

SEC ADOPTS NEW FINANCIAL STATEMENT AND PERIODIC REPORTING RULES FOR GUARANTEED SECURITIES

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On August 4, 2000 the Securities and Exchange Commission (the "SEC") issued a release¹ (the "Release") adopting new financial statement rules relating to issuances of guaranteed securities and putting in place an exemption from Exchange Act periodic reporting for subsidiary issuers and guarantors. As a general matter, if a subsidiary issuer or subsidiary guarantor is 100% owned by its parent company, and the guarantee of the parent company or the subsidiary guarantor is full and unconditional, the new rules permit the presentation of condensed consolidating financial information for the subsidiary issuer or subsidiary guarantor instead of presentation of separate financial statements. In cases where a subsidiary issuer or subsidiary guarantor is not 100% owned by its parent company or where the guarantee is not full and unconditional, separate financial statements for the subsidiary issuer or subsidiary guarantor will continue to be required.

The new rules continue the practice of only requiring certain narrative disclosure instead of additional financial information in cases of securities issued by 100% owned finance subsidiaries that are fully and unconditionally guaranteed by their parent companies. The new rules eliminate the alternative of presenting summarized financial information with respect to subsidiary issuers of guaranteed securities and subsidiary guarantors that had been permitted in certain circumstances.

The new rules codify, in part, the positions that the SEC Staff has developed through Staff Accounting Bulletin No. 53 ("SAB 53"), later no-action interpretations and the registration statement review process. The SEC's action is intended to:

- eliminate uncertainty regarding what financial statements are required for issuers and guarantors of guaranteed securities;
- benefit issuers and guarantors of guaranteed securities by clarifying ongoing reporting requirements in relation to such securities; and
- reduce the need for no-action letters and exemptive requests in this area.

¹ SEC Release No. 33-7878; 34-43124 (August 8, 2000). The new rules are similar to the rules proposed in its proposing release (SEC Release No. 33-7649) issued on March 5, 1999 but have been revised in certain significant respects.

The new rules and the positions expressed in the Release will replace **all** prior SEC staff no-action positions relating to SAB 53. As a result, it is imperative that issuers of guaranteed securities and guarantors carefully consider the new rules and assess whether they will need to change their historical reporting practices. The new rules generally become effective for U.S. issuers on September 25, 2000, although if a reporting company does not file a registration statement after that date, it will first need to comply with the new rules in periodic reports with its first annual report on Form 10-K for a fiscal year ending after September 25, 2000.

SUMMARY

The Release revises Rule 3-10 of Regulation S-X in its entirety and retitles this Rule “Financial statements of guarantors and issuers of guaranteed securities registered or being registered”. As recast, Rule 3-10 generally permits the presentation of condensed consolidating financial information instead of separate financial statements of a subsidiary issuer or subsidiary guarantor so long as the subsidiary issuer or subsidiary guarantor is 100% owned by its parent company and the guarantee of the parent company or subsidiary guarantor, as the case may be, is full and unconditional. In addition, the Rule specifies four cases in which neither separate financial statements nor condensed consolidating financial information are required:

- a subsidiary issuer is a finance subsidiary² and the only guarantor is the parent company;
- (i) a subsidiary issuer is a finance subsidiary, (ii) the parent company has no independent assets or operations³ and (iii) the parent company and all of the parent company’s subsidiaries other than the subsidiary issuer guarantee the securities;
- (i) the parent company of a subsidiary issuer has no independent assets or operations, (ii) the parent company guarantees the securities, (iii) the securities

² For the purposes of Rule 3-10, a subsidiary is a finance subsidiary if it has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent.

³ For the purposes of Rule 3-10, a parent company has no independent assets or operation if each of its total assets, revenues, income from continuing operations before income taxes and cash flows from operating activities (excluding amounts related to its investment in its consolidated subsidiaries) is less than 3% of the corresponding consolidated amount.

are not guaranteed by any subsidiary of the parent and (iv) any subsidiaries of the parent company other than the subsidiary issuer are minor;⁴

- a parent company issuer has no independent assets or operations and all of its subsidiaries (other than minor ones) guarantee the securities.

In each of these cases, in order to be exempt from the requirement to provide separate financial statements or condensed consolidating financial information, the subsidiary issuer and/or subsidiary guarantors must be 100% owned by the parent company and all of the guarantees must be full and unconditional. In addition, certain narrative disclosures must be included in the footnotes to the parent company's financial statements.

