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SEC Adopts New Rules on Disclosure of Off-Balance Sheet Arrangements and Contractual Obligations

The SEC has adopted new rules requiring the disclosure:

- of off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships of an issuer with unconsolidated entities or other persons; and

- in tabular form, of aggregate contractual obligations.

The new disclosure must be located in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of SEC disclosure documents. The disclosure regarding off-balance sheet arrangements must be made in a separately captioned subsection of the MD&A.

The rules apply to both domestic and non-U.S. companies and amend Item 303 of Regulation S-K and the MD&A requirements of Form 20-F and Form 40-F. The rules do not change the current disclosure requirements of generally accepted accounting principles ("GAAP") or the disclosure requirements for financial statements and the related footnotes.

The off-balance sheet arrangement disclosure must be included in registration statements, annual reports and proxy or information statements that are required to include financial statements for fiscal years ending on or after June 15, 2003. The aggregate contractual obligations disclosure must be included in registration statements, annual reports, and proxy or information statements that are required to include financial statements for fiscal years ending on or after December 15, 2003. Registrants may voluntarily comply with the new disclosure requirements before these compliance dates.

I. Background

The rules implement Section 401(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), which requires the SEC to adopt rules that would require each annual and quarterly financial report filed with the SEC to disclose 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 financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. The language and concepts in Section 401(a) of the Act are consistent with a statement made by the SEC in January 2002, which called for enhanced

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

II. Off-Balance Sheet Arrangements

A. Scope of Arrangements Covered

The definition of off-balance sheet arrangement is designed to capture instances where a registrant must provide financial support designed to reduce risks to an unconsolidated entity or other third parties in order to facilitate a transfer of assets or otherwise finance the activities of the unconsolidated entity. The definition includes any contractual arrangement to which an unconsolidated entity is a party, under which the registrant has:

- any obligation under certain guarantee contracts;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets;
- any obligation, including a contingent obligation, under certain derivative instruments; or
- any obligation, including a contingent obligation, arising out of a variable interest in an unconsolidated entity that is held by, and material to, the registrant, where the entity provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant.

Contingent liabilities arising out of litigation, arbitration or regulatory actions (not otherwise related to off-balance sheet arrangements) are not considered off-balance sheet arrangements.

One aspect of the definition that is not explicitly called for by the Act is that the arrangements be contractual. The rules include an instruction that no obligation to make disclosure regarding an off-balance sheet arrangement will arise until an unconditionally binding definitive agreement, subject only to customary closing conditions, exists or, if there is no such agreement, when settlement of the transaction occurs.

1. Guarantees

The definition of off-balance sheet arrangements includes certain guarantees that may be a source of potential risk to a registrant's future liquidity, capital resources and results of operations, regardless of whether or not they are recorded as liabilities. The definition borrows concepts from Financial Accounting Standards Board ("FASB") Interpretation No. 45 ("FIN 45") to provide the basis for determining the guarantee contracts that must be disclosed. References to US GAAP apply whether or not an issuer presents its primary financial statements in accordance with US GAAP. Contracts and arrangements that would be considered guarantees include:

- financial standby letters of credit, market value guarantees, guarantees of the market price of the common stock of the guaranteed party and guarantees of the collection of the scheduled contractual cash flows from individual financial assets held by a special purpose entity;
- performance guarantees;

- indemnification agreements that contingently require the indemnifying party to make payments to the indemnified party based on contingencies such as adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law; and

- indirect guarantees of the indebtedness of others, such as keepwell agreements.

FIN 45 excludes certain guarantee contracts, and these are similarly excluded from the definition of off-balance sheet arrangements. The excluded items include:

- guarantees issued by insurance and reinsurance companies and accounted for under specialized accounting principles for those companies;

- a lessee's guarantee of the residual value of leased property in a capital lease;

- vendor rebates;

- product warranties;

- contingent consideration in a business combination;

- guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability);

- guarantees issued between either parents and their subsidiaries or corporations under common control;

- a parent's guarantee of a subsidiary's debt to a third party; and

- a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

2. Retained or Contingent Interests

The second element of the definition of off-balance sheet arrangements captures situations where a registrant retains an interest in assets transferred to an unconsolidated entity. For example, a subordinated retained interest in a pool of receivables transferred to an unconsolidated entity can provide credit support to the entity by cushioning the senior interests in the event that a portion of the receivables becomes uncollectible. In this event, the value of the retained interest can decline and can therefore have a material effect on a registrant's financial condition.

