N82# 29 d  
M82#34 d  
N81# 30 a  
M81#58 a  
M81#59 b  
M81#60 a  
N80# 58 c  
N80# 60 c  
M80#18 d  
N79# 48 c  
N79# 49 d  
M79#47 d

**D. Federal Securities Acts**

N83# 42 a  
N83# 43 a  
N83# 44 d  
N83# 45 d  
N82# 30 c  
N82# 31 c  
N82# 32 a  
N82# 33 c  
N82# 59 c  
N80# 39 a  
N80# 40 d  
N80# 41 c  
N80# 42 d  
N80# 43 d  
N80# 44 b  
N79# 27 b  
N79# 28 b  
N79# 29 d  
N79# 32 c  
M79#43 b  
M79#48 b

**B. Antitrust Law**

N83# 33 c  
N83# 34 a  
N83# 35 b  
N83# 36 c  
N83# 37 a  
N83# 38 c  
M83#31 a  
M83#32 a  
M83#33 b  
M82#27 c  
M82#28 c  
M82#29 d  
M82#30 c  
M82#31 a

**VI. Uniform Commercial Code**

**A. Commercial Paper**

- N83# 49 b
- N82# 35 b
- N82# 36 b
- N82# 37 c
- N82# 38 c
- N82# 39 b
- N82# 40 c
- N82# 41 c
- N82# 42 d
- N82# 43 c
- N82# 51 c
- N82# 60 a
- M82#35 a
- M82#36 b
- M82#37 d
- M82#38 d
- M82#39 c
- M82#40 d
- M82#41 c
- M82#42 b
- M82#43 c
- N81# 35 b
- N81# 36 a
- N81# 37 c
- N81# 38 b
- N81# 40 d
- N81# 41 c
- N81# 42 a
- N81# 43 a
- N80# 1 a
- N80# 2 a
- N80# 3 d
- N80# 4 c
- N80# 5 c
- N80# 6 d
- N80# 7 c
- N80# 8 c
- N80# 9 b
- N80# 46 b
- M80#15 d

- M80#19 a
- M80#21 b
- M80#22 b
- M80#23 b
- M80#24 d
- M80#30 b
- M79#25 d
- M79#26 d
- M79#27 b
- M79#28 a
- M79#29 b
- M79#30 d
- M79#31 a
- M79#32 a

- N83# 58 c
- N83# 59 b
- N83# 60 d
- M83#11 a
- M83#38 a
- M83#39 a
- M83#40 b
- M83#42 c
- N82# 4 d
- N82# 6 d
- N82# 45 b
- N82# 47 c
- N82# 48 a
- N82# 49 b
- N82# 50 b
- M82#47 d
- M81#14 c
- M81#16 d
- M81#17 d
- M81#18 d
- M81#20 d
- N80# 11 d
- N80# 12 a
- N80# 13 c
- N80# 14 b
- N80# 15 a
- M80#27 d
- M80#29 d
- M80#32 c
- M80#33 a
- M80#34 c
- M80#37 b
- M80#38 c
- N79# 1 d
- N79# 9 b
- N79# 11 a
- N79# 13 c
- M79# 7 d
- N79# 8 d
- M79#33 c
- M79#34 c

- M79#37 a
- M79#38 a
- M79#39 c
- M79#44 c

**B. Documents of Title and Investment Securities**

- N83# 46 c
- N83# 47 c
- N83# 48 d
- M83#43 b
- M83#44 d
- M83#45 b
- M83#46 a
- N82# 46 d
- M82#44 a
- M82#45 b
- N81# 47 b
- N80# 10 d

**C. Sales**

- N83# 50 a
- N83# 51 b
- N83# 52 b
- N83# 53 b
- N83# 54 a
- N83# 55 b
- N83# 56 a
- N83# 57 c

**D. Secured Transactions**

- M83#47 c
- M83#48 a
- M83#49 b
- M83#50 b
- M83#52 d
- N82# 52 b
- N82# 53 d
- N82# 54 b
- N82# 55 a
- N82# 56 c
- N82# 57 a
- N82# 58 c
- M82#46 c
- M82#48 c
- M82#49 c
- M82#50 a
- N81# 44 c
- N81# 46 d
- N81# 48 d
- N81# 49 b
- N81# 50 a
- N80# 31 d
- N80# 32 b
- N80# 33 d
- N80# 34 d
- N80# 36 a
- N80# 37 c
- N80# 38 a
- N79# 25 d
- N79# 26 b
- M79#18 a
- M79#20 a
- M79#21 c

**VII. Property, Estates, and Trusts**

**A. Real and Personal Property**

- M83#53 d
- M83#54 b
- M83#56 d
- M82#51 d
- M82#52 d
- M82#53 d
- M81#52 d
- N80# 47 d
- N80# 48 c
- N80# 50 c
- M80#11 c
- M80#26 c

- N79# 10 b
- N79# 41 a

**B. Mortgages**

- M83#57 a
- M83#58 c
- M83#59 c
- M83#60 a
- M82#54 d
- M81#53 c
- M81#54 b
- N79# 40 b

**C. Administration of Estates and Trusts**

- M82#55 d
- M82#56 d
- N81# 51 d
- N81# 54 d
- M81#49 a
- M81#51 b
- N80# 49 c

- N80# 52 b
- M80#28 a
- M80#40 d
- M80#49 a
- M80#50 b
- N79# 20 a
- N79# 43 b
- N79# 44 b
- N79# 46 d
- N79# 47 c

*Business Law*

**D. Fire and Casualty  
Insurance**  
M83#36 c  
M83#37 b  
M82#58 b  
M82#59 b

M82#60 d  
N81# 55 a  
N81# 56 b  
N81# 58 b  
N81# 59 c

N81# 60 c  
M81#48 a  
N80# 53 c  
N80# 55 d  
M80#46 a

M80#48 c  
M79# 2 b  
N79# 12 b  
N79# 38 c  
N79# 45 d

## ESSAYS — SELECTED QUESTIONS

### I. The CPA and the Law

**M83**

**Number 2 (Estimated time — — 15 to 20 minutes)**

**Part a.** The common stock of Wilson, Inc. is owned by 20 stockholders who live in several states. Wilson's financial statements as of December 31, 1982, were audited by Doe & Co., CPAs, who rendered an unqualified opinion on the financial statements.

In reliance on Wilson's financial statements, which showed net income for 1982 of \$1,500,000, Peters on April 10, 1983, purchased 10,000 shares of Wilson stock for \$200,000. The purchase was from a shareholder who lived in another state. Wilson's financial statements contained material misstatements. Because Doe did not carefully follow GAAS it did not discover that the statements failed to reflect unrecorded expenses which reduced Wilson's actual net income to \$800,000. After disclosure of the corrected financial statements, Peters sold his shares for \$100,000, which was the highest price he could obtain.

④ Peters has brought an action against Doe under federal securities law and state common law.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Will Peters prevail on his federal securities law claims?
2. Will Peters prevail on his state common law claims?

**Part b.** Able Corporation decided to make a public offering of bonds to raise needed capital. On June 30, 1982, it publicly sold \$2,500,000 of 12% debentures in accordance with the registration requirements of the Securities Act of 1933.

The financial statements filed with the registration statement contained the unqualified opinion of Baker & Co., CPAs. The statements overstated Able's net income and net worth. Through negligence Baker did

not detect the overstatements. As a result, the bonds, which originally sold for \$1,000 per bond, have dropped in value to \$700.

Ira is an investor who purchased \$10,000 of the bonds. He promptly brought an action against Baker under the Securities Act of 1933.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will Ira prevail on his claim under the Securities Act of 1933?

**M82**

**Number 2 (Estimated time — — 15 to 20 minutes)**

**The following information applies to both Parts a and b.**

James Danforth, CPA, audited the financial statements of the Blair Corporation for the year ended December 31, 1981. Danforth rendered an unqualified opinion on February 6, 1982. The financial statements were incorporated into Form 10-K and filed with the Securities and Exchange Commission. Blair's financial statements included as an asset a previously sold certificate of deposit (CD) in the amount of \$250,000. Blair had purchased the CD on December 29, 1981, and sold it on December 30, 1981, to a third party who paid Blair that day. Blair did not deliver the CD to the buyer until January 8, 1982. Blair deliberately recorded the sale as an increase in cash and other revenue thereby significantly overstating working capital, stockholders' equity, and net income. Danforth confirmed Blair's purchase of the CD with the seller and physically observed the CD on January 5, 1982.

**Part a.** Assume that on January 18, 1982, while auditing other revenue, Danforth discovered that the CD had been sold. Further assume that Danforth agreed that in exchange for an additional audit fee of

\$20,000, he would render an unqualified opinion on Blair's financial statements (including the previously sold CD).

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. The SEC charges Danforth with criminal violations of the Securities Exchange Act of 1934. Will the SEC prevail? Include in your discussion what the SEC must establish in this action.

2. Assume the SEC discovers and makes immediate public disclosure of Blair's action with the result that no one relies to his detriment upon the audit report and financial statements. Under these circumstances, will the SEC prevail in its criminal action against Danforth?

**Part b.** Assume that Danforth performed his audit in accordance with generally accepted auditing standards (GAAS) and exercised due professional care, but did not discover Blair's sale of the CD. Two weeks after issuing the unqualified opinion, Danforth discovered that the CD had been sold. The day following this discovery, at Blair's request, Danforth delivered a copy of the audit report, along with the financial statements, to a bank which in reliance thereon made a loan to Blair that ultimately proved uncollectible. Danforth did not advise the bank of his discovery.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

If the bank sues Danforth for the losses it sustains in connection with the loan, will it prevail?

## M82

Number 3 (Estimated time — — 15 to 20 minutes)

**Part a.** Ralph Sharp, CPA, has audited the Fargo Corporation for the last ten years. It was recently discovered that Fargo's top management has been engaged in some questionable financial activities since the last audited financial statements were issued.

Subsequently, Fargo was sued in state court by its major competitor, Nuggett, Inc. In addition, the SEC commenced an investigation against Fargo for possible violations of the federal securities laws.

Both Nuggett and the SEC have subpoenaed all of Sharp's workpapers relating to his audits of Fargo for the last ten years. There is no evidence either that Sharp did anything improper or that any questionable financial activities by Fargo occurred prior to this year.

Sharp estimates that the cost for his duplicate photocopying of all of the workpapers would be \$25,000 (approximately one year's audit fee). Fargo has instructed Sharp not to turn over the workpapers to anyone.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. If Sharp practices in a state which has a statutory accountant-client privilege, may the state's ac-

countant-client privilege be successfully asserted to avoid turning over the workpapers to the SEC?

2. Assuming Sharp, with Fargo's permission, turns over to Nuggett workpapers for the last two audit years, may the state's accountant-client privilege be successfully asserted to avoid producing the workpapers for the first eight years?

3. Other than asserting an accountant-client privilege, what major defenses might Sharp raise against the SEC and Nuggett in order to resist turning over the subpoenaed workpapers?

**Part b.** Pelham & James, CPAs, were retained by Tom Stone, sole proprietor of Stone Housebuilders, to compile Stone's financial statements. Stone advised Pelham & James that the financial statements would be used in connection with a possible incorporation of the business and sale of stock to friends. Prior to undertaking the engagement, Pelham & James were also advised to pay particular attention to the trade accounts payable. They agreed to use every reasonable means to determine the correct amount.

At the time Pelham & James were engaged, the books and records were in total disarray. Pelham & James proceeded with the engagement applying all applicable procedures for compiling financial statements. They failed, however, to detect and disclose in the financial statements Stone's liability for certain unpaid bills. Documentation concerning those bills was available for Pelham & James's inspection had they looked. This omission led to a material understatement (\$60,000) of the trade accounts payable.

Pelham & James delivered the compiled financial statements to Tom Stone with their compilation report which indicated that they did not express an opinion or any other assurance regarding the financial statements. Tom Stone met with two prospective investors, Dickerson and Nichols. At the meeting, Pelham & James stated that they were confident that the trade accounts payable balance was accurate to within \$8,000.

Stone Housebuilders was incorporated. Dickerson and Nichols, relying on the financial statements, became stockholders along with Tom Stone. Shortly thereafter, the understatement of trade accounts payable was detected. As a result, Dickerson and Nichols discovered that they had paid substantially more for the stock than it was worth at the time of purchase.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will Pelham & James be found liable to Dickerson and Nichols in a common law action for their damages?

## N81

Number 3 (Estimated time — — 15 to 20 minutes)

**Part a.** Herbert McCoy is the chief executive officer of McCoy Forging Corporation, a small but rapidly growing manufacturing company. For the past several years, Donovan & Company, CPAs, had been engaged

## Selected Questions

to do compilation work, a systems improvement study, and to prepare the company's federal and state income tax returns. In 1980, McCoy decided that due to the growth of the company and requests from bankers it would be desirable to have an audit. Moreover, McCoy had recently received a disturbing anonymous letter which stated: "Beware you have a viper in your nest. The money is literally disappearing before your very eyes! Signed: A friend."

McCoy believed that the audit was entirely necessary and easily justifiable on the basis of the growth and credit factors mentioned above. He decided he would keep the anonymous letter to himself.

Therefore, McCoy on behalf of McCoy Forging engaged Donovan & Company, CPAs, to render an opinion on the financial statements for the year ended June 30, 1981. He told Donovan he wanted to verify that the financial statements were "accurate and proper." He did not mention the anonymous letter. The usual engagement letter providing for an audit in accordance with generally accepted auditing standards (GAAS) was drafted by Donovan & Company and signed by both parties.

The audit was performed in accordance with GAAS. The audit did not reveal a clever defalcation plan by which Harper, the assistant treasurer, was siphoning off substantial amounts of McCoy Forging's money. The defalcations occurred both before and after the audit. Harper's embezzlement was discovered in October 1981. Although the scheme was fairly sophisticated, it could have been detected had additional checks and procedures been performed by Donovan & Company. McCoy Forging demands reimbursement from Donovan for the entire amount of the embezzlement, some \$20,000 of which occurred before the audit and \$25,000 after. Donovan has denied any liability and refuses to pay.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. In the event McCoy Forging sues Donovan & Company, will it prevail in whole or in part?
2. Might there be any liability to McCoy Forging on McCoy's part and if so, under what theory?

**Part b.** Arm Watchband Company manufactures a full line of expansion watch bands, including platinum, gold, and a medium-priced silver. With the skyrocketing prices of precious metal and booming sales, Arm is bursting at the seams with cash and extremely valuable inventory. Dutch, the controller of Arm, noted some irregularities which aroused his suspicion that there might be some embezzlement of company funds. He therefore instituted a full-fledged internal audit of the company's books and records, examined all accounting procedures, and took other appropriate steps necessary to assure himself that nothing was amiss. The only thing unearthed by this was a \$300 discrepancy in petty cash which had apparently been stolen.

Dutch talked to Wheeler, the president of Arm and told him his fears. He also suggested that in ad-

dition to the regular annual audit performed by Rice & Campbell, CPAs, that they be engaged to perform a full-fledged defalcation audit. This was authorized by Wheeler, and the engagement letter for the audit in question clearly reflected this understanding.

Rice & Campbell performed the normal annual audit in their usual competent, nonnegligent manner. The special defalcation audit revealed additional shortages in petty cash. The method was determined and the culprit was exposed and dismissed. Nothing else was revealed despite the fact that the customary procedures for such an audit were followed. Ten months later, Schultz, the warehouse supervisor, was caught by another employee substituting inexpensive copies of the watchbands for the genuine Arm items. The copies were remarkably similar to the originals in appearance. In fact, it would take a precious metals expert to tell the difference based upon a careful visual examination. The packaging was the same since Schultz had access to the packaging materials including the seals which were used in an attempt to provide greater security and detect theft. Schultz always placed the boxes of the copies at the bottom of the inventory supplies. Despite this fact one such carton had been shipped to a leading department store several months ago, but the substitution of copies for the originals had not been detected.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Would Rice & Campbell be liable for failure to detect the defalcation scheme in question?

### N80

**Number 4 (Estimated time — — 15 to 20 minutes)**

**Part a.** Whitlow & Company is a brokerage firm registered under the Securities Exchange Act of 1934. The Act requires such a brokerage firm to file audited financial statements with the SEC annually. Mitchell & Moss, Whitlow's CPAs, performed the annual audit for the year ended December 31, 1979, and rendered an unqualified opinion, which was filed with the SEC along with Whitlow's financial statements. During 1979 Charles, the president of Whitlow & Company, engaged in a huge embezzlement scheme that eventually bankrupted the firm. As a result, substantial losses were suffered by customers and shareholders of Whitlow & Company, including Thaxton who had recently purchased several shares of stock of Whitlow & Company after reviewing the company's 1979 audit report. Mitchell & Moss's audit was deficient; if they had complied with generally accepted auditing standards, the embezzlement would have been discovered. However, Mitchell & Moss had no knowledge of the embezzlement nor could their conduct be categorized as reckless.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What liability to Thaxton, if any, does Mitchell & Moss have under the Securities Exchange Act of 1934?

2. What theory or theories of liability, if any, are available to Whitlow & Company's customers and shareholders under the common law?

**Part b.** Jackson is a sophisticated investor. As such, she was initially a member of a small group who were going to participate in a private placement of \$1 million of common stock of Clarion Corporation. Numerous meetings were held between management and the investor group. Detailed financial and other information was supplied to the participants. Upon the eve of completion of the placement, it was aborted when one major investor withdrew. Clarion then decided to offer \$2.5 million of Clarion common stock to the public pursuant to the registration requirements of the Securities Act of 1933. Jackson subscribed to \$300,000 of the Clarion public stock offering. Nine months later, Clarion's earnings dropped significantly and as a result the stock dropped 20% beneath the offering price. In addition, the Dow Jones Industrial Average was down 10% from the time of the offering.

Jackson has sold her shares at a loss of \$60,000 and seeks to hold all parties liable who participated in the public offering including Allen, Dunn, and Rose, Clarion's CPA firm. Although the audit was performed in conformity with generally accepted auditing standards, there were some relatively minor irregularities. The financial statements of Clarion Corporation, which are part of the registration statement, contained minor misleading facts. It is believed by Clarion and Allen, Dunn and Rose, that Jackson's asserted claim is without merit.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Assuming Jackson sues under the Securities Act of 1933, what will be the basis of her claim?
2. What are the probable defenses which might be asserted by Allen, Dunn, and Rose in light of these facts?

**M80**  
**Number 2**

Number 2 consists of two unrelated parts.

**Part a.** For the first time in the history of federal income tax law, Congress enacted legislation in 1976 that imposed civil liabilities and penalties upon individuals who are guilty of certain misconduct in connection with their preparing income tax returns for a fee. Prior provisions of the Internal Revenue Code which dealt with criminal fraud remained unchanged.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What potential civil liabilities and penalties to the United States government should the practitioner be aware of in connection with the improper preparation of a federal income tax return, and what types of conduct would give rise to these liabilities and penalties?

**N79**  
**Number 5 (Estimated time — — 20 to 25 minutes)**

**Part a.** Marcall is a limited partner of Guarcross, a limited partnership, and is suing a CPA firm which was retained by the limited partnership to perform auditing and tax return preparation services. Guarcross was formed for the purpose of investing in a diversified portfolio of risk capital securities. The partnership agreement included the following provisions:

The initial capital contribution of each limited partner shall not be less than \$250,000; no partner may withdraw any part of his interest in the partnership, except at the end of any fiscal year upon giving written notice of such intention not less than 30 days prior to the end of such year; the books and records of the partnership shall be audited as of the end of the fiscal year by a certified public accountant designated by the general partners; and proper and complete books of account shall be kept and shall be open to inspection by any of the partners or his or her accredited representative.

Marcall's claim of malpractice against the CPA firm centers on the firm's alleged failure to comment, in its audit report, on the withdrawal by the general partners of \$2,000,000 of their \$2,600,000 capital investment based on back-dated notices, and the lumping together of the \$2,000,000 withdrawals with \$49,000 in withdrawals by limited partners so that a reader of the financial statement would not be likely to realize that the two general partners had withdrawn a major portion of their investments.

The CPA firm's contention is that its contract was made with the limited partnership, not its partners. It further contends that since the CPA firm had no privity of contract with the third party limited partners, the limited partners have no right of action for negligence.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the various theories Marcall would rely upon in order to prevail in a lawsuit against the CPA firm.

**Part b.** Farr & Madison, CPAs, audited Glamour, Inc. Their audit was deficient in several respects:

- Farr and Madison failed to verify properly certain receivables which later proved to be fictitious.
- With respect to other receivables, although they made a cursory check, they did not detect many accounts which were long overdue and obviously uncollectible.
- No physical inventory was taken of the securities claimed to be in Glamour's possession, which in



## Selected Questions

fact had been sold. Both the securities and cash received from the sales were listed on the balance sheet as assets.

There is no indication that Farr & Madison actually believed that the financial statements were false. Subsequent creditors, not known to Farr & Madison, are now suing based upon the deficiencies in the audit described above. Farr and Madison moved to dismiss the lawsuit against it on the basis that the firm did not have actual knowledge of falsity and therefore did not commit fraud.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

May the creditors recover without demonstrating Farr & Madison had actual knowledge of falsity?

**Part c.** The Bigelow Corporation decided to liquidate. A board member suggested the possibility of electing a one calendar month liquidation pursuant to section 333 of the Internal Revenue Code. In order to determine whether this type of liquidation was desirable, Bigelow engaged Fanslow & Angelo, CPAs, to perform a tax analysis of the corporation's data and figures to ascertain the amount of dividend per share that would be taxable as dividend income to the shareholders if this method of liquidation were elected. Such a determination is largely dependent on the amount of earnings and profits present, both current and historical.

In making the computation, Fanslow and Angelo treated retained earnings as stated in the financial statements as earnings and profits for tax purposes. However, on two prior occasions transfers were made from retained earnings to stated capital upon the issuance of stock dividends. The result of failure to adjust earnings and profits to reflect these transfers was to understate the amount of taxable dividend income per share by some \$20 per share.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Do Fanslow & Angelo have any liability under the above-stated facts?

**M79**

**Number 2 (Estimated time — 25 to 20 minutes)**

**Part a.** Factory Discount Prices, Inc., is a chain store discount outlet which sells women's clothes. It has an excessively large inventory on hand and is in urgent need of additional cash. It is bordering on bankruptcy, especially if the inventory has to be liquidated by sale to other stores instead of the public. Furthermore, about 15% of the inventory is not resalable except at a drastic discount below cost. Faced with this financial crisis, Factory approached several of the manufacturers from whom it purchases. Dexter Apparel, Inc., one of the parties approached, indicated a willingness to loan Factory \$300,000 under certain conditions. First, Factory was to submit audited financial statements for the express purpose of providing the correct financial condition of the company. The loan was to be predicated

upon these financial statements and Factory's engagement letter with Dunn & Clark, its CPAs, expressly indicated this.

The second condition insisted upon by Dexter was that it obtain a secured position in all unsecured inventory, accounts, and other related personal property. In due course a security agreement was executed and a financing statement properly filed and recorded.

In preparing the financial statements, Factory valued the inventory at cost which was approximately \$100,000 over the current fair market value. Also, Factory failed to disclose two secured creditors to whom substantial amounts are owed and who take priority over Dexter's security interests.

Dunn & Clark issued an unqualified opinion on the financial statements of Factory which they believed were fairly presented.

Six months later Factory filed a voluntary bankruptcy petition. Dexter received \$125,000 as its share of the bankrupt's estate. It is suing Dunn & Clark for the loss of \$175,000. Dunn & Clark deny liability based upon lack of privity and lack of negligence.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Is Dexter entitled to recover its loss from Dunn & Clark?

**Part b.** The CPA firm of Blank, Miller & Tague prepares a significant number of individual and corporate income tax returns. Jones is a newly hired junior accountant. This is Jones's first job since graduation from school. Jones's initial assignment is to work with the tax department in the preparation of clients' 1978 income tax returns.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What is the principal legal basis for potential liability of the CPA firm and Jones to clients in connection with the preparation of income tax returns?

2. Give some examples of performance which would result in such liability.

3. What is the basis for determining the amount of damages to be awarded to the client?

**Part c.** Smith, CPA, is the auditor for Juniper Manufacturing Corporation, a privately-owned company which has a June 30 fiscal year. Juniper arranged for a substantial bank loan which was dependent upon the bank receiving, by September 30, audited financial statements which showed a current ratio of at least 2 to 1. On September 25, just before the audit report was to be issued, Smith received an anonymous letter on Juniper's stationery indicating that a five-year lease by Juniper, as lessee, of a factory building which was accounted for in the financial statements as an operating lease was in fact a capital lease. The letter stated that there was a secret written agreement with the lessor modifying the lease and creating a capital lease.

Smith confronted the president of Juniper who admitted that a secret agreement existed but said it was necessary to treat the lease as an operating lease to meet the current ratio requirement of the pending loan and that nobody would ever discover the secret agreement with the lessor. The president said that if Smith did not issue his report by September 30, Juniper would sue Smith for substantial damages which would result from not getting the loan. Under this pressure and because the working papers contained a copy of the five-year lease agreement which supported the operating

lease treatment, Smith issued his report with an unqualified opinion on September 29.

In spite of the fact that the loan was received, Juniper went bankrupt within two years. The bank is suing Smith to recover its losses on the loan and the lessor is suing Smith to recover uncollected rents.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Is Smith liable to the bank?
2. Is Smith liable to the lessor?

## II. Business Organizations

### A. Agency

#### M80 Number 5

Number 5 consists of four unrelated parts.

**Part a.** Vogel, an assistant buyer for the Granite City Department Store, purchased metal art objects from Duval Reproductions. Vogel was totally without express or apparent authority to do so, but believed that his purchase was a brilliant move likely to get him a promotion. The head buyer of Granite was livid when he learned of Vogel's activities. However, after examining the merchandise and listening to Vogel's pitch, he reluctantly placed the merchandise in the storeroom and put a couple of pieces on display for a few days to see whether it was a "hot item" and a "sure thing" as Vogel claimed. The item was neither "hot" nor "sure" and when it didn't move at all, the head buyer ordered the display merchandise repacked and the entire order returned to Duval with a letter that stated the merchandise had been ordered by an assistant buyer who had absolutely no authority to make the purchase. Duval countered with a lawsuit for breach of contract.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will Duval prevail?

