Navigating Defense Tech and Dual-Use Investments: Key Legal Considerations

Understanding Fund Restrictions, ESG, Export Control, FDI, and Financing Documentation

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What You Need to Know

- Defense tech is an increasingly relevant – but legally and strategically complex – investment area.
- Fund documentation may contain restrictions on investments in weapons, military equipment, or dual-use goods, particularly where institutional or government-backed LPs are involved.
- Accurate classification of a company's products and activities is essential to determine investment eligibility and regulatory exposure.
- The EU's sustainable finance framework – including SFDR, the EU Taxonomy, and CSRD – does not prohibit investments in defense or dual-use technologies, but places limits on controversial weapons.
- Export control and foreign direct investment (FDI) regimes can apply earlier than expected – including in early-stage financings, cross-border investments, or where foreign investors are involved.
- Company governance documents should include mechanisms to address regulatory risks, such as the ability to exclude sanctioned shareholders.

1. Introduction

Amid growing geopolitical tensions and a **shifting global security landscape**, investment activity in the defense technology sector has accelerated significantly. As governments ramp up defense budgets and seek to strengthen **industrial resilience, private capital** is playing an increasingly vital role in driving innovation across defense and dual-use technologies.

While **EU defense policy** and regulation continue to evolve in response to these new realities, investors and companies must navigate a **complex and fragmented regulatory environment** – including **investment restrictions, export controls, and foreign direct investment (FDI)** regimes. Given the scope of regulatory obligations and the potential consequences of non-compliance, it is critical for all stakeholders to engage with these issues **early and strategically**.

This briefing aims to provide an overview of **key legal and regulatory considerations** relevant to both defense tech start-ups and investors, with a particular focus on the **European defense tech sector** and the applicable **legal framework in Germany**.

2. Investment Restrictions

For both **private equity and venture capital investors**, as well as the defense tech start-ups they support, a critical threshold issue is whether the investment is permissible under the investor's **governing documents**. Many established European venture capital and private equity funds – particularly those backed by public institutions – are subject to investment restrictions prohibiting investments in companies involved in the development, production, or trade of **weapons and ammunition**.

Importantly, such investment restrictions do not automatically rule out investments in companies developing **dual-use technologies** or even certain types of **military equipment**. In most cases, such restrictions apply specifically to investments in companies whose business activities or products qualify as weapons or ammunition. To determine whether an investment is permissible, it is essential to clearly classify both the nature of the company's business and its specific products – particularly in distinguishing between dual-use goods, military equipment, and weapons as defined in the relevant fund documentation.

2.1. Classification for Investment Eligibility

2.1.1. Dual-Use Goods

Dual-use goods are defined as items that can serve both **civilian and military purposes**, encompassing products, technologies, and software. Common examples include machine tools, testing and measurement devices, valves, and electronic components.

The primary legal framework for the regulation of dual-use goods in the European Union is Regulation (EU) 2021/821 of May 20, 2021 (**EU Dual-Use Regulation**), which governs export control and licensing requirements. In Germany, this framework is supplemented by Part I B of the **Export List** (*Ausfuhrliste*), an annex to the **German Foreign Trade and Payments Regulation** (*Außenwirtschaftsverordnung – AWV*).

2.1.2. Weapons

While various legal frameworks exist at both the European and German levels to regulate the possession, sale, and transfer of weapons, the most relevant statute for defense tech start-ups operating in Germany is the **German War Weapons Control Act** (*Kriegswaffenkontrollgesetz – KrWaffKontrG*). This law provides a clear definition of what constitutes a **war weapon**, with examples including combat aircraft, tanks, fully automatic firearms, and warships.

In addition, the German Foreign Trade and Payments Regulation (*Außenwirtschaftsverordnung – AWV*) plays a key role. Its annexed Export List (*Ausfuhrliste*) covers a broader category of military-relevant goods, including both conventional weapons and other types of military equipment. These may also **trigger export restrictions** or **notification obligations**, even if they do not fall under the narrower scope of the German War Weapons Control Act (*Kriegswaffenkontrollgesetz – KrWaffKontrG*).

2.1.3. Military Equipment

Sitting between dual-use goods and classified weapons is a category of equipment that serves a **clear military purpose** but does **not meet the legal definition of a weapon**. Examples include parachutes, specialized diving equipment, and certain types of protective gear.

Although these items are not classified as war weapons under the German War Weapons Control Act (*Kriegswaffenkontrollgesetz – KrWaffKontrG*), they **frequently appear in the Export List** (*Ausfuhrliste*) and may be subject to licensing or notification requirements.

2.1.4. Practical Implications

Determining whether a product qualifies as a weapon under the German War Weapons Control Act (*Kriegswaffenkontrollgesetz – KrWaffKontrG*) is typically straightforward, as the law contains a clear list of covered items. However, export control obligations may still apply to military equipment not formally classified as war weapons, particularly where such items are listed in the Export List (*Ausfuhrliste*).

