PAUL HASTINGS

The Buyer's Playbook
Legal Insights Into M&A

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Legal Due Diligence: What Really Matters

In this instalment of *The Buyer's Playbook*, we explore the recent trends in legal due diligence in M&A transactions.

Legal due diligence is a critical tool for a buyer to understand what it is acquiring and, just as importantly, what risks it is assuming. While the process is familiar, its impact on valuation, deal structure, contractual protections and execution risk is often underestimated.

A well-run diligence exercise allows buyers to identify issues early, prioritise what matters and make informed decisions on price, risk allocation and timing. Conversely, gaps in diligence can surface late, limit available protections, and create avoidable friction during negotiations or post-completion.

Legal due diligence exercise serves several core functions for buyers:

- **Risk Identification:** Identifying legal risks or liabilities that may affect valuation, purchase price mechanics, deal structure or, in some cases, the buyer's willingness to proceed with the transaction.
- **Contractual Protections:** Informing the negotiation of transaction documentation, including the scope of warranties, indemnities, conditions precedent and other risk allocation provisions.
- **Regulatory and Governance Comfort:** Confirming compliance with applicable laws and identifying any approvals or actions required in connection with the transaction.

Once an issue has been identified in a due diligence process, the question is no longer whether it is a problem, but how it should be addressed. In practice, that may mean a price reduction, a specific indemnity, a condition precedent, an escrow or a holdback, or, in some cases, a decision to walk away.

This is where due diligence becomes a deal tool. The buyer must assess the financial impact of the issue, its effect on execution and the most effective mechanism to protect value. The most effective buyers use due diligence not simply to identify risk, but to drive price, contractual protection and deal strategy.

In this instalment, we examine how diligence findings feed into valuation, deal structure and contractual protection, and how buyers can use that to strengthen their negotiating position.

Findings

The legal due diligence report usually sits alongside other due diligence reports covering such topics as accounting and tax, and it is critical that they are viewed together.

Vendor due diligence is now standard in many sale processes, in particular private equity exits. While this offers clear advantages, such as early access to structured information and reduced duplication of work, it is not a substitute

for buyer due diligence. In practice, sophisticated buyers will interrogate the vendor due diligence and conduct targeted "top up" diligence on high-risk areas. The goal is not to replicate the vendor due diligence, but to test it.

Buyers are increasingly working to accelerated timelines, meaning the traditional model of exhaustive, "boil the ocean" due diligence is rarely feasible or desirable. We are increasingly preparing reports focussing on material "red flag" issues, as opposed to exhaustive reports covering everything to do with the target business.

Legal due diligence also plays a central role in the underwriting of warranty and indemnity (W&I) insurance. Insurers rely heavily on the due diligence exercise undertaken by buyers and their advisers when assessing risk and determining the scope of cover available. However, warranty and indemnity insurance only covers unknown risks and therefore "known issues" identified in a due diligence report will not be covered. We explore the impact of warranty and indemnity insurance in our forthcoming note: "Insuring the Deal: The Role of W&I Insurance".

Converting Risk to Value

Legal risks are not all the same. A missing assignment of core software IP, for example, raises a fundamentally different issue from a minor procedural deficiency in a non-material jurisdiction. The buyer's response should therefore be driven by the commercial consequences of the issue and not just its legal classification.

In practice, buyers should categorise findings into three buckets. First, issues that have a clear cost to fix or a clear balance sheet impact. Second, issues that are real but uncertain in amount or timing. Third, issues that create completion, ownership or operational risk. Each bucket points to a different form of protection.

Price Adjustment

The cleanest outcome for a buyer is often a direct adjustment to price. Where an issue will cost money, the natural argument is that the seller should be responsible for that cost.

A price adjustment is strongest where four features are present: the issue is known, quantifiable, unavoidable and not already accounted for elsewhere in the financials. Examples include an employment or tax liability discovered during due diligence, a contract that will require a payment to secure consent or the cost of repairing an IP chain of title.

The form of price protection will often depend on the deal mechanics. In a locked box transaction, the buyer has limited scope to revisit price after completion, so due diligence findings will often need to be addressed through pre-signing price pressure, a specific price adjustment or bespoke contractual protection. Under completion accounts, there may be greater scope for certain liabilities to be reflected in the pricing mechanics if they fall within the relevant accounting definitions and methodology. That said, many legal risks sit outside traditional cash, debt or working capital concepts, and therefore require separate treatment.

Indemnity

Where a risk is known but not necessarily certain or quantifiable, a specific indemnity becomes the buyer's next best option.