**Part b.** Foremost Realty, Inc., is a real estate broker that also buys and sells real property for its own account. Hobson purchased a ranch from Foremost. The terms were 10% down with the balance payable over a 25-year period. After several years of profitable operation of the ranch, Hobson had two successive bad years. As a result, he defaulted on the mortgage. Foremost did not want to foreclose, but instead offered to allow Hobson to remain on the ranch and suspend the payment schedule until Foremost could sell the property at a reasonable price. However, Foremost in-

sisted that it be appointed as the irrevocable and exclusive agent for the sale of the property. Although Hobson agreed, he subsequently became dissatisfied with Foremost's efforts to sell the ranch and gave Foremost notice in writing terminating the agency. Foremost has indicated to Hobson that he does not have the legal power to do so.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Can Hobson terminate the agency?

### B. Partnerships

#### N82 Number 3

Number 3 consists of two unrelated parts.

**Part b.** While auditing the financial statements of Graham, Phillips, Killian, and Henderson, a real estate partnership, for the year ended December 31, 1981, a CPA uncovers a number of unrelated events which warrant closer analysis:

- Graham died and left her partnership interest to her spouse.

- Phillips owned some real estate prior to the formation of the partnership but never formally transferred legal title to the partnership. The real estate has been used for partnership business since the partnership began its existence, and the partnership has paid all taxes associated with the real estate.

- Killian owes a considerable sum of money to a creditor, Jamison. Jamison has a judgment against Killian and has begun a foreclosure action against certain land owned by the partnership in order to satisfy his claim against Killian.

- Henderson sold some of the partnership real estate for value remitted to the partnership without the approval of the other partners. This sale exceeded Henderson's actual authority but appeared to be a customary sale in the ordinary course of business.

## Selected Questions

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Graham's spouse is presently seeking to exercise his spousal rights to obtain certain specific property owned by the partnership. Discuss the likely outcome of this matter.
2. Regarding the real estate that is legally in Phillips's name, can the partnership properly reflect this as an asset in the partnership's balance sheet?
3. Will Jamison succeed in his land foreclosure action?
4. If the partnership now wishes to rescind the sale of the real estate by Henderson, can it lawfully do so?

### M81

**Number 5 (Estimated time — 15 to 20 minutes)**

**Part a.** Davis and Clay are licensed real estate brokers. They entered into a contract with Wilkins, a licensed building contractor, to construct and market residential housing. Under the terms of the contract, Davis and Clay were to secure suitable building sites, furnish prospective purchasers with plans and specifications, pay for appliances and venetian blinds and drapes, obtain purchasers, and assist in arranging for financing. Wilkins was to furnish the labor, material, and supervision necessary to construct the houses. In accordance with the agreement, Davis and Clay were to be reimbursed for their expenditures. Net profits from the sale of each house were to be divided 80% to Wilkins, 10% to Davis, and 10% to Clay. The parties also agreed that each was to be free to carry on his own business simultaneously and that such action would not be considered a conflict of interest. In addition, the agreement provided that their relationship was as independent contractors, pooling their interests for the limited purposes described above.

Ace Lumber Company sold lumber to Wilkins on credit from mid-1980 until February 1981. Ace did not learn of the agreement between Davis, Clay and Wilkins until April 1981, when an involuntary bankruptcy petition was filed against Wilkins and an order for relief entered. Ace Lumber has demanded payment from Davis and Clay. The lumber was used in the construction of a house pursuant to the agreement between the parties.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In the event Ace sues Davis and Clay as well as Wilkins, will Ace prevail? Discuss the legal basis upon which Ace will rely in asserting liability.

**Part b.** Lawler is a retired film producer. She had a reputation in the film industry for aggressiveness and shrewdness; she was also considered somewhat overbearing. Cyclone Artistic Film Productions, a growing independent producer, obtained the film rights to

"Claws," a recent best-seller. Cyclone has decided to syndicate the production of "Claws." Therefore, it created a limited partnership, Claws Productions, with Harper, Von Hinden and Graham, the three ranking executives of Cyclone, serving as general partners. The three general partners each contributed \$50,000 to the partnership capital. One hundred limited partnership interests were offered to the public at \$50,000 each. Lawler was offered the opportunity to invest in the venture. Intrigued by the book and restless in her retirement, she decided to purchase 10 limited partnership interests for \$500,000. She was the largest purchaser of the limited partnership interests of Claws Productions. All went well initially for the venture, but midway through production, some major problems arose. Lawler, having nothing else to do and having invested a considerable amount of money in the venture, began to take an increasingly active interest in the film's production.

She began to appear frequently on the set and made numerous suggestions on handling the various problems that were encountered. When the production still seemed to be proceeding with difficulty, Lawler volunteered her services to the general partners who as a result of her reputation and financial commitment to "Claws" decided to invite her to join them in their executive deliberations. This she did and her personality insured an active participation.

"Claws" turned out to be a box-office disaster and its production costs were considered to be somewhat extraordinary even by Hollywood standards. The limited partnership is bankrupt and the creditors have sued Claws Productions, Harper, Von Hinden, Graham, and Lawler.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the legal implications and liabilities of each of the above parties as a result of the above facts?

### M80

**Number 5**

Number 5 consists of four unrelated parts.

**Part c.** Whipple, Ryan, and Lopez decided to pool their assets and talents in a partnership. The partnership was to provide management consulting services. The partnership agreement provided the following:

- All policy questions regarding the scope, nature, billings, size, and future expansion of the business are to be decided by a majority vote of the partners. Each partner shall be bound by the decision reached.
- Since each party to this agreement has discontinued a profitable individual business at great financial sacrifice, it is mutually agreed that this partnership shall be irrevocable for a period of five (5) years from the date of execution.

For the first year things went smoothly for the partnership. The relationship of the partners was amicable as they integrated the three separate businesses into one. However, in the middle of the second year, policy disputes began to arise. In virtually every instance, Ryan and Lopez opposed Whipple on matters of expansion and billing rates. At the end of the second year, Whipple announced "he had had enough." He indicated that the ultra-conservative thinking of his partners was deplorable and he could not remain in the partnership under the circumstances. He immediately resigned as a partner, re-established his own business, and actively competed with the partnership. Many of his former clients followed him.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What recourse, if any, do Ryan and Lopez, or the partnership, have against Whipple?

**Part d.** Marvello and Stein decided to promote the Beacon Limited Partnership and to act as the general partners thereof. The partnership was to engage in the machinery leasing business. The general partners had no previous experience in this business nor did they have what one would call exemplary personal characters. However, by grandiose claims, pressure tactics, and extolling the supposed tax benefits of the investment they managed to sell 250 limited partnership interests at \$2,000 each. All this was done via a "private placement" as the promoters called it. The venture got off the ground. However, largely through the incompetence of the general partners, the partnership lost a substantial amount of money in the first year of operations. The limited partners are shocked by the performance of the general partners and the heavy losses incurred. They also have been informed by their tax advisors that there are definite limits on the tax benefits they were promised.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the rights of the limited partners under common law?
2. Has there been any violation of the federal securities laws, and do the limited partners have any rights thereunder?
3. What is the maximum federal income tax loss that an individual limited partner may take on his or her investment?

**M79**

**Number 4 (Estimated time — — 20 to 25 minutes)**

**Part a.** Strom, Lane, and Grundig formed a partnership on July 1, 1974, and selected "Big M Associates" as their partnership name. The partnership agreement specified a fixed duration of ten years for the partnership. Business went well for the partnership for several years and it established an excellent reputation in the business community. In 1978, Strom, much to his amazement, learned that Grundig was padding

his expense accounts by substantial amounts each month and taking secret kickbacks from certain customers for price concessions and favored service. Strom informed Lane of these facts and they decided to seek an accounting of Grundig, a dissolution of the firm by ousting Grundig, and the subsequent continuation of the firm by themselves under the name, "Big M Associates."

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Were there any filing requirements to be satisfied upon the initial creation of the partnership?
2. What will be the basis for the accounting and dissolution and should such actions be successful?
3. Can Strom and Lane obtain the right to continue to use the firm name if they prevail?

**Part b.** Palmer is a member of a partnership. His personal finances are in a state of disarray, although he is not bankrupt. He recently defaulted on a personal loan from the Aggressive Finance Company. Aggressive indicated that if he did not pay within one month, it would obtain a judgment against him and levy against all his property including his share of partnership property and any interest he had in the partnership. Both Palmer and the partnership are concerned about the effects of this unfortunate situation upon Palmer and the partnership.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Has a dissolution of the partnership occurred?
2. What rights will Aggressive have against the partnership or Palmer concerning Palmer's share of partnership property or his interest in the partnership?
3. Could Palmer legally assign his interest in the partnership as security for a loan with which to pay off Aggressive?

**C. Corporations**

**M83**

**Number 4 (Estimated time — — 15 to 20 minutes)**

Cox is a disgruntled shareholder of Hall, Inc. She has owned 6% of the voting stock for several years. Hall is a corporation with 425 shareholders. However, the members of the Hall family own 65% of the corporate stock, dominate the board, and are the principal officers of the corporation. There is one minority board member. Recently, there have been major changes in Hall's board and its officers as the older generation of the family has relinquished the management in favor of the next generation of Halls. It is the action of this new board and management that has caused Cox to contemplate taking drastic action against the current

## Selected Questions

board and officers. Specifically, she objects to the following:

- The board has drastically cut the dividend payments on the common stock. The board's explanation is that additional funds for expansion or acquisitions are critical for the growth of the corporation. The earnings have been increasing at a rate of 10% per year during this period. Cox claims that the real reason for the dividend cut is to force minority shareholders such as herself to sell. This claim is based on conjecture on her part. Cox is considering an action against the board to compel reinstatement on the prior dividend payout.
- The board also decided to sell 5,000 shares of treasury stock at \$10 a share to raise additional capital. The stock in question had originally been sold at \$16 a share and had a \$12 par value. It was reacquired at \$13 per share. Cox first alleges that the corporation is prohibited from acquiring its own shares without specific authorization in the articles of incorporation. The articles of incorporation are silent on this matter. Cox also asserts that the corporation is prohibited from selling the shares at a price less than par.
- Substantial salaries are paid to the officers of the corporation. Salaries of the newcomers have been increased at an annual rate of 10%, which is far in excess of raises voted by the old board. Cox has evidence to show that the corporation's salary scale has risen from the top 50% to the top 33 $\frac{1}{3}$ % of salaries paid by similar corporations in the industry. Cox asserts that based upon the recipients' ages, experience and contribution to the corporation, they are so grossly overpaid that the payments constitute a waste of corporate assets. Cox demands that the salary increases be repaid.
- The board has become factionalized because of hostility within the Hall family. Cox claims that this acrimony has generated useless debate and bickering and is counterproductive to the continued success of Hall, Inc. The majority has threatened to oust the opposition at the next election of the board. Cox claims that all of these actions are seriously impairing the effective management of the corporation and she is contemplating seeking a court-ordered dissolution of Hall.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the merits of each of the above claims and indicate the probable outcome of any court action taken by Cox personally or taken by her for and on behalf of the corporation.

### N82 Number 3

Number 3 consists of two unrelated parts.

**Part a.** William Harrelson is president of the Billings Corporation, a medium-size manufacturer of yogurt. While serving as president, Harrelson learns of an interesting new yogurt product loaded with vitamin additives and with a potentially huge market. He immediately forms another corporation, the Wexler Corporation, to produce and market the new product. In his zeal, however, Harrelson overextends his personal credit and utilizes Billings's credit, along with its plant and employees, as needed, to produce the new product. The new product becomes a big success. As a result, Harrelson's Wexler stock is presently worth millions of dollars.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Billings's shareholders contend that Harrelson's actions are improper and seek a remedy against him. Will they succeed and what remedies are available to them?

### N80 Number 2

Number 2 consists of two unrelated parts.

**Part a.** The Dexter Corporation has not paid a dividend since 1970 on its 7% noncumulative preferred stock. In the years 1970–1973 the company had net losses which threatened to impair its financial position. Since 1974 the company has had earnings sufficient to pay the preferred stock dividend. In fact, earnings have gradually increased since 1974, and by 1976 Dexter had recouped all losses which occurred in the years 1970–1973. During the years 1974–1979 the profits were credited to retained earnings.

The funds were neither committed to physical plant or equipment nor did the board indicate that it had long range plans calling for such a commitment. Preferred shareholders had complained at board meetings regarding the repeated passing over of preferred dividends. The board's actions were explained on the grounds of pessimism about the company's and the economy's outlook and, therefore, the need to build up adequate additional reserves to provide for the possibility of future losses. The board's outlook during the time in question could properly be categorized as one of pessimism and conservatism.

On January 15, 1980, the board decided to pay the 7% dividend on the preferred stock and a large dividend on the common stock. The preferred shareholders were irate. A group of preferred shareholders have commenced a suit seeking an injunction against Dexter and its board of directors prohibiting the payment of dividends on the common stock unless it first pays dividends on the noncumulative preferred for previous years to the extent that the corporation had net earnings available for payment.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will the preferred shareholders prevail?

**N79**

**Number 2 (Estimated time — — 25 to 30 minutes)**

**Part a.** Fairfax Corporation was created on April 2, 1979. Its initial capitalization consisted of (1) 5,000 shares of no-par voting common stock which it sold to subscribers at \$20 a share; (2) 1,000 shares of cumulative, non-voting, 8%, \$100 par value, preferred stock which it sold at \$100 per share; and (3) 2,000 20-year debentures with a face value of \$1,000 each, interest at 10%, which it sold at a 5% discount. All securities were sold for cash during April 1979. At a meeting on May 15, 1979, the board of directors voted to increase the capital surplus of the corporation by transferring to capital surplus \$19 per share of the \$20 per share originally credited to stated capital upon the sale of the no-par common stock.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What is the stated capital of the Fairfax Corporation as of May 16, 1979?

**Part b.** The directors of Despard & Company, Inc., are considering several alternatives to their usual declaration of a cash dividend. The cost of borrowing money has become prohibitive and the directors would prefer to retain the cash to further the corporation's expansion plans. The following possibilities have been suggested:

- A dividend to each shareholder consisting of 60% treasury stock and 40% cash.
- A stock dividend declared and paid in its own authorized and unissued \$1.00 par value common shares.
- A 2-for-1 split-up of the issued shares of the \$1.00 par value common shares. Par value would be changed from \$1.00 to \$0.50.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Separately analyze and discuss the legal impact of each of these possibilities from the standpoint of the corporate requirements (ignore accounting entries) that must be met and the effect that each would have upon the stated capital of the corporation.

2. What is the federal income tax effects or implications to the shareholder as to each of the above possibilities?

3. What is the federal income tax consequence if the corporation continuously elects **not** to pay any cash dividends?

**Part c.** The United States Justice Department commenced a criminal action against Sky Manufacturing Corporation and its president, Masterson, for conspiring to fix prices on the sale of certain heavy industrial machinery. Both the corporation and Mas-

terson denied the allegations. After a lengthy trial, the jury found that although a conspiracy did exist among certain manufacturers, neither Sky nor Masterson were parties to the illegal conspiracy. The cost to the corporation to defend the action against it was \$500,000. Masterson's individual legal fees and expenses amounted to \$250,000 of which Sky has paid \$50,000 directly. Masterson seeks indemnification for the remaining \$200,000.

Heinz, a dissenting shareholder of Sky, advised the board of directors that payment by the corporation of any of Masterson's expenses was improper. In the event no action is taken to recover the \$50,000 already advanced, Heinz will commence a shareholder derivative action against Masterson. Furthermore, unless the board unequivocally promises **not** to indemnify Masterson for the unpaid balance of his legal expenses, Heinz will seek injunctive relief.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What rights and limitations apply to Sky's payment of Masterson's legal fees and expenses in defending the criminal action brought against him?

**M79**

**Number 3 (Estimated time — — 25 to 30 minutes)**

**Part a.** The Decimile Corporation is a well-established, conservatively managed, major company. It has consistently maintained a \$3 or more per share dividend since 1940 on its only class of stock, which has a \$1 par value. Decimile's board of directors is determined to maintain a \$3 per share annual dividend distribution to maintain the corporation's image in the financial community, to reassure its shareholders, and to prevent a decline in the price of the corporation's shares which would occur if there were a reduction in the dividend rate. Decimile's current financial position is not encouraging although the corporation is legally solvent. Its cash flow position is not good and the current year's earnings are only \$0.87 per share. Retained earnings amount to \$17 per share. Decimile owns a substantial block of Integrated Electronic Services stock which it purchased at \$1 per share in 1950 and which has a current value of \$6.50 per share. Decimile has paid dividends of \$1 per share so far this year and contemplates distributing a sufficient number of shares of Integrated to provide an additional \$2 per share.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. May Decimile legally pay the \$2 per share dividend in the stock of Integrated?

2. As an alternative, could Decimile pay the \$2 dividend in its own authorized but unissued shares of stock? What would be the legal effect of this action upon the corporation?

3. What are the federal income tax consequences to the noncorporate shareholders—

### Selected Questions

- (a) If Decimile distributes the shares of Integrated?
- (b) If Decimile distributes its own authorized but unissued stock?

**Part b.** Clayborn is the president and a director of Marigold Corporation. He currently owns 1,000 shares of Marigold which he purchased several years ago upon joining the company and assuming the presidency. At that time, he received a stock option for 10,000 shares of Marigold at \$10 per share. The option is about to expire but Clayborn does not have the money to exercise his option. Credit is very tight at present and most of his assets have already been used to obtain loans. Clayborn spoke to the chairman of Marigold's board about his plight and told the chairman that he is going to borrow \$100,000 from Marigold in order to exercise his option. The chairman was responsible for Clayborn's being hired as the president of Marigold and is a close personal friend of Clayborn. Fearing that Clayborn will leave unless he is able to obtain a greater financial interest in Marigold, the chairman told Clayborn: "It is okay with me and you have a green light." Clayborn authorized the issuance of a \$100,000 check payable to his order. He then negotiated the check to Marigold in payment for the shares of stock.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the legal implications, problems, and issues raised by the above circumstances?

**Part c.** Towne is a prominent financier, the owner of 1% of the shares of Toy, Inc., and one of its directors. He is also the chairman of the board of Unlimited Holdings, Inc., an investment company in which he owns 80% of the stock. Toy needs land upon which to build additional warehouse facilities. Toy's president, Arthur, surveyed the land sites feasible for such a purpose. The best location in Arthur's opinion from all standpoints, including location, availability, access to transportation, and price, is an eight-acre tract of land owned by Unlimited. Neither Arthur nor Towne wish to create any legal problems in connection with the possible purchase of the land.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the legal parameters within which this transaction may be safely consummated?
2. What are the legal ramifications if there were to be a \$50,000 payment "on the side" to Towne in order that he use his efforts to "smooth the way" for the proposed acquisition?

### III. Contracts

**N83**

**Number 4 (Estimated time — — 15 to 20 minutes)**

Bar Manufacturing and Cole Enterprises were arch rivals in the high technology industry and both were feverishly working on a new product which would give the first to develop it a significant competitive advantage. Bar engaged Abel Consultants on April 1, 1983, for one year, commencing immediately, at \$7,500 a month to aid the company in the development of the new product. The contract was oral and was consummated by a handshake. Cole approached Abel and offered them a \$10,000 bonus for signing, \$10,000 a month for nine months, and a \$40,000 bonus if Cole was the first to successfully market the new product. In this connection, Cole stated that the oral contract Abel made with Bar was unenforceable and that Abel could walk away from it without liability. In addition, Cole made certain misrepresentations regarding the dollar amount of its commitment to the project, the stage of its development, and the expertise of its research staff. Abel accepted the offer.

Four months later, Bar successfully introduced the new product. Cole immediately dismissed Abel and has paid nothing beyond the first four \$10,000 payments plus the initial bonus. Three lawsuits ensued: Bar sued Cole, Bar sued Abel, and Abel sued Cole.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the various theories on which each of the three lawsuits is based, the defenses which will be asserted, the measure of possible recovery, and the probable outcome of the litigation.

**M82**

**Number 4 (Estimated time — — 15 to 20 minutes)**

**Part a.** Craig Manufacturing Company needed an additional supply of water for its plant. Consequently, Craig advertised for bids. Shaw Drilling Company submitted the lowest bid and was engaged to drill a well. After a contract had been executed and drilling begun, Shaw discovered that the consistency of the soil was much harder than had been previously encountered in the surrounding countryside. In addition, there was an unexpected layer of bedrock. These facts, unknown to both Craig and Shaw when the contract was signed, significantly increased the cost of performing the contract. Therefore, Shaw announced its intention to abandon performance unless it was assured of recovering its cost. Craig agreed in writing to pay the amount of additional cost if Shaw would continue to drill and complete the contract. Shaw, on the strength of this written promise, completed the job. The additional cost

amounted to \$10,000 which Shaw now seeks to recover. Craig refuses to pay and asserts that the additional burden was a part of the risk assumed and that the only reason it agreed to pay the additional amount was that it needed the additional water supply on time as agreed.

Shaw has commenced legal action to recover the \$10,000 in dispute. Craig denies liability.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What is the legal liability of Craig as a result of the facts described above?
2. Suppose the contract had been for the purchase of computer parts and the manufacturer had encountered a significant increase in labor cost which it wished to pass on to the purchaser. Would the purchaser's subsequent written promise to make an additional payment have been binding?

**Part b.** Ogilvie is a wealthy, prominent citizen of Clarion County. Most of his activities and his properties are located in Vista City, the county seat. Among his holdings are large tracts of farmland located in the outlying parts of Clarion. He has not personally examined large portions of his holdings due to the distance factor and the time it would take. One of his agents told him that 95% of the land was fertile and could be used for general farming. Farber, a recent college graduate who inherited a modest amount of money, decided to invest in farmland and raise avocados. He had read certain advertising literature extolling the virtues of avocado farming as an investment. He called upon Ogilvie and discussed the purchase of his land. In the process, Ogilvie praised his land as a great investment for the future. He stated that the land was virtually all splendid farmland and that it would be suitable for avocado growing. Farber entered into a contract of purchase and made a deposit of 10% on the purchase price.

On the eve of the closing, Farber learned of the presence of extensive rock formations at or near the surface of the land. These rock formations make avocado growing virtually impossible but still permit limited use for some other types of farming. These rock formations are partially visible and could have been seen if Farber had examined the property. They cover approximately 25% of the land.

Accordingly, Farber refused to perform the original contract and demanded that the unsuitable 25% of the land be severed from the contract and the price diminished accordingly.

Ogilvie asserted that "a contract is a contract" and that the doctrine of caveat emptor is applicable in the sale of land. Specifically, he stated that he committed no fraud because:

1. Nothing he said was a statement of fact. It was opinion or puffing.
2. His statements were not material since most of the land is okay, and the balance can be used for some types of farming.

3. He had not lied since he had no knowledge of the falsity of his statements.
4. Farber could have and should have inspected and by failing to do so he was negligent and cannot recover.

Farber then commenced legal proceedings against Ogilvie based on fraud.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In separate paragraphs, discuss the validity of each of Ogilvie's four assertions that he committed no fraud.

**N80**

**Number 5 (Estimated time — — 15 to 20 minutes)**

**Part a.** Fennimore owned a ranch which was encumbered by a seven percent (7%) mortgage held by the Orange County Bank. As of July 31, 1980, the outstanding mortgage amount was \$83,694. Fennimore decided to sell the ranch and engage in the grain storage business. During the time that he was negotiating the sale of the ranch, the bank sent out an offer to several mortgagors indicating a five percent (5%) discount on the mortgage if the mortgagors would pay the entire mortgage in cash or by certified check by July 31, 1980. The bank was doing this in order to liquidate older unprofitable mortgages which it had on the books. Anyone seeking to avail himself of the offer was required to present his payment at the Second Street branch on July 31, 1980. Fennimore, having obtained a buyer for his property, decided to take advantage of the offer since his buyer was arranging his own financing and was not interested in assuming the mortgage. Therefore, on July 15th he wrote the bank a letter which stated: "I accept your offer on my mortgage, see you on July 31, 1980, I'll have a certified check." Fennimore did not indicate that he was selling the ranch and would have to pay off the full amount in any event. On July 28, the bank sent Fennimore a letter by certified mail which was received by Fennimore on the 30th of July which stated: "We withdraw our offer. We are over-subscribed. Furthermore, we have learned that you are selling your property and the mortgage is not being assumed." Nevertheless, on July 31 at 9:05 in the morning when Fennimore walked in the door of the bank holding his certified check, Vogelspiel, a bank mortgage officer, approached him and stated firmly and clearly that the bank's offer had been revoked and that the bank would refuse to accept tender of payment. Dumbfounded by all this, Fennimore nevertheless tendered the check, which was refused.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In the eventual lawsuit that ensued, who will prevail?



## Selected Questions

**Part b.** Austin wrote a letter and mailed it to Hernandez offering to sell Hernandez his tuna canning business for \$125,000. Hernandez promptly mailed a reply acknowledging receipt of Austin's letter and expressing an interest in purchasing the cannery. However, Hernandez offered Austin only \$110,000. Later Hernandez decided that the business was in fact worth at least the \$125,000 that Austin was asking. He therefore decided to accept the original offer tendered to him at \$125,000 and telegraphed Austin an unconditional acceptance at \$125,000. The telegram reached Austin before Hernandez' prior letter, although the letter arrived later that day. Austin upon receipt of the telegram telegraphed Hernandez that as a result of further analysis as to the worth of the business, he was not willing to sell at less than \$150,000. Hernandez claims a contract at \$125,000 resulted from his telegram. Austin asserts either that there is no contract or that the purchase price is \$150,000.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

If the dispute goes to court, who will prevail?

**M80**

**Number 3 (Estimated time — — 20 to 25 minutes)**

**Part a.** Smithers contracted with the Silverwater Construction Corporation to build a home. The contract contained a detailed set of specifications including the type, quality, and manufacturers' names of the building materials that were to be used. After construction was completed, a rigid inspection was made of the house and the following defects were discovered:

- (1) Some of the roofing shingles were improperly laid.
- (2) The ceramic tile in the kitchen and three bathrooms was not manufactured by Disco Tile Company as called for in the specifications. The price of the alternate tile was \$325 less than the Disco but was of approximately equal quality.
- (3) The sewerage pipes that were imbedded in concrete in the basement were also not manufactured by the specified manufacturer. It could not be shown that there was any difference in quality and the price was the same.
- (4) Various minor defects such as improperly hung doors.

