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DUAL USE: RISK ASSESSMENT AND M&A TRANSACTIONS

1. What is a “dual use” item?

Dual use items are usually products of **high technological content**, both tangible and intangible, which have a **main civilian use** – and are sold for that purpose – **but may also be used for military purposes**.

The main piece of legislation governing dual use items and related authorizations and export procedures is **Regulation 2021/821** of the European Union Council (“**Dual Use Regulation**”)¹ which replaced **Regulation (CE) 428/2009**. At the Italian national level, the implementation of the dual use regime is set out in Legislative Decree 221/2017².

The Dual Use Regulation provides a **list of the main dual use items** (Annex I), each corresponding to a **classification code** (which, however, differs from the customs classification code) and divided into **subcategories**, comprising, *inter alia*, the following:

- Electronics (systems, equipment and components) e.g., electronic products, including general purpose integrated circuits (ICs), analog-to-digital converters (ADCs) and digital-to-analog converters (DACs), when having certain technical requirements or uses;
- Computers e.g., electronic computers, such as neural and optical calculators, command and control equipment for intrusion software, and their related software and equipment;
- Special materials and related equipment e.g., equipment and protective devices not especially designed for military purposes, such as full-face masks, filters and decontamination equipment, gloves and protective clothing against biological and radioactive agents, as well as equipment for the production of composite materials, such as cable laying machines and x-ray technologies;
- Telecommunications and information security systems and equipment e.g., specially designed components and accessories, having any of the required characteristics, functions or features under the Dual Use Regulation (such as underwater communication systems, radio equipment operating in the band 1.5 MHz to 87.5 MHz);

¹ Article 2 of the Dual Use Regulation defines dual-use goods as “*items, including software and technology, which can be used for both civil and military purposes, and includes items which can be used for the design, development, production or use of nuclear, chemical or biological weapons or their means of delivery, including all items which can be used for both non-explosive uses and assisting in any way in the manufacture of nuclear weapons or other nuclear explosive devices*”.

² Legislative Decree 221 of 2017 adjusted the Italian national legislation in order to comply with the European provisions of Reg. (CE) 428/2009, for the purpose of reorganizing and simplifying the authorization procedures for the export of dual-use items. Legislative Decree 221 of 2017, however, has not yet been updated in light of the Dual Use Regulation.



- Sensors and lasers e.g., naval acoustic systems or equipment, underwater equipment for topographic mapping, hydrophones, optical sensors), as well as imaging equipment, including cameras and instrumentation cameras, having specific technical characteristics, and aimed to specific uses, such as the capability for annotating internally generated “camera tracking data”;
- Avionics and navigation equipment e.g., accelerometers or gyroscopes to measure changes in velocity and orientation in order to determine or maintain heading or position without requiring an external reference once aligned;
- Nuclear materials, facilities and equipment e.g., metal containers, or major shop-fabricated parts thereof, used in the nuclear energy sector, when specially designed or prepared to contain the core of a “nuclear reactor” or other components of nuclear reactors, such as pressure resistant tubes.

The above list is not exhaustive, as Article 4 of the Dual Use Regulation contains a “**catch-all clause**”, according to which the dual use classification may also apply to items which are not included in Annex I, provided that certain conditions are met.

In particular, based on said Article 4, national authorities have considered as dual use items, *inter alia*, the following goods: self-contained breathing apparatus with semi-closed circuit; centrifugal pumps (which, e.g., may be integrated into machineries used to spray pesticides in the fields); drive shafts intended to be inserted into electric motors of boats, and many other goods also depending on the country of the export destination (see also paragraph 2 below).

The Dual Use Regulation also flags as particularly relevant the goods and technologies, even if not listed in Annex I, that can be used to control so called **emerging technologies** (including, *inter alia*, certain non-listed cyber-surveillance items) and provides for coordination mechanisms among national authorities and controls with respect to such technologies.

Furthermore, the Dual Use Regulation considers as dual items some **components** (i.e., parts of finished goods), which are also listed in Annex I and are subject to the same regulatory provisions as the finished dual use goods. Indeed, if a listed components constitutes a main element of a non-dual use item (so-called “non-controlled good”) and can feasibly be removed and used for other purposes, then the non-controlled finished good will be subject to the regime of the Dual Use Regulation. In order to assess whether a controlled component constitutes the main element of a non-controlled good, the quantity, value and the technological capability of the listed component in the non-controlled good shall be considered.

