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A Primer on Royalties

QUENTIN MARKIN (qmarkin@stikeman.com)

MINING

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The following was prepared for the Canadian Mining Law and Finance Conference held in Toronto, April 7-8, 2008, and Vancouver, April 14-15, 2008. This paper provides a basic overview of royalty agreements in the extractive mineral resources sector.

WHAT IS A ROYALTY?

A royalty is a payment to the holder of the royalty by a property owner and/or operator of a mineral project. It is generally based on (i) a percentage of the value of the minerals or other products produced, or (ii) the profits or revenue generated from the mineral project.

There are a number of reasons why an owner or operator would enter into such an obligation. The most common are:

> to provide capital and funding prior to initial production in exchange for granting the royalty, which alleviates the need to seek more traditional methods of financing such as bank loans, joint ventures or the equity capital markets;

> to raise capital without diluting the equity of the owners in the operating company and therefore permitting them to maintain a high level, if not full, ownership in the mineral project;

> as part payment for property interests to prospectors or junior mining companies; or

> to convert an equity or other participating interesting in a joint venture, company or mineral project into a royalty.

These features make the use of a royalty particularly suitable for small emerging explorers and developers.

Mineral royalties are generally not working interests in a property. Consequently, the royalty holder is not responsible for contributing funds for any purpose associated with operating the mineral project, including operating or capital costs, or environmental or reclamation liabilities. The royalty holder is most often a passive participant in the mineral project.

Although royalty interests are most frequently granted over precious metals (and petroleum and natural gas production, which we do not discuss here), there are no limitations as to what type of natural resource a royalty can be granted over.

Royalties can be created by contract between private parties or they can be created as a matter of statutory law.

Contractual royalties are just that—a contractual obligation between private parties, the terms of which are the product of negotiation.

Statutory royalties on the other hand, are a common means by which governments earn income from mineral exploitation on their territory. These are most commonly characterized as the payment due to the sovereign owner of the minerals in exchange for the right to extract, or for the actual extraction of, the mineral underlying the royalty. Such statutory royalties are in effect a tax, and can be found globally in a variety of forms, based on both measures of profit, but also on the basis of quantity of material produced.

This paper focuses exclusively on contractual royalties in the extractive mineral resources sector.

TYPES OF ROYALTY INTERESTS

Royalty interests are generally characterized and described by how the royalty is calculated. There are principally three types of royalties in the extractive mineral resources sector:

> **Revenue-based royalties** such as net smelter return royalties (NSRs), gross royalties and gross overriding royalties;

> **Profit-based royalties** such as a net profit interest (NPIs) and net proceeds royalties; and

> **Other royalties** such as advance minimum royalties.

Each is briefly discussed below.

> **NSR** (**Net Smelter Return Royalties**) are based on the proceeds paid by a smelter or refiner to the miner for the mining production from the property less certain agreed transportation, smelting and refining costs as defined in the royalty agreement. Only costs associated with the smelting or refining process are deducted. This type of royalty provides cash flow that is free of any operating or capital costs and environmental liabilities. Accordingly, a smaller percentage NSR on an ore body can effectively equate to the economic value of a larger percentage NPI of the same ore body given that with an NSR the value on which the royalty is calculated will be higher, as there are only limited deductions from the revenue earned from the mineral production.

> **NPI or NPR** (**Net Profit Interest or Net Proceeds Royalties**) are based on the **profit** made after deducting costs related to production, which are specifically negotiated and set out in the royalty agreement. NPI or NPR payments generally begin after payback of capital costs. Although the royalty holder is not responsible for providing capital or covering operating losses or environmental liabilities, increases in production costs will affect net profit and accordingly the royalties payable.

NSRs, NPIs and NPRs are by far the most common royalty types found in the extractive mineral resources sector. Of these, NSRs are the most common royalty for mineral projects with variations being based on a sliding scale of royalty rates indexed to metal prices, grade and/or capital repayment schedules.

