

International renegotiations: the case of the Dominican Republic and Falconbridge

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In 1969, Falconbridge Ltd agreed to expand greatly the facilities operated by its subsidiary in the Dominican Republic. Over the succeeding years, the company mined, processed and exported a large proportion of the country's nickel reserves. Due to worldwide market conditions, however, the company made losses rather than profits, and the Dominican government received little financial benefit from the company's operations. Matters came to a head in November 1987 when President Balaguer of the Dominican Republic unilaterally imposed taxes on company imports and exports. This action was significant because under a long-standing agreement with the Dominican government, Falconbridge was only obligated to pay income taxes and had an exemption in perpetuity from all other taxes. When the company refused to pay the new taxes, the government began to curtail nickel exports. Meanwhile, on world markets, the price of nickel soared. This paper briefly describes how the world nickel market has evolved, and then focuses attention on the relationship between Falconbridge and the Dominican Republic. It outlines the issues that arose, describes the renegotiation process itself and analyses how matters were resolved.

To exploit their nation's natural resources, less developed nations often make agreements with firms from more developed countries. At the time they are made, those agreements usually reflect worldwide market conditions and therefore the benefits that are expected to accrue to the respective parties. Often and over time, however, worldwide market conditions change in unanticipated ways and one or other of the parties, or even both, find themselves faced with unexpected losses. In such cases, there is often a desire by at least one of the parties to renegotiate the existing agreement to take account of the changed conditions.

If the market prospects for the resources that a less developed country produces decline, so too will the revenues that are received. The disappointment is likely to increase as the difference between actual and anticipated revenues becomes greater. In addition, as

many less developed countries have only limited capacities to investigate and assess the extent to which the agreements they have made with foreign firms are, in fact, being adhered to, the possibility that they may have been deceived by those entrusted with exploiting their country's resources often looms large. To the extent that a sense of betrayal actually develops, the demeanour of those in the host country towards the multinational firm is also likely to change, moving from an emphasis on tolerance and hospitality to a stance of aggressive confrontation. Such developments are likely to be mirrored in the national press where commentators may make vigorous criticisms of the foreign firm and raise questions of national pride and honour. Political leaders, as a result, are called upon to act in ways that demonstrate sovereignty and clearly communicate feelings of pent up frustration and indignation over unmet expectations.

As an illustrative example of what can happen in that kind of situation, the relation between the Dominican Republic and Falconbridge is examined.

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Falcondo, Falconbridge's Dominican subsidiary, had a long-standing agreement to mine and process nickel in the Dominican Republic, but over the years the financial returns from those operations had been disappointing to both sides. As the international price of nickel started to improve in 1987, one might have anticipated that the situation would change for the better for both parties. In fact, however, because of the structure of the agreements between the Dominican Republic and Falconbridge, it became clear that despite an improvement in prices, it would still be years before any benefits would accrue to the Dominican Republic. In response, in 1987, President Balaguer of the Dominican Republic took the initiative and by presidential decree imposed import and export taxes on Falcondo. At one level, this action was designed to raise revenues. Of more symbolic significance, this action clearly broke the long-standing tax agreements that had existed between the Dominican Republic and Falcondo. Thus, the president's action signalled the government's intention to regain control over its resources by renegotiating the agreements with Falconbridge.

The context of the renegotiations

The nickel industry: background

Nickel's greatest value is in alloys where, over a wide range of temperatures, it serves to add strength, resistance to corrosion, resistance to heat and other desirable properties. The metal is vital to the iron and steel industry and many applications, such as efforts to develop armour plating, are directly related to national defence. As a result, nickel is considered a strategic metal and is included as one of the four metal categories in the US National Defense Stockpile. As nickel is a key ingredient to stainless steel, it also plays a key role in the aerospace, chemical, consumer durable, electrical equipment and shipbuilding industries. There are substitutes available for nickel, but most are more expensive.

About 20–25% of the world's nickel reserves are sulphide ores, and about 75–80% are laterite oxide deposits. The nickel content of sulphide ores tends to be higher than in laterite ores. Particularly in Canada, most nickel mining has been underground and involves the processing of sulphide ores.

Laterite ores, in contrast, are found extensively in the Caribbean and in many less developed countries and can often be mined using open-cut methods. The downside is that energy costs for processing laterite ores are much higher than for processing sulphide ores.

The evolution of the nickel industry

Historically, Canada has been the dominant world producer of nickel. Within Canada, the International Nickel Co Inc (Inco) held an essentially monopolistic position with at least an 85% share of the world market until World War II. Through the 1960s, Inco was able to use its monopoly power to set and control the world price for nickel. Thus, in times of both under and over supply, prices tended to be stable.

In the 1950s, the USA consumed approximately 50% of the world supply of nickel. Since that time, though tonnage use by the USA has stayed about the same, US consumption as a proportion of world consumption has steadily declined, as shown in Figure 1. As new civilian uses for nickel were found beginning in the 1950s, world consumption of nickel started to expand. Figure 2 shows how this increased demand (Figure 1) was matched, gradually, by expanded production. Yet in the mid-1960s, demand still exceeded supply (see Figure 3) and producers rationed nickel. Nickel prices started to rise in the late 1960s, and had a peak in the late 1970s (see Figure 4).

In the late 1960s, the major nickel producers and a number of new entrants made plans to expand greatly nickel production. As the lead-time to bring facilities on stream is 3–4 years, most of this new capacity was expected to be available in the mid-1970s. Much of this capacity was also to come from parts of the world which had important reserves but, up to that point, had not been important players in the nickel industry. The new countries included Australia, Botswana, the Dominican Republic, Guatemala, Indonesia, the Philippines and South Africa and expanded facilities in New Caledonia, Cuba and the USSR. This geographic dispersion of supply contrasts with the situation in 1950 when nickel was produced only in Canada, the USSR and New Caledonia. Thirty years later, nickel was being mined in 25 different countries.

