

Department of Commerce Activates Denial Order Against Chinese Telecommunications Company ZTE

April 20, 2018

International Trade Controls

On April 15, 2018, the U.S. Department of Commerce, Bureau of Industry and Security (“BIS”) lifted its suspension of a [denial order](#) against two companies, Zhongxing Telecommunications Equipment Corporation of Shenzhen, China (“ZTE Corporation”) and ZTE Kangxun Telecommunications Ltd. of Hi-New Shenzhen, China (“ZTE Kangxun,” and together with ZTE Corporation, “ZTE”), thus denying ZTE’s export privileges for a period of nearly seven years, until March 13, 2025. The Denial Order went into immediate effect on April 15, denying ZTE access to goods, software, and technology subject to U.S. export control jurisdiction. ZTE is one of China’s largest telecommunications firms, and the order already is having a broad impact on its customers and suppliers.

Overview of the Denial Order

On March 7, 2017, ZTE entered into settlement agreements with BIS and other U.S. government agencies to resolve allegations of civil and criminal export controls and sanctions violations related to shipments to Iran and North Korea. As part of the settlement with BIS, BIS issued a denial order against ZTE, but agreed to suspend its application. This week, BIS lifted the suspension of the Denial Order, alleging that ZTE had made false statements to BIS in reporting on compliance-related steps it had taken.

In particular, on February 2, 2018, BIS requested a status report on actions taken against employees named in two letters sent by ZTE on November 30, 2016, and July 20, 2017. In the letters, ZTE indicated that it had implemented certain disciplinary measures against a number of employees, many of whom had been specifically identified by the U.S. government as having a role in the company’s export controls and sanctions violations. ZTE described these disciplinary actions to the U.S. government as showing ZTE’s “overall approach to discipline and compliance” and argued that the actions were “significant and sufficient to prevent past misconduct from occurring again.” However, in response to the February 2 request for a status report, ZTE communicated that it had not actually undertaken the disciplinary measures. BIS therefore concluded that ZTE’s previous representations in November 2016 and July 2017 constituted false statements. BIS found that these false statements fit within a pattern of concealing misconduct, misleading the government, and repeatedly violating U.S. law.

The Denial Order issued by the Department of Commerce follows standard language generally used in such measures. It prohibits ZTE and, when acting for or on ZTE’s behalf, its successors, assigns, directors, officers, employees, representatives, or agents, from directly or indirectly

participating in transactions involving any commodity, software, or technology (any “item”) subject to U.S. jurisdiction under the Export Administration Regulations (“EAR”), as described in the order. Generally speaking, items are subject to U.S. jurisdiction under the EAR (or “subject to the EAR”) if they are being exported from the United States, are of U.S. origin, contain more than a *de minimis* level of controlled U.S.-origin content, or, in certain cases, are the non-U.S. direct product of sensitive EAR-controlled technology or software, or products of plants made from such sensitive U.S.-origin technology or software.

In particular, the Denial Order prohibits ZTE from applying for, obtaining, or using any license, license exception, or export control document; engaging in a wide range of actions—carrying out negotiations concerning, ordering, buying, receiving, using, selling, delivering, storing, disposing of, forwarding, transporting, financing, or servicing in any way—any item exported or to be exported from the United States that is subject to the EAR; engaging in any other activity subject to the EAR; or benefitting in any way from any transaction involving any item exported or to be exported from the United States that is subject to the EAR or from any other activity subject to the EAR.

It also prohibits *any person*—whether a U.S. or a non-U.S. person—from engaging in the following activities, either directly or indirectly:

- Exporting or reexporting any item subject to the EAR to or on behalf of ZTE;
- Facilitating ZTE’s acquisition or attempted acquisition of ownership, possession, or control of any item subject to the EAR that has been or will be exported from the United States, including through providing financing or other support;
- Acquiring, or facilitating the acquisition or attempted acquisition of, any item subject to the EAR from ZTE that has been exported from the United States;
- Obtaining from ZTE in the United States any item subject to the EAR with knowledge or reason to know that the item will be, or is intended to be, exported from the United States;
- Engaging in any transaction to service any item subject to the EAR in the ownership, possession, or control of ZTE that has been or will be exported from the United States (with “service” meaning installation, maintenance, repair, modification, or testing); and
- Engaging in any transaction to service any item of any origin that is owned, possessed, or controlled by ZTE, if the service involves use of any item subject to the EAR that has been or will be exported from the United States.

While the Denial Order does not apply directly to subsidiaries or other affiliates of ZTE (apart from the two entities specifically named), the export control restrictions would apply to dealings with subsidiaries and affiliates when they are acting on behalf of ZTE. The order also notes that other affiliates of ZTE may be similarly designated as Denied Parties under the order in the future, subject to due process requirements of notice and an opportunity to respond.

U.S. and non-U.S. persons who fail to comply with the terms of the order may themselves be found to be in violation of the EAR. Penalties for such violations include civil penalties of \$295,141 per violation or twice the value of the transaction, whichever is higher, and criminal penalties of up to \$1 million per violation or twice the value of the gain from the violation or loss caused by the violation (whichever is higher), or 20 years in prison, or both.

Potential Impact of the Denial Order

The Denial Order likely will have a significant impact on ZTE. ZTE is China's second largest telecommunications firm, and the fourth largest seller of smartphones in the United States. ZTE is heavily reliant on U.S. products and software, and it will no longer be able to source such items without specific relief from BIS. As a result, ZTE may face significant limitations on its ability to continue bringing its products to market.

