SEC PROPOSES RULES ON DISCLOSURE OF OFF-BALANCE SHEET ARRANGEMENTS

Disclosure of Contractual Obligations and Contingent Liabilities and Commitments Also Proposed

The Securities and Exchange Commission ("SEC") recently proposed rules[1] to implement Section 401(a) of the Sarbanes-Oxley Act of 2002 (the "Act") that would require public companies to disclose off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships with unconsolidated entities that have, or may have, a material effect on their financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. The new disclosure would be located in a separate section of "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") in a company's disclosure documents.[2]

The proposals would also require companies to include in their MD&A an overview of their aggregate "on-" and "off-" balance sheet contractual obligations and contingent liabilities.

The SEC has requested comments on these proposed rules no later than December 9, 2002. The Act requires the SEC to issue final rules regarding disclosure of off-balance sheet arrangements no later than January 26, 2003.

Commentary:

- Absent any special transition provisions, these rules could apply to fiscal year 2002 annual reports.

Foreign companies and Canadian issuers will generally be required to make the proposed disclosures in their annual reports. Registered investment companies are exempt from the proposed disclosures.[3]

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1 SEC Release Nos. 33-8144; 34-46767 (November 4, 2002).

2 The disclosures would be required in a company's quarterly and annual reports filed with the SEC under the Securities Exchange Act of 1934 (the "Exchange Act") and registration statements filed under the Securities Act of 1933 (the "Securities Act") that require MD&A disclosure.

3 Pursuant to Section 405 of the Act, registered investment companies are exempt from the provisions of Section 401 of the Act. Business development companies, as defined in Section 2(a)(48) of the Investment Company Act of 1940, will be subject to the proposed new disclosure requirements.

Off-Balance Sheet Arrangements

Disclosure Requirement

Section 401(a) of the Act directs the SEC to establish rules that would require companies to disclose in each quarterly and annual financial report filed with the SEC all material off-balance sheet transactions. In implementing this section, the SEC is proposing that public companies discuss, in a separately-captioned section of their MD&A, all off-balance sheet arrangements that may have a current or future material effect on their financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.[4]

Definition of "Off-Balance Sheet Arrangement"

An "off-balance sheet arrangement" is defined as a transaction or other contractual arrangement to which an entity unconsolidated with a company is a party, under which the company has, or in the future may have:

(A) Any obligation under a direct or indirect guarantee or similar arrangement;

(B) A retained or contingent interest in assets transferred to the unconsolidated entity;

(C) Derivatives whose fair value is not fully reflected as a liability or asset in the financial statements; or

(D) Any obligation or liability, including a contingent obligation or liability, not "fully reflected" in the company's financial statements.

- Off-balance sheet arrangements arise solely out of *contracts*. Contingent liabilities arising out of litigation, arbitration or regulatory actions (not otherwise related to off-balance sheet arrangements) are *not* off-balance sheet arrangements.
- Disclosure of an off-balance sheet arrangement is not required until a definitive agreement that is unconditional or subject only to customary closing conditions exists or, if there is no such agreement, when settlement of the transaction occurs.
- The structure of an off-balance sheet arrangement is not as important as the effects that the arrangement may have on a company. Thus, an arrangement

[4] In its release, the SEC noted that GAAP requires disclosure of some information about off-balance sheet arrangements in footnotes to the financial statements, but the proposed disclosures are intended to provide more comprehensive information and analysis than that provided in the financial statement footnotes.

to which a company is not formally a party may nevertheless be deemed to be its off-balance sheet arrangement. For example, a loan agreement with a third-party lender entered into by an entity unconsolidated with the company may be deemed an off-balance sheet obligation of the company if the borrowing entity is the beneficiary under a pre-existing guarantee or "keepwell" agreement of the company.

- An obligation or liability is not "fully reflected" in a company's financial statements[5] - and will therefore be deemed to be an off-balance sheet arrangement - if the amount of the obligation recognized in the financial statements is less than the "reasonably possible maximum exposure to loss" under the obligation as of the date of the company's financial statements.[6]

Commentary:

- ➢ Companies will be compelled to examine each liability where the amount has been estimated in accordance with GAAP to determine whether the estimated amount also satisfies the SEC's "fully reflected" standard. The proposed MD&A disclosure will be required for those liabilities that do not.

