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Creditors' Rights (May 15, 1972)

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CREDITORS' RIGHTS

May 15, 1972

Mr. Scott

Instructions: The examination consists of a single question. Read the entire question carefully before you begin to answer any part of it. To the extent that knowledge of state law is necessary for your analysis, you may answer, based on either Virginia law or the prevailing statutory scheme in the majority of jurisdictions. Raise, discuss and decide all issues presented whether or not dispositive of the matter. It is suggested that you discuss both sides of each issue. In your discussion be sure to state why you are disposing of the issue[s] or claim[s] raised in the manner you have decided upon. If you are compelled to assume additional facts, state your assumptions and then proceed to give your answer with and without the assumption.

CLS, Inc. is a closely held corporation whose principal business is providing legal computer services to law firms. CLS was incorporated February 1, 1971; its offices are located in the City of Springfield in the State of Marshall. The assets of the corporation consisted of certain "hardware," specifically twenty computers purchased by the corporation from Computex, Inc., a manufacturer of small computers; and certain "software," specifically a computer program designed to provide law firms with a fully computerized billing and debt collection operation. CLS sells its "system" which includes the computer and the program plus installation and operational training for prices ranging from \$40,000 and up.

The "hardware" was purchased by CLS for \$300,000 on April 1, 1971 for \$10,000 cash with the balance payable in monthly installments of \$5,000 due the first of each month. Computex secured the balance of the purchase price with a purchase money security interest covering the twenty computers. The security interest, in proper form, was filed in accordance with state law on December 1, 1971. The "software" was developed initially by Robert A. Hendel, President and principal stockholder of CLS, and was subsequently developed further between February-April, 1971 by Frank "Punchcard" Jones, a systems analyst who was hired by Hendel on February 5, 1971 for a contract price of \$10,000. The program, as completed by Mr. Jones in April 1971, has an agreed valuation of \$50,000.

In order to sell his systems to prospective law firms, Hendel on April 1, 1971 hired Mr. J. T. "Fast" Tongue as a marketing agent with a salary of \$100 per week and a commission of \$3,000 for every system he sold. CLS, Inc. got off to a good start when Tongue was able to sell on April 15 a computer system to a large New York law firm, Bruggindge and Bruggindge, at a price of \$50,000 payment to be made December 15, 1971. Heartened by this development, Hendel, between April 15 and May 1 hired twenty additional employees to provide secretarial and administrative assistance to his burgeoning operation. The monthly payroll for these employees was \$10,000.

On May 1, 1971, Hendel, on behalf of CLS, Inc. leased from AR Insurance Co. the second floor of its office building in downtown Springfield for a 5-year term at a stated rental of \$2,000 per month. CLS, Inc. also purchased on credit office furniture for \$10,000 from Furniture World, Inc., payment to be made ninety days after delivery. Feeling flush with his newly found prominence as a businessman, Hendel on behalf of CLS purchased a private plane on May 17 for \$50,000 from Aviators Ltd. for \$10,000 cash and a purchase money security interest covering

the balance. The security interest was never filed. The plane was ostensibly for use in sales trips by Tongue and Hendel, but Hendel's primary purpose was to develop flying as an avocation.

In order to acquire additional operating capital, on June 15, Hendel borrowed \$50,000 from EZ Credit Bank and Trust. Because the President of EZ Credit was a good friend, the debt was evidenced only by an unsecured demand note signed by Hendel personally and in his corporate capacity. Upon making application for the loan, Hendel signed a financial statement listing as the sole debt of the corporation, the amount owed to Computex for the computers in inventory.

Subsequently, however, CLS, Inc. was unable to make any further sales of its system and all available capital went to meeting the monthly payroll. As a result on August 17, 1971 Great Power Electric Company secured a judgment against CLS for the amount past due on the corporation electric bill (\$1,500). A writ of execution was issued on this judgment on September 12, 1971 and delivered to the sherriff the next day, but pursuant to instructions from the Power Company who hoped to effect an amicable settlement no levy has yet been made. However, on August 10, 1971 Western Telephone Company secured a judgment against CLS for the amount of the phone bill, \$5,000. The judgment was docketed on August 11 and the writ of execution was delivered to the sheriff on September 2, 1971. The sheriff proceeded to the CLS office at 6:00 a.m. on November 22, 1971 and knocked on the door. Receiving no answer, he used a "skeleton" key to gain entrance to the front door. Once inside he swept his hand around the room stating, "I levy on all this furniture." He then returned the writ on November 24, having written on the back a list of all the items of furniture found in the CLS office. After duly advertising in the local paper, the sheriff held a sale of the furniture on December 5, 1971. Over the objection of Furniture World and CLS, the furniture was sold to Western Telephone for the amount of its judgment. The sheriff gave the Telephone Company a sheriff's bill of sale covering the furniture which still remains in the possession of CLS.

