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Natural Disaster Risks Appearing On “Risk Factor” Radar

By Stephen Taub — October 4, 2005

The widespread shutdown of businesses—from utilities and retailers to casinos and restaurants—from the two recent devastating hurricanes has been a stark reminder that weather and other natural disasters potentially pose major risks to a large number of companies.

Henkin

And though companies have been detailing the business risks of earthquakes and floods for years, attorneys assert that there has been greater attention paid to the disclosure of these threats in recent months. “This is something people have been doing for awhile,” confirms Doug Henkin, partner in the litigation group at Milbank Tweed. But these days, he adds, “People are developing a better understanding of what to disclose.”

“There is now more of a discussion [about these issues]," adds Michael Littenberg, partner with Schulte Roth. "It’s now part of due diligence practice.”

Recent Examples

To be sure, a number of companies pointed out these kinds of risks in their recent 10-K filings.

For example, Corn Products International warned in a 10-K published back in March that the price and availability of corn is influenced by economic and industry conditions, including supply and demand factors such as crop disease and severe weather conditions such as drought, floods or frost “that are difficult to anticipate and cannot be controlled” by the company.

Del Monte Foods recently noted that “severe weather conditions and natural disasters, such as floods, droughts, frosts, earthquakes or pestilence” may affect the supply of its products.

Transmontaigne, a petroleum distributor, recently noted in its 10-K that the primary objective of its risk management strategy is to minimize the financial impact from changes in petroleum commodity prices affected by world-wide crude oil and petroleum products supply and demand disruptions, such as the Iraq war, OPEC production quotas, as well as “disruptions due to hurricanes and other weather-related occurrences,” among other factors.

Energy producer Warren Resources warned that its operations in Wyoming are subject to extreme weather conditions and often in difficult terrain. “Primarily in the winter and spring, our operations are often curtailed because of cold, snow and wet conditions,” it elaborated. “Unusually severe weather could further curtail these operations, including drilling of new wells or production from existing wells, and depending on the severity of the weather, could have a material adverse effect on our business, financial condition and results of operations.”

A number of companies, like Omnicell, have talked about the risks they face as a result of an earthquake. The Mountain View, Calif.-based medical services company recently warned that its facilities are located near known earthquake fault zones and "are vulnerable to significant damage from earthquakes. "We are also vulnerable to damage from other types of disasters, including fires, floods, power loss, communications failures and similar events including the effects of war or acts of terrorism," it adds." If any disaster were to occur, our ability to operate our business at our facilities could be seriously or completely impaired or destroyed. The insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions."

Aames Investment Corp., a Los Angeles-based mortgage real estate investment trust, stressed that its production is concentrated in California, Florida, Texas and New York. It then pointed out that historically, California has been vulnerable to earthquakes, erosion-caused mudslides and wildfires, and Florida and Texas have been vulnerable to tropical storms, hurricanes and tornadoes. "Since such natural disasters are not typically covered by the standard hazard insurance policies maintained by borrowers, the borrowers have to pay for repairs due to such disasters," it adds. Noting that uninsured borrowers may not repair the property or may stop paying their mortgage loans if the property is damaged, the company warns that "this would cause the number of foreclosures to increase and decrease our ability to recover losses on properties affected by the disasters."

And Los Angeles-based REIT Arden Realty similarly noted that, "All of our properties are located in Southern California which is a high risk geographical area for earthquakes. Depending upon its magnitude, an earthquake could severely damage our properties which would adversely affect our business." And while it maintains earthquake insurance for its properties and the resulting business interruption, it warns, "We cannot assure you that our insurance will be sufficient if there is a major earthquake."

Now More Careful


Littenberg

"Companies have always been disclosing about climatological events such as earthquakes and floods," stresses Littenberg of Schulte Roth. "What's different now is there is a lot more focus on this."

He asserts that during due diligence sessions, underwriters, their attorneys and the issuers' counsel are coming out and asking: What are the weather-related risks? What do they mean? What happens if there is a major earthquake? Where are the flood zones? Are they 20 miles inland? If there is a natural disaster, what is the risk that the company will be forced to shut down? Or what is the risk that they can't get critical supplies or can't service their end market? "People are trying to better understand these issues," Littenberg insists.

This is not to say these issues were ignored until recently; however, Littenberg stresses that all parties are paying more attention to these issues. "They are now more careful," he adds.

Henkin at Milbank Tweed agrees. "People are developing a better understanding of what to disclose," he says.

Experts note that the phenomenon is similar to the period shortly after the 2001 terrorist attacks. Before Sept. 11, it would have been hard to find warnings about terrorist risks in the average 10-K filing. Now, they are included by many companies.

Host Marriott, for example, recently warned that it may incur losses "in excess of insured limits" and, as a result, "may be even less likely to receive sufficient coverage for risks that affect multiple properties such as earthquakes or certain types of terrorism."

