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BIS Imposes \$300 Million Penalty Against Seagate for Export Control Violations and Makes Controversial Changes to Voluntary Self-Disclosure Program

On April 19, 2023, the U.S. Department of Commerce's Bureau of Industry and Security ("BIS") issued an order imposing a \$300 million civil penalty against California-based Seagate Technology LLC ("Seagate U.S.") and Singapore-based Seagate International Headquarters Pte. Ltd. (collectively, "Seagate") to resolve alleged violations of U.S. export controls.¹ The alleged violations related to sales of millions of hard disk drives ("HDDs") to Huawei Technologies Co. Ltd., a company listed on the Entity List (with its other affiliates on the Entity List, "Huawei") over the course of several years in violation of the foreign direct product rule of the Export Administration Regulations (the "EAR"). BIS noted that this \$300 million resolution is the largest standalone administrative penalty imposed in BIS history.² The resolution also included a multiyear audit and reporting requirement and a five-year suspended denial order.

Separately, on April 18, 2023, Matthew Axelrod, the Assistant Secretary of Commerce for Export Enforcement issued a memorandum announcing significant changes to the BIS voluntary self-disclosure ("VSD") program.³ The memorandum announces two significant changes to the BIS VSD program: (i) BIS is providing an incentive to companies to report other companies' potential violations of export controls to BIS, stating that BIS will credit such tips that lead to enforcement actions in any potential future export control enforcement action targeting the tipper; and (ii) at least with regard to "significant possible violations" of export controls, BIS will now consider the failure to file a VSD as an aggravating factor in its enforcement actions. These changes are controversial and are likely to affect the traditional calculus regarding whether or not to make a VSD as companies now have a more challenging set of risks and incentives to weigh.

In the sections below we discuss this resolution and the memorandum in greater detail.

The Seagate Resolution

In May 2019, BIS added Huawei and certain of its non-U.S. subsidiaries and affiliates to the Entity List, broadly prohibiting their ability to receive items that are subject to the EAR without the issuance of an export license from BIS. Historically, the EAR had included provisions of general applicability known as the "foreign direct product rule" that stated that items produced outside of the United States are subject to the EAR if they are the "direct product" of certain specified U.S.-origin technology or software or if they are produced by a non-U.S. plant where a "major component" of the plant is itself a "direct product" of such specified technology or software. In August 2020, BIS implemented further controls that created a new "foreign direct product rule"

specifically targeting Huawei by imposing a license requirement on certain items produced outside of the United States when (i) there is knowledge that a listed Huawei entity is a party to the transaction and (ii) the item produced outside of the United States is produced by an overseas plant or major component of a plant that is itself a direct product of U.S.-origin technology or software subject to the EAR within certain delineated export control classification numbers (“ECCNs”).

According to BIS, despite the imposition of these additional controls and despite the fact that Seagate’s only two competitors in the HDD market publicly announced that they would cease selling to Huawei, in September 2020 Seagate announced that it would continue to do business with Huawei. As a result, BIS noted that Seagate became Huawei’s sole source provider of HDDs and significantly increased the amount of HDDs that it was selling to Huawei. According to BIS, subsequently Seagate entered into a three-year “strategic cooperation agreement” with Huawei that identified Seagate as “Huawei’s strategic supplier” and granted Seagate “priority basis over other Huawei suppliers.” As a result of these continued sales, BIS determined that between August 2020 and September 2021, Seagate ultimately engaged in 429 exports, reexports, or transfers of approximately 7.4 million HDDs subject to the EAR valued at over \$1 billion to Huawei without the required authorization from BIS.

BIS determined that the cause of these violations was that Seagate had incorrectly interpreted the Huawei foreign direct product rule as requiring evaluation of only the last stage of its HDD manufacturing process, instead of evaluating the entire process. BIS explained that Seagate had HDD manufacturing sites in China, Northern Ireland, Malaysia, Singapore, and Thailand that used equipment, including testing equipment, that were subject to the EAR. Seagate used an unnamed company’s automated-laser based surface inspection system to detect and classify critical defects on HDDs’ substates and media that, according to BIS, was subject to the EAR with the ECCN of 3B991 (which was one of the ECCNs subject to the August 2020 Huawei foreign direct product rule). BIS determined Seagate’s use of this equipment to be “essential, i.e., a major component” of the Seagate HDD plants. As a result, BIS determined that the HDDs were covered by the Huawei foreign direct product rule and subject to the EAR such that they could not be provided to Huawei without a license from BIS. BIS further determined that Seagate’s HDD plants also used other U.S.-origin equipment that were “essential” to the HDD plants, such that there were multiple bases for the HDDs produced by the plants to be determined to be subject to the EAR under the Huawei foreign direct product rule.

Additionally, according to BIS, in January 2021, Seagate US received a notification from one of the suppliers of the “essential” equipment in its HDD plants notifying Seagate that the equipment was subject to the EAR and that if the equipment was involved in any essential production or development in a plant outside of the United States, the items produced by the plant would be subject to the EAR under the foreign direct product rule if destined for Huawei. According to BIS, despite receiving this notification, Seagate not only continued to ship already-ordered HDDs to Huawei, but continued to significantly increase its sales of future units to Huawei.

