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# WHY DUE DILIGENCE MATTERS IN CORPORATE TRANSACTIONS

-Sarvesh Kanakgiri<sup>1</sup>

In modern corporate practice, transactions such as mergers, acquisitions, joint ventures, and strategic partnerships involve significant financial and legal commitments. Before entering into such arrangements, it is essential for the parties involved to carefully evaluate the risks associated with the transaction. One of the most important mechanisms used for this purpose is due diligence.

Due diligence refers to the process of investigating and evaluating a company or business entity before finalising a transaction.<sup>2</sup> It allows potential investors or business partners to verify the legal, financial, and operational position of the target company. By conducting due diligence, parties can identify potential risks, liabilities, and regulatory issues before entering into binding agreements.<sup>3</sup>

In practice, due diligence is not merely a procedural formality. For lawyers and investors involved in corporate deals, it is often the most important stage of the transaction because it reveals risks that may otherwise remain hidden.

## IDENTIFYING TRANSACTION RISKS

One of the primary objectives of due diligence is to identify the risks involved in a proposed transaction. Corporate transactions often involve various forms of risk, including legal, financial, regulatory, and operational risks.

Through due diligence, companies can analyse the legal and financial structure of the target company and identify potential liabilities that may affect the transaction.<sup>4</sup> For example, the process may reveal pending litigation, outstanding debts, regulatory non-compliance, or contractual obligations that could negatively impact the value of the transaction.

A practical example can illustrate this. Suppose an investor plans to acquire a manufacturing company. During the due diligence process, lawyers discover that the company is involved in a long-pending

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<sup>2</sup> <https://chiefperspective.com/blog/due-diligence-guide>

<sup>3</sup> <https://fastercapital.com/topics/the-importance-of-due-diligence.html/1>

<sup>4</sup> <https://www.fbm.nl/en/what-is-due-diligence/>

environmental litigation relating to pollution control violations. Such a discovery could significantly affect the investor's decision, because potential penalties or regulatory restrictions may impact the future profitability of the business.

By identifying such risks at an early stage, the acquiring party can take appropriate steps to address them. In some cases, this may lead to renegotiation of transaction terms or even reconsideration of the deal.

## **ENSURING REGULATORY COMPLIANCE**

Another significant aspect of due diligence involves verifying whether the target company complies with applicable laws and regulatory requirements. Companies operate within a complex legal framework that includes corporate laws, tax regulations, labour laws, and industry-specific regulations. Failure to comply with these legal requirements can result in significant penalties and reputational damage. Therefore, due diligence helps ensure that the target company has complied with relevant legal obligations and regulatory standards.

For instance, if a company operating in the financial technology sector is being acquired, the acquiring party would carefully examine whether the company complies with RBI regulations, data protection obligations, and payment system rules. Any non-compliance discovered during due diligence may require corrective action before the transaction proceeds.

This process reduces the likelihood of unexpected legal complications after the transaction is completed.

## **ASSESSING THE LEGAL HEALTH OF THE COMPANY**

Legal due diligence focuses on evaluating the overall legal status of the target company. This involves examining various legal documents and agreements to ensure that the company has proper authority and ownership over its assets and operations.

For example, legal due diligence typically includes reviewing the company's constitutional documents such as the Memorandum of Association (MOA) and Articles of Association (AOA), shareholder agreements, and board resolutions. Lawyers also analyse key commercial contracts to determine whether they contain clauses that may affect the transaction, such as change-of-control provisions.

A change-of-control clause may allow a contracting party to terminate the agreement if ownership of the company changes. If a major customer contract contains such a clause, the acquisition could potentially result in the loss of that client.<sup>5</sup>

Additionally, the process includes verification of intellectual property rights, licences, and permits held by the company. Ensuring that these rights are properly documented and owned by the company is essential for protecting the interests of investors and stakeholders.

## **TYPES OF DUE DILIGENCE IN CORPORATE TRANSACTIONS**

In practice, due diligence is not limited to a single form of investigation. Corporate transactions often involve multiple types of due diligence depending on the nature of the transaction and the industry in which the target company operates.<sup>6</sup>

Legal due diligence focuses on reviewing the legal structure of the company, contractual obligations, litigation exposure, and regulatory compliance. Lawyers typically examine corporate documents, key commercial agreements, intellectual property ownership, and licences required for business operations.

Financial due diligence involves analysing the financial health of the company by examining financial statements, tax records, outstanding debts, and revenue streams. This helps determine whether the company's valuation accurately reflects its financial condition.

Commercial due diligence evaluates the market position of the company, its competitive environment, customer base, and long-term business prospects.<sup>7</sup> Investors often rely on this analysis to understand whether the target company has sustainable growth potential.

