



Understanding Royalty Structures

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UNDERSTANDING ROYALTY STRUCTURES

INTRODUCTION: THE ROYALTY VALUATION THEOREM

Before examining the different types of royalty in detail, it may be useful to consider the dynamic which influences all royalty agreement negotiations, and all subsequent disputes and litigation between the operator and recipient. This is described by Professor David Keith in “The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs”, *Energy Law & Minerals Institute*, Vol 23 (not yet published) as the “royalty value theorem”. The royalty value theorem states:

When compensation under a contract is based upon a set percentage of the value of something, there will be a tendency by each party to either minimize or maximize the value.”

The significant variation in definition that is possible within each category of royalty results from, or is perhaps proof of, this theorem. Put another way, every royalty can be expressed as $x\%$ ($a - b$) where “a” is the aggregate of what shall be included in calculating the royalty and “b” is the aggregate of all deductions in calculating the royalty, and the theorem compels the operator to minimize “a” and maximize “b” and, of course, the royalty holder to maximize “a” and minimize “b”.

Professor Pierce (writing in the oil and gas context and making the assumption that the negotiated royalty is $1/8^{\text{th}}$, for illustrative purposes) explains the effect of the theorem as follows:

[L]essors will pursue courses of action designed to obtain $1/8^{\text{th}}$ of $X+$ instead of $1/8^{\text{th}}$ of X . Because any additional royalty paid to the lessor will come out of the lessee’s interest, the lessee will object to paying royalty on $X+$ instead of X , unless required by the terms of the oil and gas lease. The royalty-based lease relationship, by its very nature, is the classic *uncooperative* venture where each response to changed circumstances crates a new opportunity to purse royalty value theorem strategies.

TYPES OF ROYALTIES

There are two major types of royalties in use in the North American mining industry today. They are the net smelter returns royalty and the net profits interest royalty. A third type of royalty, the gross overriding royalty, is sometimes used in relation to diamonds and thus is becoming better known outside the oil and gas industry, where it had its origins.

There is a range of opinion as to whether the meaning of any of these terms is sufficiently certain to make them useful.

L.E. Talbot observed in “Royalty Provisions: Issues for the ‘90’s” in *The Mining Industry: Meeting the Challenges of the Decade* (Mississauga, Ontario: Insight Press, 1992) that:

Although mention is often made in the industry of a “standard” form of royalty, there is, in reality, no such animal. At most, it can be said that there are a number of generic types of royalties with each generic type having the same general characteristics. A sure way to invite

costly litigation is to sign an agreement agreeing to pay or receive a “standard net smelter return royalty” or “net profits interest”, or to retain a “carried interest” without further elaboration and definition.

This warning is reiterated by Barry Barton in *Canadian Law of Mining* (Calgary, Alberta: Canadian Institute of Resources Law, 1993 at 460-461) and again by Karl Harries in “Mining Royalty Agreements between Private Parties: the Relationship between Payor and Recipient” in *Mining Royalty Agreements* (Journal of Energy & Natural Resources, 1996, Vol 14 No 3 at 356), although the latter went even further, saying:

However, issue must be taken even with this broad statement. Talbot’s comment “that there are a number of generic types or royalties with each type having the same general characteristics” is open to serious dispute. Consider, for example, the “net profit royalty”, which one would expect to have an accepted meaning and to be tantamount to a generic royalty. In Canada, this term appears with: definitions for “revenues” based upon all revenues derived from a project regardless of source to those based upon revenues generated only from the sale of product; recoupment extending to all expenditures made by the payor (often including expenditures made to acquire the property) or to only limited expenditures ... [with even more examples being given].”

Mr. Harries’ objection is perhaps in the nature of a quibble since the terms “net smelter returns” and “net profits interest” and, perhaps, “gross overriding royalty” are useful at least to identify types or categories of royalties, with significant variation possible within each category. The fact that each category allows for variation means the terms can only be used as a kind of shorthand and, in formal legal documentation, they will need careful definition.

The Gross Overriding Royalty

The legal calculus of royalties becomes more complex as one moves from the gross overriding royalty through the net smelter returns royalty to the net profits interest royalty. A logical starting point is thus the gross overriding royalty (“GORR”).

The GORR has its beginnings in the oil and gas industry, where it is known more simply as an overriding royalty. It has been standardized in the CAPL (Canadian Association of Petroleum Landmen) Overriding Royalty Procedure 1997.

The GORR is sometimes used in connection with diamond mining but not in relation to precious or base metal mining. Production royalties on gravel and other quarrying operations, which are based strictly on quantity produced without deduction of costs, are a variation on the theme.

Since there is not a great deal of shared or common experience with the GORR in the hardrock mining context, it would probably be incorrect to suggest that a standard or widely-accepted definition of it exists.

What might be more appropriate is to see how it is defined in the oil and gas context, from whence it comes, and how it can then be adapted for use in the hardrock mining context.

In the CAPL Overriding Royalty Procedure, the royalty owner is entitled to a share of the market price of petroleum substances as at the time they are available to be taken in kind less any costs incurred by the operator to bring the petroleum substances to the point of sale. These deductions therefore include costs of making the substances merchantable and delivering them to market.

In oil and gas royalty agreements which do not deal adequately with the deductibility of costs, disputes will arise as to whether down-stream marketing costs can or cannot be deducted in calculating the royalty. The operator will maintain that the costs are deductible, since they must be incurred to create the market value on which the royalty is based. The royalty owner will dispute this, arguing that the operator has an implied duty to market the product to maximize the royalty owner's interest and must bear the expense of discharging that obligation. As Professor Pierce notes in "Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market" (48 Rocky Mtn. Min. L. Inst.) there is conflicting authority in the United States as to the existence and nature of this covenant; and there is little if any authority in Canada.

These principles are readily adaptable to certain types of hardrock mines, but not all. A gross overriding royalty can be created on a mine which produces a product like petroleum in that it can be sold without alteration of its basic character. Thus, a gross overriding royalty could be created on a mine that produces coal or gravel or, perhaps less obviously, rough diamonds (less obviously because the cost of removing the diamonds from kimberlite must be ignored). However, a gross overriding royalty loses its defining character and becomes something else, if created in relation to a mine whose product must undergo significant alteration before it is saleable. As illustration, a royalty on a gold mine is going to be based not on the value of the gold-bearing ore but rather on the value of the gold itself. The costs of smelting and refining the gold will reduce the proceeds to the mine owner, a percentage of which will be paid as royalty. However the deduction of these expenses alters the basic character of the royalty to such an extent that it requires a different name, which in this case is the net smelter returns royalty.

