1895

The Contract of Subscription to Corporate Stock

John Fred Woodell

Cornell Law School

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THE CONTRACT OF SUBSCRIPTION TO CORPORATE STOCK.

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THESIS PRESENTED BY

JOHN FRED WOODDELL

FOR THE DEGREE OF BACHELOR OF LAWS.

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CORNELL UNIVERSITY.

SCHOOL OF LAW.

1895.
## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>NATURE AND FORM OF THE CONTRACT OF SUBSCRIPTION</td>
<td>1</td>
</tr>
<tr>
<td>II.</td>
<td>PAROL AGREEMENTS, VALIDITY OF</td>
<td>5</td>
</tr>
<tr>
<td>III.</td>
<td>LIABILITY ON A PRESENT SUBSCRIPTION TO STOCK</td>
<td>10</td>
</tr>
<tr>
<td>IV.</td>
<td>LIABILITY ON AN AGREEMENT TO SUBSCRIBE AND DISTINCTION FROM A PRESENT</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>SUBSCRIPTION</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(a) Discussion as to the Law in New York</td>
<td>21</td>
</tr>
<tr>
<td>V.</td>
<td>MEASURE OF DAMAGES</td>
<td>23</td>
</tr>
</tbody>
</table>
THE CONTRACT OF SUBSCRIPTION TO CORPORATE STOCK.

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If one should contemplate the importance and the extent of the subject of the contract of subscription to corporate stock, and the vast mass of adjudication that has necessarily resulted from a consideration of its principles, it will not appear apparent what is the precise scope and intent of this paper.

For anticipating the many and varied relations arising out of the contract from the time of the conception to the time of its termination, with the consequent rights and liabilities attendant thereon, together with the ambiguous and oftentimes irreconcilable attitudes of the different courts toward what they deem a proper construction, it is obvious that the subject can not here be treated in its entirety but it is rather intended to present the recognized nature and form of the contract of subscription and what is believed to be the precise and immediate relation the subscriber assumes from his formal act of affixing his signature to the subscription paper. A discussion of those topics which relate to subscriptions upon conditions precedent and upon special terms, the various phases and effects of fraud upon the contract, and
the grounds that will justify recission: all of which are properly within the scope of a broader review of the subject, will not be here attempted. A reference will be made to them only so far as it may seem necessary to a proper discussion of the subject more immediately under consideration and as we have indicated above.

The existence of a corporation was not recognized by the common law of England. The privilege of chartering a number of individuals to act in a corporate capacity was construed to be the valuable and exclusive prerogative of the Crown, and later of Parliament. All associations of individuals organized for corporate purposes and assuming to act without the sanction of express authority from the state were deemed to have usurped functions which they could not lawfully exercise: their acts and contracts made in furtherance of the common object were held void and unenforceable.

It is manifest that the contract of subscription to the stock of a corporation is the creature of the statute alone. The rights and liabilities of the subscriber and his relation to his fellow shareholders, to creditors and to the state must depend upon the construction placed upon the statute under which the subscription was taken, for
that alone can finally determine the legality and extent of his contract. No rights can be acquired by resorting to the common law theory of contracts and no liabilities can thus be incurred. The principles of the common law, an adherence to which are necessary to the efficacy and enforceability of ordinary contracts, have no application to the contract of subscription to the stock of a corporation. No technical requirements of the common law need be here observed and reference need be had only to the governing statute as to the final repository of the requirements of a legal undertaking. Perhaps the best example of the imbecility of the common law in relation to a binding contract of subscription is the abandonment of the necessity of a consideration. This element so essential to the enforceability of an ordinary contract is of no necessary consequence here. But while all the above is true, it may be said, that any element which in the nature of things is essentially a factor in every contract exists here as well as elsewhere. As such may be mentioned the necessity of competent parties and of mutual assent. Without the incorporation of those elements no true contract would be possible.

