



Option and Royalty Agreements: The Legal Perspective

Justin F. Hewitt
Tyler Callahan

Agenda

1. Option Agreements
2. Royalties
3. Taxation

What is an Option Agreement?

- Grant by the owner of mineral rights (the “Optionor”)
- to another party (“the Optionee”)
- of the right to acquire all or part of the Optionor’s mineral rights
- upon the Optionee’s satisfaction of certain conditions (\$ payments, securities deliveries and/or work expenditures)
- within an agreed timeframe

Basic Legal Requirements for Option Agreements under NL Law

- To be valid under NL law, an Option Agreement must be:
 - in writing
 - reflect with certainty the key terms – the property, the price and the timing
 - be executed by the Optionor and the Optionee
 - be registered with the Mineral Claims Recorder (in practice, requires the Minister's consent)

Registration Requirement Onerous

- Section 6 of the *Mineral Act* provides that an agreement relating to NL mineral rights “...**is not valid and does not have an effect in law** until it is registered by the recorder and the registration fee... is paid” (emphasis added)

NL Law Proof of Agreement for Registration Unusual

- There are specific requirements for proof of registration under NL law – execution must be directly witnessed by, e.g.:
 - a lawyer
 - a notary public
 - a commissioner of oaths
 - a justice of the peace
- If not directly witnessed an affidavit of a witness to execution must be sworn and attached to the agreement to permit registration

Identification and Definition of the Property

- Best practice is to identify the Property by reference to the relevant license or lease, its location, and the number of claims, viz “ mineral license No. 01234M dated July 1, 2010 for 22 claims located at Port Leamington, Newfoundland and Labrador”
- If the Property includes surface rights, this should be specified

Identification and Definition of the Property, Cont.

- To protect the Optionor's interest, the Property definition should include:
 - substitute or successor titles (e.g. reduced/extended licenses, mineral leases)
 - mineral rights acquired by a party in any Area of Interest

Certainty of Consideration (\$ and Securities)

- “Time is of the essence” is a standard clause – means what it says
- Means that cash and/or securities must be delivered on the dates specified in the Option Agreement (usually the signing and anniversary dates) or the Option will fail

Accepting Securities as Consideration

- If you take all or part of a purchase price or Option payment for the Property in “securities”, the transaction will engage securities law and corporate law considerations
- In addition, it is important to realize that by taking securities you are investing in the Optionee

Securities Exemption

- In order for an Optionee to issue securities to you without preparing a **prospectus** – there must be an exemption from securities laws available for the sale (whether or not the Optionee is a private or public company)
- Most likely exemption - section 2.13 of NI 45-106 *Prospectus Exemptions*, which provides that the prospectus requirements do not apply to the issuance of securities by an issuer in consideration for the acquisition of **petroleum, natural gas or mining properties** or any interest in them

Public Company Considerations

- If the Optionee is a public company, you should be aware:
 - that the transaction will be subject to the public company regulatory regime - which will require exchange approval, may impact price and may require other approvals
 - that securities issued to you under the resource property exemption will be subject to a **four month** hold period
 - that the receipt of a large number of shares may impact your personal securities obligations. Note the 10% and 20% thresholds

Public Company Considerations Cont.

- that insider trading rules and prohibitions against tipping will likely apply to you
 - no trading when in possession of material, undisclosed information about the Optionee or the Property
 - no tipping others with respect to such information

Private Company Considerations

- If the Optionee is a private company (i.e., hasn't issued securities pursuant to a prospectus, isn't listed on a stock exchange), you should:
 - expect a longer term investment as securities are not “freely tradable” and will be more difficult to sell
 - consider protecting yourself with a shareholders' agreement
 - be wary of promises that the company is about to “go public” or “list”
 - note that stock exchanges have ability to escrow shares on listing

Due Diligence and Risk Tolerance

- **A word on the “investment” aspect of the transaction:**
 - Prior to accepting securities as consideration for your Property you should ensure that you do all the business, legal and financial “due diligence” necessary to ensure that you are making a sound “investment” decision
 - Understand your own risk tolerance and know what your goal is

Due Diligence and Risk Tolerance Cont.