Silverwater has corrected defects (1) and (4) but has refused to correct defects (2) and (3) because the cost would be substantial. Silverwater claims it is entitled to recover under the contract and demands full

payment. Smithers is adamant and is demanding literal performance of the contract or he will not pay.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. If the dispute goes to court, who will prevail, assuming Silverwater's breach of contract was intentional?
2. If the dispute goes to court, who will prevail, assuming Silverwater's breach of contract was unintentional?

**Part b.** Jane Anderson offered to sell Richard Heinz a ten-acre tract of commercial property. Anderson's letter indicated the offer would expire on March 1, 1980, at 3:00 p.m. and that any acceptance must be received in her office by that time. On February 29, 1980, Heinz decided to accept the offer and posted an acceptance at 4:00 p.m. Heinz indicated that in the event the acceptance did not arrive on time, he would assume there was a contract if he did not hear anything from Anderson in five days. The letter arrived on March 2, 1980. Anderson never responded to Heinz's letter. Heinz claims a contract was entered into and is suing thereon.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Is there a contract?

**Part c.** Betty Monash was doing business as Victory Stamp Company. She sold the business as a going concern. The assets of the business consist of an inventory of stamps, various trade fixtures which are an inherent part of the business, a building which houses the retail operation, goodwill, and miscellaneous office equipment. On the liability side, there are numerous trade accounts payable and a first mortgage on the building.

Joe Franklin purchased the business. In addition to a cash payment, he assumed all outstanding debts and promised to hold Monash harmless from any and all liability on the scheduled debts listed in the contract of sale.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What is the legal relationship of Monash, Franklin, and the creditors to each other after the consummation of the sale with respect to the outstanding debts of the business?

#### IV. Debtor-Creditor Relationships and Consumer Protection

##### A. Bankruptcy

###### N83 Number 3

Number 3 consists of two unrelated parts.

**Part a.** Skidmore, doing business as Frock & Fashions, is hopelessly insolvent. Several of his aggressive creditors are threatening to attach his property or force him to make preferential payments of their debts. In fairness to himself and to all his creditors, Skidmore has filed a voluntary petition in bankruptcy on behalf of himself and Frock & Fashions. An order for relief has been entered.

Skidmore's bankruptcy is fairly straightforward with the following exceptions:

- Skidmore claims exemptions for his summer cottage and for his home.
- Morse, a business creditor, asserts that commercial creditors have a first claim to all Skidmore's property, business and personal.
- Walton seeks a denial of Skidmore's discharge since Skidmore obtained credit from him by use of a fraudulent financial statement.
- Harper claims a priority for the amount owed him which was not satisfied as a result of his resorting to the collateral securing his loan.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the principal avoiding powers of the trustee in bankruptcy?
2. Discuss in separate paragraphs each of the various claims and assertions stated above.

###### N81 Number 4

Number 4 consists of two unrelated parts.

**Part a.** A small business client, John Barry, doing business as John Barry Fashions, is worried about an involuntary bankruptcy proceeding being filed by his creditors. His net worth using a balance-sheet approach is \$8,000 (\$103,000 assets - \$100,000 liabilities). However, his cash flow is negative and he has been hard pressed to meet current obligations as they mature. He is, in fact, some \$12,500 in arrears in payments to his creditors on bills submitted during the past two months.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the current requirements for a creditor or creditors filing an involuntary petition in bankruptcy and could they be satisfied in this situation?
2. Will the fact that Barry is solvent in the bankruptcy sense result in the court's dismissing the credi-

tors' petition if Barry contests the propriety of the filing of a petition?

###### N80 Number 3

Number 3 consists of two unrelated parts.

**Part b.** In connection with the audit of One-Up, Inc., a question has arisen regarding the validity of a \$10,000 purchase money security interest in certain machinery sold to Essex Company on March 2nd. Essex was petitioned into bankruptcy on May 1st by its creditors. The trustee is seeking to avoid One-Up's security interest on the grounds that it is a preferential transfer, hence voidable. The machinery in question was sold to Essex on the following terms: \$1,000 down and the balance plus interest at nine percent (9%) to be paid over a three year period. One-Up obtained a signed security agreement which created a security interest in the property on March 2nd, the date of the sale. A financing statement was filed on March 10th.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Would One-Up's security interest in the machinery be a voidable preference?
2. In general, what are the requirements necessary to permit the trustee to successfully assert a preferential transfer and thereby set aside a creditor's security interest?

##### B. Suretyship

###### N83 Number 3

Number 3 consists of two unrelated parts.

**Part b.** Mars Finance Company was approached by Grant, the president of Hoover Corp., for a loan of \$25,000 for Hoover. After careful evaluation of Hoover's financial condition, Mars decided it would not make the loan unless the loan was collateralized or guaranteed by one or more sureties for a total of \$30,000. Hoover agreed to provide collateral in the form of a security interest in Hoover's equipment. The initial valuation of the equipment was \$20,000 and Hoover obtained Victory Surety Company as a surety for the additional \$10,000. Prior to the granting of the loan, the final valuation on the equipment was set at \$15,000 and Mars insisted on additional surety protection of \$5,000. Grant personally assumed this additional surety obligation. Hoover has defaulted and Mars first proceeded against the collateral, which was sold for \$17,000. It then proceeded against Victory for the balance. Victory paid the \$8,000 and now seeks a \$4,000 contribution from Grant.

## Selected Questions

Grant asserts the following defenses and arguments in order to avoid or limit his liability:

- That he is not liable since Mars elected to proceed against the collateral.
- That Mars, by suing Victory for the deficiency, released him.
- That he is not a cosurety because Victory did not know of his existence until after default and his surety obligation was not assumed at the same time nor was it equal in amount, hence, there is no right of contribution.
- That in no event is he liable for the full \$4,000 sought by Victory.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss in separate paragraphs each of the above defenses asserted by Grant and indicate the amount of Grant's liability.

**N80**

**Number 3**

Number 3 consists of two unrelated parts.

**Part a.** Hardaway Lending, Inc., had a 4-year \$800,000 callable loan to Superior Metals, Inc., outstanding. The loan was callable at the end of each year upon Hardaway's giving 60 days written notice. Two and one-half years remained of the four years. Hardaway reviewed the loan and decided that Superior Metals was no longer a prime lending risk and it therefore decided to call the loan. The required written notice was sent to and received by Superior 60 days prior to the expiration of the second year. Merriweather, Superior's chief executive officer and principal shareholder, requested Hardaway to continue the loan at least for another year. Hardaway agreed, provided that an acceptable commercial surety would guarantee \$400,000 of the loan and Merriweather would personally guarantee repayment in full. These conditions were satisfied and the loan was permitted to continue.

The following year the loan was called and Superior defaulted. Hardaway released the commercial surety but retained its rights against Merriweather and demanded that Merriweather pay the full amount of the loan. Merriweather refused, asserting the following:

- There was no consideration for his promise. The loan was already outstanding and he personally received nothing.
- Hardaway must first proceed against Superior before it can collect from Merriweather.
- Hardaway had released the commercial surety, thereby releasing Merriweather.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the validity of each of Merriweather's assertions.

**N79**

**Number 4 (Estimated time — — 20 to 25 minutes)**

**Part a.** The King Surety Company, Inc., wrote a performance bond for Allie Stores, Inc., covering the construction of a department store. Rapid Construction Company, the department store contractor, is a general contractor and is simultaneously working on several buildings. Until the entire building is completed, the bond contained a provision that obligated Allie to withhold 20% of the progress payments to be made to Rapid at various stages of completion. After approximately two-thirds of the project had been satisfactorily completed, Rapid pleaded with Allie to release the 20% withheld to date. Rapid indicated that he was having a cash flow problem and unless funds were released to satisfy the demands of suppliers, workmen, and other creditors, there would be a significant delay in the completion date of the department store. Rapid claimed that if the 20% withheld were released, the project could be completed on schedule. Allie released the amounts withheld. Two weeks later Rapid abandoned the project, citing as its reason rising cost which made the contract unprofitable. Allie has notified King of the facts and demands that either King complete the project or respond in damages. King denies liability on the surety bond.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Who will prevail?

**Part b.** Barclay Surety, Inc., is the surety on a construction contract that the Gilmore Construction Company made with Shadow Realty, Inc. By the terms of the surety obligation, Barclay is not only bound to Shadow, but also is bound to satisfy materialmen and laborers in connection with the contract. Gilmore defaulted, and Barclay elected to complete the project and pay all claims and obligations in connection with the contract, including all unpaid materialmen and laborers' claims against Gilmore. The total cost to complete exceeded the construction contract payments Barclay received from Shadow. Some of the materialmen who are satisfied had either liens or security interests against Gilmore. Gilmore has filed a voluntary bankruptcy petition.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What rights does Barclay have as a result of the above facts?

**C. Bulk Transfers**

**N81**

**Number 5**

Number 5 consists of two unrelated parts.

**Part a.** A client engaged its CPA to perform services in connection with the proposed acquisition of the entire inventory of a company that decided to terminate its business and dissolve. Among the services requested was the examination of the seller's inventory schedules which describe the subject matter of the sale. In addition, the client-buyer obtained from the seller a list of the seller's creditors and requested the CPA to make an examination of the seller's accounts payable ledger to verify the accuracy of the list. The sale was consummated on March 1, 1981, and the examination of the inventory schedules and the accounts payable ledger was completed 20 days prior to that date. The CPA performed the services as agreed and the schedules of

inventory and the list of the seller's creditors appeared to be proper and were accepted by the client-buyer.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What is the legal nature of the proposed acquisition described above?

2. There are certain legal procedures necessary to make the transaction described above valid and effective against any creditor. What are the major procedures and what do they attempt to prevent?

3. Were the two precautions taken by the buyer in connection with the purchase necessary in order to protect its rights?

## V. Government Regulation of Business

### B. Antitrust Law

**M83**

**Number 3**

Number 3 consists of two unrelated parts.

**Part a.** Higgins Corporation sells coffee to chain stores and independent grocers. It offers two types of discounts. For the chain stores, Higgins offers a substantial flat discount regardless of volume purchased. For the independent grocers, Higgins grants only volume discounts, on a sliding-scale basis. Higgins received a cease and desist order from the Federal Trade Commission (FTC), and has retained Daniel Chapman, CPA, to assist Higgins in its defense. Basically, the FTC contends that Higgins' discount practices are in violation of the Robinson-Patman Act and thus must be enjoined. Higgins' management has decided not to plead possible defenses of "changed conditions" or "meeting competition" but rather focus exclusively on the "cost justification" defense. Chapman is concerned about the nature and effect of cost data he should obtain.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Discuss the key issues and problems faced in a cost justification defense.

2. Suppose instead that Higgins had sold coffee under its own brand name to independent grocers, and under a private label to chain stores at a lower price. What ramifications, if any, would this have under a Robinson-Patman action?

**N82**

**Number 4**

Number 4 consists of two unrelated parts.

**Part a.** Spencer, Inc., manufactures quality stereo systems and parts. It markets these items through franchised dealers who purchase the goods, take title to them, and are granted the exclusive right to sell the product in clearly defined geographic areas. The dealers in turn are obligated not to sell in any other geographic area. The following is typical of such a territorial clause:

Dealer is hereby granted the exclusive right as hereinafter described to sell, during the term of this agreement, in the territory described below, Spencer products purchased from the company hereunder.

*(Assume geographic description of territory paragraph is included.)*

Dealer agrees to develop the aforementioned territory to the satisfaction of Spencer.

Dealer further agrees not to sell, nor to permit, nor to authorize any other party to sell, Spencer products in any other franchised territory.

The franchised dealers are not obligated to sell only Spencer's products, but are free to handle competing lines if they wish to do so.

Blaine Hi-Fi, Inc., applied for a franchised dealership. Spencer refused to permit Blaine to sell in the territory already granted to another dealer. Blaine claims that Spencer's franchised dealerships are illegal per se as an unreasonable restraint of trade.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Are the above described franchised dealership arrangements illegal per se under the antitrust laws?

**N80**

**Number 2**

Number 2 consists of two unrelated parts.

*Selected Questions*

**Part b.** In 1979 Banner was one of 38 retail Marco gasoline stations in greater Fort Wayne, Massachusetts, and one of 8 such stations in its particular sales territory. The nearest competing Marco station was 11 blocks away. Banner's supplier, Marvel Company, was a major integrated refiner and distributor of petroleum products. Like other Marco stations in Fort Wayne, Banner purchased gasoline from Marvel at 94.1 cents per gallon and resold it at 98.9 cents per gallon.

In September 1979 Best by Test Oil Company, operator of a chain of 65 retail gasoline stations, opened its only Best by Test station in Fort Wayne diagonally across the street from Banner and began selling its gasoline at 96.9 cents per gallon. Best by Test was exclusively a retailer and did not compete with Marvel. This differential of 2 cents per gallon between Banner's and Best by Test's retail prices was the normal differential between "major" and "non-major" brands of gasoline. Subsequently however, beginning in December, Best by Test from time to time reduced its price, sometimes to 91.9 cents or 90.9 cents per gallon, and on each occasion Banner's sales suffered. Banner sought assistance from Marvel to meet Best by Test's competition. After four months of watchful waiting, Marvel gave Banner a discount of 1.7 cents per gallon in April 1980 to permit the latter to reduce its retail price to 95.9 cents per gallon to counter a Best by Test retail price of 94.9 cents per gallon, later lowered to 93.9 cents per gallon. At this point, other Marco dealers, located within a three and one-half mile radius of Banner, suffered substantial declines in sales; they had not received any discount from Marvel and had not reduced their retail prices. They observed some of their former customers buying gasoline from Banner. Those Marco retail stations which suffered losses as a result of Marvel's pricing policies have claimed a violation of federal antitrust law by Marvel and have brought legal action against it to recover damages.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Will the Marco retail stations which suffered losses prevail?
2. What probable defense will Marvel assert in order to avoid liability?

**D. Federal Securities Acts**

**M83  
Number 3**

Number 3 consists of two unrelated parts.

**Part b.** Smith Corp. proposed to merge with Jones, Inc. The stock of both corporations was listed on a national securities exchange. In connection with the merger, both corporations distributed to their shareholders proxy statements seeking their favorable votes.

The shareholders of both corporations overwhelmingly voted in favor of the merger. Following the vote, but before consummation of the merger, the stock of Jones dropped substantially in value, from \$10 per share to \$5 per share.

The reason for the fall in value was the discovery that Smith Corp. had entered into several highly unprofitable long-term contracts. The contracts, which were not disclosed in the proxy statement, will result in substantial losses from Smith's operations in the coming years. The proxy statements indicate that Smith expected continued profitability for the years in question.

West, a long-time Jones shareholder, opposes the merger and decided to bring legal action under the Securities Exchange Act of 1934.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will West prevail, and if so, what remedy or remedies will be available to him?

**N82  
Number 4**

Number 4 consists of two unrelated parts.

**Part b.** Powell Corporation, which owns 5% of the stock of Baron, Inc., approached the board of directors and several of the principal shareholders of Baron to see if they were willing to sell to Powell their effective controlling interest. Baron is listed on the American Stock Exchange and its management either owns or has the unquestioned support of approximately 37% of the shares outstanding. Baron's board and the shareholders who were contacted rejected Powell's overtures. Powell is now considering waging a proxy fight to obtain effective control of Baron.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Can Baron lawfully refuse to give Powell access to the list of shareholders?
2. What rights does Powell have under the Securities Exchange Act of 1934 to have its proxy materials distributed to shareholders?
3. What major requirements under the Securities Exchange Act of 1934 must be met by both sides in a proxy fight?

**M82  
Number 2 (Estimated time — — 15 to 20 minutes)**

Various Enterprises Corporation is a medium sized conglomerate listed on the American Stock Exchange. It is constantly in the process of acquiring smaller corporations and is invariably in need of additional money. Among its diversified holdings is a citrus grove which it purchased eight years ago as an investment. The

grove's current fair market value is in excess of \$2 million. Various also owns 800,000 shares of Resistance Corporation which it acquired in the open market over a period of years. These shares represent a 17% minority interest in Resistance and are worth approximately \$2½ million. Various does its short-term financing with a consortium of banking institutions. Several of these loans are maturing; in addition to renewing these loans, it wishes to increase its short-term debt from \$3 to \$4 million.

In light of the above, Various is considering resorting to one or all of the following alternatives in order to raise additional working capital.

- An offering of 500 citrus grove units at \$5,000 per unit. Each unit would give the purchaser a 0.2% ownership interest in the citrus grove development. Various would furnish management and operation services for a fee under a management contract and net proceeds would be paid to the unit purchasers. The offering would be confined almost exclusively to the state in which the groves are located or in the adjacent state in which Various is incorporated.
- An increase in the short-term borrowing by \$1 million from the banking institution which currently provides short-term funds. The existing debt would be consolidated, extended and increased to \$4 million and would mature over a nine month period. This would be evidenced by a short-term note.
- Sale of the 17% minority interest in Resistance Corporation in the open market through its brokers over a period of time and in such a way so as to minimize decreasing the value of the stock. The stock is to be sold in an orderly manner in the ordinary course of the broker's business.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In separate paragraphs discuss the impact of the registration requirements of the Securities Act of 1933 on each of the above proposed alternatives.

**N81**

**Number 2 (Estimated time — — 15 to 20 minutes)**

**Part a.** Diversified Enterprises, Inc., and Cardinal Manufacturing Corporation have each appointed a committee to discuss Diversified's proposed acquisition of Cardinal. After protracted bargaining, the two committees have agreed to the following terms: Diversified would acquire Cardinal in exchange for 500,000 shares of Diversified's voting common stock and 250,000 shares of its 11% noncumulative, nonvoting preferred. The committees have submitted a proposal incorpo-

rating the above to their respective boards of directors. Both corporations are incorporated in the same state and this state has adopted the Model Business Corporation Act. Cardinal has only one class of stock outstanding, 250,000 shares of common. Diversified has 2,000,000 shares of \$1 par value common stock authorized of which 700,000 shares are outstanding. The preferred stock would be a new class of stock with a \$5 par value. Diversified is in the lower 20th percentile of the Fortune 500 companies and is listed on the New York Stock Exchange. Cardinal is considerably smaller with assets of \$11 million and sales of \$4 million. It is traded in the over-the-counter market. Diversified does not compete with, nor does it buy from or sell to, Cardinal. The form of the acquisition is to be a statutory merger.

You have been assigned to an accounting team to provide assistance to Diversified in this undertaking.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. In separate paragraphs, discuss the requirements of the Securities Act of 1933 arising out of the above facts as well as federal antitrust implications.

2. From a corporate law standpoint, what must be done to validly consummate the proposed merger?

**Part b.** During the initial audit of Haskell Corporation, a medium-sized company engaged in interstate commerce, the CPA discovers that Haskell has recently instituted a generous and broadly-based employees' stock purchase plan. Haskell's philosophy is based upon maximum participation by all employees. This philosophy is generally stated in Haskell's employment brochures and has been fully implemented. Haskell employs approximately 13,000 people in plants located in several states. Approximately 95% of the employees are participating in the plan.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Does the Securities Act of 1933 pose any problems to Haskell in connection with its employees' stock purchase plan or can it claim an exemption as a private placement?

**M81**

**Number 4 (Estimated time — — 15 to 20 minutes)**

**Part a.** Delwood is the Central American representative of Massive Manufacturing, Inc., a large diversified conglomerate listed on the New York Stock Exchange. Certain key foreign government and large foreign manufacturing company contracts were in the crucial stages of bidding and negotiation. During this crucial time, Feldspar, the CEO of Massive, summoned Delwood to the company's home office for an urgent consultation. At the meeting, Feldspar told Delwood that corporate sales and profits were lagging and something definitely had to be done. He told Delwood that

## *Selected Questions*

his job was on the line and that unless major contracts were obtained, he would have to reluctantly accept his resignation. Feldspar indicated he was aware of both the competition and the legal problems that were involved. Nevertheless, he told Delwood "do what is necessary in order to obtain the business." Delwood flew back to Central America the next day and began to implement what he believed to be the instructions he had received from Feldspar. He first contacted influential members of the ruling parties of the various countries and indicated that large discretionary contributions to their re-election campaign funds would be forthcoming if Massive's bids for foreign government contracts were approved. Next, he contacted the large foreign manufacturers and indicated that loans were available to them on a non-repayment basis if they placed their business with Massive. These payments were to be accounted for by charging certain nebulous accounts or by listing the payments as legitimate loans to purchasers. In any event, the true nature of the expenditures was not to be shown on the books. All this was accomplished, and Massive's sales improved markedly in Central America.

Two years later the Securities and Exchange Commission discovered the facts described above.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the legal implications of the above to Delwood, Feldspar, and Massive Manufacturing?

**Part b.** Marigold Corporation is incorporated in one of the states of the United States and does substantially all of its business within that state. It is considering reliance upon the intrastate exemption to the Securities Act of 1933 in order to offer and sell its securities without registering them under the 1933 Act. Its proposed offering will consist of \$800,000 of common stock and \$1 million of debentures. Most of the people it has talked to about the feasibility of such an offering are very wary of such a course of action and warn of significant limitations and dangers inherent in such action.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the requirements, limitations, and problems that are typically encountered in an intrastate offering?

2. Even if the Securities Act's requirements for the exemption can be satisfied, what must be done from the standpoint of state law?

### **M80**

#### **Number 2**

Number 2 consists of two unrelated parts.

**Part b.** The directors of Clarion Corporation, their accountants, and their attorneys met to discuss the desirability of this highly successful corporation going public. In this connection, the discussion turned to the potential liability of the corporation and the parties involved in the preparation and signing of the registration statement under the Securities Act of 1933. Craft, Watkins, and Glenn are the largest shareholders. Craft is the Chairman of the Board; Watkins is the Vice Chairman; and Glenn is the Chief Executive Officer. It has been decided that they will sign the registration statement. There are two other directors who are also executives and shareholders of the corporation. All of the board members are going to have a percentage of their shares included in the offering. The firm of Witherspoon & Friendly, CPAs, will issue an opinion as to the financial statements of the corporation which will accompany the filing of the registration statement, and Blackstone & Abernathy, Attorneys-at-Law, will render legal services and provide any necessary opinion letters.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the types of potential liability and defenses pursuant to the Securities Act of 1933 that each of the above parties or classes of parties may be subject to as a result of going public.

VI. Uniform Commercial Code

A. Commercial Paper

N83  
Number 2

Number 2 consists of two unrelated parts.

**Part b.** Hardy & Company was encountering financial difficulties. Melba, a persistent creditor whose account was overdue, demanded a check for the amount owed to him. Hardy's president said that this was impossible since the checking account was already overdrawn. However, he indicated he would be willing to draw on funds owed by one of the company's customers. He drafted and presented to Melba the following instrument.

October 1, 1983
TO: Stitch Fabrications, Inc. 2272 University Avenue Pueblo, Colorado 81001
Pay Hardy & Company, ONE THOUSAND and no/100 dollars (\$1,000.00) 30 days after acceptance, for value received in connection with our shipment of August 11, 1983.
Hardy & Company by <u>Charles Hardy</u> , President 242 Oak Lane Drive Hinsdale, Illinois 60521
Accepted by: _____

Hardy endorsed the instrument on the back as follows:

Pay to the order of Walter Melba
Hardy & Company <u>Charles Hardy</u> , President

Melba asserts that he is a holder in due course.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What type of instrument is the above? How and in what circumstances is it used?
2. Is it negotiable?
3. Assume that the instrument is negotiable and

accepted by Stitch, but prior to payment, Stitch discovers the goods are defective. May Stitch successfully assert this defense against Melba to avoid payment of the instrument?

M83  
Number 5

Number 5 consists of two unrelated parts.

**Part a.** Dunhill fraudulently obtained a negotiable promissory note from Beeler by misrepresentation of a material fact. Dunhill subsequently negotiated the note to Gordon, a holder in due course. Pine, a business associate of Dunhill, was aware of the fraud perpetrated by Dunhill. Pine purchased the note for value from Gordon. Upon presentment, Beeler has defaulted on the note.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the rights of Pine against Beeler?
2. What are the rights of Pine against Dunhill?

M81  
Number 2 (Estimated time — — 15 to 20 minutes)

**Part a.** Oliver gave Morton his 90-day negotiable promissory note for \$10,000 as a partial payment for the purchase of Morton's business. Morton had submitted materially false unaudited financial statements to Oliver in the course of establishing the purchase price of the business. Morton also made various false statements about the business' value. For example, he materially misstated the size of the backlog of orders. Morton promptly negotiated the note to Harrison who purchased it in good faith for \$9,500, giving Morton \$5,000 in cash, a check for \$3,500 payable to him which he indorsed in blank and an oral promise to pay the balance within 5 days. Before making the final payment to Morton, Harrison learned of the fraudulent circumstances under which the negotiable promissory note for \$10,000 had been obtained. Morton has disappeared and the balance due him was never paid. Oliver refuses to pay the note.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In the subsequent suit brought by Harrison against Oliver, who will prevail?

**Part b.** McCarthy, a holder in due course, presented a check to the First National Bank, the drawee bank named on the face of the instrument. The signature of the drawer, Williams, was forged by Nash who took the check from the bottom of Williams' check book along with a cancelled check in the course of



Selected Questions

burglarizing Williams' apartment. The bank examined the signature of the drawer carefully, but the signature was such an artful forgery of the drawer's signature that only a handwriting expert could have detected a difference. The bank therefore paid the check. The check was promptly returned to Williams, but he did not discover the forgery until thirteen months after the check was returned to him.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Williams seeks to compel the bank to credit his account for the loss. Will he prevail?
2. The facts are the same as above, but you are to assume that the bank discovered the forgery before returning the check to Williams and credited his account. Can the bank in turn collect from McCarthy the \$1,000 paid to McCarthy?
3. Would your answers to 1 and 2 above be modified if the forged signature was that of the payee or an indorser rather than the signature of the drawer?

**N79**

**Number 3 (Estimated time — — 20 to 25 minutes)**

**Part a.** Glasco Machinery and Manufacturing, Inc., sells industrial machinery to various customers on credit terms of 20% down and three-month promissory notes for the balance.

Glasco was experiencing severe financial difficulty and desperately needed a loan for working capital and to stave off persistent creditors. Its bank insisted upon security for any loan it might make. Glasco agreed to pledge \$25,000 of its customer's promissory notes as collateral for a \$20,000 demand loan. The notes pledged included some which Glasco knew had been received on sales of defective machinery and several notes which Glasco's president forged in anticipation of future shipments to customers.

