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HRO Alert

The Sarbanes-Oxley Act of 2002

Final Rules:

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

On January 27, 2003, the SEC released final rules relating to the disclosure of:

- Off-balance sheet arrangements; and
- Contractual obligations.

These rules, issued under the Sarbanes-Oxley Act of 2002 (the "SO Act"), finalize and, in some cases, revise the SEC's proposed rules in these areas, which were released on November 4, 2002.

This HRO Alert summarizes the main provisions of the final rules, which apply to both U.S. public companies and foreign private issuers. The off-balance sheet arrangement disclosure must be included in registration statements, annual reports and proxy or information statements for fiscal years ending on or after **June 15, 2003**. Companies (other than small business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements for fiscal years ending on or after **December 15, 2003**.

OFF-BALANCE SHEET ARRANGEMENTS

Background

In the release accompanying the proposed rules relating to off-balance sheet arrangements, the SEC noted that 80% of public companies engage in off-balance sheet arrangements. Typical off-balance sheet arrangements include: obtaining financing at a lower cost of capital than would otherwise be available; allocation of risk among third parties; and facilitation of the transfer of assets through the use of structured finance or special purpose entities, often with continuing involvement with the transferred assets by use of financial guarantees, retained interests or keepwell agreements.

To increase the transparency of public company off-balance sheet arrangements and implement the requirements of the SO Act, the final rules adopted by the SEC require companies to include specific disclosures regarding their off-balance sheet arrangements in a separately-captioned section of the MD&A.

Definition of Off-balance Sheet Arrangement

The proposed rules define "off-balance sheet arrangement" as any transaction, agreement or other contractual arrangement to which an entity not consolidated with the reporting company is a party, under which the reporting company (whether or not a party to the arrangement) has:

- Any obligation under a **guarantee contract** that has any of the characteristics identified in paragraph 3 of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002) ("FIN 45"); which generally includes contracts such as:

- a financial standby letter of credit,
 - a market value guarantee,
 - a guarantee of the collection of the contractual cash flows from individual financial assets held by a special purpose entity,
 - a performance guarantee,
 - an indemnification agreement, or
 - a keepwell agreement.
- 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 such entity for such asset;
 - Any obligation, including a contingent obligation, under a contract that would be accounted for as a **derivative instrument**, except that it is both indexed to the company's own stock and classified in stockholders' equity in the company's statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instrument and Hedging Activities* (June 1998); or
 - Any obligation, including a contingent obligation, arising out of a **variable interest** (defined in FASB Interpretation No. 46 as a "contractual, ownership, or other pecuniary interests in an entity that change with changes in the entity's net asset value") in an unconsolidated entity that is held by, and material to, the company, where such unconsolidated entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the company.

Disclosure Standard

Under the final rules, a company must disclose off-balance sheet arrangements that "have or are reasonably likely to have a current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors." In the proposed rules, the SEC proposed a disclosure standard for off-balance sheet arrangements that "may have" a current or future effect on the company. After receiving a number of comments on this heightened disclosure standard, the SEC adopted the final rules with the "reasonably likely" standard, which is consistent with the existing disclosure threshold for information that could have a material effect on the financial condition, changes in financial condition or results of operations required to be included in MD&A.

The SEC suggested a two-step analysis for a company to apply when determining whether disclosure of its off-balance sheet arrangements is required in its MD&A. First, a company should identify and review its off-balance sheet arrangements. Second, the company must assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could require the company to perform under any of its off-balance arrangements. No disclosure relating to the off-balance sheet arrangement is necessary if management concludes that the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur. If management cannot make such a determination, an objective evaluation must be completed regarding the consequences of the known trend, demand, commitment, event or uncertainty coming to fruition. Following this analysis, the company would make the necessary disclosures about the off-balance sheet arrangement, unless management concluded that a material effect on the company's financial condition, changes in financial condition, revenues or expenses, result of operations, liquidity, capital expenditures or capital resources is not reasonably likely to occur.

Disclosures

The proposed rules require that, in a separately-captioned section of the MD&A, a company analyze and disclose the following items to the extent necessary to understand the effect of the off-balance sheet arrangements on the company's financial condition:

- The nature and business purpose of the off-balance sheet arrangements;
- The importance to the company of such off-balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits;
- 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 in connection with the off-balance sheet arrangements;
- The nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from the off-balance sheet arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise;
- Any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination, or material reduction in availability to the company, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the company has taken or proposes to take in response to any such circumstances.