The **classification of specific products** under the Export List (*Ausfuhrliste*) often requires a **case-by-case legal analysis** and it is not always possible to clearly delineate between categories, including weapons and broader categories of military-relevant equipment. This can be particularly nuanced in borderline cases and may have direct implications for the **permissibility of an investment** under a fund's governing documents.

While many fund documents provide for the possibility of approving otherwise restricted investments – for example, through **consent** from a **Limited Partner Advisory Committee (LPAC)** or a similar body – such provisions often have **limited practical effect**. **Institutional investors** are frequently **bound by** their **own mandates or regulatory obligations**, which prohibit investments in defense-related companies irrespective of internal fund approvals. As a result, even theoretically available approvals rarely offer a viable path for proceeding with investments that fall within these restricted categories.

2.2. ESG Considerations

As defense and dual-use investments enter the mainstream, fund managers must carefully navigate evolving **ESG expectations**, investor mandates, and **disclosure requirements** under the EU's sustainable finance framework.

In its Joint Communication on European Defence Industrial Strategy (JOIN(2024) 10 final) of March 5, 2024, the European Commission emphasized that the EU's sustainable finance framework is fully compatible with efforts to strengthen the European defense sector. Specifically, the Commission clarified that the **Sustainable Finance Disclosure Regulation (SFDR)**, the **EU Taxonomy Regulation**, and the **Corporate Sustainability Reporting Directive (CSRD)** do not prohibit investments in defense or dual-use technologies – including weapons and ammunition.

The only express limitation applies to **so-called 'controversial weapons'** which are defined under the SFDR's Delegated Regulation (EU) 2022/1288 (RTS) as anti-personnel mines, cluster munitions, chemical and biological weapons. Managers who consider Principal Adverse Impacts (PAIs) on sustainability factors are required to disclose annually whether their funds have invested in such weapons.

Funds classified under **Article 9 SFDR** – and ambitious Article 8 funds with a 'sustainable investment' quota – must comply with the **'Do No Significant Harm' (DNSH)** principle. Since controversial weapons are presumed to violate environmental and social objectives, such funds may not invest in them. While other funds may theoretically do so, such investments are likely to be precluded by investor mandates or national legal restrictions, and remain highly sensitive from both legal and reputational standpoints.

A more complex question is whether investments in **conventional weapons (*i.e.*, non-controversial)** could qualify as **'sustainable investments' under Article 2(17) SFDR**. The SFDR and EU Taxonomy do not exclude such a classification, and the European Commission has acknowledged the defense industry's role in contributing to peace, resilience, and social sustainability. Based on that guidance, it may be arguable that certain investments in conventional defense technologies support a **social objective**.

However, this interpretation is inherently fragile: shifts in public perception, political climate, or the actual use of the weapons in question may trigger reassessment – potentially undermining a fund's ESG classification mid-term. Moreover, Article 9 funds must demonstrate DNSH compliance, meaning that any such classification would require a robust justification that the destructive **risks associated with the investment are proportionate to the societal benefit** (*e.g.*, national or European security). In our view, the inclusion of weapons-related investments – at least under an Article 9 strategy – is therefore highly debatable and difficult to justify within the current regulatory framework.

Finally, the SFDR also requires disclosure of how sustainability risks are integrated into the investment process. Beyond environmental and social concerns, **long-term risks** related to governance, corruption, diversion, terrorism, and misuse of defense technologies should also be considered in ESG assessments.

3. Export Control

Export control compliance is a critical regulatory consideration for defense tech start-ups – particularly those working with dual-use goods, military-grade components, or advanced software. Under both **EU and German law**, the export or transfer of such items may require prior authorization, even in non-commercial or research-related contexts. The core legal framework consists of the EU Dual-Use Regulation and the German Foreign Trade and Payments Regulation (*Außenwirtschaftsverordnung – AWV*).

Start-ups should be aware that compliance obligations may arise **earlier than expected** – especially in cases involving **cross-border collaboration, foreign investment**, or international hiring. Notably, export control can also apply to software and intangible know-how (*e.g.*, design files, source code, or manufacturing

blueprints). In addition, foreign export regimes (such as U.S. export control law) may apply if there is a **U.S. nexus** (*e.g.*, through U.S.-origin technology, funding, or personnel). Violations, whether intentional or negligent, can result in **severe penalties** and may affect a company's eligibility for future licenses or public funding.

For investors, export control compliance should be a **standard component of legal and operational due diligence**. A potential area of concern is the lack of internal processes for product classification, export licensing, and related documentation.

4. Foreign Direct Investment Control

Investments in German dual-use and defense tech start-ups may be subject to foreign direct investment (FDI) control under German law. A **filing requirement** and **standstill obligation** can be triggered if a foreign investor – whether EU-based or not – acquires (directly or indirectly) **10% or more of the voting rights** in a German company that engages in sensitive defense-related goods or technologies.