This production capacity expansion not only greatly increased the supply of nickel; it also reduced the concentration of the industry and the market shares of the dominant companies. Canada's world market share, for example, dropped from more than 75% in 1950 to less than 25% in 1980. Figure 1 shows that a good deal of the new production capacity became available and on stream by 1975. Figure 2 shows, however, that worldwide demand for nickel seems to have peaked in 1977 and then to have stagnated. As a result, the continued efforts to expand production in the late 1970s resulted in more nickel being produced than was consumed (see Figure 3).

Responses to this oversupply differed. Some producers, such as those in New Caledonia, the Philippines, Cuba and the USSR received government subsidies. Sibley [4] estimated that from 1975 to

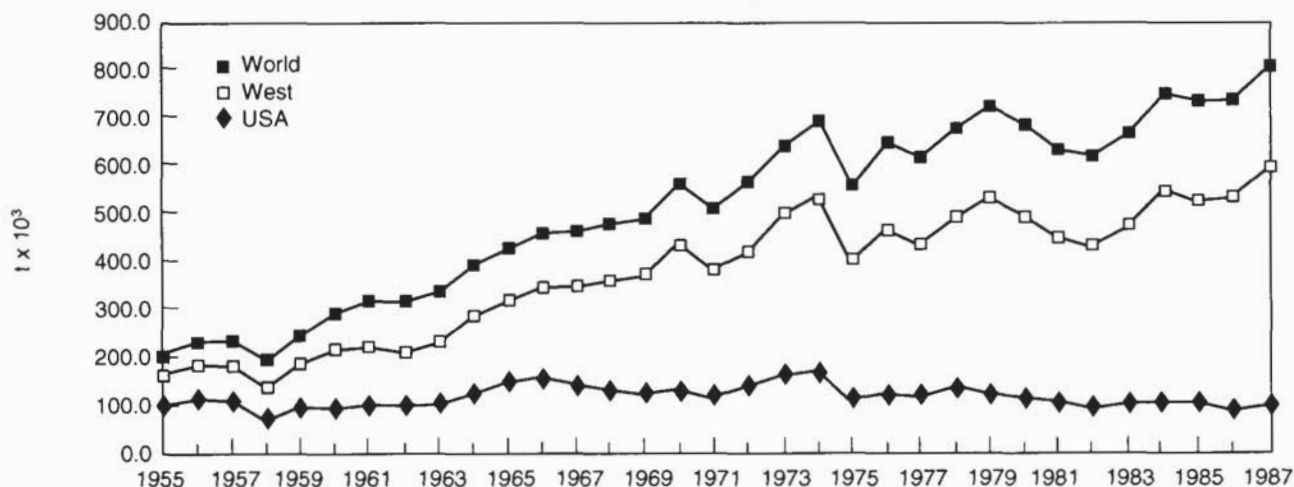


Figure 1. World nickel consumption, 1955-87.

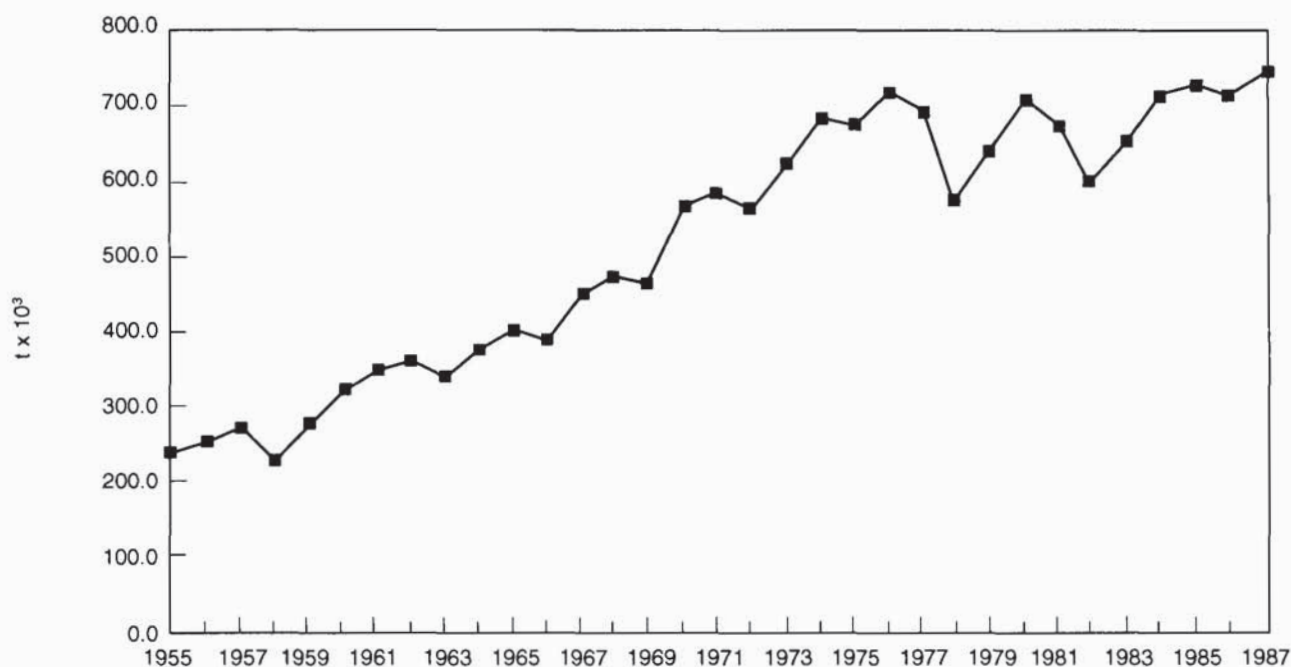


Figure 2. World nickel production 1955-87.