> **GR or GOR** (**Gross Royalties or Gross Overriding Royalties**) are based on the total revenue stream from the sale of mineral production from the property with few, if any, deductions. This structure is more frequently used in the petroleum and natural gas sectors.

> **ORR** (**Overriding Royalties**) are based on the proceeds from the gross production and are usually free of any operating, capital and environmental costs.

- **AMR** (**Advance Minimum Royalty**) is effectively rent paid to the royalty holder in lieu of the payment of royalties on production. Once production begins, the AMR payments are often credited against a stream of production royalty payments.

A royalty interest is significantly different than a working interest in that a holder of a working interest is liable for a share of capital, operating and environmental costs, usually in proportion to its ownership percentage, and it receives its pro-rata share of revenue. Minority working or equity interests are not considered to be royalties because of the ongoing funding commitments, although they can be similar in their calculations to NPIs or NPRs.

As royalties are contractual instruments limited only by commercial needs and imagination, the above list is by no means exhaustive. As well, any person comparing NSRs or NPIs should be cautioned that there are no standardized measures for these types of royalties, and as such, each is unique. What may be a deduction in one royalty agreement may not be a deduction in the other.

CREATING AND GRANTING ROYALTY INTERESTS

In their basic structure, royalty agreements require the same provisions as any other contract—governing law, notice, dispute resolution, termination provisions, currency, type and frequency of payment, and perhaps most importantly, a covenant to pay the royalty as defined. Beyond this, however, there are key critical provisions to any royalty contract that should be considered in order to allow for certainty of the contract as well as ensure the long-term objectives of the parties can be fulfilled.

As elements affecting royalty interests may vary greatly between national jurisdictions or even within such jurisdiction, care should be taken to use local counsel when drafting or transferring royalty agreements.

The following are some of the key provisions that are important in creating and granting a royalty interest. This list is not exhaustive.

Structuring the Royalty

A royalty interest can for all intensive purposes carry on in perpetuity at a set rate NPI or NSR. Frequently, however, there are limitations set on payment or duration of such pay-outs. Examples include:

- Limiting royalty payments to a specific time frame whether set calendar dates or for a fixed period commencing with production.
- In some instances, payments are limited to a point in the mineral production cycle, for example the royalty may cease after a given number of ounces have been produced. Similarly, a royalty percentage may diminish as production increases thereby; gradually disappearing over the span of production.
- Given the price fluctuations of minerals and metals, percentage royalty payments can similarly be tied to market price, often in the form of a sliding percentage scale, with the royalty percentage increasing or decreasing with commodity prices.

Certainty of Royalty Calculations, Accounting and Audit Rights

Uncertainty in what is included or excluded in royalty calculations may be the most contentious (and often litigated) provision of any royalty agreement. Such provisions

need to be defined with a great deal of certainty. For example, whereas a net profit interest is calculated on its face by subtracting operating expenses from revenue, the accounting for these two elements may vary greatly. What do you include? Are interest charges related to the development of mining operations included as an operating expense? In the event that revenues are based on the value of the mineral itself, how is that calculated? The greater the certainty with which these terms can be defined, the less likely the operator of the property is able to manipulate the royalty entitlement. Provisions for audit rights and the right to inspect records of the operator may prove beneficial in this regards.

There are a number of operational issues common in mining that may affect a royalty payment. Three common ones that should be addressed in creating the royalty are:

> **Tailings:** Does the royalty agreement apply to tailings? How is it calculated? Depending on the amount of tailings, available technology, changes in commodity prices, or location of the tailings, this could affect the royalty payment.

> **Stockpiling:** If ore is stockpiled at different locations, an agreement with the owner of the location should be made so as to ensure no security, liens, or other encumbrances are granted over the stockpiled ore in favour of a third party.

> **Commingling:** If ore from other properties are commingled with the ore from the property underlying the royalty interest, it may be difficult to determine amount of ore attributable to the property or its mineral content. As such, royalty agreements should specifically exclude commingling or set out proper procedures that allow for accounting of ore from different properties.

Certainty in Land

A number of elements should be taken into consideration when defining the land constituting the mineral project underlying any royalty.

