

Federal Housing Finance Board

Memorandum

July 11, 1991

TO: J. Stephen Britt
Executive Director

FROM: Beth L. Climo
General Counsel

SUBJECT: Availability of Offset to Federal Home Loan Bank on
Cancellation of Departing Member's Capital Stock

You have asked for an opinion on an offset procedure recently inaugurated by one of the Federal Home Loan Banks ("FHLBanks") to be available when any of its members withdraw from the FHLBank System. The FHLBank procedure offsets the par value of the departing member's capital stock in the FHLBank against the value of the departing member's outstanding advances owed to the FHLBank. The FHLBank cites Federal Home Loan Bank Act ("Bank Act") subsection 6(b)(3) as permitting such offset upon departure of a member.

ISSUES:

- A) Whether the Bank Act permits FHLBanks to offset the value of a departing member's FHLBank stock against the advances owed by the member?
- B) If the Bank Act permits such a procedure, under what circumstances may it be used?

CONCLUSIONS:

- A) While Bank Act section 6 has an explicit offset provision, the authority in that provision is not available when a member withdraws from a FHLBank. Bank Act section 12(a), however, may provide for an implied right of equitable offset as a general power of the FHLBanks.
- B) A FHLBank may use equitable offset only when the par value of a departing member's FHLBank stock equals or exceeds the total amount of its outstanding advances owed the FHLBank. Otherwise, a FHLBank's use of offset would violate Bank Act sections 6 and 10. Offset is inappropriate when the Federal Housing Finance Board determines that a FHLBank's capital is impaired at the time the member leaves, or when the FHLBank has a negative net worth.

DISCUSSION:1) INTRODUCTION

One of the FHLBanks proposes to apply the money (debt) that would be owed to a departing member upon the cancellation of its capital stock in a FHLBank, against the outstanding advances that the member still owes the FHLBank. The means by which this is done is called "offset." If two parties both owe a debt to each other, one of them can cancel the debt owed to the other party with the debt owed it. BLACK'S LAW DICT. 1237 & 1538 (rev. 4th ed. 1968).

The right of offset can be granted by statute, but it is also recognized as a general equitable right. In this case, the FHLBank proposes to utilize a specific statutory provision in Bank Act section 6 that expressly permits offset. If that provision is determined not to be applicable to a departing member, then it must be determined whether an implied right of equitable offset exists under Bank Act subsection 12(a).

II) BANK ACT SECTION 6A) Section 6 permits offset only when reducing oversubscribed stock

The method by which the FHLBanks may retire or cancel stock held by a member is prescribed by Bank Act section 6. Section 6 contains two separate procedures for stock cancellation -- each for one of two different situations. They are:

- - when an ongoing member (an institution that will continue to be a member after it cancels stock) has oversubscribed to stock in a FHLBank and wishes to reduce its FHLBank stock holdings;
- - when a member departs the FHLBank System and, thus, must cancel its entire stock in a FHLBank.

Subsection 6(b) governs the first situation. The other one is addressed by subsection 6(e).

Only subsection 6(b) mentions offset. Subsection 6(b) is codified as three separate paragraphs. Subsection 6(b)(1) sets minimum stock subscription requirements for FHLBank membership, and permits a FHLBank, on request, to retire stock in excess of the subscription requirements. 12 U.S.C.A. § 1426(b)(1) (West supp. 1990). Subsection 6(b)(3), allows an offset by a FHLBank if a member opts to retire excess stock under subsection 6(b)(1). It states:

Except as provided in subsection (e)¹ [sic) of this section, upon retirement of stock of any member the shall pay such member for the stock retired an amount equal to the par value of such stock,- or, at the election of the bank, the whole or any part of the payment which would otherwise be so made shall be credited upon the indebtedness of the member to the bank. In either such event, stock equal in par value to the amount of the payment or credit, or both, as the case may be, shall be canceled.

Id. at § 1426(b)(3) (emphasis added).

B) Subsection 6(e) does not authorize offset when a FHLBank cancels stock of a departing FHLBank member

Subsection 6(e), as amended, addresses the termination of FHLBank membership. That subsection lacks an offset provision. The second and fourth sentences of subsection 6(e) specifically deal with the cancellation of a departing member's entire stock subscription. They state the following method for canceling FHLBank stock:

If any member's membership in a [FHLBank) is terminated, the indebtedness of such member to the [FHLBank] shall be liquidated in an orderly manner (as determined by the (FHLBank]), and upon completion of such liquidation, the capital stock . . . owned by such member shall be surrendered and canceled. Any such liquidation shall be deemed a prepayment of such indebtedness, and shall be subject to any penalties or other fees applicable to such prepayment. Upon the liquidation of such indebtedness such member shall be entitled to the return of its collateral, and, upon surrender and cancellation of such capital stock, the member shall receive a sum equal to its cash paid subscriptions for the capital stock surrendered, except that if at any time the [Finance Board] finds that the paid-in capital of a [FHLBank) is or is likely to be impaired as a result of losses in or depreciation of the assets held, the FHLBank shall on the order of the [Finance Board)

1. The text of subsection 6(b)(3) refers to "subsection (i) of this section. " The Financial Institutions Reform, Recovery and Enforcement Act of 1989 amended the Bank Act to re-designate subsection 6(i) as 6(e). 103 Stat. 416 (1989). The failure to amend the above reference appears to have been an oversight.

withhold from the amount to be paid in retirement of the stock a pro rata share of the amount of such impairment as determined by the [Finance Board].

Id. at § 1426(e) (emphasis added).

Since the offset provision in section 6 is not part of the procedures for FHLBank stock cancellation on terminating FHLBank membership, the issue becomes whether that fact prevents use of the subsection 6(b) offset procedure when canceling stock of a departing member. While subsections 6(b) and 6(e) speak to different situations, they are codified in the same Bank Act section. That may permit using subsection 6(b)(3) offset for a subsection 6(e) stock cancellation. The question hinges on whether Congress intended to restrict subsection 6(b)(3) or intended it as a procedure for all of section 6.

III) CONGRESSIONAL INTENT WITH RESPECT TO SECTION 6

A) The terms of subsection 6(b)(3) do not authorize the application of its offset provision when canceling stock on termination of FHLBank membership

Whether Congress intended to allow use of the subsection 6(b) offset provision when canceling stock of a departing member, depends on the interpretation of subsection 6(b)(3). The starting point of statutory interpretation is the plain meaning of the terms of subsection 6(b)(3). CPSC v. GTE Sylvania, 447 U.S. 102, 108 (1980).

1) Plain Meaning of Terms

Subsection 6(b)(3) begins with the phrase "Except as provided in subsection (e) [sic] of this section" 12 U.S.C.A. at § 1426(b)(3) (emphasis added). Use of "except" in a statute in this context means: not including; excluding. State v. Young, 519 A.2d 587, 588 (R.I. 1987); State v. Atencio, 513 P.2d 1266, 1268 (N.M. App. 1973). The above phrase is a "proviso"² to subsection 6(b)(3). Generally, the purpose of a proviso is to take a specified case out of the operation of the terms of the section containing the proviso. See 2A SUTHERLAND, STAT. CONST. § 47.08 (Sands 4th ed.) (1984 rev.) citing: McDonald v. U.S., 279 U.S. 12, 20-21 (1929).

2. Statutes may contain "provisos" or "exceptions": both are analyzed in the same scope and manner. Strictly speaking, an exception is usually separate from the section affected while a proviso is part of the section affected. 2A SUTHERLAND, STAT. CONST. § 47.11 (Sands 4th ed.) (1984 rev.).

The terms of the proviso in subsection 6(b)(3) appear to indicate that Congress did not intend to authorize the offset therein to apply to cancellation of a member's entire capital stock holdings upon termination of membership. If so, subsection 6(b)(3) does not permit an offset of the value of a departing member's stock against the advances still owed to the FHLBank on termination of membership:

2) Legislative History

Although the plain meaning of the terms of subsection 6(b)(3) seems to indicate that the offset provision is not to be used when a FHLBank retires a departing member's capital stock, its legislative history also has been reviewed.³ Neither the committee report for Bank Act section 6 as originally enacted, nor the one for its subsequent amendment (when subsection 6(b)(3) became a subparagraph), discuss the scope of the offset provision. See H. R. Rep. No. 1418, 72d Cong., 1st Sess. (1932); see also S .Rep. No. 778, 87th Cong., 1st Sess. (1961).

However, the legislative background of section 6 is instructive. As originally enacted, its subsection 6(b) contained the same offset procedure currently in effect, but the subsection was not organized as separate subparagraphs. Instead, it was a single, multi-sentenced paragraph (in the current style of subsection 6(e)). The composition of subsection 6(b), as one paragraph, made it clear that its offset procedure was limited to the retiring of excess stock of ongoing members.

Subsection 6(b) was later divided into separate paragraphs because of changes regarding the minimum stock requirements for member s. At that time, the offset provision was codified as a separate subparagraph. See 75 Stat. 480, 482-83 (1961). That, in and of itself, does not expand the scope of the offset provision. Cutting up an existing statutory provision into separate paragraphs does not, by itself, alter its scope. Fourco Glass Co. v. Transmission Prod. Corp., 353 U.S. 222, 227 (1957). Further, the proviso phrase was added to Bank Act subsection 6(b)(3) at the time it was reorganized into three separate paragraphs. See 75 Stat. at 482. A proviso not enacted with the original - legislation, but added later, must be given effect. Cal. v. Desert Water, Oil & Irrigation Co., 243 U.S. 415, 420 (1917).