After a short time Glasco's president saw that detection was inevitable, withdrew all funds in the bank, and absconded with the cash. The bank is seeking to enforce payment of the notes against the various parties.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the bank's rights, if any, to collection on the various promissory notes.

**Part b.** Grover had an \$80 check payable to the order of Parker that Parker had indorsed in blank. The check was drawn by Madison on State Bank. Grover deftly raised the amount to \$800 and cashed it at Friendly Check Cashing Company. Friendly promptly presented it at State Bank where it was dishonored as an overdraft. Grover has been apprehended by the police and is awaiting trial. He has no known assets. Friendly is seeking collection on the instrument against any or all of the other parties involved.

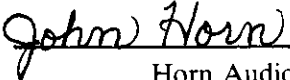
**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will Friendly recover against Madison, State Bank, or Parker?

**Part c.** Horn Audio purchased some audio components from Samuels Sounds. The high quality audio components were to be used by Horn in its expensive customized sound systems to be sold to its customers. Samuels fraudulently substituted a large number of re-conditioned audio components for the new ones that Horn was shown and believed he had purchased. In payment of the purchase, Horn executed and delivered the following instrument to Samuels:

January 8, 1979

For value received, Horn Audio promises to pay Three Thousand Dollars (\$3,000.00) to the order of Samuels Sounds, two weeks after their receipt and out of the proceeds from the resale of the audio components this day purchased from Samuels Sounds and used as major components in the customized sound systems sold to our customers.

  
Horn Audio

Samuels transferred the instrument to Wilmont for value by signing it on the back and delivering it to him. Wilmont had no knowledge of the fraudulent substitution of the audio components by Samuels. Several months later, Wilmont presented the instrument to the maker for payment. Horn refused to pay the instrument alleging fraud and breach of warranty. Furthermore, Horn stated that all the audio components were returned to Samuels immediately upon discovery of the facts. Wilmont has commenced legal action against Horn on the instrument.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will Wilmont prevail in his legal action against Horn on the instrument?

**B. Documents of Title and Investment Securities**

**M80**

**Number 4**

Number 4 consists of three unrelated parts.

**Part b.** Norwood Furniture, Inc., found that its credit rating was such that it was unable to obtain a line of unsecured credit. National Bank indicated that it would be willing to supply funds based upon a "pledge"

of Norwood's furniture inventory which was located in two warehouses. The bank would receive notes and bearer negotiable warehouse receipts covering the merchandise securing the loans. An independent warehouseman was to have complete control over the areas in the warehouse set aside as field warehousing facilities. The Hastings Field Warehousing Corporation was selected to serve as the independent warehouseman. It was to retain keys to the posted area in which the inventory was contained. Negotiable bearer warehouse receipts were issued to Norwood when it delivered the merchandise to Hastings. The receipts were then delivered by Norwood to National to secure the loans which were made at 80% of the market value of the furniture indicated on the receipts. Upon occasion, Norwood would take temporary possession of the furniture for the purpose of packaging it, surrendering the warehouse receipt for this limited purpose. As orders were filled out of the field warehouse inventory, the requisite receipt would be relinquished by National, the merchandise obtained by Norwood, and other items substituted with a new receipt issued.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Based upon the facts given, is the field warehousing arrangement valid?
2. When does a security interest in the negotiable warehouse receipts attach?
3. What, if anything, is necessary to perfect a security interest in goods covered by negotiable warehouse receipts?
4. What are the dangers, if any, that National faces by relinquishing the warehouse receipts to Norwood?

### C. Sales

#### M83

##### Number 5

Number 5 consists of two unrelated parts.

**Part b.** Dennison Corporation, a Los Angeles-based manufacturer, recently ordered some hardware from Elba Corporation, a Boston-based seller of fine tools. Unfortunately, all of the hardware was destroyed while in transit by the carrier. Further examination revealed that while one set of tools was shipped under terms F.O.B. Los Angeles, the other set was shipped under terms F.O.B. Boston.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Which party will bear the risk of loss for each set of tools destroyed in transit assuming conforming goods were shipped?
2. Assume that Dennison also purchased some tools from San Francisco-based Drew Corporation which were shipped under terms F.O.B. San Francisco.

The property is found defective upon arrival in Los Angeles. Which party will bear the risk of loss if the property is destroyed immediately after receipt?

#### M82

##### Number 5 (Estimated time — — 15 to 20 minutes)

**Part a.** Sure Rain Apparel, Inc., manufactures expensive, exclusive rain apparel. One model is very popular and sold widely throughout the United States. About six months after their initial sale to distributors, Sure started receiving complaints that there was a noticeable fading of the color of the material. Many of the distributors seek to return the goods, recover damages, or both. Sure denies liability on the following bases: (1) there was an "Act of God," (2) there was no breach of warranty since the fading was to be expected in any event, and (3) any and all warranty protection was disclaimed unless expressly stated in the contract.

The contract contained the following provisions relating to warranty protection:

- First: The manufacturer warrants that the material used to make the raincoats is 100% Egyptian long fiber cotton.
- Second: The manufacturer guarantees the waterproofing of the raincoat for one year if the directions as to dry cleaning are followed.
- Third: There are no other express warranties granted by the seller, except those indicated above. This writing is intended as a complete statement and integration of all express warranty protection.
- Fourth: The manufacturer does not purport to give any implied warranty of merchantability in connection with this sale. The express warranties above enumerated are granted in lieu thereof.
- Fifth: There are no warranties which extend beyond the description above.

The fourth and fifth provisions were conspicuous and initialed by the buyers.

Several buyers have commenced legal actions against Sure based upon implied warranties and express oral warranties made prior to the execution of the contract.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Is Sure liable for breach of warranty?

**Part b.** Nielson Wholesalers, Inc., ordered 1,000 scissors at \$2.50 a pair from Wilmot, Inc., on February 1, 1982. Delivery was to be made not later than March 10. Wilmot accepted the order in writing on February 4. The terms were 2/10, net/30, F.O.B. seller's loading platform in Baltimore. Due to unexpected additional orders and a miscalculation of the backlog of orders,

## Selected Questions

Wilmot subsequently determined that it could not perform by March 10. On February 15, Wilmot notified Nielson that it would not be able to perform, and cancelled the contract. Wilmot pleaded a reasonable mistake and impossibility of performance as its justification for cancelling. At the time the notice of cancellation was received, identical scissors were available from other manufacturers at \$2.70. Nielson chose not to purchase the 1,000 scissors elsewhere, but instead notified Wilmot that it rejected the purported cancellation and would await delivery as agreed. Wilmot did not deliver on March 10, by which time the price of the scissors had risen to \$3.00 a pair. Nielson is seeking to recover damages from Wilmot for breach of contract.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Will Nielson prevail and, if so, how much will it recover?
2. Would Nielson be entitled to specific performance under the circumstances?
3. Assuming that Wilmot discovers that Nielson was insolvent, will this excuse performance?

### **N81** **Number 5**

Number 5 consists of two unrelated parts.

**Part b.** Maxwell was window shopping one day when she noticed an advertisement at Ultraclear Electronics for the sale of a shortwave radio for \$495. Beneath the large caption indicating the sale and the price were the following:

- Never sold before below \$550.
- Listen to the BBC, Radio Moscow, Radio Tokyo, and other international radio stations.
- Easy tuning, great reception, and made of the highest quality material.
- Don't hesitate, this is a limited offer on the buy of a lifetime.

Maxwell entered the store and proceeded to the place where the shortwave radio featured in the window was displayed with a similar although smaller sign extolling the virtues of the radio. Maxwell was examining the radio when Golden, an Ultraclear salesman, approached her. Maxwell told Golden that she was a great music lover and that she had long wished to listen to the Moscow symphony, the Moscow opera, and the music of the Bolshoi Ballet. Golden merely nodded his head and smiled knowingly. Golden said that at this price the company could not afford to give any implied warranties of quality beyond the replacement of defective parts for ninety days.

When Maxwell got home and used the radio she found it to be in proper working order and that the shortwave reception was satisfactory for much of the world, but that it was not capable of picking up Moscow without severe static and at an exceptionally low audio level. Maxwell returned to Ultraclear and demanded

that the radio be put in proper working order. The complaint department told her there was nothing that they could do about it, that the set was in proper working order and the fact that reception of Radio Moscow was poor was something she would just have to live with. Maxwell asserted that there has been a breach of warranty and demanded her money back. This was refused. Ultraclear's agent then informed Maxwell that she had no warranty protection. The company never "guaranteed" or "warranted" anything. In fact, the only thing stated with respect to warranties at all was Golden's remark clearly disclaiming any and all warranties.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In the subsequent suit brought by Maxwell against Ultraclear to rescind the sale, who will prevail?

### **M80** **Number 4**

Number 4 consists of three unrelated parts.

**Part a.** After much study and deliberation, the marketing division of Majestic Enterprise, Inc., has recommended to the board of directors that the corporation market its products almost exclusively via consignment arrangements instead of other alternate merchandising - security arrangements. The board moved favorably upon this proposal.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the key legal characteristics of a consignment?

## **D. Secured Transactions**

### **N83** **Number 2**

Number 2 consists of two unrelated parts.

**Part a.** Despard Finance Company is a diverse, full-line lending institution. Its "Problems & Potential Litigation" file revealed the following disputes involving loans extended during the year of examination.

- Despard loaned Fish \$4,500 to purchase a \$5,000 video recording system for his personal use. A note, security agreement, and financing statement, which was promptly filed, were all executed by Fish. Unknown to Despard, Fish had already purchased the system from Zeals Department Stores the previous day for \$5,000. The terms were 10% down, the balance monthly, payable in three years, and a written security interest granted to Zeals. Zeals did not file a financing statement until default.

- Despard loaned Moderne Furniture Co. \$13,000 to purchase certain woodworking equipment. Moderne did so. A note, security agreement, and financing statement were executed by Moderne. As a result of an oversight the financing statement was not filed until 30 days after the loan-purchase by Moderne. In the interim Moderne borrowed \$11,000 from Apache National Bank using the newly purchased machinery as collateral for the loan. A financing statement was filed by Apache five days prior to Despard's filing.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the priorities among the conflicting security interests in the same collateral claimed by Despard and the other lenders?

**M81**

**Number 3 (Estimated time — — 15 to 20 minutes)**

**Part a.** Walpole Electric Products, Inc., manufactures a wide variety of electrical appliances. Walpole uses the consignment as an integral part of its marketing plan. The consignments are "true" consignments rather than consignments intended as security interests. Un-sold goods may be returned to the owner-consignor. Walpole contracted with Petty Distributors, Inc., an electrical appliance wholesaler, to market its products under this consignment arrangement. Subsequently, Petty became insolvent and made a general assignment for the benefit of creditors. Klinger, the assignee, took possession of all of Petty's inventory, including all the Walpole electrical products. Walpole has demanded return of its appliances asserting that the relationship created by the consignment between itself and Petty was one of agency and that Petty never owned the appliances. Furthermore, Walpole argues that under the consignment arrangement there is no obligation owing by Petty at any time, thus there is nothing to

secure under the secured transactions provisions of the Uniform Commercial Code. Klinger has denied the validity of these assertions claiming that the consignment is subject to the Code's filing provisions unless the Code has otherwise been satisfied. Walpole sues to repossess the goods.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the requirements, if any, to perfect a true consignment such as discussed above?
2. Will Walpole prevail?

**Part b.** Lebow Woolens, Inc., sold several thousand bolts of Australian wool on credit to Fashion Plate Exclusives, Inc., a clothing manufacturer, obtaining a duly executed security agreement and a financing statement. Fashion Plate became delinquent in meeting its payments. Lebow subsequently discovered that a mis-captioned financing statement for a \$12,500 sale had been filed under the name of Fashion Styles Limited, another customer. Lebow took the following actions. First, on August 11, 1980, it repossessed the bolts of wool which were not already altered by Fashion Plate. This amounted to some 65% of the invoice in question. Next on August 20, 1980, it filed a corrected financing statement covering the sale in question. Dunbar, another creditor of Fashion Plate's, levied against Fashion Plate's inventory, work in process, and raw materials on August 13th and obtained a judgment of \$14,000 against Fashion Plate, an amount in excess of the value of the Lebow bolts of wool. The judgment was obtained and entered on August 18, 1980. Dunbar asserts its rights as a lien judgment creditor.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In a lawsuit to determine the rights of the parties, how should the competing claims of Lebow and Dunbar be decided?

VII. Property, Estates, and Trusts

A. Real and Personal Property

**N83**  
**Number 5**

Number 5 consists of two unrelated parts.

**Part a.** Dogwood Construction Company purchased from Acorn a tract of land for use in its business. There was a secondary roadway in the rear of the tract. At the closing of the sale, Dogwood received a deed with a description which was based on a 20-year old survey. The survey showed the secondary road to be entirely included within the tract purchased. The survey was in error by approximately nine feet and therefore did not reveal that the roadway was encroaching upon an adjoining tract of land by six feet. Acorn was the only prior owner of the property, which included both tracts of land. He had owned both tracts for 11 years, and had continuously used the back road. Dogwood took possession and used the back road for five years until Maple purchased the adjoining tract. Maple's survey accurately indicated the exact location of the boundary lines in relation to the road. Consequently, Maple informed Dogwood that unless it ceased using the road, that he, Maple, would bring an action for trespass. Dogwood claims an easement right to continue to use the road.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What kind of an easement is Dogwood claiming?
2. In general, what are the requirements that must be satisfied by Dogwood to establish such an easement?
3. In the event Maple brought a lawsuit for trespass against Dogwood, who would likely prevail?

**N82**  
**Number 5**

Number 5 consists of two unrelated parts.

**Part b.** Darby Corporation, a manufacturer of power tools, leased a building for 20 years from Grayson Corporation commencing January 1, 1981. During January 1981, Darby affixed to the building a central air conditioning system and certain heavy manufacturing machinery, each with an estimated useful life of 30 years.

While auditing Darby's financial statements for the year ended December 31, 1981, the auditor noted that Darby was depreciating the air conditioning equipment and machinery, for financial accounting purposes, over their estimated useful lives of 30 years. In reading the lease, the auditor further noted that there was no provision with respect to the removal by the lessee of the

central air conditioning system or machinery upon expiration of the lease. To verify that the appropriate estimated useful lives are being utilized for recording depreciation, the auditor is interested in establishing the rightful ownership of these assets upon the expiration of the lease. The auditor knows that in order to determine ownership of the assets at the expiration of the lease, one must first determine whether the assets would be considered personalty or realty.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What major factors would likely be considered by a court in determining whether the air conditioning system and the machinery are to be regarded as personalty or realty, and what would be the likely determination with respect to each?

**M79**  
**Number 5 (Estimated time — — 15 to 20 minutes)**

**Part a.** Hammar Hardware Company, Inc., purchased all the assets and assumed all the liabilities of JoMar Hardware for \$60,000. Among the assets and liabilities included in the sale was a lease of the building in which the business was located. The lessor-owner was Marathon Realty, Inc., and the remaining unexpired term of the lease was nine years. The lease did not contain a provision dealing with the assignment of the leasehold. Incidental to the purchase, Hammar expressly promised JoMar that it would pay the rental due Marathon over the life of the lease and would hold JoMar harmless from any future liability thereon.

When Marathon learned of the proposed transaction, it strenuously objected to the assignment of the lease and to the occupancy by Hammar. Later, after this dispute was resolved and prior to expiration of the lease, Hammar abandoned the building and ceased doing business in that area. Marathon has demanded payment by JoMar of the rent as it matures over the balance of the term of the lease.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Was the consent of Marathon necessary in order to assign the lease?
2. Is JoMar liable on the lease?
3. If Marathon were to proceed against Hammar, would Hammar be liable under the lease?

**Part b.** The Merchants and Mechanics County Bank expanded its services and facilities as a result of the economic growth of the community it serves. In this connection, it provided safe deposit facilities for the first time. A large vault was constructed as a part of the renovation and expansion of the bank building. Merchants purchased a bank vault door from Foolproof Vault Doors, Inc., for \$65,000 and installed it at the vault entrance. The state in which Merchants was lo-

cated had a real property tax but did not have a personal property tax. When the tax assessor appraised the bank building after completion of the renovation and expansion, he included the bank vault door as a part of the real property. Merchants has filed an objection claiming the vault door was initially personal property and remains so after installation in the bank.

There are no specific statutes or regulations determinative of the issue. Therefore, the question will be decided according to common law principles of property law.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What is the likely outcome as to the classification of the bank vault door?

2. The above situation involves a dispute between a tax authority and the owner of property. In what other circumstances might a dispute arise with respect to the classification of property as either real or personal property?

## B. Mortgages

N81

Number 4

Number 4 consists of two unrelated parts.

**Part b.** Vance Manufacturing, Inc., needed an additional plant location. The executive committee of Vance made a survey to determine what property was available and to select the most desirable location. After much deliberation, Vance decided to purchase a four-acre tract of land belonging to Dave Lauer. Lauer was in financial difficulty and desperately needed to raise money. Vance felt that the asking price of \$70,000 was too high and that Lauer would come down to \$60,000 in light of his financial difficulties. After much negotiation, Lauer agreed to sell for \$61,000. Vance's attorney promptly examined Lauer's title to the property and found that a \$40,000 mortgage had recently been filed by Second Bank & Trust Company. Lauer had mentioned this and indicated that the mortgage would be satisfied out of the \$61,000 sale price. The title search, completed on February 2, 1981, revealed that Lauer's title was otherwise clear. Closing was scheduled for March 1.

Meanwhile, desperate for additional financing, Lauer had been negotiating a second mortgage with Adventure Mortgage Company. Lauer did not reveal to Adventure that he was in the process of selling the property to Vance, nor did he tell Vance about the second mortgage. Adventure loaned Lauer \$10,000 on February 20 and took a second mortgage on the property. This mortgage was filed by Adventure on February 22. Vance's attorney made a cursory final examination of the title on February 20, and the parties proceeded to close on March 1 as scheduled. Lauer promptly cashed his check for \$21,000 and disappeared.

Adventure is demanding that it be paid by Vance and threatens foreclosure of its second mortgage.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the legal rights and liabilities of each of the parties involved in the above situation.

M80

Number 4

Number 4 consists of three unrelated parts.

**Part c.** Newfeld purchased a parcel of land in New City from Stoneham Realty. His plan was to construct a professional building and parking lot on the property. In order to do this, Newfeld needed financing and approached the New City National Bank for a first mortgage loan. The proposal looked good to New City National and they loaned Newfeld \$200,000 to help finance the venture. Newfeld engaged builders who accomplished the construction of the building and the parking lot. After two years of ownership and operation of the building and lot, Newfeld decided to sell. Robbins agreed to purchase Newfeld's interest but indicated she was not willing to assume the existing mortgage. It was finally agreed that the entire property would be transferred to Robbins subject to the New City National's first mortgage. Robbins subsequently defaulted.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Who is expected to make the payments during the remaining life of the mortgage?

2. What rights does New City Bank have against Robbins and Newfeld upon default?

3. Assume that the bank has to resort to foreclosure and that after the debt, interest, and all expenses have been paid, there is \$2,000 remaining. Who is entitled to this amount?

## C. Administration of Estates and Trusts

N83

Number 5

Number 5 consists of two unrelated parts.

**Part b.** Mr. & Mrs. Charles Crawford were in the 50% income tax bracket for federal income tax purposes. The Crawfords had two children, June and Virgil, ages 16 and 15. The Crawfords decided that they would like to shift some of their income to the children, but were unwilling to make outright gifts. They consulted with their CPA, banker and attorney and, after considerable discussion, decided to create a short-term irrevocable trust for the benefit of the children with Clearview Trust Company as trustee. The duration of the trust was, as stated in the trust agreement, ten years plus one day from the execution of the trust agreement. The trust agreement was dated August 1, 1982, and the

intent of the parties was to convey the Sunnydale property to the trustee after the mortgage on the property had been satisfied. The mortgage was satisfied on November 15, 1982, and the property conveyed in trust to the trustee on December 1, 1982. Net rental income from the Sunnydale property for the period from December 1, 1982 to December 31, 1982, the end of the tax year chosen for the trust, was \$14,000. This amount was paid to the children in 1982 and \$7,000 of trust income was reported for income tax purposes by each of the children. Mr. & Mrs. Crawford excluded the \$14,000 from their income tax return.

As a result of a routine audit of the Crawford family returns for 1982, the Internal Revenue Service refused to accept the income as being properly includable in the children's returns and reallocated it to Mr. & Mrs. Crawford.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the basic elements for the creation of a valid trust?
2. At what point in time was the trust created in this case?
3. Is the Internal Revenue Service's denial of the shifting of the \$14,000 income to the children proper?
4. Can Mr. & Mrs. Crawford, without the consent of the beneficiaries revoke the trust, assuming the Internal Revenue Service is correct?

#### D. Fire and Casualty Insurance

**N82**

##### Number 5

Number 5 consists of two unrelated parts.

**Part a.** While auditing the financial statements of Jackson Corporation for the year ended December 31, 1981, Harvey Draper, CPA, desired to verify the balance in the insurance claims receivable account. Draper obtained the following information:

- On November 4, 1981, Jackson's Parksdale plant was damaged by fire. The fire caused \$200,000 damage to the plant, which was purchased in 1970 for \$600,000. When the plant was purchased, Jackson ob-

tained a loan secured by a mortgage from Second National Bank of Parksdale. At the time of the fire the loan balance, including accrued interest, was \$106,000. The plant was insured against fire with Eagle Insurance Company. The policy contained a "standard mortgagee" clause and an 80% coinsurance clause. The face value of the policy was \$600,000 and the value of the plant was \$1,000,000 at the time of the fire.

- On December 10, 1981, Jackson's Yuma warehouse was totally destroyed by fire. The warehouse was acquired in 1960 for \$300,000. At the time of the fire, the warehouse was unencumbered by any mortgage; it was insured against fire with Eagle for \$300,000; and it had a value of \$500,000. The policy contained an 80% coinsurance clause.

- On December 26, 1981, Jackson's Rye City garage was damaged by fire. At the time of the fire, the garage had a value of \$250,000 and was unencumbered by any mortgage. The fire caused \$60,000 damage to the garage, which was constructed in 1965 at a cost of \$50,000. In 1975 Jackson expanded the capacity of the garage at an additional cost of \$50,000. When the garage was constructed in 1965, Jackson insured the garage against fire for \$50,000 with Eagle, and this policy was still in force on the date of the fire. When the garage was expanded in 1975, Jackson obtained \$100,000 of additional fire insurance coverage from Queen Insurance Company. Each policy contains an 80% coinsurance clause and a standard pro-rata clause.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. How much of the fire loss relating to the Parksdale plant will be recovered from Eagle?
2. How will such recovery be distributed between Second National and Jackson?
3. How much of the fire loss relating to the Yuma warehouse will be recovered from Eagle?
4. How much of the fire loss relating to the Rye City garage will be recovered from the insurance companies?
5. What portion of the amount recoverable in connection with the Rye City garage loss will Queen be obligated to pay?





## SELECTED ESSAYS — UNOFFICIAL ANSWERS

### 1. The CPA and the Law

**M83**

**Answer 2** (10 points)

**Part a.**

1. No. Peters will not prevail. The facts do not involve liability in the sale of registered securities nor liability for reports filed with the SEC. Because the stock transaction involved interstate commerce, Peters's claim may be based on section 17 (the antifraud provision) of the Securities Act of 1933 and rule 10b-5 under the Securities Exchange Act of 1934. In either case, he will have to show fraud on the part of Doe, or a manipulative device or scheme, in connection with the sale of a security under the 1933 act or the purchase or sale of a security under the 1934 act. If this can be shown, an implied civil damage remedy is available to Peters against Doe.

Although Doe was negligent, the United States Supreme Court, in the *Hochfelder* case, held that a violation of rule 10b-5 requires scienter, something greater than mere negligence. Unless the violation of GAAS involves intent, or gross negligence, Doe would not be held in violation of rule 10b-5.

Similarly, Peters might claim a remedy against Doe for violation of section 17 of the 1933 Securities Act. The Supreme Court, in the *Aaron* case, held no scienter is required in certain section 17 cases brought by the SEC, but it appears that private actions, such as the one by Peters, would be subject to provisions similar to those in rule 10b-5.

2. No. Peters will not prevail based upon his state common law action either. At common law, privity is required before an accountant can be held liable to users of the financial statements, absent fraud. Doe was not in privity of contract with Peters, nor does the question indicate that Doe was even aware that Peters would rely on the financial statements.

**Part b.**

Yes. Ira will prevail and recover damages from Baker. He will base his action on section 11 of the Securities Act of 1933. Section 11 imposes liability on experts, including accountants, whose opinions appear in a registration statement. The experts are liable to all those who in reliance on their opinions purchase securities

in a public offering under the 1933 act. Ira does not have to prove Baker was negligent in auditing Able. All he need allege and prove is that there is a material false statement or omission of a material fact in the registration statement. The only defense that Baker may assert is that it exercised the degree of care that would be exercised by certified public accountants in similar circumstances. This is commonly referred to as the "due diligence" defense. Negligence by Baker is therefore a violation of section 11, and makes Baker liable to Ira for his damages.

**N82**

**Answer 2** (10 points)

**Part a.**

1. Yes. Section 32 (a) of the Securities Exchange Act of 1934 provides that any person who "willfully" violates a substantive provision of the 1934 act or any person who "willfully and knowingly" makes, or causes to be made, false or misleading statements in reports required to be filed with the SEC shall be subject to criminal sanctions. The elements of the government's case would be (1) falsity, that is, the false information included in the Form 10-K; (2) of a "material" fact, satisfied here based on the facts; and (3) criminal intent, as evidenced by the acceptance of the additional \$20,000 fee by Danforth as payment for not mentioning the CD in his report. To prove criminal intent, it need only be established that Danforth rendered his opinion knowing that the financial statements were false.

2. Yes. The fact that Danforth can establish that no one was damaged will not be a valid defense to the criminal action. The reason is that such damage is not an element of proof in criminal proceedings.

