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SEC Issues Rule Proposal on Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities

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On November 4, 2002, the SEC issued a proposed rule to implement Section 401(a) of the Sarbanes-Oxley Act of 2002 and to codify earlier SEC statements regarding the transparency and quality of financial disclosure. The complete text of this proposed rule can be found at http://www.sec.gov/rules/proposed/33-8144.htm.

Although this rule is currently only a proposal, we expect the SEC to adopt a final rule very quickly after the 30-day comment period ends, and we expect the substance of the final rule to be very similar to the proposed version.

The rule proposal affects public companies in two separate areas:

- disclosure of off-balance sheet arrangements; and
- disclosure of contractual obligations and contingent liabilities and commitments.

I. Proposed Rule Regarding Disclosure of Off-Balance Sheet Arrangements

Section 401(a) of the Sarbanes-Oxley Act directed the SEC to issue rules requiring public companies to disclose in their annual and quarterly financial reports all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships with unconsolidated entities or other persons that may have a material current or future effect on one or more of the companies' financial measures.

What would the proposed rule require companies to disclose?
The SEC's proposed rule would require public companies to discuss "off-balance sheet arrangements" that may have a current or future material effect on their financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources.

What does the SEC mean by the term "off-balance sheet arrangement"?
The proposed rule defines the term "off-balance sheet arrangement" to mean any transaction, agreement or other contractual arrangement to which an entity that is not consolidated with the company is a party, under which the company has, or in the future may have:

- any obligation under a direct or indirect guarantee or similar arrangement; or
- a retained or contingent interest in assets transferred to the unconsolidated entity or similar arrangement.

The proposed definition of "off-balance sheet arrangement" also explicitly includes:

- derivatives, to the extent that their fair value is not fully reflected as a liability or an asset in the company's financial statements (for example, derivatives that are classified as stockholders' equity under GAAP); and
- any obligation or liability, including a contingent obligation or liability, to the extent that it is not "fully reflected" on the face of the financial statements. These would include:
  - obligations that are not classified as liabilities according to GAAP;
  - 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, is not reasonably estimable; or
  - liabilities as to which the amount recognized in the financial statements is less than the reasonably possible maximum exposure to loss under the obligations as of the date of the financial statements.

Excluded from the definition of off-balance sheet arrangements are contingent liabilities arising out of litigation, arbitration or regulatory actions (not otherwise related to off-balance sheet arrangements) because these contingent liabilities are already the subject of disclosure requirements.

The proposed definition of off-balance sheet arrangements could encompass arrangements between a company and an entity conducting off-balance sheet activities, as well as arrangements between that entity and third parties (even if the company is not a party to those arrangements) and between the company and third parties.

How formal must an arrangement be before it must be disclosed?
The definition of off-balance sheet arrangements requires the existence of a contractual relationship. The SEC has indicated that no disclosure is required until an unconditionally binding definitive agreement (or an agreement subject only to customary closing conditions) exists or, if there is no such agreement, when settlement of the transaction occurs.

How would the materiality of an arrangement be assessed?
If management determines either that an off-balance sheet arrangement is material in the current period or that it may become material in the future, the proposed disclosure would

be required. Disclosure would not be required for an off-balance sheet arrangement where the likelihood of the occurrence of an event, or the materiality of the effect of that occurrence, is remote. In other words, an off-balance sheet arrangement "may" have a current or future material effect, and disclosure would be required, unless management determines that the occurrence of an event or the materiality of its effect is outside the realm of reasonable possibility. This is a lower threshold for disclosure than the threshold for MD&A disclosure of known events, trends and uncertainties. Even if this specific disclosure standard is not met, disclosure regarding these arrangements may still be required under general disclosure principles, if necessary to make any required statements that are included in a report not misleading.

What process does the SEC recommend for management assessments regarding the necessity of disclosure?

