FINANCIAL NON-WORKING INTERESTS IN THE RESOURCES INDUSTRY

By Howard Player-Bishop*

This paper is intended not so much as an academic treatise but as a practical guide. In the first part of the paper, a number of the different types of financial non-working interests arising in the mining and petroleum industries (FNWIs) are examined. In the second part of the paper, some of the considerations a lawyer should take into account when taking instructions and drafting the relevant FNWI Deed, whether on behalf of the payer or the payee, are examined.

TYPES OF FINANCIAL NON-WORKING INTERESTS

Definition

FNWIs encompass a number of different arrangements which loosely and conveniently fall within the family of private 'royalties'. FNWIs are not terms of art[1] and as a family are not readily capable of definition. Each type of arrangement is a creature of commerce and contract and as such is limited only by the imagination of the person proposing the arrangement, the ability of his advisers to translate the proposal into an effective and enforceable agreement and the input or variations suggested by the other party (and his advisers). Therefore, I will refer to such interests as royalties in the remainder of this paper (save in relation to the Tax Issues Section).

It is important to realise that the term 'royalty' is generic and in practice will have the meaning ascribed to it in the document which creates such interest.

This paper assumes that a holder of a 'non-working interest' no longer participates in the management, risks and liabilities associated with a project and does not remain registered on the particular tenement as an owner. In practice, this will not always be the case.

In the remainder of this paper I will refer to the royalty holder as the 'payee' and to the person obliged to make or deliver the royalty as the 'payer'.

Why and When Do They Occur?

The principal reason for royalties being granted is that the payee wishes to retain some right to future 'income' from the project in hand without any associated risks or liabilities. The payee will be looking for the 'blue sky'.

The circumstances in which royalties arise are numerous and include, but are not limited, to the following:

* LL.B. (Exeter UK), Solicitor, NSW.

1 *Bensette v. Reece* (1973) 34 DLR (3d) 723.

SELLING OUT

The payee may have become disenchanted with a tenement or may run out of funds to continue exploration work or may never have had the necessary funds and as a result sells the whole or part of its interest in that tenement in return for either cash or a royalty or a combination of the two.

PAYMENT FOR SERVICES

Self-employed geologists are increasingly requesting that as part of their consulting contracts they be rewarded both in cash and by way of royalties arising from any future discoveries which may occur in the area within which they have performed their services. An example of this would be the royalty granted to Mr Weeks and which subsequently became the subject of the *BHP v. Oil Basins* cases[2].

A FORM OF NON-BANK FUNDING

The payee may transfer a part or the whole of its interest in a tenement to the payer in return for the payer carrying out certain work obligations and incurring certain expenditures to a stated amount or to a particular stage of the exploration/development of the project. Coupled with the payer's expenditure obligations may be an obligation to pay a royalty to the payee, especially if the payee only retains a small interest in the tenement having transferred a large interest to the payer in return for disproportionate expenditure requirements.

A FORM OF BANK FINANCE

Production payments have been used as a form of limited recourse finance in the petroleum industry[3] and in the mining industry (i.e. gold loans).

TRADE OFFS OR SWAPS

The payer may wish to obtain certain confidential information or an interest in a particular tenement belonging to the payee and in order to do this the payer grants the payee a royalty interest in relation to a tenement held by the payer.

AS A FORM OF COMPENSATION TO LANDOWNERS

A private landowner, whose land may be classified as agricultural, may negotiate a royalty as compensation for allowing a mining company to explore or develop a tenement situate on such land.

2 *BHP Petroleum Pty Ltd v. Oil Basins Ltd* [1985] VR 725.

3 Bass Strait productions payments and see R A Ladbury, 'Recent Trends in Limited Recourse Financing with Particular Reference to Limited Recourse Loans, Production Payments and Forward Sale and Purchase Agreements' (1979) 2(1) *AMPLJ* 68.

PRIVATE MINERAL OWNERS

In those states where minerals are privately owned, the landowner may negotiate a royalty in return for allowing mining on his land.

SO AS TO OBTAIN PROCESSING TECHNOLOGY OR KNOW-HOW

A payer may grant a royalty to a company in consideration of that company licensing certain processing or other technology which the payer can utilise in relation to the relevant project[4].

Royalties are becoming more prevalent especially in the mining industry, and this may be a reflection of:

— those involved adopting a more commercial attitude;
— those involved becoming more aware of the options; and
— the present economic downturn.