Net Smelter Returns Royalty

A Net Smelter Returns Royalty has been generically described as follows:

"A royalty calculated on the net smelter return is essentially calculated on the amount received by the mine or mill owner from the sale of the mineral product to the treatment plant that converts the output of the mill to marketable metal. From the gross proceeds received there may be deductions for costs incurred by the owner after the product leaves the mine property and before sale, such as the costs of: transportation, insurance or security, penalties, sampling and assaying, refining and smelting, and marketing. No deductions are made for the operating costs of the mine-mill complex." (B.J. Barton, *Canadian Law of Mining* (Calgary: Institute of Resources Law, 1993) at 461.)

Royalty on Net Profits

A royalty based on net profits, known as a net profits interest, has been generically described as follows:

“A net profits interest (also known as an NPI or, especially in the United states, a net proceeds royalty) is ... calculated as a percentage of the gross cash income from a mine-mill complex less all expenses incurred to produce the income.” (B.J. Barton, *Canadian Law of Mining* (Calgary: Institute of Resources Law, 1993) at 462.)

Typically the NPI does not become payable until the operator has recouped, from net profits, its capital investment in the project and all pre-production costs.

CHECKLIST FOR DRAFTING ROYALTY AGREEMENTS

Regardless of the type of royalty that has been selected, the royalty agreement should address the following matters:

The Parties

In this context, consideration should be given to the question of whether each party may assign the contract freely, or only with the other's consent. If the latter, must consent not be unreasonably withheld? If so, it should perhaps be deemed unreasonable for consent to be withheld by the royalty owner where the proposed assignee is a responsible mining company. Conversely, it should perhaps be deemed to be unreasonable for consent to be withheld by the operator where the proposed assignee is anyone other than another mining company.

The operator may want a right of first refusal on any proposed assignment of the royalty, to give it an opportunity to eliminate the royalty as a burden on the project. The royalty owner may wish a reciprocal right, but with less clear justification particularly if the royalty owner is not a mining company.

Where the royalty owner is an individual, consider whether the obligation to pay the royalty will survive his or her death.

The Property

The property to which the royalty applies must be defined with legal certainty, and it should be clear that it applies not just to mineral claims held by the operator when the royalty is granted but also to mining leases or other forms of mineral tenure that replace the claims when the property is taken to development. Karl Harries in “Mining Royalty Agreements between Private Parties: the Relationship between Payor and Recipient” (supra, at page 367) suggests that the royalty owner should require the operator to re-grant the royalty by a re-executed royalty agreement whenever new forms of tenure are acquired.

In jurisdictions where mineral claims expire after a set number of years unless taken to lease and the claim-holder is not permitted to restake them, it is not unknown for claim-holders to allow the claims to lapse but to arrange for a related company to restake them immediately. Such actions have given rise to litigation; see for example *Gerle Gold Ltd. v. Golden Rule Resources Ltd.* [1999] 2 F.C. 630 (T.D.). The royalty holder should be assured in the agreement that his or her royalty would not be lost as a result.

It is sometimes appropriate to include an “area of interest” clause. This would typically provide for the royalty to extend to production from any claims staked or acquired in the future by the operator and/or the royalty holder within a specified area. The specified area is then defined as the area within x kilometres of the outermost boundaries of the claims initially subject to the agreement. Without this temporal limitation, the area of interest has the potential to expand infinitely. The area of interest should be defined to include internal fractions, in jurisdictions where fractional claims are possible. Less typically, the area of interest clause might apply to any claims that are staked to follow mineralization discovered on the initial claims. Whether an area of interest clause should be included depends on the circumstances. If the royalty holder is a prospector whose work first attracted the operator to the area, he can make a case for participation in any future success that the operator has in the area. His case is much weaker if the operator was already active in the area and acquired property from the royalty owner to build a land position around an existing discovery.

Grant of Royalty

If the royalty is to be an interest in land (discussed in detail below), there should be a grant or reservation of an interest in the minerals to make it apparent that the royalty owner is entitled to more than a share of the proceeds of sale less defined deductions. It should be stated expressly that the royalty is intended to be an interest in land. The royalty owner should be given rights under the agreement consistent with his or her position as an “owner”, such as, for example, the right to withhold consent to the abandonment of the property.

If the royalty is an interest in land, and particularly where the royalty owner seeks involvement in the operations or decisions of the operator to protect that interest, the royalty owner may become exposed to liability as an owner or operator, including for damage to the environment, and may also find that contractors and others dealing with the operator may require the royalty owner to become a party to such contracts. As an example, a contract for the construction of a mine may contain a provision limiting the contractor’s liability to its insurance coverage; if the royalty owner owns an interest in the land, the contractor may well require its agreement to this limitation.

Covenant to Pay

In this section the operator will agree to pay the royalty, defined as a percentage of net smelter returns, net profits or gross proceeds.

Calculation of the Royalty: Definitions of Key Terms

The key terms that will be used to calculate the royalty need to be defined with as much precision as possible. The cases of *Utah International Inc. v. Milbourne* and *Candelaria Industries Inc. v. Occidental Petroleum Corporation* referred to later in this paper provide object lessons in the importance of this.

i) Net Profits Interest

A typical Net Profits Interest royalty will require the operator to establish a Royalty Account comprised of Pre-production Expenditures, Operating Losses, Capital Expenditures and Interest Charges. The operator will calculate Net Profits and apply them to reduce the Royalty Account. While there is a debit balance in the Royalty Account, the operator retains all Net Profits. Whenever

the Royalty Account shows a credit balance, a percentage of the Net Profits are paid to the royalty owner.

“Net Profits” will be defined as Revenue less Operating Expenses.

