Royalty Companies' Effect on Royalty Agreements and Other Recent Trends

Alan L. Monk and David Allman
Edwards Kenny & Bray LLP
Vancouver, British Columbia

I. Introduction*

Royalties are common in the mineral exploration business. Royalties typically arise when an owner of mineral claims (the "Owner") sells or options them to another party (the "Royalty Holder"), while retaining a royalty if production ever occurs on those claims. A royalty may also arise when a joint venture partner is "diluted down" to a specified percentage interest in the joint venture, resulting in a loss of its participating interest in exchange for a royalty.

More recently, royalties have been used as a source of financing, particularly over the past several years when traditional sources of financing were more difficult to access. As a result, royalty companies have emerged, whose sole business purpose is to acquire mineral royalties (often along with mineral streams). Since the main asset of such companies involves the royalties it purchases or otherwise acquires, it is incumbent on the management of such companies to ensure as much as possible that the royalties are not lost or impaired, thus reducing or eliminating their value. Indeed, what has resulted from these royalty companies are self-contained and comprehensive royalty agreements that cover many more contingencies than earlier royalty agreements did.

In the context of the purchase of mineral interests, options and joint ventures, the royalty is usually a small part of a larger commercial arrangement. The granting of the royalties under such agreements is contingent on some future event, which may occur years in the future, or not at all. As discussed during the 2014 CLE on this topic, there is a tendency to pay less attention to drafting the royalty than the main agreement in such circumstances, perhaps because the client is reluctant to pay for a well thought out agreement due to the possibility that a royalty will never become payable. Often, the royalty provisions are sparse and are attached as a schedule, sometimes without a lot of care taken to integrate the schedule with the body of the agreement or to deal with various contingencies that could occur if the royalty is ultimately granted. In extreme cases, reference may be made to the granting of "a 2% NSR" or "a 10% net profits interest royalty" without further definition or elaboration. The result may

* For a discussion of different types of mineral royalties and for additional coverage of royalty agreements, see Alan L. Monk, "Understanding Streaming Agreements and Royalty Agreements: Alternatives to Traditional Financing," a paper presented at the 2014 Mining Law course for The Continuing Legal Education Society of BC.

be that the royalty is unenforceable in Court, or is subject to being lost if the property is transferred to a third party or the owner of the mineral property goes bankrupt.

II. The Nature of a Royalty

A royalty in the mineral exploration and mining industries typically involves a right of the Royalty Holder to receive a cash payment from an Owner of some portion of the proceeds from the sale of minerals sold from production of the property to which the royalty relates. In some cases, the royalty may consist of a portion of the actual minerals recovered.

Royalties are non-participating interests in relation to a mining project, which means that the Royalty Holder makes no further investment and has no right to participate in or have any say in the development or mining operations. Furthermore, the Royalty Holder generally does not have the right to review technical information or data, such as exploration results on the property to which the royalty relates, and may not have the right to review or audit the books and records of the Owner to verify the veracity of the Owner's calculations of the royalty, absent express rights granted by a royalty agreement.

Royalties may be restricted to the recovery of only one or a few minerals, such as gold, either because the client is only interested in gold, or is convinced that the property is highly prospective for gold, and only gold. However, in the process of exploration, it is not uncommon that a property that was initially thought to be prospective for one mineral actually contains an economic deposit of another mineral. Therefore, it is in the Royalty Holder's interest to make the royalty applicable to all valuable minerals that are recovered from the property.

III. Some Common Royalty Provisions

Royalty agreements will invariably set out the amount of the royalty, either as a percentage of some unit of measure (e.g., $1.00 per tonne of coal; 5% of the value of minerals produced; 3% of the revenue generated from the sale of ore, concentrates or other mineral products produced; or 10% of the products realized from operations carried out on the property that is subject to the royalty). In addition, most royalties will set out how they are to be calculated. The case of a royalty of $1.00 per tonne of coal is pretty straightforward to calculate, but royalties that are based on net amounts (e.g., net smelter returns or net profits) should set out the specific costs that will be deducted from revenues[1].

A. Definition of "Property"

The mineral interests to which the royalty applies must be defined with certainty. Usually, this is accomplished by defining the mineral interests subject to the royalty as the "Property", with reference to a Schedule to the agreement. The Schedule provides details on the mineral interests (e.g., a list including

[1] For example, typical deductions for a Net Smelter Return royalty are the costs of transportation, insurance or security, penalties, sampling and assaying, refining and smelting, and marketing.

claim numbers, a map with boundaries shown, or a set of geographical coordinates that describe the boundaries of the Property).