**Part b.**

Yes. Danforth would be found liable to the bank. According to the facts, the bank made the loan to Blair in reliance on the audit report and financial statements. Danforth's failure to disclose the subsequently discovered information to the bank, constituted a common law fraud. Danforth had a duty to correct the financial

statements, which he knew to be in error and which he knew the bank would rely upon. The necessary fraudulent intent of the auditor may be inferred where, as here, the auditor sits by silently while others rely on his original representations.

Danforth's performance of his audit in accordance with GAAS did not relieve him of his responsibility to disclose to the bank the fact that the CD was erroneously included in the financial statements. The auditor owes such a duty to third parties, the breach of which constitutes an intentional misrepresentation rather than mere negligence.

**M82**

**Answer 3** (10 points)

**Part a.**

1. No. Subpoenas issued by the SEC involve the enforcement of federal law. Hence any state statutes concerned with the accountant-client privilege are not applicable. Under federal law, no privilege exists on behalf of CPAs in such proceedings.

2. No. The privilege is designed to preserve the confidentiality of communications between the client and the accountant, that is, to foster a free flow of information. However, statutory privileges may be waived. Producing two of the past ten prior-year audit files would effectively constitute a waiver of the privilege for the remaining eight.

3. Sharp may contend that the subpoenas are "overly broad" in that they call for all of his workpapers for the prior ten years where there is no evidence that Fargo engaged in questionable activities during that period. Sharp may also contend that the subpoenas are onerous or overly burdensome in that he will bear the substantial cost of duplicating the workpapers.

**Part b.**

Yes. Pelham & James will be found liable to Dickerson and Nichols based on their negligent misrepresentation that the trade accounts payable balance was accurate within \$8,000, when in fact it was materially understated. The understatement was due to the firm's failure to detect certain unpaid bills that were available for their inspection.

It should be recognized that Pelham & James will be liable to Dickerson and Nichols even though they are third-party users of the financial statements and not in privity of contract with Pelham & James. Dickerson's and Nichols's reliance, both on the financial statements and on Pelham & James's oral representations, was specifically known, and, thus, Pelham & James owed them a duty of due care. Moreover, Pelham & James's compilation report, which disclaimed any opinion or other assurances, will not release them from liability.

**N81**

**Answer 3** (10 points)

**Part a.**

1. No. Although the normal or typical audit may very well detect defalcations, an auditor's duty to detect fraud is limited to that which can be detected in the course of a GAAS audit. Nor does the engagement encompass taking the additional steps necessary that might detect a defalcation, unless this is specifically agreed. The engagement in the instant case in no way indicated that it was intended to discover defalcations. Even if McCoy had told Donovan of the anonymous letter, it is doubtful that liability would attach unless there was a negligently performed audit or a specific engagement to detect defalcations that was not properly performed. The fact that McCoy thought the usual audit would automatically include procedures to specifically detect defalcations would not affect the outcome of the case in the absence of additional facts—for example, if Donovan knew of McCoy's belief. Even assuming negligence on Donovan's part, recovery by McCoy Forging would be limited to the amount of damages caused by the negligent failure to discover the defalcation. In effect, recovery would be limited to defalcations subsequent to the audit.

2. Yes. The facts raise the question of whether or not McCoy acted as a reasonably prudent person in light of the circumstances. The theory applicable is negligence. McCoy owed the corporation a duty of due care in the performance of his duties as chief executive officer of McCoy Forging. Either the corporation or a shareholder suing derivatively could proceed against McCoy under the negligence theory for failing to disclose the letter and take appropriate action.

**Part b.**

No. A CPA who engages in a defalcation audit is not an insurer. Liability, if any, must be predicated on fault based on the failure to exercise the care of a reasonable person under the circumstances and in accordance with the special skill or training of that person. As indicated, recovery for negligence is predicated on fault and, consequently, where there is a defalcation that cannot be discovered even with the exercise of the special care required in the performance of a defalcation audit, there is no liability. This certainly appears to be the case here. Furthermore, the difficulty of detection of the particular scheme is evidenced by the failure of the internal audit to detect anything and by the failure of the company to detect anything until Schultz was caught in the act, even though the company had continuous control of the inventory.

Finally, the excellence of the copies, the near impossibility of detection by physical examination except by an expert, and the identical repackaging, all seem

to indicate that the defalcation was such that it would not have been detected even by a carefully and competently executed defalcation audit.

**N80**

**Answer 4 (10 points)**

**Part a.**

1. In order for Thaxton to hold Mitchell & Moss liable for his losses under the Securities Exchange Act of 1934, he must rely upon the antifraud provisions of section 10(b) of the act. In order to prevail Thaxton must establish that

- There was an omission or misstatement of a material fact in the financial statements used in connection with his purchase of the Whitlow & Company shares of stock.
- He sustained a loss as a result of his purchase of the shares of stock.
- His loss was caused by reliance on the misleading financial statements.
- Mitchell & Moss acted with scienter.

Based on the stated facts, Thaxton can probably prove the first three requirements cited above. To prove the fourth requirement, Thaxton must show that Mitchell & Moss had knowledge (scienter) of the fraud or recklessly disregarded the truth. The facts clearly indicate that Mitchell & Moss did not have knowledge of the fraud and did not recklessly disregard the truth.

2. The customers and shareholders of Whitlow & Company would attempt to recover on a negligence theory based on Mitchell & Moss's failure to comply with GAAS. Even if Mitchell & Moss were negligent, Whitlow & Company's customers and shareholders must also establish either that—

- They were third party beneficiaries of Mitchell & Moss's contract to audit Whitlow & Company, *or*
- Mitchell & Moss owed the customers and shareholders a legal duty to act without negligence.

Although recent cases have expanded a CPA's legal responsibilities to a third party for negligence, the facts of this case may fall within the traditional rationale limiting a CPA's liability for negligence; that is, the unfairness of imputing an indeterminate amount of liability to unknown or unforeseen parties as a result of mere negligence on the auditor's part. Accordingly, Whitlow & Company's customers and shareholders will prevail only if (1) the courts rule that they are either third-party beneficiaries or are owed a legal duty and (2) they establish that Mitchell & Moss was negligent in failing to comply with generally accepted auditing standards.

**Part b.**

1. The basis of Jackson's claim will be that she sustained a loss based upon misleading financial statements. Specifically, she will rely upon section 11(a) of

the Securities Act of 1933, which provides the following: In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue . . . every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement. . . .

To the extent that the relatively minor irregularities resulted in the certification of materially false or misleading financial statements, there is potential liability. Jackson's case is based on the assertion of such an untrue statement or omission coupled with an allegation of damages. Jackson does not have to prove reliance on the statements nor the company's or auditor's negligence in order to recover the damages. The burden is placed on the defendant to provide defenses that will enable it to avoid liability.

2. The first defense that could be asserted is that Jackson knew of the untruth or omission in audited financial statements included in the registration statement. The act provides that the plaintiff may not recover if it can be proved that at the time of such acquisition she knew of such "untruth or omission."

Since Jackson was a member of the private placement group and presumably privy to the type of information that would be contained in a registration statement, plus any other information requested by the group, she may have had sufficient knowledge of the facts claimed to be untrue or omitted. If this be the case, then she would not be relying on the certified financial statements but upon her own knowledge.

The next defense assertable would be that the untrue statement or omission was not material. The SEC has defined the term as meaning matters about which an average prudent investor ought to be reasonably informed before purchasing the registered security. For section 11 purposes, this has been construed as meaning a fact that, had it been correctly stated or disclosed, would have deterred or tended to deter the average prudent investor from purchasing the security in question.

Allen, Dunn, and Rose would also assert that the loss in question was not due to the false statement or omission; that is, that the false statement was not the cause of the price drop. It would appear that the general decline in the stock market would account for at least a part of the loss. Additionally, if the decline in earnings was not factually connected with the false statement or omission, the defendants have another basis for refuting the causal connection between their wrongdoing and the resultant drop in the stock's price.

Finally, the accountants will claim that their departure from generally accepted auditing standards was too minor to be considered a violation of the standard of due diligence required by the act.

**M80**

**Answer 2**

**Part a.**

The 1976 Tax Reform Act substantially changed the liability imposed upon individuals who prepare income tax returns for compensation. In addition to disclosure requirements and ethical standards, the act imposed civil liability and penalties and empowered the government to obtain injunctive relief.

The basis for liability under the 1976 Tax Reform Act is an understatement of the taxpayer's federal income tax liability. A final determination of the taxpayer's tax liability by the Internal Revenue Service or the courts is not a necessary condition for establishing an understatement of that liability. Where the understatement is due to the negligent or intentional disregard of the income tax rules or regulations, the penalty is \$100. The penalty does not extend to the employer of a tax return preparer solely by reason of the relationship. In the event of a trial of the question of the proper assessment of the penalty, the preparer has the burden of proving he was not at fault.

Where it is found that the preparer willfully understated the taxpayer's liability, the penalty is \$500 per return. Where the willful understatement of liability also constitutes a negligent or intentional disregard for the rules and regulations, as it usually will, the combined penalty is a maximum of \$500.

The 1976 Tax Reform Act also established new procedures for return preparers. Noncompliance with these procedures subjects the preparer to the following penalties.

1. \$25 for failure to furnish a copy of the completed return to the taxpayer.
2. \$50 for failure to retain either a copy of all returns prepared or a list of all taxpayers and their identification numbers.
3. \$25 for failure to reflect the preparer's identification number on the tax return.
4. \$25 for failure to sign the return.
5. \$500 for each taxpayer's income tax check endorsed or otherwise negotiated by the preparer.

Finally, the Internal Revenue Service has the power to seek injunctive relief by enjoining a preparer from engaging in prohibited practices; or, if his conduct has repeatedly violated the proscribed practices, he may be enjoined from practicing as an income tax return preparer.

The specific practices of an income tax return preparer that can initiate an action to enjoin on the part of the service are the following:

1. Conduct subject to disclosure requirement penalties and understatement-of-taxpayer-liability penalties.
2. Conduct subject to criminal penalties under the Internal Revenue Code.
3. Misrepresentation of (a) the return preparer's el-

igibility to practice before the IRS or (b) his experience or education as an income tax return preparer.

4. Guarantee of payment of a tax refund or of allowance of a tax credit.
5. Other fraudulent or deceptive conduct that substantially interferes with proper administration of the internal revenue laws.

**N79**

**Answer 5** (12 points)

**Part a.**

The issue of privity is clearly raised by the CPA firm's contention that the duty of care is to the limited partnership with which it had contracted and not to third-party limited partners, such as Marcall.

The common law privity limitation, as it applies to CPAs, is currently in a state of change. However, recent cases indicate a gradual erosion of this limitation on the recovery rights of third parties. Because the basis of Marcall's claim is clearly negligence and not fraud, the traditional fraud exception to the privity rule is not available. The following theories undoubtedly would be asserted by Marcall:

- The third-party beneficiary doctrine would be asserted based upon the fact that it was clear that the audit was intended to benefit the limited partners. Therefore, although not directly parties to the contract, they may sue as its intended beneficiaries.
- The services of the accountants clearly did not extend beyond a class of persons actually known and limited at the time of the engagement. The privity barrier is essentially based upon a reluctance to impose liability against CPAs to the extensive and indeterminate investing public-at-large. However, where the audit was expected to be relied upon by a fixed, definable, and contemplated group whose conduct was to be governed by the audit, the duty of care extends to this class of people. It is not necessary to state the duty in terms of contract or privity.
- Although the facts indicate ordinary negligence, it is possible that gross negligence might be present. The dividing line between ordinary and gross negligence is such that liability to third parties could be found on this basis.
- Although the audit was performed pursuant to a contract with the limited partnership, the real parties-in-interest were the partners. The partnership is not a separate and distinct entity for this purpose. The general partners signing the engagement letter were doing so as agents for each of the members of the limited partnership.

**Part b.**

Ordinarily, users of financial statements, other than those who contracted for the audit and those known in

advance to the auditor, may not recover for ordinary negligence by the auditor in the performance of an audit. Usually, recovery of damages by third parties must be based on fraud. Actual knowledge of falsity (scienter) is generally required for an action based upon fraud; however, the scienter requirement for an action based upon fraud may be satisfied by either

- Showing a reckless disregard for the truth.
- Demonstrating that the auditor was grossly negligent.

It appears that the three deficiencies in the audit by Farr & Madison might be sufficient to satisfy either approach. The deficiencies of failure to check the existence of certain receivables, collectibility of other receivables, and existence of security investments, taken collectively, if not individually, appear to show a reckless disregard for the truth by the auditor. In fact, the audit probably lacks sufficient competent evidential matter as a reasonable basis for an opinion regarding the financial statements under examination.

The audit appears to have been conducted in a woefully inadequate fashion, without regard to the usual auditing standards and procedures necessary to exercise due professional care. Therefore, the auditors were grossly negligent in the performance of their duties.

**Part c.**

Yes. Fanslow & Angelo were negligent in the performance of the task undertaken. The concept of retained earnings resembles earnings and profits for tax purposes, but it is clear they are not identical. Several adjustments are normally required to be made to reconcile one with the other. To assume retained earnings are equivalent to earnings and profits without a careful analysis of all prior years, after 1913, is to proceed at one's peril. Any competent tax accountant would be aware of the distinction. Furthermore, stock dividends have no impact on earnings and profits, but they may affect retained earnings as was the case here.

The facts are not sufficient to determine the exact amount of damages. Fanslow & Angelo would be held liable for any interest and penalties imposed upon the shareholders, and they might also be held liable for additional taxes incurred by the shareholders as a result of their erroneous advice.

**M79**

**Answer 2** (14 points)

**Part a.**

Yes. Dexter Apparel, Inc., is entitled to recover its loss from Dunn & Clark upon a showing of negligence. Dunn & Clark will not succeed if they assert the defense of lack of privity. One well-recognized exception to the privity rule is the third-party beneficiary doctrine: When an audit is being performed for the benefit of a

designated third party, privity is not required. This exception is applicable to the facts of this case. The audit engagement was undertaken expressly to satisfy Dexter's conditions for making the loan, and the engagement letter stated this fact.

The facts indicate that there was negligence on Dunn & Clark's part. First, the valuation of the inventory was not in accordance with generally accepted accounting principles and did not represent the fair market value, which was significantly less than the cost of the goods. In addition, it would appear that Dunn & Clark were negligent in not discovering and disclosing the security interests of Factory's other creditors, especially in light of the facts surrounding the purpose of the engagement.

**Part b.**

1. The principal legal basis for liability of the firm and Jones is negligence. Jones, acting as an agent of the firm, is personally liable to clients for his negligent preparation of their tax returns. The firm, as principal, is responsible for the acts of its agent.

2. Some common examples of negligence are—

- Failure to timely prepare and submit tax returns to the client for filing as agreed.
- Erroneous application of the law to facts submitted.
- Failure to recommend timely elections.
- Failure to review performance of, supervise, and train employees.
- Lack of awareness or understanding of the law essential to the proper preparation of returns.

3. The amount of damages to be awarded to the client because of negligent preparation of tax returns is typically the amount of penalties assessed, interest assessed, no-longer-recoverable taxes erroneously paid by the client, and other costs directly resulting from negligence depending upon the specific circumstances (e.g., fee paid to another tax return preparer for an amended return). In cases of gross negligence, punitive damages may also be awarded.

**Part c.**

1. Yes. Smith was a party to the issuance of false financial statements and as such is a joint tortfeasor. The elements necessary to establish an action for common law fraud are present. There was a material misstatement of fact, knowledge of falsity (scienter), intent that the plaintiff bank rely on the false statement, actual reliance, and damage to the bank as a result thereof. If the action is based upon fraud there is no requirement that the bank establish privity of contract with the CPA. Moreover, if the action by the bank is based upon ordinary negligence, which does not require a showing of scienter, the bank may recover as a third-party beneficiary (an exception to the strict privity requirement). Thus, the bank will be able to recover its loss from Smith under either theory.

2. No. The lessor was a party to the secret agreement. As such, the lessor cannot claim reliance on the financial statements and cannot recover uncollected rents.

Even if he was damaged indirectly, his own fraudulent actions led to his loss, and the equitable principle of "unclean hands" precludes him from obtaining relief.

## II. Business Organizations

### A. Agency

**M80**

**Answer 5** (12 points)

#### Part a.

Yes. Despite the stated lack of express or apparent initial authority of Vogel, Granite City Department Store's agent, there would appear to be a ratification by the principal.

It is clear from the facts stated that Granite would not have been liable on the Vogel contract if the head buyer had immediately notified Duval and returned the goods. Instead the head buyer retained the goods and placed some on display in an attempt to sell them. Had they proved to be a "hot" item, undoubtedly the art objects would have been gratefully kept by Granite. Granite wants to reject the goods if they don't sell but wants to have the benefits if they do sell. Such conduct is inconsistent with a repudiation based upon the agent's lack of express or apparent authority. The retention of the goods for the time indicated, the attempted sale of the goods, and a failure to notify Duval in a timely way, when taken together, constitute a ratification of the unauthorized contract.

#### Part b.

No. The facts reveal an agency coupled with an interest and therefore an irrevocable agency. Most agency-principal relationships are terminable by either party. However, one clearly recognized exception to this generally prevailing rule is that the agency may not be terminated when the agent has an interest in property that is the subject of the agency. This agency, coupled with an interest rule, applies here since the creditor (Foremost Realty, Inc.) has the requisite interest in the property because it is the mortgagee-creditor of the defaulting mortgagor-debtor. Thus, the appointment by Hobson of Foremost as the irrevocable agent for the sale of the mortgaged property cannot be terminated unilaterally by Hobson.

### B. Partnerships

**N82**

**Answer 3**

#### Part b.

1. Graham's spouse would lose in such an action. One of the principal characteristics of a tenancy in partner-

ship is that upon the death of a partner, that partner's right in specific partnership property vests in the surviving partner or partners. Another characteristic provides that a partner's right in specific partnership property is not subject to dower, curtesy, or allowances to a surviving spouse, heirs, or next of kin.

2. Yes. Despite the fact that legal title to the real estate remains with Phillips, this is not conclusive evidence that the real estate is not a partnership asset. This is a factual question in which the objective intention of the parties may be inferred by examining a variety of factors such as whether the property was improved with partnership funds, whether expenses relating to the asset (such as insurance and taxes) were paid for by the partnership, and so forth. Since the partnership actually paid the real estate taxes, such property may properly be considered a partnership asset and thus included on its balance sheet.

3. No. Jamison may attach Killian's partnership interest in the firm by obtaining a charging order (which would, for example, entitle Jamison to receive Killian's share of the partnership profits) but cannot obtain a fractional interest in any specific item of property.

4. No. The act of every partner for apparently carrying on in the usual course the business of the partnership binds the partnership, unless the partner so acting has in fact no authority and the person with whom he is dealing has knowledge of the lack of authority. The acts of Henderson appeared to be in the usual course of business, and there is no indication that the purchaser knew of Henderson's lack of authority. Accordingly, the partnership is bound.

**M81**

**Answer 5** (10 points)

#### Part a.

Yes. Ace will prevail. A partnership did exist and the parties are jointly liable. The legal basis upon which Ace will seek recovery is that a partnership exists among Wilkins, Davis, and Clay. If the parties are deemed partners among themselves, then Ace can assert liability against such partnership and against the individual partners as members thereof, since they are jointly liable for such partnership obligations.

The Uniform Partnership Act, section 7, provides rules for determining the existence of a partnership. Although it is frequently stated that the intent of the parties is important in determining the existence of a

partnership relationship, this statement must be significantly qualified: It is not the subjective intent of the parties that is important when they categorically state that they do not wish to be considered as partners. If much effect were given to such statements, partnership liability could easily be shed. Further, the party dealing with the partnership need not in fact rely upon the existence of a partnership. Thus, the fact that Ace did not learn of the Davis, Clay, Wilkins agreement until after he had extended credit does not preclude him from asserting partnership liability.

The bearing of section 7 of the Uniform Partnership Act on this case can be examined as follows. First, joint, common, or part ownership of property of any type does not of itself establish a partnership. It is only one factor to be considered and was present to a limited extent in this case. Second, the sharing in gross returns does not of itself establish a partnership, but its importance is rendered moot as a result of the profit-sharing arrangement between the parties. Finally, and the key factor in partnership determination, is the receipt of profits: The act states "the receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business. . . ."

Sharing in profits is prima facie evidence of the existence of a partnership. The defendants (Davis and Clay) must affirmatively rebut this prima facie case against them or lose. There do not appear to be facts sufficient to accomplish this.

**Part b.**

The limited partnership, the general partners, and Lawler are all jointly liable for the debts of Claws Productions.

Claws Productions limited partnership is liable and must satisfy the judgment to the extent it has assets. Harper, Von Hinden, and Graham are liable for the unpaid debts of the limited partnership. An interesting problem posed by the fact situation is Lawler's liability. The general rule, in fact the very basis for the existence of the limited partnership, is that the limited partner is not liable beyond its capital contribution. However, a notable exception contained in section 7 of the Uniform Limited Partnership Act applies to the facts presented here:

A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.

The statutory language covers the facts stated. Lawler assumed a managerial role vis à vis the partnership and in the process became liable as a general partner.

**M80**

**Answer 5**

**Part c.**

Whipple's withdrawal from the partnership caused a dissolution. The Uniform Partnership Act provides that the dissolution of a partnership is the change in the

relation of the partners caused by any partner's ceasing to be associated in carrying on the business. Furthermore, the dissolution was in contravention of the partnership agreement, which provided an irrevocable term of five years. Whipple resigned after two years.

There are several consequences of such wrongful conduct. First, with respect to Whipple, who caused the dissolution wrongfully, the other partners have the right to damages for breach of the agreement. These may be charged against him in an accounting or by an action at law. In addition, if the partners who have not caused the dissolution desire to continue the business in the same name, they may do so during the agreed term of the partnership. In doing so, they may possess the partnership property, provided they secure a bond approved by the court or pay to the partner who caused the dissolution wrongfully, the value of his interest in the partnership, less damages and indemnify him for all present and future liabilities.

The partnership cannot sue in the partnership name according to the common law rule, since it is not a legal entity. A growing number of states (some thirteen) have changed this rule, but the Uniform Partnership Act is silent on the point.

The final action that could be taken by the partners is to seek to recover for damages caused as a result of Whipple's establishing his own business in competition with the partnership and to seek some form of injunctive relief in equity that wholly or partly precludes him from competing for the remainder of the five years.

**Part d.**

1. The limited partners would have a common-law right to sue the general partners for damages based upon their negligence or breach of fiduciary duty. They can seek an accounting and raise these claims in that proceeding.

2. Yes. The Securities Act of 1933 applies to the offering and sale of the limited partnership interests, which are treated as "securities" within the meaning of the act. The failure to register at all violates the act and gives an absolute right of rescission to the investors. Additionally, the promoter's representations may have contained material misstatements of fact, in violation of the Securities Act of 1933 and Securities Exchange Act of 1934. For these violations, either damages or restitution may be available.

3. The 1976 Tax Reform Act significantly limited the availability of loss deductions generated by limited partnerships beyond the amount of the limited partner's contribution and any additional liability upon which he was personally obligated. The Internal Revenue Code accomplished this by enacting an "at-risk" limitation on the limited partner's deductions. Normally, this will equal his contribution, which becomes his basis and does not include the liabilities incurred by the partnership. In the absence of special circumstances, the maximum loss available for income tax purposes in this fact situation would be \$2,000 per limited partnership interest purchased.

**M79**

**Answer 4** (12 points)

**Part a.**

1. Yes. Although no filing of the partnership agreement is required, virtually all states have statutes that require registration of fictitious or assumed names used in trade or business. The purpose of such statutes is to disclose the real parties in interest to creditors and those doing business with the company. This is typically accomplished by filing in the proper office of public records the names and addresses of the parties doing business under an assumed name. The statutes vary greatly in detail (e.g., some states require newspaper publication)

2. The facts indicate a clear breach of fiduciary duty by Grundig. Section 21 of the Uniform Partnership Act holds every partner accountable as a fiduciary. It provides that "every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of other partners from any transactions connected with the . . . conduct . . . of the partnership or from any use by him of its property." Grundig's conduct is squarely within the act's language. Section 22 of the act gives any partner a right to a formal accounting of partnership affairs if there is a breach of fiduciary duty by a fellow partner.

Section 32(c) and (d) of the act provides for a dissolution by court decree upon application of a partner whenever—

- A partner has been guilty of conduct that tends to prejudicially affect the business.
- A partner willfully or persistently commits a breach of the partnership agreement or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him.

Certainly Grundig's conduct would appear to fall within one or both of the above categories. He breached his fiduciary duty, was dishonest with his fellow partners, was in fact stealing from his partners, and may have involved the partnership in illegal price discrimination. Thus, the grant of application for dissolution would be appropriate.

3. Probably yes. Section 38(2)(b) of the Uniform Partnership Act relating to the right to continue the business in the same firm name, under the circumstances described, is narrowly drawn. This provision was designed to cover situations where partnerships have fixed durations and one of the partners has caused a dissolution wrongfully "in contravention of the partnership agreement." The facts indicate that Big M Associates did have a fixed duration (10 years); consequently, this requirement is met. While the acts by Grundig are not in contravention of any specific express language of the partnership agreement, as would be the case where a partner wrongfully withdraws, the courts treat other types of wrongful conduct to be in contravention of the partnership agreement and, thus, to be the basis for

dissolution. Strom and Lane could obtain the right to continue to use the firm name for the duration of the partnership agreement if Grundig's conduct was deemed both wrongful and in contravention of the agreement.

**Part b.**

1. No. Since the facts clearly indicate that Palmer is not bankrupt, his financial problems will not precipitate a dissolution of the partnership. However, if Palmer were bankrupt, the Uniform Partnership Act (Sec. 31(5)) specifically provides that the bankruptcy of one of the partners causes a dissolution. The fact that creditors take action against a delinquent partner's interest in the partnership, although annoying and inconvenient, does not result in a dissolution.

2. Aggressive will have no rights to the partnership property either directly or indirectly by asserting Palmer's rights. In fact, Palmer only has the right to the use of partnership property for partnership purposes. Since partnership property is insulated from attack by Aggressive, Aggressive will assert its rights against Palmer's partnership interest. The method used to reach this interest is to reduce its claim against Palmer to a judgment and then obtain from the court a "charging order" to enable Aggressive to collect on the judgment. In effect Aggressive has obtained a right comparable to a lienholder against Palmer's interest in the partnership. The "charging order" would provide Aggressive with the right to payments (earnings or capital distributions) that would ordinarily go to Palmer, the partner-debtor.

