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Formation of Contract and Contract Law through Multinational Joint Ventures: Indonesia, China and the Third World

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Introduction

President Carter's decision to "normalize" diplomatic relations with the People's Republic of China (the PRC) in 1978 focuses anew the fascination of the public, the press, and the business community on the vast potential of the China trade. The Chinese themselves were also eager to utilize the capital and technology of American and Western firms for economic development projects and for expansion of their international trade. By July of 1979, the Fifth National People's Congress had adopted a law governing joint ventures in order to attract foreign capital, technology, and marketing participation in PRC development projects under joint control of PRC state enterprises.[1]

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[1]For a survey of the literature on these developments, *see, e.g.*, F.C. Rich, *Joint Ventures in China: The Legal Challenge*, 15 THE INT'L LAW. 183 (1981). *Cf.* also the discussions of N.T. Wang, *New Forms of Cooperation Between China and International Enterprises*, 1 CHINA—INT'L BUS. 11 (1981), and H.M. HOLTZMANN and W.S. SURREY, eds., A NEW LOOK AT LEGAL ASPECTS OF DOING BUSINESS WITH CHINA (New York: PLI, 1980).

Despite the sudden explosion of interest in this area, it had been by no means neglected in the immediately preceding years. Dr. Oskar Weggel of the Institut für Asienkunde of the University of Hamburg includes an extensive bibliography of the major earlier contributions in his own work, O. WEGGEL, DAS AUSSENHANDELSRECHT DER VOLKSREPUBLIK CHINA (THE FOREIGN TRADE LAW OF THE PEOPLE'S REPUBLIC OF CHINA) (Baden-Baden: Nomos, 1976), at pp. 479-82. Recent innovations such as the new joint venture law have also to be read against the background and experience of Chinese trade negotiations and political ideology. For this reader, Weggel's contribution is fundamental to a systematic approach to understanding the conceptual framework of trade with the PRC and should not be overlooked in the pressure to be current.

Over the years there has been a recurring fascination in Western business circles with tales of the legendary mineral riches and the almost untouched market of the world's most populous country. For those embarking on trade ventures in that part of the world for the first time, however, there is another world of business and contract relationships to be explored. Some who have rushed in too quickly—or relied on only their own wits and their instant experts—have already been forced to repeat the lessons that many their predecessors learned long ago.

Yet there is wealth of experience in trade with China and other Asian countries, and countries with similar attitudes to law and business that can and should be drawn upon to avoid these pitfalls. We should not forget too soon that up to the present time, the U.S. trade with the PRC is only a fraction of that of the U.S. with the Chinese on Taiwan. And the output of foreign petroleum and minerals development companies in Southeast Asia have constituted vital segments of the world's market in these natural resources for over fifty years.

A number of studies of Third World countries' petroleum and minerals development contracts since the termination of the great oil concessions in the late 1950s have appeared in recent years.[2] If there was ever any doubt that Third World contracts were consummated in an atmosphere quite different from the realm of contract as executed in countries where the Western legal system has been well established—following the formal model of offer, acceptance, and generally final written integration which can serve as the basis of binding judicial decision in the event of subsequent dispute over terms or performance—the studies reviewed below should provide materials to further assess the theories of the "death of contract" school.

A standard contract provision generally employed in the PRC, for example, calls for "friendly negotiation" as the basis of settlement of disputes.[3] As long as the political circumstances surrounding the event have not clouded the issue (as in the unfortunate results of cases which arose during the "cultural revolution" or during other periods of strained international relations[4]) the deliberations of the arbitration committees seem to have been conducted in the effort to achieve a mutually acceptable reconciliation. To that extent the procedures employed by the arbitration committees are fairly relaxed and informal, though the final agreement is reduced to a new joint protocol.

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[2]*See generally* DAVID N. SMITH and LOUIS T. WELLS, JR., NEGOTIATING THIRD-WORLD MINERAL AGREEMENTS (Camb., Mass.: Ballinger, 1975) [hereinafter cited as SMITH/WELLS, '75]; MALCOLM GILLIS, ed., TAXATION AND MINING: NONFUEL MINERALS IN BOLIVIA AND OTHER COUNTRIES (Ballinger, 1978) [hereinafter cited as GILLIS, '78]; M. GILLIS and R.E. BEALS, eds. TAX AND INVESTMENT POLICIES FOR HARD MINERALS: PUBLIC AND MULTINATIONAL ENTERPRISES IN INDONESIA (Ballinger, 1980) [hereinafter GILLIS/BEALS, '80]; M. Domke, *Indonesian Nationalization Measures before Foreign Courts*, and H.W. Baade, *Reply*, 54 A.J.I.L. 305; 801 (1960).

[3]*See* discussion of standard contracts in WEGGEL, pp. 144ff.

[4]*See* discussion by Jerome Cohen in *Chinese Law and Sino-American Trade*, in ALEXANDER ECKSTEIN, ed., CHINA TRADE PROSPECTS AND U.S. POLICY (New York: Praeger, 1971).

Although Chinese accounts may be somewhat idealized, there is certainly a lot of good sense in the attitude attributed to PRC trade representatives: ". . . our aim is to settle the dispute in an amicable atmosphere and by friendly means. You do not do business again with a partner who has sued you in the court. Do you?"[5]

The procedure doubtless sounds unusual to American businessmen, but there appears to be a growing tendency also among leading American businesses which have equal financial ability to damage each other through legal proceedings to choose mediational settlement or arbitration in much the same manner. Unquestionably the ability to go into court—even more than the ability to bear the financial and legal burden—is fundamental to the willingness to settle in these cases. But the trend may be worthwhile noting as a model. Professor Stewart Macaulay even calls for re-thinking of our ideas about contract law—and its reform—on the basis of his findings which establish this parallel both with Chinese procedure, and the experiences of other socialist countries, where bringing fellow members of the bureaucracy, or frequent business partners, into court can have adverse effects on long-term relationships:

> Studies in nations with different social and economic systems indicate that the norms of contract law are seldom applied through the litigation process and that disputes are avoided or settled where there is a long-term relationship between the parties. Yet legal scholarship, as well as many proposals for reform, continue to be based on a picture of the contracts lawsuit, to a great extent. It is likely that this distortion is prompted by overgeneralization from a nonrepresentative sample of possible and actual disputes, and by indirect influence of legal norms; it may also express the needs of legal scholars and reformers. It is questionable whether capitalist, socialist, or mixed economic systems would benefit if more disputes were resolved by the application of officially sanctioned contract norms.[6]

Their experience in negotiation and formation of petroleum and hard minerals development contracts in Indonesia since nationalization of the great concessions presented the first multinationals with many of the terms and conditions now suddenly part of the new vocabulary of those engaged in discussion of joint ventures in China. That experience may also soon serve in other areas of the Third World where these forms of business and development had not spread before.

