

KIRKLAND ALERT

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U.S. Imposes \$1.19 Billion in Penalties on Chinese Company for Economic Sanctions and Export Control Violations

On March 7, 2017, Zhongxing Telecommunications Equipment Corporation, headquartered in the People's Republic of China ("PRC"), along with its subsidiaries and affiliates (collectively, "ZTE") entered into settlement agreements with the U.S. Department of Commerce, Bureau of Industry and Security ("BIS"); U.S. Department of the Treasury, Office of Foreign Assets Control ("OFAC"); and U.S. Department of Justice ("DOJ") to resolve civil and criminal violations of U.S. economic sanctions and U.S. export control regulations. The settlement resulted in the imposition of penalties on ZTE totaling over \$1.19 billion and a mandatory independent corporate compliance monitor for three years.

ZTE Investigation and Settlement Overview

The \$1.19 billion total settlement amount includes the largest sanctions penalty ever imposed by OFAC on a non-financial institution (approximately \$101.8 million) as well as the largest criminal penalty (approximately \$430.4 million imposed by DOJ) and civil penalty (\$661 million imposed by BIS) ever imposed for export control violations. The huge penalties cap a multiyear investigation of ZTE by the three agencies. That investigation revealed thousands of willful violations of U.S. economic sanctions and export controls that resulted in tens of millions of U.S.-origin goods being diverted from the PRC to Iran. ZTE also diverted a smaller amount of U.S.-origin goods from the PRC to North Korea in violation of U.S. export controls. Although the penalties imposed were steep, through the settlement agreement ZTE avoided a BIS designation that likely would have been even costlier for ZTE.

The settlement agreement follows a series of contentious interactions between the agencies and ZTE, whose lack of cooperation with the U.S. government's investigation resulted in its designation on the BIS Entity List in March 2016, a designation that prohibits the export, reexport or transfer of virtually any U.S.-origin goods to ZTE.¹ The designation had been suspended pending the investigation and in view of the disruption that would have ensued for U.S. and other global companies. ZTE had been under investigation by OFAC, BIS, and DOJ since at least 2012 with regard to these diversions to Iran and North Korea and had previously been investigated by authorities in Hong Kong and at least one supplier in the United States regarding prior potential diversions of U.S.-origin goods to sanctioned countries.

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Key Aggravating Factors in the ZTE Investigation

Beyond the large scale of ZTE's diversions to Iran and the number of years that such diversions took place, the huge penalties imposed on ZTE also resulted from OFAC and BIS' determination that ZTE's conduct was "egregious," i.e., that there were numerous aggravating factors, but limited to no mitigating factors, with regard to ZTE's conduct. Aggravating factors that contributed to ZTE's penalties included:

- ZTE's highest-level management was specifically aware of, considered the legal risks and consequences of, and deliberately violated U.S. economic sanctions and export control laws.
- ZTE's top management undertook significant measures to conceal its resales of U.S.-origin goods to Iran (e.g., removing references to Iran in internal databases, destroying internal records of shipments to Iran, purposely failing to list U.S.-origin items on external packing lists for shipments to Iran).
- ZTE did not make a voluntary self-disclosure ("VSD") regarding the violations to OFAC, BIS, or DOJ. Further, ZTE and top management misled U.S. government investigators as to its business with Iran, including representations that its Iran-related business was "winding down" in 2012, despite top management's awareness of diversions to Iran through 2016.
- To mislead its U.S. suppliers and customs officials in the United States and the PRC, ZTE used third party companies as intermediaries to deliberately conceal and facilitate its business with jurisdictions subject to comprehensive U.S. economic sanctions.
- ZTE did not have a U.S. economic sanctions or export control compliance policy or program in place during the relevant time period.

The Trump Administration's OFAC and BIS Enforcement Focus

The Trump Administration continues to focus on international trade as a key vector of national security risk, not only with regard to imports into the United States, but, as this \$1.19 billion penalty shows, also with regard to U.S. sanctions and export controls. In describing the ZTE settlement, Commerce Secretary Ross indicated that a key priority of the administration will be to "aggressively enforce" economic sanctions and export control regulations. Recent guidance from OFAC, BIS and DOJ has echoed this focus on the increased enforcement of trade control laws as well as increased penalties for those individuals and entities that "flout" such laws. Other key takeaways include:

- As part of the plea agreement with DOJ, ZTE will be subject to an independent corporate compliance monitor for three years. The use of mandatory, independent compliance monitors in criminal sanctions and export control plea agreements is likely to increase.

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- ZTE used complex intermediary entities to conceal illegal activity, highlighting the importance of transactional due diligence to ensure new business partnerships do not include sanctions and export controls liability.
- ZTE did not submit a VSD, did not cooperate with U.S. government investigators, and, at times, intentionally misled the agencies investigating its conduct. The huge penalty assessed on ZTE underscores the impact that cooperation or noncooperation with investigators can have on the outcome of a sanctions or export control investigation.²
- The “tone from the top” remains a critical factor in OFAC or BIS’ evaluation of a company’s sanctions and/or export controls compliance framework. Both agencies noted ZTE top management’s knowledge of and involvement in the violations and the lack of a sanctions or export control compliance program as aggravating factors that resulted in a higher penalty.
- OFAC and BIS have continued to focus enforcement efforts on companies operating in jurisdictions known to have elevated sanctions and/or export control diversion risk from the U.S. Government’s perspective (e.g., the PRC). Therefore, companies operating in such jurisdictions should carefully review their U.S. economic sanctions and export controls compliance frameworks to ensure that they are reasonably designed to prevent violations.

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The United States, the EU and other countries scrutinize or regulate international business activities to advance priority national security, foreign policy and other objectives. If not addressed effectively, such governmental scrutiny or regulation can adversely impact business strategy and investment decisions, lead to significant individual and corporate civil and criminal penalties, and may even result in imprisonment for responsible persons.

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1 As part of the settlement agreement, BIS will lift this designation on the condition of ZTE’s ongoing cooperation with BIS and its compliance with U.S. export controls going forward.

2 For example, submitting a VSD to OFAC or BIS is almost always treated as a significant mitigating factor and often can reduce any penalties assessed by as much as 50 percent.

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If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

Mario Mancuso, P.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/mmancuso
+1 202 879 5070

Joanna M. Ritcey-Donohue
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/jritcey-donohue
+1 202 879 5980

Joshua R. Thompson
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/jthompson
+1 202 879 5179

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