3. Yes. There is nothing in the Uniform Partnership Act that prevents a partner from assigning all or part of his interest in a partnership. The assignment may be outright or for the more common purpose of securing a loan. If there is to be any such restriction on a partner's right to assign his partnership interest, the partnership agreement must so provide. Section 27 of the Uniform Partnership Act specifically provides that a partner's assignment of his partnership interest does not cause a dissolution. The act limits such an assignment to the partner's right to share in profits and capital distributions but does not make the assignee a partner.

### **C. Corporations**

**M83**

**Answer 4** (10 points)

The action to compel reinstatement of prior dividends would fail. The declaration of dividends is a matter within the discretion of the board of directors. There are very few instances in which the board's discretion will be disturbed, and the facts of this problem are not within any of them unless Cox can prove the fraudulent purpose of the board, which she asserts.

The predominant rule gives a corporation the right to acquire its own shares. Such purchases may be made



only to the extent of unreserved and unrestricted earned surplus. Capital surplus may be used only if the articles of incorporation so provide or if there is an affirmative majority vote by shareholders. The law and the facts indicate that in all probability there was no problem from the standpoint of the proper source of funds. With respect to the sale below par value there is no requirement to sell treasury shares at par value. The corporation laws require only that newly issued shares be sold at or above par value.

Cox's action to demand repayment of the salary increases would fail. The board of directors has broad discretionary power to fix salaries of officers, even if the officers also are members of the board. The courts have supported the board's determination of salary unless the amounts are grossly unreasonable. A 10 percent per year raise and the fact that the salaries are within the upper one-third of those paid by other similar corporations do not suggest salaries that would likely be found unreasonable and a waste of corporate assets.

Cox's action for dissolution would fail. The courts have power to dissolve a corporation in an action by a shareholder when the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock. To obtain a court-ordered dissolution Cox must also prove that irreparable injury to the corporation is being suffered or is threatened. None of these facts are present. The fact that there is bitterness and animosity does not constitute a deadlock of the management. The corporation is continuing to increase its earnings at a 10 percent year rate. Courts are loath to grant an order for an involuntary dissolution even if there is a serious deadlock, provided the corporation continues to be a viable economic entity.

**N82**

**Answer 3**

**Part a.**

Yes. The shareholders will succeed. Directors and officers are fiduciaries and consequently must exercise the utmost good faith in respect of their corporation. If a "corporate opportunity" arises, they are required to offer the opportunity to the corporation. Generally a corporate opportunity will be found to exist if

- a director or officer becomes aware of the opportunity in his corporate capacity, or
- the opportunity relates to the business of the corporation.

The facts clearly indicate that such a corporate opportunity did exist, and thus the new yogurt opportunity should have been offered to Billings in the first instance. As a fiduciary, such an offer was necessary prior to exploitation of the opportunity by Harrelson. Moreover, Harrelson's use of corporate credit and personnel was a further violation of his fiduciary obligation. Accordingly, Billings' shareholders will prevail in their action. The remedy will include the holding of the

Wexler stock in constructive trust for Billings, as well as possible damages against Harrelson for his personal use of corporate employees and credit.

**N80**

**Answer 2**

**Part a.**

No. The stock in question was noncumulative preferred. The relationship of the preferred shareholders to the corporation is essentially contractual and the stock certificate is, in fact, the contract. The contract agreed to by the owners of this preferred stock was essentially that if the board of directors passed over the declaration of the preferred dividend in a given year or years, it would not accumulate but would be lost. Whether or not to declare a dividend is within the discretion of the board. Its judgment is not over-ridden by the courts unless there is dishonesty or a clear abuse of discretion. The fact that there were earnings sufficient to pay preferred dividends after 1973, that the funds were not actually expended for purchase of physical plant or property, or that the earnings were not being accumulated for the purpose of expansion are not sufficient to persuade a court to grant the injunction. Although the board was pessimistic and conservative, that would not be an abuse of their discretion. The Model Business Corporation Act states that "the board of directors of a corporation may, from time to time, declare . . . dividends," thus retaining discretion in the board regarding dividend declaration. In conclusion, the law respects the business judgment of directors in determining whether to declare dividends. The board is afforded wide discretion in such matters, and, unless there is an abuse of such discretion, a court will not interfere with its judgment.

**N79**

**Answer 2 (16 points)**

**Part a.**

The stated capital on May 16, 1979, is \$105,000. It consists of \$1 per share allocated to stated capital by action of the board for the no-par voting common stock ( $\$1 \times 5,000 \text{ shares} = \$5,000$ ) and the \$100 per share par value attributable to the preferred stock ( $\$100 \times 1,000 \text{ shares} = \$100,000$ ).

The Model Business Corporation Act allows the issuance and sale of no-par stock and provides for allocation of any portion of the consideration received to the capital surplus account. The amount not allocated to capital surplus account is stated capital. This allocation must be made within 60 days or the entire amount received becomes a part of the stated capital. The bonds are debt and do not enter into the stated capital computation. The Model Business Corporation Act states the following:

In case of the issuance by a corporation of shares having a par value, the consideration received therefor shall constitute stated capital to the extent of the par

value of such shares, and the excess, if any, of such consideration shall constitute capital surplus.

In case of the issuance by a corporation of shares without par value, the entire consideration received therefor shall constitute stated capital unless the corporation shall determine as provided in this section that only a part thereof shall be stated capital. Within a period of sixty days after the issuance of any shares without par value, the board of directors may allocate to capital surplus any portion of the consideration received for the issuance of such shares.

**Part b.**

1. The payment of a dividend partially out of treasury stock and partially in cash poses a few problems. There are few restrictions, limitations, or requirements regarding the use of treasury stock as a dividend. The general requirements, that the board may not declare a dividend when the corporation is insolvent or where the dividend will render it such, are not a barrier here. The facts do not indicate a restriction in the articles of incorporation; therefore, the partial treasury stock dividend may be paid. Stated capital is not affected in any way, and the Model Business Corporation Act merely indicates that dividends may be declared and paid in a corporation's own treasury shares. The 40 percent cash dividend is subject to the foregoing solvency and restriction requirements. In addition, a cash dividend may be declared and paid only out of the unreserved and unrestricted earned surplus of the corporation.

A corporation may declare and pay a stock dividend in its authorized and unissued shares out of any unreserved and unrestricted surplus. When the share dividend has a par value, such shares must be issued at not less than their par value and, at the time such dividend is paid, an amount of surplus equal to the aggregate par value of the shares to be issued as a dividend must be transferred to stated capital.

The act allows a split-up or division of the issued shares of any class into a greater number of the same class without increasing the stated capital of the corporation. This is not to be construed as a share dividend within the meaning of the act. The effect of a share split is to increase the number of shares without changing the stated capital and to allocate the par equally among the increased number of shares issued and outstanding after the share split. However, because the par value of the shares must be reduced, the articles of incorporation must be amended by vote of the shareholders.

2. The Internal Revenue Code exemption from taxation of stock dividends and stock splits would apply to the foregoing situations; there are exceptions to this favorable treatment, but none would appear germane based upon the particular facts stated. However, the shareholder must allocate basis (typically cost) for the shares originally owned to the total number of shares owned after the stock dividend or split. To the extent that the payment is out of earnings and profits, the only

taxable dividend would be the 40 percent payment in cash. Such income is ordinary income subject to an 85 percent dividend exclusion to a corporate shareholder or a \$100 dividend exclusion to a noncorporate shareholder.

3. The Internal Revenue Code contains a provision aimed at the unreasonable accumulation of earnings and profits. There is a \$150,000 credit against the amounts permitted to be accumulated. Accumulations must be retained only for the reasonable needs of the business. Where little or no dividends are paid by a corporation there is always the danger that the accumulations may be wholly or partly unreasonable. It would not appear that the accumulations provisions pose a significant danger here in light of the ambitious expansion plans that would normally constitute a *bona fide* business purpose.

**Part c.**

Sky's payments were proper. The Model Business Corporation Act provides for the indemnification of officers and directors in various situations. Specifically included are cases in which a person is a party to a criminal action by reason of the fact that he was serving as an officer at the request of the corporation. The act provides as follows:

To the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) or (b) [which includes criminal actions], or in defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith.

Thus, Masterson is not required to return to the corporation the \$50,000 advanced on his behalf and is entitled to indemnification for the remaining \$200,000.

**M79**

**Answer 3 (14 points)**

**Part a.**

1. Yes. The Model Business Corporation Act authorizes the declaration and payment of dividends in cash, property, or the shares of the corporation as long as the corporation is not insolvent and would not be rendered insolvent by the dividend payment. The act limits the payment of dividends in cash or property to the unreserved and unrestricted earned surplus of the corporation. Decimile meets this requirement since it has retained earnings of \$17 per share. Thus, payment of the dividend in the shares of Integrated is permitted.

2. Yes. The Model Business Corporation Act permits dividends to be declared and paid in the shares of the corporation. However, where the dividend is paid in its authorized but unissued shares, the payment must

be out of unreserved and unrestricted surplus. Furthermore, when the shares paid as a dividend have a par value, they must be issued at not less than par value. Concurrent with the dividend payment, an amount of surplus equal to the aggregate par value of the shares issued as a dividend must be transferred to stated capital.

3. (a) If the shares of Integrated stock are paid as a dividend to the noncorporate shareholders, the shareholders must include the fair market value of the Integrated shares as dividend income received. Such income is ordinary income subject to a \$100 dividend exclusion. The recipient taxpayer will have as a tax basis for the Integrated shares an amount equal to the fair market value of the stock received.

(b) If the shares of Decimile stock are paid as a dividend, the recipient taxpayer is not subject to tax upon receipt of the shares. Internal Revenue Code Section 305 provides that such stock dividends are not taxable. However, the recipient must allocate his basis (typically his cost) for the shares he originally owned to the total number he owned after the distribution.

#### Part b.

The Model Business Corporation Act specifically deals with loans to employees and directors. If the loan is not for the benefit of the corporation, then such a loan must be authorized by the shareholders. However, the board of directors may authorize loans to employees when and if the board decides that such loan or assistance may benefit the corporation. It would appear that the loan was made for the benefit of the corporation so the latter rule applies. However, the chairman's individual authorization clearly does not meet these statutory requirements and could subject him to personal liability.

Therefore, a meeting of the board should be called to consider the ratification or recall of the loan.

#### Part c.

1. The Model Business Corporation Act allows such transactions between a corporation and one or more of its directors or another corporation in which the director has a financial interest. The transaction is neither void nor voidable even though the director is present at the board meeting which authorized the transaction or because his vote is counted for such purpose if—

- The fact of such relationship or interest is disclosed or known to the board of directors or committee that authorizes, approves, or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; *or*
- The fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve, or ratify such contract or transaction by vote or written consent; *or*
- The contract or transaction is fair and reasonable to the corporation. Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof that authorizes, approves, or ratifies such contract or transaction.

2. A \$50,000 payment to Towne would be a violation of his fiduciary duty to the corporation. In addition, it might be illegal depending upon the criminal law of the jurisdiction. In any case he would be obligated to return the amount to the corporation. Furthermore, the payment would constitute grounds for permitting Toy to treat the transaction as voidable.

### III. Contracts

N83

#### Answer 4 (10 points)

Bar's lawsuit against Cole will be based upon the intentional tort of wrongful interference with a contractual relationship. The primary requirement for this cause of action is a valid contractual relationship with which the defendant knowingly interferes. This requirement is met in the case of Cole. The contract is not required to be in writing since it is for exactly a year from the time of its making and is therefore valid even though oral. Cole's knowledge of the contract is obvious. The principal problem, however, is damages. Since Bar was the first to successfully market the product, it would appear that damages are not present. It is possible there were actual damages incurred by Bar; for example, it hired another consulting firm at an increased price. It also might be possible that some courts would permit the recovery of punitive damages since this is an intentional tort.

Bar's cause of action against Abel would be for breach of contract. Once again, damages would appear to be a serious problem. Furthermore, punitive damages would rarely be available in a contract action. Finally, Bar cannot recover the same damages twice. Hence, if it proceeds against Cole and recovers damages caused by Abel's breach of contract, it will not be able to recover a second time.

Abel's lawsuit against Cole will be based upon fraud and breach of contract. There were fraudulent statements made by Cole with the requisite intent and possibly to Abel's detriment. The breach of contract by Cole is obvious. However, the contract that Cole induced Abel to enter into and which it subsequently breached was an illegal contract, that is, one calling for the commission of a tort. Therefore, both parties are likely to be treated as wrongdoers and Abel will be denied recovery.

**M82**

**Answer 4** (10 points)

**Part a.**

1. Craig owes nothing beyond the terms of the original contract. The fact situation poses a classic example of a preexisting legal duty. The common law rule applicable to such situations is to deny recovery for any additional amount promised if the promisee does nothing more than he was obligated to do in any event. This resolution is arrived at by finding that there is no new consideration to support the modification of the original contract. It may be helpful to think in terms of two contracts, the original contract and the modification. The use of the identical consideration present in the first contract is not legal consideration for the second contract. Some jurisdictions have attempted to mitigate the harshness of this result either by statutory provision or by a strained judicial construction of the rule by the courts. The major change has occurred by the adoption of the Uniform Commercial Code throughout the United States, but the code applies only to contracts relating to personal property.

2. Yes. The drafters of Article 2 (Sales) of the Uniform Commercial Code considered the preexisting legal duty rule to be unreasonable when applied to commercial transactions involving the purchase or sale of goods. The rule had the effect of defeating the reasonable expectations of businessmen. Code section 2-209 rejects the preexisting legal duty rule by providing as follows: "An agreement modifying a contract within this article needs no consideration to be binding." The code also provides that if the contract as modified is within the provision of the statute of frauds, the modification must be in writing. Since the modification needs no consideration and it is contained in a writing signed by the party to be charged, thus satisfying the statute of frauds, it is binding.

**Part b.**

Ogilvie's first asserted defense is not valid. Although there was much in Ogilvie's representations that was opinion and/or praise of the land, there were two statements of fact. One, that the land in question was virtually all splendid farmland and two, that it would be suitable for avocado growing. Neither turned out to be true. Thus, part of the first requirement for establishing fraud—a misstatement of fact—is present.

Second, Ogilvie's misstatement of fact was material to the transaction—25 percent of the land is not usable for avocado growing and has only limited utility as farmland. A substantial decrease in utility and value must be categorized as material.

Third, Ogilvie's statement that he had not lied is no defense. Although he had some basis for making a statement about the quality of the land in general, he had no basis for making the statements he made. Even if he was not aware of the facts and cannot be said to have intentionally misstated the facts, he nevertheless

manifested a reckless disregard for the truth. The scienter requirement was satisfied when he made positive statements of fact without any knowledge of their truth or falsity.

The final defense asserted is based upon the reliance requirement necessary to establish fraud. Ogilvie argued that Farber's failure to inspect the land when the opportunity was available results in a bar to recovery. However, although Farber's conduct may be categorized as negligent, such conduct does not normally allow the intentional tort-feasor to escape liability. Furthermore, to allow such a defense to prevail in general would have the potential of causing and fostering fraud, particularly on the unsophisticated investor.

**N80**

**Answer 5** (10 points)

**Part a.**

Orange County Bank will prevail. The fact situation poses a classic illustration of a withdrawal of an offer to enter into a unilateral contract. The bank's offer to Fennimore called for the performance of an act (the actual paying of the mortgage), not a promise to pay it, as the means of acceptance. The language in the offer is clear and unambiguous, providing a 5 percent discount on a mortgage if the mortgagor would pay the entire mortgage in cash or by certified check by July 31, 1980, at the Second Street branch of the bank. Thus, the bank's letter was an offer to enter into a unilateral contract that required the performance of the act as the authorized and exclusive means of acceptance. Fennimore's promise to perform the act was ineffectual in creating a contract. Contract law generally provides that offers may be revoked at any time prior to acceptance; even if the bank revoked its offer the instant before the purported acceptance, it was a timely revocation and the acceptance was too late. The tender of performance would also be of no avail since notice of revocation had been received on the 30th.

In this situation, strict common law rules would deny the creation of a contract. Some states, in recognition of the hardship of such results, have adopted what is known as the *restitution of contracts* rule. This modification of the common law rule in respect to the unilateral contract rule holds that the unilateral promise in an offer calling for an act becomes binding as soon as part of the requested performance actually has been rendered or a proper tender of performance has been made. The courts have required substantial action on the part of the offeree, which does not appear to be present here.

The fact that Fennimore was selling his property and did not disclose the fact that he would have to pay the mortgage off in any event is immaterial. There was no material misrepresentation of fact made by him; hence his action was not fraudulent nor did he misrepresent. He was silent. Additionally, the fact that the bank was using the sale as a reason for terminating the offer was immaterial.

**Part b.**

Hernandez will prevail. An offer is not effective until communicated to the offeree. The same rule applies to counteroffers including a change in the price, as occurred here. Therefore, a counteroffer is not effective until received by Austin, the original offeror. Hernandez's counteroffer does not destroy the offer until it is received. Thus, Hernandez's telegram, which accepted Austin's offer and arrived ahead of Hernandez's letter containing the counteroffer, is effective in creating a binding contract.

This rule applies even if Hernandez had mailed a letter that unequivocally accepted Austin's offer and that would have been effective upon dispatch. The general rule that an acceptance is effective when dispatched is subject to an exception that is designated to prevent entrapment of an offeror who is misled to his disadvantage by an offeree who attempts to take two inconsistent positions. Thus, when an offeree first rejects an offer, then subsequently accepts it, the subsequent acceptance will be considered effective upon dispatch by an authorized means only if it arrives prior to the offeror's receipt of the rejection. If the rejection arrives first, the original offeror may treat the attempted acceptance as a counteroffer which he is free to accept or not. Were this not the rule, an offeror who, upon receipt of a rejection, in good faith changed his position (that is, sold the goods to another customer), could find himself having sold the same goods twice.

**M80**

**Answer 3 (12 points)**

**Parts a. 1 and a. 2**

The general common-law rules require literal performance by a party to a contract. Failure to literally perform constitutes a breach. Since promises are construed to be dependent upon each other, the failure by one party to perform releases the other. However, a strict and literal application of this type of implied condition often results in unfairness and hardship, particularly in cases such as this. Therefore, the courts developed some important exceptions to the literal performance doctrine. The applicable rule is known as the substantial performance doctrine, which applies to construction contracts and is a more specific statement of the material performance rule that applies to contracts other than construction contracts. The general rule holds that if the breach is immaterial, the party who breached may nevertheless recover under the contract, less damages caused by the breach. The substantial performance doctrine requires the builder (party breaching) to prove the following facts.

- a. The defect was not a structural defect.
- b. The breach was relatively minor in relation to the overall performance of the contract. The courts and texts sometimes talk in terms of a 95 percent or better performance.

- c. The breach must be unintentional or, to state it another way, the party breaching must have been acting in good faith.

It would appear that requirements *a* and *b* are clearly satisfied on the basis of the facts. Requirement *c* cannot be determined on the facts given. If Silverwater deliberately (with knowledge) substituted the improper and cheaper tile or sewerage pipes, then it may not be entitled to the benefit of the substantial performance exception. On the other hand, if these breaches were the result of an innocent oversight or mere negligence on its part, recovery should be granted. The recovery must be decreased by the amount of the damages caused by the breach. The substitute of sewer pipe of like quality and value would be considered substantial performance.

**Part b.**

No. The offer for the sale of real property is governed by the common law of contracts.

Anderson's letter constituted an offer that stated it would expire at a given time. In addition to stating the time, the letter indicated that acceptance "must be received in her (Anderson's) office" by said time. This language is clear and unambiguous and effectively negated the rule whereby acceptance may take place upon dispatch. Thus, despite use of the same means of communication, acceptance was not effective until receipt by Anderson on March 2, 1980. This was too late. Thus, the purported acceptance was a mere counteroffer by Heinz and had to be accepted in order to create a contract. Silence does not usually constitute acceptance. In fact, the common-law exceptions to this rule are limited in nature and narrowly construed. The law clearly will not permit a party to unilaterally impose silence upon the other as acceptance. The narrow exceptions are the following:

1. The parties intended silence as acceptance.
2. Prior dealing indicates that silence is an acceptable method of acceptance.
3. The custom of the trade or industry recognizes silence as acceptance.

It is clear that our case is not within any of the exceptions; hence, silence does not constitute acceptance, and there is no contract.

**Part c.**

The sale of the business to Franklin was both an assignment (sale) of all rights and a delegation (assumption) of the duties connected with the business. Consequently, Monash assumes the role of a surety and remains liable to pay the existing debts immediately (for example, the mortgage) upon default by Franklin. The creditor's rights are unaffected. Franklin becomes

the principal debtor and in the relationship between Monash and him, he should pay as he promised her. Although his promise was made to Monash only, the creditors are third-party creditor beneficiaries of that promise. Therefore, they have the standing to sue

Franklin on that promise despite the lack of privity and even though they have given no consideration for Franklin's promise. They may also proceed on the original promise made by Monash upon which she remains liable.

#### IV. Debtor-Creditor Relationships and Consumer Protection

##### A. Bankruptcy

N83

Answer 3

###### Part a.

1. The principal avoiding powers of the trustee are
  - The power to set aside certain statutory liens.
  - The power to set aside preferential transfers.
  - The power to set aside fraudulent conveyances.
  - The power to set aside post-petition transfers.
2. The various claims and assertions would be resolved as follows:
  - The claim for an exemption allowance for the cottage will be disallowed. The Bankruptcy Code provides for one exemption for one's principal residence, not to exceed \$7,500. The home will qualify for this exemption.
  - There is no such rule applicable to business assets as contrasted with personal assets. In fact, there is no distinction between Skidmore and his business, Frock & Fashions. They are one and the same, and all assets will be collected and shared among the creditors without distinction of the source.
  - The Bankruptcy Code makes it clear that such conduct would not result in a denial of the discharge of the bankrupt. It will, however, result in the denial of that particular debt from discharge in bankruptcy. Thus, Walton's claim will survive the bankruptcy proceeding.
  - A bona fide secured creditor is entitled to the collateral or its monetary equivalent. If this is insufficient to satisfy the loan, the secured creditor has the status of a general creditor for the balance. The priorities section of the Bankruptcy Code provides for no such priority as claimed by Harper.

N81

Answer 4

###### Part a.

1. Under the Bankruptcy Reform Act of 1978, an involuntary petition may be filed by three or more cred-

itors having claims aggregating \$5,000 more than the value of any liens securing the claims. In the event there are fewer than 12 creditors, one or more creditors with claims of \$5,000 or more can file. The facts indicate that Barry has \$12,500 in overdue debts. It would appear likely that these requirements could be met and an involuntary petition could be validly filed. The act permits the involuntary debtor to file an answer to the petition.

2. No. Under the 1978 act, the principal defense available to an involuntary debtor would still be solvency. However, the defense of solvency in the bankruptcy sense (essentially a balance sheet approach) has been rejected when an involuntary liquidation is sought. Instead, the act has adopted a modified or expanded version of insolvency in the equity sense. A debtor is insolvent if he is generally not paying debts as they become due. In addition, a debtor is insolvent if within 120 days before the date of the filing of the petition a custodian was appointed or took possession of the debtor's property. Barry, of course, appears to be squarely within the scope of the first part of this test. Realistically, he could not hope to have the petition dismissed on the grounds of solvency.

N80

Answer 3

###### Part b.

1. No. The Bankruptcy Reform Act of 1978 has not only modified the requirements for establishing a voidable preference, it has also specified transactions that do not constitute preferences. One such transaction is the creditor's taking a security interest in property acquired by the debtor as a contemporaneous exchange for new value given to the debtor to enable him to acquire such property (a purchase money security interest). The security interest must be perfected (filed) within 10 days after attachment. The act is in harmony with the secured transactions provisions of the Uniform Commercial Code. Thus, One-Up has a valid security interest in the machinery it sold to Essex.

2. The Bankruptcy Reform Act of 1978 does not require that the creditor have knowledge or reasonable cause to believe the debtor is insolvent in the bankruptcy sense. Instead, under the act, where such in-

solvency exists on or within ninety days before the filing of the petition, knowledge of insolvency by the transferee need not be established. The act also assumes that the debtor's insolvency is presumed if the transfer alleged to be preferential is made within 90 days. Finally, the time period in which transfers may be set aside is 90 days unless the transferee is an "insider." If the transfer is to an insider, the trustee may avoid transfers made within one year prior to the filing of the petition. Thus, the trustee may avoid as preferential any transfer of property of the debtor that is

- To or for the benefit of a creditor.
- For or on account of an antecedent debt owed by the debtor before such transfer was made.
- Made while the debtor was insolvent in the bankruptcy sense (however, if the transfer is made within 90 days, the debtor's insolvency is presumed).
- Made on or within 90 days of the filing of the petition (or if made after the 90 days but within one year prior to the date of the filing of the petition and the transfer was to an "insider," it may be set aside if the transferee had reasonable cause to believe the debtor was insolvent at the time of the transfer).
- Such that it enables the creditor to receive more than he would if it were a straight liquidation proceeding.

The bankruptcy act contains a lengthy definition of the term "insider" that includes common relationships that the transferee has to the debtor, which, in case of an individual debtor, could be certain relatives, a partnership in which he is a general partner, his fellow general partners, or a corporation controlled by him.

## B. Suretyship

**N83**

**Answer 3**

### Part b.

Grant is incorrect in his first three assertions and correct in connection with his fourth assertion for the following reasons:

- The law is clear regarding the right to collateral and its effect between the creditor and the surety. The creditor has the right to resort to any available collateral. Resort to the collateral by the creditor in no way affects the creditor's right to proceed against a surety or sureties for the balance.
- A creditor may choose to sue one or more of the sureties without impairing his rights against those not sued. Similarly, he has the right to sue one surety if he wishes, and such a choice does not release the surety who was not sued insofar as the rights of his fellow surety to seek contribution. Suing one but not all of the sureties does not constitute a release by the creditor.
- All of the defenses asserted in the fact situation are invalid. Grant is a cosurety since he is answering for the same debt as Victory, and there is a right of

contribution which Victory may assert against Grant.

- Since Grant's surety undertaking was one-third of the combined surety undertakings, he is liable for \$2,666.67 only and not the full \$4,000.

**N80**

**Answer 3**

### Part a.

The first two defenses asserted by Merriweather are invalid. The third defense is partially valid.