Having thus sustained the conclusion that the statute
forms the basis of all accruing rights and liabilities a very brief statement of the methods and form that will subserve a valid and binding subscription will suffice for the purposes of this paper. If the statute prescribes no particular form of subscription and designates no express mode of entering into the contract, the general rules of law applicable to the creation of a binding obligation under like circumstances will here apply. No formalities are deemed necessary and any act which in the eyes of the law signifies an intention to become a shareholder will, if such act is favorably considered by the company, bind the subscriber and the corporation alike. It is well settled that one may be a shareholder de facto in a corporate body although the manner of his subscription may have been defective and even though there may have been no subscription at all. If he assumes to act and in fact does act as a constituted member of a corporate association leading subscribers to invest and speculate on the faith of his alliance and creditors to extend credit to the corporation on the presumption of that position, any subsequent attempt of his to withdraw or to stifle his liability on the plea of an incomplete subscription will be confronted by the objection of an equitable estoppel.
But when the statute presumes to prescribe a method of subscription the legislative enactment must be scrupulously observed in its particulars. Yet a substantial compliance will satisfy the law. A failure to comply with a technical and trivial demand of the statute will not afford sufficient ground to avoid the binding force of a subscription valid on other grounds. But a substantial departure from the rule of the statute will engender a void and useless contract that can give rise to no rights or a corresponding liability. For instance, if the statute should require each subscriber to sign articles of association, a mere signing of the preliminary subscription paper would not constitute the subscriber a stockholder or render him liable for any of the corporate obligations.

A suggestive and interesting question but one which will probably not cause a wide divergence among the authorities when the question is fairly presented and necessarily involved in a given decision, is that occasioned by the inquiry whether a parol subscription to the stock of a corporation is a valid and binding obligation. To venture a plausible estimate of what the unanimous conclusion should be will necessitate a brief reference to the contract in its relation to the common
law and to the Statute of Frauds. It may be said that so far as the question has been directly adjudicated the conclusions have been unanimous in favor of the validity and binding force of a parol subscription. Such we find was the ruling in the oft cited case of Colfax Hotel Co. v Lyon, 19 N. W. 780 (Ky.) followed and supported by,

Bullock v Falmouth, 3 S. W. 129 (Ky.)
Cookney's Case, 3 De G. & J. 170.

In the work of Thompson on "Liability of Stockholders" we are confronted by the remark that parol subscriptions are not conducive to a binding contract and cites the following cases in support of his contention:

Vreeland v Stone Co. 20 N. J. Eq. 188.
Tunnel v Sheldon, 6 Barn. & C. 341.
Hotel v Bolton, 46 Tex. 633.

and the later case of Fanning v Ins. Co., 37 Ohio St. 339 is cited by another text writer in support of the same view.

But none of these cases justify the conclusion advanced, it will be observed upon an investigation of these authorities that in every case the decision of the court involved to a more or less degree the construction of a statute in its re-
lation to the parol agreement. In no one of the cases last referred to did the court essay to hold that a parol contract of subscription, relieved from the mandatory requirements of a statute, was unenforceable. And there would seem to be no legitimate reason for a difference of opinion upon this inquiry. There is nothing in the nature of the contract which should require a construction that a writing is necessary in order to induce a binding obligation, any more than such an interpretation is necessary in construing ordinary contracts. A corporation, for the purpose of effecting its organization and for the purpose of exercising its appropriate functions as a corporate body, should have as comprehensive a power incident thereto as any natural individual requires for the proper conduct of a private enterprise. Among these legitimate functions is the privilege of disposing of its capital stock by a parol subscription and have it regarded as an enforceable agreement.

The relation of the contract of subscription to the Statute of Frauds while not so apparent on its face will probably occasion no greater amount of dispute. There are two provisions of the statute with which the contract is said to be in conflict and it is with reference to these provisions
that we will now direct our inquiry. Let us suppose, for illustration, that one agrees to subscribe for the stock of a corporation when it shall be formed. When the subscriber is sued for the amount of his subscription may he plead the statute as a defense, relying especially on the provision which renders all contracts not to be performed within a year void and unenforceable unless in writing? There would seem to be no substantial ground for holding that he has this right: for by a long line of cases, too numerous to admit of a question, the rule has been established that where the contract could in the possible course of events be performed within a year it is not within the operation of the statute although as a matter of fact it may not have been performed within that time.