CATEGORIES OF ROYALTIES

Whilst it is difficult to define royalties, it is possible to categorise royalties by reference to their characteristics. Royalties usually fall into any one of four categories:

Owner Royalties

This type of royalty usually involves a landowning payee reserving to itself the right to take or have delivered to it a certain share of product or take an in-cash royalty in consideration of the payee allowing the payer to work and win minerals/petroleum from a leased area. The concept is derived from North America[5] where in certain cases the landowner actually owns the minerals/petroleum in the ground. In Australia (with the exception of certain areas where minerals are privately owned as for example in New South Wales), all minerals and petroleum are vested in the Crown and as such this type of royalty cannot normally be reserved to a payee as it has no title to such minerals or petroleum until they are severed from the ground. However, the royalty provisions in petroleum licences and mining leases granted by the Commonwealth and each State or Territory are examples of this type of royalty.

In-kind Royalties

These usually involve the payee transferring certain rights and/or a working interest in relation to a tenement to the payer in return for which the payer grants the payee the right to receive a share or other measurement of production of the relevant mineral or petroleum from that tenement after it is severed from the ground and title thereto is vested in the payer. Alternatively, the payee may be given the right to mine and take a certain percentage or share of product rather than the right to take delivery alone. (This would be an unusual arrangement in Australia.)

4 *Commissioner of Taxation v. Sherritt Gordon Mines Limited* (1977) 137 CLR 612.
5 *Borys v. CPR and Imperial Oil* (1953) 7 WWR (NS) 546. W H Ellis, 'Property Status of Royalties in Canadian Oil and Gas Law' (1984) 22(1) *Alberta Law Review 1.*

In-cash Royalties

These usually involve the payee transferring certain rights and/or a working interest in relation to a tenement to the payer in return for which the payee is granted a present or future cash payment which is derived from the revenue or product generated on or from the tenement by the payer (or his assigns/successors). It is important to note that the amount of the cash payment may be a percentage of the actual revenue generated from a project or more usually a sum calculated by reference to such revenue.

Combinations of, or Options in Relation to, In-kind and In-cash Royalties

PARTICULAR ROYALTIES

The individual members of the royalty family that one commonly encounters in the resources industry and which I have been asked to address in this paper are:

— Overriding Royalties and Royalties;
— Gross and Net Revenue Returns;
— Net Smelter Returns;
— Net Profits Interests;
— Carries or Carried Interests; and
— Production Payments and Ore Payments.

Overriding Royalties and Royalties

Overriding royalties have their derivation in the United States and their meaning has been addressed in numerous papers and cases[6]. The essential element of an overriding royalty is that it is usually taken free and clear of all deductions (other than Crown royalties and State or Territory imposts and certain commonly accepted deductions in the petroleum and mining industries). It is thus a share of gross value or gross quantity.

Royalties have already been dealt with above. The remaining types of FNWIs examined below (with the exception of Carries or Carried Interests) are either in-kind or in-cash royalty.

Gross/Net Revenue Returns

This type of royalty usually consists of a share (usually a percentage) of:

— the payer's gross revenue arising from the sale of product derived from the tenement (which is a form of overriding royalty); or
— the payer's net revenue arising from the sale of product derived from the tenement.

The terms 'gross' and 'net' are discussed later in this paper[7].

6 R C Nicholls 'A Review of Some Aspects of the Organisation and Financing of Mineral Resource Ventures — Part 1' (1976) 1 *University of New South Wales Law Journal 271; Mecker v. Ambassador Oil Co* (1962) 308 F (2d) 875.

7 See infra 406.

Either of these types of royalty may be referred to as in-cash royalties.

Net Smelter Returns

This type of return is specific to the mining industry and is usually utilised where a smelting process is likely to be involved in order to produce the product, for example with regard to certain base metals. The meaning of this term was discussed at length by Ipp J in the *Technomin* case[8] and his Honour held that the term did not have an accepted meaning in the gold mining industry but did have an accepted meaning in the mining industry generally: in that industry, he said:

> It is regarded as the price received by the producing mine for the mineral less the smelting costs and associated costs such as transportation and penalties.

Thus, the royalty is usually calculated by reference to a share of the revenue arising to the payer from products derived from the smelter and sold after deducting certain operating costs (usually excluding capital costs and including only certain operational costs relating to the smelter, transportation and penalties). In essence, it is a revenue return which is probably closer to a gross return than a net return.