In addition to the items specified above, a company's discussion of its off-balance sheet arrangements should include any other information necessary for a full understanding of the company's off-balance sheet arrangements. The SEC instructed that the discussion of off-balance sheet arrangements will generally relate to the most recent fiscal years. However, where comparison of fiscal years increases the understanding of the company current situation, disclosure regarding changes in off-balance sheet arrangements from the previous year should be included.

If a number of a company's off-balance sheet arrangements have effects that are common or similar, management should analyze such effects in the aggregate to the extent it would increase understanding of the company's off-balance sheet arrangements. The company, however, must discuss important distinctions in terms and effects of the aggregated arrangements.

DISCLOSURE OF CONTRACTUAL OBLIGATIONS

In addition to the required disclosures about off-balance sheet arrangements, the final rules require a public company (other than a small business issuer) to disclose information about its contractual obligations, including both on- and off-balance sheet arrangements, as of the date of its latest balance sheet. This disclosure goes beyond that required by the SO Act and does not contain a materiality threshold for the obligations that must be included. Likewise, the fact that a note or other commercial instrument may be used to satisfy contractual obligations does not affect the company's obligation to disclose those obligations if covered by the rule.

Under the final rules, a company would be required to disclose the amounts of its contractual obligations, aggregated by type, in a table similar to the following:

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]					

Unlike the proposed rules, the final rules specify that the following categories must be included in the table:

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

The first three categories are defined by reference to the corresponding concepts under GAAP (U.S. or non-U.S.). A "purchase obligation" is defined as "an agreement to purchase goods or services that is enforceable and legally binding on the registrant and 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." This category is designed to capture the company's "capital expenditures for purchases of goods or services over a five-year period." The "other long-term liabilities" category is intended to cover all other long-term liabilities required to be disclosed by the company's GAAP (U.S. or non-U.S.). Provisions that could create, increase or accelerate obligations should be disclosed in footnotes to the table.

The proposed rules would have allowed companies to use different categories in the table as would be appropriate for each company's business, provided that the specified time frames were included. A company may still choose to use additional categories or subcategories under the final rules, but the disclosure must include all obligations that fall within the specified categories.

The final rules do not implement the SEC's proposal to require a company to disclose, either in a table or in text, the expected amount, range of amounts or maximum amount of contingent liabilities or commitments that are expected to expire within the same time frames included in the table above. The SEC was persuaded that a tabular format might not be the most meaningful way to disclose these obligations, and noted that several other new disclosure requirements implicate contingent liabilities and may eliminate the need for a separate disclosure rule.

The disclosure required by these rules must be included in the MD&A section of a company's annual report on Form 10-K, 20-F or 40-F. Quarterly or interim reports will not need to include this disclosure, but the reporting company should discuss material changes to the information previously disclosed in its annual report. Unlike the disclosure about off-balance sheet arrangements, the contractual obligations disclosure need not be set apart in a separately-captioned section of the MD&A.

SAFE HARBOR FOR FORWARD-LOOKING INFORMATION

You should also be aware that some of the disclosure contemplated by the final rules necessarily entails the use of forward-looking statements. The final rules provide that the statutory safe harbor applies to any forward-looking statement that is required by the final rules 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 identified in the statement;
- it is not material; or
- in a private liability action, the plaintiff fails to prove that the 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.

The safe harbor is available to the company, persons acting on its behalf, outside reviewers retained by it and (when using information provided by the company) its underwriters. The final rules also provide that the "meaningful cautionary statements" condition will be satisfied if the company satisfies all disclosure requirements with respect to its off-balance sheet arrangements.

HOW HRO CAN HELP

These final rules are likely to have a significant impact on your company's disclosure practices. If you would like to discuss these rules and how they may affect your company, we encourage you to contact any of the persons listed in the margin of the first page of this HRO Alert.

This HRO Alert is a periodic publication of Holme Roberts & Owen LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances. Nor is it intended to address specific disclosure or compliance issues that may arise in particular circumstances or all of the provisions included in the newly adopted rules. The contents are intended for general informational purposes only, and you are urged to consult counsel concerning your own situation and any specific legal questions you may have. For further information regarding the rules described herein, please contact any of the persons listed in the margin of the first page of this HRO Alert.

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