The common elements in the experience of the first multinational corporations in Indonesia and the new joint venture partners in China are: the formation of contracts in a mixed traditional Asian business/semi-Westernized legal atmosphere stressing executive over judicial solutions; the foreign

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[5] *Id.*, p. 166.

[6] Stewart Macaulay, *Elegant Models, Empirical Pictures, and the Complexities of Contract,* LAW & SOCIETY (Winter, 1977); *see also* Stewart Macaulay, *Lawyers and Consumer Protection Laws: An Empirical Study*, Working Paper 1979-1, Disputes Processing Research Program, University of Wisconsin-Madison Law School, which deals further with the "conciliatory rather than adversary roles" played by American lawyers at the present time. In all of the above Macaulay seems to carry on in the spirit of G. GILLMORE, THE DEATH OF CONTRACT.

developer/trading partner is made to appear to be carrying all the risk of the joint undertaking, while the state enterprise presents more the character of an arm of the government bureaucracy "administering" development of the country's resources by contract rather than "engaging in a business venture" itself; production- or profit-sharing is employed as a means of payment for the foreign developer; and conciliatory rather than adversary dispute settlement must be resorted to while the business relationship lasts and contracts are subject to renegotiation.

This parallel experience does not mean that all those in the China trade today will find themselves in exactly the same situation of the first multinational corporations in Indonesia. What is described here is rather the course of development in contract relationships, or, properly, transnational contract law, in Southeast Asia over the past twenty years. For China today is already prepared to talk in terms of "joint ventures" where the Indonesians until recently only have been willing to think in terms of "production-sharing contracts" and "contracts of work." It is, therefore, not that the terms will be precisely the same, it is rather that the outlook and ideology of the contract partner have much in common that makes the Indonesian experience of the first multinationals relevant to China and other Third World countries.

Even among Asians, the Indonesians seem to have raised hard bargaining to an art. And while many an ideological confession of faith is laid down in the terms and concepts of individual contracts, these do not seem to have presented insuperable barriers to avoidance in the course of ordinary business practice: Title to minerals extracted must remain with the sovereign power on its own soil, for example—title passing only at the point of export. Title to the operations and equipment often remains with the government as well. Nevertheless the foreign company affiliate must overcome this formal legal obstacle in securing investment, obtaining insurance, and in obtaining loan advances against this "collateral" as if it were the title holder. The foreign contractor is required to incorporate a local affiliate under Indonesian law and subject itself to Indonesian sovereignty and tax jurisdiction. Yet, out of business necessity, the contract with the foreign firm—until the Rio Tinto agreement of 1977—generally specified that New York law would be the governing law of the contract, and that disputes would be settled by arbitration. There is clearly no intention on the part of either party that Indonesian law should set aside any principle established by contract between the parties.

As conditions have changed, contract provisions have changed along with them—depending upon the momentary bargaining power of the parties. But the fact is that, for the period of its duration, the contract arrangements between the multinational corporation and the Indonesian government, or state owned monopoly, has become a kind of law unto itself.

The foreign contract partner in the Third World should, therefore, not be deceived by such events as the media's enthusiasm for the development of Chinese law, for example. For while there have been new statutes promulgated, there is otherwise very little "law" in that area. What the contract partner should look for is a means of specifying all the terms of "law" and their construction that he hopes to be governed by as terms of the particular contract.

Here again the Indonesian experience of the first multinationals is relevant but not exhaustive. Above all the Western contract partners in China must realize that they are not all great multinationals. Their bargaining power depends very much on the world market. But domestic, political and economic situations of the Third World partners also have substantial and immediate impact upon the process of contract negotiation and formation.

Again, the chief characteristic of the new Chinese "law" is that the bargain's the thing. Both in formation of the original contract—and, if need be, in resort to arbitration in dispute settlement, readiness to come to terms, the spirit of conciliation, and bargaining power are important. Those who omit terms they later expect to apply, or who do not take corrective action when they see their venture partner has a different concept of the work, do so at their own peril.

I. Background of Indonesian Minerals Development

A. *Nationalization and Reopening: From Foreign Investment to "Foreign Credit"*

Between 1957 and 1965 foreign concessions in Indonesia were terminated, and most foreign-owned enterprises were taken over by the government. Mining was closed to foreign control. Yet, at the same time, new foreign companies undertook new petroleum production and mining operations (and many old foreign operations took on new form), with foreign ownership replaced by various kinds of contractual relationships. These relationships have gone through a number of stages of development, corresponding both to changes in the government and greater sophistication in contract negotiation, which has in turn been facilitated by greater dominance of the energy resource producing countries in the marketplace.

Following the nationalization of foreign holdings in the early 1960s, the Indonesian government negotiated a number of new agreements, primarily with Japanese firms. Under these agreements, "production-sharing" was the "preferred form of foreign investment." In many cases the foreign company and management remained in place (as contractors for an Indonesian, government firm), while ownership of land and capital equipment was maintained by, or transferred to, the government. In fact, the foreign firm often remained responsible for technical operations, management and/or marketing. But, in theory, the foreign companies owned nothing. Instead,

they were considered to be providing "redeemable fixed interest loans," plus service, to the Indonesian government.