In the SEC's view, management must first identify and carefully review the company's direct or indirect guarantees, retained interests, equity-linked or equity-indexed derivatives and obligations (including contingent obligations) that are not fully reflected on the face of the company's financial statements. Management must then 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, no disclosure would be required. 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 occur. The company would then need to make disclosure unless it concludes that the likelihood of the event having a material effect is remote. Management's assessment of remoteness must be objectively reasonable, viewed at the time the determination is made. In addition, under the existing judicial probability/magnitude definition of materiality, a company may need to make disclosure even though the likelihood of occurrence is remote if the effects of a particular arrangement are of sufficient magnitude.

Where must companies make any required disclosure?

Companies are required to provide comprehensive explanations of off-balance sheet arrangements in their annual reports and quarterly reports (for example, Forms 10-K and 10-Q), and in their registration statements, in each case in a separately captioned section within MD&A.

If disclosure is necessary, what types of information must be provided?

A company must disclose the following information to the extent necessary for an investor to understand the effects of the off-balance sheet arrangements on the company's financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures and capital resources:

- the nature and business purpose of the off-balance sheet arrangements, including why and how the company engages in off-balance sheet arrangements;
- the significant terms and conditions of the arrangements to the extent material to an understanding of the required disclosures;
- the nature and amount of the total assets and of the total obligations and liabilities (including contingent obligations and liabilities) of the entity in which the off-balance sheet activities are conducted;
- the amounts of revenues, expenses and cash flows of the company arising from the off-balance sheet arrangements;
- the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the company;
- the nature and amount of any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from the off-balance sheet arrangements that are or may become material and the triggering events or circumstances that could cause them to arise; and
- management's analysis of the material effects of the off-balance sheet arrangements and resulting obligations and liabilities on the company's financial condition, revenues, expenses, results of operations, liquidity, capital expenditures and capital resources, including 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 support risk or other benefits.

Disclosure regarding similar arrangements must be aggregated to the extent possible (although important distinctions in terms must be discussed), and effects that are common or similar with respect to a number of arrangements must be analyzed in the aggregate to the extent aggregation increases understanding.

What disclosure must be made if benefits of an arrangement will be lost or reduced?
If under a contractual provision, or as a result of a known event, trend or uncertainty, an off-balance sheet arrangement that materially benefits the company will be terminated or its benefits to the company will be materially reduced, or if it is reasonably likely that such a termination or reduction will occur, then the company must describe the circumstances under which this termination or reduction may occur and discuss any material effects of the termination or reduction.

Would I have any protection against liability for statements of future effects?
The proposed rule provides that the statutory safe harbor protections for forward-looking information will apply to information provided about off-balance sheet arrangements. It also presumes that management's analysis of the material effects of the off-balance sheet arrangements and all information provided about loss of benefits upon a termination or

material reduction of off-balance sheet arrangements are forward-looking statements, except for historical facts.

The statutory safe harbors provide three separate bases for a company to claim the protection against liability for forward-looking statements made in its MD&A. First, a forward-looking statement would fall within the safe harbors if it is identified as forward-looking and accompanied by meaningful cautionary statements that identify important factors that could cause actual results to differ materially from those in the forward-looking statement. Second, the safe harbors protect from private liability any forward-looking statement that is not material. Third, the safe harbors preclude private liability if a plaintiff fails to prove that the forward-looking statement was made by or with the approval of an executive officer of the company who had actual knowledge that it was false or misleading. Accordingly, in the rule proposal, the SEC urges companies to consider the terms, conditions and scope of the statutory safe harbors in drafting their disclosure and to tailor the required cautionary language to the specific forward-looking statements being made.

II. Proposed Rule Regarding Disclosure of Contractual Obligations and Contingent Liabilities and Commitments

Although the Sarbanes-Oxley Act did not direct the SEC to propose a disclosure requirement with regard to contractual obligations and contingent liabilities and commitments, the SEC used this rule proposal to advance this theme from its January 2002 statement on MD&A. In the SEC's view, aggregate information about contractual obligations and contingent liabilities and commitments in a single location would improve transparency of a company's short-term and long-term liquidity and capital resource needs and demands. Further, this disclosure would provide an appropriate context for investors to assess the relative role of off-balance sheet arrangements with respect to liquidity and capital resources.