Violations of the standstill obligation can have severe consequences. Investors may face significant financial penalties and, in extreme cases, imprisonment for up to five years. In addition, a **transaction** completed without the necessary clearance may be deemed **invalid** and subject to reversal.

Importantly, **FDI review can also be triggered below the 10% threshold** – for example, where an investor is granted atypical governance rights such as veto powers, board representation, or enhanced information rights. In such cases, the competent German ministry may initiate a review *ex officio*.

For **private equity and venture capital funds**, this means that investments in defense tech start-ups – whether at the early stage or in connection with an exit – may require FDI analysis. The FDI implications should be assessed **early in the process**, as they may significantly affect transaction structure, timing, and required documentation. Proactive consideration of these issues, ideally with legal counsel experienced in both regulatory and transactional matters, helps minimize regulatory delays and legal uncertainty at a later stage.

5. Specific requirements for due diligence

Due diligence in the defense sector requires heightened attention to several areas – most notably **know-your-customer (KYC)** compliance, **export control**, and non-disclosure agreements. KYC due diligence entails a comprehensive investigation of the company, encompassing all shareholders, investors and co-investors. This process demands significant effort from the company to ensure and guarantee the seamless flow of information. Investors are particularly attentive to the presence of **sanctioned shareholders, politically exposed persons (PEPs)**, and the **structure of follow-on investments**, as well as any links to governmental institutions or **state-related entities**. In addition, the handling of sensitive information in the due diligence process may require setting up a **clean room** and a **clean team** and the execution of corresponding clean team agreements.

However, due to **national security** and **classified information** requirements, certain defense-related data may **not be disclosed** during due diligence – even to clean team members – as they may lack the necessary **security clearance** from public authorities. As a result, standard **representations and warranties** regarding the **completeness of disclosures** may need to be adjusted accordingly in the investment agreement.

6. Key Clauses in Investment and Governance Documents

The specific regulatory requirements applicable to defense tech companies should be reflected in the transaction and financing documentation – including the **investment agreement**, **shareholders' agreement**, and **articles of association**.

For example, in case a **FDI filing** is required, closing of the transaction must be **subject to the condition precedent** that the relevant clearance decision has been obtained. The investment agreement should also provide for a **cooperation mechanism** between the parties to ensure an efficient filing and review process. It may in certain cases also be sensible to address the allocation of the risk that remedies are required to obtain the relevant clearance certificate.

From a timing and liquidity planning perspective, companies should also consider including a **two-step closing mechanism**: one allowing a limited number of shares (*e.g.*, up to 9.99%) to be issued or transferred prior to FDI clearance, with the balance to be completed after approval. This may allow investors to participate early without reaching relevant FDI thresholds, while providing the company with partial liquidity before the full closing.

Another example relates to the **risk of sanctioned shareholders**. If a shareholder becomes subject to sanctions or blacklisting after closing, this risk can be addressed through a **regulatory call option** in the shareholders' agreement, enabling the company to repurchase the affected shares at fair market value. In such a case, the shareholder should also lose any right to appoint a member to the advisory board (if applicable).

Similarly, the **articles of association** may stipulate that the shares of a shareholder that becomes a sanctioned and/or blacklisted person may be **redeemed by the company** against compensation.

7. Practical Takeaways for Funds and Founders

As the defense tech landscape continues to evolve, funds and founders should keep the following practical points in mind to stay aligned with regulatory expectations and market realities:

- **Fund Restrictions**: Private equity and venture capital funds should review their fund documentation – including side letters – for restrictions on investments in weapons, dual-use goods, or military equipment, particularly where institutional investors or government-backed LPs are involved.

- **ESG Positioning:** While Article 8 SFDR funds may invest in defense tech under certain conditions, Article 9 funds face stricter sustainability criteria, including DNSH requirements and restrictions on controversial weapons. Clear ESG positioning is essential to avoid reclassification risks during the fund lifecycle.
- **Product and Activity Classification:** Start-ups must assess and document whether their products or activities fall under the categories of dual-use goods, military equipment, or weapons. This classification should be done early and with legal support, as it may determine fund eligibility and trigger regulatory obligations.
- **Early Compliance Planning:** Export control and FDI requirements can arise earlier than expected – especially in cross-border financings or where foreign investors are involved. Establishing basic internal compliance structures early on reduces risk and avoids costly delays.
- **KYC and Diligence Expectations:** Investors will apply heightened scrutiny in defense-related transactions. Start-ups should expect detailed KYC reviews, including cap tables, investor backgrounds, and product use cases. However, certain sensitive information may not be disclosable due to national security or classified information rules. Transparency and readiness are key to passing diligence, but disclosure limitations should be anticipated.
- **Company Governance Measures:** Start-ups should ensure that their own corporate documents include mechanisms to address regulatory risks, such as the ability to redeem shares or exclude rights of sanctioned persons.

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