2. Relevant transactions under Dual Use Regulation

The Dual Use Regulation also encompasses – in relation to the wide range of products and goods mentioned in Paragraph 1 above – a broad array of business transactions, which are, in practice, frequently carried out by various **companies active in different industries, including, *inter alia*, SMEs.**

In particular, the following categories of activities and transactions, when they involve a “dual use” item, are relevant for the Dual Use Regulation:



1. Export
2. Brokering
3. Technical assistance
4. Transit and transfer

(jointly, the “**Relevant Transactions**”).

The Relevant Transactions are defined in detail in Article 2 of the Dual Use Regulation.

It is worth noting that some of these definitions have been further broadened (if compared with the prior regime under Regulation (CE) 428/2009) by said Article 2, also considering the occurred development of new technologies. By way of example:

- (i) the “Export” activity now also includes the **transmission of software or technology by electronic media, including by fax, telephone, electronic mail or any other electronic means** (also by making available in an electronic form the relevant software and technologies and/or transmitting the technology through voice transmission) to a destination outside the customs territory of the European Union;
- (ii) in connection with “Brokering” activity, the definitions of “broker” and “brokering services” have been revised and updated.

The number and categories of products and components - and the activities and transactions - falling within the scope of the Dual Use Regulation is, therefore, quite wide, involving many operators in the industrial supply chain system and impacting several business activities.

3. Control regime - Authorization regime and sanctions

According to the Dual Use Regulation, the Relevant Transactions concerning dual use items are subject to a control regime both at the European and the National level (in Italy, the competent National Authority is the UAMA, established at the Ministry of Foreign Affairs of International Cooperation (MAECI)).

In particular, pursuant to the Dual Use Regulation, a specific **authorization** is mandatory in order to carry out any of the Relevant Transactions. More precisely:

- as to the Export activities, the Dual Use Regulation provides for **five** different types of authorizations, depending on the relevant activity to be carried out: *(a) individual export authorization; (b) global export authorization; (c) large project authorization; (d) EU general export authorization, and (e) national general export authorization;*
- as to the other Relevant Transactions, such as the provision of brokering services, technical assistance and transit services, specific authorizations are issued by the competent authorities of the EU member states or by other competent states, depending on the



applicable case, in accordance with the forms and procedures provided for under the Dual Use Regulation (Article 13 and 15 and Annex III) and applicable Italian law.

Said authorizations are granted to Italian operators upon submission of the relevant request according to the procedures provided for by Legislative Decree 221/2017, in combination with the provisions of the Dual Use Regulation.

With specific reference to the Italian **export authorization** procedure, it is expected that **a new electronic system** (so-called **E-Licensing**) **will soon enter into force**. Indeed, the EU Commission recently created an E-Licensing software that will be customized in Italy, as a pilot project, during 2022, in order to simplify the filing of the relevant applications and to make it easier for authorities of the different EU member states to uniformly conduct controls.

In addition to the foregoing, the competent authorities are also entitled, according to the Dual Use Regulation control regime, to conduct **supervision activities**, including controls and inspections, with respect to Relevant Transactions.

Pursuant to Article 18 of Legislative Decree 221/2017, if a Relevant Transactions is carried out in the absence or in violation of the required authorization, **penalties apply**. Such penalties, in light of the criminal nature of the relevant offences, include measures like imprisonment (where applicable) or a fine ranging from € 15,000.00 up to € 250,000.00, depending on the applicable case, as well as mandatory confiscation not only of the dual-use products but also of any items that served or were destined to commit the relevant offence or, where not possible, the seizure of assets for a value corresponding to the price or profit of the offence.

4. Dual use compliance in the ordinary business of a company

In light of the foregoing, the Dual use Regulation particularly focuses on the accountability of all operators – such as e.g., exporters – who are required to carry out a **risk assessment analysis** related to the handling of dual use items.

In particular, natural and legal persons shall verify whether their **business activities** fall **within the scope** of the Relevant Transactions, thereby triggering the application of the relevant control regime and the potential need of an authorization.