- ➢ Under GAAP, an entity is consolidated with a company for financial statement reporting purposes if the company owns a controlling financial interest in the entity, usually the ownership of a majority voting interest.[7] A current initiative by the Financial Accounting Standards Board ("FASB")[8] would require many entities that were previously unconsolidated for financial statement reporting purposes to now be consolidated. In such case, the SEC's proposed MD&A

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5 Other examples of obligations or liabilities that are not "fully reflected" in the company's financial statements include, without limitation: (i) obligations that are not classified as a liability according to generally accepted accounting principles ("GAAP"); or (ii) contingent liabilities as to which, as of the date of the financial statements, it is not probable that a loss has been incurred or, if probable, the amount of the loss is not reasonably estimable.

6 Under GAAP, where a liability is probable and its amount can be reasonably estimated, an accrual of the estimated amount is required. If only a range of losses can be reasonably estimated, GAAP requires that the most probable amount within that range be accrued and that the financial statement footnotes disclose the additional exposure to loss. In contrast, under the SEC's proposed standard, a liability is considered to be "fully reflected" in the financial statements only when it is recorded at its "fair value," meaning the amount at which a liability could be incurred or settled in a current transaction between willing parties other than in a forced or liquidation sale.

7 FASB SFAS 94, *Consolidation of all Majority-Owned Subsidiaries* (October 1987).

8 FASB Exposure Draft, Proposed Interpretation, Consolidation of Certain Special Purpose Entities (June 2002). In its release, the SEC indicated that it would not delay its MD&A disclosure proposal to allow for FASB to propose amendments to GAAP consolidation standards.

disclosures would be rendered moot in many instances. The FASB's initiative has, however, drawn significant public comment, and it is therefore uncertain whether it will ultimately result in any formal changes to GAAP.

Elements of Disclosure

Under the proposals, a company must disclose:

1. The nature and business purpose of its off-balance sheet arrangements;[9]

2. The significant terms and conditions of the arrangements;[10]

3. The nature and amount of the total assets and of the total obligations and liabilities (including contingent obligations and liabilities) of any entity through which the company's off-balance sheet activities are conducted;[11]

4. Specific disclosure of:

    - the amounts of revenues, expenses and cash flows of the company arising from the arrangements;

    - the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the company;

    - any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from the arrangements that are or may become material; and

    - the triggering events or circumstances that could cause them to arise.

5. Management's analysis of the material effects of any of the off-balance sheet arrangements and resulting obligations and liabilities on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures and capital resources.

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[9] This disclosure should explain why and how the company engages in off-balance sheet arrangements.

[10] These would include arrangements between the company and any entity through which the company's off-balance sheet activities are conducted or between that entity and other persons. Terms and conditions that are not necessary for an understanding of the arrangement are not required to be disclosed.

[11] For example, the company would have to identify the total amount of assets that it transferred to the off-balance sheet entity, amounts receivable or payable and any debt obligations incurred by the entity.

- Management's analysis should provide management's insight into the impact and proximity of the potential risks that may arise from material off-balance sheet arrangements.

- If particular triggering events or circumstances would require a company to become directly obligated, or accelerate its obligations, under a number of off-balance sheet arrangements, and the overall obligations would be material, then management's analysis should consider these circumstances and their aggregate effect.

- Management's analysis should include an analysis of the degree to which the company relies on off-balance sheet arrangements for its liquidity and capital resources or market risk or credit risk support.

- Management's analysis should disclose whether under any contractual provision or as a result of any known event, trend or uncertainty, an off-balance sheet arrangement that materially benefits the company will, or is reasonably likely to, be terminated or the benefits therefrom will or are reasonably likely to, be materially reduced, and any material effects.

- Management's analysis must be presented in language and a format that is clear, concise and understandable. In its release, the SEC cautioned companies against presenting the required information in such a manner that only an accountant or financial or industry expert could fully understand the presentation.