Under arrangements such as these, the foreign investor was not to appear either as an independent entrepreneur, or as a partner, or even a contractor. Rather, he was to be conceived of as a creditor to whom a loan would be repaid by the government within a stipulated time and in the form of an agreed percentage of the production from the minerals development project. Thus, in time, principal and interest on the "loan" was to be recovered, and services compensated for, by assignment of a percentage of the annual production valued at world prices. (*See also* Smith and Wells, 1975, at 49-50 appendix this article.)

The kinds of contracts employed for petroleum production and for hard minerals development were originally quite distinct from one another. In part, as Smith and Wells suggest, this reflects the relative bargaining power of the parties in the petroleum and hard minerals sectors.

> A comparison of Indonesian oil and copper concession contracts negotiated in the late 1960s tells one a great deal about the relative bargaining powers of the government vis à vis oil and copper investors in that period. In oil arrangements the effective tax rate was around 65 percent; title to equipment imported by the company was vested in the government; and investors were restricted to production-sharing agreements. In contrast, the tax rate for copper agreements began at 35 percent; the foreign firm held title to all equipment; and agreements had most of the characteristics of very traditional concession agreements.

On the other hand, the terminology employed in the contracts of both sectors was similar, though it might have quite different effect. Smith and Wells tell us, for example, that in the early 1960s there were "a number of 'work contracts' for the exploration and exploitation of oil." These were, *then*, "essentially profit-sharing arrangements"; this result appears to have come about because marketing was still in the hands of the foreign operator. At that time, profits were distributed after marketing. Today, the government oil company markets its own share of production. We are told, however, that "the '*work contracts*' for the development of hard minerals are quite different from the '*production-sharing* contracts' for the development of oil" [emphasis added]. This was written with reference to contracts in 1968 and 1969, however.[7] As will appear shortly, this distinction is disappearing in "third generation" contracts.

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[7]For a model of the earlier petroleum, "*profit sharing*," "*work contracts*," *see, e.g.*, *Contract of Work between P.N. Pertambangan Minjak Nasional (Pertamina) and P.T. Stanvac Indonesia* (1963), in 3 INT'L LEGAL MATERIALS 248 (1964) [hereinafter cited as *Stanvac/Indonesia*]. This model may be contrasted with both recent hard minerals development contracts employing the same terminology, *e.g.*: "*Contract of Work* between the Republic of Indonesia and P.T. Kennecott Indonesia" (1969), for copper mining and current petroleum production contracts, *e.g.*: *Production-Sharing Contract between P.N. Pertamina and Phillips Petroleum Company*, (1968) in ROBERT FABRIKANT, OIL DISCOVERY AND TECHNICAL CHANGE IN SOUTHEAST ASIA, where it is also discussed more fully—*cf.* Petroleum Legislation q.v. Biblio. V. *infra*. For further discussion of the latter form of agreements, *see* Joyce Gibson, Production Sharing, 3: 4 BULL. OF INDONESIAN ECON. STUDIES [hereinafter cited as BIES] 52; 75 (1966).

Both petroleum production and hard minerals development contracts have gone through several stages of development, and recent models appear to reflect the same trends. This works to our advantage in the study of recent Indonesian hard minerals contracts insofar as petroleum production contracts have been more thoroughly studied and, therefore, are more readily available from different sources than are hard minerals development contracts.

Thus, Gillis now refers to "typical second generation oil agreements" (Gillis, at 124, see appendix this article), employing terminology from a line of development taken by hard minerals contracts for oil. And the I.R.S. rulings of April, 7 and 14, 1976, rendered on the question of the creditability to U.S. taxes of tax payments due foreign governments on petroleum production-sharing contracts (especially as the issue was raised by Mobil Oil Indonesia), have become a central focus in the development of the so-called "third generation" of hard minerals contracts. (*See* Gillis, 1978, at 125 and Gillis and Beals, 1980, at ch. 4, appendix this article).

B. *Production-Sharing: Basis of the New Theory of Foreign Investment*

As outlined above, the theory of foreign economic relations adopted by the Indonesian government in the early 1960s rejected the previously accepted form of foreign investment, and put in its place a system of "credits on the basis of production-sharing." The principles of this new relationship were summarized in official statements in 1962, 1963 and 1964, then radically altered in 1965. Essentially, these statements first articulate official persuasion on economic theory, then substitute a way of doing business in terms of "foreign capital . . . in the form of loans but not of equity" and "repayment in the form of an agreed share of the goods resulting from the credit" (Presidential Statement of August 1962, *see* Gibson, at 53, appendix this article).

In response to foreign business inquiries, principles and rules were rearticulated in a series of official statements in 1963 and 1964. Very briefly these indicate that "production-sharing" is an association of a foreign creditor and Indonesian investor on a domestic project. Repayment on the basis of principal, interest and possibly "remuneration" for services is made from a percentage share of annual production valued at world prices or from foreign exchange earned. While all such "loans" were to be guaranteed, the nature of that guaranty would be considered from case to case and would "not be given automatically by the Bank of Indonesia." Beyond this there were a number of other provisions "which 'normally,' 'as a rule,' 'if necessary,' 'in general,' or 'usually' are included" (Gibson at 55).

In an official announcement in January 1965, further concessions to world business conditions were made, doubtless reflecting the current perceptions of the declining regime toward their economic situation. According to these, attention would be given to "the conditions and regulations in the country providing the credit" in fixing terms of repayment. Repayment

would not have to be made from the product of the project concerned. The foreign creditor might participate in management "for a specific period." By implication, the foreign "creditor" might market traditional exports as well as new products. And, finally, foreign participation would not be limited in time. An elaborate machinery was set up to review and implement such agreements in those years, and a sizable number of projects were undertaken, especially with the Japanese.

As noted below in reference to many paradoxes in the Indonesian business world, despite these new approaches to foreign investors, the law guarantying foreign investments was repealed in May 1965. The "New Order" administration, which replaced the Sukarno government, also in 1965, had, however, taken a new interest in, and a more vigorous attitude toward, attracting foreign investment. Yet, the system of contract relationships remains the way it was redesigned under the Sukarno theory of economics.

