

Corporate Finance Alert

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The SEC Proposes New Rules to Implement Sarbanes-Oxley Act Provisions Regarding Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments

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On November 4, 2002, the Securities and Exchange Commission announced a proposed rule to implement Section 401(a) of the Sarbanes-Oxley Act concerning off-balance sheet arrangements. Although that Act does not compel rule-making regarding contractual obligations and contingent liabilities and commitments, the proposed rule also codifies prior guidance given by the SEC with respect to such obligations, liabilities and commitments. The proposed new rule attempts to clarify the nature of off-balance sheet arrangements and the disclosure that registrants must provide about such arrangements and other contractual obligations and contingent liabilities and commitments. While the proposed rule clarifies the required disclosure, the SEC made clear its view that existing rules respecting disclosure already require disclosure of off-balance sheet arrangements and other contingencies.

Off-Balance Sheet Arrangements

Under the proposed new rule, which adds a new disclosure directive to Section 303 of Regulation S-K, registrants must describe and discuss off-balance sheet arrangements **in a new separate section of the MD&A** to the extent that the off-

balance sheet arrangements “**may** have a current or future material effect on the registrant’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.” (emphasis not in original). However, the obligation to disclose (a) does not arise “until a definitive agreement that is unconditional or subject only to customary closing conditions exists or, if there is no such arrangement, when settlement of the transaction occurs”, and (b) will not exist if “the likelihood of either the occurrence of an event implicating an off-balance sheet arrangement, or the materiality of its effect, is remote.”

It is important to note that the standard for disclosure in the MD&A, generally, is different than the standard for disclosure in the proposed rule respecting off-balance sheet arrangements. The general rule is that disclosure in the MD&A is required where an item is “reasonably likely” to have a material effect on the registrant. The standard for disclosure with respect to off-balance sheet arrangements is lower, involving only whether the arrangement may have a material effect on the registrant. The SEC believes that in

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the Sarbanes-Oxley Act Congress mandated a lower threshold for disclosure with respect to off-balance sheet arrangements.

The term “off-balance sheet arrangement” is defined in the proposed rule as:

“any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party, under which the registrant, whether or not a party to the arrangement, 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 an unconsolidated entity or similar arrangement;
- (C) derivatives to the extent that the fair value thereof 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, to the extent that it is not fully reflected in the financial statements (excluding the footnotes thereto). Obligations or liabilities that are not fully reflected in the financial statements (excluding the footnotes thereto) include, without limitation: obligations that are not classified as a liability according to generally accepted accounting principles; 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 obligation as of the date of the financial statements. Contingent liabilities arising out of litigation, arbitration or regulatory actions (not otherwise related to off-balance sheet arrangements) are not off-balance sheet arrangements.”

The definition of off-balance sheet arrangements diverges slightly from the definition contained in the Sarbanes-Oxley Act. The difference reflects the SEC’s desire to aid registrants in providing focused disclosure of the arrangements that warrant disclosure. Examples of off-balance sheet arrangements are:

- securitization of assets where the transferor of the assets retains some risk associated with the transferred assets
- guarantees of obligations of third-parties
- certain derivative transactions
- keepwell agreements which typically involve a guarantee by a corporate parent to keep a subsidiary solvent

When describing the off-balance sheet arrangements, the proposed rule requires registrants to include the following information to the extent necessary to an understanding of the effect of the off-balance sheet arrangement on the registrant:

- (A) “the nature and business purpose of the registrant's off-balance sheet arrangements and, to the extent necessary to an understanding of the disclosures under this paragraph ..., the significant terms and conditions of the arrangements, including those between the registrant and any entity in which off-balance sheet activities are conducted and between the registrant or that entity and other persons;
- (B) with respect to an entity in which off-balance sheet activities are conducted, the nature and amount of the total assets and of the total obligations and liabilities (including contingent obligations and liabilities) of that entity;
- (C) the amounts of revenues, expenses and cash flows of the registrant arising from the arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the registrant; and any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from the arrangements that are or may become material and the triggering events or circumstances that could cause them to arise; and
- (D) management's analysis of the material effects of any of the items identified in [the preceding] paragraphs ... on the registrant's financial condition, changes in financial condition, revenues or

expenses, results of operations, liquidity, capital expenditures and capital resources. 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. An analysis of the degree to which the registrant relies on off-balance sheet arrangements for its liquidity and capital resources or market risk or credit risk support or other benefits also must be disclosed.”

Registrants that materially benefit from off-balance sheet arrangements which will terminate or that will have the benefits materially reduced are also obligated to discuss the circumstances of the change in the off-balance sheet arrangement and its material effect on the registrant.

Contractual Obligations, Contingent Liabilities and Commitments

While registrants ordinarily disclose contractual obligations and contingent liabilities and commitments throughout disclosure documents, there is no current requirement to aggregate such information. Even though not required by the Sarbanes-Oxley Act, the SEC has now proposed that registrants aggregate that information in one location of the registrant's choice to improve the “transparency of a registrant's short- and long-term liquidity and capital resource needs and demands.” The proposed rule will require that registrants (other than small business issuers) disclose, on an aggregate basis, broken down by type of obligation,

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					

contractual obligations in tabular form and contingent liabilities or commitments in either tabular form or in text. Registrants will also need to disclose any material changes in the amount of contractual obligations and contingent liabilities and commitments.

The proposed rule offers a model table and directs that the table used by the registrant to disclose contractual commitments include at least the periods set forth in the model table. The table is to be presented as of the most recent balance sheet date. A copy of the model table is set forth above.

The rules described in this Alert are proposed rules and not final rules. As we have done with the

other corporate governance reform developments, we will keep you posted on the status of these rules and on any substantive modifications that the SEC makes before finalizing them. Please note that these rule proposals would also apply to small business issuers (Regulation S-B filers) unless otherwise specified, and foreign issuers.

For more information about the new SEC rules or other corporate governance reform measures, please contact Peter H. Ehrenberg, Member of the Firm and Chairman of Lowenstein Sandler's Corporate Department and its M&A and Corporate Finance Practice Group, or Jeffrey M. Shapiro, Counsel and a member of the M&A and Corporate Finance Practice Group, at (973) 597-2500.