1982, for example, the USSR continued to expand its production capacity and sold about 30 000 tons of nickel per year to consumers in Western Europe and the USA at US\$1.00 to US\$1.50 below producers' list prices, then set at around US\$3.20/lb. In those circumstances, unsubsidized facilities in market economy countries such as Canada, were often unprofitable and large cutbacks in production were made. Several Canadian mines were put on standby, and some facilities run by Canadian firms in Central America were deactivated. Production was cut back and continuing stagnant demand in the early 1980s persuaded most firms to shelve plans for increasing production. Instead, they resolved to rely on their

stockpiles to meet the demand increases that began to appear in 1984.

The increased competition from a variety of international sources in the 1970s greatly increased consumers' choices so far as suppliers were concerned. A sign of this change occurred in the late 1970s when nickel contracts started trading for the first time on the London Metal Exchange (LME). By 1982, the quotations at the LME were starting to reflect overall world supply conditions and also to determine world prices. LME quotes had dropped to around US\$1.50/lb in 1982. Because nickel demand is price inelastic, this drop in price did not lead to a demand increase. It did decrease firm revenues, however, and many

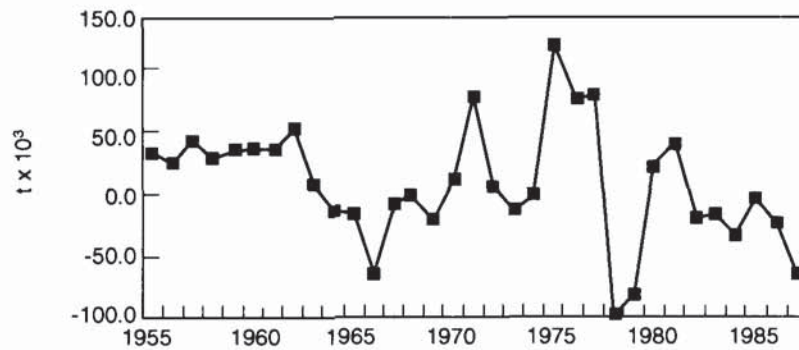


Figure 3. World nickel production less consumption, 1955-87.

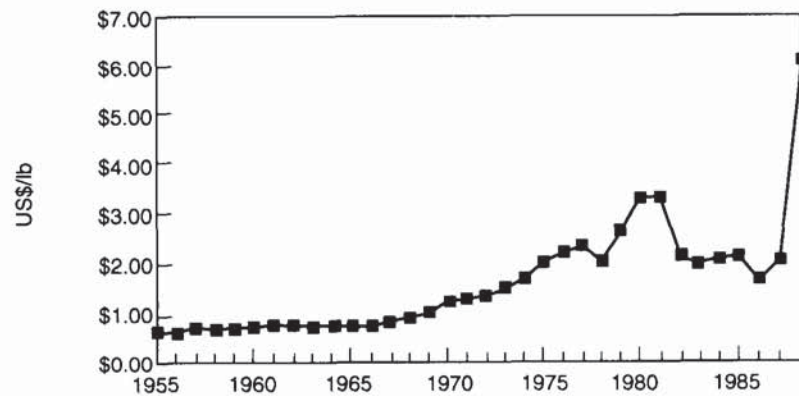


Figure 4. Average world nickel price 1955-88.

nickel producers suffered heavy losses in the early 1980s. The other side of the coin, however, is that nickel has a relatively high income elasticity of demand, and so nickel sales tend to be brisk in business upturns. Demand for nickel started to increase in the mid-1980s.

When demand started to increase more rapidly in 1987, accumulated stockpiles were soon exhausted and there were few facilities available that could be quickly expanded to meet the new demand. Additional supply problems occurred as a result of difficulties at the Norlisk plant in the USSR and from Falconbridge's dispute with the Dominican Republic. Figure 4 shows that nickel prices started to rise rapidly in 1988 and they continued at higher levels as demand growth continued. Spot prices for nickel on the LME reached an all-time high of US\$10.84/lb on 28 March 1988.

Falconbridge within the nickel industry

Falconbridge has operated in Inco's shadow from its inception in 1928. Founded and controlled with capital from New York, Falconbridge's initial reserves

were also in the Sudbury area but were modest when compared to Inco's. In the early 1930s, Falconbridge purchased a refinery in Kristiansand, Norway, and its market focus became Europe rather than the USA. When Falconbridge lost its Norwegian refinery in 1940 due to the German invasion of Norway, Inco agreed to refine the matte of its smaller competitor. In the 1950s, however, helped by a 10 year contract to supply 200 million pounds of nickel to the US Defense Materials Procurement Agency, Falconbridge succeeded in establishing itself as a major rival to Inco [3]. With so much demand guaranteed, Falconbridge needed to expand sources of supply and it embarked on an extensive, world-wide exploration effort. By the early 1960s, it had taken over 10% of the US market for nickel.

Falconbridge in the Dominican Republic

Falconbridge came to the Dominican Republic in 1955 to explore promising nickel deposits. In 1956, its subsidiary, Falcondo, obtained a concession in the area around Bonao and opened a pilot plant employing 175 people. The concession agreement required Falconbridge to pay tax at a 33% rate on its net in-

come, but granted the company a perpetual exemption from all other taxes. There followed 10 years of civil unrest and disruption in the Dominican Republic culminating in a civil war and the arrival of US marines in 1965. During this period, Falcondo maintained its pilot plant, obtained some additional concessions, but did not attempt further expansion. The election of President Balaguer in 1966, however, signalled a return to relative stability and a warm welcome for foreign investors. In 1969, Falconbridge agreed to expand Falcondo's facilities in the Dominican Republic.