- Private company due diligence may be more difficult depending upon what material the Optionee has available in a form able to be reviewed
- Public company due diligence can be assisted by records available on the SEDAR website (www.sedar.com)
- Also pay attention to:
 - the liquidity of the Optionee's securities – trading price and volume
 - the Optionee's cash position and record of completed financings

Securities Summary

- Adding a securities feature to an option deal will change the nature of the deal
- The transaction costs are likely to be higher as a result of: (i) additional complexity and documentation, (ii) due diligence, and (iii) additional regulatory requirements

Title to Property During Option Period

- Possible for Optionor to retain and transfer the Property only if Option exercised (best for Optionor)
- Alternative is to transfer the Property to the Optionee upon execution of the Option Agreement
 - can simply transfer subject to all terms and conditions of the Option Agreement
 - can manage via escrow agreement (execute and deliver transfer to third party escrow agent for release to the Optionee upon notice that all Option Agreement terms and conditions have been performed)
 - alternatively, can transfer the Property and have the Optionee execute a Declaration of Trust with the obligation to re-transfer if the Option is not exercised

Conventional Representations and Warranties – Both Optionor and Optionee

- Corporate capacity
- Due authorization, execution and delivery of, and enforceability of, the Option Agreement
- Solvency
- No conflict with third-party agreements and no third-party consents required

Conventional Representations and Warranties of the Optionor

- The Optionee shall be entitled to conduct mineral exploration on the Property
- Respecting title to the Property, that:
 - the Property is validly staked and recorded, and is in good standing
 - title to the Property is good and marketable, free and clear of liens, encumbrances, litigation and/or third party claims
 - the Optionor has delivered all Property information in its possession

Conventional Representations and Warranties of the Optionor, Cont.

- Need to be careful to qualify title representations and warranties respecting:
 - surface rights – confirm whether or not held, and if held, on what basis and record any limitations (e.g. third-party consents required under section 12 of the *Mineral Act*)
 - underlying agreements or interests
 - applicable aboriginal rights (discussed below)
- Property is in compliance with applicable laws, including environmental laws

Conventional Optionee's Covenants and Commitments

- If securities are to be issued:
 - represent the Optionee's issued and outstanding share capital
 - covenant to use best efforts to obtain Exchange approval within a specified timeframe
- Keep the Property in good standing, including via filing annual assessment work reports
- Keep the Property free and clear of liens and encumbrances (except with Optionee's written consent)

Optionee's Commitments, Cont.

- Conduct mineral exploration and mining activities on the Property:
 - in accordance with good and prudent mineral exploration and development standards prevailing in the Canadian mineral exploration and mining industry
 - in compliance with the *Mineral Act* and the *Mineral Regulations* and all other applicable Canadian and NL laws, including environmental laws

Optionee's Commitments, cont.

- Obtain and maintain liability insurance and registration/compliance with the *Workplace Health, Safety and Compensation Act*
- Provide the Optionor with access to the Property at the Optionor's risk on reasonable notice
- Provide the Optionor with material exploration results and data from the Property in a timely fashion

Work Commitments

- Option agreements will often contain specific work expenditure commitments by the Optionee
- Useful to:
 - ensure work commitments will qualify as “assessment work” under section 48 of the *Mineral Regulations*
 - ensure work commitments fit with assessment work timing requirements for the Property
 - ensure verifiability by written accounting from the Optionee

Dropped Claims

- Typically, the Optionee will wish to have the right to drop some ground
- Should require reasonable written notice to Optionor (30 days)
- The Optionor should be entitled to re-acquire dropped claims without any cost, with one year's assessment work credit, free of any obligations under the Option Agreement

Area of Interest

- Operates to ensure that any mineral rights acquired during the Option Agreement term by the Optionor, Optionee and/or related parties within an area outside the Property as initially defined will automatically become part of the Property
- Ensure delimited by the boundaries of the Property as described in the Option Agreement (and not later as may be the case with surrenders, etc.)
- Beneficial to an Optionor if a royalty or other interest in the Property is retained

Some Standard Commercial Clauses

- Entire agreement clause – supersedes letters of intent/verbal dealings/letter agreements
- Assignability – clarify and confirm assignability/transferability (resist ROFR's and ROFO's)
- Ensure successorship obligations – particularly important if the Optionor is to retain an interest (e.g. percentage interest in the Property or royalty)
- “Time is of the essence”

Some Standard Commercial Clauses, Cont.