Net Profits Interest

This type of royalty normally consists of a share (usually a percentage) of the net profit arising to the payer from a particular project based on or around the tenement[9].

Carries/Carried Interests

These usually involve the payee not being responsible for any operating costs during a stated period (for example until commercial production) so that the payer incurs all costs and risks during the relevant period and thereafter recoups such costs out of production, and once such recoupment has been completed ('payout'), the payee is then entitled to participate in the costs and receipts of the project in accordance with the payee's remaining interest. The formulas governing payout vary considerably and may relate to the recovery of all costs incurred by the payer together with interest or a multiple of all such amounts. The standard carry arrangement is, in my view, a financial working interest (i.e. the carried party will continue to participate in the management of the project, will usually remain registered as a holder of the tenement and will at some future date share in the costs, risks and liabilities associated with the project) and therefore, is not strictly speaking caught by this paper.

8 *Technomin Australia NL v. Southern Resources and Others,* Unreported 13 Nov. 1989 Supreme Court of Western Australia (appeal heard and further appeal pending).

9 *Australia Energy Limited v. Lennard Oil NL* [1986] 2 Qd R 216 and [1988] 2 Qd R 230, a dispute as to the meaning of 'net profit revenue interest'; and *Australian Oil and Gas Corporation Limited v. Bridge Oil Limited.* Unreported Supreme Court of New South Wales (Court of Appeal 12 April 1989) regarding the meaning of 'net profits interest'.

Production Payments/Ore Payments

These are only mentioned for the sake of completeness. They are generally another form of overriding royalty and involve a promise by the payer to deliver a share of product (or the proceeds of sale thereof) to the payee until such time as the payee has received an amount of product that is equivalent to a specified monetary sum from such deliveries (or the cash equivalent itself). The payer has no obligations with regard to the ongoing costs of the project and the only real difference between these interests and overriding royalties is one of duration. An overriding royalty is usually paid by reference to a point in time (i.e. the expiry of the lease, or ceasing of mining operations) and production payments (usually used with regard to petroleum operations) or ore payments (usually used in relation to mining operations) expire once the stated amount of product (cash) has been received by the payee.

DRAFTING — GENERAL

As with all contracts, the negotiation and execution of a Royalty Deed will to a large extent depend on the relative negotiating strengths of each of the parties. Normally a payer will be looking to reduce the amount of the royalty payment as much as possible and a payee will be looking for the opposite and to protect his interest as much as possible. The payee will be looking for certainty whereas the payer may not.

Looking at recent cases,[10] it is clear that considerable care is required to ensure that the Deed accurately reflects one's instructions, is not open to misinterpretation and above all is not void for uncertainty[11] and therefore, is enforceable. As one American author put it, albeit with reference to oil and gas leases in the United States:

> Too much care cannot be devoted to the preparation of a royalty clause in an oil and gas lease. The prospective payment of royalties of great monetary value is involved, potentially at least, in the drafting of every lease, and any slight error in content or terminology is apt to prove exceedingly costly.[12]

In this regard, I think it is most important when taking instructions to analyse the royalty arrangement and break it down into its component parts. In this regard, the royalty arrangement should be examined in the context of each stage of the particular mining or petroleum project from exploration, through development to production and sales to see what problems there may be and what further enquiries or investigations may be required. Having identified the inherent or other problems (whether legal or practical) associated with the royalty, one should seek to remedy them, where possible, in the drafting of the document.

10 *Australian Energy Limited v. Lennard Oil NL* [1986] 2Qd R216 and [1988] 2Qd R 230.

11 *Hammond v. Vam Limited* [1972] 2 NSWLR 16.

12 A. W. Walker, 'Nature of Property Interests created by an Oil and Gas Lease in Texas' (1932) 10 *Texas Law Review* 291.

DRAFTING — TYPICAL PROVISIONS

A standard Royalty Deed might contain the following provisions:

— Parties;
— Recitals;
— Definitions and Interpretation;
— Royalty Clause;
— Calculation;
— Payment and Delivery;
— Record Keeping;
— Supply of Information;
— Right to Audit;
— Disputes Procedure;
— Confidentiality;
— Relationship of the Parties;
— Registration and Conditions;
— Security;
— Covenants;
— Assignment;
— Force Majeure; and
— Miscellaneous Boiler Plate Provisions.

I will not address all of these clauses but will make some general comments in relation to the more important ones.