The proposed plant which was the largest single nickel expansion anywhere at that time, greatly diversified Falconbridge's sources of nickel and increased its processing facilities. The new facilities were also the biggest industrial project in the Dominican Republic. Besides construction, the project provided more than 1300 permanent jobs. Roads, housing complexes, schools and electric power plants were also built by the company. The processing plant was complete by December 1971. In 1972, reflecting the high hopes that each side had for the financial future of the project, President Balaguer opened the facility and presented the then president of Falconbridge, Marsh Cooper, with the Dominican Republic's highest medal of honour [1].

In expanding its facilities in the Dominican Republic, Falconbridge committed itself to operate on a much larger scale in a country that had just experienced a period of political instability and disruption. As sponsor of the project, it was exposed to large economic risks which it attempted to reduce so far as was possible. An example was the equity arrangements for the Falcondo project. Around 68% of the shares were assigned to Falconbridge, 17.5% to Armco Steel and around 10% to interests in the Dominican Republic. Armco was a major user of ferronickel and committed itself to be Falcondo's single largest customer. The Falconbridge equity contribution, assessed at US\$15 million, consisted of capitalized exploration and related evaluation expenditures that were associated with the pilot plant. Thus, Falconbridge actually invested none of its own capital, and the allocation of equity reflected no infusions of cash.

To raise the US\$180 million needed for the project, Falconbridge arranged for Falcondo to obtain a loan for US\$135 million from a US consortium including Citibank (then First National City Bank), Metropolitan Life, Equitable Life and Northwestern Mutual Life. In addition, US\$25 million was provided by the World Bank, and another US\$20 million came from the Canadian Imperial Bank of Commerce. As project sponsors, Falconbridge and Armco were

required to guarantee unconditionally the interest and principal payments on those loans. Political risk insurance from the US Overseas Private Investors Corporation (OPIC) gave the US consortium additional protection. For its part, the Dominican Republic agreed that interest on loans, including subordinated shareholders' loans, were all to be considered part of the project's cost structure so far as taxes were concerned.

According to the 1969 agreement, government income was to be based on income taxes and dividends and not on royalties. Falconbridge guaranteed the working capital needs of the project. Within the contract clauses was a provision entitling the company, in addition to full cost reimbursement, to a management fee of 2.5% on total sales. To persuade the government to accept its proposal, Falconbridge made a formal submission separate from the contract that promised direct income to the government in the form of tax and dividends that would amount to US\$120 million and would be generated over 1969–91.

From 1971 to 1987, a number of unforeseen environmental developments had important effects on the financial success of the project. First, although Falcondo's plants were modern and highly efficient, their design was based on the assumption made in the late 1960s that oil would continue to be readily available and cheap at around two or three dollars a barrel. The unanticipated rise in the price of oil during the 1970's made the economic assumptions of the Falcondo project much less positive, and the additional costs further added to the project's woes. Second, there was a large increase in worldwide nickel production with additional capacity coming on stream soon after Falcondo's new facility in the Dominican Republic was completed. One consequence was that from the late 1970s through the mid-1980s, nickel supplies exceeded worldwide demand and new production only served to aggravate the problem.

Unlike some of its competitors who were benefiting from government subsidies, Falconbridge had to continue to compete as a capitalistic firm in a market economy. Sensitive to market developments, the company first accumulated stockpiles of nickel, then cut back production at some of its facilities and eventually, temporarily closed some facilities. From 1979 to 1986, the Falcondo project had losses and failed to cover its debt service costs. As Falconbridge and Armco had given guarantees for those payments, they loaned Falcondo additional money to meet its debt service obligations, to cover operating losses and to meet cash flow deficiencies. Thus, over the period, the amount owed to the consortium of banks dropped steadily to US\$30 million in 1987. In contrast, the

amounts that were owed to Falconbridge and Armco grew steadily, particularly in the early 1980s when interest rates were at very high levels. As interest on the loans was charged at the rates current at the time the debt was incurred, the average rate charged on the Falconbridge and Armco loans in 1987 was very high, coming out at around 13%. Accumulated losses along with the accrued interest obligations increased the subordinated loans to Falcondo shareholders to around US\$180 million.

The overall consequence was that by 1987, while Falcondo had revenues of over US\$1 thousand million, it had generated very little income. Hence, it had paid the Dominican Republic less than US\$5 million in income taxes and nothing in dividends. In addition, Falcondo was saddled with debt, some of which was due to outside lenders but most of which was owed to Falconbridge and Armco. If nothing changed, there was also little prospect of the Dominican government receiving tax payments for years to come as the company had accumulated operating losses in the hundreds of millions of pesos which it could carry forward as a charge against income. Based on the history of the project, its future prospects did not look good and the prospects for tax revenue accruing to the Dominican Republic looked much worse.

The main reason the situation changed was not because of any actions taken by either of the parties but because of changes that occurred in world nickel markets. By 1987, most of the accumulated stockpiles of nickel had been exhausted and there were no new projects coming on stream. As the demand for nickel started to increase, so too did nickel prices start to rise. In late 1987, Falcondo announced it was making profits for the first time in eight years.

Renegotiations between the Dominican Republic and Falcondo

In 1986, after an eight year absence, Joaquin Balaguer, 78 years old, blind but still charismatic and respected, was elected for the fourth time as President of the Dominican Republic. As he had done in earlier terms, he proceeded to spend large sums of money on public works projects. In 1987, however, the country was saddled with a thousand million dollar trade deficit, a foreign debt of more than US\$3 thousand million, a 35% inflation rate, and a 25% unemployment rate. Interest payments on foreign debt were suspended by the Dominican government in February 1987, and the country was in chronic need of money. The Falcondo project, particularly as it became profitable, became an obvious source.