In this system, the foreign company, which seeks to explore for and develop petroleum resources in Indonesia, must, for example, first create a new corporate entity under Indonesian law and enter a contract with Pertamina, the state owned oil company. Contracts must conform to the standard terms foreseen in Law 44 of 1960 on oil and natural gas. Under these terms, the contractor assumes all risk.[8] If oil is found, the contractor may receive up to a maximum of 40 percent (*cf.* II.C.) of the value of the crude oil and/or natural gas produced to meet exploration, development and operating expenditures. Of the remaining 60 percent plus, 65 percent goes to Pertamina and 35 percent to the foreign company. When production reaches set higher levels, the Pertamina percentage/share is increased on a sliding scale.

This model appears to hold for exploration and development efforts in other sectors as well. The agreement on production-sharing does not exhaust all matters of contract concern, however. The new corporate entity founded in Indonesia by the foreign company is subject to corporate income tax, and royalties also may be required on production volume. These, and other matters such as land rent and import and export duties, remain to be fixed in the general contract negotiations.

C. *The New Reopening and the MBA's Approach to Asian Law and Business*

Oil production continued under the auspices of the newly nationalized firms during the Sukarno regime. But, "[i]nstability and economic problems pervaded the whole economy during the early 1960s" (Gillis and Beals, 1980, at 114). Consequently, the "New Order" regime of General Suharto, which came to power in 1965, sought actively to attract foreign

[8]A. Hunter refers to one example which departs from this pattern. In an agreement with Pexa Oil of Australia, Pertamina contributed 25% of exploration costs. In return, the production-sharing ratio in favor of Pertamina rose to 75:25%. *See* 7 BIES 98 (1971), n.4.

investment back to Indonesia in order to help finance their plans for the rehabilitation of the economy.

The new Indonesian Foreign Investment Law, Law No. 1 of 1967, symbolizes this effort. The law authorizes tax concessions and certain other protections to approved foreign investors. And, with few exceptions, all foreign investment is controlled by Law No. 1.[9]

Substantively, however, the new Law No. 1 of 1967 is not much different from the Foreign Investment Law of 1958 enacted by Sukarno, which was repealed on May 27, 1965, long after the takeover of most foreign holdings by the state (*see* Manring, at 432, appendix this article). Yet, the Indonesian relationship to law and business is more complex than this apparent conflict would suggest. Sukarno was taken with revolutionary rhetoric in the later years of regime, and, as Manring summarizes, "independence of the judicial system was seriously eroded and the role of lawyers criticized as preventing the development of 'Hukum Revolusi' (Revolutionary Law)". On the one hand, as von Mehren puts it, "if the picture painted by Mr. Lev [on Indonesian law] is accurate and symptomatic—the values and purposes of the legal order, as they emerged in the West, are either little understood or little valued in Indonesia." But the picture of law and business in Indonesia is also illuminated by an acute perception of self interest even if drawn "in unrelieved terms of personal and political advantage."[10]

Thus, while the Indonesians could guaranty foreign investment and nationalize foreign holdings at the same time (in the case of former Dutch enterprises, without compensation),[11] they could also evolve the new concept for "the preferred form of foreign investment"—i.e., "production-sharing"—at the same time they contemplated repeal of the law guarantying foreign investments.[12]

The Japanese, who have among "non-Western" societies come closest to Western aspirations in adoption of Western legal order, also have preserved their eye for the bargain in the Asian marketplace.[13] Japanese firms were

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[9]For an outline and summary of exclusions, priorities and formalities set forth in Law No. 1, *see* Timothy Manring, *Indonesia*, in JOHN O. HALEY, ed., CURRENT LEGAL ASPECTS OF DOING BUSINESS IN JAPAN AND EAST ASIA (A.B.A., 1978). A more complete outline is contained in INVESTMENT LAWS OF THE WORLD, vol. IV, *The Developing Nations* (Dobbs Ferry, N.Y., 1979). *See also* M. Kusumaatmadja, *Mineral Resources Exploration and Exploitation and the Law in the Southeast Asian Region: Indonesia*, in VIRGINIA S. CAMERON, ed., PRIVATE INVESTMENTS AND INTERNATIONAL TRANSACTIONS IN ASIAN AND SOUTH PACIFIC COUNTRIES (New York: Matthew Bender, 1974).

[10]*See* Daniel S. Lev, *The Politics of Judicial Development in Indonesia*, 7 COMP. ST. IN SOC. & HIST. 173 (1965) Comment, A.T. von Mehren at 200-01; *see also The Lady and the Banyan Tree: Civil Law Change in Indonesia*, 14 AM. J. OF COMP. L. 282 (1965);.and *Judicial Institutions and Legal Culture in Indonesia*, in CLAIRE HOLT, ed., CULTURE AND POLITICS IN INDONESIA 246 (1972).

[11]*See* discussion of the recognition of nationalization in foreign courts by Domke and Baade in 54 A.J.I.L. 305; 801 (1960).

[12]For discussion of "production-sharing" *see* Gibson in 3; 4 BIES 52; 75 (1966).

[13]*Cf., e.g.*, VON MEHREN, ed. LAW IN JAPAN, 1963; and von Mehren in 71; 76 HARV. L. REV. 1468 (1958); 1170 (1963).

conspicuously the pioneers in undertaking the new form of investment agreement with the Indonesians: in oil (1960), and nickel and timber (1961). From their experience, the new formal relationships and conceptual structure of production-sharing emerged (*see* Gibson).

But it is really the experts from the Harvard Business School, Law School, Institute for International Development, etc., who have raised the instincts of the Asian marketplace to business science, judging by the leading studies on the development of Indonesian and Third World minerals agreements. "Improving the bargaining position of the developing countries in their negotiations with foreign investors interested in access to natural resources," Smith and Wells tell us, for example, "was the original intent of this book":

> It was our original assumption that most developing countries, no matter how long they have been in the natural resources business, need some help in dealing with the foreign firm. . . .