Commentary:

- The proposed MD&A disclosures will force companies, in essence, to present two sets of "books," one under GAAP and one under MD&A. There may be significant negative public and shareholder reaction to companies that reveal material discrepancies between these two presentations, and such reaction may well outweigh the economic benefits that these companies anticipated realizing from their off-balance sheet arrangements. Such potential reaction may, in turn, have a significant impact on industries that provide off-balance sheet financing arrangements, such as the multibillion dollar credit tenant lease industry.

Disclosure Threshold--Remoteness Standard

Under the proposed rules, off-balance sheet arrangements must be disclosed if they may have a current or future material effect on a company's financial condition, changes in financial condition, results of operations, revenues or expenses, liquidity, capital expenditures or capital resources. The proposed disclosure would be required if management determines either that an off-balance sheet arrangement is material in the current period or may become material in the future. With respect to a company's potential exposure for a future event, the proposed rules

would require disclosure wherever management concludes that the likelihood of the occurrence of the event and its material effect on the company's financial condition is "higher than remote." In other words, disclosure would *not* be required only where management determines that the occurrence of an event and the materiality of its effect is "outside of the realm of reasonable possibility."[12]

To apply the proposed threshold, company management must:

1. Identify and carefully review the company's off-balance sheet arrangements, and then

2. Assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could either require performance of a guarantee or other obligation, or require the company to recognize an impairment.

    - If management concludes that the likelihood of occurrence is remote, then no disclosure would be required under the proposed rules.

    - If management cannot make that determination, it would have to evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure then would be required unless management concludes that likelihood of the event having a material effect is remote.

    - Consistent with other disclosure threshold determinations that management must make in drafting MD&A, the assessment of remoteness must be objectively reasonable, viewed as of the time the determination is made.

Contractual Obligations and Contingent Liabilities and Commitments

Disclosure Requirement

The SEC has also proposed that companies be required to disclose aggregated information about their contractual obligations and contingent liabilities.[13] The proposed disclosure would include information about a company's known contractual obligations as well as its contingent liabilities

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[12] FASB SFAS No. 5, *Accounting for Contingencies* (March 1975), defines "remote" as a "slight" chance of a future event or events occurring, and "reasonably possible" as "more than remote but less than likely." Note that existing MD&A disclosure requirements employ a "reasonably likely" standard - if management is unable to determine the reasonable likelihood of the occurrence of a future event or the materiality of its effect, then disclosure is required. While the proposed rules lower the disclosure threshold for off-balance sheet arrangements, the existing disclosure threshold for other MD&A disclosure requirements remains unchanged.

[13] These proposed rules were not mandated under Section 401(a) of the Act.

and commitments - including both its “on-” and “off-” balance sheet arrangements - as of its latest balance sheet date.

This requirement would not apply to small business issuers.[14]

- Contractual obligations would be disclosed in MD&A in tabular format as set forth on Exhibit A. A company may use the categories of obligations specified in the proposed table or other categories suitable for its business. The table should be accompanied by footnotes necessary to describe provisions that create, increase or accelerate obligations, or other pertinent data.

- The proposed disclosure rules would also require a company to disclose, either in tabular format or in text, the expected amount, range of amounts or maximum amount of contingent liabilities or commitments that are expected to expire in (a) less than one year, (b) one to three years, (c) three to five years and (d) more than five years.

  - The disclosure of contingent liabilities and commitments should indicate whether the amount disclosed is an expected amount or maximum amount if a range is not presented and must be aggregated by type in a manner that is suitable for the company’s business.

  - Examples of contingent liabilities or commitments that would be covered under the proposals are lines of credit, standby letters of credit, guarantees and standby repurchase obligations.

  - The disclosure should address, in footnotes to the table or in the text, provisions of contingent liabilities that create, increase or accelerate obligations, or other pertinent data.

- While the discussion of off-balance sheet arrangements (described in the previous section) must be in a separately designated section of MD&A, the tabular and textual disclosures about known contractual obligations and contingent liabilities and commitments may be included in an appropriate, existing MD&A section.