ZTE's global suppliers and customers also may be affected significantly by the order. ZTE suppliers and customers must cease dealings with ZTE that involve U.S.-origin items and non-U.S. items subject to the EAR, including exports or reexports of such items to ZTE, acquisition from or supply to ZTE of such items, or servicing of such items. Indeed, suppliers cannot even service an item not subject to U.S. jurisdiction in ZTE's ownership, possession, or control, if the supplier must use an item subject to U.S. jurisdiction in the course of the service.

It will be important for companies to identify U.S.-origin items furnished to or obtained from ZTE and any non-U.S. items that contain more than *de minimis* controlled U.S.-origin content, which would be supplied to or procured from ZTE. Companies also will want to identify whether any of the commercial items they handle may be covered by the foreign-produced direct product rule in the EAR, whereby certain "direct products" of sensitive U.S.-origin technology or software, or direct products of plants made from such sensitive technology, are subject to the EAR.

Notably, the order does not prohibit dealings with ZTE if no item subject to U.S. jurisdiction is involved in any way. ZTE suppliers and customers thus may sell to or purchase from ZTE non-U.S.-origin items not subject to the EAR, provided no other aspects of the Denial Order are violated. Thus, the extent to which ZTE and its suppliers and purchasers will be impacted by the Denial Order hinges on whether those dealings involve items subject to U.S. jurisdiction.

Likewise, the Denial Order applies only to the two ZTE entities named in the order. If there are other ZTE-affiliated entities manufacturing products using U.S. inputs or otherwise acquiring items subject to U.S. jurisdiction, their business may be unaffected. They would be able to continue to procure items from the United States or otherwise subject to U.S. jurisdiction, as long as they do not retransfer the items to either of the two entities named in the order or otherwise act as agents or representatives for or on behalf of those two entities. Accordingly, as companies evaluate the impact of the Denial Order on their businesses, they will need to determine which ZTE-affiliated entities are counterparties; whether those counterparties are acting as agents or representatives for or on behalf of the two ZTE denied parties; and whether the two denied parties have any role in ongoing or planned transactions.

As noted above, the Denial Order went into effect on April 15, the day that BIS lifted the suspension of the order. As a result, companies should evaluate all transactions involving ZTE that are in progress to determine if they will be affected by the order. Even if a company received orders or payments for products subject to U.S. jurisdiction before April 15, the transactions may be affected. Similarly, for orders placed with ZTE prior to April 15 and involving products subject to U.S. jurisdiction that were exported from the United States, companies should not take possession of such products or take other actions related to acquiring them.

Background to the Denial Order

The Denial Order is only the latest blow for ZTE with U.S. regulators. It follows settlements that ZTE entered into with BIS, the Treasury Department's Office of Foreign Assets Control ("OFAC"), and the Justice Department in March 2017. The settlement agreements alleged that from 2010 through 2016, ZTE conspired to violate U.S. trade controls by illegally shipping U.S.-origin items to Iran through an elaborate scheme and, to a lesser extent, shipping such items to North Korea. The agreements further alleged that ZTE obstructed justice by lying to and misleading federal investigators, as well as its own attorneys and internal investigators. In particular, ZTE allegedly took action to establish and service telecommunications networks in Iran using U.S.-origin equipment and software. It concealed such actions by using Chinese intermediary shippers on internal paperwork, omitting U.S.-origin items from packing lists, commingling U.S.-origin items with non-U.S.-origin items, and omitting references to Iran in internal communications.

In its settlement, in addition to imposing the suspended Denial Order discussed above, BIS assessed a penalty against ZTE in the amount of \$661 million, of which \$300 million was suspended for a seven-year probationary period. The agreement also required ZTE, among other things, to conduct audits of its compliance with U.S. export control laws, and to hire an unaffiliated third-party consultant with expertise in U.S. export control laws to conduct these audits. ZTE also was required to retain certain records and make these records available to the U.S. government.

OFAC and the Justice Department also reached settlement agreements with ZTE in which ZTE was assessed a total monetary penalty of more than \$530 million. The Justice Department also required ZTE to engage an independent corporate compliance monitor to assess ZTE's compliance with the terms of the agreement.

Notably, while the government's investigation of ZTE's trade controls violations was ongoing, on March 8, 2016, BIS [added](#) ZTE and several of its affiliates to the Entity List for their involvement in the scheme to reexport U.S.-controlled items to Iran. This designation required a BIS license for all exports, reexports, and in-country transfers to these entities of items subject to the EAR, and license requests were subject to a presumption of denial. On March 24, 2016, however, BIS issued a temporary [general license](#) that authorized nearly all exports and other transfers of items subject to the EAR to two of the listed entities, ZTE Corporation and ZTE Kangxun. Eventually, on March 29, 2017, those two companies were removed from the list altogether.

While relief was afforded previously to the Entity List designation of ZTE through the issuance of the general license, it is not clear that any such broad relief would be considered with respect to the Denial Order. However, under the EAR, BIS may, upon written request and on an "exceptional basis," authorize actions otherwise prohibited by a denial order. Application would need to be made specifically to BIS to secure such an authorization.

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International Trade Controls

If you have any questions concerning the material discussed in this client alert, please contact the following members of our International Trade Controls practice:

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