3. Certain Derivative Instruments

Similar to guarantees or retained interests, certain derivative instruments have been used in structuring off-balance sheet arrangements. For example, registrants may issue or hold derivative instruments that are indexed to its stock and classified as stockholders' equity under GAAP. The impact of those derivative instruments often is not transparent to investors because those derivative instruments are classified as equity and subsequent changes in fair value may not be periodically recognized in the financial statements. For registrants whose financial statements are prepared in accordance with U.S. GAAP, off-balance sheet arrangements include a contract that would be accounted for as a derivative instrument, except that it is both indexed to the registrant's own stock and classified in its statement of stockholders' equity. For other registrants, off-balance sheet arrangements include derivative instruments that are both indexed to the registrant's own stock and classified in stockholder's equity, or not reflected, in the registrant's statement of financial position.

4. Variable Interests

Off-balance sheet arrangements also include any obligation, including a contingent obligation, arising out of a material variable interest held by the registrant in an unconsolidated entity, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the registrant. The SEC intends for this element of the definition to be consistent with the concept of a "variable interest" that is included in the recently issued FASB Interpretation No. 46 ("FIN 46"). The term "variable interest" is defined in FIN 46 as "contractual, ownership, or other pecuniary interests in an entity that change with changes in the entity's net asset value." In other words, variable interests are investments or other interests that will absorb a portion of an entity's expected losses if they occur or receive portions of the entity's expected residual returns if they occur. A registrant must assess the variable interests it holds in the specified unconsolidated entities regardless of whether the entity is deemed to be a "variable interest entity" as defined in FIN 46. To focus the disclosure on the most crucial off-balance sheet arrangements, however, the definition only applies to variable interests that are material to the registrant in entities that provide financing, liquidity, market risk or credit risk support to the registrant, or engage in leasing, hedging or research and development services with the registrant.

B. Mandated Disclosure

The rules require that every MD&A include, in a separately-captioned section, a discussion of the registrant's off-balance sheet arrangements that either have, or are *reasonably likely* to have, a current or future material effect on the registrant. The disclosure is to generally cover the most recent fiscal year; but it also should address changes from the previous year where such discussion is necessary to an understanding of the disclosure.

The disclosure must include the following items to the *extent necessary to an understanding* of the off-balance sheet arrangements and their material effects on the registrant's financial condition, changes in financial condition, revenues and expenses, results of operations, liquidity, capital expenditures and capital resources.

1. Nature and Business Purpose of the Arrangements

The disclosure regarding the nature and business purpose of the off-balance sheet arrangements must explain to investors why and how the registrant engages in off-balance sheet arrangements. For example, a registrant may indicate that the arrangements enable the registrant to lease certain facilities rather than acquire them, where the latter would require the registrant to recognize a liability for the financing. Other possible disclosure under this requirement may indicate that the off-balance sheet arrangement enables the registrant to readily obtain cash through sales of groups of loans to a trust; to finance inventory, transportation or research and development costs without recognizing a liability; or to lower borrowing costs of unconsolidated affiliates by extending guarantees to creditors of those affiliates.

2. Importance to Registrant

The disclosure must provide investors with an understanding of the importance of off-balance sheet arrangements to the registrant in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits. For example, if a registrant materially relies on off-balance sheet arrangements for its liquidity and capital resources, the registrant may be required to disclose how often it securitizes financial assets, to what degree its securitizations are a material source of liquidity, whether it has materially increased or decreased securitizations from past periods and to explain such increase or decrease. Together with the other disclosure requirements, registrants should provide information sufficient for investors to assess the extent of the risks that have been transferred and retained as a result of the arrangements.

3. Magnitude of Off-Balance Sheet Arrangements

Registrants also must provide investors with insight into the overall magnitude of the registrant's off-balance sheet activities, the specific material impact of the arrangements on the registrant and the circumstances that could cause material contingent obligations or liabilities to come to fruition. Disclosure is required to the extent material and necessary to investors' understanding of:

- the amounts of revenues, expenses and cash flows arising from the arrangements;
- the nature and amounts of any interests retained, securities issued and other indebtedness incurred in connection with such arrangements; and
- the nature and amount of any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from the arrangements that are, or are reasonably likely to become, material and the triggering events or circumstances that could cause them to arise.