On 12 November the Central Bank of the Dominican Republic established a 20% tax on imports, and

on 20 November 1987, President Balaguer issued Decree 578 levying a special contribution tax on all exports from the Dominican Republic. The rate of this tax was to be tied to the value of the Dominican peso relative to the US dollar, the idea being to provide the government with some foreign currency protection against a decline in the value of the peso. Given the official exchange rate at the time, the special contribution amounted to about a 25% tax, with the actual rate fluctuating and depending on the value of the Dominican peso relative to the US dollar. Just a few days before the government's unexpected actions, Armco had arranged to sell all its equity and loan interests in Falcondo to Falconbridge. The equity was estimated to have no value and the value of the loans outstanding was discounted at a rate of 50% on the dollar. Falconbridge's cash payment to Armco was US\$36.35 million. Hence, at the time of the confrontations, Falconbridge had just substantially increased its investment in its Falcondo subsidiary and held more than 85% of its shares.

Initially, Falcondo believed the new taxes were none of its concern because of the firm's long-standing agreements with the Dominican Republic which stipulated that the company was exempt from all taxes except income taxes. The Dominican's initial attempts to collect the tax were also inconsistent. For example, attempts were made to collect the import tax at only one of four import locations. With respect to the export tax, five ships loaded with ferronickel left the country untaxed after the decree was passed. On 8 December, however, the Finance Minister requested the company to submit formally its records for the purpose of assessing the export tax.

Explaining his unilateral actions, President Balaguer said: 'Out of the billion dollars Falconbridge has shipped away since they started, we have only received four million dollars in taxes. The country is losing a non-renewable resource and getting nothing for it. . . . We want foreign investments, but the company has to be fair and understand our situation. It has to give us a better return on our resource. Right now, we are giving it away for nothing' [1].

The President's decision to impose taxes on Falcondo had wide public support in the Dominican Republic. Falconbridge itself, was also not insensitive to these local concerns. They were also aware that the president's actions placed the agreement that had guided the company's relationship with the government in jeopardy. Their initial response was to reject the Presidential decree, temporarily suspend nickel shipments, and argue with government representatives that the company was not subject to the new taxes. The firm continued to produce nickel but to stockpile it while awaiting shipment. Government

representatives countered by defending President Balaguer's rights to govern his own country as he saw fit, and by depicting the new duties not as taxes but as foreign exchange regulations. In discussions, they also emphasized their country's obvious need for cash. Behind the scenes, they had enlisted the services of a knowledgeable local consultant, Sr Jose A. Herrero, in November 1987, and in early 1988 they also engaged a team of advisors from the UN Department of Technical Co-operation for Development (UN/DTCD).

The company acknowledged the country's need, but reiterated its position that contracts should be modified by negotiation and not by decree. The company stated it was willing to discuss a renegotiation of the existing arrangement. In the meantime, however, it emphasized its desire to keep operations and exports functioning normally, particularly as market conditions seemed to be developing favourably. Of particular importance was the need to maintain exports while market prices were high. In order to persuade the Dominicans to allow exports, the company indicated its willingness to make advances to the government of payments against future taxes yet to be agreed upon.

The company's expectation was that a renegotiation process could be concluded by 31 March. In fact, it seemed to the company that a provisional agreement had been reached in early January. Government officials, however, suddenly became reluctant to sign. One of the problems was that the government representatives insisted that the company payments were for import and export duties; the company insisted that the payments were simply advances for future taxes that were yet to be determined.

On 19 January 1988, President Balaguer issued another decree, this time appointing Sr Isaías, Secretary of Finance; Sr Andino, Secretary to the President; Sr Read Vittini, Legal Advisor to the President; and Sr Amezcuita, Director of Mining, to be members of a special government commission to renegotiate with Falconbridge. Meanwhile, the Dominican Customs was refusing to allow vessels to load and so Falconbridge responded by paying them DR\$5 million to indicate its continuing good faith and as an advance against future taxes. Members of the Commission suggested that if the company could make a commitment to continue on-going payments in February and March, this might convince President Balaguer to solve the company's problems with the Customs officials. The company responded with an offer of DR\$1 million a week and export shipments were again permitted. On 28 January, there was a photo session with company members and members of the government negotiating commission that im-

plied that all was going well. Falcondo agreed to increase the DR\$1 million weekly payments to DR\$5 million.

Although meetings with some members of the Commission occurred in February, Sr Isaías spent much of the time out of the country and little was accomplished. The company continued having difficulties with Customs officials, however, and despite repeated overtures, nickel exports were again stopped in early February. At about this time, it also became well-known that cabinet changes would be announced at the end of February in President Balaguer's state of the republic address. Knowing this, both sides appear to have decided to wait before pressing forward. As expected, President Balaguer announced a reshuffling of his cabinet and, on 29 February, he announced a new negotiating commission. Chairman of the new commission was the new Secretary of Finance, Sr Roberto Martinez, while other members included the Secretary of Industry and Commerce, Sr Rafael Marion-Landais; Secretary to the President, Sr Andino; and the Director of Mining, Sr Frank Amezcuita. In addition, Sr Jose A. Herrero was appointed as a special advisor to the Commission.

At a meeting in early March between the company and a representative of the new Commission, it was suggested that the company's continuing difficulties with Customs would be resolved and that normal shipments would resume if a further payment of DR\$5 million was made to the government. The company paid this amount. On 7 March, there was a formal meeting between company representatives, including Falconbridge President Bill James, and members of the new Commission. Members of the Commission reiterated that nickel shipments would stop unless tax payments were made, but that if they were made, normal shipments would be allowed to resume. They also asked Falcondo to prepare a draft proposal concerning what the company might be prepared to renegotiate. The company agreed to prepare a proposal that outlined how the 1969 Supplementary agreement might be modified. On 12 March, Customs officers permitted another shipment of nickel to sail.