Meanwhile, it had become clear to Hendel that he would need some additional financing until the sales operation of CLS became more established. Consequently on November 1, 1971, after explaining that he needed the money to pay certain obligations, he borrowed \$100,000 from the ABC Bank giving the bank a security interest in the amount due CLS from the sale of the computer system in May. In addition, the security interest extended to any amounts payable to CLS for the sale of any new systems in the future. This security interest was filed pursuant to state law on November 2. Hendel used the funds received to pay the rent on the office space from May through October (\$12,000) wages for the twenty employees from August 15 to October 15 (\$20,000), and the remaining \$68,000 was paid to Hendel Advertising, Inc. in partial payment of a \$100,000 claim for services rendered in providing a national advertising campaign to promote sales of CLS systems. Hendel Advertising Inc. is a closely held corporation, whose president and principal stockholder is Robert A. Hendel.

On November 3, "Fast" Tongue struck again, selling a system for \$50,000 to Wheel and Deal, a law firm in Williamsburg, Virginia. The system was delivered and installed on November 15, and the contract called for payment by December 21, 1971. On November 27, while demonstrating a new system to Jake "The Rake" Dickson, a local attorney, Tongue carelessly pushed Dickson closer to the computer asking him to "take a good look." Dickson slipped and fell, seriously injuring his back. This action so angered Dickson's associate, Eager Beaver, that he called Tongue a "clumsy _____ oaf," whereupon Tongue punched him in the mouth breaking his nose and knocking out six teeth. Two days

later Dickson and Beaver both filed suit against CLS, Inc., each claiming \$10,000 in personal injuries. In its answer filed on December 2, CLS admitted the agency of Tongue but denied liability on the merits.

On December 6, 1971, the President of EZ Credit Bank, disturbed about the sheriff's sale of the furniture and realizing for the first time that CLS might be in financial difficulty consulted his attorney, J. L. King, senior partner of King, King and Kong. King after a brief investigation found that the financial status of CLS (including all potential liabilities and assets) on December 6, 1971 was as follows:

Liabilities

(1)	\$50,000	Owed to EZ Credit Bank
(2)	255,000	Owed to Computex, Inc. (CLS having paid the \$5,000 monthly payments from May 1 through November 1).
(3)	10,000	Owed to Frank "Punchcard" Jones on contract dated February 5, 1971.
(4)	6,000	Commissions owed to "Fast" Tongue for sale of two systems.
(5)	4,000	Rent due to AR Insurance Company for November and December, 1971.
(6)	20,000	Wages owed to twenty employees October 15 through December 15.
(7)	10,000	Owed to Furniture World for furniture supplied CLS.
(8)	1,500	Outstanding judgment in favor of Great Power Electric Company.
(9)	100,000	Owed to ABC Bank.
(10)	10,000	Claim of Jake "The Rake" Dickson for personal injuries.
(11)	10,000	Claim of Eager Beaver for personal injuries.
(12)	32,000	Balance of claim owed to Hendel Advertising for services rendered.
(13)	5,000	Judgment in favor of Western Telephone Company.
(14)	40,000	Balance due Aviators, Ltd. for airplane.

Assets

(1)	\$270,000	Eighteen computers on inventory (agreed valuation \$15,000 each).
(2)	100,000	Accounts receivable from sale of two systems.
(3)	10,000	Office furniture in possession.
(4)	50,000	Agreed valuation of "software."
(5)	50,000	Agreed valuation of airplane.

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| (6) | 5,000 | Cash on hand. |
| (7) | 5,000 | Cash surrender value of "Keyman" insurance policy on life of R. A. Hendel. |
| (8) | 10,000 | Claim pending against Computer Research, Inc. for copyright and patent infringement, based on alleged use of CLS software. |
| (9) | 15,000 | Goodwill (agreed valuation) arising out of national advertising campaign. |

Mr. King now comes to consult you, an associate in his office. He relates the above facts and shows you the fruits of his research. He tells you that EZ Credit Bank is considering the possibility of instituting involuntary bankruptcy proceedings against CLS, Inc.

- (a) King first wants to know whether or not an involuntary petition can be filed by the Bank at this time.
- (b) King then says that if, in fact, CLS, Inc. is adjudicated a bankrupt (either voluntarily or involuntarily), it is highly probable that EZ Credit Bank, being a large unsecured creditor, will be elected Trustee. Furthermore, under prevailing state law, it is possible that Hendel as President of CLS will have personal liability for any corporate debts not discharged in bankruptcy.

Therefore, he wants to know:

- (1) what claims will be provable in bankruptcy--both secured and unsecured;
- (2) what assets will be available to the trustee for distribution to unsecured creditors generally;
- (3) in what court[s] will it be necessary or possible for the Trustee to proceed in order to determine the validity of disputed claims and the amount of assets available for distribution to unsecured creditors;
- (4) assuming costs of administration are \$15,000, what the probable distribution of available assets upon liquidation will be;
- (5) what claims, if any, will remain even after discharge in bankruptcy and how and where these claims can be enforced.

Mr. King asks you to prepare a memorandum on these questions. He reminds you that he likes his memoranda "thorough but terse; well-organized and well-written."