“Revenue” can be calculated in terms of the revenue from sales or the money received from sales or the value of the minerals sold. If the value of the minerals is used, reference will be made to the spot price or an average weekly or monthly spot price on specified markets. Insurance proceeds may be included in Revenue unless they are used to rebuild or replace mine assets. Proceeds from the sale of mine assets should also be included if the cost of those assets was previously debited to the Royalty Account.

“Operating Expenses” will mean direct costs of commercial operations categorized as such under Canadian GAAP and taxes, specifically excluding income taxes and depreciation, depletion and amortization. Query whether interest on an operating line of credit should be deducted.

“Interest Charges” will either consist of the operator’s cost of borrowing money used to develop and construct the mine or it will consist of all that plus imputed interest at a defined rate on funds from other sources used to develop and construct the mine.

The more detail in which these terms can be defined, the less likely the operator can manipulate the calculation to its benefit with potential for dispute. As an example, where the operator is a major mining company “Operating Expenses” should deal expressly with its entitlement to deduct head office overhead. Where the operator is a junior mining company, “Operating Expenses” should deal expressly with its entitlement to deduct promotional expenses such as the cost of visits to the property by stock analysts.

ii) Net Smelter Returns

Typically a Net Smelter Returns royalty will be defined in terms of a percentage of the Net Value of minerals from the property, where “Net Value” is “Gross Value” less certain permitted expenses. “Gross Value” will usually be defined with reference to the spot price or an average weekly or monthly spot price on specified markets for the commodity.

The permitted deductions will include all charges by the smelter, such as smelting and refining charge as well as penalties for impurities in the ore, and the cost of transportation to the smelter and insurance. In some cases deductions may also be made for taxes except income taxes and, depending on the nature of the commodity, for marketing costs.

If the operator ships to its own smelter, charges should not exceed those that would be charged by an arm’s length smelter in similar circumstances.

Time and Manner of Payments

This section will prescribe the frequency and manner in which payments are to be made and the contents of the detailed statement that should accompany each payment showing how it was calculated. Interest should be charged on late payments.

Provision might be made for advance payments, particularly if the royalty is an NPI which may not otherwise become payable for many years, after the operator has recouped capital costs and pre-production expenditures with interest. An issue will arise as to whether the interest charge applies to advance payments. Minimum payments might also be required, after the royalty payment stream has begun.

In relation to precious metal mines, the agreement might provide for the royalty owner to have the right to take payment in kind. The royalty owner will have the right to elect to take payment in cash or in kind, by giving notice to the operator not less than a specified number of days before payment is due. The royalty owner will want the notice period to be short, so as to keep his or her options open as long as possible. The quantity of gold or silver deliverable to the royalty owner will be determined using the spot price in effect on the day on which the royalty is calculated. The owners of diamond mine royalties often want the right to payment in kind, but this is not easily accommodated by the operator, as noted below.

Buy-out; Cap

The operator will be interested in capping the royalty at a fixed amount (which might increase with the cost of living) and in having the right to buy the royalty out or at least to purchase a reduction in the rate at which it is paid. The rationale for this in relation to an NPI will be that it is reasonable to place some limit on the leverage that can result from changes in commodity prices. The rationale in relation to an NSR will be that, since it is payable whether or not the mine is profitable, it is reasonable for the operator to want to discharge the burden of the royalty at some point.

Security Interest

If the royalty is not an interest in land, then it is a contractual right only to payment of money. As such, if it is not secured, it is vulnerable in the event of the operator's insolvency or bankruptcy or in the event the operator sells the property to a purchaser who does not assume the royalty obligation. The royalty owner may therefore wish to take security over the mine to which the royalty applies or over all of the operator's assets including that mine.

In some jurisdictions, such as British Columbia, recorded mineral claims are not land and so charges against them cannot be registered in the land title office; nor are they personal property under personal property security legislation (having been specifically excluded by definition) and so security granted in them cannot be perfected in the personal property registry. To complicate the situation further, mining leases, which will ultimately replace the operator's mineral claims when the property is taken to development, are treated as personal property under personal property security legislation. Thus considerable care must be taken in drafting the security documentation.

The solution to the British Columbia problem is to take a specific charge over the mineral claims and register it in the office of the gold commissioner (mining recorder) and a security interest over after-acquired mining leases and file a financing statement in the personal property registry.

Representations and Warranties

Each party will give to the other the usual warranties dealing with its corporate status and the enforceability of the agreement.

One of the parties will also give to the other representations and warranties dealing with the underlying property.

Where the royalty is reserved to the prospector or other person vending mineral claims to the operator, these representations and warranties will be given by the royalty owner to the operator and will be fairly modest in scope. Their purpose will be to establish the status and validity of the claims; the royalty owner's title to them; and compliance by past operators with laws, regulations and permits including environmental protection legislation.

Where the royalty is created and sold by the operator to raise capital, the representations and warranties will be given by the operator to the royalty holder and may be quite extensive in order to assure the royalty owner that it is fully informed about the current status of the project and the requirements the operator will have to satisfy to commence production and payment of the royalty.

Term

The term of the agreement will be specified and, if it is in perpetuity, a provision dealing with the rule against perpetuities will be included.

Commingling

The royalty owner will be concerned that ore from the property to which the royalty applies may be commingled with lower-grade ore from the operator's neighbouring properties before sale, thereby exposing the royalty to relatively higher per-unit costs and making the calculation of the royalty difficult to verify.

The agreement will therefore either prohibit commingling outright, or stipulate that the operator must measure and sample the ore for moisture, metal and other appropriate content before commingling in accordance with a detailed procedure.

Hedging Transactions

Some operators engage heavily in commodity futures trading, option trading, metals trading, gold loans and other hedging transactions, particularly where the commodity can be sold on an exchange without marketing effort or expense. Others as a matter of corporate policy prefer to have unhedged exposure to rises (and falls) in the commodity markets for all of their production or at least for the portion of it not required to meet operating costs.

The operator will have to decide whether it is prepared to involve the royalty owner in the results of its hedging transactions and the royalty owner will have to decide whether it wants the involvement. The agreement should then make express provision one way or the other.

Usually the agreement provides that the operator may engage in hedging transactions but all resulting profits and losses are specifically excluded from the calculation of the royalty. Instead, the royalty is calculated using the spot price for the commodity on the day it is delivered or credited to the account of the operator by the smelter, refiner or other processor, purchaser or user of the minerals.

