

DUE DILIGENCE

How Legal Due Diligence Creates Leverage for Buyers

Reflections from an energy and petrochemical M&A transaction: why the value of due diligence lies not in the number of risks identified, but in how effectively those risks are translated into transaction advantages for the buyer.

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I recently completed a legal due diligence (“LDD”) report for an energy and petrochemical M&A transaction.

While the experience is still fresh, I wanted to capture a few reflections — not only as a personal record, but also in the hope that they may be useful to fellow lawyers, investors, and professionals involved in M&A transactions.

This was one of the larger due diligence projects I have independently led to date. The target company operated in a highly regulated, asset-intensive industry, with an estimated valuation of several billion RMB. The scope of review covered a wide range of areas, including land use rights, manufacturing facilities, production equipment, hazardous chemicals operations, environmental compliance, workplace safety, financing arrangements, and other operational matters.

One key takeaway from this project is:

The value of legal due diligence is not measured by the number of risks identified, but by how effectively those risks can be translated into transaction advantages for the buyer.

As buyer's counsel, I believe that every dollar spent on legal fees should contribute to a better investment decision. In many cases, protecting a client's interests does not start at the negotiation table — it starts with identifying the right issues early and presenting them clearly in the due diligence report.

Below are a few observations from this project.

1. BEFORE LOOKING AT PROFITABILITY, ASK WHETHER THE BUSINESS CAN CONTINUE OPERATING

When evaluating an acquisition target, buyers often focus on financial performance, revenue, profitability, and growth potential. These factors are undoubtedly important.

However, for businesses operating in highly regulated industries such as energy and petrochemicals, one of the first questions legal counsel should consider is not financial — it is operational: **can the business continue operating in compliance with applicable regulations after closing?**

In reviewing the data room, one of the first areas I typically examine is the company's licenses and permits, including:

- Work safety permits;
- Hazardous chemicals operation licenses;
- Pollution discharge permits;
- Special equipment registrations;
- Major hazard source filings.

However, holding a valid permit today does not necessarily mean the business can continue operating without issues in the future. Key questions include:

- Has the company expanded production capacity without updating relevant approvals?
- Have manufacturing processes changed?
- Has the company experienced environmental penalties or safety incidents?
- Are critical licenses approaching expiration?

For buyers, an acquisition is not simply a purchase of historical performance — it is an investment in future operations.

Therefore, the real question is not: “Does the company currently have the required permits?” but rather: **“Will these permits continue to support the company’s future operations?”**

2. MORE ASSETS DO NOT ALWAYS MEAN MORE VALUE

Energy and petrochemical companies are typically asset-heavy businesses. Land, factories, production facilities, storage facilities, and equipment often represent a significant portion of enterprise value.

However, legal due diligence does not simply ask: “Do these assets exist?” The more important question is: **“Can the buyer legally control, use, and benefit from these assets after closing?”**

Key considerations include:

- Are the assets legally owned by the target company?
- Are they subject to mortgages, pledges, or other encumbrances?
- Are there finance lease arrangements?
- Are there buildings or facilities lacking proper title documentation?

In practice, one of the most significant concerns is not the absence of assets, but assets that exist yet cannot be freely utilized or transferred.

For buyers, the ultimate question is simple: will these assets continue generating value after completion of the transaction?

3. SOME OF THE MOST SIGNIFICANT RISKS ARE COMMERCIAL, NOT MERELY LEGAL

One of the most interesting aspects of this project was that some of the most important considerations extended beyond traditional legal issues.

A company may have advanced facilities and strong production capabilities, but its value can still be affected if:

- Key suppliers cannot continue providing essential raw materials;
- Major customers are lost after closing;
- Important contracts can be terminated due to a change of control.

Therefore, legal due diligence should also examine:

- Stability of major suppliers and customers;
- Related-party transactions;
- Termination rights under key contracts;
- Change-of-control provisions.

Sometimes, a single contractual provision hidden in a commercial agreement can have a significant impact on post-closing operations. A company's value is not only reflected in its tangible assets — it is also reflected in the commercial relationships it has built over time.

4. IDENTIFYING RISKS IS ONLY THE BEGINNING — TURNING RISKS INTO DEAL PROTECTION

A common misconception is that due diligence is simply an exercise of identifying problems. It is not.

Identifying risks is only the first step. The more important question is: **how do those risks affect the transaction structure, valuation, and allocation of risk between the parties?**

For example, where due diligence identifies:

- Defects in land use rights;
- Outstanding environmental remediation issues;
- Financing arrangements restricting changes of control;
- Encumbered assets;

the appropriate response is rarely simply: “Do not proceed with the transaction.”

Instead, buyers and their counsel may consider:

- Purchase price adjustments;
- Pre-closing remediation requirements;
- Closing conditions;
- Representations and warranties;
- Indemnification mechanisms.

This is where transaction lawyers create value. The role of legal due diligence is not merely to identify risks, **but to help buyers manage and allocate those risks through the transaction documents.**

5. WHY DO BUYERS INVEST IN LEGAL DUE DILIGENCE?

Some may ask: “If the target company appears to be operating normally, why spend significant time and resources on due diligence?”

The difference between litigation and due diligence is this:

Litigation addresses problems after they occur. Due diligence identifies problems before they affect the investment.

For buyers making investments worth hundreds of millions or even billions of RMB, due diligence may not always result in a dramatic reduction in purchase price. However, it enables buyers to:

- Better understand the target company's true value;

- Identify potential operational and compliance risks;
- Structure the transaction more effectively;
- Negotiate more favorable contractual protections.

Ultimately, the value of legal due diligence lies not only in preventing problems, but also in helping clients make better-informed decisions.

FINAL THOUGHTS

Looking back after completing this project, I have gained a renewed appreciation for a simple but important principle:

Legal due diligence is not about proving that a company should not be acquired. It is about helping clients understand how to acquire it — and how to do so with greater confidence.

Lawyers are not the decision-makers when it comes to investment decisions. However, a well-prepared due diligence report can help buyers develop a more complete understanding of the target company, make better-informed judgments, and approach negotiations from a stronger position.

And if the report can ultimately help a client avoid unnecessary costs, mitigate risks, or make a more informed investment decision, then the time and effort invested in preparing it have been worthwhile.

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FROM THE FIRM

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