The definition of "Property" should include any future mineral interests in which the existing interests may be converted into the future. For example, it is common for a mineral claim to be converted into a mining lease when a Property is being prepared to be mined. The Royalty Holder should not lose their royalty due to the conversion of the mineral interest into a different kind of mineral interest that was not described in the agreement. Therefore, the agreement should explicitly provide that the "Property" includes any other types of mineral interests into which the original mineral claims or other interests (which are specifically described in the Schedule) are converted.

Where the Royalty Holder has the negotiating power to do so, the Royalty Holder may be able to expand the property subject to the royalty, by subsuming within the definition of "Property" new mineral interests acquired by the Owner that are contiguous to the existing property or within a pre-defined "area of interest" or "area of influence".

B. Taking in Kind

Usually, royalties are payable in cash. However, some royalties (typically, precious metals royalties) provide the holder of the royalty (Royalty Holder) with the option to receive the royalty payment in minerals (that is, "in kind"). This provision does not cause problems if the royalty relates to precious metals such as gold and silver, as long as the royalty agreement provides for how the permitted deductions are to be dealt with (i.e., usually a percentage of the minerals are withheld to cover the cost of the deductions), but could create problems when dealing with other minerals. Royalties on diamonds should not permit taking in kind, since they are highly individualistic and virtually impossible to divide equitably.[2]

C. Advance Royalties

Royalties do not become payable until commercial production commences, or sometime after commercial production in the case of net profits interest ("NPI") Royalties, which may also be referred to as "net proceeds interest" royalties. Royalty agreements can provide for advance royalties which are payable periodically (usually, annually) until commercial production occurs, and are usually credited towards payments owing following production. Advance royalties discourage an Owner from "warehousing" the property (i.e., just holding the property and not exploring and developing it).

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[2] *See* Karl J. C. Harries, *Mineral Agreements and Royalties*, vol. 1, ch. 5 & vol. 2, at 648 (Can. Inst. of Mining, Metallurgy & Petroleum, spec. vol. 55, 2003). Vol. 2.

Advance royalties are not typically found in the more fulsome agreements of royalty companies, probably because the royalties are acquired from advance stage development properties or properties already in production, where warehousing the property is unlikely.

D. Minimum Royalties

Royalty agreements may also include minimum royalties, which, although not paid until after the commencement of commercial production, guarantee a minimum payment per period (usually, per year) to the Royalty Holder. The amount of the minimum royalty that exceeds what the Royalty Holder would otherwise receive under the royalty agreement may in some cases be credited against royalty payments in future years, effectively reducing the payments made in those years.

Like advance royalties, minimum royalties are not typically found in the agreements with royalty companies, due to the advanced stage of the projects.

E. Capped Royalties

Royalties may be capped at a certain fixed amount, so that royalty payments will cease once the cap is reached. The agreements of royalty companies do not typically contain a cap on the royalties payable to the Royalty Holder. Although a cap will limit the Royalty Holder's "upside" on the project, it may be negotiated in exchange for some other benefit to the Royalty Holder, such as increased royalty payments so that that Royalty Holder receives more income earlier in the mining process.

F. Right of Owner to Buy Back the Royalty

Some royalties permit the Owner to acquire the entire royalty (or part of it; the right to buy 50% is typical) from the Royalty Holder for a fixed price, although this is not common in the agreements with royalty companies. Sometimes the right of the Owner to buy back the royalty is limited to a certain time period (e.g., before commencement of commercial production). The ability to purchase all or part of a royalty (especially a royalty that is based on revenue rather than profit) is beneficial to companies developing a mine, because it could enable them to reduce the costs that must be accounted for in a feasibility study to make a project "economic". From the point of view of the Royalty Holder, however, such a buyout provision reduces the potential value of the royalty (and thus the "upside potential" to the Royalty Holder), as it essentially acts as an option granted to the Owner to cap the royalty (or part of it) at a pre-determined price.

G. Periodic Reporting, Auditing, and Site Visits

Many royalty agreements provide for periodic (usually monthly and annual) reporting by the Owner to the Royalty Holder on production from the mine, production forecasts for the next period and certain financial information. Notice of any event that may materially adversely affect a project, such as labour disruptions, legal actions and failures to obtain necessary regulatory approvals, may also be required.