In its official proposal, Falcondo offered to forgo the company's tax loss carry forwards for the years 1988-90. This legal write-off amounted to more than DR\$900 million. The point of this gesture on the part of the company and the implication from a Dominican standpoint was that all of Falcondo's current income would be immediately subject to Dominican income tax. In addition, the company offered to estimate its taxes quarterly and to pay them in advance. Its proposal included a three-year projection of tax income that suggested, assuming a continuation of

the high nickel prices, that the Dominican Republic could expect to receive around US\$20 million from Falcondo in income taxes in each of the next three years. In return, Falcondo indicated it expected the new import and export duties would be dropped along with any other disputed taxes. Falcondo also reiterated that it did not object to a renegotiation process and, indeed, had expected one would be needed if and when market conditions improved.

The Commission took no position but said it would ask its outside advisors and local experts to evaluate the company's proposal. It showed the proposal to both Sr Herrero and the team of UN advisors. Both agreed the proposal was inadequate. A new problem arose, however, because the advisors disagreed on how the Dominicans should respond. The UN group envisaged an approach in which the Dominicans would openly set out its demands for significant changes in the relationship with Falcondo, including fixed royalties, a financial restructuring of the Falcondo subsidiary, and other adjustments. Supporting this renegotiation effort would be a well-managed public relations effort to keep the world mining press informed and supportive of what was happening and why. In contrast, Sr Herrero had concluded, based on extensive analysis from a variety of information sources, that Falcondo had under reported its income and over reported its costs. As a result, based on his calculations, the company was liable for taxes of unreported income of approximately US\$300 million. The resulting tax claim was around US\$100 million plus accumulated interest, or US\$120 million. In contrast to the UN Group's approach, Sr Herrero's approach was to work behind closed doors and directly confront the company with his demand which he thought they had no choice but to pay.

The UN advisors were very opposed to Sr Herrero's approach. They did not believe the company had lied, they did not believe the claim for US\$120 million would stand up to close scrutiny, and they feared the company would respond by walking away, abandoning the project to the mutual disadvantage of both the company and the country. It was clear, however, that Sr Herrero had strong support from people within the Dominican government up to and including the President. The UN team agreed, therefore, to seek independent advice on Sr Herrero's allegations and claims. They also recruited a member of the Harvard Negotiating Project to offer some advice on the process of negotiating. They felt it was particularly important for the Dominicans to be aware of the advantages of negotiations designed to define a non-zero sum game, where both parties worked to find mutual benefits, as opposed to the directly confrontative approach advocated by Sr Herrero that pre-

sumed a zero-sum game and distributive outcomes [2].

After discussions amongst the various advisors and government officials, the government decided Sr Herrero would be their representative to carry out most of the negotiations. This decision was not formally announced, however. Instead, the UN advisors were asked to prepare an outline of an agenda, including proposals for a royalty payment and a tentative schedule of general matters to be discussed. The Commission then met again on 23 and 24 March with company officials and stated that Falcondo's proposals were insufficient. For its part, the Falcondo representatives said that they felt the Dominican counter proposal prepared by the UN was lacking specifics, and they again repeated their own more specific proposals. This included the need for an interim agreement which would allow nickel shipments to continue even as the negotiations proceeded, given that the company would pay monies to the government in advance at special contribution rates which would be accrued against future tax obligations yet to be agreed upon. The result was no further progress in the negotiations, though one more ship loaded with nickel was allowed to sail. On 26 March, Bill James flew back to Falconbridge Headquarters in Toronto.

A day earlier on 25 March and without fanfare, Falcondo has its first direct contact with Sr Herrero. Company officials were impressed by his intelligence and by the fact that he seemed to know more about the company than any government official they had met. He presented company officials with a lengthy report that provided details of his estimates of Falcondo's costs of production. The company quickly observed that the report implied that because of alleged unreported income from 1977 to 1987, according to Sr Herrero's imputed numbers, Falcondo owed the Dominican Republic over US\$100 million in back taxes. This allegation had not been anticipated by the company and was a cause for some alarm. On 28 March, Bill James flew back to Santo Domingo. On the same day, the Customs authorities allowed another ship loaded with nickel to sail.

Sr Herrero met that evening with the company's top officials. The evening's conversation centred around the justification for choosing to impute numbers rather than relying on company records to determine what a company was doing. In the process, the implication was confirmed that the Dominicans believed that Falcondo's accounting records were manipulated and that Falcondo did, in fact, owe back taxes for unreported income. On 29 March, and on behalf of the government, Sr Herrero communicated a proposal that would have required Falcondo to pay US\$120 million in cash or convertible notes to settle

immediately the unpaid taxes owed for the years 1977–87. The proposal also required Falcondo to commit itself to pay an additional US\$50 million in 1988 as a royalty that would be linked to international nickel prices. From 1989 on, the company would then commit itself to pay an additional royalty of US\$25–30 million per year. The minimum royalty would be 22 cents/lb, when nickel prices fell below US\$2.00/lb. Sr Herrero also communicated President Balaguer's wish that an agreement in principle to settle the dispute in a way that was consistent with the above proposal should be reached by 31 March.

On 30 March, Falcondo representatives met with Sr Herrero and Sr Rafael Marion-Landais and held an acrimonious discussion about the Dominican's refusal to accept the company's records of costs and prices and their allegations that Falcondo owed unpaid taxes amounting to US\$120 million for the period 1977–87. At an evening meeting, Falcondo rejected the US\$120 million up front concept, and countered with an offer to pay the import and export taxes with a cap of 20% or 33% of accounting profit for 1988, whichever was greater. Sr Marion-Landais and Sr Herrero were equally unyielding, implying the company could find itself in still more trouble and liable for even higher taxes if it continued to be uncooperative. The atmosphere was extremely tense. On 31 March, Sr Herrero informed Falcondo that their rejection of his proposal had been reported to President Balaguer who, angry and disappointed, had directed that pressure was to be applied on Falcondo in every possible way. This was evident on 2 April when, although sufficient money had been paid to cover the export taxes in advance, military personnel nevertheless advised the Falcondo crews that they were to cease their efforts to load ships with nickel for export.