New Exchange Act Rule 12h-5 is also being adopted to clarify periodic reporting requirements for subsidiary issuers and subsidiary guarantors. Rule 12h-5 provides that subsidiary issuers and subsidiary guarantors that are permitted to omit separate financial statements under Rule 3-10 are exempt from Exchange Act reporting requirements. The SEC is also amending Form 20-F to make changes to conform to the new rules.

Each of the new rules is discussed in greater detail below.

**FINANCIAL STATEMENT REQUIREMENTS
FOR ISSUERS OF GUARANTEED SECURITIES
AND SUBSIDIARY GUARANTORS**

GENERAL

In 1983 the SEC issued SAB 53 that provided that one of three different levels of financial information disclosure would be appropriate in connection with issuances of debt by subsidiary issuers guaranteed by their parent companies:

- no separate disclosure;
- summarized disclosure; or
- in cases where the guarantees were not full and unconditional or the subsidiary was not wholly owned by the parent guarantor, full disclosure.

SAB 53 contemplated that no separate disclosure would be necessary where the issuer of a guaranteed security was wholly owned by the guarantor and essentially had no independent

⁴ For the purposes of Rule 3-10, a subsidiary is minor if each of its total assets, stockholders' equity, revenues, income from continuing operations before income taxes and cash flows from operating activities is less than 3% of the parent company's corresponding consolidated amount.

operations and where the guarantee was full and unconditional. SAB 53 stated that summarized disclosure was appropriate where the issuer of a guaranteed security was wholly owned by the guarantor but had more than minimal independent operations of its own and where the guarantee was full and unconditional. In the light of the significant increase in recent years of complex financing structures involving multiple guarantors and, in some cases, co-issuers, diminishing clarity in terms of whether summarized or condensed consolidating financial information was required in registration statements and periodic reports and the large number of requests for exemptive relief in relation of guarantor periodic reporting requirements, the SEC determined to codify subsidiary issuer and subsidiary guarantor financial information requirements and adopt the new rules set forth in the Release.

RULE 3-10 OF REGULATION S-X

Rule 3-10(a) requires that issuers and guarantors of registered securities each include separate financial statements, regardless of the nature of the securities, the relationship between the entities or whether the guarantee is full and unconditional. However, subsections (b)-(f) of the Rule provide for a number of exceptions permitting modified financial information in registration statements (and in the parent company's Exchange Act filings). Upon the satisfaction of certain conditions, exceptions are permitted when:

- a finance subsidiary issues securities guaranteed by its parent;
- an operating subsidiary issues securities that its parent company guarantees;
- a subsidiary issues securities that its parent or one or more subsidiaries of the parent guarantee;
- a parent company issues securities that one of its subsidiaries guarantees; or
- a parent company issues securities guaranteed by more than one of its subsidiaries.

To take advantage of any of these Rule 3-10 exceptions, the parent company's financial statements must be filed for the periods specified in Rules 3-01 and 3-02 of Regulation S-X. In addition, the subsidiary issuer or subsidiary guarantor must be 100% owned by the reporting parent company and the guarantees must be full and unconditional. For the purposes of Rule 3-10, a subsidiary is 100% owned if all of its outstanding voting shares⁵ and any outstanding

⁵ The Release provides that, in the case of non-corporate entities, the ownership test will be applied by reference to interests in the subsidiary issuer or guarantor, as the case may be. A subsidiary not in corporate form is 100% owned if all outstanding interests in that subsidiary are owned, either directly or indirectly, by its parent company other than (i) securities to which Rule 3-10 applies that are guaranteed by its parent company and, if applicable, other 100% owned subsidiaries of its parent

securities convertible into its voting shares (including options) are owned directly or indirectly by the parent.⁶ The SEC has put this standard in place to assure investors that there is no competing equity interest in the subsidiary and to allow investor to evaluate the creditworthiness of the issuer and guarantor. If the 100% owned test cannot be met, relief can be requested from the Division of Corporation Finance if the underlying facts show sufficient financial unity needed to qualify for the exceptions to Rule 3-10.⁷

In addition, to take advantage of any of these Rule 3-10 exceptions, the guarantees must be full and unconditional. Rule 3-10 provides that a guarantee will be considered to be full and unconditional if :

- the guarantor is obligated to make a scheduled payment immediately upon failure of the issuer to make that payment; and
- any securityholder has the right to immediately sue the guarantor for unpaid amounts.