Definitions

This is probably the most important clause in the Deed as the way that the various terms are defined will govern the interpretation and construction of the Deed as a whole. As a general rule, if one, as a draftsperson, is unable to understand a term used in any definition or in the body of the Deed then it is advisable to define that term after consulting one's client so as to put the issue beyond doubt.

In-kind Royalty Considerations

— The definitions of the payer and the payee should include their respective successors and permitted assigns[13].
— The payee's lawyer should, following *Australian Energy Limited v. Lennard Oil NL*[14], always ensure that the definition of 'Tenements' is all embracing, particularly if the royalty is granted at the exploration stage. The definition should, at the very least, cover sub-divisions, renewals, consolidations, extensions, successor tenements. The question of surrenders/relinquishments of part of the existing tenement should be dealt with, whether in the definition or, more appropriately, in the main body of the Deed. Again this is a matter for negotiation in that the payer will want to have no responsibility (and will probably be unable) to deliver production from an area over which it is no longer in control whilst the payee

13 See further *infra* 424.
14 Supra fn. 9.

may be concerned that the payer will conditionally surrender a tenement to a related third party and then claim that the royalty no longer applies. A payee may wish to have an option to acquire the area to be surrendered so that if the payee refuses to exercise such option within a stated time then its rights to the royalty in that area will be forfeited. Such an option will be registrable.

— 'Production' or the 'Product' should be carefully defined. This to a large extent depends on the time when the royalty is granted (i.e. the exploration stage, the development phase or when production is on stream). It may not be possible to specify exactly what the product will be in which case a payee will wish to ensure that all minerals and/or petroleum are covered. A payer may have other ideas.

— The delivery point should also be specified even if it is a point to be agreed. Any such definition should be consistent with that set out in any joint venture agreement.

— The measurement scale for product (tonnes, ounces, barrels, etc.) will have to be defined.

In-cash Royalties

These may be expressed to be at a rate of X dollars per tonne mined or X dollars per barrel produced or as a percentage or other share of gross or net revenues arising from all sales of product, or as a net profit interest arising from the project or part thereof.

Most of the points just raised in respect of in-kind Royalties apply equally. The definition should cover as appropriate:

— '*gross revenues*' — what deductions (if any) should be allowed, for example Crown royalties/Government imposts, Aboriginal royalties etc.

— '*net revenues*' — this will involve further definitions of gross revenues[15] and allowable deductions[16].

— *net smelter returns* — a very careful definition of this term is required. The definition should make it abundantly clear what costs and deductions are allowable and will inevitably involve a number of other definitions[17].

— *net profit interests* — this will usually involve definitions of gross revenue and allowable deductions. Great care should be taken with all such definitions[18].

15 The *Technomin* case involved interpretation of the terms 'treatment costs' and 'penalties' in the context of a net smelter return.

16 *The Australian Energy Limited* case examined definitions of 'payment', 'wellhead value', 'normal operating costs' and 'exploration expenses'. The Mineral Royalty Act 1982 (NT) contains certain definitions appertaining to the royalty payable to the Department which is based on 'net value' of mineral commodities removed or sold.

17 See *Technomin Case* Unreported, Supreme Court of Western Australia, which concerned a dispute about a 'net smelter return'. In fact, there was no smelter used in any processing operations and the dispute was really in relation to the interpretation of a net revenue formula.

18 Supra fn. 9.

I do not intend to comment on carries as they do not fall within the ambit of this paper or on production or ore payments as to a large extent my comments above apply.

The Royalty Clause

The following issues should be addressed:

— For how long is the royalty intended to take effect? (i.e. a number of years, the life of the mining/petroleum tenement, the life of the mine, until a stated monetary limit or amount of production is reached)? This may involve consideration of the perpetuities period and whether an appropriate provision should be inserted[19].

— To what area is the royalty intended to apply?
One should be careful, when acting for the payer, of definitions which refer to 'the area presently covered by the Tenement and outlined in red on the map attached hereto and marked X.' If the royalty is granted at an early stage of exploration the area may well change and a payer will not want to be obliged in relation to an area over which it has no control or interest.
The payee may seek to extend the ambit of the royalty so as to cover the situation where an ore body is situate below one or more tenements. Thus the payee may sell its interest in tenement 'A' for a royalty in relation to product derived from that particular tenement and any contiguous tenement ('B') which the payer may acquire in connection with the mining of an ore body which extends over A and B.

