When is a Mining Royalty an Interest in Land and Why Does Anyone Care?

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Royalty interests form an important part of mineral ownership and mining finance. Under a royalty arrangement the operator of a mining project will pay to the royalty holder a stream of income based on the output or returns of the mining project. Oftentimes royalty interests are retained when mineral dispositions are sold to an operator for further exploration and development. Royalty agreements are so ubiquitous in mining that they have helped generate a whole new breed of financier, the royalty streaming company. Royalty interests and royalty agreements are also common in the oil and gas industry.

Over the decades, Canadian courts have had to grapple with the nature of royalty interests in general, and the specific nature of different types of royalty interests. The question often comes to light in the context of insolvency on the part of the operator or a transfer of the underlying mineral interest (whether voluntary or involuntary). If the royalty interest forms what is known in law as an "interest in land", it will be considered to "run with the land" and be binding upon third parties who acquire a later interest in the mining property. Conversely, a royalty interest that is not considered to be an interest in land is classified as a purely contractual right and can only be enforced by the royalty holder against the original grantor of the royalty, not against parties who subsequently acquire an interest in the underlying mining rights.

Take the case of a transfer of a mineral disposition from the operator to a third party. If the royalty interest is an interest in land (and is properly recorded in the appropriate mining registry office), the party acquiring the mineral rights will have to take those mineral rights subject to the royalty and will be bound by the royalty agreement. If the royalty is not an interest in land, the new owner may accept the transfer of mineral rights without regard to the obligation of the operator toward the royalty holder. The royalty holder is then left to enforce its rights against the former operator, who no longer owns the mining property. The same scenario plays out when a subsequent secured creditor, receiver or trustee in bankruptcy comes in and attempts to deal with the mineral interest that forms security under a loan. Unless the royalty interest has created an interest in land, it will generally not survive

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realization by the secured creditor or a disposition (by vesting order or otherwise), by the trustee or receiver.

Needless to say, when the fat hits the fire, royalty holders will argue that their interests can't be ignored by third parties who come to acquire the underlying mineral rights.

In North American mining, one typically talks about two types of royalty interests: the net smelter returns royalty (NSR) and the net profits interest royalty (NPI). The NSR is described as a royalty calculated on the amount received by the mine or mill owner from the sale of mineral product to the smelter or treatment plant that converts the ore concentrate to marketable metal. The NSR may provide for deductions for costs incurred by the owner of the product after it leaves the mine property, but before sale, such as transportation, refining and marketing costs.

The NPI royalty is typically calculated as a percentage of gross cash income from a mine-mill complex after all expenses incurred to produce that income have been taken into account. Usually no NPI royalty is payable until the operator has recovered its capital investment and preproduction expenses from the net income stream.

A third type of royalty, more common in the oil and gas sector, is the gross overriding royalty (GOR). In the petroleum industry, the GOR owner receives a share of the market price of the petroleum products at the time that they can be put to market, and after deduction of all costs incurred by the operator to bring those products to the point of sale, as saleable product.

Historically courts looked to a number of factors to determine whether or not the royalty created an interest in land. Did the royalty agreement provide for the royalty holder to take its royalty by physical delivery of the commodity, as opposed to holding just a right to receive cash? Did the royalty holder retain a right to enter and work the mineral disposition on default by the operator? The intention of the parties to create an interest in land, even if specified in the agreement, would not necessarily displace these common law tests.

The Ontario Court of Appeal had a recent opportunity to consider the classification of a royalty agreement in a pair of decisions in *Third Eye Capital Corporation* v. *Dianor Resources Inc.* Dianor was an insolvent exploration company under receivership. The Receiver sought to dispose of Dianor's mining claims to the successful bidder, Third Eye. Third Eye's bid was conditional upon the extinguishment of a GOR in favour of a third party which also held the surface rights. The royalty holder objected to a court vesting order that would vest the mining claims free and clear of its royalty interest.

In a June 2018 decision the Court considered the agreement as a whole along with surrounding circumstances to determine that the intention of the parties was to create an interest in land that would run with the mineral claims. The Court also looked at the interest

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that was being created. It found that the non-operating interest held by the royalty holder, which did not include a right to enter into the property to explore and extract minerals, could still create an interest in land. Finally, the Court held that the GOR's status as an interest in land was not defeated merely because the royalty was calculated based on the proceeds of production, rather than a share of the physical minerals that were produced.

The Court then invited the parties to make submissions as to whether the lower court had jurisdiction to issue a vesting order in favour of the buyer, Third Eye, that would have the effect of wiping out the existing royalty interest. The Court held that the GOR constituted an interest in the gross product extracted from the land and not a fixed monetary sum, and was therefore an interest in land. It held that the judge could not extinguish the GOR through the issuance of the vesting order.

The lesson learned from the two *Dianor* decisions is that care must be taken in the drafting of royalty agreements if it is the intention of the parties to have the royalty run with the land and be binding upon subsequent acquirers of the mineral interests. Courts will look not only to the language of the agreement, but also the surrounding circumstances to divine the parties' mutual intent. Lastly, parties need to take necessary steps to protect their royalty interests, including registration of notice in the appropriate registry office.

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