Books; Records; Inspections

Even if the royalty owner's position is that of a passive recipient of money, the operator should be required to keep true and accurate books and records of its activities and the royalty owner should have the right to inspect and audit them, to the extent they contain information relevant to the calculation of the royalty.

If the royalty owner is in a more assertive position, it may be entitled to unrestricted access to the operator's books and records, the right to detailed activity reports and the right to inspect the property and operations.

The royalty owner will be required to keep all information confidential, except as required to be disclosed by law or securities regulatory authorities. Press releases are sometimes made subject to prior approval.

Tailings

Waste rock today can be valuable ore tomorrow, if commodity prices rise or new recovery technologies are developed. It should be clear in the agreement that the royalty applies to tailings.

Stockpiling

The operator may wish to stockpile ore from the property at other locations. The agreement should then require the operator to obtain an agreement from the owner of that location in favour of the royalty owner in which the royalty owner's rights are recognized and the minerals are protected from third-party liens.

Maintenance of Property

The agreement might obligate the operator to maintain the property in good standing, to pay all taxes and to keep the property free from liens. The operator may be required to notify the royalty owner where it intends to abandon any part of the property. The operator might even be required to carry out at least the amount of work needed to advance the property toward specified milestones (such as preparation of a feasibility study).

On the other hand, the operator may consider that the royalty owner is entirely passive and must be content that the operator's self-interest will ensure that the best decisions for the project are made.

Insurance

The agreement might obligate the operator to arrange insurance against third-party claims, property loss and business interruption to ensure that the royalty owner does not suffer direct loss and that the operator is able to continue the operation of the mine for the royalty owner's benefit.

On the other hand, the operator may consider that the royalty owner is entitled only to a share of its profits or revenues, if any, and as such does not need or warrant such protection.

Conduct of Operations

The same theme continues here: if the royalty owner has the negotiating strength to obtain a royalty that is an interest in land and he or she is not averse to the risks that may entail, then there may be covenants by the operator to conduct all its activities in compliance with law; and depending on the status of the project, to develop the property only in accordance with an independently commissioned feasibility study or to adhere to its mine plan without departure, unless approved by the royalty owner. A royalty owner in a particularly strong negotiating position might even bargain for the right to approve the recommendations in the feasibility study or mine plan. A situation in which this could be quite beneficial for the royalty owner would be where the operator must decide between different processing methods, one of which involves lower production costs but a lower rate of recovery and the other of which involves higher production costs and a higher rate of recovery. If the royalty owner holds an NSR he may well prefer the latter method.

If, however, the royalty owner is in the position of a passive recipient of cash payments then it is unlikely that any provisions to this effect will be included.

Implied Covenants

Craig Haase and Peter Babin writing in the American context in “Mining Royalties from the Royalty Owner’s Perspective – Forming Symbiosis with the Operator”, 42 Rocky Mtn. Min. L. Inst. 21-1 state that:

... the royalty owner cannot assume that the operator will be burdened, as a matter of law, with any duties to develop the property, or to commence or continue mineral production, or to otherwise advance the interest of the royalty owner, or to furnish or disclose information to the mineral owner regarding the operator’s exploration, development, operations, or processing activities or plans for that particular property (or any other property), or to refrain from preferring development of other properties over development of the royalty owner’s property. Virtually the only generally imposed requirement that benefits a royalty owner, as a matter of law, is the duty of the operator to accurately account for production from the property that is subject to the royalty. If it is important to the royalty owner that the operator adhere to any of the other above-listed but not legally imposed duties, then it is incumbent upon the royalty owner to raise such matters, and to ensure that an acceptable statement of the agreed-upon duties is memorialized in the agreement.

While this prescription might be true in the Canadian context (which must be the subject of another paper) it is nonetheless fairly common in royalty agreements for operators to expressly disclaim any such implied covenants and to expressly deny the existence of any fiduciary relationship between royalty owner and operator.

The reason for this might be an instinctive fear that if it is possible to produce an encyclopaedic listing of implied covenants that do not exist, then maybe they really do exist. More likely, particularly in Canada, there may be a concern about where courts will go with the relatively new notion that contracts contain an implied duty of good faith. A large number of duties of good faith appear in statutes and in contracts but the judicial consideration of good faith has not been consistently applied. In some instances, courts have found an implied duty of good faith and while

such activism has been less than frequent it has been gaining momentum since the decision in *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1991), 106 N.S.R. (2d) 180 (N.S.S.C.).

Registration of Interest

Most jurisdictions have legislation that would permit the royalty owner to record its royalty on title to the mineral claims. If the royalty is not an interest in land, this will serve as notice to third parties of the existence of the royalty, but may not bind them legally.

Usual Boilerplate

A royalty agreement is like any other contract and as such should contain provisions dealing with governing law, time as of the essence, dispute resolution; etc. etc.

ADVANTAGES AND DISADVANTAGES OF DIFFERENT ROYALTIES

Each type of royalty creates different advantages and disadvantages for the royalty owner and the operator. There are circumstances in which a choice could be made between an NSR or an NPI, but not between a GORR and an NSR or NPI, and therefore it is useful only to compare and contrast the NSR and NPI.

In purely economic terms, the choice between an NSR or an NPI could be made by a coin toss if the factors that went into the calculation of both could be predicted with absolute certainty. The inclusions and deductions that go into the calculation of an NSR and an NPI on a particular ore body, and the timing of receipts and expenditures, can be modeled and rates assigned to each such that their present values are the same. The result of this sort of exercise is that typically the rate of an NSR would be in a range starting at 2% and the rate of an NPI would be in a range that might start around 10%.

Leverage

However, these predictions are only that and are inherently uncertain. An advantage which the NPI has over an NSR is that it provides much greater leverage, where there is an unpredicted price increase or cost decrease. As illustration, suppose a mine sells gold for \$370 per ounce; its cash costs are \$200 per ounce and its total production costs are \$300 per ounce. Very roughly, the holder of a 2% NSR would receive \$3.40 per ounce and the holder of a 10% NPI would receive \$7 per ounce. Predictions have been made¹ that the price of gold will increase to \$800 per ounce, which would be a 116% price increase. In our scenario the NSR holder then receives \$12 per ounce - a 252% increase - but the NPI holder receives \$50 per ounce - a 614% increase.