In this extremely contentious context, a series of meetings then took place through the month of April and into May. The main participants were Sr Herrero representing the Dominican government, and accountants from Falcondo and the treasurer's department of Falconbridge. As far as claims of accounting manipulation were concerned, the company simply refused to recognize them or respond to them. Instead, the focus turned to an exchange of proposals and counter proposals. For example, to satisfy indirectly the claim of US\$120 million in taxes, the company proposed a 17% income surtax on its future income, bringing its effective income tax rate up to 50%. This surtax would remain until the Dominicans had accumulated US\$120 million in additional income taxes. The company felt that in this proposal it was responding to the Dominican government's financial claims but in a way that took account of

world market conditions and also did not impugn the integrity of the company.

Sr Herrero wanted to establish a new basis for dealings between the Dominican Republic and Falcondo which would not bypass the concerns he had about the reliability of the company's reporting for tax purposes. He wanted rules for calculating tax obligations that reflected 'arms length' positions and whose consequences for tax purposes would be transparently clear to both sides. As revenues could be subject to 'arms length' assessments based on world market prices as these were recorded at the LME, he suggested that future taxes should be based on Falcondo's revenues rather than on its income. This was not acceptable to the company which insisted that taxes had to be based on income. As there was no similar external standard available for assessing company costs, the rules for determining Falcondo's costs for tax purposes had to be determined through negotiations between the company and Sr Herrero.

These negotiations were particularly difficult, for they went directly to many points which were at the centre of Sr Herrero's difficulties with the company's past practices. Sr Herrero was adamant, for example, that interest on subordinated loans that was owed to Falconbridge would no longer be recognized as a cost against income. On the other hand, he recognized oil as a special input, the cost of which depended on world prices, and he was prepared to negotiate a separate oil allowance rate based on world oil prices. However, he was not prepared to allow the company to deduct all increases in oil prices. Other costs were lumped together as an imputed cost per pound of nickel. Though Sr Herrero's estimates of imputed costs varied during the negotiations, as he tried to be both responsive but also sceptical of the company's assertions, they never reached levels corresponding to what the company believed were the actual costs it was incurring.

On 19 April, Falcondo halted all of its production activities, notified its customers that it had declared *force majeure*, and informed the US consortium of lenders that in the firm's opinion, there was a real possibility that a *de facto* nationalization of Falcondo's facilities was in the process of occurring. In turn, the US consortium informed its insurer, OPIC, of the possibility the ongoing dispute might be leading to expropriatory action and, as a consequence, to a loan default by Falcondo for which OPIC would then be liable. OPIC representatives then contacted the chairman of the Dominican Republic's negotiating committee, Secretary of Finance Martinez, to find out what was going on.

On 21 April, there was an important meeting between Sr Herrero accompanied by other members of

the Commission and members of Falcondo and Falconbridge. At this meeting, company representatives thought they detected a change. There was no mention of the US\$120 million in owed back taxes. The allowable levels at which costs would be imputed were raised and triggers, based on world nickel prices, were introduced to determine at which point the various surtaxes – 17%, plus 6% to cover duties – would actually be imposed. This more positive atmosphere then continued and between 22 and 27 April, the parties hammered out an agreement in principal based on the application of transparently clear rules, as advocated by Sr Herrero. On 9 May, a final settlement was in draft form and on 26 May, agreement was announced in the presence of President Balaguer.

As a result of the new agreement, the Dominican Government removed the special contribution import and export duties. Falcondo was prevented from carrying forward any previous losses against future income. Reflecting Sr Herrero's insistence that the company's income for Dominican tax purposes should be determined based on 'arms length' methods, the company agreed it would pay an income tax on nickel produced based on the difference between deemed revenues and deemed costs. In general, deemed revenues were to be based on pounds of nickel exported and the average three-month price of nickel on the London Metal Exchange. Deemed costs were to include a base cost of US\$1.63 adjusted for changes in crude oil prices and inflation. As taxes were to be not less than US\$0.17 per pound of nickel produced, this implicitly established a minimum royalty for nickel exports. President James reported he could live with the new tax arrangement which he anticipated would yield US\$48–56 million to the Dominican Republic. In fact, because the world nickel prices stayed high, the Dominican Republic received US\$123 million in additional taxes in 1988. Falcondo also did well, reporting record profits of US\$88 million, allowing it to reduce significantly the accumulated debt owed to its parent, Falconbridge.

The roles played by the parties

Both parties had a need for a resolution of the dispute. The Dominican Republic was in great need of financial help in 1987–88, and the Falcondo project was a ready and potentially available source of immediate funds. Falconbridge also felt it could not walk away from its facilities in the Dominican Republic because, over the years, it had sunk huge resources into the project and, in 1987–88, it had stockpiles of nickel worth untold millions on world markets if only they could be exported. What is most interesting about the case, therefore, is not so much that an ag-

reement was reached, for the context made this the sensible choice for both parties, but the types of approach and styles of initiative taken by the respective parties, and the process by which those initiatives were eventually able to lead to a renegotiated agreement.