In a royalty agreement, provision should be made to give the Royalty Holder the right to information that enables the Royalty Holder to verify the calculation of the royalty payment. A Royalty Holder that contemplates selling his interest in the future may wish to seek a right to obtain broader access to information about the project, not just the financial information necessary to verify the royalty payments, as this information will be useful to justify the value of a royalty to a potential purchaser. This may include access to invoices, production records, financial reports, the reserve report and mine plan (which is usually updated annually) relating to the property. Such provisions are contained in most agreements with royalty companies.

Closely related to the rights of the Royalty Holder to receive periodic reports and access to information sufficient to confirm the royalty calculations are rights of the Royalty Holder to inspect the mine at reasonable times, at such party's sole risk and expense. The right to access the site may be useful to confirm the reasonableness of the current or future mine plan when valuing the royalty if it is to be sold.

Some royalty agreements also provide the Royalty Holder with a right to audit the Owner's books and records to confirm the calculation and payment of the royalty. Often, the agreement provides that the Royalty Holder will pay the costs of the audit unless the results of the audit indicate that the Royalty Holder has been underpaid, in which case the cost of the audit will be paid by the Owner.

Pursuant to National Instrument 43-101, *Standards for Disclosure for Mineral Projects* of the Canadian Securities Administrators (NI 43-101), an issuer in Canada is required, under certain circumstances, to prepare and file on the SEDAR.com website a technical report on a "mineral project" that is material to such issuer.[3] Subject to limited exceptions, the qualified person who prepares or supervises the preparation of the technical report must personally inspect the property subject to the technical report prior to completing the report. A "mineral project" is defined in NI 43-101 to include "a royalty or similar interest," which is considered to include an interest in a revenue or commodity stream from a proposed or current mining operation.[4] Section 9.2 of NI 43-101 provides certain limited exemptions from the requirement of a Royalty Holder or purchaser of the royalty to file a technical report, because it is recognized that the holder of a "royalty or similar interest" may not have a right to access the scientific and technical data on the property that is necessary to prepare a technical report, absent an

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[3] Part 4 of NI 43-101 sets forth the circumstances in which a technical report will be required, which include (but are not limited to) the filing of a preliminary prospectus, annual information form, offering memorandum or proxy circular concerning an acquisition of a material mineral property where such documents contain scientific or technical information on a material mineral project.

[4] See section 9.2(1) of Companion Policy 43-101CP to National Instrument 43-101 Standards of Disclosure for Mineral Projects, of the Canadian Securities Administrators.

express contractual right to demand such data from the Owner. However, the exemptions generally require that either the Owner has publicly disclosed all scientific and technical information that is material to the issuer or the issuer has requested but not received access to the necessary data and is not able to obtain it in the public domain. Accordingly, some royalty agreements specifically include provisions that require the Owner to use commercially reasonable efforts to assist the Royalty Holder to obtain scientific and technical information sufficient for the Royalty Holder to produce a technical report required by NI 43-101, and to grant the Royalty Holder rights to access the property so that the qualified person preparing or supervising the preparation of the technical report may fulfil his or her obligations to conduct a personal inspection of the property, as required by NI 43-101.

H. Owner Maintains Control over Decisions

Royalty agreements usually contain provisions that maintain the sole discretion of the Owner over decisions in respect of exploration, development and mining of the property. A Royalty Holder under a royalty agreement is not a joint venturer and accordingly should not be entitled to participate in such decisions.

Usually it is assumed that the interests of the Owner and the Royalty Holder are aligned, but this may not always be the case. A prudent decision of an Owner to maximize return on investment over recovery (e.g., choosing a heap leach operation over conventional milling for gold) may result in a reduction in the amount of the mineral recovered and therefore, a lower royalty payable. To avoid disputes about whether the Owner has to take the interests of the Royalty Holder into account when making such a decision, the agreement should clearly specify that all operational decisions are to be made by the Owner, subject only to ordinary prudence.[5]

I. Commingling and Unitization

Often an Owner will want to be able to commingle ores from the property subject to the royalty agreement with ores from surrounding properties. In circumstances where a royalty agreement only covers part of the property being mined, commingling may increase the efficiency of the mining operation, because ore from the property subject to the agreement will not have to be run through the mill separately from ore outside of such area. However, the Royalty Holder will want to ensure ore subject to its interest is not commingled with lower grade ore or different metallurgies from surrounding areas, so provisions for testing the ore from the different locations before it is processed are usually included in the royalty agreement.