Operators sometimes try to restrict the benefit that this leverage gives the royalty owner by negotiating for a cap on the royalty or a rate which declines as the price of gold increases or a right to buy the royalty out for a fixed, agreed amount.

¹ By Rod McEwen, President, Goldcorp Inc. as reported by the National Post newspaper on January 30, 2003.

Timing of Payments

The holder of an NSR begins to receive payments as soon as mine product is shipped to the smelter, while the holder of an NPI must wait until the operator has recouped its pre-production expenditures and its capital investment. This exposes the NPI to the risk that recoupment will take longer than predicted. This could result from increased costs of borrowing, increased operating costs such as costs of labour, fuel or electricity, a fall in commodity prices and so on. To combat this, in negotiating the terms of an NPI, the royalty owner will often demand that advance royalty payments be made to him until the operator has achieved capital pay-back (perhaps with the payments beginning on commercial production) and that minimum payments be made to him thereafter.

Effect on Operator's Decision to Develop

The NSR represents a cost that the operator must bear even if the operation is not profitable, whereas the NPI ought to be a less painful burden in that the amount paid varies with the mine's profitability and is not payable at all unless and until the mine is profitable. A possible consequence of this is that the existence of an NSR may make a project economically unfeasible such that it is never developed.

Liquidity

There are fewer factors that go into the calculation of an NSR which are subject to change, with the result that its value can be estimated at any time with a greater degree of certainty than an NPI. This may give the NSR holder an advantage he or she would not have as the holder of an NPI, should a decision be made to sell the royalty.

Large or Small Administrative Burden

The royalty holder will be entitled to receive, and will normally have the right to audit, all the information needed to verify that the royalty has been calculated correctly. The holder of an NPI will have the right to all information needed to calculate the profit generated by the mine, while the NSR holder's claim to information will be quite limited. The NPI therefore represents a greater administrative burden than an NSR and also requires the disclosure of information which the operator might prefer to keep to itself.

Potential for "Manipulation" by the Operator

Because more factors go into the calculation of an NPI than an NSR, there has always been a general perception that the NPI is more susceptible to manipulation by the operator. As Haase and Babin note in "Mining Royalties from the Royalty Owner's Perspective – Forming Symbiosis with the Operator" (supra): "cynical observers have suggested that the "NPI royalty" should be more accurately described as the "no payment intended" royalty. Recent accounting scandals will have done nothing to reduce this apprehension.

Two examples may be offered to show that distrust of the NPI is not without some justification.

The first example is found in *Utah International Inc. v. Milbourne* (1977), 1 B.L.R. 223 (B.C.C.A). Here the royalty owner saw his expectation of profit disappear through the magic of compounding imputed interest. The head note provides the following account:

The defendant had explored certain mining properties and in January 1966 he entered into an agreement with the plaintiffs whereby they would develop the properties. The defendant was entitled to receive certain advances until the mine was put into production after which he was to receive 10 percent of the “net profits” until the plaintiffs had been repaid all their “pre-production expenses” out of the remaining 90 percent of such “net profits”. Thereafter the defendant was entitled to receive 25 percent. A disagreement arose as to whether the plaintiffs could claim for (i) interest on funds invested by them in the mine as a cost in the calculation of pre-production expenses and operating expenses and (ii) depreciation (including amortization) of pre-production expenses in the calculation of operating expenses. The agreement contained definitions of “pre-production expenses” and “operating expenses” which included a wide variety of direct and indirect costs but did not expressly include as a cost the interest claimed. On the first issue the trial Judge found that there was a cost to the plaintiffs attached to all moneys and that the word “cost” as used in the agreement was broad enough to cover interest actually borrowed by them or obtained in part from other funds generated by the plaintiffs. On the second issue the trial Judge found that on a construction of the agreement the plaintiffs were entitled to claim depreciation of pre-production expenses in the calculation of operating expenses (which were defined to be expenses incurred after commencement of production) even though the actual outlay for such pre-production expenses was made prior to commencement of production. The defendant appealed. [The appeal was dismissed.]

The second example is provided by the woeful experience of the royalty owner in *Candelaria Industries Inc. v. Occidental Petroleum Corporation*, 662 F.Supp.1002 (D.Nev. 1984), which served to cement a distrust for NPIs in the minds of many. Candelaria sold mining claims to Occidental, reserving a 10% NPI. Ten months before commercial production commenced, Occidental entered into contracts to sell silver forward. It did this because, at the time, silver prices were at record high levels and were not expected by Occidental to increase. Each of these contracts obligated Occidental to sell a specific quantity of silver on a specific date at a fixed price. In aggregate the quantity of silver to be delivered would have approximated the quantity which could be recovered from production from the mine over the period of the contracts. Soon after, and before production at the mine had commenced, the price of silver plummeted. In the result, Occidental could produce silver and sell it under the forward sales contracts at a price significantly higher than the prevailing market prices. This would have generated revenue to which Candelaria would have been partially entitled under its NPI. However, Occidental chose not to produce silver for delivery and sale under its forward sales contracts. Instead, it sold the forward sales contracts themselves for a profit of \$120 million. It then terminated production at the mine, since silver prices were so low. It paid Candelaria nothing. Candelaria sued and lost. It lost because, as the court found, according to the actual language of the contract, its NPI entitled it to a share of net profits from the sale of silver, but not to the sale of silver forward sales contracts. In coming to this conclusion, the court stated:

... the plaintiffs contend that the hedging transactions constituted a sale of minerals or other lawful use of the property thus triggering the net profits interest. We cannot agree with that contention.

Section 4 of the Agreement reserves ten percent of the gain from activities on the property. Both that language and the language in section 2 describing the activities subject to the plaintiffs' interest clearly imply that the net profits interest only attaches to minerals actually produced from the property. Furthermore, the formula used by the Agreement to determine the amount of net profits contemplates actual production. Net profits are computed by deducting from the costs of exploration, development, and production from the proceeds of sales of minerals produced from the property or any other sales of property upon which such costs have been incurred. Accordingly, the net profits interest is limited to profits realized through actual production of minerals from the property.