- Force Majeure – will suspend Optionee’s performance obligations for such reasonable time as necessary for the Optionee to cure
- Exclusion of partnership/joint venture relationships
 - Excludes fiduciary relationships
- Exclusion of corporate opportunity doctrine
- Non-waiver (resist default-and-cure provisions)

Some Standard Commercial Clauses, Cont.

- Service Addresses:
 - Important from a legal point of view
 - Technical point here is that it is a good idea to ensure that if your Optionee is a foreign company, it is registered in NL
 - ease of service in the event of a legal dispute
 - arguably required under the *Corporations Act* and to permit agreement registration under the *Mineral Regulations*
 - Arbitration(?)
 - Choice of NL law and attornment to NL courts – important to minimize your costs of litigation if necessary

Indemnities

- Not unusual to see reciprocal indemnities whereby the Optionor and the Optionee agree to indemnify each other respecting their representations/warranties and their respective activities/work on the Property

Option Termination Events

- Important to ensure that there is clarity
- Typical automatic Option Agreement termination events will include:
 - notice by the Optionee
 - failure to deliver cash consideration on time
 - failure to deliver securities consideration on time
 - failure to complete work commitments on time
- Any waiver or indulgence should be in writing

Termination of Option Agreement

- Ensure there is provision that the Property be returned or re-transferred to the Optionor
 - with a minimum of one year's assessment credit
 - free and clear of liens and encumbrances
 - in compliance with all applicable laws (e.g. reclamation/rehabilitation obligations under exploration approvals, under the *Mineral Regulations* and/or under certificates of approval issued under the *Environmental Protection Act*)

Termination of Option Agreement, Cont.

- Ensure Optionee is required to deliver all relevant technical data respecting the Property to Optionor
- Ensure Optionee removes mining facilities on the Property within 90 days (or the facilities become the Optionor's property)
- Ensure Optionee remains liable for all pre-termination obligations under the Option Agreement

Royalties

- A modern hardrock mineral royalty is the right to obtain some percentage or value from mineral production if a Property becomes a mine
 - there is no such thing as a “standard” royalty
 - there are many different types of royalties – e.g. royalty in kind, a tonnage royalty, a gross royalty, a net smelter returns royalty, a net profits royalty and a net proceeds royalty.

Today's Royalties

- In modern day option agreements, mostly:
 - gross royalty (GR)
 - net smelter returns royalty (NSR)
 - net profits royalty (NPR)

Gross Royalty

- “Gross royalty” (GR) – this is probably the cleanest and simplest form of royalty
 - A GR is simply calculated and payable as a straight percentage of gross mineral product revenues from the mine
 - The attraction of a GR is its simplicity – there are no deductions

Net Smelter Returns Royalty

- “Net smelter returns royalty” (NSR) – an NSR is an entitlement to a percentage of “net smelter returns”
 - “net smelter returns” means the revenue received by the mine from the sale of its mineral product, after deducting some limited and well understood deductions
 - typical deductions associated with handling and processing costs, include, e.g. such things as:
 - transportation costs from the mine property
 - smelting and refining charges
 - sampling and assaying costs
 - insurance costs
- Concept is that the royalty will be payable on the value of the recoverable minerals from the Property

Net Smelter Returns Royalty, Cont.