— With in-cash royalties which are not related to profits it is always advisable to consider capping the royalty in some manner or other so that the payer is not forced to make a payment when the project itself is running at a loss in any year. A payee may not be agreeable to this. Careful consideration should be given to the phrasing of such a clause.

— The possibility of non-arm's length sales should be addressed in relation to certain in-cash royalties. A deeming provision corresponding to market value may be inserted to ensure that through devious dealings the royalty is not substantially reduced in the hands of the payee.

— Consideration should be given to the question of stockpiling. The payer may have good reasons for stockpiling the relevant product (i.e. downturn in market prices; gas reinjection for storage near markets for ease of recovery at peak periods of demand. This may reduce infrastructure costs but delay royalty payments). The payee may request that the royalty be calculated by reference to product produced (rather than product produced and sold).[20] Thus a payee might seek to recover royalties on oil and gas that is recovered but then used in the production process. A payer will vigorously resist such request.

19 *Ellison v. Vukicevic* (1986) 7 NSWLR 104.
20 Supra fn. 16.

— With regard to revenue related royalties, one should consider what is to happen with such matters as forward sales arrangements, bartering arrangements, transfer pricing arrangements etc. All of these matters may have a significant impact for a payee whilst a payer will always want to have the freedom to react to market conditions as it sees fit. Certain in specie loans may also present problems; for example where the producer returns gold to a financier by way of settlement of a gold loan. A shrewd payee will want to ensure that such transactions are deemed to be sales at market value for the purpose of calculating the royalty. A royalty calculated by reference to product 'removed' but not necessarily sold may be helpful in this regard.

— If the royalty is of an in-kind nature (and does not involve mining by the payee) it should be made clear that the payer will appropriate the payee's share of product first out of the production stream so as to give the payee priority. As soon as the product is ready for collection, the payer should store it in a separate area where it is marked clearly as the property of the payee. Consideration should also be given to making some form of declaration in favour of the payee that the product when severed from the ground is, and, until delivered, remains the property of the payee and is held on trust by the payer. If a trust is created, the Royalty Deed may be registrable under the applicable legislation[21].

— Great care should be taken with regard to in-kind royalties that allow the payee to go on to the tenement and actually mine and take a percentage or other measure of product from that tenement. From a payer's perspective it will be necessary to consider whether or not a joint venture exists. It may well be preferable for the payer to ensure that a joint venture agreement is signed by the payee to avoid any problems and to ensure that the payer acts as manager and has control of the relevant operations etc.

— If possible, with regard to in-cash royalties, a clause should be inserted making it clear that a separate account will be opened by the payer in which it will deposit the moneys representing the relevant payment at the earliest opportunity and it should also be made clear that the payer holds such money on trust until payment to the payee is made in accordance with the relevant Royalty Deed.

— The issue as to set-offs, counter-claims and deductions should also be addressed in relation to in-cash royalties.

— With regard to net profit arrangements (and possibly net smelter returns and net revenue related royalties), the question arises as to whether the payer should retain an accrued deduction in relation to years when the project is making a loss. Thus if there is a loss in any one year should the payer be allowed to carry this forward against future revenue or profits and thereby reduce the amount of the royalty payable in future years? For how long should this right

21 An additional issue in relation to in-kind royalties is the question of who will be responsible for government charges, e.g. royalty, excise, export levies.

subsist? A payee will be reluctant to accept a proposal along these lines with some justification in that it will consider that all risks in relation to the project rest with the payer.

— With regard to in-kind royalties, consideration should be given as to whether the payer (especially if a large producer) may wish to have the right to satisfy the delivery obligation from product produced from another project. This will no doubt be treated with suspicion by the payee, but it may have certain advantages to both parties (although the questions of when the payee's proprietary interest in the product arises and the place and time at which delivery and title passes will have to be carefully considered). This also raises another possibility which involves a two or three stage processing joint venture whereby, for example, a mineral is produced from a mine (stage one) and this is then sent to another processing facility (stage two) which produces an upgraded product with a higher profit margin and conceivably this product is then sent to another processing facility (stage three) which produces a further upgrade of the product with an even higher profit margin than at stage two. If the payee is alert to the possibilities and has the negotiating strength it may be possible to negotiate an option to either take the product from the mine or the processed product at stage two or at stage three.

Clearly this will be a very difficult transaction to negotiate and finalise but the payee should nonetheless be alert to the possibility.