4. Known Causes of Termination or Reduction

The disclosure must also identify any known event, demand, commitment, trend or uncertainty that will, or is reasonably likely to, result in the termination, or material reduction in availability to the registrant, of its off-balance sheet arrangements that provide the registrant with material benefits. A registrant must disclose, for example, any material contractual provisions calling for the termination or material reduction of an off-balance sheet arrangement.

The disclosure also must address factors that are reasonably likely to affect the registrant's ability to continue using off-balance sheet arrangements that provide it with material benefits. For example, if a registrant's credit rating were to fall below a certain level, some off-balance sheet arrangements may require the registrant to purchase the assets or assume the liabilities of an unconsolidated entity. In addition, a change in a registrant's credit rating could either preclude or materially reduce the benefits to the registrant of engaging in off-balance sheet arrangements. In such cases, the registrant must disclose known circumstances that are reasonably likely to cause its credit rating to fall to the specified level and discuss the material consequences of the drop in ratings.

In addition, the registrant must discuss the course of action that it has taken or proposes to take in response to a termination or material reduction in the availability of an off-balance sheet arrangement that provides material benefits.

5. Other Information

In addition to the specifically enumerated disclosure, a registrant must also provide such other information as it believes necessary for an understanding of its off-balance sheet arrangements and the material effects of these arrangements on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. Consistent with traditional MD&A disclosure, management has the responsibility to identify and address the key variables and other qualitative and quantitative factors that are peculiar to, and necessary for, an understanding and evaluation of the registrant. The disclosure should provide investors with management's insight into the impact and proximity of the potential material risks that are reasonably likely to arise from material off-balance sheet arrangements.

C. Disclosure Threshold

The new rules require disclosure of off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. This test differs from the proposed requirement that would have focused on arrangements that may have a material current or future effect, which would have required disclosure unless the likelihood of the occurrence of an event, or its materiality, is remote. The disclosure threshold is consistent with the existing disclosure threshold for MD&A. Nevertheless, even if a material effect is not reasonably likely, disclosure may still be required in the footnotes to the registrant's financial statements. As proposed, the rules would have required disclosure of off-balance sheet arrangements that "may" have a current or future material effect on the registrant.

To apply the disclosure threshold, management first must identify and critically analyze the registrant's off-balance sheet arrangements. Management must then undertake the customary analysis under SEC interpretations of the MD&A rules. It must first assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect an off-balance sheet arrangement (e.g., performance under a guarantee; an obligation under a variable interest or equity-linked or indexed derivative instrument; or recognition of an impairment). If management concludes that the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur, then no disclosure is required in MD&A. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources is not reasonably likely to occur.

Consistent with the existing standard for disclosure threshold determinations that management must make in drafting MD&A, the assessment described above must be objectively reasonable, viewed as of the time the determination is made.

No disclosure will be required until a binding definitive agreement, subject only to customary closing conditions, exists or if there is no such agreement, upon settlement.

D. Location and Format of Disclosure

The rules require registrants to present the proposed disclosure about off-balance sheet arrangements in a separate, designated subsection of MD&A. MD&A should be presented in language and a format that is clear, concise and understandable. Disclosure regarding similar arrangements should be aggregated to the extent practicable, but important distinctions in terms and effects of aggregated arrangements must be discussed. Effects that are common or similar with respect to a number of off-balance sheet arrangements must be analyzed in the aggregate to the extent the aggregation increases understanding.

Information should be organized in an efficient and understandable manner, while avoiding repetition and disclosure of immaterial information. The SEC warned that disclosure that could easily be transferred from year to year, or from company to company, with no change, would neither inform investors adequately nor reflect the independent thinking that must accompany the assessment by management that is intended for MD&A disclosure.

To eliminate unnecessary repetition, the rules allow a registrant to include within its MD&A section a cross-reference to information in the footnotes to the financial statements. The cross-reference must clearly identify specific information in the footnotes and must integrate the substance of the footnotes into the MD&A discussion in a manner designed to inform readers of the significance of the information that is not included within the body of the MD&A.