- In calculating the NSR, no deductions are made for the mine's development, capital or operating expenditures
- Again, the attraction of the NSR is its simplicity and certainty (very few readily-verifiable handling and processing cost deductions)
 - E.g. Voisey's Bay Mine NSR held by Labrador Nickel Royalty Limited Partnership

Net Profits Royalties

- “Net profits royalty” (NPR) – sometimes also known as a Net Profits Interest or an “NPI” – this is a royalty calculated as a percentage of a mine’s net profits
- Historically the NPR has been a common form of royalty because it is less risky to a mine owner – it is payable only from profits (unlike GR or NSR which are payable regardless of mine profitability)
- Deductible costs to determine the “net profits” royalty base will typically include exploration and development costs, capital expenditures, operating costs and allowances for, e.g., working capital and reclamation costs
- NPR is complex, and potentially subject to manipulation – would be prudent to have an accountant to both advise and negotiate deductions and, after commencement of commercial production, to verify payments.

Advance and Minimum Royalties

- An advance royalty is payable before the Property is brought into commercial production
- Will require negotiation:
 - amount? duration – time limit or until commercial production?
 - to be credited against royalty paid after commencement of commercial production?
- A minimum royalty is typically payable after commercial production is attained – simply the minimum royalty amount per year (often payable quarterly but calculated on an annual basis)
 - will cease be payable when the royalty itself exceeds the minimum amount
 - typically payable for life of mine (evergreen)

Royalty Agreements – Key Issues for Negotiation

- GR, NSR or NPI – royalty rate?
- Term (Life of Mine or otherwise) – time limited? - \$ cap?
- Advance royalty payments – if so, how to be credited?
- Minimum royalty?
- What mineral products will be subject to the royalty (e.g. all minerals of every type and nature)
- Will the royalty cover bulk samples? Pilot plant production?
- Royalty calculation formula, including applicable deductions – for deductions, ensure protection against non-arm's length deductions/costs
- Timing of payment?

Royalty Agreements – Key Issues for Negotiation, Cont.

- Audit rights (including reasonable access to payor's records at reasonable times) and time limits for objections/deemed acceptance
- Assignability of the royalty (there is a market for royalties), and if so on what basis (Right of First Offer? Right of First Refusal? Absolute right to assign?)
- Buyback rights? – in particular the price, percentage interest subject to buyback, and purchase and sale transaction mechanism
- Royalty-holder's right to access and visit the mine site during the currency of the royalty?
- Clarify dispute resolution mechanism – private arbitration or litigation in Court (public)?

Royalty Agreements – Key Issues for Negotiation, Cont.

- Successorship – important to ensure that the royalty agreement is binding upon successors and assigns, and that the Property owner will notify any purchaser of the Property as to the royalty, and will make it a condition of sale that the purchaser will be bound by and will observe and perform the royalty obligations directly to the royalty-holder
- Other exceptional provisions for consideration:
 - Provisions of an annual report as to exploration of this Property, future mine production, reserves, etc.

Legal Nature of Royalties

- The ‘legal’ nature of the royalty is relevant – really two main possibilities
- A royalty can be:
 1. A contractual entitlement (simply the mine owner’s promise to pay the royalty) or
 2. An interest in the Property itself (which is stronger for the royalty-holder)

Legal Nature of Royalties, Cont.

- In the 2002 case of *Bank of Montreal v Dynex Petroleum Ltd.*,¹ the Supreme Court of Canada decided that under Canadian law a “royalty interest” can be an interest in land if
 - 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 to a portion of the ... substance recovered from the land; and*
 - 2) *The interest, out of which the royalty is carved, is itself an interest in land.*²
- An Optionor with leverage can negotiate a royalty interest which is expressed to grant or reserve an interest in the Property
 - benefits include:
 - will bind successor owners of the Property automatically
 - will survive the insolvency of the Property owner
 - will participate in an expropriation or confiscatory taking
 - possible risks include:
 - NL *Environmental Protection Act* obligations as a “person responsible”
- An Optionee will typically prefer that the royalty be limited to a contractual entitlement (e.g. ease of dealing with Property, title opinions, financings)

¹ *Bank of Montreal v Dynex Petroleum Ltd.* [2002] SCR 146 (S.C.C.)