A guarantee is not full and unconditional if any of the following conditions exist:

- the guarantor's liability is less than the issuer's;
- upon an issuer default, the guarantor's payment schedule differs from the issuer's; or
- there are any conditions to the guarantor's obligation to pay.⁸

company and (ii) guarantees of securities issued by its parent company and, if applicable, other 100% owned subsidiaries of its parent company.

⁶ Appendix A to the Release contains examples regarding the application of the 100% ownership requirement. The appendices to the proposing release have been rescinded and should not be relied upon.

⁷ The Release acknowledges that subsidiaries organized in certain foreign jurisdictions may be required to have a minimum number of shareholders and that directors of companies organized under the laws of certain foreign jurisdictions may also be required by local law to be shareholders, with the effect that such subsidiaries would not be 100% owned by the parent company. The Release indicates that the SEC believes that it would be appropriate to make exceptions to the 100% ownership requirement in cases where non-parent company ownership was at the minimum level required to comply with local law but indicates that a specific exception addressing such cases has been excluded from the Rule because it is an uncommon situation that should continue to be handled through the no-action process.

⁸ For example, a securityholder cannot be required to exhaust its remedies against the issuer before pursuing the guarantor.

A guarantee can be full and unconditional, however, even if it has subordination terms that differ from those of the underlying securities. In addition, the existence of a savings clause relating to bankruptcy and fraudulent conveyance will not result in a guarantee being considered as less than full and unconditional so long as there is no specific limit on the amount of the guarantor's regular payment obligation.

**FINANCE SUBSIDIARY ISSUER OF SECURITIES GUARANTEED BY ITS
PARENT COMPANY ONLY**

A finance subsidiary issuer with its parent company as sole guarantor need not include financial information, but its parent company's financial statements must include a footnote to the effect that the issuer is a 100% owned finance subsidiary and that the parent has fully and unconditionally guaranteed the securities. A subsidiary is considered to be a finance subsidiary if it has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company.

**OPERATING SUBSIDIARY ISSUER OF SECURITIES GUARANTEED BY ITS
PARENT COMPANY ONLY**

An operating subsidiary⁹ with its parent company as sole guarantor need not include separate financials, but its parent company's financial statement footnotes must include condensed consolidating financial information with separate columns for:

- the parent guarantor;
- the subsidiary issuer;
- any other subsidiaries of the parent on a combined basis;
- consolidating adjustments; and
- total consolidated amounts.

However, neither this condensed consolidating financial information or separate issuer financial statements are required if the parent's financial statement footnotes state, if true, that the parent company has no independent assets or operations, that its subsidiaries other than the issuer are minor and that the guarantee is full and unconditional. A subsidiary is minor if each of its total assets, stockholders' equity, revenues, income from continuing operations before income taxes and cash flows from operating activities is less than 3% of the parent company's corresponding consolidated amount.

⁹ Rule 3-10 defines operating subsidiary to mean any subsidiary which is not a finance subsidiary.

SUBSIDIARY ISSUERS WITH PARENT AND SUBSIDIARY GUARANTORS

A finance or operating subsidiary issuer issuing securities that are guaranteed by its parent company and one or more subsidiaries of the parent may omit separate financial statements if the guarantees are joint and several and the parent company's financial statement footnotes include condensed consolidating financial information with separate columns for:

- the parent guarantor;
- the subsidiary issuer;
- the guarantor subsidiaries on a combined basis;
- any other subsidiaries of the parent on a combined basis;¹⁰
- consolidating adjustments; and
- total consolidated amounts.

However, neither this condensed consolidating financial information nor separate issuer or subsidiary guarantor financial statements are required if the parent's financial statement footnotes state, if true, that the parent company has no independent assets or operations, the issuer is a finance subsidiary and all of the parent company subsidiaries (other than the subsidiary issuer and subsidiaries that are minor)¹¹ guarantee the securities on a full and unconditional and joint and several basis. To the extent that a subsidiary guarantor's guarantee is not joint and several with the parent's guarantee, or with the parent and the other subsidiaries' guarantees, an additional column must be included in the condensed consolidating financial information with respect to that subsidiary guarantor.

PARENT ISSUER WITH A SINGLE SUBSIDIARY GUARANTOR

Where a parent company issues securities with one subsidiary acting as a guarantor, the subsidiary need not include separate financials, but the parent company's financial statement footnotes must include condensed consolidating financial information with separate columns for:

- the parent issuer;

¹⁰ This column may be omitted if the subsidiaries are minor.

