

**IN THE MATTER OF AN ARBITRATION
UNDER THE RULES OF ARBITRATION OF THE
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES, THE
CENTRAL AMERICA – UNITED STATES – DOMINICAN REPUBLIC FREE TRADE
AGREEMENT AND THE FOREIGN INVESTMENT LAW OF EL SALVADOR**

PAC RIM CAYMAN LLC,)	
)	
Claimant,)	
)	
v.)	ICSID Case No. ARB/09/12
)	
REPUBLIC OF EL SALVADOR,)	
)	
Respondent)	
)	

WITNESS STATEMENT OF STEVEN K. KRAUSE

1. My name is Steven K. Krause. I currently serve, on a part-time, contract basis, as the Chief Financial Officer (“CFO”) for Pacific Rim Mining Corp. In that capacity, my duties include overseeing the consolidated financial statements of Pacific Rim Mining Corp. and its subsidiaries (the “Pacific Rim Companies” or the “Companies”). I have full access to the books and records of Pacific Rim Mining Corp. and I am responsible for ensuring that the Pacific Rim Companies comply with all regulatory and tax filings in the various jurisdictions where such filings are required of them.

2. I submit this Witness Statement in support of Claimant’s Counter Memorial in opposition to the Objections to Jurisdictions submitted by the Government of El Salvador (“El Salvador” or “the Government”). I understand that those objections have made been in the context of an arbitration that has been brought at the International Centre for Settlement of

Investment Disputes (“ICSID”) under both the Central America – United States – Dominican Republic – Free Trade Agreement (“CAFTA”) and the Investment Law of El Salvador.

3. The purpose of this Witness Statement is to explain my understanding, as CFO, of how the Companies are managed, financed, and structured, and why the overall corporate structure of the Companies has changed several times over the past few years. I will state at the outset that I worked for the Companies from 1998 to 2002, and then from October 2008 to the present, so I was not present at the Companies for several of the changes in corporate structure that I will discuss in my Witness Statement. However, with respect to these restructurings, I have reviewed the Companies’ books and records. I have also discussed the restructurings with Mr. Thomas C. Shrake, the President and CEO of the Companies, and with also with KPMG LLP, which advised the Companies on the restructuring that took place at the end of 2007. Given my intimate understanding of the Companies’ business and finances, and my accounting work for numerous other mining companies in the same time frame, I am confident that I understand the reasons for the restructurings and can explain them to the Tribunal.

4. I will also state at the outset that during my time at the Companies from 1998 to 2002, and from October 2008 to the present, the Companies were always managed primarily by our CEO, Mr. Shrake, from his offices in Reno, Nevada. In particular, Mr. Shrake has principally made the Companies’ decisions about where to undertake exploration activities and how those activities would be managed. Moreover, the Companies’ investments in El Salvador have been significantly funded from the Companies’ mining operations in Nevada, as well as from the equity investments of the shareholders in Pacific Rim Mining Corp. I understand that a majority of the shareholders of Pacific Rim Mining Corp. reside in the United States. From 2002 forward, Pacific Rim Mining Corp. has been listed on both U.S. and Canadian stock exchanges.

From 2002 forward, the Companies have filed consolidated financial statements in both the United States and Canada.

5. In the remainder of this Witness Statement, I will first provide an overview of my personal and professional background. I will then explain how the Companies have been managed, financed, and structured dating back to 1998.

I. BACKGROUND

6. I am currently a partner and director of Avisar Chartered Accountants (“Avisar”), a firm of chartered accountants, located in Langley, British Columbia, Canada. I am a Chartered Accountant in British Columbia, Canada. I also obtained a Certified Public Accountant designation in the State of Illinois, U.S.A. I am a Canadian citizen and currently reside in Langley, Canada.

7. In addition to various accounting services I perform for clients of Avisar, I currently serve as CFO, on a part-time, contract basis, for three publicly traded mining companies whose focus has been on assets in Latin America: Bear Creek Mining Corporation (a position I have held since 2003); Rio Cristal Zinc Corp. (a position I have held since 2007); and Pacific Rim Mining Corp. (a position I have held since December 2008). I also serve on the Board of Directors for Luna Gold Company, a publicly traded mining company with operations in Brazil, since 2009.

8. I received my Bachelor’s Degree in Business Administration from Trinity Western University in British Columbia in 1993. After graduation, I worked for various accounting firms, including a firm that merged with PricewaterhouseCoopers. In 1998, I started

my own company, Steven Krause, Inc., and worked on a contract basis as Controller for several companies, including Pacific Rim Mining Corp. from 1998 to 2002. In this capacity I received stock options in Pacific Rim Mining Corp. during that period.

