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M&A Due Diligence: What You Miss Can Cost You

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Mergers and acquisitions are among the most complex and transformative business endeavors, with due diligence serving as the cornerstone. Conducting due diligence encompasses a thorough, detailed examination of a target company's legal and financial operations. This scrutiny enables buyers, sellers and their advisors to make informed decisions, mitigate risks and lay the groundwork for successful integration.

M&A due diligence involves a diverse group of stakeholders, each contributing critical expertise. Business executives and investment bankers assess the strategic fit and operational and financial viability of the target. Legal professionals examine potential risks and liabilities. Accountants scrutinize the financial health and performance of the organization, while consultants offer cross-functional insights that connect these various domains. Together, they provide a comprehensive picture of the target company, ensuring that nothing essential is overlooked.

Why Due Diligence Matters

At its core, due diligence is about risk management and value creation. For business leaders, this process helps determine whether the target company aligns with their strategic

goals and is worth its stated valuation. Legal experts rely on due diligence to uncover past or potential future liabilities, ensure compliance with various regulatory requirements and structure protections through indemnities, carve-outs or other contractual arrangements. Financial teams validate the target's financial metrics and identify synergies, cost optimization or revenue growth opportunities post-acquisition.

Thorough due diligence is also essential for post-merger integration. A well-executed diligence process lays the groundwork for smooth integration, reducing the likelihood of unforeseen challenges. Conversely, inadequate diligence can lead to missteps that undermine the target's value.

Case Study: Overlooked Operational Dependency

In a recent deal, a public company sold a subsidiary to a private equity sponsor. The seller had been providing a specialized service critical to operations that it wouldn't provide post-closing. The sponsor couldn't replicate the service and only realized the gap late in the process. It had to source the service from a third party at significant cost and ultimately negotiated a steep purchase price reduction to reflect the new reality. This type of overlooked operational dependency can erode value quickly.

Three Key Components of M&A Due Diligence

There are several important components of M&A due diligence, including legal, financial and operational, each warranting dedicated attention.

1. Legal Due Diligence

Legal due diligence focuses on understanding the target company's legal structure, identifying risks and ensuring compliance. A strategic "macro-to-micro" approach is particularly effective. Prioritize business-critical issues that could pose the greatest risks or constitute deal-breakers first. This allows teams to allocate resources efficiently, drilling down to smaller issues only after addressing major concerns.

By understanding the business, teams can determine which legal matters warrant extensive investigation versus those where the potential impact doesn't justify the effort or legal expense. A good place to start is by evaluating key contracts with customers, suppliers and partners. Look for change-of-control, exclusivity and pricing adjustments triggered by the transaction.

Case Study: Buried Supplier Agreement Amendment

In one transaction, a private equity sponsor discovered, midway through diligence, that the seller had quietly uploaded an amended agreement with a critical supplier. The amendment included onerous new terms that significantly altered the deal value. The diligence team caught it just in time.

Subsequent steps should include ensuring the target owns or has adequate rights to its IP and identifying any infringement risks, as well as analyzing current and potential litigations, their financial implications and reputational risks. In addition, legal due diligence should include assessing adherence to any industry-specific regulations and identifying potential liabilities.

Legal diligence also plays a key role in structuring protections. Risks may be addressed through:

- Indemnities (*e.g.*, covering unresolved tax liabilities)
- Carve-outs (*e.g.*, removing problematic assets or business lines)
- Purchase price adjustments
- In extreme cases, walking away entirely

Case Study: Carve-Out Asset Gaps

In carve-out deals, one challenge is determining whether the target holds all the assets necessary to run the business. Critical assets may be legally owned by the parent company, not the subsidiary being sold. Diligence teams must define the business "perimeter" and ensure the buyer receives all required assets and avoids liabilities tied to excluded assets.

In the supplier contract example above, the parties ultimately resolved the risk through negotiated indemnification, ensuring that the buyer would be protected if the new terms created a post-closing exposure.

2. Financial Due Diligence

Financial due diligence is critical for validating the target's performance and identifying red flags that may affect valuation. Key areas of focus include reviewing historical financials — income statements, balance sheets and cash flow statements — to assess profitability, liquidity and financial stability, as well as evaluating the target's tax history, liabilities and potential exposure.