By combining these different forms of due diligence, parties can obtain a comprehensive understanding of the risks and opportunities associated with the transaction.<sup>8</sup>

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<sup>5</sup> <https://lawandmore.eu/ma-transactions-the-complete-legal-guide-to-warranties-indemnities-escrow-and-liability/>

<sup>6</sup> <https://bridgepointconsulting.com/look-before-you-leap-5-due-diligence-activities-for-a-successful-ma-transaction/>

<sup>7</sup> <https://finvisor.com/article/due-diligence-consulting/>

<sup>8</sup> <https://xnergy.com/the-importance-of-due-diligence-in-ma-how-business-advisors-can-ensure-a-smooth-process/>

## **IDENTIFYING RISK MANAGEMENT MEASURES**

Due diligence also assists in determining appropriate risk management mechanisms between the parties involved in the transaction. Once potential risks are identified, the parties can negotiate contractual protections to address them.

These protections may include representations and warranties, indemnity clauses, or escrow arrangements in the transaction documents.<sup>9</sup> Such mechanisms help allocate risk between the parties and ensure that any undisclosed liabilities are properly addressed. In practice, due diligence findings often influence the scope of representations and warranties included in transaction agreements, as parties seek contractual safeguards against identified risks.

For instance, if due diligence reveals uncertainty regarding regulatory approvals, the acquiring party may insist on a specific representation confirming compliance with applicable laws.

## **IMPORTANCE IN CROSS-BORDER TRANSACTIONS**

Due diligence becomes even more critical in cross-border corporate transactions. When companies from different jurisdictions engage in business transactions, they must comply with multiple legal and regulatory frameworks.

Cross-border due diligence often involves analysing foreign investment laws, import and export regulations, taxation policies, and political risks in the relevant jurisdictions.

For example, in transactions involving foreign investment in India, lawyers must examine compliance with the Foreign Exchange Management Act (FEMA) and related regulations governing foreign direct investment.

Therefore, conducting comprehensive due diligence is essential to ensure that international transactions proceed smoothly and remain legally compliant.

## **JUDICIAL RECOGNITION OF DUE DILIGENCE PRINCIPLES**

Although due diligence is largely a commercial practice, courts have occasionally recognised its importance in corporate disputes.

For example, in *ICICI Bank Ltd. v. Official Liquidator of APS Star Industries Ltd.*,<sup>10</sup> the Supreme Court emphasised the importance of proper documentation and verification in financial transactions.

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<sup>9</sup> <https://gnalawyers.com/blog/how-corporate-and-commercial-laws-intersect-in-business-transactions/>

<sup>10</sup> AIR 2011 SUPREME COURT 1521

The case highlighted how inadequate scrutiny of financial arrangements can lead to complex legal disputes.

Similarly, in *Dale & Carrington Investment Pvt. Ltd. v. P.K. Prathapan*,<sup>11</sup> the Supreme Court dealt with issues relating to corporate governance and shareholder rights. The case underscored the importance of transparency and proper corporate decision-making—principles that are closely linked with the objectives of due diligence in corporate transactions.

## **PRACTICAL IMPORTANCE OF DUE DILIGENCE IN CORPORATE DEALS**

The importance of due diligence becomes particularly evident in large corporate acquisitions. In several international transactions, acquiring companies have discovered significant liabilities only after conducting detailed investigations of the target company.

For instance, due diligence may reveal previously undisclosed litigation, hidden tax liabilities, or regulatory violations. Such findings may significantly affect the valuation of the target company or lead to renegotiation of the transaction terms.

In many cases, investors rely on due diligence reports to decide whether to proceed with a transaction or withdraw from negotiations altogether. Therefore, due diligence serves not only as a risk-identification tool but also as a critical factor influencing strategic decision-making in corporate transactions.

The importance of transparency in corporate transactions has also been recognised in corporate governance frameworks, where thorough disclosure and verification of information are considered essential for protecting the interests of investors and stakeholders.

## **PROMOTING TRANSPARENCY AND INFORMED DECISION-MAKING**

One of the broader benefits of due diligence is that it promotes transparency between the parties involved in a transaction. By thoroughly reviewing the legal and financial position of the target company, investors and stakeholders can make informed decisions.

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<sup>11</sup> AIR 2005 SUPREME COURT 1624

The process also encourages companies to disclose relevant information openly, thereby strengthening trust between the parties. This transparency is particularly important in large corporate transactions where significant financial investments are involved.

Ultimately, due diligence helps ensure that transactions are structured in a manner that protects the interests of all stakeholders.

## **CONCLUSION**

Due diligence is a fundamental component of corporate transactions. By carefully examining the legal, financial, and operational aspects of a company, the process enables parties to identify potential risks and make informed decisions before entering into binding agreements.

In practice, due diligence often determines whether a transaction proceeds smoothly or encounters unexpected complications. By uncovering potential risks and enabling appropriate contractual safeguards, it plays a crucial role in ensuring the success of corporate transactions.

As business transactions become increasingly complex, the importance of thorough and well-conducted due diligence will only continue to grow.