Consideration on Hardaway's part consisted of foregoing the right to call the Superior Metals loan. The fact that the loan was already outstanding is irrelevant. By permitting the loan to remain outstanding for an additional year instead of calling it, Hardaway relinquished a legal right, which is adequate consideration for Merriweather's surety promise. Consideration need not pass to the surety; in fact, it usually primarily benefits the principal debtor.

There is no requirement that the creditor first proceed against the debtor before it can proceed against the surety, unless the surety undertaking expressly provides such a condition. Basic to the usual surety undertaking is the right of the creditor to proceed immediately against the surety. Essentially, that is the reason for the surety.

Hardaway's release of the commercial surety from its \$400,000 surety undertaking partially released Merriweather. The release had the legal effect of impairing Merriweather's right of contribution against its cosurety (the commercial surety). Thus, Merriweather is released to the extent of  $\frac{1}{3}$  (\$400,000 (commercial surety's guarantee)/\$1,200,000 (the aggregate of the cosureties' guarantees)) of the principal amount (\$800,000), or \$266,667.

**N79**

**Answer 4** (10 points)

### Part a.

King Surety Company will prevail. The creditor (Allie), without King's consent, has modified the surety contract. Under these circumstances, a noncompensated surety would be discharged without question; however, a compensated surety is not discharged completely unless the modification materially increases the risk. If the risk is not materially increased, the obligation is decreased to the extent of the loss. In this case, there was a material increase in the risk. First, there is nothing to indicate that the monies released by Allie were committed by Rapid to the particular project (Allie's department store) because Rapid had several simultaneous projects. Moreover, it is clear that the monies withheld provided a strong inducement for a builder such as Rapid to complete the undertaking since the expected final payment would have been large in relation to the final outlays to complete construction. Finally, the withheld payments reduced the exposure of the surety to the extent of 20 percent.

**Part b.**

Barclay is, of course, entitled to reimbursement from Gilmore. However, since Gilmore is bankrupt, Barclay will receive the same percentage on the dollar as will all other general creditors of Gilmore's estate. However, Barclay is subrogated to the rights of the materialmen and laborers it has satisfied. Specifically, it would have the right to assert the liens and security interest of the materialmen. Furthermore, wage earners are entitled to a limited priority in a bankruptcy proceeding, which Barclay could assert.

**C. Bulk Transfers**

**N81**

**Answer 5**

**Part a.**

1. The transaction is a bulk sale as described in article 6, Bulk Transfers, of the Uniform Commercial Code, because the seller's entire inventory is being sold in other than the ordinary course of business.
2. The Uniform Commercial Code provides that the

following procedures must be followed for a bulk transfer to be valid and effective against any creditor:

- The transferee (bulk purchaser) must require the transferor to furnish a list of his existing creditors and amounts due.
- The parties must prepare a schedule of the property transferred sufficient to identify it.
- At least 10 days prior to taking possession or paying for the goods, the transferee must give notice to the creditors.

The bulk sale provisions are aimed at preventing two types of wrongful sales by a dishonest, financially distressed merchant. The merchant either sells in bulk at unrealistically low prices to a favored buyer and his creditors receive very little, or he sells and disappears with the proceeds.

3. Yes, with respect to the inventory; no, with respect to the list of creditors. A full and accurate description of the inventory is the responsibility of the parties; hence, the examination of the seller's inventory schedules was required. The preparation of the list of creditors is exclusively the responsibility of the bulk transferor. The purchaser is not required to incur the cost to verify the accuracy of the list of creditors and has the right to rely upon it unless he knows otherwise.

**V. Government Regulation of Business**

**B. Antitrust Law**

**M83**

**Answer 3**

**Part a.**

1. Since Higgins has two different discount structures, there is a *prima facie* price discrimination case. In order to prevail in such a case the seller may affirmatively prove cost justification as a defense as provided in the Robinson-Patman Act. Although, in general, quantity discounts may be granted based on amounts purchased, a manufacturer must grant these discounts on the basis of reasonably drawn classes. The company need not prove actual cost savings resulting from purchases made by each member of the class. However, the costs of the sales to the buyers must be of sufficient homogeneity. This means that the costs incurred in selling to members of a particular class must be very similar, i.e., there must be a rational and persuasive basis for the determination of the class. Higgins has established two classes, chain stores and independent grocers. In order for Higgins to establish the cost reductions, it might look to manufacturing, sales, delivery, collection, and accounting costs. The defense of cost justification requires precise accounting data and historically has not met with much success in the courts.

2. One of the elements set forth in this action is that the sales relate to commodities of "like grade and quality." The test here is that the commodities affected must either be physically identical or so physically similar that the commercial value of the commodities is not significantly different. Thus, the phrase "like grade and quality" relates exclusively to the physical characteristics of the commodity. In this case, the fact that some of the sales were under Higgins's brand name and some under a "private label" would not affect the outcome.

**N82**

**Answer 4**

**Part a.**

No. The question of the status of franchised dealerships containing territorial restrictions on where the franchised dealer may sell has appeared before the Supreme Court twice in recent times. Despite its utility and widespread use as a marketing device for manufacturers, it had previously been held to be illegal *per se* if title to the goods had passed to the buyer, as in this fact situation.

The Supreme Court subsequently overruled its prior decision and held that vertical territorial marketing restrictions are to be tested in accordance with their economic effect. The Court believed that such restric-



tions do not always lack any redeeming value, since they may actually promote interbrand competition. Accordingly, it overruled the *per se* rule and held that a rule-of-reason standard is applicable.

**N80**

**Answer 2**

**Part b.**

1. Yes. Marvel's price discrimination is a violation of the Robinson-Patman Act, and the defense of "meeting competition" is not available. The price discrimination involved is at the buyer level, a secondary-line price discrimination. That is, it was a price discrimination among various customers (the retail gas stations) of the manufacturer or producer (Marvel) that enables the customer receiving the lower price to undersell its competitors. Marvel's selling to Banner at 1.7¢ less than it sold to its other service stations is squarely within the proscribed conduct. Where there is such a secondary-line price discrimination, the requirement of "injury to competition" is met if there is a reasonable possibility that competition will be adversely affected. Here, the decreased sales and loss of customers by the other stations would satisfy such a requirement, and thus, there is a *prima facie* Robinson-Patman violation.

2. Marvel's chief defense would be that it had reduced its prices to meet the lower prices of a competitor. However, the facts indicate that Marvel and Best by Test did not compete since Best was not a supplier. The price reduction being met must be that of a competitor of the firm cutting its price, not a competitor of a purchaser of that firm. Thus, the good faith "meeting competition" defense is not available.

#### **D. Federal Securities Acts**

**M83**

**Answer 3**

**Part b.**

West will prevail. The failure to include information concerning the unfavorable contracts is a violation of section 14(a) of the Securities Exchange Act of 1934, which applies to the proxy material of companies whose securities are traded on a national securities exchange.

A violation of section 14 gives rise to an implied right of action by aggrieved shareholders if the omitted or erroneous information is "material." The Supreme Court has defined the word material as meaning "likely to affect the vote of a shareholder on the proposed action." Here, the information is clearly material to the vote of the Jones shareholders.

The possible remedy for violation of section 14 is within the court's discretion and includes damages or injunctive relief. In the case of a merger that has not been consummated, a court would likely set aside the vote and require resolicitation of the proxy material.

**N82**

**Answer 4**

**Part b.**

1. No. The Model Business Corporation Act provides that any person who has held stock for at least six months or owns at least 5 percent of the stock has the right to examine and make extracts of the list of shareholders for any proper purpose. Proper purpose includes ousting the existing management. Since Powell owns 5 percent of the stock, it qualifies under this provision. If Baron refuses such access, Baron is liable to Powell for a penalty of 10 percent of the value of the stock held by Powell in addition to any other damages or remedy afforded by law.

2. Baron, having a class of securities regulated under the act, must either provide a list of shareholders or mail the proxy materials of the insurgents to the corporation's shareholders. The expense of this mailing must be assumed by the insurgents.

3. Pursuant to the rules and regulations promulgated under section 14 of the Securities Exchange Act of 1934, The SEC has required that

- Proxy material must disclose all material facts on matters to be voted upon in order to enable shareholders to vote intelligently.
- Where control is at issue, names and interests of all participants must be disclosed.
- The proposed proxy material must be submitted for advance review by the SEC.
- Proxy materials must be distributed to the shareholders of record.

**M82**

**Answer 2 (10 points)**

The impact of the registration requirements of the Securities Act of 1933 on each of the proposals is as follows:

- The offering of the participation units in the citrus groves, although ostensibly the sale of an interest in land, constitutes an offer to sell, or the sale of, securities within the meaning of section 2 of the Securities Act of 1933. Although land itself is not a security, the offering of the land in conjunction with a management contract has been held to constitute the offering of a security. Since interstate commerce and communications are to be used and since there is no apparent transactional exemption available, a registration under the 1933 act is required. Whatever hope there was of an intrastate offering exclusion is dashed by the fact that the units will be offered and sold in two states.
- The short-term borrowings evidenced by the promissory notes of Various Enterprises are exempt from registration. This exemption from categorization as a security for purposes of registration under the act applies to commercial paper such as notes, drafts, checks, and similar paper arising out of a current

transaction that have a maturity not exceeding nine months. In addition, the private placement exemption is applicable.

- If Various is deemed to be a controlling person insofar as Resistance is concerned, it must register the securities in question before it can legally sell them. The Securities Act of 1933 provides in connection with its definition of the term “underwriter,” that, “the term ‘issuer’ shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.”

Securities Act rule 405(f) further defines the term “control.” It states that “the term ‘control’ . . . means the possession, direct or indirect, of the power to direct or cause the direction of the policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” It is obvious that “control” as defined is a question of fact. In general, a controlling person has the power to influence the management and policies of the issuer. If an individual is an officer, director, or member of the executive committee, a low percentage of stock would suffice. Actual or practical control is sufficient and the power to exercise control will also be sufficient even if it is not exercised. Stock ownership is looked to and majority ownership naturally constitutes control. Although ownership of 17 percent of the stock is certainly not conclusive, it is a substantial block of stock and, if any of the above factors is also present, it would be most likely that Various would be a controlling person. Thus, although not the issuer of the stock, it would need to register the securities. This resembles a secondary offering of a large block by the owners of the corporation. This sale through the brokers will in no way insulate the transaction from registration.

#### N81

#### Answer 2 (10 points)

##### Part a.

1. The Securities and Exchange Commission has ruled that a merger such as this one constitutes a “sale.” Therefore, this merger must satisfy the requirements of the Securities Act of 1933. Accordingly, absent some possible exemption or exclusion, the securities must be registered and a prospectus must be distributed by Diversified to the Cardinal shareholders.

Also a possible danger, albeit a remote one, is that the merger may violate the provisions of section 7 of the Clayton Act. Although the two corporations do not compete and Cardinal is not a customer of Diversified’s, the act applies not only to vertical or horizontal mergers but also to conglomerate mergers such as this one. The Justice Department’s guidelines should be examined, and if there is any doubt about the validity of the acquisition from an antitrust standpoint, a ruling from the Justice Department should be sought.

2. Since this is to be a statutory merger pursuant to state law, the provisions of the appropriate statute, the Model Business Corporation Act, must be strictly complied with as well as any additional state law requirements. The steps to be followed by Diversified and Cardinal are as follows:

- The representatives of the two corporations must agree on a formal plan of merger. The plan containing the details of the merger must then be submitted to the board of directors in the form of a resolution and be approved by both boards.
- After approval of the plan of merger, the board, by resolution, directs that the plan be submitted to a vote at a meeting of shareholders.
- Due notice of the meeting, including a copy or summary of the plan, should be given to the shareholders. At each corporation’s meeting, a vote of the shareholders must be taken on the proposed plan. The plan or merger must be approved upon the affirmative vote of a majority of the shareholders of each corporation.
- Upon such approval by the respective shareholders, articles of merger are executed by the president or a vice president and the secretary of each corporation and then verified by one of the officers signing. The articles, along with the appropriate fees and taxes, must then be filed with the secretary of state, who will then issue a certificate of merger if the articles conform to law.
- Diversified need not amend its corporate charter to reflect the new class of preferred stock to be used in the merger. The act provides that, “In the case of a merger, the articles of the surviving corporation shall be deemed to be amended to the extent, if any, that changes in the articles of incorporation are stated in the plan of merger.”

##### Part b.

Yes. Problems are posed for Haskell Corporation because it is engaged in the offering and sale of its securities in interstate commerce. Therefore, under the Securities Act of 1933, it must file a registration statement, have it become effective, and supply a prospectus to the employees to whom stock is offered.

A claim of exemption as a private placement would fail for several reasons. First, among a great number of the employees, the quality of the investor’s financial knowledge would undoubtedly be quite low, and their employee relationship to Haskell would likely be such that they would not have access to the kind of information a registration would disclose. These are the very individuals that the act seeks to protect. Second, the number of individuals involved is so large that the offering cannot be considered nonpublic.

If Haskell does not comply with the registration and prospectus requirements, the SEC could obtain an injunction prohibiting such offers and sales. The possibility of damages is also present. In addition, pur-

chasers of the Haskell stock could later seek rescission or damages based on noncompliance with the act's requirements.

**M81**

**Answer 4** (10 points)

**Part a.**

The legal implications of the conduct described can be best described as grave. Massive Manufacturing, Delwood, and its CEO, Feldspar, will all undoubtedly face criminal prosecution as a result of their conduct. Massive Manufacturing also has potential civil liability. The facts reveal clear-cut criminal violations of the Foreign Corrupt Practices Act of 1977.

The Foreign Corrupt Practices Act of 1977 prohibits payments to any foreign official or foreign political party or official thereof to influence the act or decision of that person or party acting in an official capacity. Any issuer convicted of engaging in such illegal conduct is subject to fines not exceeding \$1 million. The act also requires that adequate accounting books and records must be maintained. This broad and somewhat nebulous provision applies to any securities issuer that is subject to registration under section 12 of the Securities Exchange Act of 1934 and that must file reports thereunder. This provision applies to Massive in that its stock is listed on a national exchange. Massive has obviously violated the part of the act stating that an issuer must "make and keep books, records and accounts which in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer." This separate violation is subject to the omnibus criminal and civil sanctions applicable to activities proscribed by the Securities Exchange Act of 1934.

Feldspar and Delwood, acting in their capacities as officers, agents, and/or directors of Massive, are personally subject to the provisions of the Foreign Corrupt Practices Act. If they are convicted of willfully violating the act, each is subject to a fine of not more than \$10,000 or to imprisonment for not more than five years or both.

In addition the SEC may take administrative action against Massive by seeking injunctive relief, which could result in the suspension of trading of Massive's shares.

**Part b.**

1. The Securities Act of 1933 exempts from registration "any security which is part of an issue offered and sold only to persons resident within a single state . . . where the issuer of such security is a corporation incorporated by and doing business within such state." If an offering otherwise qualifies for this exemption, the use of the facilities of interstate commerce is permitted. According to the facts, Marigold could qualify for the intrastate exemption.

However, very strict requirements apply to the offerees and purchasers: They must all be "residents" of the single state in question. Consequently, an offer to one nonresident can nullify the entire exemption. Meticulous care must be taken to ensure that no offers or sales are made to nonresidents, which, from a practical standpoint, may be extremely difficult to ascertain. A further limitation applies to issuers. Since the underlying rationale of the exemption as articulated by the SEC is "to provide for local financing for local industries carried out through local investment," the judicial and administrative interpretations of "doing business" have been strict. Essentially, the SEC has ruled that an issuer is doing business within the state if it derives 80 percent of its revenues from the state, has 80 percent of its assets within the state, intends to use 80 percent of the proceeds from the offering within the state, and has its principal office within the state.

If the above requirements and limitations are not enough, an added requirement regarding resale of the distributed securities must be satisfied. In effect, there must not be a resale of the securities to nonresidents for a period of nine months.

2. Even if an exemption to federal registration is available, state law must be complied with. State securities laws popularly known as "blue sky" laws are not entirely uniform; however, at least a minimum filing generally will be required as well as a clearance to offer and sell the securities within the state.

**M80**

**Answer 2**

**Part b.**

The Securities Act of 1933 permits an aggrieved party to sue various parties connected with the registration statement for an untrue statement of a material fact in the registration statement or the omission of a material fact required to be stated therein or necessary to make the statements therein not misleading. Those having potential liability include issuers of the security, those who signed the registration statement, every director, underwriter, and expert.

Any acquirer of the security may sue unless it is proved that at the time of such acquisition he knew of such untruth or omission.

Since all the directors and signers are also issuers along with the corporation, they may be sued in that capacity, since with the one exception mentioned above, issuers may not avoid liability for untrue statements or omissions. They are insurers of the truth contained in the registration statement; that is, they are liable without fault.

Contrast their liability with that of the accountants and lawyers who are both experts. As such, they are not liable for parts of the registration statement on which they did not render an expert opinion. Moreover, as experts, they have the benefit of the "due diligence"

defense. That is, liability can be avoided if it can be shown by the expert that he had, after reasonable investigation, reasonable ground to believe and did believe at the time such part of the registration statement became effective that the parts for which he gave expert

opinion were true and that there was no omission to state a material fact required to be stated.

The act also provides certain defenses based on the amount of damages and their relationship to the misstatements or omissions.

## VI. Uniform Commercial Code

### A. Commercial Paper

**N83**

**Answer 2**

#### Part b.

1. The instrument in question is a draft and is commonly known as a trade acceptance. Such an instrument arises out of a sales transaction, whereby the seller is authorized to draw upon the purchaser for payment of the goods. Normally, as is the case here, the seller is both the drawer and the payee. The instrument is then presented for the buyer's acceptance.

2. No. The instrument lacks the "magic" words of negotiability on its face. That is, it is not payable to order or bearer but instead payable solely to Hardy & Company. The endorsement on the back of the instrument neither cures the defect nor provides the requisite words of negotiability. Hence, the instrument is not negotiable. The "for value received. . ." does not in any way affect negotiability.

3. No. Melba would be a holder in due course. He took in good faith and gave value even though the value in question is an antecedent indebtedness. The Uniform Commercial Code specifically provides that an antecedent indebtedness is value. Therefore, Melba as a holder in due course takes free of the so-called personal defenses. Breach of warranty and contractual defenses are personal defenses and a holder in due course such as Melba is not subject to them.

**M83**

**Answer 5**

#### Part a.

1. Pine is not a holder in due course because he has knowledge of a defense against the note. However, Pine has the rights of a holder in due course because he acquired the note through Gordon, who was a holder in due course. The rule wherein a transferee, not a holder in due course, acquires the rights of one by taking from a holder in due course is known as the "shelter rule." Through these rights, Pine is entitled to recover the proceeds of the note from Beeler. The defense of fraud in the inducement is a personal defense and not valid against a holder in due course or one with the rights of a holder in due course.

2. As one with the rights of a holder in due course,

Pine is entitled to proceed against any person whose signature appears on the note, provided he gives notice of dishonor. When Dunhill negotiated the note to Gordon, Dunhill's signature on the note made him secondarily liable. As a result, if Pine brings suit against Dunhill, Pine would prevail because of Dunhill's secondary liability.

**M81**

**Answer 2 (10 points)**

#### Part a.

Harrison will prevail, but only to the extent of "value," here \$8,500, given for the negotiable promissory note. The primary issue in the case is the "value" requirement for holding in due course. The facts reveal that Harrison purchased the instrument in good faith, that it was not overdue, and, at the time the negotiation took place, Harrison had no knowledge of the fraudulent circumstances under which the instrument was originally obtained from Oliver. The facts indicate that the note was negotiable and that the negotiation requirement was satisfied.

The Uniform Commercial Code section dealing with "taking for value" provides that a holder, here Harrison, takes for value to the extent that the agreed consideration has been performed. Certainly, the payment of the \$5,000 in cash constitutes value. The code further provides that when a holder gives a negotiable instrument for the instrument received, he has given value. Although this provision is primarily concerned with the giving of one's own negotiable instrument, it is obvious that the negotiation of another's negotiable instrument as payment is value. However, the promise to pay an agreed consideration is not value even though it constitutes consideration.

#### Part b.

1. No. Williams will not prevail. The Uniform Commercial Code imposes upon the depositor the responsibility for reasonable care and promptness in discovering and reporting this unauthorized signature. In any case, the depositor must discover and report his unauthorized signature within one year from the time the items (checks) are made available to him. The latter rule applies irrespective of lack of care on the part of either the bank or depositor. This absolute rule is based in part upon the rationale that, after certain periods of

time have elapsed in respect to commercial transactions, finality is the most important factor to be considered. Thus, after this amount of time has elapsed, existing expectations and relations are not to be altered.

2. No. The bank cannot collect from McCarthy. The Uniform Commercial Code places the burden upon the bank to know at its peril the signature of its drawer. Therefore, when the bank has paid on the forged signature of a depositor, it cannot recover the loss by seeking collection from a party who has received payment in good faith.

3. The first answer (b.1.) would be changed in that the law allows the depositor a three-year period in which to discover the forged signature of the payee or an indorser. Thus, if both the bank and depositor are not negligent (as it would appear from the excellence of the forgery), the loss rests with the bank. However, if it can be shown that the depositor was negligent (for example, he disregarded a notice from the proper party that he had not received payment), the bank will prevail if it was in no way negligent.

The restated circumstances also change the second answer (b.2.). A bank is not deemed to know the signatures of indorsers; therefore, the bank may recover its loss from McCarthy, the party collecting on the item. Section 3-417 of the Uniform Commercial Code provides that a party receiving payment on the instrument warrants to the payor that he has good title to the instrument.

**N79**

**Answer 3** (12 points)

**Part a.**

The first issue to be decided is whether the bank is a holder in due course, which would require that the notes in question be negotiable and that the bank be a holder. When a bank is involved, these requirements usually would be met. The next question is whether the bank took for value and, if so, to what extent. Section 3-303 of the Uniform Commercial Code provides that a holder takes for value to the extent that he acquires a security interest in or a lien on the instrument. A lender taking one or several negotiable instruments as security for a loan becomes a holder in due course to the extent of the amount loaned (and not the face amount as would a holder in due course who purchased notes at a discount). Thus, the bank will not be entitled to recover more than the amounts it advanced. However, this creates a problem based upon the facts in this situation—Does the bank qualify as a holder in due course collectively against all the notes or is it limited to a collection of the amount loaned attributable to each note individually?

There are two assertable defenses—forgery and breach of contract and/or warranty. Additionally, there

are a number of notes against which no defense is applicable. Forgery is a real defense and is valid even against a holder in due course. As to the forged notes, the bank will not be able to collect anything from the purported makers. Breach of contract, or breach of warranty, is only a personal defense and not assertable against a holder in due course. Thus, the bank will recover against the makers of those notes, but the question is to what extent? If each note is considered individually, then the bank can only collect 80 percent on each. If, however, the notes are considered to secure the loan collectively, then the bank will obtain a recovery of the overall amount loaned. This could increase the percentage payable due to the uncollectibility of the forged notes.

**Part b.**

Grover materially altered the instrument within the meaning of Uniform Commercial Code Section 3-407, which provides that a holder in due course, such as Friendly, in all cases may enforce the instrument according to its original tenor. Thus, Friendly would be entitled to recover \$80, the original tenor of the instrument, from Madison.

Friendly is entitled to nothing from State Bank. The bank rightfully dishonored the instrument, but even had it done so wrongfully, Friendly has no relationship to the bank and hence no right to recover from it.

Parker, as a transferor of the instrument by indorsement, gave certain implied warranties, including that the instrument had not been materially altered. This warranty is at the time of transfer and is not a warranty that the instrument will not be subsequently altered, as it was in this case. Although there would appear to be no recourse against Parker under the alteration warranty, in the event of dishonor by the maker, Parker is liable on the instrument according to its tenor (\$80) at the time of indorsement.

There is one possibility for full recovery against Madison; Friendly must assert and prove that Madison was negligent in the way he drafted the instrument and thereby contributed to the alteration.

**Part c.**

No. The instrument is not negotiable. First, it is not payable at a definite time, and second, it is payable only out of the proceeds from the resale of the audio components. This is referred to as the “particular fund doctrine.” Once there has been an initial determination that the instrument is nonnegotiable, it does not matter that the remaining steps for qualification as a holder in due course have been met. The defense is clearly a personal defense, but because Wilmont is a mere transferee (assignee), he has no better rights than Samuels. In light of the facts, Wilmont has no right to recovery because the goods were properly returned by Horn, and thus Wilmont will not prevail against Horn.

**B. Documents of Title and Investment Securities**

**M80**

**Answer 4**

**Part b.**

1. Yes. Independent dominion and control by the field warehouseman is the essential test that must be met in order to create a valid security interest in the field warehoused goods. If the debtor (Norwood) were allowed to retain dominion and control of the goods placed in the field warehouse on its premises, the validity of the field warehousing arrangement would be questionable. But where the warehouseman is an independent warehousing company and where the formalities are adhered to (that is, posting, and the keys are in the warehouseman's exclusive control), the arrangement will withstand an attack upon its validity.

2. The Uniform Commercial Code provides that a security interest attaches when

- a. The collateral is in possession of the secured party pursuant to agreement or the debtor has signed a security agreement that contains a description of the collateral.
- b. Value has been given.
- c. The debtor has rights to the collateral.

Typically the security interests in such situations arise upon delivery of the warehouse receipts to the creditor.

3. Nothing. A security interest in goods covered by negotiable documents may be perfected by taking possession of the documents. When possession is obtained, no filing is necessary.

4. The danger inherent in relinquishing the negotiable document of title to Norwood is that he may "duly negotiate" it to a holder. The code provides that "such holders take priority over an earlier security interest even though perfected. Filing . . . does not constitute notice of the security interest to such holders. . . ."

Negotiation of a negotiable bearer document of title is by delivery alone. The instrument is "duly negotiated" when negotiated "to a holder who purchases it in good faith without notice of any defense against or claim to it on the part of any person and for value, unless it is established that the negotiation is not in the regular course of business or financing or involved receiving the document in settlement or payment of a money obligation."

**C. Sales**

**M83**

**Answer 5**

**Part b.**

1. Although the parties involved are permitted to allocate risk of loss in any manner they deem appropriate,

assuming that there was no provision in the agreement regarding risk of loss, the Uniform Commercial Code sets forth very specific rules which depart sharply from the common law concept dependent upon whether title had been transferred. Sales contracts that require the seller to ship the goods F.O.B. seller's location are known as "shipment" contracts, while contracts requiring the seller to deliver to a particular destination are known as "destination" contracts.