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[5] *See* Ralph W. Godell & Paul J. Schlauch, "Precious Metals Royalties," 35 *Rocky Mt. Min. L. Inst.* 10-1, 10-11 (1989).

Unitization, which may be permitted in some royalty agreements, eliminates the need to account for production from the area subject to the royalty and surrounding areas. Unitization allows accounting and operations to be based on an agreed specific percentage division of production from the property subject to the royalty and surrounding properties from combined ores. It is a concept borrowed from the oil and gas industry, where liquids or gases can migrate from one property to another during extraction. Consequently, unitization is most appropriate for in situ leach operations (which can be used in uranium, copper and potash) if the grade and distribution is relatively stable across the entire project.[6]

J. Confidentiality

If a royalty agreement provides for periodic reporting of financial or project information to the Royalty Holder or site visits by the Royalty Holder, the agreement should contain confidentiality provisions, prohibiting the Royalty Holder from disclosing such non-public information to third parties. There are always certain limited exceptions to the confidentiality obligation, which typically include circumstances in which the information:

- is or becomes generally available to the public, other than as a result of breach of the confidentiality provision,
- was lawfully and in good faith obtained by the recipient from an independent third party without breach of the confidentiality provision,
- was in the possession of the recipient on a non-confidential basis prior to disclosure of such confidential information,
- is provided to the recipient's auditor, legal counsel, lenders, brokers, underwriters and investment bankers with which it is considering or intends to enter into a transaction for which the confidential information would be relevant, provided such third parties agree to maintain the confidentiality of the information;
- is provided to the recipient's and its affiliates' directors, officers, employees, representatives and agents who need to have knowledge of the confidential information, provided such third parties agree to maintain the confidentiality of the information; or
- is required to be disclosed pursuant to applicable securities or other laws, legal process or stock exchange rules or regulations.

Often, the confidentiality provision also prohibits disclosure of the existence of the agreement itself. However, if a public company is involved, disclosure of the existence of the agreement, and even filing of the agreement itself on SEDAR (Canada) or EDGAR (USA), publicly accessible websites, may be

[6] Stan Dempsey & Randy L. Parcel, "The Evolution of the Mining Royalty," 53 *Rocky Mt. Min. L. Inst.* 30-1, 30-13 (2007).

required. In Canada, the agreement will generally be required to be filed (although redaction of sensitive information is permitted) if the transaction is material to the company and the agreement is not entered into in the ordinary course of business.[7] Usually, a royalty agreement is not entered into "in the ordinary course of business" for an Owner, but it would be "entered into in the ordinary course of business" for a royalty company. Therefore, if the contract is material to its business, the mining company would be required to file the contract on SEDAR, while the royalty company would not be so required. Where disclosure of the royalty agreement will be required, the royalty agreement should specifically permit such disclosure.

As royalty companies usually want the ability to sell the royalties they hold to third parties, the royalty agreements will usually include the right of the Royalty Holder to disclose confidential information to prospective purchasers of the royalty, provided that the prospective purchasers agree in writing to keep the information confidential.

K. Hedging Transactions

Sophisticated producers will typically engage in forward sales, future trading, commodity options trading and other hedging transactions to reduce their risk of loss. Royalty agreements should stipulate that the Royalty Holder will neither benefit from, nor participate in, any losses resulting from such hedging activities.

L. Abandonment of Mineral Interests

It may be useful to provide the Owner the right to drop mineral tenures in order to reduce holding costs over parts of the property that the Owner is not interested in exploring further. However, if such mineral tenures are dropped, it is likely that the royalty will cease to apply to such tenures. Therefore, some royalty agreements contain a provision that permits the Owner to terminate or let lapse mineral tenures, provided that the Owner first offers such tenures to the Royalty Holder for no, or nominal, consideration. The royalty agreement may also contain a provision that if mineral interests are abandoned and then reacquired by the Owner within a specified period of time (e.g., a year), then the royalty re-attaches to those mineral interests.