But there is, however, an inquiry involving the nature of the contract and the operation of the statute, which does not so easily admit of an answer. If one should subscribe by parol to the stock of a corporation for an amount exceeding fifty (50) dollars would his contract be unenforceable under the provisions of the statute which renders void all "agreements for the sale of goods for the value of fifty (50) dollars or more" unless in writing? The stock of a corpor-
ation is a chose in action and as such subject to a valid sale. Thus it would be only natural to hold as an obvious necessity that the parol agreement could not be enforced.

But the accepted doctrine would seem to be otherwise. The construction by which this conclusion is attained is based on the reasoning that in an original subscription the corporation has no present stock which can be the subject of a sale. The subscription agreement itself is the instrument by which the stock is primarily created; it is thus, according to this view, a creation of stock and not a sale, thereby being relieved from the provisions of the statute. A distinction between stock once issued and then subjected to a sale and stock created by the original subscription is the inevitable consequence necessarily of an adherence to this doctrine. Holding, as they do, that a sale of the former must comply with the statute and the undertaking embodied in a writing, while in the latter instance stock may pass from the corporation to the subscriber as a consideration for his subscription and yet the transaction rest beyond the pale of the statutory enactment. Such a construction obviously subordinates the clear and definite purpose of the Statute of Frauds to the necessities of a barren technicality.
Taking leave now of the discussion of these well established and for the most part undisputed principles of corporation law we enter upon a field of investigation only to be confronted by the many contradictions and distinctions of court adjudications and text writings which have tended to confuse rather than enlighten the present state of judicial chaos. There is no more important question than that attendant upon a consideration of a subscriber's liability on his subscription before the organization of the corporation. And it will be the purpose of this paper to now extract, if possible, from the vast mass of authority the true status of a subscriber so situated with his rights and liabilities. To formulate our question:—what is the undertaking of one who subscribes for the stock of a corporation not yet in being but to be incorporated in the future?

In view of the uncertainty and confusion which would otherwise follow it would seem best to state, what is believed to be, the established rules and then endeavor to sustain them by competent authority. In compliance therefore the conclusion is ventured that in a pure orthodox subscription before incorporation, as distinguished from an agreement to subscribe, the transaction is in the nature of a continuing
offer to become a shareholder in the prospective corporation, which offer is made to the corporation and can in no sense be regarded as a binding contract, existing between the several subscribers; and further that the offer may be accepted by the properly constituted agents of the corporation which acceptance will transform it into a binding and irrevocable agreement, but that at any time before a due acceptance the subscriber may revoke and withdraw the offer, thereby divesting himself of all rights in the prospective corporation and relieve him from all subsequent possible liability. Excluding the last element as to the power of revocation it is believed there is no judicial decision now extant, which is given the credit of being responsible authority and where the question was directly adjudicated, in which the propositions as laid down are denied. But it here to be observed again that reference is had only to a subscription "pure and simple" as distinguished from an agreement to subscribe which some courts have construed to be quite a different undertaking.

But the soundness of the above propositions would not seem apparent upon a casual reading of the cases and textbooks, and indeed it can only be admitted that the contrary would seem well established, in some jurisdictions at least.
A most careful and laborious scrutinizing of the cases is essential in order to discern the true status of affairs, but it is believed such an investigation will bear out and support the above propositions. The main source of confusion would seem to be in the distinction drawn by a considerable number of the courts between a present subscription and an agreement to subscribe, but this will be considered presently.

While not attempting to analyze all the apparently hostile statements of various authorities it will be profitable to refer to one erroneous conclusion of a text writer so often misleading because of the unblushing character of the assertion. Cook in Vol. 1. of his work on "Stockholders and Corporation Law" after developing and sustaining the principle that a subscription is a mere offer to the prospective corporation and not an agreement among the several subscribers, informs us that a contrary rule prevails in New York and cites the case of Lake Ontario Shore R.R. v Curtiss, 80 N.Y. 219 as authority.

But an examination of that case will not justify the remark. In the first place the contract brought to the attention of the court resolved itself into an agreement to subscribe and was in no sense a present subscription. In
the second place the decision of the court rested upon the
fact that the subscription was made upon a condition preced-
ent which condition had not been performed; and all that was
said by the learned judge who delivered the opinion not bear-
ing on the precise point in issue was not the adjudged sen-
timent of the court but mere dicta.