One gets the impression that they must have learned a little themselves from the Indonesians, however. (*Cf.* Gillis and Beals, at XIXf.)

Today we probably all realize that profit margins of foreign investors cannot grow to levels outrageously disproportionate to initial risk and investment; and periodic contract renegotiation is a factor to be considered in transnational agreements, when the original situation changes. Objective science "useful to both sides" may sound a little disingenuous, however, when it seems to institutionalize change:

> The initial negotiation of the contract is merely one step in a process of unfolding relationships. The contract itself may set off a chain of events that will alter the ultimate shape of the relationship.

While protesting that nothing has changed "essentially" at all, as, for example: "control need not be linked at all with ownership."

The experts recognize the dilemmas of managers in boardroom and shareholders' meetings when it comes to investing in and insuring operations and equipment that they do not own. But they find this matter largely "symbolic":

> In other cases the problems facing the private managers considering innovative arrangements have been real. They have worried about how to explain the new structures to shareholders, how to set up insurance against expropriation and other risks on assets they do not own, or how to raise loans on property to which they do not have title. Usually, however, resistance from management seems to have been based less on economic and legal grounds than on the symbolic meaning of ownership.

They make a virtue of the political importance of the symbolic transfer of ownership for the host country—and the substantial, though diminished, profits of the contracting company:

> The 1960s brought major innovations in the structure of mineral agreements. Most important, the new structures have broken the tight link between ownership, control, and financial risks and benefits that was inherent in the traditional

> concession. Arrangements have been negotiated that have repackaged these elements in ways not feasible under the old structures. Because ownership and control have become important political symbols in most developing countries, new contractual forms have been created to allow greater freedom in allocating ownership, control and financial risks and benefits in ways that satisfy both the economic and new political imperatives.

Yet, despite these optimistic insights, they must concede that strength—and security—in the third world minerals market is a function of attributes of strength and power in the world market:

> Where a foreign firm is considered important for its financial, technological, or marketing contributions, the new structures permit the negotiation of agreements that grant control and financial agreements reflecting the bargaining powers of the parties.

For even the giants of the world petroleum and minerals markets that bargaining power is sharply reduced when world energy, and perhaps minerals, markets are controlled by marketing monopolies and standardized contract terms are imposed.

Still, here again the experts find a virtue in a necessity, which seems very much to reflect "the bargaining powers of [one of] the parties." From the defensible proposition that it is advantageous for the foreign company to negotiate standard terms which allow it tax credits rather than tax deductions in the home country:

> Tax credits are substantially more valuable than deductions: each dollar of foreign tax credit reduces the firm's home country income tax by a dollar, while each dollar of deduction reduces the firm's home country tax base by a dollar and thus reduces the tax liability by only a fraction of a dollar . . . (Gillis and Beals, 1980, at 130).

Gillis and Beals go on to a defense of standardized terms in general:

> The context in which the issue of contract form is considered here takes as granted that a single standard form is desirable. Indeed, standardization is virtually essential in order to avoid heavy negotiating costs for both the government and the multinational companies and to reduce administrative problems in efforts to implement and monitor agreements of widely varying structure.

There is no question but that costs of attorneys' fees, in transnational contract negotiations, are high on both sides. Standardization of some terms is doubtless useful. But contract terms are to protect interests; and this requires counsel. It is recourse not form which is the abiding concern of the lawyers, if not the systems scientists.

These are, at any rate, the questions raised at the stage of development we have reached in the "third generation" of Indonesian hard minerals contracts. A closer look at the development of these "generations" of contracts follows.

II. Three Generations of Hard Minerals Development Contracts (1965-Present)

The "New Order" administration of General Suharto, which replaced the Sukarno government, recognized the decline in the economic situation in the country and was prepared to go much further than the previous government in its last days in 1965, in making concessions in the effort to attract foreign investment back. This was a vital element of their revitalization policy, both in order to help finance a rehabilitation of the economy and to promote new benefits they planned to introduce.

Hoping both to overcome the reluctance of foreign mining companies to invest in a country which had so recently nationalized foreign holdings, and also to extract the greatest immediate return from contract negotiations, the government adopted the strategy of offering favorable terms to the first applicant, then demanding progressively harder terms from those prospects that followed. Thus was born the "three generations" in hard minerals contracts the authorities on Indonesian minerals development agreements speak of. Actually, different authorities use the term "generations" of contracts differently, both as to whether the term applies to hard minerals contracts, only, and also as to what years are encompassed by each generation. Here, however, the term "three generations" is applied as used by Gillis and Beals, for *hard minerals* contracts, only, and starting with the Freeport Sulphur Agreement (1967).

A. *The "1st Generation": (1967)*

The Indonesians drive a hard bargain, and the "1st generation" of new hard minerals contracts covers only one agreement: that was made in 1967 with the Freeport Sulphur Company which was interested in extending their operations into copper production. There was a large, known copper deposit at Ertzberg in western New Guinea (Irian Jaya), but exploitation would require building the entire infrastructure needed in a very remote and largely inaccessible area. Small concessions on the part of the government in this contract, therefore, brought considerable return.

The "*contract of work*" concept allowed the government to retain title to the land and the ore until it was extracted. Actually, it has been practice in *production-sharing* to turn over title only upon export. The company received a tax holiday for the first three years after beginning of production. During the next seven years, the company was to pay a reduced corporate income tax of 35 percent, whereas the rate of 60 percent then applied. In succeeding years, Freeport was to be taxed at the rate of 41.75 percent. Actually, the general rate of corporate income tax was dropped from 60 percent to 45 percent in 1970, but existing mining contracts were not affected. The company was to be free of other central government taxes and royalties on copper and gold. However, during the years in which the 35 percent income tax rate applied, a special royalty of 5 percent of sales value was to be levied, though this would be creditable against corporate

income tax, thus serving as a hedge for the government against possible failure of the company to realize profits. (*See* Gillis and Beals, at 115f.)