“Under well settled rules of contract construction a court has no power to create a new contract for the parties which they have not created or intended themselves.” *Old Axtec Mine, Inc. v. Brown*, 97 Nev. 49, 623 P.2d 981 (1981). We cannot rewrite the unambiguous terms of the Agreement.

Best of Both Worlds

Royalty owners sometimes try for the best of both worlds by negotiating for the right to switch from an NSR to an NPI, or vice versa, at rates which are agreed to be equivalent, as defined milestones are met (completion of feasibility study, permitting, commencement of construction, commencement of commercial production).

And the Winner Is:-

Clearly there is no pat answer as to which is more preferable, the NSR or the NPI, from either the perspective of the royalty owner or the operator.

The choice should be made on a case by case basis, taking into account the particular circumstances. As seen from the above, there are a multitude of factors which are relevant, with perhaps the most important being those on which an economic model for the ore-body would be based.

From the royalty holder's perspective, a relatively clear case for an NPI might be a situation in which the ore-body is large, high-grade and simple; interest rates are expected to decrease; commodity prices are expected to increase (and the operator does not hedge aggressively); labour conditions and fuel prices are stable; inflation is modest (or, at least, predictions are not for high inflation coupled with static commodity prices); no significant capital expenditure will be required after initial construction; and the operator has the financial capability and technical expertise to develop the mine quickly and operate it efficiently.

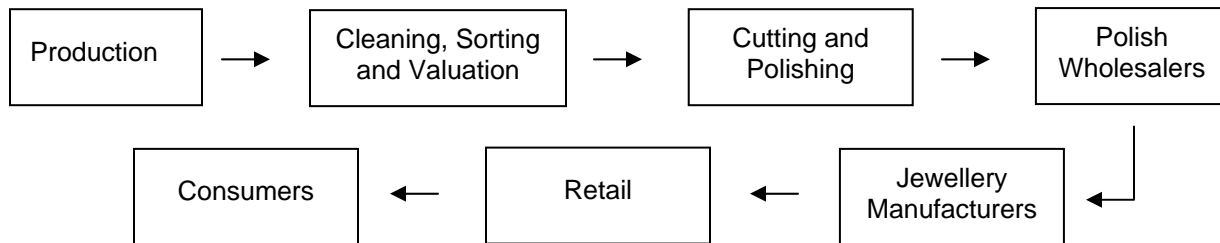
On the other hand, the royalty owner might more clearly prefer an NSR where these factors are reversed.

If, however, only some of these factors were reversed (suppose the ore-body is complex, low-grade and small but all other factors remain the same) the royalty owner may well be unsure as to what is the better choice.

Since, in any given situation, different people will make different predictions, and since the best interests of the royalty owner and the operator do not always converge, both the NSR and NPI continue to enjoy popularity.

A NOTE ON DIAMOND ROYALTIES

Diamonds may take as long as two years to reach the ultimate consumer as they move through the “diamond pipeline”, which looks like this:



Rough diamonds are recovered from kimberlite ore at a processing plant. They are then cleaned and then sorted and valued into over 16,000 categories by shape, quality, color and size. They may then be sold to the Diamond Trading Company (DeBeers) or alternatively the operator may market them itself, independently of the DTC. The DTC markets approximately two-thirds of the supply of gem quality diamonds to approximately 120 customers or “sightholders”, who are diamond polishers and dealers or “diamantaires”. These sales take place in London, Lucerne and Johannesburg ten times per year. The diamonds are sold by the DTC in packets that contain strategic blends of diamonds with different values and characteristics. The diamantaires cut and polish the rough diamonds at the traditional diamond cutting centers in Antwerp, Mumbai, Tel Aviv, New York or Johannesburg and they are then sold in the 24 registered diamond bourses around the world.

Canadian diamonds are sorted and valued where they are mined, in the Northwest Territories. They cannot be removed from the mine until they have also been valued by a government valuator for purposes of the royalty payable under the Canada Mining Regulations. A secondary diamond industry is growing in Yellowknife, where some Canadian diamonds are cut and polished by businesses in which aboriginal groups participate.

Although a royalty on diamonds could theoretically be calculated at any point in the pipeline, so long as the operator still owns them, there is logic to determining the royalty at the time of the government valuation.

Royalty owners may negotiate for the right to take the royalty in kind. This is not necessarily in the royalty owner’s economic interest, for two reasons: the royalty owner must market and sell the diamonds himself, without the market access and expertise that the operator has; and the operator may be able to obtain a higher value for lower quality stones by packeting them with higher quality stones prior to sale. Taking in kind also raises administrative and logistical issues. For example, will the royalty owner be given one high-quality stone or ten low-quality stones with the same aggregate value and what procedure will be established to satisfy the royalty owner that he or she is being treated fairly?

ROYALTIES AS INTERESTS IN LAND

Courts have historically shown reluctance in recognizing mineral royalties as an interest in land. While more recent case law has concluded that oil and gas royalties may constitute an interest in land if that is the intention of the parties, the application of this (oil and gas based) case law to royalties over mineral properties remains uncertain.

Historical Treatment of Royalties on Mining Properties

For many years, the leading case on mining royalties was *Saskatchewan Minerals Ltd. v. Keyes*, [1972] S.C.R. 703 (Sask.). In that case, alkali leases were granted by the Government of Saskatchewan to Astral. Astral, the lessee, entered into an overriding royalty agreement with Keyes. Astral later assigned its mining leases to Saskatchewan Minerals, a Crown corporation. At issue was whether Saskatchewan Minerals was obliged to recognize the royalty interest of Keyes, which it was only required to do if the royalty to Keyes was found to be an interest in land. The granting language at issue was as follows:

The consideration to be paid by Astral . . . shall be . . .

(b) a royalty of twenty-five cents (25¢) per ton on all anhydrous salt produced and sold from the said [lease A-4010].