And the rule as laid down should commend itself to a
careful and considerate judgment for it is based on conclu-
sions fundamental and natural. The primary scope and fun-
c tion of a subscription to the stock of a corporation is an
offer to become a shareholder on consideration of the com-
p any extending the benefits and privileges resulting from
such a situation. It is primarily an offer to the corpo-
at ion intended to be accepted by the corporation. It is not
the purpose of the agreement to obligate one subscriber to
another and is not made to operate between them. While it
is true the subscription of one is often, and perhaps always,
the sole inducement and consideration for the agreement of
the others yet this alone is not sufficient competent evi-
dence to establish a meeting of the minds. Such a procedure
is merely a method of bringing the parties together. They
intend to deal with the corporation and bind themselves to it
alone. The corporation accepts or rejects the offer at its will regardless of the provisions of the prior agreement among the individual subscribers; and if accepted the company conveys the stock acting in its own corporate capacity, not in the pursuance, primarily, of the original undertaking of the several subscribers but in accordance with the terms of the new contract initiated by its own acceptance.

The true, sound and logical doctrine was well enunciated in the leading case of Athal Music Hall Co. v Carey, 116 Mass. at page 475 in which Wells, J. said:— "In agreements of this nature entered into before the organization is formed or the agents constituted to receive the amount subscribed, the difficulty is to ascertain the promise in whose name alone suit can be brought. The promise of each subscriber to and with each other is not a contract capable of being enforced or intended to operate literally as a contract to be enforced between each subscriber and each other who may have signed previously, or who would sign afterwards, nor between each other and all the others collectively as individuals. The undertaking is inchoate and incomplete as a contract until the contemplated organization is effected or the mutual agent constituted to represent the association of individual rights
in accepting and acting upon the propositions offered by the several subscriptions. When thus accepted the promise may be construed to have legal effect according to its purpose and intent and the practical necessity of the case: to wit, as a contract with the common representative of the several associations. Although his promise (referring to the case at bar) was originally voluntary or in the nature of a mere open proposition, yet having been accepted and acted on by the party authorized to do so, before he attempted to retract it, he has lost his right to revoke. His promise has become an accepted mutual contract and is binding upon him as well as upon the corporation."

It then being clear that in a present subscription the subscriber's rights proceed from the corporation and his liability, if any exist, is to that body only and that the remaining subscribers have no resource whatever upon his undertaking, we now grapple with a more difficult proposition. Various courts while conceding and sustaining the proposition heretofore considered refuse to apply the same construction to a mere agreement to subscribe among the different promisors. It is here contended that no proposition is made to the corporation, that no liability to that body can arise
therefrom and that if any responsibility is induced by the contract at all it exists on behalf of the remaining subscribers.

The doctrine contended for is best stated by Morawetz in his excellent work on "Private Corporations" Vol. I where we find the following:— "A different case is presented where the parties mutually agree to subscribe for shares in a corporation to be formed thereafter. Here there is no unconditional agreement to become a shareholder as soon as the corporation shall be formed, but it is contemplated that the parties shall themselves perform an additional act before becoming shareholders: 'namely, execute the statutory contract of membership by subscription upon the stock books. It is plain therefore that in this case there is no offer which the corporation can accept and the parties do not become shareholders and cannot be charged as such unless they subsequently carry out their agreement by subscribing for the shares."

In the illustrative case of Strasburg R.R.Co. v Echter- nacht, 21 Pa. St. 220 we find perhaps, the first and leading exposition of the foregoing position. Chief Justice Black in delivering the opinion of the court gave vent to the following remarks which are the accepted authority of those who
sustain this view and distinction:—"A contract cannot be made by one person alone. It takes two to make a bargain. Before a promise becomes a binding obligation it must not only be made to, but must be expressly or impliedly accepted by, the party for whose benefit it was meant. The paper before us was no more than a naked expression of the subscriber's intention to purchase certain shares in the capital stock of a company which it was expected would be incorporated by the legislature. Besides it is without any sufficient consideration. Again if there was a binding engagement it was not made with the Railroad Company which did not exist at the time."