3. Legislative history is a proper means to discern legislative intent where the plain meaning of a statute's terms might be susceptible to different meanings. Burlington N. R.R. Co. v. Okla. Tax Comm., 481 U.S. 454, 461 (1987). While such history may consist of committee reports, debates or other legislative materials, the research in this case was limited to the committee reports on Bank Act section 6 and amendments thereto.

Thus, the minimal amount of legislative history that exists for the subsection 6(b)(3) offset procedure seems to support the position that its use is limited to subsection 6(b) activities.

IV) BANK ACT AUTHORITY FOR EQUITABLE RIGHT OF OFFSET

- A) Bank Act section 12 implies the power of a FHLBank to use equitable offset as one of the customary incidental powers that a corporation enjoys

Subsection 12(a) of the Bank Act grants the FHLBanks the incidental powers customary and usual to corporations, generally, if they are not inconsistent with other Bank Act provisions. See 12 U.S.C.A. § 1432(a) (West Supp. 1998). Corporations generally enjoy the right of equitable offset. Courts have recognized that if a corporation is at the same time both a debtor and a creditor to a party on mutual debts, it may offset its debt to the party against the debt owed. See generally 80 C.J.S. Set-off & Counterclaim § 9 (1953 ed.).⁴ Accordingly, under subsection 12(a), the FHLBanks would seem to enjoy the equitable right of offset, notwithstanding the fact that Bank Act section 6 does not so authorize.

As a general grant of power under Bank Act subsection 12(a), it is subordinate to express specific requirements or prohibitions elsewhere in the Bank Act. HCSC-Laundry v. U.S., 450 U.S. 1, 6 (1981). In other words, a FHLBank's right to use offset as an incidental power pursuant to subsection 12(a) is subordinate to the requirements for stock cancellation in Bank Act subsection 6(e) and the collateral requirements concerning capital stock in subsection 10(c).

- B) Bank Act subsection 6(e) requires that a departing member's entire indebtedness be retired at or before cancellation of the member's stock

Subsection 6(e), governing stock cancellation when a member leaves the FHLBank System, conditions the cancellation "upon the completion of ..." the liquidation of the departing member's indebtedness to the FHLBank. 12 U.S.C.A. at § 1426(e) (emphasis added). "Completion" means the state of being complete. See WEBSTER'S NINTH NEW COLL. DICT. 269 (1985). The use of the term "upon," in subsection 6(e) suggests that it means "following" or "at the time of," depending on its context. Para v. Para, 336 S.E.2d 157, 161 (Va. App. 1985); Turner v. Koscot Inter-planetary, Inc., 191 N.W.2d 624, 631 (Iowa 1971).

4. Courts also have recognized this offset right for the federal government. U.S. v. Isthmian Steamship Co., 359 U.S. 314, 318 (1958). The FHLBanks are federal instrumentalities.

"Upon the completion" means that payment to a FHLBank of the balance due on all outstanding advances by a departing member either precedes cancellation of the stock and payment of par value to the former member, or is simultaneous thereto. An offset contemplates a mutual reduction of debts owed by two parties each as creditor and debtor. See 80 C.J.S. Set-off & Counterclaim § 48 at 74 (1953 ea.); cf. Studley v. Boyleston Nat. Bank, 229 U.S. 525, 528-29 (1913). Thus, in order for the equitable right of offset implied in subsection 12(a) not to be inconsistent with the provisions of subsection 6(e), subsection 6(e) must be interpreted to permit stock cancellation simultaneous with the liquidation of the member's indebtedness. We believe subsection 6(e) could be so interpreted to permit offset, subject to the conditions discussed below.

- C) Bank Act subsection 10(c) requires a FHLBank to hold a collateral lien upon a member's capital stock as long as the member is indebted to the FHLBank

Bank Act subsection 10(c) mandates that a FHLBank "shall have a lien upon and shall hold the stock of [each member borrower] as further collateral security for all indebtedness of the member to the [FHLBank]." 12 U.S.C.A. § 1430(d) (West Supp. 1990). In statutes, "shall" is command language. Andersen v. Yungkau, 329 U.S. 482, 485 (1946). Accordingly, FHLBanks must hold the capital stock of borrowing members as back-up collateral as long as an advance is outstanding.