Case Study: Multistate Sales Tax Exposure

A recurring issue in middle-market transactions is the discovery of uncollected sales tax obligations. In one deal, the buyer found that the target had failed to collect sales tax in multiple states. The exposure was material, and the buyer successfully negotiated a purchase price reduction to account for the cleanup process, which included voluntary disclosure procedures and back payments.

It's also vital to understand the sustainability of revenue sources, assess customer concentration and evaluate outstanding obligations and their impact on valuation. Determine if revenues are diversified or concentrated and which customer contracts are near expiration or have pricing terms that could change post-closing.

Case Study: Hidden Earnout

In another deal, due diligence uncovered a significant earnout obligation that the seller had not emphasized, despite having every reason to believe the targets would be met soon after closing. Surfacing this in diligence allowed the buyer to adjust the economic terms before signing.

Thorough financial due diligence not only informs the valuation of the target but also helps identify opportunities for financial optimization post-acquisition.

3. Operational Due Diligence

Operational diligence connects the dots between legal and financial findings and how the business runs. This involves examining the target's day-to-day operations, identifying strengths, weaknesses and potential synergies. Areas to investigate include core processes, technology and systems, IT infrastructure, cybersecurity measures and supply chain risks.

Operational due diligence also requires a focus on the workforce. Evaluating the capabilities and stability of the leadership team and broader workforce is critical, as is assessing alignment between the acquirer and target's corporate cultures to ensure a seamless integration. A thorough operational review ensures that the acquirer understands the target's core operations and is prepared to address any challenges that may arise during integration.

Case Study: Executive Fraud Uncovered

In one public company transaction, legal and operational diligence revealed that the target's

executives had fraudulently misrepresented their business model, claiming customer deployment figures inflated by an order of magnitude. Further review uncovered financial impropriety, including misappropriated investor funds. The executives involved were ultimately convicted and imprisoned. That diligence outcome didn't just protect value — it preserved reputational integrity.

Overcoming Common Due Diligence Challenges

Due diligence can be fraught with challenges. Tight timelines, complex processes and the need for coordination among multiple stakeholders can create bottlenecks. Additionally, integrating diverse systems, people and contracts post-acquisition can be daunting.

To navigate these challenges, effective communication and collaboration among team members are paramount. Clear roles and responsibilities should be established early on to ensure that all aspects of due diligence are covered comprehensively.

Case Study: The Limits of AI Review

A client who outsourced parts of diligence to a third-party provider offering an AI-based tool nearly missed important data. The tool misclassified key documents and overlooked critical risks. With little time left before signing, legal counsel had to rereview the data manually. The client was ultimately reimbursed for the third-party AI tool expenses, but the experience reinforced the wisdom of using technology to augment — rather than replace — human intelligence and judgment. The right tools can streamline review, but only when properly vetted and actively monitored.

The Strategic Value of Due Diligence

While due diligence is often seen as a procedural step, it holds strategic value for all stakeholders. For buyers, it provides a road map for realizing the full potential of the acquisition. For sellers,

thorough preparation for due diligence can enhance their credibility and help maximize transaction value. Sellers who enter diligence with well-organized data rooms, updated contract summaries and clear disclosures often avoid surprises and can command higher valuations with fewer conditional holdbacks.

The diligence process is a critical checkpoint for deal teams to align key objectives and mitigate risks. By fostering collaboration and leveraging the collective expertise of the team, due diligence transforms from a compliance exercise into a strategic opportunity to create value.

For organizations that engage in frequent M&A activity, due diligence represents an opportunity to refine and improve processes over time. By documenting lessons learned about standardization, prioritization or team coordination from each transaction, deal teams can develop best practices that enhance efficiency and effectiveness in future deals.

A Foundation for Long-Term Value

M&A due diligence is a multifaceted process that requires meticulous planning, collaboration and execution. By focusing on the legal, financial and operational dimensions of the target company, deal teams can uncover risks, identify opportunities and set the stage for successful post-merger integration.

Ultimately, the success of any M&A transaction hinges on the quality of due diligence. When approached with precision and foresight,

due diligence becomes more than a step in the process — it becomes the foundation for achieving long-term value and sustainable growth. Embracing a comprehensive and strategic approach to due diligence allows organizations and their deal teams to navigate the complexities of M&A with confidence and unlock the full potential of their investments.

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