— If product is being sold overseas and paid for in foreign currency, or if the industry practice is to sell by a foreign currency reference price, then currency exchange provisions will have to be inserted for the purposes of calculating revenue. This will involve consideration of currency fluctuation issues.

— Care should be taken with regard to overseas royalty payments. A payee may, for example, seek to have 'grossing up' provisions inserted to deal with deductions such as withholding tax.

— Provisions dealing with what happens if product is sold and is offset against a loan made by the purchaser to the payer should also be considered. The payer is not receiving income but is reducing a liability. The payee will be anxious to ensure that this type of transaction is deemed to be a sale at market value.

— If an in-cash royalty is expressed to be a stated amount per tonne (which is not so common these days) then one should always take care to ensure, when acting for a payee, that an indexing provision (which allows for the effect of inflation) is included in the Deed. This type of royalty does not take into account the market price obtainable for the product and as such the payee is protected against falls in the market price (assuming that it has pitched the royalty at an appropriate level) but will not be positioned to take advantage of increases in the market price. A payee will want to address this problem. The payer should consider inserting provisions which give it a right to renegotiate the amount of the royalty in the event that the market price falls substantially.

— One should always try to ensure, when acting for a payer, that an in-cash royalty is not paid or payable until such time as the revenue relating to that royalty has been received by the payer so that the payer has sufficient funds in its hands to discharge the particular royalty.
— For the sake of certainty, a payee may be well advised to link his private royalty to that calculated and paid to the Commonwealth or the State. Thus the royalty may be a percentage of that paid to the relevant authority or it may be a factor of such governmental royalty. Calculation of the royalty should be made in accordance with the relevant statutory provisions.
— It will always pay, where possible, to examine each project with a view to identifying:
  (a) what the product will be;
  (b) when the product is identifiable and saleable;
  (c) what is the point of sale;
  (d) what deductions up to such point of sale should be allowed; and
  (e) how sales are likely to be effected and how payment will be made.

  This will involve one in detailed discussions in relation to the project with a number of people for example the mine or processing managers, pipeline managers, refiners, marketing and sales personnel and project accountants.

The Calculation Clause

This will usually relate to in-cash/formula royalties and will vary depending on the complexities of the relevant royalty. However it should provide:

— who will be responsible within the payer's organisation for calculating the royalty;
— for detailed records to be kept as to how the royalty has been calculated;
— the time by which each payment is to be calculated and made; and
— what particular rules (whether accounting or otherwise) should be applied in making the calculation.[22]

THE PAYMENT OR DELIVERY CLAUSE

In the case of in-cash royalties, this will provide for when, how and to whom a payment is to be made e.g. 'within X days of the end of the previous month by telegraphic transfer to an account nominated by the payee'. Most payments will be made in arrears and the payer will want to ensure that the payments are made as infrequently (annually or half-

22 For some of the problems involved see J. C. La Grone, 'Calculating the Landowner's Royalty' (1983) 28 *Rocky Mountain Mineral Law Institute* 803 and R. C. Maxwell 'Oil and Gas Royalties — A Percentage of What?' (1988) 34 *Rocky Mountain Mineral Law Institute* 15–1.

yearly) as possible so as to save valuable management and administrative time and consequent costs. The payee will naturally wish to ensure a regular cash flow.

An interest clause should also be added in relation to late cash payments. However, in relation to in-kind royalties, the payee could incur substantial costs or liabilities which should be recoverable against the payer if product is not available for collection on time. The extent of any indemnity in this regard will need to be carefully considered particularly in relation to the thorny question of consequential losses and fluctuating market prices. If product is not available for collection on time then an interest charge calculated by reference to the market value of such product could be inserted but this would be a complex provision which may result in enforcement problems.

Another alternative to an interest clause for in-kind royalties might be for some form of escalation clause relating to increasing the amount or percentage of product that the payee is entitled to in the event of late delivery.

One should also ensure that the payee is not acting as a banker for the payer. The payee's interest rates should always be considerably above current market rates.

Care should be taken, when acting for a payer where there are numerous payees, to ensure that the payer can make one payment to one person or one account. Payment in such manner should be acknowledged by all the payees to be a proper method of payment and each payee should be deemed to have acknowledged receipt by payment to the relevant person or account without recourse to the payer.