When a member leaves a FHLBank, the FHLBank cannot offset the value of the departing member's capital stock if, subsequent to the offset, the former member is still indebted on an outstanding advance. The result is not permitted by subsection 10(c) because the FHLBank no longer has a lien on the former member's stock as additional security for the continued indebtedness.

- V) EQUITABLE OFFSET CAN BE HARMONIZED WITH BANK ACT SUBSECTIONS 6(e) AND 10(c)

The requirements of subsections 6(e) and 10(c) would seem not to entirely prevent use of equitable offset on retiring the capital stock of an outgoing member, but they do restrict its use. The FHLBanks' general powers under Bank Act subsection 12(a) cannot be interpreted in a manner that effectively renders another Bank Act section (i.e., subsections 6(e) or 10(c)) inoperative. South Carolina v. Catawba Indian Tribes, 476 U.S. 498, 510 (1986). These various powers and requirements must be read in harmony with each other. See Stafford v. Briggs, 444 U.S. 527, 535 (1980). We believe they can be harmonized.

- A) Offset may be used when the par value of the capital stock equals or exceeds the total indebtedness of the departing member to the FHLBank

The practical effect of these various provisions is that a FHLBank may offset the par value of a departing member's entire capital stock against the balance due on such member's outstanding advances only when the balance due on the advances is (i) equal to or (ii) less than, the par value of such member's entire capital stock. In those cases, the FHLBank does not contravene subsection 10(c) because after the entire balance due on the advances is paid off, the FHLBank needs no further lien on the capital stock. It also is arguable that subsection 6(e) is not violated since the term "upon" used therein may mean "at the time of ." Para v. Para (supra).

In the event the indebtedness of a departing member to a FHLBank exceeds the par value of its capital stock, the FHLBank would seem to be required to effect an orderly payment of the balance on the outstanding advances until the indebtedness equals or is less than the stock's par value, before offset can be utilized.

- B) Equitable offset is not available if the Finance Board determines that the capital of the FHLBank is, or is about to become, impaired

Subsection 6(e) of the Bank Act permits the Finance Board to order a FHLBank to withhold part of the value of a departing member's capital stock holdings if the Finance Board determines that the FHLBank's capital assets have been impaired. 12 U.S.C.A. at § 1426(e). Any procedure for allowing an equitable offset of the departing member's stock should keep in mind capital impairment .

- C) Equitable offset is not available if the FHLBank has a negative net worth at the time the member departs the FHLBank System

The procedure envisioned for equitable offset would have the FHLBank cancel and retire the stock and treat its par value as a debt owed to the departing member. This is necessary in order to offset the par value of the canceled, retired stock against the outstanding indebtedness of the member to the FHLBank -- as offset involves the reduction of mutual debts.

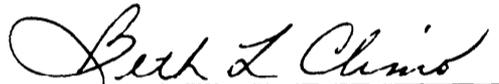
The capital stock, as a certificate, represents an equity interest in the FHLBank, rather than a debt instrument. See J. DOWNES, J.E. GOODMAN, DICT. OF FIN. & INVSTMNT TERMS (BARRON'S) 90, 115 (1985). It is fundamental to corporate law that debt instruments have priority over equity shares to the assets of a corporation. The conversion of the stock interest into debt

raises an issue as to whether it is proper to convert the departing shareholder's stake in the FHLBank to that of a debt holder.

This issue is resolved by the facts more than the law. If the FHLBank has a positive net worth both before the member departs and following the departure and offset, then the offset makes no difference to other debt holders. In such case, the FHLBank has ample funds to pay the other debt holders after the offset. However, the opposite is true if the FHLBank is insolvent or has a negative or near negative net worth. In such case, the offset procedure would seem to permit the equity interest holders access to the depleted assets ahead of bona fide debt holders?

CONCLUSION:

The Bank Act enables the FHLBanks to offset mutual debts with a member in one of two ways: for the limited purposes of Bank Act subsection 6(b) and as an implied power incident to their status as a corporation. The explicit offset procedure contained in subsection 6(b) is not available for the purpose of canceling the indebtedness of a departing member against the par value of the member's capital stock. However, as an implied incidental power, equitable offset would seem to be available for that purpose under certain conditions or circumstances. A FHLBank may offset the value of a departing member's FHLBank stock against any indebtedness owed to the FHLBank when (1) the FHLBank will have a positive net worth both before and after the offset, (2) the Finance Board has not determined that the capital of the FHLBank has become -- or is likely to become -- impaired, and (3) the par value of the departing member's FHLBank capital stock equals or exceeds the total of its indebtedness to the FHLBank.


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5. Corporations will at times issue bonds that are convertible to equity shares in the corporation, but not the other way around.
 3. DOWNES, J.E. GOODMAN (supra) at 78.