9. After the merger between Pacific Rim Mining Corp. and Dayton Mining Corp. (“Dayton”) in 2002, Mr. John Norman, who had been the Controller for Dayton, became CFO of the merged entity. Accordingly, from 2003 to 2008, I did not work for Pacific Rim Mining Corp. Upon my departure from the Companies, I sold my stock options. However, during that time frame, I generally followed the Companies, and continued to work with Ms. Catherine McLeod-Seltzer, the Chairman of the Board of Pacific Rim Mining Corp, in connection with Bear Creek Mining Corporation, where Ms. McLeod-Seltzer has served as Chairman of the Board since 2000.

10. In January 2004, my previous company, Steven Krause, Inc., merged with another firm, Tonelli & Associates, to form Avisar.

11. In April 2006, Ms. April Hashimoto replaced Mr. John Norman as CFO of Pacific Rim Mining Corp. However, at the end of 2008, the Pacific Rim Companies were reducing their workforce, and Ms. Hashimoto was one of the employees who was laid off. To save costs, Pacific Rim Mining Corp. asked me to act as part-time CFO beginning in December 2008. Avisar is compensated for my work for the Pacific Rim Companies with a monthly fee and I am also personally compensated with stock options in Pacific Rim Mining Corp. I have continuously owned stock in Pacific Rim Mining Corp. since September 2008.

II. THE MANAGEMENT, FINANCING, AND STRUCTURE OF THE COMPANIES

A. Prior to the 2002 Dayton Merger

12. The current management of the Pacific Rim Companies essentially dates back to 1997, when Ms. McLeod-Seltzer (currently the Chairman of Pacific Rim Mining Corp.) hired Mr. Shrake to be the CEO of Pacific Rim Mining Corp. Mr. Shrake currently serves as the President and CEO of Pacific Rim Mining Corp.

13. Upon starting work as CEO in 1997, Mr. Shrake set up offices in Reno, Nevada, from where he has always led the Companies. Shortly after Mr. Shrake's arrival, the Companies established Pacific Rim Exploration Inc. ("Pac Rim Exploration") as a Nevada corporation (which was originally called Andes Exploration Inc.). Pac Rim Exploration has always served as the exploration arm of the Companies and pays or contributes to the salaries and benefits of the Companies' senior geologists, including Mr. Shrake. Also in that time frame, the Companies established several Cayman Islands holding companies – including Pac Rim Cayman, the claimant in the arbitration – to hold the Companies' foreign subsidiaries. The Companies' purpose in using Cayman Islands holding companies as intermediate subsidiaries at that time was to create potential tax savings upon the potential sale of a mining project.

14. From the outset, the administrative functions of the Companies (*e.g.*, the accounting, marketing and similar functions) were handled by Pacific Rim Mining Corp. in its office in Vancouver. However, all of these functions reported to Mr. Shrake in Reno. When I served as Controller of Pacific Rim Mining Corp. from 1998 to 2002, I reported to Mr. Shrake. In addition, the Companies' mining activities, including the decisions about where and how to

explore for and mine mineral deposits, were made by Mr. Shrake and his team of exploration geologists in Reno.

15. From 1997 to 2002 (prior to the Dayton merger), the Companies had operations and subsidiaries in Argentina, Mexico, and Peru. Again, the subsidiaries in Argentina, Mexico, and Peru were held through subsidiaries in the Cayman Islands. In this time frame, the Companies were financed principally from the equity investments of its investors.

B. The 2002 Merger and Afterwards

16. In 2001-2002, Mr. Shrake led the Companies' merger with Dayton Mining Corporation, a publicly traded Canadian company, along with its various subsidiaries (collectively, "Dayton"). The main purpose of the merger with Dayton was to acquire Dayton's assets in El Salvador, in particular, the El Dorado site, which Mr. Shrake had determined to be extremely promising from a variety of perspectives, including its potential to be mined in an environmentally clean manner, which was (and remains) a major priority of the Companies.

1. Management

17. In terms of the Companies' overall management, little changed following the merger. Mr. Shrake remained CEO of the Companies and continued to manage them from Reno. The administrative or "back office" functions continued to be carried out largely by Pacific Rim Mining Corp. in Vancouver, although the Vancouver employees report to Mr. Shrake in Reno.