M. Rights of First Refusal

Royalty agreements may contain rights of first refusal ("ROFR"). A mutual ROFR provides a party to an agreement the first right to acquire all or part of the other party's interest in the agreement on the terms offered by a third party, provided the offeror is willing to accept such third-party offer. A right of first refusal granted to the Royalty Holder of the applicable mineral property is not generally found in

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[7] *See* National Instrument 51-102, "Continuous Disclosure Obligations," § 12.2 (Can. Sec. Adm'rs).

the royalty agreements used by royalty companies, as royalty companies generally have little interest in acquiring mineral properties.

Royalty agreements may contain a right of first refusal granted by the Royalty Holder to the Owner, which gives the Owner the right to acquire all or part of the Royalty Holder's royalty interest for the amount of consideration offered by a third party. Such provisions usually require a Royalty Holder that has received an offer from a third party on all or part of its interests in a royalty, which the Royalty Holder is willing to accept, to offer such interests to the Owner on the same (or substantially similar) terms. The Owner is given a period of time (usually 30 to 45 days), within which it may accept the offer. If the Owner does not accept the offer, the Royalty Holder is free to sell that interest in the royalty to the third party on the same terms within a specified period of time (e.g., 90 or 120 days). Usually, a transfer of the royalty interest will not be subject to the right of first refusal if the transfer is to an affiliate of the Royalty Holder. Other transfers of the royalty interest may also be exempted from the right of first refusal, such as transfers to family members or transfers between multiple holders of the royalty. This type of ROFR is not common in the agreements of royalty companies, because it can reduce the resale value of the royalty. It is more typical to find this form of ROFR in royalty agreements between an Owner and a purchaser or optionee of mineral claims, or in respect of a royalty that may be granted under a joint venture agreement.

The form of royalty agreements used by royalty companies usually contain a right of first refusal granted by the Owner to the royalty company, which gives the royalty company the right to acquire any royalty or mineral stream, or a participating interest in, the minerals subject to the royalty agreement that are produced from the property for a price offered by a third party.

A variation on the right of first refusal – the right of first offer – may be used instead of a right of first refusal. In the right of first offer, the Owner must first offer the royalty, mineral stream, or participating interest that it wishes to sell, to the royalty company for a certain price, and only if the royalty declines to exercise the right may the Owner sell the royalty, mineral stream, or participating interest to a third party for the same or a higher price.

IV. Additional Provisions in Agreements used by Royalty Companies

A. Representations and Warranties

Unlike most royalty agreements that arise as the result of the sale by a prospector of mining claims or under an option or joint venture agreement, the more fulsome agreements used by royalty companies usually contain representations and warranties by each party to the other. Each party will typically represent and warrant that as a corporate entity (i) it is in good standing; (ii) it has complied with all required corporate acts and proceedings to approve the royalty agreement; (iii) it has all requisite corporate power, capacity and authority to enter into the royalty agreement; (iv) it has received all required third-party approvals to enter into the royalty agreement; (v) it has not suffered an insolvency event; (vi) entering into the royalty agreement will not conflict with any other agreement or obligation, or constitutional documents of the company, or violate any law, and (vii) the royalty agreement constitutes a legal and binding obligation of the company. These are obviously relatively standard representations and warranties that may be found in many different types of commercial agreements. The owner will usually further represent and warrant that (i) it is the legal and beneficial owner of the mining properties as described in the royalty agreement; ii) the mineral properties are in good standing; and (iii) the property is free and clear of all liens, charges, security interests, claims, mortgages and other encumbrances. Of course, the parties may make other representations and warranties as well, depending on the circumstances.

B. Covenants

Royalty agreements may also usually contain covenants from the Owner to the Royalty Holder, whereby the Owner agrees to indemnify the Royalty Holder for losses incurred by it as a result of a breach of the royalty agreement by the Owner, or as a result of operations on or in respect of the mineral property, including environmental liability. Some royalty agreements also contain the right of the Royalty Holder to be indemnified for its legal expenses in disputing the “Allowable Deductions” claimed by the Owner, where it is ultimately found that the Owner overstated the Allowable Deductions by a material amount.

C. Security

The rights of a Royalty Holder under a royalty agreement may be secured, although this is less common, particularly if the royalty is granted as consideration for the acquisition of mineral tenures from a prospector or under an option or joint venture agreement.