Of course, companies need to consider the potential materiality of the risk. For example, experts note that a retailer with thousands of stories might not need to warn investors that a potential storm could hurt a handful of locations.

In fact, attorneys stress that while regulators have shied away from mandating disclosure language for risk factors, they seem to frown on these trivial citings. They also discourage boilerplate disclosures. "Companies must tailor the risks that they actually do face," Henkin stresses. He adds that companies should include risk factors they need "to get protection of the safe harbor" provisions of the securities laws.

"From a practitioner's standpoint, don't just jump on the bandwagon and throw in everything you think of," he adds. "It obviates the entire exercise."

But is there a legal hazard in adding such potential risk factors? No, say attorneys; Littenberg asserts companies don't get into trouble for disclosing risks they face: "They get in trouble for what they don't disclose," he adds.

D. Michael Jones, partner with McGuireWoods, points out that if a company makes a forward-looking statement and does not include risk factors that wind up negatively impacting a company's performance, "you could have more difficulty disposing of the case in a summary judgment."


Jones

The moral of the story, he says, is: "Think it through as thoroughly as possible and think of as many things that can change your business. As we learned in the past five years, there are things that can change your business that you never would have dreamed of."

RELATED RESOURCES: Below are excerpts of recent disclosures that mentioned the impact of various weather-related or natural disasters. Please note that these are only excerpts:

Tidel Technologies (10-K, Aug. 1, 2005)

All of our manufacturing occurs at our facility in Carrollton, Texas. Our manufacturing operations utilize equipment that, if damaged or otherwise rendered inoperable, would result in the disruption of our manufacturing operations. Although we maintain business interruption insurance, our business would be injured by any extended interruption of the operations at our manufacturing facility. This insurance may not continue to be available on reasonable terms or at all. Our facilities are also exposed to risks associated with the occurrence of natural disasters, such as hurricanes and tornadoes.

Warren Resources (10-K, Mar. 17, 2005)

Our operations in Wyoming are conducted in areas subject to extreme weather conditions and often in difficult terrain. Primarily in the winter and spring, our operations are often curtailed because of cold, snow and wet conditions. Unusually severe weather could further curtail these operations, including drilling of new wells or production from existing wells, and depending on the severity of the weather, could have a material adverse effect on our business, financial condition and results of operations.

SVB Financial (10-K, Mar. 16, 2005)

Our operations can be subject to natural disasters and other events beyond our control, such as earthquakes, fires, power failures, telecommunication loss, terrorist attacks, and acts of war. Our corporate headquarters and a portion of our critical business offices are located in California near major earthquake faults. Such events of disaster, whether natural or manmade, could cause severe destruction or interruption to our operations and as a result, our business could suffer serious harm. To mitigate these risks we have begun a phased business continuity program, with initial capabilities scheduled to become available during 2005 and additional work continuing throughout 2006.

Arden Realty (10-K, Mar. 14, 2005)

All of our properties are located in Southern California which is a high risk geographical area for earthquakes. Depending upon its magnitude, an earthquake could severely damage our properties which would adversely affect our business. We maintain earthquake insurance for our properties and the resulting business interruption. We cannot assure you that our insurance will be sufficient if there is a major earthquake.

RAE Systems (10-K, Feb. 28, 2003)

Our success depends on the efficient and uninterrupted operation of our business. Our facilities in Sunnyvale, California are in an area that is susceptible to earthquakes.

We do not have a backup facility to provide redundant capacity in the event of a natural disaster or other unexpected damage from fire, floods, power loss, telecommunications failures, break-in and similar events. If we seek to replicate our operations at other locations, we will face a number of technical as well as financial challenges, which we may not be able to address successfully. Although we carry property and business interruption insurance, our coverage may not be adequate to compensate us for all losses that may occur.

Del Monte Foods (10-K, Sept. 30, 2002)

Severe weather conditions and natural disasters, such as floods, droughts, frosts, earthquakes or pestilence, may affect the supply of our products. Irregular weather patterns may persist over a long period and further impact the supply of our products. These events can result in reduced supplies of raw materials, lower recoveries of usable raw materials, higher costs of cold storage if harvests are accelerated and processing capacity is unavailable or interruptions in our production schedules if harvests are delayed. Competing manufacturers can be affected differently depending on the location of their supplies. If our supplies of raw materials are reduced, we may not be able to find enough supplemental supply sources on favorable terms, which could adversely affect our business, operating results and financial condition.

Peets Coffee & Tea (10-K, Mar. 28, 2002)

We have only one coffee roasting and distribution facility. A significant interruption in the operation of this facility, whether as a result of a natural disaster or other causes, could significantly impair our ability to operate our business on a day-to-day basis. Moreover, our roasting and distribution facility and most of our stores are located near several major earthquake faults. The impact of a major earthquake on our facilities, infrastructure and overall operations is difficult to predict and an earthquake could seriously disrupt our entire business process. Our earthquake insurance does not cover revenue lost as a result of earthquakes.