In order to perform this assessment, both the following aspects shall be considered:

- (i) the **objective scope of the activity**, to be evaluated by analyzing **the relevant products** from a technical standpoint, in order to ascertain whether **any of them falls within the scope of Dual Use items**. Such verification shall be made in compliance with a specific procedure, which also implies the analysis of the customs classification and the review of so-called “Integrated Tariff of Usage” (TARIC) on the Italian Customs Agency website; and
- (ii) the **subjective scope of the activity**, such as, *inter alia*, the **final country of destination** of the Relevant Transaction.



In this respect, e.g., Italian exporters must make sure that their client, under applicable regulations, is not considered as a person with whom it is forbidden to do business, and shall carefully assess any issues deriving from relevant regulations to which a given country may be subject.

Specific restrictive measures may, in fact, be imposed, *inter alia*, by the EU against governments of third countries, non-state entities and/or natural or legal person, which may include arms embargoes, other specific or general **trade restrictions** (such as import and **export bans**), financial restrictions and many others. Official lists of the main trade sanctions are generally available on public sources.

Therefore, when planning exports of dual use goods to restricted countries, **companies are required to assess whether such delivery is allowed**, together with the verification on the dual-use classification of the traded products of the relevant company.

The Dual Use Regulation provides that the risk assessment analysis (both for the objective and subjective aspect) may be carried out through **transaction-screening measures** as a part of an **Internal Compliance Program (ICP)** that the relevant company may adopt. According to the instructions of the Italian National Authority, the adoption of ICPs is mandatory for Italian exporting companies intending to operate under the EU General Authorization (EU 007) for intra-company export of software and technology, as per the Dual Use Regulation (Annex II, Section G).

The ICP is, in summary, a set of internal procedures and policies created and implemented by a company for monitoring compliance under the Dual Use control regime. Such compliance procedures (i) shall not be standardized documents and **need to be, instead, as much tailored as possible**, considering, in particular, the size and organizational structure of relevant companies/businesses, and (ii) are, therefore, often carried out with the support of both the internal functions of the company and of **legal advisors** with a **specific expertise** in such matters.

Also contractual arrangements are a very important aspect for entrepreneurs, in order to protect them from international commercial disputes and legal risks related to infringement of trade regulations. **Commercial agreements**, including e.g., distribution, sale and re-sale, supply, license agreements, should, in fact, **provide for specific clauses** addressing compliance with Dual-Use and trade sanctions regulations and adequate remedies in case of breach of the same by the counterparty. Also considering the new Dual Use Regulation, an **accurate review of the terms and conditions of the contractual documentation** used by a company is highly recommended.

5. Relevance of Dual use in M&A transaction

Trade compliance and related risks shall be carefully taken into consideration also in the context of extraordinary transactions, such as **M&A transactions**.

In particular, in carrying out a **due diligence** process over a target company, it is increasingly important for a buyer to **assess the risks related to the failure by the target company to comply** with the Dual Use Regulation. It is, indeed, not uncommon that target companies are not even aware that the dual use regime may be applicable to them.



In this respect, red flags can typically arise when a product of the company is still under development or it has not yet reached a large number of customers in a domestic market, as well as when the product features are technically superior to those of established competitors. Also cases where customers have requested an unusual customization of a standard product or there are questionable modification requests that raise doubts about the potential applications of the customized product, could be relevant.

On the other hand, a seller of a target company may be interested in carrying out a vendor due diligence addressing, *inter alia*, compliance with the Dual Use Regulations and trade sanctions.

Any material/potential risks identified in the preliminary phase of an M&A process can obviously have an important impact on the negotiation of the legal (and, possibly, economic) terms of the relevant acquisition (or investment) agreements.

In this respect, as a **protection of the buyer/investor**, specific representations and warranties on the target company and, where applicable, special indemnities, and adequate indemnification obligations may be inserted in the relevant acquisition/investment agreement.

Furthermore, as a general rule, **dual use activities** are also relevant for the purposes of the **Golden Power regulation** and for complying with the related notification obligations, being included in the scope of the “critical activities” of national interest. Thus, in the context of extraordinary transactions and/or or the execution of ordinary commercial agreements (including, e.g., transfer of know-how and license contracts) the dual-use regime has an impact on determining whether the commercial and/or corporate transaction shall be filed before the competent Golden Power Authorities.

As it can be inferred from the foregoing, various categories of individuals and/or companies, commercial activities and ordinary and extraordinary transactions can be involved in the dual use regime. Therefore, the importance of such matter and the need of appropriate support and legal assistance in relation thereto is becoming more and more relevant for companies and other businesses.

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