III. Contractual Obligations

Additional amendments to the MD&A rules require tabular disclosure of a registrant's known contractual obligations as of the latest fiscal year end balance sheet date. The disclosure is similar to that called for by the SEC in its January 2002 statement regarding MD&A. The tabular presentation should include at least the periods of less than one year, one to three years, three to five years and more than five years. In contrast to the proposed rules, which only suggested categories to be addressed, the table must provide amounts of the following types of contractual obligations, aggregated by type:

- Long-term debt obligations;
- Capital leases obligations;
- Operating leases obligations;
- Purchase obligations; and
- Other long-term liabilities reflected on registrant's balance sheet under the registrant's applicable GAAP.

The format of the table should be in substantially the same form as provided in Annex A to this memorandum.

The specified categories may be disaggregated using other categories suitable to the registrant's business, but the presentation must include all obligations that fall within the specified categories. The tabular presentation should be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the contractual obligations.

To aid registrants, the rules define the first four categories of obligations. For issuers that present their privacy financial statements in accordance with US GAAP, the rules define the first three categories by reference to US GAAP accounting pronouncements. Registrants using non-U.S. GAAP should include obligations that are consistent with the classifications used in that GAAP.

As used in the rule, the term "purchase obligation" means an agreement to purchase goods or services that is enforceable and legally binding on the registrant that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. If the purchase obligations are subject to variable price provisions, then the registrant must provide estimates of the payments due and appropriate footnotes. According to the SEC, the purchase obligations category is meant to capture the registrant's capital expenditures for purchases of goods or services over a five-year period. Disclosure of the amounts of a registrant's purchase obligations should be made without regard to whether notes or other commercial instruments will be used to satisfy such obligations because those instruments could have a significant effect on the registrant's liquidity.

A registrant is not required to include the table for interim periods. Instead, a registrant should disclose material changes outside the ordinary course of the registrant's business in the specified contractual obligations during the interim period by including a discussion of the relevant changes.

The SEC originally proposed, but did not adopt, a disclosure requirement for contingent liabilities and commitments. According to the SEC, meaningful disclosure of contingent liabilities and commitments is not necessarily best accomplished by an aggregated disclosure format (either tabular or textual) because such a format would inevitably omit important information about the operative facts and circumstances of contingent liabilities and commitments. In addition, a number of new developments in the accounting literature, including the newly adopted rules regarding off-balance sheet arrangements and contractual obligations, address a registrant's contingent liabilities and commitments and may obviate the need for this additional disclosure requirement. The SEC intends to continue to assess the costs and benefits of an MD&A disclosure requirement for aggregate contingent liabilities and commitments in connection with its ongoing review of MD&A. Pending future SEC action on the subject, registrants should refer to the SEC's existing guidance in its January 2002 statement to consider whether it would be beneficial to investors to include tabular disclosure of aggregate commercial commitments.

IV. Effect on Other SEC Statements and Proposals

A. January 2002 Statement Regarding MD&A

In an effort to provide guidance to public companies, the SEC issued a statement in January 2002 regarding a number of factors that management should consider regarding the MD&A disclosure requirements for liquidity and capital resources, off-balance sheet arrangements, certain trading activities that include non-exchange traded contracts accounted for at fair value, and transactions with persons or entities that derive benefits from their non-independent relationships with the registrant or the registrant's related parties. The amendments relating to disclosures that fall within the scope of the new rules will supersede the guidance in the January 2002 statement on disclosure of off-balance sheet arrangements as of the compliance date for the amendments. On the compliance date for the amendments relating to disclosure of the table of contractual obligations, the guidance in the January 2002 statement on disclosure of the table of contractual obligations also will be superseded by the amendments. All other guidance in the January 2002 statement will remain in effect.

While the compliance dates for the amendments apply to annual reports, registration statements and proxy or information statements that are required to include financial statements for the fiscal years ending on or after June 15, 2003 for disclosure about off-balance sheet arrangements and December 15, 2003 for the table of contractual obligations, the SEC expects that registrants with fiscal years ending before the compliance dates will continue to follow the guidance in the January 2002 statement.