18. Pac Rim Exploration in Nevada continued to pay Mr. Shrake's salary and benefits. It also paid for or contributed to the salary and benefits of a number of other senior

geologists and engineers who worked in El Salvador, including: Mr. William Gehlen, who currently serves as the Chief Executive of the Companies' subsidiaries in El Salvador; Mr. Frederick Earnest, who served as the President of the Companies' subsidiaries in El Salvador from 2002 to 2006; Mr. David Ernst, who currently is the Chief Geologist for Pacific Rim Mining Corp. and Pac Rim Exploration, and who spent substantial time doing exploration work in El Salvador; and Mr. Scott Wood, a metallurgist and safety officer who worked for the Companies, principally in El Salvador, from 2005 to 2009.

2. Financing the Project in El Salvador

19. As a result of the merger, the Companies owned mining assets in several jurisdictions, the most important of which were in El Salvador, the United States, and Chile. Following the merger, the primary and collective focus of the Companies was on El Salvador. The Companies' public filings, including its Annual Reports, explicitly say so from 2002 forward.

20. The assets in the United States and Chile were used to generate cash that the Companies invested in El Salvador. Of these respective assets, the assets in the United States were far more significant, as I discuss further below. In addition, as discussed further below, most of the money invested by the Companies in El Salvador was through Pac Rim Cayman.

21. The U.S. assets acquired in the 2002 merger consisted of Dayton Mining (U.S.) Inc., a Nevada corporation that had been a Dayton subsidiary prior to the merger, and its 49% of a Nevada mining joint venture called Denton-Rawhide.

22. From 2001 forward, Dayton Mining (U.S.) Inc. generated approximately US\$22.164 million in net cash flow (*i.e.*, after payment of taxes and administrative costs that it paid to the joint venture), all of which was invested into the advancement of the Companies' El Salvador projects. In 2008, Dayton Mining (U.S.) Inc. sold its interest in Denton-Rawhide for US\$3.1 million. These funds were invested in El Salvador, and are included in the net cash flow calculation above. Based on my review of the Companies' books and records, most of these monies flowed from Dayton Mining (U.S.) Inc. to Pacific Rim Mining Corp.; then from Pacific Rim Mining Corp. to Pac Rim Cayman; and then from Pac Rim Cayman to the Salvadoran subsidiaries. Some monies were transferred from Dayton Mining (U.S.) Inc. directly to Pac Rim Exploration, which used the monies to pay firms and vendors who were working on the El Salvador project, most of which were also located in the United States.

23. Similarly, in 2005, the Companies sold their assets in Chile (the Andacollo Gold Mine) for approximately US\$5.4 million. The Companies also invested these monies in El Salvador through Pac Rim Cayman.

24. The other major source of financing for El Salvador came from the equity investments of shareholders in Pacific Rim Mining Corp. As stated above, a majority of the shares in Pacific Rim Mining Corp. are held by U.S. shareholders.

3. Restructurings

25. Following the 2002 merger, the Pacific Rim Companies had a new and complex corporate structure that did not make much business sense in several respects. For example, immediately following the merger, the Companies' foreign subsidiaries were held by a variety of different holding companies incorporated in different jurisdictions with different tax regimes and

different tax consequences. It also held companies in jurisdictions where it had no activities. The corporate structure that resulted from the 2002 merger underwent several changes over the next few years, for various reasons.

26. On 30 November 2004, ownership of Pacific Rim El Salvador, S.A. de C.V. (“PRES”) – which held the Companies’ ownership interest in the El Dorado site in El Salvador (which was believed to be the Companies’ most important asset) – was transferred from the Canadian company that had held it prior to the merger (a British Columbia company called 449200 B.C. Ltd.) to Pac Rim Cayman. This was plainly done for tax planning reasons. The Companies’ books and records show that as of 2005, US\$5,792,800 in investments made by the Companies prior to this restructuring had been reassigned to Pac Rim Cayman.¹

27. From 30 November 2004, all of the Companies’ direct investments of financial capital in El Salvador were made through Pac Rim Cayman.² When the Companies established another El Salvadoran subsidiary, Dorado Exploraciones S.A. de C.V. (“DOREX”) in 2005, they established DOREX as a direct subsidiary of Pac Rim Cayman. All of the Companies direct financial capital payments to DOREX were also made through Pac Rim Cayman.

28. In 2005, the Companies underwent another restructuring when they sold their interest in the Andacollo Gold Mine in Chile. The Companies effectuated that sale by selling another Cayman Islands holding company (DMC Cayman Inc.), which in turn owned another Cayman Islands holding company (Andacollo Gold Inc.), which in turn owned one of the

¹ See Pacific Rim Mining Corp., Unconsolidated financial statements (**C-PROTECTED-1**).