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[14] A “small business issuer” is defined as an entity that (i) has revenues of less than $25 million; (ii) is a U.S. or Canadian issuer; (iii) is not an investment company; and (iv) if a majority-owned subsidiary, has a parent company that also is a small business issuer. An entity is not a small business issuer, however, if it has a public float (the aggregate market value of outstanding equity securities not owned by affiliates) of $25 million or more.

- As with other MD&A requirements, a company would have to disclose material changes to the amounts of contractual obligations and contingent liabilities and commitments. The company would not be required to include the table or repeat the other proposed required textual disclosure in its quarterly reports. Instead, it may disclose material changes by including a discussion of the relevant changes.

Applicability to Foreign Private Issuers and Canadian Issuers

Foreign private issuers will be required to include the proposed new disclosures in their annual reports on Form 20-F and in their Securities Act registration statements. Foreign private issuers will not, however, be required to include these disclosures on periodic reports filed with the SEC on Form 6-K.[15] Canadian issuers will be required to include the proposed new disclosures in their annual reports on Form 40-F.[16]

Safe Harbor for Forward-Looking Statements

Certain elements of the proposed MD&A disclosure concerning off-balance sheet arrangements - in particular, management's analysis of off-balance sheet arrangements - will require companies to provide forward-looking information. To encourage the type of information and analysis necessary for investors to understand the impact of these off-balance sheet arrangements, the proposed rules include a safe harbor for such forward-looking information.[17] The safe harbor protects the required MD&A forward-looking statements against private legal actions based upon material misstatements or omissions.

Under the safe harbor, the MD&A forward-looking statements made in management's analysis of off-balance sheet arrangements will be protected if they are identified as forward-looking statements and accompanied by meaningful cautionary statements that identify important factors that could cause actual results to differ materially from those presented. The MD&A forward-looking statements will also be protected under the safe harbor unless a plaintiff can prove that the statements were made by or with the approval of an executive officer of the company who had actual knowledge that it was false or misleading. Finally, MD&A forward-looking statements that are not material will also be protected.

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[15] Accordingly, unless a foreign private issuer files a Securities Act registration statement that includes interim period financial statements and related MD&A disclosure, it would only be required to update the proposed MD&A disclosure annually.

[16] Canadian issuers will not, however, be required to include the proposed disclosures in their Securities Act registration statements filed under the MJDS system.

[17] The proposed safe harbor explicitly applies the statutory safe harbor protections (Sections 27A of the Securities Act and 21E of the Exchange Act) to the MD&A forward-looking statements required by the proposals.

The proposed safe harbor is, however, limited in a number of key respects:

- The safe harbor does not apply to forward-looking statements included in financial statements, only in MD&A.
- The safe harbor does not apply to MD&A forward-looking statements made in connection with:
    - an initial public offering;
    - a tender offer, going private transaction or roll-up transaction;
    - an offering by certain types of issuers, including a partnership, limited liability company, blank check company, penny stock issuer, or an issuer convicted of specified securities violations or subject to certain SEC administrative actions.
- The safe harbor will apply only if all of its requirements are met. Accordingly, the SEC urges companies preparing the proposed MD&A disclosure to consider the terms, conditions and scope of the safe harbor in drafting their disclosure and to tailor the required cautionary language to the specific forward-looking statements being made.[18]

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If you wish to obtain additional information regarding these new proposals or other initiatives, assistance in developing a detailed program to help ensure compliance or copies of any of our previous client memoranda, please contact John S. D'Alimonte (212-728-8212, jd'alimonte@willkie.com), Yaacov M. Gross (212-728-8225, ygross@willkie.com), Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), or the partner who regularly works with you.

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[18] Even if the proposed safe harbor is unavailable, certain current SEC rules (Securities Act Rule 175 and Exchange Act Rule 3b-6) may also provide protection for forward-looking statements included in MD&A under the proposed rules. For example, the Securities Act Rule 175 safe harbor would protect MD&A forward-looking statements made in a registration statement or prospectus for an initial public offering. The MD&A forward-looking statements could also be protected by the "bespeaks caution" doctrine developed under case law.

EXHIBIT A

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
[Long-Term Debt]					
[Capital Lease Obligations]					
[Operating Leases]					
[Unconditional Purchase Obligations]					
[Other Long-Term Obligations]					
[Total Contractual Obligations]					