² *Ibid.*, p. 11-12.

³ *Bank of Montreal v Dynex*

Legal Nature of Royalties, Cont.

- Since the *Dynex* case, the Courts seem to have been fairly generous in finding that royalties can constitute interests in land.
- In *Blue Note Mining Inc. v Fern*,⁴ the royalty was described as an NPI which “...grants a freely assignable 10% net profits interest in the mine.” This was sufficient for the Court to find that the royalty constituted an interest in the land.
- In *Third Eye Corporation v Ressources Dianor Inc./Dianor Resources Inc.*,⁵ a gross overriding royalty was found to be an interest in land based on the following language:

It is the intent of the parties hereto that the GOR shall constitute a covenant and an interest in land running with the Property and the Mining Claims and all successions thereof or leases or other tenures which may replace them, whether created privately or through governmental action, and including, without limitation, any leasehold interest.
- There are no NL precedents, so still an open question under NL law as to whether a royalty can be an interest in a mineral licence and/or mining lease.

⁴ *Blue Note Mining Inc. v Fern*, 2008 NBQB 310

⁵ *Third Eye Corporation v Ressources Dianor Inc./Dianor Resources Inc.*, 2018 ONCA 253.

Royalty Agreements - Generally

- Can be stand-alone or in an option agreement or joint venture agreement
- It is the language of the royalty provisions which will be critical
- Registration is necessary. Many cases highlight the importance of registration/successorship, e.g.:
 - *National Trust v Johnson*⁶ – the royalty-holder had not registered and appropriately protected its royalty interest, and lost its royalty rights
 - *Blue Note Mining, Inc. v Fern Trust*⁷ – an unregistered NPI was held to be valid only because the mine property owner was found to have had actual notice of the NPI before he bought the mine

⁶*National Trust v Johnson*, 2002 MBQB 143.

⁷*Blue Note Mining, Inc. v Fern Trust*, 2008 NBQB 310.

Taxation: General Principles

- Canadian taxpayers pay tax on worldwide income realized in the year
- Integration – taxes should be roughly the same regardless of structure by the time an individual gets the money
 - Not perfect, but reasonably close
- Tax avoidance versus tax deferral
- Money now > Money later
- The intersection of tax and mining is very complicated and fact-specific – seek advice

Regular Income vs Capital Gains

- Regular income taxed at 100%
 - Income from employment, business, or property
- Capital gains taxed at 50%
 - Disposition of a capital asset for a price greater than the price for which it was acquired

Option Agreements and Taxation

- Common forms of Option Agreement remuneration:
 - Cash payments – included in income for the year
 - Royalties – included in income for the year
 - Shares – not included in income for the year, capital gains once sold
- Remuneration may be paid immediately, over a fixed period of time, or some combination of the two
- Timing matters (e.g. marginal rates for individuals)

Taxation: Structure of a Business

- Sole proprietorship (unincorporated)
 - Most common
 - Simple, but no protection from liability, and no potential for tax deferral
- Partnership
 - Similar to sole proprietorships from a tax standpoint
 - Shared commercial liability, some ability to share income

Taxation: Structure of a Business

- Corporation
 - Pay yourself salary or dividends
 - Best protection from liability
 - Best options for tax deferral
 - Expenses associated with incorporating and compliance, both legal and accounting, so not always worth it
 - Less attractive after 2018 due to TOSI, but still a good option
 - Generally want to first make more than you spend

Taxation: Structure of a Business

- Corporation
 - Corporate tax rates are generally lower –
more opportunity to reinvest into the business

Taxation: Succession Planning

- Operating as a corporation = transfer your business as one “package”
- The estate freeze
 - “Freeze” the value of the corporation in preferred shares and redeem over time
 - Pass along growth shares to another entity (often a trust)

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QUESTIONS?



Justin F. Hewitt
jhewitt@stewartmckelvey.com
709.570.8846



Tyler Callahan
tcallahan@stewartmckelvey.com
709.570.8825



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