² See *id.*

Companies' Chilean subsidiaries (Compañía Minería Dayton), which in turn owned the Companies' interest in the Andacollo Gold Mine. Thus, after the sale of DMC Cayman Inc. in 2005, all of these entities disappeared from the corporate organizational chart.

29. In 2007, the Companies were looking for ways to save money. As reported in the Companies' 2007 Annual Report, for the fiscal year ended 30 April 2007, the Companies recorded a loss of US\$9.4 million, as compared to a loss of US\$600,000 for the fiscal year ended 30 April 2006.³ The dramatic increase in losses arose mainly from an increase in exploration being undertaken in El Salvador in 2007, combined with less cash flow being generated by Denton-Rawhide and other investments of the Companies.⁴ Accordingly, the Companies were looking for ways to cut costs wherever possible.

30. One way to save costs was to deactivate subsidiaries in jurisdictions where the Companies had not done business for some time, but still paid various fees and costs – and devoted administrative time – in order to maintain the subsidiaries in good standing. In particular, the Companies had maintained subsidiaries in Mexico (Minería Pacific Rim) and Peru (Exploradora Pacific Rim Peru), even though the Companies had not done any work in Mexico or Peru for some time. The Companies owned the Mexican and Peruvian subsidiaries through a Cayman Islands subsidiary called Pacific Rim Caribe. To save costs, the Companies decided to dissolve all three of these corporations.

³ Pacific Rim Mining Corp. – 2007 Annual Report at 5 (C- 32).

⁴ *See id.*

31. This led to an examination of the overall corporate structure of the Companies, including the holding of the Salvadoran subsidiaries through a Cayman Islands subsidiary. There were administrative costs involved in maintaining Pac Rim Cayman as a Cayman Islands entity. But at the same time, it was determined that since the Companies' intention was to build a mine at the El Dorado property, there were no tax benefits to be derived from maintaining the Salvadoran subsidiaries through a Cayman Islands subsidiary. To maintain an entity managed in Nevada as a corporation of the Cayman Islands – when it was costly to do so, and when the tax benefits of Nevada appeared to be the same – made no sense. Finally, Mr. Shrake believed that, if a dispute with El Salvador ever arose under CAFTA, it would be preferable and far more efficient to bring it through a single U.S. entity. Based on my experience with other mining companies, I can say that many companies consider tax benefits, administrative costs, as well as investment treaty protections, in establishing or reorganizing their corporate structure.

32. For tax reasons, it was decided to domesticate Pac Rim Cayman to Nevada (rather than, for example, to transfer ownership in the Salvadoran entities to one of the pre-existing Nevada subsidiaries, such as Pac Rim Exploration or Dayton Mining (U.S.) Inc.), because such domestication would not be seen as a taxable event in the United States or Canada. Thus, in December 2007, the Board of Directors of Pacific Rim Mining Corp. resolved to domesticate Pac Rim Cayman to Nevada, where it became a limited liability company under Nevada law, and where it also became the direct parent company of Pac Rim Exploration. In addition, the Board

of Directors resolved to dissolve Pacific Rim Caribe, Minería Pacífica, S.A., and Explorada Pacific Rim Peru S.A.C.⁵

33. Because I did not join the Companies until December 2008, when Pac Rim Cayman filed its Notice of Intent to bring arbitration under CAFTA, I am not in a good position to offer testimony on when a dispute under CAFTA arose between the Companies and El Salvador, which I understand is an issue of contention in the instant objections. I will note, however, that the Companies continued to invest substantial monies in exploration activities well into 2008. The monies that the Companies invested in El Salvador through Pac Rim Cayman actually increased in each of the fiscal years 2006, 2007, and 2008.⁶ The Companies only began to slow down exploration activities and to lay off employees in El Salvador in July 2008, after President Saca had been reported as stating that El Salvador would grant no further mining permits. I will also note that it was only after those reported statements that the share price of Pacific Rim Mining Corp. began to fall dramatically – from approximately US\$1.22 per share in March 2008 to under \$0.30 per share by July 2008. By the end of 2008, the share price fell to under \$0.20 per share. The share price has never recovered and remains below \$0.20 per share currently.

⁵ Consent Resolution of the Directors of Pacific Rim Mining Corp. (4 Dec. 2007) (C- 58).

⁶ See Pacific Rim Mining Corp., Unconsolidated financial statements (**C-PROTECTED-1**).

Being in full agreement with the statements contained in this document, I hereby sign it
and acknowledge its contents on this 31 day of December 2010.



Steven K. Krause