B. Form 8-K Proposal

The SEC has separately proposed amendments to Form 8-K that would require domestic issuers to file current reports on Form 8-K in the event of the creation of a direct or contingent material financial obligation or the occurrence of an event triggering a direct or contingent material financial obligation. Those amendments are not affected by the new MD&A amendments. If adopted, the Form 8-K requirements will require disclosure of material contingent obligations arising from off-balance sheet arrangements even if they fall below the "reasonably likely" threshold adopted for MD&A disclosure.

V. Application to Foreign Private Issuers

The new MD&A disclosure requirements will apply to foreign private issuers that file annual reports on Form 20-F or on Form 40-F. This represents a continuation of the SEC's general policy that the MD&A-equivalent requirements for foreign private issuers mirror the substantive MD&A requirements for U.S. companies.

The proposed MD&A disclosure requirements also apply to Canadian issuers that file Form 40-F. Although a Canadian issuer typically prepares its Form 40-F MD&A discussion in accordance with Canadian disclosure standards, the SEC has nevertheless required that Form 40-Fs include disclosure of off-balance sheet arrangements and a table of contractual obligations in accordance with the adopted SEC rules.

Section 401(a) of the Act also requires the SEC to adopt off-balance sheet disclosure rules that apply to quarterly financial reports. Foreign private issuers are not required to file quarterly reports with the SEC and the adopted rules do not apply to Form 6-K reports. 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 will not be required to update the proposed MD&A disclosure more frequently than annually.

The MD&A disclosure that foreign private issuers currently provide in documents filed with the SEC must focus on the primary financial statements, whether those are prepared in accordance with U.S. GAAP or non-U.S. GAAP. Foreign private issuers whose primary financial statements are prepared in accordance with a non-U.S. GAAP should include in their MD&A a discussion of the reconciliation to U.S. GAAP, and any differences between foreign and U.S. GAAP, if it would be necessary for an understanding of the financial statements as a whole. Consistent with this SEC view, the disclosure about off-balance sheet arrangements and the table of contractual obligations must focus on the primary financial statements presented in the document, while taking the reconciliation into account.

The definition of off-balance sheet arrangements covers the same types of arrangements regardless of whether a registrant is a foreign private issuer or a domestic issuer. In the SEC's view, references to U.S. GAAP in the definition best achieve the appropriate scope of arrangements that require more transparent disclosure, regardless of any particular accounting treatment. To identify the types of arrangements that are subject to disclosure under the amendments, a foreign private issuer must assess its guarantee contracts and variable interests pursuant to U.S. GAAP. Foreign private issuers must already make this assessment when they reconcile or prepare their financial statements in accordance with U.S. GAAP. A foreign private issuer's MD&A disclosure should continue to focus on its primary financial statements despite the fact that its various "off-balance sheet arrangements" have been defined by reference to U.S. GAAP.

VI. Safe Harbor for Forward-Looking Information

To encourage the type of information and analysis necessary for investors to understand the impact of off-balance sheet arrangements and to reduce the burden of estimating the payments due under contractual obligations, the rules include a safe harbor for forward-looking information. The safe harbor explicitly applies the existing statutory safe harbor protections (Sections 27A of the Securities Act and 21E of the Exchange Act) to forward-looking information that would be required to be disclosed by the new rules.

The adopted safe harbor is designed to remove possible ambiguity about whether the statutory safe harbors would apply to some of the statements made in response to the disclosure requirements. The adopted safe harbor language specifies that, except for historical facts, all information called for regarding management's analysis of the material effects of off-balance sheet arrangements and the discussion of the effects of the termination or reduction of off-balance sheet arrangements would be deemed to be a "forward-looking statement" as that term is defined in the statutory safe harbors.

In addition, with respect to the MD&A discussion of off-balance sheet arrangements, the SEC is adopting a provision that the "meaningful cautionary statements" element of the statutory safe harbors will be satisfied if a registrant satisfies all of its off-balance sheet arrangements disclosure requirements. Because the new MD&A safe harbor is closely linked to the statutory safe harbors, the SEC urges registrants preparing their disclosure to consider the terms, conditions and scope of the statutory safe harbors in drafting their disclosure.

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The summary of the newly adopted rules set forth herein is intended to be general in nature. It is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (see below). In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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Annex 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]					
[Purchase Obligations]					
[Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP]					
Total					