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Smartphones And Foreign Policy: ZTE Sanctions Explained

Law360, New York (March 18, 2016, 11:07 AM ET) --

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On Tuesday, March 8, the U.S. Department of Commerce placed Chinese telecommunications equipment manufacturer ZTE Corp. and three affiliates on the Entity List, prohibiting exports to ZTE Corp. of items subject to the Export Administration Regulations, including U.S.-origin hardware, software and technology. The designation comes in response to ZTE's apparent reexport of controlled dual-use items from the United States to Iran in violation of U.S. law, which the Commerce Department found was "contrary to the national security and foreign policy interests of the United States."

Companies in the telecommunications sector — including U.S. companies and non-U.S. companies that trade in U.S.-origin items — are advised to evaluate their customer base to ensure that they are not supplying U.S.-origin items to ZTE or its affiliates, whether directly or indirectly through intermediaries.

ZTE's Impact in the Global Economy

This designation will have a profound impact on the telecommunications sector in the United States and abroad. Deeply embedded in the global supply chain for high-end telecommunications and computer networking equipment, ZTE is the world's fourth largest supplier of smartphones with approximately 7 percent of the U.S. market share. ZTE has described U.S. companies Microsoft Corp., Intel Corp., IBM, Avaya Inc. and Honeywell International Inc. as "key strategic partners" and industry experts estimate that 10-15 percent of the components for ZTE's products come from U.S. suppliers. ZTE has reportedly already received all such parts from U.S. suppliers for the year, but the company's long-term supply chain is now in jeopardy.

The designation's effect on global markets is already palpable. After news of the impending designation was leaked on March 7, ZTE suspended trading on its stock on the Hong Kong and Shenzhen stock exchanges. And shares in U.S. companies that supply ZTE — including chip suppliers Qualcomm Inc. and optical components company Oclaro Inc. — have declined.

ZTE and U.S. National Security

Although it took many by surprise, last Tuesday's Entity List designation was the culmination of years of investigations and closed-door discussions. In 2012, word leaked that the FBI and the Commerce Department were investigating ZTE for selling prohibited equipment and technology to Iran. In September 2012, a senior ZTE executive testified before the House Permanent Select Committee on Intelligence regarding accusations of violations of U.S. export control laws.

One month later, in October 2012, the House Intelligence Committee released a report on the "U.S. National Security Issues Posed by Chinese Telecommunications Companies Huawei and ZTE." That report stopped short of calling for sanctions to applied against Huawei and ZTE, but it recommended that the Committee on Foreign Investment in the United States — an interagency body led by the U.S. Department of the Treasury — block any mergers or acquisitions by the two Chinese companies and cautioned U.S. businesses to "consider the long-term security risks associated with doing business with either ZTE or Huawei." The report also emphasized that "classified and unclassified information" indicated that "Huawei and ZTE cannot be trusted to be free of foreign state influence and thus pose a security threat to the United States and to our systems."

Almost four years later, the U.S. Commerce Department announced that ZTE, along with affiliates ZTE Kangxun Telecommunications Ltd., Beijing 8-Star International Co. and ZTE Parsian, would be placed on the Entity List for actions contrary to U.S. national security and foreign policy. In the formal notice, the Commerce Department found that ZTE had violated U.S. export control laws by reexporting controlled items produced by U.S. companies to Iran in violation of U.S. export control law. In an unusual move, the Commerce Department's Bureau of Industry and Security also posted on its website two documents that served as the "principal bases" for the listing of ZTE and its affiliates. The dense documents posted in Mandarin and English — "Report Regarding Comprehensive Reorganization and the Standardization of the Company Export Control Related Matters" and "Proposal for Import and Export Control Risk Avoidance" — describe "a ZTE-developed scheme to violate U.S. export control laws by establishing, controlling and using a series of 'detached' (e.g., shell or front) companies to illicitly reexport controlled items to sanctioned countries without authorization."

Both ZTE and the Chinese Foreign Ministry urged the U.S. government to reconsider the Entity List designation, but reversal in the near term is highly unlikely. The designation comes almost four years after the controversial report of the House Intelligence Committee and likely followed years of discussions between the Chinese and U.S. governments. And while ZTE can appeal its Entity List designation, it is unlikely to be overturned given the unanimity requirement that applies to Entity List removals within the multiagency End-User Review Committee (composed of representatives of the departments of Commerce, State, Defense, Energy and, where appropriate, the Treasury) that would review such an appeal, and the deference given to U.S. national security concerns during any subsequent judicial review.

Practical Implications

ZTE's Entity List designation — a sort of "coming out" party for a U.S. government list that many have never even heard of — has immediate effect. It makes unlawful any unlicensed exports, reexports or in-country transfers to ZTE and its affiliates; it makes unavailable any license exceptions; and it creates a presumption that applications for a license will be denied absent a truly compelling reason that is difficult even to imagine. The practical effect of the listing is that U.S. exports and reexports to ZTE and its affiliates are prohibited for the indefinite future.

But the effect of the listing is not as sweeping as it might have been. Placement on either the Treasury Department's list of Specially Designated Nationals or Foreign Sanctions Evaders would have imposed a blanket prohibition on *any* transactions with ZTE by U.S. persons, including imports of ZTE products and services. By opting instead for the Entity List, the U.S. government has selected a more nuanced diplomatic tool. It appears that ZTE's significant penetration of the U.S. smartphone market saved the company from those more thoroughgoing sanctions, as this would have created unimaginable headaches inside the United States. Because Commerce Department jurisdiction extends only to exports, reexports and in-country transfers of U.S.-origin items, other transactions with ZTE are unaffected by the company's designation. Moreover, the Commerce Department does not apply the so-called "50 percent" rule that governs the Treasury Department lists, meaning that the sale of U.S.-origin products to ZTE's subsidiaries that are not on the Entity List — including ZTE's U.S. affiliate, ZTE USA Inc. — technically remain lawful. Of course, the specter of illicit diversion by these affiliates will probably work to deter many such sales.

And the restrictions only apply to items that are "subject to the EAR," so businesses with no exposure to U.S. jurisdiction that deal exclusively in non-U.S. origin items and technology are unaffected. U.S.-origin items and items exported from the United States are subject to the EAR, as are foreign made items that contain more than a "de minimis" amount of U.S. origin content or that are the "direct" product of U.S. origin technology. Applying these rules can be complicated, so foreign companies should proceed with caution when dealing with ZTE.

Conclusion

ZTE's listing deals a significant blow to the global telecommunications equipment sector and a setback for ZTE's U.S suppliers. The designation is also a shot across the bow of foreign companies that try to conduct business in violation of U.S. law with Iran by hiding their business activities in foreign shell companies. If caught, companies that knowingly skirt U.S. sanctions laws will be subject to severe measures.

The listing is also another skirmish in the deepening tensions between the United States and China. In light of protests from the Chinese Foreign Ministry that the move would "jeopardize economic cooperation and [the] relationship between China and the United States," ZTE's listing makes clear that even a significant impact on the U.S. economy will not protect a company from U.S. sanctions when national security and foreign policy interests are implicated.

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