The majority found that the royalty was not an interest in land based on *St. Lawrence Petroleum v. Bailey Selburn Oil & Gas* and a statutory requirement that a lessee must get government approval to transfer an interest in land (which Astral had not done). Specifically, on the question of whether the use of the word “royalty” implied an intention on the part of the lessee to create an interest in land in the third party, the Martland, J. for the majority stated: “I would doubt that it does.” (*Saskatchewan Minerals* at 709). Because the majority had decided the case on other grounds, the brief comment regarding the nature of the royalty was clearly *obiter dicta*.

Mineral claims in the Northwest Territories were considered in *Isaac v. Cook*, [1983] N.W.T.R. 11 (S.C.). In that case net smelter return royalties of two percent (2%) were granted by the holders of a lease and mining claims. The owner of the claims went into receivership and the receiver claimed the right to sell the property free of the royalty interests. The NWT Supreme Court concluded that the royalty was not an interest in the ores or minerals nor an interest in the mining lease or mining claims themselves.

The language contained in the royalty agreements considered in *Isaac v. Cook* (at paragraphs 21 and 22) is as follows:

“21. The agreements recite that in consideration for the assignee having arranged financing for the assignor, the assignor has agreed to assign to the assignee:

an amount equal to two (2%) per cent of the net smelter returns received by the Assignor from the sale of ores and other products from the said lands, all as hereinafter provided.

22. The agreement in each instance recites the sum paid by the assignee to the assignor as a binding consideration for which:

1. The assignor hereby agrees to pay to the Assignee a royalty on net smelter returns for any ores processed in any manner other than by smelter or on the market value (FOB the said lands) subsequent to processing for any ores processed by smelter on the said lands (the net smelter returns and the market value as aforesaid herein called “Returns”) as follows:

2% of all Returns (hereinafter called “royalty”).”

The court, in basing its conclusion on the language of the agreements, did leave open the possibility that an agreement with different language may lead to a different result.

Oil and Gas Royalty Cases

Barton observes: “Oil and gas cases will be considered by the courts in the analysis of hardrock mineral royalties, notwithstanding the differences between the industries.” (Barton at 465.) Until recently, the preponderance of case law regarding oil and gas royalties had found that such royalty did not constitute an interest in land. However, the Supreme Court of Canada has recently clarified the circumstances under which such a royalty may become an interest in land in the case of *Bank of Montreal v. Dynex Petroleum Inc.*, 2002 SCC 7 (hereafter “*Dynex*”). It is likely that the reasoning in *Dynex* will be applied to hardrock mining claims as well given that the Court’s reasoning in *Dynex* was largely based upon the dissenting opinion of Laskin, J. in *Saskatchewan Minerals v. Keyes*, *supra*.

Laskin, J. Dissent in *Saskatchewan Minerals v. Keyes*

Laskin, J. found, at para. 53, that the royalty granted to Keyes was an interest in land and specifically:

[Keyes] became entitled to an overriding royalty in respect of the lessee’s interest in lease A-4010, whether that interest was a leasehold in the strict sense or a profit-à-prendre for a term and the royalty, unaccrued, was an interest in land, analogous to a rent-charge, and, in the circumstances, binding on the appellant as subsequent assignee of lease A-4010.

Laskin, J. explicitly stated at para. 50:

This is not to say that every reservation or grant of a royalty creates an interest in land. The words in which it is couched may show that only a contractual right to money or other benefit is prescribed, However, if the analogy is to rent, then the fact that the royalty is fixed and calculable as a money payment based on production or as a share of production, or of production and sale, cannot alone be enough to establish it as merely a contractual interest.

Dynex

The recent decision of the Supreme Court of Canada in *Dynex* relies on Laskin, J’s dissent in considering whether and in what circumstances an oil and gas royalty interest can constitute an

interest in land. Dynex Petroleum Ltd., a lessee, granted overriding royalty and net profit interests to third parties respecting its oil and gas leases. Dynex was petitioned into bankruptcy and at issue was whether the third party royalty interests were interests in land so as to give the holders of those royalties higher priority in the bankruptcy proceedings.

The Court expressly stated that an overriding royalty interest can be an interest in land if it was the intention of the parties to create such an interest. The court concluded at para. 82 that “parties may create overriding royalties that are interests in land if they manifest their intention to do so.” (emphasis added). Findings of fact are necessary in relation to the parties’ intentions. It appears from the authorities that these findings may be made based on the language of the granting language itself and, if necessary, on parol evidence concerning the circumstances in which the agreement was made.

The Court rejected outright the longstanding but archaic common law principle that an interest in land could not be created from an incorporeal hereditament (a *profit-à-prendre*). The Court emphasises that it is the intention of the parties that will determine whether the specific royalty interest at issue is an interest in land or not. The Court referred the matter back to trial for a determination on the parties’ intentions in entering the agreements at issue.

The court in *Dynex* also cited with approval the analysis at the trial level in *Scurry-Rainbow Oil v. Galloway Estate*, [1993] 4 W.W.R. 454 (Alta. Q.B.); aff’d [1995] 1 W.W.R. 316 (Alta. C.A.). There the court held that a Lessor’s Royalty can constitute an interest in land “given the proper construction.” In particular, the head note is helpful:

“The courts must search for an interpretation which would advance the intent of the parties at the time they entered into the contract. A literal approach should not be followed if it would bring about an unrealistic result not contemplated in the commercial context of the times.”

Regardless of the fact that a royalty may be an interest in land, the test remains one of exploring the intentions of the parties. Such intention may be reflected in the words of the document itself or by resorting to the surrounding circumstances.

Thus the matters to consider in determining whether a particular royalty is an interest in land will include:

1. Whether the underlying interest is itself an interest in land (corporeal or, if the application of the *Dynex* case is extended to the hardrock context, incorporeal);
2. The intentions of the parties, as evidenced by the language of the grant and any admissible evidence of the surrounding circumstances of behaviour, indicate that it was understood that an interest in land was created/conveyed;
3. Whether the interest is capable of lasting for the duration of the underlying estate.