Where such rights are secured, the agreement usually provides for the granting of a first charge security interest by the Owner to the Purchaser or Royalty Holder over the mining property, project assets, produced minerals and proceeds thereof. Any subsidiaries of the Owner that have an interest in the mine’s assets may be required to guarantee the obligations of the Owner under the security agreements. Where security is granted, the agreement may contemplate additional financing requirements by the Owner by including an agreement of the purchaser to execute “inter-creditor” agreements with such new financiers in order to subordinate its first charge in some respects. Usually, Owners in the development stage will anticipate substantial project financing and the requirement of such lenders to obtain a first charge on most mine assets, so the participation of the Purchaser in executing inter-creditor agreements will be essential in order for mine construction to be completed. Agreements entered into by Owners with an operating mine may not need to contemplate additional financings, as project financing, if it was required at all, will have already been obtained and secured and any security taken by the Purchaser or Royalty Holder will be subordinated to the existing security of the project financing lenders.

The form of security will vary depending upon the local laws of the area in which the mine is situated. Assets of the mine that are interests in land (such as Crown Granted Mineral Claims in British Columbia) may be mortgaged; personal property, including future acquired personal property, may be subject to a general security agreement registered in the local Personal Property Registry; and property that is neither land nor personal property (such as mineral claims in British Columbia) may be subject to a general security agreement, which in the case of mineral claims should be recorded in the applicable mineral titles registry or mining recorder's office to provide notice of the encumbrance to any potential purchaser of the mineral claims. Alternatively, the Owner may be required to grant a debenture, which will secure all of the assets of the mining operation, including real property, personal property, minerals, inventory, and other assets, and which can be filed in the various government registries.

D. Transfer of Royalties

As mentioned above, royalty companies will typically want the right to sell a royalty to a third party. The royalty company may also want the right to charge, pledge, or assign as security to a lender its rights under the royalty agreement.

Where the royalty is transferrable, the royalty agreement should contain provisions that require an Owner that transfers all or any part of the property, or its interest in the agreement itself, to a third-party transferee to require such transferee to agree in writing to be bound by the terms of the agreement. If the royalty is found to be a contractual interest only (as opposed to an interest in land), a third party may not be bound to a royalty agreement unless such third party has agreed, in writing, to be bound.

E. Guarantors

Royalty agreements may require a guarantor to guarantee that the Owner complies with its obligations under the royalty agreement. This is particularly likely if the Owner is the party who grants the royalty and is a wholly-owned subsidiary of a public mining company, wherein the public mining company would guarantee the obligations of its subsidiary.

As mining laws in many countries require a resident owner of mining interests, the usual approach is to have a subsidiary incorporated in that foreign country, which holds the mineral interests and is wholly-owned by the Canadian mining company. In such circumstances, it makes sense to have the Canadian parent company guarantee the obligations of the Owner (i.e., the foreign subsidiary) where the Owner has granted the royalty. Where the preference is for the Royalty Holder to contract with the Canadian parent instead, the parent corporation may grant the royalty and its foreign subsidiary, as Owner, will guarantee the obligations of the parent corporation, which guarantee may be secured by the assets of the subsidiary, including, if possible, the Property.

F. Tailings and Residue

Royalty companies' more fulsome royalty agreements may contain a provision that the royalty applies to minerals recovered from tailings, residues, waste rock, spoiled leach materials and the catch all "other materials resulting from the Owner's operations and activities on the property", should the same be processed or reprocessed in the future and the minerals recovered are sold. Indeed, improved processing technology or an increase in the price of minerals may justify processing tailings or other waste material that was formerly uneconomic to process.

If care has been taken to think through how this would work in practice, the provision may go on to permit the Owner to store the tailings and waste rock on or outside of the property that is subject to the royalty, and to co-mingle the tailings or waste rock with that derived from other properties. This language recognizes that it may not realistic or economic to keep tailings and waste rock from the royalty area separate from that derived from other properties. The provision may then go on to provide that if the tailings, waste rock and other materials are processed, the royalty will be determined on a *pro-rata* basis as determined by reasonable and customary engineering or technical practices as are then available if the materials. However, this would require the Owner to keep track of the volume of tailings, waste rock and perhaps other materials from the royalty property as well as other properties that are deposited from time to time in the areas they are stored, and this may or may not be realistic under the circumstances of the particular mine.