B. *The "2nd Generation": (1968-71)*

The Freeport Sulphur agreement offered the breakthrough the Indonesian government was waiting for. Many other contract offers followed, and "[c]onsistent with the government plan and strategy the agreements negotiated with these 'second generation' firms were less favorable to foreign investors . . ." (Gillis and Beals, at 116). From 1968 to 1972, fifteen foreign firms signed "second generation" "contracts of work" for hard minerals development. But, no more tax holidays were granted, and royalties, non-creditable against U.S. corporate income tax, were reimposed. "The last second generation contract was signed in 1971." And despite applications, "no new contracts of work with foreign investors were signed until 1977."

Under these contracts, well-defined territories were granted for a "general survey" to be conducted over a two-year period. The area assigned was to be reduced by 25 percent after the first year and by at least 50 percent of the original area at the end of the second year. From this time, the contracting company had another three years for closer exploration. At the conclusion of that period, another 50 percent of the remaining contract area was to be relinquished—unless substantial outlays for exploration were to continue in the area in question, in which case an extension of three years was allowed. Upon completion of exploration, another twelve months was allowed for a feasibility study before construction began on the project. Once production actually began, the contract term extended for thirty years.

During years of production, the foreign company was to be subject to Indonesian corporate income tax. This would be reduced during the first ten years of operation, and rates would differ according to three categories of minerals. Subject to requirements, a tax credit of 8 percent was allowed companies with an investment of over $75 million. Beyond corporate income tax, the company was also subject to royalties based upon production levels. "Second generation" contracts were exempted from export duties. But high land rents were exacted on the contract area. These land rents increased on a sliding scale during the course of the contract term as the contract area was proportionately reduced. (*See* Gillis and Beals, 1980, at 120-21.)

Gillis' and Beals', usage of "2nd generation" is restricted to hard minerals contracts. Yet, at the same time, "new style" agreements for petroleum production and timber exploitation were also reached. And these, too, show characteristics of the Indonesians new bargaining posture, although the "production-sharing" contracts, for oil production, differ in form from the "contracts of work" for hard minerals development.

The concept of "production-sharing" was preserved in the new oil production contracts of the Suharto, "New Order" administration. But, Smith

and Wells tell us, "The new production-sharing agreements bore only superficial resemblance to the production-sharing agreements of the 1960-65 period, or to traditional concession contracts." By early 1971, thirty-six foreign companies had negotiated these new-style agreements with Pertamina, the state oil company. These included: Shell, Compagnie Francaise de petroles, Gulf, BP, and Mobil.[14]

As noted above, the Smith and Wells book points out that: "In Indonesia the 'work contracts' for the development of hard minerals are quite different from the 'production-sharing contracts' for the development of oil." For details, they refer us to a comparison of the Kennecott/Indonesia, 1969, *Contract of Work*, and the *Production-Sharing Contract* Pertamina/Phillips Petroleum, 1968. Among leading hard minerals contracts are also those with Pacific Nickel, Alcoa, and Inco (*cf.* Gillis, at 134).

There are two key elements of the Pertamina/Phillips agreement distinguishing it from a simple service contract, as Smith/Wells describes it: (1) "Phillips was entitled to recover, in the form of oil, operating costs up to an amount equal to 40 percent per calendar year of crude oil produced," and (2) "of the balance of oil, Pertamina took 53 percent and Phillips received 35 percent." Further, "[w]hile it was provided that 'Phillips should be subject to the income tax law of the Republic of Indonesia and shall comply with the requirements of such laws,' Pertamina undertook to pay such taxes on behalf of Phillips" (Smith and Wells, at 50).

The distinctions between *"production-sharing"* contracts for petroleum production, and *"contracts of work"* for hard minerals, signed during this period, are also enumerated by Kusumaatmadja,[15] who concludes: "Paradoxical as it may sound, the production-sharing contract [for petroleum production] is . . . more truly a contract of work . . . with the foreign company acting as a contractor, than is the [contract of work for hard minerals] in which the contractor, although indirectly, does have actual mining rights." He further distinguishes between the two forms of contract as follows:

> 1. Under production sharing, the government (through Pertamina) retains management and control over the resources. Under the work contract, both are in the hands of the contractor.
> 2. Under production-sharing, the work program and budget are submitted to Pertamina for approval annually. Most contracts of work for minerals do not have this provision.
> 3. Under production-sharing, Pertamina, as holder of the authority to mine, is responsible for taxes and levies. Under a contract of work, the contractor pays land rent, royalties, taxes and other levies.

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[14]For further discussion of the innovations in oil production contracts during this period, *see* Alex Hunter, *Oil Developments*, 7 BIES 98 (1971). *See also* Fabrikant's analytical study of the production-sharing contracts of the post-Sukarno period. *Cf.* SMITH/WELLS, '75, p. 57, n.57.

[15]In *Mineral Resources, Exploration and Exploitation, and the law in the Southeast Asian Region: Indonesia*, in VIRGINIA S. CAMERON, ed., PRIVATE INVESTMENTS AND INTERNATIONAL TRANSACTIONS IN ASIAN AND SOUTH PACIFIC COUNTRIES (New York: Matthew Bender, 1974), p. 418f.

4. Under the production-sharing contract, the contractor takes title to his share of crude oil at the point of export. Contract of work agreements have "no such provision." In other words, the "contract of work" for hard minerals extraction demonstrated the greater bargaining power and independence of developers in this sector at that time.

C. *The "3rd Generation": (1977-Present)*

According to Gillis and Beals, the Indonesian government decided in 1972 that they would offer less favorable terms on future hard minerals contracts, but negotiations were allowed to slide until a new basic model contract was developed. A major issue here was whether to follow the "contract of work" or "production-sharing" contract model. The decision in this matter came in 1976, and the first "third generation" contract was signed with Rio Tinto in 1977.

