



Are net smelter royalties enforceable against Quebec mining properties?

BY DIMITRI MANIATIS AND PASCAL ARCHAMBAULT

Mining companies frequently offer royalties as part of property option or purchase deals. A net smelter return (NSR), through which the holder is typically paid a percentage of the value of production or net proceeds received from a smelter or refinery, is a popular type of mining royalty. But if the producer company goes bankrupt or the mine is sold, does the holder of the NSR retain the royalty as per its agreement with the company? Is the royalty good if the mine starts up again? A recent judgment by the Quebec Court of Appeal (QCA) illustrates the complexity of creating enforceable NSR royalties under the civil law of Quebec.

In 2009, Anglo Pacific Group entered into a deal with Northern Star Mining Corp. and Jake Resources Inc., giving them a loan and requiring that the joint owners pay an NSR royalty in return. Anglo Pacific later registered the debenture deed, containing the NSR agreement, in the public register of real and immovable mining rights (known as the Mining Register) maintained by Quebec's Ministry of Natural Resources. Following their bankruptcy in 2011, Northern Star and Jake Resources' assets were sold, with court approval, by the receiver, Ernst & Young, and Anglo Pacific lost its royalty. Anglo appealed the court's judgment, but the QCA ruled that its NSR rights were unenforceable against the new acquirer.

The question before the court came down to whether the NSR created a "real right" or a "personal right." A real right is a direct right over a thing or property, and it is enforceable against anyone once the formalities of registration have been satisfied. In contrast, a personal right is one against another person for the performance of an obligation. Practically speaking, the result is that if the NSR agreement merely creates a personal right, the royalty may turn out to be unenforceable – and quite possibly worthless – if the producer company becomes insolvent or if the underlying mining property is sold to a third party. In those cases, the NSR will not follow the property.

So how does a company go about creating a real right? The QCA stated that to have a real right, the NSR holder must have a right that can be exercised directly over the property through one or more of the attributes of ownership. That means it must have the right to use, enjoy the products from, or dispose of the property. If the NSR agreement does not confer one or more of the aforementioned attributes of ownership in the underlying mining property, but merely a proportion of the profits from the sale of minerals extracted from the subsoil, then the NSR will constitute a personal right enforceable against the original owner. It will, however,

be unenforceable against third parties, unless they sign on to the NSR or agree to be bound by it. This is what happened in the Anglo Pacific case. Despite express wording in the NSR agreement to the effect that the parties wished to "create a direct real property interest in the Products and the Properties in favour of the Holder," in reality Anglo Pacific was granted a right to receive certain payments upon the sale of the mineral substances, and none of the attributes of ownership mentioned above.

But there is more. The QCA also ruled that real mining rights that are not subject to an exemption under the Mining Act must be published in the register of real rights of state resource development, which is part of the Quebec land register – not the Mining Register – in order to be asserted against third parties. Real mining rights published in the Mining Register alone may only be set up against the state. So even if Anglo Pacific's NSR had created some real right, it still could not have been set up against a third party. Care must therefore be given to the registration of mining rights on the appropriate registries.

Even though the QCA held that it is possible to create a mining royalty that is a partial ownership right and provided guidance on how to do so, the practical reality is that royalty agreements are seldom designed to grant the royalty holder with such direct rights in the mining claims, leases or extracted mineral substances. The QCA also made it clear that industry customs and the intention of the parties to such agreements are insufficient. The court stressed the uniqueness of Quebec's French-inherited legal system as compared with its counterparts in the rest of Canada, and issued a word of caution about some of the legal authorities that Anglo Pacific relied upon to argue its case, stating that "care must be taken not to adopt principles from foreign legal systems without questioning their compatibility with our law."

In Quebec, it is now clear that the holder of an NSR will have to receive more than a mere personal right to secure any entitlement to a percentage of the receipts or profits from the sale of the minerals extracted from the subsoil. Companies providing loans as part of transactions relating to Quebec mining properties should therefore pay close attention to the drafting of their NSR agreements and obtain professional advice to reduce the risk of having their royalty become a hollow promise of income. **CIM**

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