In determining whether the underlying interest is itself an interest in land, the legislation under which the underlying interest is created will have to be considered. By way of example, in the

Northwest Territories a mineral claim recorded under the *Canada Mining Regulations* is an interest in land: *Beakhurst et al. v. Williams et al.*, [1971] 1 W.W.R. 230 (N.W.T.T.C.); *Isaac v. Cook*, [1983] N.W.T.R. 11 (N.W.T.S.C.); *Smith v. Northern Geophysics Ltd.*, unreported, September 13, 1994 (N.W.T.S.C.). Prior to development of the mine, mineral claims are replaced in the NWT by mining leases. Barton, in *Canadian Law Of Mining* at 386, says that: “Mining leases invariably convey an interest that is undoubtedly property and undoubtedly an interest in land.... The exclusive right, even against the Crown, to develop and (above all) to extract minerals, a right that is granted for a term of years with considerable security of tenure and is freely transferable, is unlikely to be anything less than an interest in land.” By contrast, in British Columbia mineral claims recorded under the *Mineral Tenure Act* are not interests in land: *British Columbia v. Tener* (1986), 27 D.L.R. (4th) 305; *Cream Silver Minerals Ltd. v. British Columbia* (1993), 75 B.C.L.R. (2d) 324.

The question of whether the underlying interest is itself an interest in land may also arise in relation to provisions typically found in royalty agreements that the royalty will apply to any claims staked in the future within a defined area of interest. If the royalty is characterized in the agreement as an interest in land, there is thus an attempt to create a royalty that is an interest in land in which the operator does not yet have an interest.

Further, royalty agreements often apply not just to mineral claims or leases but also to a broad array of after-acquired rights or interests in the property, with typical language being: “any mining claim, licence, lease, grant, concession, permit, patent, or other mineral property or surface rights or water rights or other rights or interests located wholly or partly within the Area of Interest.” As discussed above, some of these rights might be interests in land but others may not.

The issue of royalties being granted on after-acquired property received some inconclusive comments in Laskin J.’s dissent in *Saskatchewan Minerals*. At para. 41, Laskin, J. noted the decision of the Alberta Court of Appeal in *Emerald Resources Ltd. v. Sterline Oil Properties Management Ltd* (1969), 3 D.L.R. (3d) 630 (Alta. C.A.); aff’d on other grounds (1969), 15 D.L.R. (3d) 256n (S.C.C.). where the royalty clause in the agreement provided for a certain royalty of the lessee’s share of specified substances “produced, saved and sold from each property acquired by [the lessee] after the date hereof and during the term of this agreement.” Whereas the Alberta Court of Appeal doubted that an interest in land had been created, Laskin J. concluded that any interest in land created by the provision would be equitable only. He then stated at para. 42:

It is convenient to say at this point that in the present case the fact that the royalty to Keyes was prescribed in an agreement which preceded Astral’s acquisition of lease A-4010 would not alone affect his right to enforce it against the appellant. Astral’s subsequent acquisition of the leasehold or of the profit à prendre fed the grant to Keyes so as to preclude Astral from denying legal effect in that respect to the agreement . . . (emphasis added).

Royalty agreements often provide that if the operator surrenders or allows any claims to lapse and then subsequently restakes them directly or indirectly, the royalty shall apply to the restaked claims. As above, this contemplates a royalty (intended to be an interest in land) which is created and meant to apply before the grantor of the royalty has acquired any underlying interest in the land to which the royalty is to apply.

As a practical matter, if it is intended that the royalty be an interest in land, these difficulties can to some extent be dealt with by inserting in the agreement a covenant by the operator to execute any

and all documents necessary to give effect to the royalty as an interest in land over any after-acquired claims in the area of interest, or in any restaked claims, such documents to be executed when the new claims are staked or acquired.

Consideration may also be given to filing a notice of the agreement or caveat in the appropriate office of public record. The effectiveness of this will vary from jurisdiction to jurisdiction and depend on local laws. For example, section 63(1)(c) of the *Canada Mining Regulations*, applicable in the Northwest Territories and parts of Nunavut, the Mining Recorder is required to register any document filed in relation to a claim or lease. Pursuant to section 63(3) all persons shall be considered to have received notice of every document so registered as of the date of registration of the document. Pursuant to section 63(4), a transfer of a recorded claim or lease is subject to the encumbrances registered against the claim or lease at the time of registration of the transfer. The notice which is typically filed with the Mining Recorder in relation to a royalty interest is called a Notice to Third Parties. While filing a Notice to Third Parties is effective in granting others notice of the claim, the Mining Recorder will take no role in evaluating the legitimacy of the royalty claim or enforcing compliance. The Mining Recorder views its role as simply a repository for such notices and refuses to involve itself with the substance of the notice. A notice to third parties which states that a property cannot be transferred without the consent of another party will not prevent the Mining Recorder from accepting and registering a transfer for that property in the absence of any consent from the party that filed the notice. Accordingly, registration should not be relied on to accomplish any purpose beyond notice.

As to the intentions of the parties evidenced by the language used by them, a plethora of authority exists on how those intentions are to be found. An instructive example is *Bensette v. Reece* (1973), 34 D.L.R. (3d) 723 in which the Saskatchewan Court of Appeal interpreted a grant in the following terms:

doth give, grant, bargain, sell, assign and transfer ... a six percent (6%) royalty in all the ... minerals ... which may be found in, under or upon the said lands.

In concluding that the royalty did in fact constitute an interest in land, the Court reasoned as follows (at page 726):

Had the word “interest” or “property” been used instead of “royalty”, it would be clear that an interest in the minerals themselves was to pass. Had the words “payment on” been used instead of “royalty in”, intention to pass an interest *in rem* would not be inferable. The question is then as to what is meant by a “royalty” in “the minerals”.

The words “royalty in” connote an interest of some kind “in” the minerals. If it were “royalty on” the minerals, some kind of a commission would be readily inferable....

Here then is a transfer and sale of a 6% royalty in minerals. Under the circumstances obtaining here, this connotes a conveyance of an interest in the minerals themselves *in situ* and hence an interest in the land

The CAPL Overriding Royalty Procedure attempts to make the overriding royalty on petroleum products sufficiently “strong” to be an interest in land. An explanatory note in the Procedure states that, to this end several provisions have been included to “give the Royalty Owner more of an

“active” interest in the Royalty Lands than the mere receipt of money; these provisions include the creation of a royalty lien, the right to take in kind, the right to review sales contracts, reversionary rights upon expiry or surrender and the right to enforce a royalty lien by seizing the Farmee’s property.”

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