¹¹ The new rule indicates that **all** subsidiaries other than the subsidiary issuer must be guarantors. However, the SEC has advised us informally that this exception will be available if there are minor subsidiaries which are not guarantors so long as the other conditions to the exception are met.

- the subsidiary guarantor;
- any other subsidiaries of the parent on a combined basis;¹²
- consolidating adjustments; and
- total consolidated amounts.

However, neither this condensed consolidating financial information nor separate subsidiary guarantor financial statements are required if the parent's financial statement footnotes state, if true, that the parent has no independent assets or operations, the guarantee is full and unconditional and any non-guarantor subsidiaries are minor.

PARENT ISSUER WITH MULTIPLE SUBSIDIARY GUARANTORS

Where a parent company issues securities with more than one subsidiary acting as a guarantor, the subsidiaries need not include separate financials if the guarantees are joint and several, but the parent company's financial statement footnotes must include condensed consolidating financial information with separate columns for:

- the parent issuer;
- the subsidiary guarantors on a combined basis;
- any other subsidiaries of the parent on a combined basis;¹²
- consolidating adjustments; and
- total consolidated amounts.

However, neither this condensed consolidating financial information nor separate subsidiary guarantor financial statements are required if the parent's financial statement footnotes state, if true, that the parent has no independent assets or operations, the guarantees are full and unconditional and joint and several, and any non-guarantor subsidiaries are minor. The existence of a subsidiary whose guarantee is not joint and several with the other subsidiaries' guarantees requires that the condensed consolidating financial information include a column for that subsidiary.

¹² This column may be omitted if the subsidiaries are minor.

RECENTLY ACQUIRED SUBSIDIARY ISSUERS AND GUARANTORS

Pre-acquisition financial statements for significant, recently acquired subsidiary issuers and guarantors are required for the subsidiary's most recent fiscal year prior to the acquisition and for any interim period specified by Rules 3-01 and 3-02 of Regulation S-X. The SEC's objective is to provide separate financial statements until the condensed consolidating financial information adequately reflects the recently acquired entity's cash flows and results of operations. This applies to any subsidiary issuer or subsidiary guarantor:

- that has not been included in the audited consolidated results of its parent for at least nine months of the most recent fiscal year; and
- whose net book value or purchase price, whichever is greater, equals 20% or more of the principal amount of the securities being registered.

The SEC indicates that this requirement has been included to ensure that investors are provided with relevant material information that would not otherwise be included in the consolidated results of the parent company for all periods.

APPLICATION OF RULE 3-10 TO DIFFERENT TYPES OF SECURITIES

Modified financial information under Rule 3-10 is only available for guaranteed debt and debt-like securities. Whether a given securities falls into these categories cannot be determined by the form or title of the security. In order to qualify, the issuer of the security must have a contractual obligation to pay a fixed sum at a fixed time, and where an obligation to pay interest is cumulative, a set amount of interest¹³ must be paid.

The exceptions found in Rule 3-10 can be applied to preferred stock only if the guarantor fully and unconditionally guarantees:

- all accumulated and unpaid dividends declared out of funds legally available for payment;
- the redemption price; and
- the aggregate stated liquidation preference and all declared and undeclared accumulated and unpaid dividends.

¹³ A "set amount" of interest means the amount can be determined from objective indices or other factors that are not within the discretion of the obligor. It is not meant to preclude floating and adjustable rate securities.

Payments upon liquidation cannot be conditioned upon whether the issuer has sufficient assets to make full payment. Guaranteed amounts cannot be limited to, for example, funds legally available to the issuer for the payment of dividends.

Similarly, the Rule 3-10 exceptions may be applied to trust preferred stock¹⁴ where:

- securityholders receive periodic payments that are cumulative if unpaid;
- securityholders receive a fixed liquidation amount; and
- “back-up undertakings” place the investor in the same position as if the parent company had fully and unconditionally guaranteed the trust’s payment obligations on the preferred securities.

The Rule 3-10 exceptions are available for guaranteed convertible securities only if those securities are convertible into equity securities of the parent company. Application of the exceptions to other types of guaranteed securities not addressed in the Rule but appearing to meet the objectives of the Rule 3-10 exceptions may be addressed through no-action letter requests to the Division of Corporation Finance.

