

# Startups in the Defence Environment: Regulatory Pitfalls and Chances

19 February 2025

As previously announced, BLOMSTEIN is publishing a series of briefings introducing into European and German legal defence matters.

Today's briefing focuses on regulatory topics that might occur in relation to the investment and ramp-up phase of startups. These issues refer to export control, public procurement and foreign direct investment control law.

## Compliance with export control specifications necessary

Export control adherence is rarely considered, especially by very young companies, but is essential due to the potentially far-reaching consequences of non-compliance. Those responsible are often not even aware that German and EU export control law requires a licence for the export or the transfer of certain goods (including technology and software). Startups involved in foreign trade are well advised to assess whether their product range includes goods that are listed in either the German national export list or the European Dual-Use Regulation. This includes for example drones but also related software and technology. If that is the case, the companies are also required to implement an internal compliance programme to comply with the provisions of foreign trade law. This includes correctly classifying the products and contacting the competent authority, the Federal Office for Economic Affairs and Export Control (BAFA), before exporting or transferring any products. The BAFA has no fixed deadlines for granting an export licence (and the associated classification of the goods). At best, it takes a few weeks to obtain a licence. In the worst-case scenario, it can take six months or longer. In addition to German export control regulations even stricter export control regulations of other countries may apply. For instance, the United States export control regime could come into play, if there is a US-nexus. This could be the case, for example, if products contain U.S. components.

Infringements of the German export control requirements can result in severe penalties. Violations are punished as a criminal offence (imprisonment for up to five years or fine) in the case of intentional action and as an administrative offence (fine of up to EUR 500,000 per violation) in the case of negligent action. Currently, higher penalties are being discussed. The maximum fine for an intentional offense would be up to EUR 40 million.

The company itself could also be fined for violations. This could lead to the company being considered unreliable which could result in refusal of licences, the confiscation of the concerned turnovers, or exclusion from public procurement procedures, e.g. by the German Armed Forces.

## **Opportunities in the field of public procurement law**

In the defence sector, customer business is driven by public authorities like the German Armed Forces. Accordingly, public procurement law applies. In general, public procurement law foresees a public tender process in which the public authority chooses the economically most advantageous tender. However, there are several exemptions under public procurement law where it is permissible to procure a product from a supplier without conducting a competitive tendering procedure (so-called direct award).

Direct awards are possible in different situations:

- First, a direct award is allowed on the basis of absence of competition for technical reasons, or due to the need to protect exclusive rights, including intellectual property rights. In such a case, there is no need for a competitive tender process because only one company can be considered as a supplier from the outset. For startups it is important to create own IP from the outset to have a competitive advantage (not only) in direct award situations.
- Second, Article 346 of the Treaty on the Functioning of the EU allows direct awards in the defence sector when they are strictly necessary for the protection of national security interests.
- Third, government-to-government contracts may provide for the supply of defence equipment.
- Finally, when NATO or other international defence bodies such as OCCAR procure material, there are fewer requirements for a public tender process.

For startups, which naturally only have limited sales and financial capacities, direct awards offer excellent opportunities to avoid lengthy procurement procedures and save valuable resources. It is therefore advisable to look into the above stated opportunities in more detail early on in order to make strategic use of them in the individual sales process.

## **FDI control law: Attention when granting 10% of the voting rights and to atypical constellations**

Early-stage startups in particular try to persuade as many domestic and foreign investors as required to invest in their company. Part of such deals is the sale of considerable shares, which are accompanied by the granting of voting rights. However, caution is

required when dealing with foreign investors against the background of foreign direct investment control regulations.

Investments in German startups active in the defence sector by a non-German investor may trigger a mandatory notification obligation if 10% or more of the voting rights are being acquired. In case of two investing entities acquiring each below 10%, the threshold is reached if the investment entities have concluded an agreement on the joint exercise of voting rights or if it can be assumed from the other circumstances of the investment that the voting rights will be exercised jointly. But even below the 10% threshold, caution is called for.

Of specific relevance in this category is the case of so-called “atypical rights”. In such situations the competent authority, the Federal Ministry for Economic Affairs and Climate Action (BMWK) could also review the investment *ex officio*. This is the instance if the investment entities are granted additional rights that would normally only be granted to an investor with a stake of 10% or more. These include additional seats or majorities in supervisory bodies or the management, veto rights on strategic business or personnel decisions, or information rights. It is therefore especially important to check the reserved matters in the corporate governance. Finally, it is noteworthy that in Germany there is no de minimis-exemption or any other exemption for start-ups regarding FDI control review procedures.

## Who to turn to

BLOMSTEIN's Defence Team (Roland M. Stein, Florian Wolf, Christopher Wolters, Leonard von Rummel and Pia Hesse) will closely monitor further developments in all aspects of export control, defence procurement and foreign direct investment. We will be happy to advise you on any related matters such as determining whether a particular good falls under the applicable export control regulations, preparing grant applications in the defence sector and complying with foreign direct investment notification requirements.

\*\*\*