While warranties are designed to flush out unknown risks and provide a contractual basis for a damages claim, a specific indemnity allocates responsibility for a particular issue that has already been identified. In effect, the seller is agreeing that, if the known problem gives rise to loss, that loss sits with the seller rather than the buyer.

Specific indemnities are particularly useful where quantum remains uncertain, timing is unclear or the outcome depends on someone other than the parties. An unresolved dispute, a regulatory enquiry, a threatened employment claim or a known sanctions review may all fall into this category. Price adjustments are more challenging in these cases as value is more difficult to estimate.

A well drafted indemnity should identify the factual issue precisely enough to avoid argument, but not so narrowly that the seller can later contend that the actual loss falls outside of the scope. Sellers accept the principle of specific indemnities more readily than a direct price cut, but they will fight over scope, duration and how easily the buyer can claim. The parties will also focus on tailored caps and claim periods, issue-specific claims procedures, including any mitigation obligations, and the interaction with tax.

By contrast, warranties should remain the principal protection for unknown risks. They operate alongside the disclosure letter, de minimis thresholds and other negotiated limitations. But buyers should not allow a seller to include an identified issue into the general warranty regime if the problem has already emerged in due diligence. Once the issue is known, the buyer is on weaker footing in a warranty claim, and the seller will almost always argue that the matter was known and fairly disclosed.

Conditions Precedent

Some issues may not need to be priced or indemnified if they can be resolved before completion.

Legal Due Diligence: What Really Matters

Conditions precedent are most effective where the issue goes directly to the buyer's ability to acquire the business it thinks it is buying or to operate it on day one. Typical examples include obtaining consent under a material change of control clause, formalising ownership of IP, transferring a key licence or implementing an essential compliance remediation step.

If the issue is capable of resolution before completion, and it is not a resolution that would materially impair the deal, the rationale is that the seller should be required to deliver the business with the necessary changes. That said, conditions precedent create the greatest execution risk in the package. They introduce uncertainty between signing and completion, create opportunities for delay and give either side a potential platform to revisit the transaction if market conditions move. For that reason, particularly in competitive processes and private equity exits where deal certainty is a priority, sellers tend to resist conditions precedents unless they are legally required, such as antitrust approvals.

A buyer will usually succeed on a conditions precedent argument only where it can demonstrate that the issue is critical to completion rather than merely unattractive. If the target cannot lawfully perform a critical contract post-completion, for example, the argument is more compelling than if the point is really one of administrative tidying, where the seller will seek to push it into a post-completion covenant instead.

Not every problem should become a condition precedent, and overuse threatens signing momentum. The most effective buyers reserve conditions precedent for issues that are critical to execution and capable of resolution within a sensible timetable.

Escrows and Holdbacks

Even a strong indemnity is only as good as the seller's ability to pay. That is why deferred consideration, escrows and holdbacks remain important tools, particularly where the seller is likely to distribute proceeds quickly after completion or where recourse is otherwise weak.

For higher risk findings, a buyer may seek to place part of the consideration into a dedicated account for a period of time. If the identified risk crystallises, there is an available source of recovery without the need to pursue the seller (or, in many cases, a dispersed group of sellers).

Escrows and holdbacks are especially useful where there is a concern about the seller's covenant strength. A private equity seller approaching fund distribution, multiple individual management sellers or sellers located in multiple jurisdictions causing enforcement concerns are all situations in which this extra security may matter.

The retained amount can be linked to a specific indemnity, subject matter cap or claims window, rather than supporting the entire warranty package. That often makes the ask more proportionate and defensible.

Sellers dislike any mechanism that delays proceeds or undermines clean exit economics. However, if the issue is known, excluded from W&I and cannot sensibly be priced, some form of secured seller recourse is often required.

Choosing the Right Protection

In practice, the buyer's choice of mechanism should follow a simple hierarchy:

- If the issue is certain and quantifiable, a price adjustment might be appropriate.
- If the issue is known but uncertain in amount or timing, seek a specific indemnity, ideally with tailored security.
- If the issue threatens ownership, legality or operational continuity, and can be fixed pre-completion, make it a conditions precedent.
- If the issue sits outside W&I, make sure the seller provides protection to close that gap.
- Use the general warranty package for unknowns, not as a substitute for solving matters already identified.

Conclusion

Due diligence is fundamental to M&A. Successful buyers are those who can scope their diligence effectively, focus quickly on key risks and translate findings into clear commercial outcomes.

A due diligence finding only becomes meaningful when it is translated into a commercial outcome, whether by way of a price adjustment, a specific indemnity, a condition precedent, an escrow or a holdback. That is where value protection is achieved.

If you would like to discuss any of the matters discussed here, please reach out to us.