What would companies be required to disclose?

The proposed rule would require public companies to disclose, in a tabular format, an overview of their known contractual obligations as of the latest balance sheet date. The proposed rule would also require public companies to disclosure, either in a text or tabular format, an overview of the expected amount, range of amounts or maximum amount of their contingent liabilities or commitments, aggregated by type in a manner that is suitable for the company's business (for example, lines of credit, standby letters of credit, guarantees and standby repurchase obligations).

What would the tabular disclosure of contractual obligations look like?

The SEC's proposed rule includes a form of table for contractual obligations as follows:

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					

The proposed rule requires that the table include at least the periods set forth in the columns in the table above. It also mandates that a company provide amounts, aggregated by type of contractual obligation, but permits use of categories other than those specified in the table where they would be more suitable for its business. The tabular presentation may be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data.

What further specific information would be required with regard to disclosure of contingent liabilities and commitments?

The proposed rule requires that tabular or textual disclosure of contingent liabilities and commitments be separated into those that are expected to expire in less than one year, in one to three years, in three to five years and in more than five years. It also requires that, unless a range of amounts is disclosed, the company disclose whether the amount disclosed is the expected or maximum amount.

Where would this disclosure appear?

The proposed rule would require companies to make disclosure of contractual commitments and contingent liabilities and commitments in their annual report on Form 10-K. They would not be required to repeat the full disclosure in their quarterly reports on Form 10-Q, but instead would need to disclose only relevant material changes, such as amounts, in their obligations, liabilities and commitments. The required disclosure would need to appear in MD&A but would not need to be separately captioned and, within that section, could be placed where management deems appropriate.

III. Other Information

Does the proposed rule apply to foreign private issuers and small business issuers?

All of the proposed new MD&A disclosure requirements would apply to foreign private issuers that file annual reports on Form 20-F or on Form 40-F. However, foreign private issuers are not required to file quarterly reports with the SEC. Thus, unless a foreign private issuer files a Securities Act registration statement that must include interim period financial statements and related MD&A disclosure, it would not be required to update the proposed MD&A disclosure more frequently than annually. Small business issuers would be required to disclose off-balance sheet arrangements but would not be required to provide tabular or textual disclosure about contractual obligations and contingent liabilities and commitments beyond the extent of existing MD&A requirements for small business issuers.

Is the SEC's January 2002 statement on MD&A disclosure still in effect?

The SEC's January 2002 statement presented a number of factors that management should consider to identify the trends, demands, commitments, events and uncertainties that would require disclosure with respect to liquidity and capital resources. It also addressed MD&A disclosure of relationships and transactions with persons or entities that derive benefits from their non-independent relationships with the company or the company's related parties. See our earlier update entitled "SEC Focus on MD&A Disclosure" for a summary of that SEC statement:
http://www.fenwick.com/pub/corp_pubs/SEC_Proposes_New_Rules/SEC_2_1_02.htm.

The SEC explicitly stated, in its November 4, 2002 release, its belief that existing disclosure requirements, including its January 2002 statement, adequately address disclosure in most areas covered by the January 2002 statement. Therefore, it indicated that it was proposing to codify only the positions in the January 2002 statement that related to off-balance sheet arrangements. The remaining factors addressed in the January 2002 statement remain useful for companies to consider, but the SEC does not intend further rulemaking with respect to these factors.

What if I have more questions?

Should you have any questions about these proposed new requirements, please feel free to contact any member of your Fenwick & West team. You may also contact Laird Simons (lsimons@fenwick.com), Horace Nash (hnash@fenwick.com) or Eileen Duffy Robinett (erobinett@fenwick.com), each of whom contributed to the preparation of this update.