Although changes in world metal markets greatly changed the prospects of what was originally anticipated to be a mutually profitable project, by 1987–88, external changes had again occurred which ensured that at least in the short term, the project could be mutually profitable if only the parties could cooperate with one another. Interpretations of past events made a new basis for the relationship essential so far as the Dominican side was concerned. Sr Herrero was charged with establishing the new basis for the relationship which was no longer to rely on the figures provided by Falcondo for tax assessment purposes. Through his decrees, the President implicitly indicated this intent by striking at the foundation stone of the company's relationship with the Dominican Republic. Company officials felt insulted when it was their honesty and the accuracy of their records that was questioned, even though from the company's standpoint it was the government which had reneged on its word.

Falconbridge regarded its investment in the Dominican Republic strictly as an economic proposition. Consistently throughout the confrontation, the company felt its responses were dictated strictly by the economics of the situation. The company had increased its financial commitment to the Falcondo project and it wanted to recoup that investment. From the company's point of view that investment was secure so long as the established relationship based on past agreements reached between the Dominican Republic and Falconbridge were adhered to. Thus, President Balaguer's decrees were an effective and disturbing tactic in that they directly challenged the presumption that existing agreements would necessarily be maintained. The suggestion of accounting manipulations made by Sr Herrero raised additional doubts. For their part, company executives believed that the economic viability of the project depended on the continuation of existing or carefully modified agreements. Throughout, therefore, the firm's negotiators considered that they should attempt to be responsive to Dominican concerns while also taking account of the economic realities that characterized world nickel markets and the operations of Falcondo's facilities.

There were pressures affecting both sides that helped the renegotiation process continue despite the confrontive emotional tone. The Dominican Republic wished to maintain its reputation of being recep-

tive to foreign investment. In fact, at the time of the confrontation, it was promoting itself in *Business Week* seeking additional direct foreign investment. It also wished to avoid US involvement in the dispute in any way. The company, on the other hand, did seek out Canadian and US political support. As it turned out, the USA had other concerns and was not interested in intervening to help a Canadian firm with US customers operating in the Caribbean. On the other hand, a *de facto* nationalization of the Falcondo facilities would probably have triggered action by OPIC and hence US involvement. One can speculate that the threat of US involvement through OPIC, apparently engineered by Falconbridge, may have been a catalyst helping to convince the Dominican government to make some concessions that led to the final agreement.

The role played by Sr Herrero on behalf of the Dominican government was very difficult and also very effective. His basic concern was that because it seemed to him that the company had manipulated its records to avoid taxes, it was necessary to find a new basis for the relationship between the company and the Dominican Republic that could not be subject to such manipulation. To get to a new basis for the relationship, he had to make it clear to the company that its records were not believable, a message that the company was simply not prepared to entertain. By being a consultant rather than a member of the government, he was probably in a better position to deliver this sensitive point of view. Given the circumstances as these were understood on the Dominican side, his aim of developing rules for calculating taxes that did not depend on the company's records were eminently reasonable. While Falconbridge did not like the approach and felt insulted by the implications, they nevertheless went along with Sr Herrero's basic proposal. As a result, the nature of the relationship between the Dominican Republic and Falcondo did change in the direction of becoming more evenly balanced.

The role played by President Balaguer is also of great interest. The President initiated the confrontation in a symbolically precise way as, by decree, he unilaterally broke the long-standing agreement with the company concerning taxes, mirroring his contention that the company had also been unfair by exploiting the country's nickel resources. Once this initial step had been taken, however, the President operated behind the scenes, even as his presence was continually felt in the company's continuing hassles and occasional successes in dealings with the Customs authorities, and in the continuing disputes concerning how Falcondo's tax payments would be recognized. Finally, one can speculate that he may have enjoyed

the surprise appearance of Sr Herrero very late in the renegotiating game, brandishing a claim for unpaid taxes in approximately the same amount as had been originally promised, for President Balaguer must surely have remembered the 1969 submission and its promises of US\$120 million.

What sort of results would another approach have achieved? The UN advisory group proposed another approach. The UN group had many questions concerning the justification for many of the clauses in the existing agreements between the Dominican Republic and Falcondo and they proposed to modify those agreements. They would have sought not only to disallow interest on shareholder's subordinate loans, for example, but also to convert these loans in order to increase the financial capitalization of Falcondo. As opposed to Sr Herrero's approach, theirs would have enlisted the help of the world-wide mining press, and would probably have been more acceptable to Falconbridge because it did not directly throw into question the integrity of the company's records. As members of the UN group felt uncomfortable with the presupposition of mistrust that was the basis of the approach proposed by Sr Herrero, it was difficult for the two groups to work together. So far as financial outcomes are concerned, those depended on world market conditions and so they are unlikely to have been too far apart regardless of which approach was chosen. The advantage achieved by Sr Herrero was a new, 'arms length' basis for the continuing relationship between the Dominican Republic and Falconbridge. The advantage the UN approach might have achieved was a more positive working relationship between the parties before and after the negotiations but, as such, the relationship would still have likely been dependent on Falcondo's records.

Conclusion

The case emphasizes the iterative nature and the surprising twists that can occur in a cross-cultural renegotiation. Particularly when a history has been mutually disappointing, each side is likely to have their own explanations. It is not surprising that one or other party should accuse the other of wrong-doing, misrepresentation, or worse. To obtain a renegotiated agreement, it is important to express such judgments so that there is an opportunity to explore, clarify and resolve the various impasses. The renegotiation process, itself, emphasizes revisions that are based on what each side believes they have learned from their past history along with the various initiatives that they have taken themselves and that have been taken by the other party.

There is a limit, of course, as to how much impugning of integrity that either side in a confrontation will tolerate from the other. Generally, however, tolerance is likely to increase as the stakes involved are higher. When the stakes are high enough, as they seem to have been in the case of Falconbridge and the Dominican Republic, it seems that a highly emotional level of confrontation was able to be tolerated. Despite differences in their respective perspectives, there was also intent on both sides to re-establish a mutually beneficial relationship.

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