EXCHANGE ACT REPORTING REQUIREMENTS

In order to reduce the number of no-action letter requests for relief from Exchange Act reporting requirements by subsidiary issuers and subsidiary guarantors that are not required to include separate financial statements, the SEC has adopted new Rule 12h-5. The new Rule automatically exempts from Exchange Act reporting requirements:

- subsidiary issuers or subsidiary guarantors that are permitted to omit financial statements under the Rule 3-10 exceptions; and
- subsidiary issuers or subsidiary guarantors that must include pre-acquisition financial statements under Rule 3-10 only because of their recently acquired status.¹⁵

The parent company’s Exchange Act periodic report must contain the modified financial information permitted by the Rule 3-10 exceptions, but need not include the non-financial

¹⁴ In a trust preferred structure, a trust holds debt securities issued by its parent and issues preferred securities to investors.

¹⁵ Note that under Rule 12h-5(b), however, the provision of financial statements by a recently acquired subsidiary does not necessarily require Exchange Act reporting by that subsidiary.

information required by the periodic report for the subsidiary (unless it is otherwise required to be included). This requirement ceases to be in effect when there are no more of the relevant securities outstanding.

A subsidiary must begin filing Exchange Act reports if it subsequently fails to qualify for the Rule 3-10 exceptions. The SEC encourages those subsidiaries to promptly file an Item 5 Form 8-K or Form 6-K in these circumstances. However, a default on a guaranteed security or its guarantee will not trigger Exchange Act reporting for the issuer or the guarantor.

Note that a foreign private issuer that files on Form 20-F and qualifies for the Rule 12h-5 exemption does not need to file quarterly information regarding a U.S. subsidiary, despite the fact that the parent company's financial statements are made available less frequently than if filed by the U.S. subsidiary. The SEC believes that the parent company's financial information, coupled with the modified financial information permitted by Rule 3-10, provide adequate disclosure to investors.

PHASE-IN OF THE NEW RULES

Amended Rule 3-10¹⁶ must be complied with:

- if a Securities Act or an Exchange Act registration statement is filed on or after September 25, 2000;
- if a post-effective amendment to a Securities Act registration statement is filed on or after September 25, 2000 that includes the registrant's most recent audited financial statements or updates the prospectus under Section 10(a)(3); and
- for all of a reporting company's Exchange Act periodic reports for periods ending after the effective date of a registration statement for that company which complied with amended Rule 3-10.

If a reporting company has not filed a registration statement subject to amended Rule 3-10, its annual report on Form 10-K, Form 10-KSB or Form 20-F, as applicable, for the first fiscal year ending after September 25, 2000 must comply with amended Rule 3-10, as must all subsequent Exchange Act periodic reports.

¹⁶ Note that the reference in Rule 3-10(a)(3) to Item 8.A of Form 20-F does not take effect until September 30, 2000. Prior to that time, foreign private issuers should look to Rule 3-19 of Regulation S-X instead.

PRELIMINARY ASSESSMENT OF THE
NEW RULES

The SEC's objectives in adopting the new rules are laudable: prospective issuers and guarantors will benefit from the greater clarity in the financial information requirements applicable to filings and savings will be realized as a result of the elimination of the need to routinely request exemptive relief. Additionally, the greater clarity in the rules will enable transactions to be structured with greater certainty regarding the ultimate financial reporting consequences applicable to issuers and guarantors. Indeed, additional savings may be realized by being able to structure transactions with certainty in ways where neither separate financial statements nor condensed consolidating financial information are required.

There are a number of significant issues arise from the new rules, however, including, most importantly, the revocation of all prior no-action positions relating to SAB 53. As a result of this revocation, **all issuers of guaranteed securities and all guarantors must carefully consider whether their historical reporting patterns are consistent with the new rules and, if inconsistent, institute arrangements to conform to the new rules and/or seek new exemptive relief.** In particular, all filers currently including summarized financial information in their reports in reliance upon old no-action letters will need to consider whether the new rules will require them to present condensed consolidating financial information.

Similarly, in order to take advantage of the new rules, guarantors may find that the terms of their guarantees may need to be amended in order to conform to the SEC's requirements for full and unconditional guarantees. Ownership structures may also need to be revisited in order to avoid the necessity of complying with the periodic reporting requirements at multiple levels.

Issuers of guaranteed securities and guarantors are urged to review the new rules and to consider their application with their counsel and accountants as promptly as practical in order to allow sufficient time to make any adjustments to their financial reporting regimens that may be required by the new rules.

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If you have any questions concerning the new rules or the Release, please contact John Lobrano (j_lobrano@stblaw.com), Ray Wagner (r_wagner@stblaw.com) or Pamela Sutton-Hall (p_suttonhall@stblaw.com) of this firm's New York office at (212) 455-2000.

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