> The property underlying the royalty must be defined with legal certainty. This will vary depending on jurisdiction.

> Purchasers of royalty interests should ensure that through proper due diligence they are made comfortable with how the title to the minerals underlying the royalty is held and whether approximate rights to extract are in place, if applicable.

> Depending on jurisdiction, provisions should be made for renewal of mineral claims if they expire; as well, if the type of tenure changes as a result of commencing mining.

Access to Information

Royalty interests are not immune to securities legislation. National Instrument 43-101 (NI 43-101) specifically defines “mineral project” to include a royalty interest. As such, owners of royalties that are subject to NI 43-101 and which are material to them should take extra care in ensuring that their royalty agreement provides them with the means to comply with applicable securities laws.

NI 43-101 will often require the holder of the royalty to have prepared and filed a technical report that complies with NI 43-101. Royalty holders may be unable to simply rely on technical reports filed by mining operator if no such report exists or if it is not current or if the underlying property, while material to the royalty holder, is not material to the operator. Without access to the property or underlying data

necessary to prepare such a report, it can be a difficult for the royalty holder to meet its legal obligations.

There is limited relief available in NI 43-101 for royalty or similar interests. The exemptions include not having a qualified person complete a site inspection of the property; as well, relief from completing required portions of the technical report items that require data verification, inspection of documents, or personal inspection of the property. However, the exemption is only available if the issuer (i) has requested but has not received access to the necessary data from the operating company and is not able to obtain the necessary information from the public domain, (ii) the issuer states that it has requested but has not received access to the necessary data from the operating company and is not able to obtain the necessary information from the public domain and describes the content referred to under the technical report requirements that the issuer did not complete; and (iii) includes in all scientific and technical disclosure a statement that the issuer has an exemption from completing certain items in the technical report required to be filed and includes a reference to the title and date of the technical report.

Given these complications, new royalty agreements should contain provisions to allow for on-going access to the technical information necessary to prepare an NI 43-101 compliant technical report, or if possible, for access to the property itself. Ideally, the royalty holder should try to negotiate the right to cause the operator to prepare an NI 43-101 technical report if required.

Security Interest

Consideration should be given to the ability of the royalty holder to take security as part of the royalty agreement. In the event the royalty holder is unable to take security in the mine or the assets of the operator it is exposed to the risk of operator insolvency, bankruptcy or even sale of the assets which provide the royalty. Operators must also consider whether the holder should be able to pledge the royalty interest and its revenue stream as security.

BUYING AND SELLING ROYALTY INTERESTS

Royalty interests created by contract are property rights that can be bought and sold if permitted under the agreement creating the royalty interest. As well, the vendor and purchaser must look at the terms of the royalty agreement to determine the processes, requirements and timing for a valid sale (assignment) of the royalty.

There are typically a number of considerations that must be addressed with respect to the sale of a royalty agreement.

- **The assignability of the royalty interest.** The parties may have agreed that the royalty cannot be assigned by one party or the other.
- **Exceptions to non-assignability**. If there are limitations on the ability of either party to assign the royalty contract, are there exceptions, including the ability to freely assign the royalty interest to an affiliate or subsidiary?
- **Consent requirements**. Is consent by the grantor of the royalty required before the holder of the royalty can sell or otherwise encumber the royalty interest? If so, can this consent be unreasonably withheld?

- **Notice periods**. In the event that the royalty may be freely transferred or assigned, is notice required? And if so, how long before or after the royalty is transferred must notice be given?
- **Rights of first refusal**. A royalty can constitute a significant economic burden on any producing mineral project. As such, it may be in the interest of the operator to require a right of first refusal on any assignment or sale of the royalty agreement by the holder. When considering a right of first refusal clause, care should be taken regarding how the price of repurchase on exercise of a right of first refusal is settled if not objectively determinable.

It is not uncommon to also include provisions with respect to change of control. This could, for example, prevent a royalty from being freely transferred to an affiliate or subsidiary of the royalty holder.