BIS imposed the \$300 million penalty, which it estimated as constituting more than double the amount of net profits earned by Seagate from these sales to Huawei, as a series of 20 quarterly payments of \$15 million over the next five years with an acceleration clause making the entire outstanding amount due immediately if BIS determines that Seagate has not complied with the payment schedule. As a part of the resolution BIS also required Seagate to perform at least three audits of its export control compliance framework over the next four years, with at least one of these audits being performed by an unaffiliated third party consultant with sufficient export control expertise as determined by BIS, and to report the findings of these audits to BIS. BIS also imposed a suspended five-year denial order (*i.e.*, a revocation of Seagate’s ability to export items from the United States) with a provision that if BIS determines Seagate has not complied with the resolution, BIS may revoke the suspension of this denial order with immediate effect.

Changes to BIS Voluntary Self-Disclosure Program

The new BIS enforcement memorandum indicates that going forward, the BIS VSD program will more strongly incentivize companies to report apparent violations of export controls that other companies may have engaged in. Under BIS’s existing settlement guidelines, BIS was able to consider “exceptional cooperation” of a party as a mitigating factor, including whether a company had “previously made substantial voluntary efforts to provide information (such as providing tips that led to enforcement actions against other parties) to federal law enforcement authorities in support of the enforcement of U.S. export controls.” What

the new memorandum emphasizes is that, “when a company becomes aware that some other company’s conduct may have violated the EAR, discloses such conduct to [BIS’s Office of Export Enforcement], and that tip results in enforcement action – then we will consider that a mitigating factor if a future enforcement action, even for unrelated conduct, is ever brought against the disclosing party.” The memorandum does not, however, include specific guidelines around how such credit would be provided or weighted in practice or how long the credit would last. The memorandum endeavors to provide further incentive for disclosing other companies’ apparent export control violations by noting that, where such violations are disclosed along with sanctions or AML violations through the whistleblower program of the Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”), it may be possible to obtain a FinCEN whistleblower award based in part on successful enforcement action against the export control violations.

Under BIS’s existing settlement guidelines, BIS could view whether a or not VSD was filed as a so-called “general factor” in its enforcement, meaning that it could be applied either as an aggravating or a mitigating factor. Historically, BIS had only treated the filing of a VSD as a mitigating factor. As a result of this memorandum, however, the failure to file a VSD will now be viewed as an aggravating factor in BIS enforcement actions where there is a “deliberate non-disclosure of significant possible violations”. The memorandum notes that the intention of BIS in making this change is to balance the benefit of a “sharply reduced penalty” where a VSD is made with the risk that a decision not to disclose potential significant violations of export controls could result in a “sharply increased [penalty].”

Implications

The Seagate resolution is one of the first BIS penalty actions under the additional rules imposed in 2020 targeting Huawei, and certainly the largest such resolution by far. Although much of the sanctions- and export control-related focus of the last year has been on Russia, this action makes clear that BIS and the U.S. government more broadly remain focused on aggressively enforcing U.S. export controls targeting Chinese companies on the Entity List and related restrictions. The size of this penalty was likely influenced not only by the sheer number of HDDs sold and revenue generated, but also by the fact that Seagate’s sales to Huawei increased significantly during a time when Seagate’s competitors had ceased sales to Huawei and that Seagate entered into a longer term sole supplier agreement with Huawei.

Additionally, BIS clearly faulted Seagate for apparently not realizing it needed a license to sell HDDs to Huawei, despite the fact that Seagate’s only two other competitors in the HDD market both made multiple public statements (referenced in the BIS order) that they were ceasing sales to Huawei due to these export control restrictions. Another factor that likely contributed to the size of this penalty was Seagate’s receipt of the notification from its supplier that at least some of the equipment it was using in its HDD plants was subject to the EAR such that products made by the equipment could not be shipped to Huawei without a license from BIS; but, according to BIS, Seagate nonetheless continued and, in fact, increased its sales to Huawei thereafter.

Taken with the Seagate action as well as other recent statements from BIS, OFAC, and DOJ (including the announcement of the creation of the interagency Disruptive Technology Strike Force⁴ in February 2023), the changes to the BIS VSD program suggest that the U.S. government is increasing its focus on the enforcement of sanctions and export controls. The current focus of many of these announcements has been on sanctions and export control evasion involving Russia, China, and Iran.

It remains to be seen how the new incentives to report on the potential export control violations of others will work out in practice. However, it seems clear that the new BIS position that failing to file a VSD will be viewed as an aggravating factor will introduce additional considerations into decisions about whether or not to file a VSD. For example, under this new guidance, companies may have to consider the risk that if they do not disclose to BIS potential violations of which they are aware, there is a risk that in the future they may have to defend in a potential BIS enforcement action both (i) the potential violations and remedial actions taken and (ii) the decision not to file a VSD once the potential violations became known. These changes also appear designed to increase the amount of VSDs and reports being made to BIS concerning significant possible export control violations, which, in turn, is likely to increase the overall number and severity of BIS enforcement actions in the coming years.

We will continue to monitor enforcement actions taken by BIS and provide further updates as appropriate.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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- ¹ BIS, *BIS Imposes \$300 Million Penalty Against Seagate Technology LLC Related to Shipments to Huawei* (Apr. 19, 2023), available [here](#).
 - ² In the 2017 resolution with ZTE Corporation totaling \$1.19 billion in penalties, BIS had issued a suspended \$300 million penalty, see DOJ, *ZTE Corporation Agrees to Plead Guilty and Pay Over \$430.4 Million for Violating U.S. Sanctions by Sending U.S.-Origin Items to Iran* (Mar. 7, 2017), available [here](#).
 - ³ BIS, *Clarifying Our Policy Regarding Voluntary Self-Disclosures and Disclosures Concerning Others* (Apr. 18, 2023), available [here](#).
 - ⁴ DOJ, *Justice and Commerce Departments Announce Creation of Disruptive Technology Strike Force* (Feb. 16, 2023), available [here](#).