If the royalty is an in-kind royalty, this clause will be a delivery clause specifying where and how product is to be stored, whose risk it is at pending delivery and when title will pass. The question as to the quality and merchantability of the product should also be addressed. A delivery point will usually be specified. A payer may also wish to charge storage fees in the event that the payee does not collect the product on time. Conversely the payee may wish to have the right to elect for the payer to sell the product, as its agent, and to account to it for the proceeds of sale less any costs in the event that it is unable to arrange collection or appropriate sales arrangements. A mechanism allowing the payee or its nominee to collect the product should also be introduced to cover circumstances where the payee has on-sold the product or the payee has arranged collection through an agent.

The payee should always seek to ensure that all payments and deliveries are made on time and in accordance with the relevant Deed and are not deferred pending the outcome of any dispute (with interest added to the late payment). The payee will thus always come to the negotiating table without undue pressures.

Record Keeping

The payer should be required to keep detailed records relating to every aspect of the royalty calculation. The number and detail of such records will vary according to the complexity of the particular royalty

calculation. In-kind royalties will require records to be kept of product produced by the payer whether it is sold, stockpiled or passed onto a secondary processing plant. Details as to the quality, grade, location of the product should also be recorded. The payer should be required to measure and record the flow or volume of all product produced at a particular point which will vary according to the nature of the project.

In-cash royalties will normally require the keeping of similar records to those outlined above and in addition detailed project accounting records. The nature and detail of such accounting records will vary according to the type of royalty. The parties should agree to a particular accounting standard with which the appropriate accounting records should accord.

How particular costs and deductions are to be treated in such accounting records should, if possible, be specified (consultation with the client's in-house or external audit and project management teams will always produce numerous problems that should be addressed). If the royalty relates to the net profit arising from a project then the definition of such term will be crucial.

All of such records should be kept in a timely manner, in accordance with specified standards and should be open to inspection by the payee and his advisers. The payee should be looking to negotiate the widest possible inspection rights and should have rights of access to the project and such of the payer's personnel as it deems necessary for verification purposes.

There will usually be a conflict here as between the payee's desire to have detailed evidentiary records kept and the payer's desire to reduce costs and management time.

Supply of Information

When the royalty has been calculated, the payer should have an obligation to provide adequate details of the calculation of the royalty to enable the payee to verify the calculation. These details/records should be provided with the appropriate payment/delivery and consideration should be given to the position with regard to late furnishings of such information. The payee should have access to all records supplied to the Commonwealth/State in connection with Commonwealth/State Royalties.

The payer should be required to warrant that it has complied in every respect with the terms of the Deed in relation to the preparation and calculation of the royalty and that all information that it has provided and kept in relation to such calculation is accurate and not misleading.

Right to Audit

The payee will wish to ensure, particularly in the case of in-cash royalties, that it has the right to audit and verify the payer's records relating to the calculation of the royalty.

Considerations here should relate to the timing of such audit (i.e. notice required), the question of interference with the payer's operations, the availability of certain records and personnel, how long such a right

should exist for and who will bear the costs. The payee will want to have as long a period as possible within which to exercise this right and the payer will want, if possible, to ensure that there is a stated period within which any query relating to the royalty calculation should be raised failing which the payee's rights will be lost. Alternatively, the payer may want it's own auditor to provide appropriate certification. A provision should be inserted dealing with who will bear the costs of carrying out such an audit, for example the payee will bear all such costs if the audit verifies the payer's calculations and the payer will bear such costs if its calculations result in a lesser royalty being paid or delivered to the payee than the audit reveals should have been paid or delivered.

Disputes Procedure

This topic could be the subject of a paper in its own right and the choice of a suitable forum may depend on the client's own experiences and preferences. The dispute mechanism should, from the payee's perspective, produce the fastest possible result (albeit that in practice this may prove otherwise). A payer may be inclined to allow the dispute to continue on for as long as possible.

The nature of the dispute may well influence the forum chosen. For example if it is a question of interpretation or construction, the parties may wish to rely on the courts or alternatively an independent expert having considerable experience in the area. If it is an accounting matter then it may be resolved by reference to an expert from that profession. The variety of methods for resolving such disputes is increasing with the advent of numerous 'alternate dispute resolution' forums.

It appears that certain of the larger corporations are adopting these forums by reference to a general provision. I have not had any experience of using these alternate dispute resolution forums but it would seem that the advantages of such forums could be the speed with which the dispute may be resolved and the consequent cost savings that may be achieved.