G. Stockpiling

For reasons such as unfavorable market conditions or lack of resources of the Owner, Owners may wish to stockpile ore prior to processing. For royalties that are payable upon sale of the minerals, the royalty will not become payable until such ore is processed and sold. Some royalty agreements provide that the royalty is payable when ore or processed materials have been stockpiled for a specific time without further beneficiation or sale. In this case, volumetric surveys and assays may be used to determine the amount of royalty owed[8]. Some agreements also prohibit the filing of storage or warehouseman's liens against stockpiled material, together with a covenant for the Owner's prompt removal of such liens, if filed[9]. Where ore or processed materials are stored off-site, the royalty agreement may provide that the Owner must first obtain from the owner of the property on which the ore or processed materials will be stored a written agreement that the Royalty Holder's rights to the mineral shall be preserved.

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[8] Bruce C. Kirchhoff and Karol L. Kajalley, "International Mining Royalties," 57 *Rocky Mt. Min. L. Inst.* 15-40 (2011)

[9] *Ibid.*

H. Dispute Resolution

Royalty agreements should contain dispute resolution mechanisms. Disputes may arise in royalty agreements with respect to calculation of the royalty payments. This is particularly true in the case of NPI Royalties, where the calculation of the NPI Royalty is complex and may be subject to varying interpretations.

V. New Issues – Loss of Royalties in Bankruptcy and Insolvency Proceedings

Royalty agreements often contain a provision that the royalty interest "runs with the land" or is an interest in land, as opposed to a merely contractual interest. The reason for this is that a contractual interest can be lost if the Owner's interest in the property is transferred to a third party, who is not a party to the original royalty agreement. A royalty can also be lost if an Owner goes bankrupt and the royalty is "vested off" from the title to the property upon a Court-monitored bankruptcy sale.

The leading case, *Bank of Montreal v. Dynex Petroleum Ltd*.[10], set the test of whether a royalty constituted an interest in land as:

1. The language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right…; and
2. The interest, out of which the royalty is carved, is itself an interest in land.

In a matter that is currently before the Ontario Superior Court of Justice (in Bankruptcy and Insolvency)[11], the Trustee in the bankruptcy and insolvency proceeding of Strike Minerals Inc. ("Strike") obtained a vesting order, which would essentially result in the removal of a royalty interest (referred to herein as the "Vencan NSR") purportedly owned by Richmont Mines, Ltd. ("Richmont") in certain mineral properties owned by Strike which, by virtue of the bankruptcy and insolvency, are the subject of a sale to a third party. In the current proceedings, Richmont claims, *inter alia*, that its royalty interest is an interest in land that cannot be vested off of the real property to which it relates under a bankruptcy and insolvency proceeding.

Strike negotiated the sale of its assets to a company incorporated by Waterton Global Value L.P. ("Waterton"). The matter has yet to be decided, but the arguments by Richmont's counsel and Waterton's counsel are instructive in assessing whether the intention of the parties as evidenced in the royalty agreement was to create an interest in land, and whether the subject matter is itself an interest in land. As

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[10] 2002 SCC 7 at para. 22 (citing *Vandergrift v. Coseka Resources Ltd*., 1989 CarswellAlta7 at paras. 31-33)

[11] In the Matter of the Proposal of Strike Minerals Inc., of the City of London, in the Province of Ontario regarding a Motion to Set Aside/Amend the Sales Process Order and Sale Approval and Vesting Order. The authors wish to thank Asim Iqbal of Thornton Grout Finnigan LLP, counsel to Strike Minerals Inc., for providing details on the motion.

can be seen from the parties' arguments, many factors may be considered when determining whether the royalty interest is an interest in land or a contractual interest.

In the matter, Richmont's counsel has argued that the Vencan NSR is an interest in land, and the Court is not entitled to vest its interest off title to the subject property. Some of the factors that Richmont's counsel references in support of its argument are as follows:

- The parties clearly intended to create an interest in land. The terms of the Vencan NSR specifically state that "it is the express intention of the parties to this Agreement that the royalty be and is a real property interest and shall run with title to the Property…", and the Vencan NSR was registered in the Land Title Office.
- The Vencan NSR was "carved" out of leasehold and freehold interests in land, which satisfies the second leg of the test in *Dynex*.
- The Vencan NSR provides for in-kind royalty payments, not just cash payments resulting from a sale of product from the mine. The agreement is not tied to profits at market, but to a quantity of smelted minerals in a Net Smelter Royalty agreement.
- The Vencan NSR creates a large breadth of other property rights, such as:
    - A general right of access to the property at reasonable times and on reasonable notice,
    - A distinct right of access to the property to supervise the milling process and weigh trucks,
    - The right of exploration for the royalty holder to take its own core samples,
    - The right to a 3% share of the specific minerals in the land, unadulterated and not commingled with or substituted for other minerals,
    - A restrictive covenant whereby the owner of the servient tenement will not mine within 30 metres of the property boundary of a dominant tenement owned by the rights holder, and
    - An expectation that the Vencan NSR would be registered on title.