The first set of tools was sold under "destination" terms which means that risk of loss passed to Dennison only when the goods arrived at that destination and were duly tendered to enable Dennison to take delivery. Thus, Elba would bear the risk of loss.

Regarding the second set, which entailed "shipment" terms, risk of loss passed when the goods were properly delivered to the carrier. Thus, although the property was destroyed prior to delivery, risk of loss had already passed to Dennison.

2. Drew. The UCC sets forth specific provisions regarding the effects of breach (both by the seller and buyer) on risk of loss. Assuming a seller's breach, as is the case here, the code provides that where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection, the risk of loss remains on the seller until cure or acceptance.

**M82**

**Answer 5 (10 points)**

**Part a.**

No. The fading was certainly not an "Act of God," nor was it to be expected. An implied warranty regarding fitness would have existed were it not for the disclaimer. The disclaimer coupled with the parol evidence rule will prevent recovery by the purchaser for breach of warranty.

The facts pose an interesting problem whether either of the implied warranties apply. Courts might differ on whether fading would prevent the goods from being merchantable or fit for the purpose for which they were purchased. However, assuming such implied warranties do exist, they will not survive the combination of the disclaimers in conjunction with the parol evidence rule.

The parol evidence rule negates any showing of an additional express warranty, oral or written, not embodied in the contract. The language of the contract, in fact, deliberately incorporates the rule. The language is clear; it states that no additional warranty protection is afforded the buyer unless incorporated into the contract. The fourth and fifth provisions of the contract eliminate the quality warranties of merchantability and fitness and do so in the manner prescribed by section 2-316 of the Uniform Commercial Code.

**Part b.**

1. Yes. Wilmot's asserted legal defenses are without merit. Recovery by Nielson will be limited to 20 cents

per pair, which is the difference between the contract price and the additional amount that it would have cost to purchase the goods elsewhere at the time the buyer learned of the breach. When the notice of cancellation was received, the contract price was \$2.50 and the market price was \$2.70.

2. No. Specific performance would not be available under the circumstances. Money damages are adequate in that it would be compensated for the amount it would have to pay to buy the goods elsewhere. Hence, it would be in as good a position as it would have been otherwise.

3. No. The Uniform Commercial Code covers these points specifically. If a seller discovers after the making of the contract, but prior to the delivery of the goods, that his customer is insolvent, he still cannot terminate the contract. However, Wilmot has the right to refuse delivery except for cash payment.

**N81**  
**Answer 5**

**Part b.**

Maxwell will prevail. As a result of advertising placed in the window and at the display counter, she may rely upon an express warranty of fitness of the radio's capability of receiving adequate reception of radio broadcasts. This would be characterized as a written express warranty, as many recent cases have held written advertising statements about the product in question to be. Next, Maxwell could claim that an oral express warranty was given by Golden, although this would appear to be a rather weak argument in regard to both the facts and the law. Maxwell's recovery also can be based upon the implied warranty protection of the Uniform Commercial Code. First, she could assert that a shortwave radio intended to receive transmissions from throughout the world was not of merchantable quality (fair and average) if it was incapable of receiving clear transmissions from the Soviet Union. Although this may be a plausible argument, it is obvious that the implied warranty of fitness for the purpose indicated is a better theory upon which to proceed. She clearly made her needs of purposes known to Golden, who nodded and smiled in apparent agreement. Thus, Maxwell has a wide variety of warranties to which she may resort in seeking recovery.

There are two arguments that Ultraclear would make in defense and that are alluded to in the final paragraph of the facts. First, they made no warranty as a result of the advertising. This they would claim to be merely either opinion or puffing. They would couple this with the fact that they didn't use the term *warranty* or *guarantee*. However, the UCC does not require the use of such words to create a warranty, and the statement "Listen to Radio Moscow" is a statement of fact or promise and not mere puffing or opinion.

Next, Ultraclear would rely upon its oral disclaimer as a defense. Although Ultraclear purported to negate any implied warranty protection, this argument

would fail because it is inapplicable insofar as the express warranties discussed above are concerned. The oral disclaimer is also ineffective with respect to the implied warranty of merchantability, since the code requires that any such disclaimer specifically mention the word merchantability. To exclude the warranty of fitness, the code also requires that the exclusion be in writing and be conspicuous.

Since there are several warranties that have been made or implied and that have been breached by Ultraclear, and, since its defenses will be of no avail, Maxwell should win her case for rescission.

**M80**  
**Answer 4**

**Part a.**

A consignment is a selling arrangement between the owner, called the *consignor*, and the party who is to sell the goods, called the *consignee*. The consignee is appointed the agent to sell the owner's merchandise. The following are the key characteristics.

1. Title to the goods remains at all times with the consignor.
2. The consignee is at no time obligated to buy or pay for the goods.
3. The consignee receives a commission for the goods sold.
4. The proceeds belong to the consignor.

**D. Secured Transactions**

**N83**  
**Answer 2**

**Part a.**

- Zeals has priority over Despard regarding the competing security interests of the parties. Zeals is a purchase money secured party involving the sale of consumer goods. As such, the security interest is enforceable against other creditors of the buyer without the necessity of a filing. Despard would also attempt to assert a purchase money security interest in the goods, but this is questionable at best since the money advanced was obviously not used for the purchase of the goods. Even if Despard qualified as a purchase money secured party, Despard was second in point of time. The fact that it filed does not change the priority, since filing was not required to perfect the interest in the consumer goods (the video system).
- Apache has priority over Despard in this instance. Although Despard was the first to advance credit and qualified as a purchase money lender, it was second in time to perfect its security interest. The subject matter of the sale was equipment, and filing is required to perfect Despard's security interest. The purchase money lender has the benefit of a 10-day grace period for filing. Despard's security interest was not perfected until it filed, which was after the grace period and five days after Apache's filing.

**M81**

**Answer 3** (10 points)

**Part a.**

1. In order to prevail against the creditors of a party to whom goods have been consigned, the consignor may do one of three things according to the Uniform Commercial Code (section 2-326):
  - a. Comply with applicable state law providing for a consignor's interest to be evidenced by a posted sign. Most states do not have such statutes.
  - b. Establish that the person conducting the business is generally known by his creditors to be substantially engaged in selling the goods of others. This is either not the case or is difficult to prove.
  - c. Comply with the filing provisions of Article 9: Secured Transactions. From a practical standpoint, this last course of action appears to be the most logical, if not the only, choice.

Article 9 (section 9-114) requires that a consignor comply with the general filing requirements of the code (section 9-302) and also give notice in writing to the creditors of the consignee who have a perfected security interest covering the same type of goods. The written notice must be given before the date of filing by the consignor and received within five years before the consignee takes possession of the goods. The notice must state that the consignor expects to deliver goods on consignment to the consignee and must contain a description of the goods.

2. No. Walpole will not prevail. Whether a consignment is a "true" consignment (an agency relationship) or is intended as a security interest, the Uniform Commercial Code requires that notice be given to creditors of the consignee.

A consignment is governed by sections from two articles of the code: Article 2: Sales and Article 9: Secured Transactions. Section 2-326 treats a consignment as a "sale or return" because "the goods are delivered

primarily for resale." Section 2-326(3) provides the following:

Where goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved, under a name other than the name of the person making delivery, then with respect to claims of creditors of the person conducting the business the goods are deemed to be on sale or return. The provisions of this subsection are applicable even though an agreement purports to reserve title to the person making delivery until payment or resale or uses such words as "on consignment" or "on memorandum."

It is obvious from the facts, that Walpole's marketing arrangement is covered by the above language. The code further provides that the creditors of the consignee will be able to assert claims against goods sold on a sale or return basis unless some form of notice is given.

**Part b.**

Lebow will prevail to the extent of the 65 percent of the bolts of wool that it repossessed on August 11, 1980. Since Lebow obtained possession of 65 percent of the shipment prior to attachment or judgment by Dunbar, Lebow's security interest with respect to those goods had been perfected as of August 11. The original erroneous filing is invalid against the creditors of Fashion Plate. Lebow's security interest was not perfected by filing initially, and, therefore, Lebow will not prevail over the rights of Dunbar, a subsequent lien creditor of Fashion Plate. The facts of the case indicate that the security interest was not perfected by filing until August 20, 1980. However, prior to that time Dunbar levied against the goods on August 13 and obtained a judgment against Fashion Plate on August 18, 1980. Both dates are prior to the August 20 filing by Lebow; thus, the lien creditor would have priority over Lebow's claim based exclusively on perfection by filing. Perfection can also be accomplished by possession, but if perfection by either method precedes the time that the lien creditor obtains rights against the property, it prevails.



## VII. Property, Estates, and Trusts

### A. Real and Personal Property

**N83**

**Answer 5**

#### Part a.

1. Dogwood is claiming an easement by prescription resulting from adverse usage.
2. The easement by prescription is the counterpart of obtaining ownership of land by adverse possession. The requirements to establish such an easement are
  - Adverse use as distinguished from a permissive usage.
  - An open and notorious use.
  - Continuous and exclusive use for the time required for the acquisition of title to real property by adverse possession, typically 15 to 20 years.
3. Maple would prevail. Although tacking (adding on) of a prior owner's use is permitted where there is privity, such tacking will not satisfy the first requirement since the use by Acorn of his own land cannot be adverse. Furthermore, the use by Dogwood for five years will not satisfy the statutory time period required for the acquisition of an easement by prescription, typically 15 to 20 years.

**N82**

**Answer 5**

#### Part b.

Based upon the facts of the problem and the legal criteria discussed below, it appears that the manufacturing machinery retains its character as personalty and therefore can be removed by Darby at the expiration of the building lease and is properly being depreciated over its estimated useful life of thirty years. The central air conditioning system, however, appears to be realty and therefore cannot be removed by Darby at the expiration of the building lease. It should therefore be depreciated by Darby over the term of the lease, that is, twenty years.

In order to determine the rightful ownership of the central air conditioning system and the manufacturing machinery upon expiration of the building lease, one needs to determine if either or both should be regarded as realty by virtue of being fixtures. Whether a particular item of personalty becomes a fixture depends on whether there has been an annexation to the realty and an intention that the item become a fixture. The intention is inferred from such matters as (1) the nature of the item, (2) the manner of its attachment to the realty, and (3) the possible injury to the realty that might be caused by its removal.

In Darby's case, both the central air conditioning system and the machinery would likely be fixtures under

this analysis. However, when personal property is attached to realty for the particular purpose of increasing the business profits of a tenant during a lease term, such personal property is ordinarily classified as a trade fixture. The manufacturing machinery clearly fits into this category, since it is directly used to increase Darby's business profits. A trade fixture may be removed by the lessee unless it is so built into the realty that it becomes an integral part thereof. Accordingly, if it can be removed at the building's lease term with no material damage to the building, it may be removed.

It is unlikely that the central air conditioning system would be considered to be a trade fixture. Thus, it is subject to the general rules applicable to fixtures discussed above. As a result, it has become realty and cannot be removed at the end of the lease.

**M79**

**Answer 5 (10 points)**

#### Part a.

1. No. In the absence of a restriction on the right to assign specifically stated in the lease, a lessee may assign his leasehold interest to another. Only in unusual circumstances, where the lease involves special elements of personal trust and confidence as contrasted with mere payment for occupancy, will the courts limit the right to assign.
2. Yes. Although JoMar may effectively assign the lease, which in effect is an assignment of the right to occupy the leasehold premises and a delegation of its duty to pay Marathon, it cannot shed its liability to Marathon for the rental payments. In the absence of a release, JoMar remains liable. The transaction described in the fact situation is in the nature of a surety relationship.
3. Yes. Marathon is a third-party creditor beneficiary of Hammar's promise to JoMar. As such, Marathon can assert rights on the promise even though it was not a party to the contract. Marathon is not barred by lack of privity or the fact that it gave no consideration to Hammar for the promise.

#### Part b.

1. Based upon the facts of the problem and the legal criteria discussed below, the vault door will probably be classified as real property. The criteria applicable are these:
  - Annexation—the mode and degree to which the chattel is physically attached to the real property.
  - Adaptation—the extent to which the chattel is used in promoting the purpose for which the real property is used.

- Intention—whether the chattel was intended as a permanent improvement of the real property.

Applying these criteria to the facts demonstrates that the degree of annexation of a vault door is by necessity very high. Furthermore, the adaptation of the personal property (the vault door) to the use of the real property by the bank also argues for a finding in favor of real property classification. Finally, the last criterion, the intent of the bank to make a permanent improvement of the real property, appears to have been satisfied. Taking these criteria together, it would appear that the bank door has become real property.

2. In addition to tax collectors, disputes involving the categorization of property as real or personal have arisen in respect of—

- Real property mortgagees versus creditors of the same debtor who have a security interest in personal property (chattel mortgagees).
- Landlord versus tenant upon expiration of the lease and the question of what property may be removed.
- Takers under a will versus the executor in cases where different takers will receive the property, based upon its classification.
- The seller versus the purchaser of real property, where a dispute arises concerning the removal of certain property by the seller.
- The mortgagor versus mortgagee, when the question arises regarding what property is included under the scope of the mortgage.

## B. Mortgages

**N81**

**Answer 4**

### Part b.

Adventure Mortgage Company is correct in its assertion. Adventure had no actual or constructive notice of the fraud. It has a valid second mortgage that was properly filed and recorded prior to the closing. Vance Manufacturing, Inc., had constructive notice of the mortgage as a result of the filing and took title to the property subject to the Adventure mortgage. Vance must either pay Adventure or be subject to a foreclosure action.

Although Vance stands to lose \$10,000 with respect to Adventure's claim, it is likely that Vance can recover the loss from its attorney, based on an action for negligence. The attorney's final examination of the title prior to closing was clearly inadequate. It was made at a time that was too far in advance of the closing to provide the protection needed. Final examination of title is generally made immediately prior to closing.

Of course, Vance would have a cause of action against Lauer based on deceit (fraud), although recovery seems unlikely. Vance's attorney, assuming he is liable as a result of a finding that he was negligent, would be subrogated to the rights of his client and entitled to recover from Lauer for deceit.

**M80**

**Answer 4**

### Part c.

1. Despite the absence of a legal obligation to do so, Robbins is expected to make the remaining mortgage payments. She is the legal owner, subject to the mortgage, and has parted with money sufficient to purchase Newfeld's equity interest. If Robbins defaults, she will lose the money already invested in the purchase. Normally one would default only if the value of the property is less than the mortgage outstanding.

2. New City has no rights against Robbins upon default. Not having assumed the mortgage, Robbins has no personal liability to pay the mortgage. Newfeld remains liable on his original promise; the sale to Robbins does not alter his liability.

3. The \$2,000 belongs to Robbins. The mortgagee is not entitled to reap a profit as a result of the foreclosure but is only entitled to complete satisfaction, principal, interest, and expenses. Newfeld is not entitled to anything since he is not the owner, did not satisfy the debt, and has been fully paid for his equity interest by Robbins.

## C. Administration of Estates and Trusts

**N83**

**Answer 5**

### Part b.

1. A trust must have a creator (settlor or grantor), trust property (principal, corpus or res), a trustee, and a beneficiary. There must be a writing if the subject matter of the trust is real property.

2. The Crawfords' trust was not created until December 1, 1982, when the land (the res) was conveyed to the trustee in writing. In the case of an *intervivos* trust of real property with an independent trustee, the settlor (here the Crawfords) must go through whatever formalities (here a conveyance) are required to vest title in the trustee.

3. Yes. Although a trust having a duration of 10 years or more will qualify as a *bona fide* transferee of property for the purposes of shifting income to the trust or its beneficiaries, a transfer to a trust for a lesser duration will not qualify according to the Internal Revenue Code and Income Tax Regulations. This trust was intended to be what is popularly known as a "Clifford Trust."

4. No. State law precludes, except in rare circumstances, the termination of an irrevocable trust once created. Hence, the Crawfords are stuck with a useless trust for the balance of its term.

**D. Fire and Casualty Insurance**

**N82**

**Answer 5**

**Part a.**

1. The recoverable loss is determined by reference to the following formula:

$$\frac{\text{Insurance carried}}{\text{Insurance required}} \times \text{the amount of the loss}$$

where the insurance required is defined as the value of the property at the time of the loss multiplied by the coinsurance percentage. Applying the foregoing formula, the amount of the loss recovered is as follows:

$$\frac{\$600,000}{\$1,000,000 \times .8} \times \$200,000 = \$150,000.$$

2. The \$150,000 will be distributed as follows: \$106,000 to Second National and \$44,000 to Jackson. This is because Second National's insurable interest equals the extent of its mortgage outstanding, which is limited to debt outstanding plus accrued interest, and is paid first. The remaining \$44,000 would then be paid to Jackson.

3. Jackson will recover \$300,000—the face amount of the policy. The coinsurance clause does not apply to a total loss.

4. Jackson will recover \$45,000. The formula for determination of the total amount recoverable under the 80% coinsurance clause is as follows:

$$\frac{\$150,000}{\$250,000 \times .8} \times \$60,000 = \$45,000.$$

5. Jackson will recover \$30,000 from Queen. This amount is determined as follows:

$$\frac{\$100,000 \text{ (Queen's coverage)}}{\$150,000 \text{ (Total coverage)}} \times \$45,000 = \$30,000.$$



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Internal Revenue Code  
Model Business Corporation Act  
Securities Act of 1933  
Securities Exchange Act of 1934  
Uniform Commercial Code  
Uniform Limited Partnership Act  
Uniform Partnership Act



## APPENDIX

### Content Specification Outline

#### Background Information

The Board of Examiners of the American Institute of Certified Public Accountants believes that content specification outlines will help assure the continuing validity and reliability of the Uniform CPA Examination. The development of the current content specification outlines was accomplished over several years. The Board of Examiners first requested Subcommittees of the Board of Examiners (Accounting Practice, Accounting Theory, Auditing, and Business Law) to draft content specification outlines for their respective sections.

The content specification outlines were drafted by each subcommittee with the assistance of the AICPA Examinations Division staff. The Chairman of the Board of Examiners then appointed an AICPA task force to coordinate the outlines and to recommend how the content specifications should be exposed to the profession. The task force recommended that the Board of Examiners approve the content specification outlines for exposure to the profession through an AICPA Exposure Draft for public comment.

On March 10, 1980, the Exposure Draft — *Proposed Content Specification Outlines for the Uniform Certified Public Accountant Examination* was issued. The Exposure Draft was sent to:

- *Members of AICPA Council,*
- *State Boards of Accountancy,*
- *Representatives of the National Association of State Boards of Accountancy (NASBA),*
- *AICPA Education Executive Committee,*
- *American Accounting Association — Committee on Professional Examinations,*
- *Persons who requested copies.*

The Board considered written comments received from the public, oral comments delivered at Board of Examiners' open meetings, and information submitted by NASBA, which gathered data through various state boards sponsoring special seminar sessions to review the *Proposed Content Specification Outlines for the Uniform Certified Public Accountant Examination*. Based on this input, the Board made certain modifications to the Exposure Draft. The Content Specification Outlines were approved by the Board of Examiners on August 31, 1981.

#### Meaning and Use of Content Specification Outlines

The content specification outlines are divided into three levels — areas, groups, and topics, with the following outline notations:

- Areas by Roman numerals (I. Area),
- Groups by capital letters (A. Group),
- Topics by Arabic numbers (1. Topic).

The content specification outlines list the areas, groups, and topics to be tested, and also indicate the approximate percentage of the total test score devoted to each area. Some of the uses of the outlines will be to:

- Assure consistent subject matter coverage from one examination to the next.
- Assist candidates in preparing for the examination by indicating subjects that may be covered by the examination.
- Provide guidance to those who are responsible for preparing the examination in order to assure a balanced examination.
- Alert accounting educators as to the subject matter considered necessary to prepare for the examination.

The relative weight given to each area is indicated by its approximate percentage allocation. The examination will sample from the groups and topics listed within each area in order to meet the approximate percentage

allocation. Generally, the group title should be sufficient to indicate the subject matter to be covered. However, in certain instances, topics have been explicitly listed in order to clarify or limit the subject matter covered within a group.

No weight allocations are given for groups or topics. For example, if there are several groups within an area or several topics within a group, no inference should be drawn about the relative importance or weight to be given to these groups or topics on an examination.

The content specification outlines are considered to be complete as to the subjects to be tested on an examination, including recent professional developments as they affect these subjects. Candidates should answer examination questions, developed from these outlines, in terms of the most recent developments, pronouncements, and standards in the accounting profession. When new subject matter is identified the outlines will be amended to include it and this will be communicated to the profession.

### **Business Law Section**

The Business Law section tests the candidates' knowledge of the legal implications inherent in business transactions particularly as they may relate to accounting and auditing. The scope of the Business Law section includes the CPA and the law, business organizations, contracts, debtor-creditor relationships and consumer protection, government regulation of business, Uniform Commercial Code, and property, estates, and trusts. Many of the subjects on the examination are normally covered in standard textbooks on business law, auditing, taxation, and accounting. However, some subjects either are not included in such texts or are not covered in adequate depth. Important recent developments with which candidates are expected to be familiar may not yet be reflected in some texts. Candidates are expected to recognize the existence of legal implications and the applicable basic legal principles, and they are usually asked to indicate the probable result of the application of such basic principles.

The Business Law section is chiefly conceptual in nature and broad in scope. It is not intended to test competence to practice law nor expertise in legal matters, but to determine that the candidates' knowledge is sufficient to recognize relevant legal issues, recognize the legal implications of business situations, apply the underlying principles of law to accounting and auditing situations, and seek legal counsel, or recommend that it be sought, when appropriate.

This section deals with federal and widely adopted uniform laws. Where there is no federal or appropriate uniform law on a subject, the questions are intended principally to test knowledge of the majority rules. Federal tax elements (income, estate or gift) may be covered where appropriate in the overall context of a question.

### **Business Law — Content Specification Outline**

- I. The CPA and the law (10%).
  - A. Common Law Liability to Clients and Third Persons
  - B. Federal Statutory Liability
    1. Securities Acts
    2. Internal Revenue Code
  - C. Workpapers, Privileged Communication, and Confidentiality
- II. Business Organizations (15%).
  - A. Agency
    1. Formation and Termination
    2. Liabilities of Principal for Tort and Contract
    3. Disclosed and Undisclosed Principals
    4. Agency Authority and Liability
  - B. Partnerships
    1. Formation and Existence of Partnerships
    2. Liabilities and Authority of Partners



3. Transfer of Partnership Interest
4. Dissolution and Winding Up

C. Corporations

1. Formation
2. Purposes and Powers
3. Stockholders, Directors, and Officers
4. Financial Structure, Capital, and Dividends
5. Merger, Consolidation, and Dissolution

D. Other Forms

1. Individual Proprietorships
2. Trusts and Estates
3. Joint Ventures
4. Associations

III. Contracts (15%).

- A. Nature and Classification of Contracts
- B. Offer and Acceptance
- C. Consideration
- D. Capacity, Legality, and Public Policy
- E. Other Defenses

1. Statute of Frauds
2. Statute of Limitations
3. Fraud
4. Duress
5. Misrepresentation
6. Mistake
7. Undue Influence

- F. Parol Evidence Rule
- G. Third Party Rights
- H. Assignments
- I. Discharge, Breach, and Remedies

IV. Debtor-Creditor Relationships and Consumer Protection (10%).

A. Bankruptcy

1. Voluntary and Involuntary Bankruptcy
2. Effects of Bankruptcy on Debtor and Creditors
3. Reorganizations

B. Suretyship

1. Liabilities of Sureties and Cosureties
2. Release of Sureties
3. Subrogation and Contribution

C. Bulk Transfers

1. Publication, Notification, and Other Requirements
2. Rights of Pre-Sale Creditors
3. Rights of Post-Sale Creditors
4. Effects of Security Interests

D. Federal Consumer Protection Legislation

1. Consumer Credit Protection Act
2. Magnuson-Moss Federal Warranty Act
3. Regulation of Deceptive Practices Pursuant to Section 5, Federal Trade Commission Act

V. Government Regulation of Business (15%)

A. Administrative Law

1. Activities Subject to Regulation
2. Functions of Regulatory Agencies
3. Judicial Review of Agency Decisions

B. Antitrust Law

1. Price-Fixing and Other Concerted Activities
2. Mergers and Acquisitions
3. Unfair Methods of Competition
4. Price Discrimination
5. Sanctions

C. Regulation of Employment

1. Equal Employment Opportunity Laws
2. Federal Unemployment Tax Act
3. Workmen's Compensation
4. Federal Insurance Contributions Act
5. Fair Labor Standards Act

D. Federal Securities Acts

1. Securities Registration and Reporting Requirements
2. Exempt Securities and Transactions
3. Insider Information and Antifraud Provisions
4. Short-Swing Profits
5. Civil and Criminal Liabilities
6. Corrupt Practices
7. Proxy Solicitations and Tender Offers

VI. Uniform Commercial Code (25%).

A. Commercial Paper

1. Types of Negotiable Instruments
2. Requisites for Negotiability
3. Transfer and Negotiation
4. Holders and Holders in Due Course
5. Liabilities, Defenses, and Rights
6. Discharge

B. Documents of Title and Investment Securities

1. Warehouse Receipts
2. Bills of Lading
3. Issuance, Transfer, and Registration of Securities

*Appendix*

C. Sales

1. Contracts Covering Goods
2. Warranties
3. Product Liability
4. Risk of Loss
5. Performance and Obligations
6. Remedies and Defenses

D. Secured Transactions

1. Attachment of Security Agreements
2. Perfection of Security Interests
3. Priorities
4. Rights of Debtors, Creditors, and Third Parties

VII. Property, Estates, and Trusts (10%).

A. Real and Personal Property

1. Distinctions Between Realty and Personalty
2. Easements and Other Nonpossessory Interests
3. Types of Ownership
4. Landlord-Tenant
5. Deeds, Recording, Title Defects, and Title Insurance

B. Mortgages

1. Characteristics
2. Recording Requirements
3. Priorities
4. Foreclosure

C. Administration of Estates and Trusts

D. Fire and Casualty Insurance

1. Coinsurance
2. Multiple Insurance Coverage
3. Insurable Interest



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