Again in the oft cited case of Thrasher v Pike Co. R.R. Co, reported in 25 Ill. 340 the court said:—"It is claimed by the plaintiffs that they are entitled to recover as damages the par value of the stock. This, we do not think, is a fair view of the defendant's liability on his promise. His undertaking is to subscribe a certain amount of stock when the subscription books should be opened. This promise does not make him a stockholder and as such liable for calls. The company has parted with no stock to him and can only claim as damages the actual loss sustained by them by his failure or refusal to subscribe when he was notified." This case
was considered and approved in

Quick v Leman, 105 Ill. 585.

Mt. Sterling Coal-road Co. v Little, 14 Bush 429 (Ky.)

These authorities would seem to have an accurate comprehension of the true nature of the agreement to subscribe but in applying the law in the character of a remedy, fundamental and natural maxims of jurisprudence are lost sight of. It is undoubtedly true that the immediate contractual relations exist between the several subscribers and that the agreement is not a promise made to the corporation as a direct proposition. The relation resulting is that of a good contract in which the promise of one is a sufficient consideration for the undertaking of each and every other. Such is, or at least should be, undoubted law.

But while it is true the original agreement is not made with the corporation, which indeed may not then be in existence, it is clearly obvious the intent of the parties is that the contract shall inure to the benefit of the proposed corporation. That is the precise scope and meaning of the undertaking and is manifestly the only construction which its terms can justify. Now it is a universally recognized rule of simple contract that where two or more individuals jointly
enter into a contract for the benefit of a third person, this
beneficiary may maintain an action upon the agreement without
the necessity of incorporating any additional consideration.
There is no sufficient reason why the rule cannot be applied
in an action by a corporation to enforce the specific per-
formance of an agreement to subscribe. And such appears to
be the better rule supported by the most competent authority.

In the case of Hotel Co. v Smith, 13 Mo. App. 7,14 the
law was well stated by Bakewell, J, in the following remarks:—
"It is a rule of simple contract that if one person makes a
promise to another, for the benefit of a third, the third may
maintain an action upon it, though the consideration does not
move from him. The mutual promises of the several subscribers
in this case constitute a sufficient consideration, and that
the promise to pay a third party is not a tenable objection,
and the promise is binding though the corporation to which
payment is to be made is not then in esse but to be formed
thereafter."

Thus it would appear the courts were tending toward the
construction that a corporation may sustain an action to com-
pell the specific performance of an agreement to subscribe as
the beneficiary of an executory contract. Prior to its or-
ganization the undertaking is primarily one between the individual subscribers, but on acceptance by the company the subscriber is constituted a qualified shareholder, is relieved of his obligation to the remaining subscribers as such, and his original contract becomes merged in the one with the corporation, which is now so situated as to be able to compel a fulfillment of the promise.

A case well illustrating the extreme frailty of the distinction between a present subscription and an agreement to subscribe is Twin Creek Road Co. v Lancaster, 79 Ky. 552 from which we extract the following brief remark of Pryor J, :-

"The contract in this case, it is true, is made with individual subscribers and not with the corporation.....but the money due is for the corporation, and the promise is to pay the corporation; and the consideration is the mutual agreement between these parties to form the corporation and build the road, and when the corporation was created the defendants were bound by their subscription".

The three cases previously referred to: namely 25 Ill. 340; 105 Ill. 585; and 14 Bush 429 seem to lay great stress upon the fact, as they claim, that the corporation has parted with no stock to the subscriber which will support an action for
specific performance. But a sufficient answer to this would seem to be that the issuance of a certificate of stock is never necessary to constitute one a shareholder; indeed, the certificate is only evidence of his right. The mere acceptance by the corporation is enough to create the relation of a stockholder and will bind the company and the subscriber alike.

The attitude of New York in regard to this question is deemed by many to still be equivocal and unsettled and the case of Lake Ontario Shore R.R. v Curtiss, supra, is frequently cited as being in accord with the view that sustains the distinction and denies the right of the corporation to specifically enforce the agreement to subscribe. But the position of the New York courts cannot be said to be in doubt and Lake Ontario R.R. v Curtiss cannot be regarded as authority to support the contention advanced. It is true that in that case the court refused to enforce an agreement to subscribe, on behalf of a corporation, and it is further to be admitted that the dicta of the learned judge who delivered the opinion of the court certainly sustains the distinction we are discussing. But the case is easily distinguishable.