REGISTERING AND SECURING A ROYALTY INTEREST

The ability to take a security interest over a royalty, and how the interest is perfected, will be affected by whether the royalty is considered an interest in land or simply personal property. Canadian courts have historically shown reluctance to recognize mineral royalties as an interest in land (not so with oil and gas royalties).

In the 2002 Supreme Court of Canada decision of *Bank of Montreal v. Dynex Petroleum Ltd* the common law prohibition against the creation of an interest in land from an incorporeal hereditament was found to be inapplicable to the oil and gas industry given its practices and the support found in the law.[1] A royalty which is an interest in land may be created from an incorporeal hereditament such as a working interest if that is the intention of the parties. In Canada, whether mineral royalty interests are subject to the same legal treatment is yet to be ascertained, and as such, it remains an open issue whether one needs to register a royalty interest in a land titles or registry office.

Many, but not all, jurisdictions have legislation that allow a royalty to be registered on title to the underlying mineral claims. In fact, some jurisdictions *require* all documents in relation to a claim or lease to be filed on the public record. If the royalty is not an interest in land as discussed above, this will at least serve as notice to third parties of the existence of the royalty.

Whether registration in a land titles or similar office is necessary, or whether registration in a personal property registry is sufficient is ultimately a matter of local jurisdiction, and one that will need to be addressed by the person looking to secure the royalty and its payments against the obligations of the royalty holder.

Quentin Markin is a Partner in the Toronto office of Stikeman Elliott, a Canadian based law firm, and a member of its Global Mining Group. Much assistance in preparing this paper was provided by Nils Engelstad, Student-at-Law at Stikeman Elliott.

[1] *Bank of Montreal v. Dynex Petroleum Ltd*., [2002] 1 S.C.R. 146, 2002 SCC 7

THE AUTHOR

Quentin Markin

5300 Commerce Court West, 199 Bay Street, Toronto, Canada M5L 1B9
Direct: (416) 869-5213 Fax: (416) 947-0866 qmarkin@stikeman.com

Law Practice

Quentin Markin is a partner practising securities and corporate law in Stikeman Elliott's Toronto office and is a member of the firm's Global Mining Group. Mr. Markin was seconded to the firm's London office (2005-2006) and the firm's Sydney, Australia office (2007). His practice emphasizes corporate finance and merger and acquisition transactions for public companies, as well as public company governance and regulation. He has significant experience acting for underwriters and issuers in public offerings, including shelf, short form, MJDS and "bought deal" financings, private placements, as well as transactions involving the AIM Market in London. He has participated in a number of contested take-over bids and cross-border acquisitions. Mr. Markin also advises public issuers on regulatory compliance matters, corporate governance, and continuous disclosure obligations, and he provides on-going securities law compliance advice to TSX and TSXV listed issuers. Mr. Markin has acted for issuers based in Norway, South Africa, India, Australia, Kazakhstan and Belgium as well as Canada and the United States.

Professional Activities

Mr. Markin is a member of the Canadian Bar Association.

Publications & Speaking Engagements

Mr. Markin spoke at "Partners For Economic Development Ltd.; A Financial Regulatory Conference" on March 14, 2008 in Kingston Jamaica, and will be speaking at the Canadian Mining Law & Finance 2008 Conference on "A Primer on Royalties" being held in Toronto, Ontario on April 7, 2008.

He has previously presented on the topic "Understanding Securities Caselaw: Fundamental Principles and Recent Trends" at the Intensive Course in Securities Law & Practice held in Toronto, Ontario on October 26, 2006.

Mr. Markin has also been a guest lecturer at the LL.M. graduate program on securities law at Osgoode Hall Law School.

Education

Dalhousie University (B.A. First Class Honours, Political Science 1994), University of Ottawa (LL.B. Magna Cum Laude 1998), Carleton University (M.A. International Affairs 1998).

Background

Mr. Markin spent six months on secondment (September 2001 to March 2002) in the Corporate Finance Branch, Ontario Securities Commission.

Bar Admission

Ontario, 2000.

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