On the other hand, Waterton's counsel has argued, *inter alia*, that Richmont's interest in the property is, at best, a contractual interest, which expired on the issuance of the Vesting Order on March 23, 2017. Some of the reasons Waterton's counsel has provided to justify its position that the Vencan NSR is not an interest in land are as follows:

- The Vencan NSR relates to a share of the resource after it has been extracted from the ground, or a share in the revenue from the sale of such share, which indicates a contractual right only.

- The bare words in the Vencan NSR that the "intention of the parties (is) that the royalty be and is a real property interest" are not sufficient to create an interest running with the land. Unless the agreement actually conveys such an interest, the royalty agreement is more appropriately characterized as granting a contractual right.
- Registering a notice under the Land Titles Act does not create an interest in land, it only indicates a *claim* to have such an interest.
- The nature of the royalty holder's rights over the property is an important factor. For example, a royalty agreement which grants the holder rights to enter upon land to explore for and extract minerals is an indicium of a property interest, while rights to access property for accounting and auditing purposes suggest a contractual interest only. The Vencan NSR provides access to the property primarily for accounting and auditing purposes, suggesting a contractual interest.
- Limits on the Owner's ability to deal with the land is an indicia of a real property interest, such as a claim to any reversionary interest in any of the property should the Owner seek to relinquish all or any portion of the property. Where a royalty agreement does not restrict the ability of the Owner to sell the underlying interest and does not obligate the Owner to require a purchaser to assume the royalty obligations, this indicates a contractual interest.

It remains to be seen how the Court will rule on this matter, but it clear that if a royalty is accepted as an interest in land, it should survive a bankruptcy and insolvency case, whereas if it is merely a contractual right, it likely will not. A similar result may occur in the case of expropriation or upon the sale by the Owner of the property to a *bona fide* third party without notice[12].

It is important to note the second part of the *Dynex* test requires that the interest, in which the royalty is carved, must itself be an interest in land in order for the royalty to be considered an interest in land. In British Columbia, crown granted mineral claims and mineral or placer leases[13] are interests in land, so it is possible to create a royalty that is itself an interest in land. However, mineral claims and placer claims are chattel interests[14] and, as such, it is not possible to create an interest in land for those mineral tenures. However, it may be useful to still attempt to utilize as many indices of an interest in land as reasonably possible. If the royalty agreement is drafted to include any subsequent tenures from which existing mineral or placer claims are converted, as it is not unusual that mineral or placer claims are

[12] *See* Harries, *supra*, p. 217-218.

[13] Section 48 of the *Mineral Tenure Act* (British Columbia).

[14] Section 28 of the *Mineral Tenure Act* (British Columbia).

converted into leases when a property is under development to be mined. Therefore, a mineral interest that was not an interest in land may at some later date be converted into an interest in land, and it may be worthwhile to draft for this contingency to help to protect the Royalty Holder's interest in the future.

VI. Conclusion

Royalties can be used as consideration or partial consideration for the sale of mineral tenures or as consideration for extinguishing a participating interest in a joint venture upon dilution. More recently, royalties have been sold to finance exploration, development or mining endeavours, and some companies have emerged that specialize in acquiring royalties and earning revenues from them.

As a result of the downturn in commodities markets over the past several years and the attendant difficulties in obtaining favourable debt or equity financing, royalties (along with streaming arrangements) have emerged as an attractive alternative to funding mining operations, especially development or expansion costs. Royalty companies have developed quite comprehensive royalty agreements. A review of these agreements may be instructive when drafting royalties granted by purchasers of mineral properties, optionees or joint venture partners.

Royalty Holders should be cognizant of the fact that they are less likely to lose their royalty under certain circumstances, such as the bankruptcy and insolvency of an Owner, if their royalty can be characterized as an interest in land. If the royalty cannot properly be characterised as an interest in land, the royalty agreement should contain provisions that require the Owner to obtain the written agreement of any proposed transferee of all or any part of its interest in the property to be subject to the royalty before it transfers all or any part of the property to agree to be bound by the royalty.