In the first instance the subscriber's agreement was one upon condition precedent which condition had not been performed
as stipulated. And this element was all the decision of the court essayed to determine. They denied the right to specific performance upon the one ground that the terms of the agreement had not been complied with. But Danforth, J. in his opinion advanced farther than a necessary discussion of the decision required and gave birth to the remarks which have given rise to a disproportionate amount of confusion and misinterpretation. The learned judge submits himself to the familiar error that the corporation not being a party to the original agreement cannot invoke the assistance of the court to compel specific performance; a fallacy which, it is hoped, has been made apparent by the foregoing consideration of the question.

The case of Lake Ontario Shore R.R. v Curtiss was considered in the later decision of Buffalo and Jamestown R.R. Co. v Gifford, 37 N.Y. 204 in which the court interpreted the "Curtiss" case as deciding only that the corporation was not entitled to specific performance while the conditions of the subscriber's agreement remained unperformed. The latter decision then proceeded to formulate the established New York doctrine. This adjudication together with that of Lake Ontario R.R. Co. v Mason reported in 16 N.Y. 451 forms the
basis of the law as it exists in New York to-day and will be
found clearly in accord with the proposition that a corporation may specifically enforce an agreement to subscribe as well as a present subscription.

It remains to consider very briefly the question of dam-
ages. Those adjudications which withhold from the corpor-
ation the privilege of a complete performance of a technical agreement to subscribe permit the recovery of such damages as the corporation has sustained by a failure to perform. And the measure of these damages is ordinarily the difference be-
tween the market value of the stock and the price agreed on.

This conclusion was reached in

Kt. Sterling Coal Road Co. v Little, supra.

Thrasher v Pike Co. R.R.Co., supra.

Quick v Lemon, supra.

Lake Ontario R.R.Co. v Curtiss, supra.

But it is submitted with due deference to those authorities that the ruling is based on a misconception of the true and fundamental nature of a subscription to corporate stock and the purposes it is intended to subsrve.

Now where a number of individuals agree to subscribe for the stock of a non-existent corporation, the entire amount of
capital stock the company will be authorized to issue is divided into shares at a stated and fixed valuation. Each member attaches his signature on the assumption that every other subscriber will be required to forfeit the par value of every share of stock he assumes to purchase: the precise contract he himself has been required to make. He does not contemplate that one shall become a qualified shareholder enjoying the privileges and benefits incident thereto without paying for his stock the same amount that has been required of him.

But such is the situation exactly, resulting from an application of the measure of damages to which reference has just been made. Let us suppose for illustration that one has so subscribed for stock and later defaulted. The corporation subsequently sells his stock for a price, we will assume, below par, and is then permitted to recover from the defaulting subscriber the deficiency when compared with the contract price. The new subscriber is thus constituted a qualified member of the corporation, paying less for his stock than was exacted from the others: but entitling him, nevertheless, to the same rights and benefits accorded to all.

It is manifest that such a construction undermines the fundamental character of the original subscriber's agreement,
requiring him to contribute to the capital stock an amount disproportionate to the benefits derived. The defaulting subscriber agreed to pay the par value of the stock when a call should be made and it is that understanding upon which the fellow subscribers mainly rely. The action by the corporation should be to recover the par value of the stock so sold and not the rule of damages as advanced by some authorities.

To briefly summarize the results of our investigation will tend to establish more clearly in mind the conclusions reached. The assertion is ventured that a careful examination of all the authorities will justify a reliance upon the accuracy of the following propositions:

1. A present subscription is in the nature of a continuing offer to the corporation which offer may be accepted by the corporation at any time before revocation, and that the agreement is not one among the individual subscribers.

2. A corporation may compel the performance of an agreement to subscribe as having been made for its benefit.

3. A parol subscription is a valid and binding contract.

4. In an action by a corporation upon a subscription the recovery should be the par value of the stock and not
damages as measured by the difference between the market value and the contract price of the stock.

---THE END---