But, Gillis and Beals believe other events also influenced the government's thinking in developing the new contract model. Recent hard minerals contracts in other diverse areas of the third world had secured more favorable terms to host countries than had previous agreements in Indonesia. Indonesia appeared to offer greater political stability than many other areas of the world, at this time. Furthermore, the domestic economy had improved significantly, so that the incentive the Suharto government had originally felt for offering more favorable terms to foreign companies had been reduced. The rise in world minerals' prices was also decisive, to the extent that the Indonesian government made a sizable equity investment itself in the Freeport project when that "first generation" contract was up for renewal and revision in 1976. In addition to these reasons, Gillis/Beals also refer to what they believe was an enhanced capability of the Indonesian bureaucracy to deal with complexities of mining, taxation, and negotiation; and dissatisfaction with the perceived slow pace of training and promotion of local people and development of domestic supply and processing activities (at 122-24).

The decision on the nature of the future contract relationship came down in Presidential Regulation 21 of 1976 (*See* Gillis and Beals, app. B).

In essence, this regulation dictates the standard terms which are to be a part of future contracts in the hard minerals sector. The basic terms with regard to taxation may be summarized as follows: (1) During the first ten years of operation, a reduced rate of 35 percent corporate income tax is allowed. Beyond that time, the prevailing rate of 45 percent will apply. (2) A scheduled rate of royalties will apply. But Gillis and Beals have had to construct their own table on the basis of rates quoted in the Rio Tinto agreement. (See their Table 2-5, at 53.) (3) Though export duties are not mentioned, they are expected to apply. Here, again, Gillis and Beals' table assembles the rates given in the Rio Tinto agreement. (4) A property/regional development tax (IPEDA), from which "second generation" contracts were exempt, is now imposed. (5) Land rend schedules continue as

they were in the past. (6) Exemption from import duties and sales taxes are granted for the first ten years of production on a specific list of items required for company operations. This is a limitation on the extensive privileges allowed under the "second generation" contracts. (7) A withholding tax of 10 percent is imposed on remissions abroad of interest, dividends, and royalties. This is half of the prevailing rate. (8) Transfers of property as subject to a stamp tax; "exemption may be granted from the tax on placement of capital." (9) Sales and excise taxes and regional development levies are also imposed. The Regulation also contains provisions relating to depreciation allowances, loss carryovers, and foreign exchange controls. (*See* Gillis and Beals, at 125-26.)

In general, the ambitions of the government reflected in the new Regulation are to attempt to avoid separate negotiations with foreign firms and to control as much as possible of the relationship with foreign firms by general mining and tax legislation. (*See* Gillis and Beals, at 124ff.)

The effort at "Indonesianization" continues to be a prime concern in all phases of operation: management, labor, supply, and equity ownership. We may therefore look for increasing emphasis on these goals in future contracts.

Concern with obtaining the full benefit of the profits derived from development of Indonesian resources is reflected in the addition of a windfall profits clause in new agreements. There is also a greater effort to close off avenues of avoidance or evasion of Indonesian taxes. This leads to new provisions governing definition of "affiliates," treatment of interest, and deductibility of expenses.

There also have been efforts at avoidance and resolution of disputes by attempting to remove ambiguities in provisions concerned with termination, arbitration, renegotiation, and taxes and levies due local branches of government.

The Indonesian government has in all this chosen to continue the "contract of work" as opposed to the "production-sharing" contract format to govern their relationship with contractors in the hard minerals sector. Gillis and Beals treat this decision as a kind of concession to the foreign mining operators, since the corporate income tax levies under this form of agreement are creditable against U.S. taxes and since this model is issued despite the political objection that there is the appearance that the foreign company has control over the minerals upon extraction.

Doubtless Gillis and Beals are correct that failure to allow conditions which would provide for creditability of corporate income taxes against home country taxes would in turn diminish the prospect for more favorable terms from the contracting firm subject to higher or double taxation. But, as they themselves point out, this hurdle has been overcome by recent "production-sharing" contracts for petroleum. And the question of contractual property rights in extracted ore is illusory, since the Indonesian constitution controls in preserving the ultimate right to the state until export.

Therefore, Gillis and Beals' earlier suggestion that the bargaining power of the hard minerals developers had been greater than that of the petroleum producers still seems applicable. The advantage that prevails in the hard minerals sector is small, however, and these authors also recognize an "essential equivalence of the two contract forms."

Our immediate concern is, therefore, has the double taxation problem been alleviated. The "contract of work" format assigns the foreign firm the role of contractor for the Indonesian government who must pay corporate income tax on his profits—in addition to royalties and other taxes—and this requires that his net income from operations in Indonesia be determined. The U.S. Internal Revenue Service seems to have put the creditability of taxes paid the Indonesian government under "production-sharing" arrangements in doubt in 1976 and 1977. This problem was resolved in May of 1978 after long negotiations between the government of Indonesia and the United States, and the parties involved and the I.R.S.[16] As a result, agreement on terms and calculations that allow for creditability of corporate taxes paid in Indonesia has been achieved for both "contract of work" and "production-sharing" contracts.

In 1974, Gillis and Beals tell us, the 60 percent of oil production which had formerly been subject to "production-sharing" on the basis: 65 percent to the government, 35 percent to the contractor, was reallocated on the basis of 85:15 percent for all oil valued at more than $5 per barrel. In 1976, a further change was made in the "production-sharing" model. This time companies were no longer allowed to take up to 40 percent of production to cover their costs, but were instead required to amortize costs over seven years (for fields with a short projected life) and fourteen years (for fields with long life). This was also to have the purpose of achieving a "true tax on profits" (at 128-29). While the oil companies were thereby demonstrably losing their bargaining power, they were presumably gaining at least with respect to the creditability demands of the I.R.S.

