10

Liabilities for past externalities – "sins"

One of the more interesting questions is how to incorporate liabilities for past sins into a valuation. For example, consider the case of the tobacco industry. It faced long years of consumer lawsuits and was ultimately defeated in court and forced to pay victims of lung cancer compensation through the Tobacco Master Settlement Agreement.[16]

A recent example is how Bayer underestimated past liabilities in their purchase of Monsanto in 2016. Monsanto was facing multiple lawsuits regarding one of their main products, a pesticide called Roundup.

How can such situations be handled? Two steps are necessary: firstly, discovery and/or recognition, and second, an estimation of the expected impact on firm value. For a listed firm, one initially needs to understand the extent to which this is already priced into the firm's market valuation.

Firstly, an analyst should acknowledge that past liabilities may exist and actively search for currently unrecognised, or mis-estimated, liabilities during the due diligence process.

Often these liabilities are not unknown – asbestos, tobacco or pesticides were all well known to be contentious long before legislation created liabilities.

How can these potential liabilities be valued? As discussed in the section on real options, one can view past liabilities as a being short a call option. This view assumes that we have sufficiently reliable estimates of

[16] Wikipedia has a good summary of this topic: https://en.wikipedia.org/wiki/Tobacco_Master_Settlement_Agreement

the potential damages as well as an understanding of the probability of the respective outcomes.

Another question can be how to limit future liabilities, e.g., as seen from an acquirer's perspective. Once it is understood that a product may be harmful, what necessary steps should be undertaken? Recognising an issue and not acting can be much more costly than timely action.

An example of how to limit exposure is KSS's acquisition of Takeda's scandalous airbag business in 2018 (Inagaki, 2018) where the acquirer carefully excluded assets and intellectual property that was involved in the scandal that caused Takeda's downfall in the first place.

Even when risks have been recognised and firms have set apart funds for expected losses, still the question is how adequate these funds are. Pensions have ESG implications too. Many firms still have legacy *defined benefit* pensions plans which represent large future pension liabilities. These plans tend to be underfunded given current lower interest rates, and an analyst should check the status of defined benefit pension plans as part of the due diligence.