Gillis and Beals list four major differences between the "contract of work" and "production-sharing" forms of contract: (1) The government option to take its share in cash or in share of production is basic to "production-sharing" but is absent in the hard minerals "contract of work." (2) Under "production-sharing" title to all equipment owned by the contractor and landed in Indonesia passes to the government-owned company. The authors tell us that for this reason there has been substantial leasing of equipment in this sector. Under the hard minerals sector "contract of work," title passes only on completion of the contract—which can be in thirty years. (3) Differences had arisen over the issue of creditability of Indonesian tax payments under "production-sharing" contracts. But, as already explained, that problem now has been settled. In the process,

[16] *See* GILLIS/BEALS, '80, p. 130. *See also* news releases of the I.R.S. from April 7, 1976, concerning Mobil Oil Indonesia, and July 14, 1976, defining the I.R.S. position cited in II.C. below.

American oil companies gained by being allowed to consolidate earnings from all separate operations in Indonesia. But tax payments had to be made in cash not in kind. (4) Finally, as previously discussed, there is the politically sensitive question of title to the extracted ore in Indonesia which arises under the hard minerals "contract of work."

Gillis and Beals concede that it is "an erroneous view" that net income does not have to be determined in a "production-sharing" contract. In fact, they maintain that in order to prevent overstatement of costs or understatement of receipts, it is necessary to have a clear idea of net income. The two forms of contract are therefore "essentially equivalent" in this respect. Furthermore, adjustment of tax rate and royalty payments under the hard minerals "contracts of work" achieves again the "essentially equivalent" result to changes in production shares.

D. *Considerations with Regard to Indonesian Contracts*

In the course of study of the above contracts, a number of questions arose repeatedly:

Questions of Definition—"Income," "net income," "royalties," "control," "processed goods," "depreciation," "affiliate," "subsidiary," etc. are frequently occurring terms whose definitions can result in different rights and liabilities in the host and the home country. Harmonizing concepts between host and home country is also important.

If any doubt arises about certainty of creditability of fees, taxes, or royalties to be paid, it may be advisable to obtain a ruling in advance from the appropriate national authority.

The language of the July 14, 1976 I.R.S. ruling on creditability of foreign taxes gives a clear example of the active role that the U.S. Internal Revenue Service has taken in transnational contracts. In this case, I.R.S. ruled that it would allow credit on corporate income taxes paid a "foreign government owning minerals extracted by U.S. taxpayers," providing such taxes were calculated on the same basis as U.S. taxes, and royalty payments were "calculated separately and independently," and *were* imposed.

Remitting Foreign Exchange—Because of Indonesia's strict control of foreign exchange, it may be advisable to finance the foreign affiliate in Indonesia through loans instead of direct equity investment, both in order to take full advantage of the Bank of Indonesia guaranties offered in some contracts, and because financing in this way also allows for payments on interest and principal to be remitted before allocation of profits or shares. "Production-sharing" prior to 1974 provided for a fixed allocation of a maximum of 40 percent of annual production to cover "costs." Since we have only recently obtained a copy of a hard minerals contract, it is not clear how "contracts of work" in the hard minerals sector handle this situation. In any event, international practice allows for remission of payments on indebtedness, though a problem may arise with remission beyond the

fixed capital deposits the Indonesian government requires to be retained in the national bank.

Indonesianization—The Indonesian government declares that along with training and employment of local personnel for management and skilled labor positions, local supply and equity sharing are announced goals. Desirable as this may be as national policy, the cost of goods, services, and equity obtained in this fashion should not exceed the costs when imported. This, too, should be a subject of on-going "renegotiation."

Dispute Settlement—Since the contractor is obliged to form a corporation under the laws of Indonesia, Indonesian law presumably governs the relationship. On the other hand, the contracts clearly intend disputes to be settled by arbitration. The studies of the experts indicate, however, that "renegotiation" should also be considered a constant feature of "Third World" contracts. The final lesson to be drawn from their analysis seems to be that it is "bargaining power" in the world market and mutual desirability of the arrangement which binds the contracts of the multinational corporations and sovereign states. This reasoning also leads to the conclusion that here is the softly spoken answer of the experts to the question of why the choice of the "contract of work" model for the "third generation" of hard minerals contracts.

That these contracts and the negotiations surrounding them have achieved a place as "law of the parties" outside "the law" is a perception based upon how they have functioned over the course of development of a series of agreements. But nothing seems to state the need for law of this kind better than the rejoinder of one of the experts to the comment cited above (in I.C. at n.5) that the "values and purposes of legal order" do not have shared meaning to both parties:

> Indonesia . . . has been engaged in a struggle . . . to create both a ruling elite and an ideological consensus. Under these circumstances, how much meaning can law have as a set of rules to which all must submit? . . . there has not as yet been sufficient agreement on principles for a system of law to be devised which is acceptable to all.
>
> . . . the response of judges, prosecutors, and police to basic institutional issues was not extraordinarily crass or cynical. . . . those issues which would now rightly be considered as fundamental in our own society were not usually perceived as such by those involved in the process of institutional change in Indonesia.
>
> . . . fundamental issues of law are also fundamental issues of politics, and here there is no reason to assume that the experience of Europe and America is especially useful elsewhere.[17]

The present writer may be optimistic about the formation and growth of contract law in China and Indonesia. Not because these countries are learning new techniques of "improving the[ir] bargaining position" by learning to impose their laws where in the past they have "need[ed] some

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[17]Daniel Lev, *Rejoinder*, 7 COMP. ST. IN SOC. & HIST. 202 (1965).

help in dealing with the foreign firm." And certainly not because the writer has any illusions about the interests which giant corporations pursue in contract negotiation.

Optimism, if any, for contract as a "law of the parties" is based rather on the conviction that whatever else it may mean "law" is constraint on the use of power. There may not be the regularity that Western businessmen look for in the contracts where all terms and conditions of performance and construction must be negotiated, where disputes must go to arbitration or conciliation, and the basic terms themselves are still subject to periodic renegotiation. But the security that the participants are at least parties to terms of their own making is already inducement for firms far less powerful than the great multinationals to try their hand.

If "law" springs from constraint on power as well as the exercise of it, there is time for still others to recognize that "law" of this kind is too attractive to be kept solely for the advantage of foreign corporations.

Appendix

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