Whatever forum or variety of forums is chosen a number of general issues should be considered in the drafting of such clauses:

— timing for references and decisions to be made;
— whether decisions will be final and binding or whether there will be rights of appeal in relation to specified matters;
— how the costs in relation to any particular reference will be borne as between the parties;
— the selection of the constituent members of the relevant forum;
— interest or other equivalents on late payment/delivery;
— time limits for raising disputes; and
— governing law clauses — these in themselves can create problems both as to jurisdiction and interpretation of laws.[23]

Confidentiality Provisions

These will usually be drafted for the benefit of the payer and I do not intend to dwell on such provisions although the payer should carefully

23 See supra fn. 2. the *Oil Basins* cases [1985] VR 725.

consider to whom the payee may be allowed to disclose the relevant information (whether in the context of a dispute or otherwise) and the payee should not be allowed to use any such information for its own benefit or profit. To a large extent this will depend on the nature of the payee's business and whether it has an interest in tenements adjacent to the tenement from which the royalty is derived.

Relationship of the Parties

Most royalty arrangements will result in the payee having a non-working interest. Thus the payee will not share in any of the risks and obligations relating to the project but will only share in the fruits of success of such project. Ideally the payer would like to be in a position whereby the payee has no interest whatsoever in the day-to-day operations, in any joint venture or in the tenements. Thus, it is from the payer's viewpoint preferable to incorporate a clause in the Deed which makes it clear that the parties are not partners, nor do they intend to carry on a partnership, are not in any other fiduciary relationship (save as may arise pursuant to the Royalty Deed) or any joint venture relationship and that the payee's rights arising under the Deed are purely contractual such that the payee has no interest or any rights in the tenements. A provision should also be added to the effect that the payee will not seek to register any caveat against the tenements.

Whether such clauses can be incorporated depends very much on the particular circumstances in hand. The payee will always seek to protect its right to the royalty and should have a number of objections to the drafting of this type of clause which are dealt with below in the next section on Registration and Conditions.

Great care should be taken to ensure that the royalty arrangements do not constitute a partnership whether under the applicable partnership law or taxation legislation.

It should always be borne in mind that whether such a partnership exists is a question of fact to be determined in the light of all the surrounding circumstances and a contractual provision designed to negative such a relationship will not in itself be effective. The issues to be addressed at general law are whether:

— two or more persons,
— carry on a business in common,
— with a view to profit.

It should be remembered also that the meaning of partnership for income tax purposes (association of persons carrying on business as partners or in receipt of income jointly)[24] is wider than for partnership law purposes so that, for example, persons in joint receipt of gross income have been held to be partners (for example persons operating joint bank accounts).

Whilst this is a very important and interesting issue, I do not intend to dwell on it as Stephen Breckenridge has addressed it in his commen-

24 Income Tax Assessment Act 1936 (Cth), s. 6(1).

tary. However, it would seem to me that, if the circumstances and documentation are such that the payee has:

— no interest in the assets that comprise the business;
— no rights in relation to any management decisions (leaving aside the question of sleeping partners);
— no obligations or liabilities in relation to the business; and either
— in relation to in-kind royalties, a right to a share of product only; or
— in relation to in-cash royalties, a right vested in it alone to receive a sum of money from the payer which sum is not jointly received by the payer and the payee; i.e. the payer alone is entitled to the income from the particular project and thereafter, pursuant to the terms of the Royalty Deed, is obliged to make a separate payment to the payee;

then it will be very hard to substantiate an argument that such a relationship exists.

REGISTRATION AND CONDITIONS

The key issues are:

— Whether ministerial approval and/or registration of the Royalty Deed are required under the relevant mining or petroleum legislation; and
— What protection mechanisms will the parties rely on if the Minister refuses to approve or register the Deed or the parties decide that it is not registrable?

These issues arise because:

— both parties (especially the payee) will be concerned to see that they comply with the legislation (it being understood that in certain cases non-compliance could result in the Deed being void)[25]; and
— the payee will want to ensure that its rights are protected as far as possible. The payee will wish to protect itself against:
  (a) the possibility of a bona fide purchaser of the tenement who buys the relevant interest without notice of the payee's rights;
  (b) the possibility of a liquidator disclaiming the Royalty Deed;
  (c) any actions taken by a receiver of the payer; or
  (d) generally in relation to the creditors of an insolvent payer.

Resolving these issues will involve:

— examining the relevant sections of the governing legislation;
— applying such sections to the circumstances and to the Deed in hand and determining whether the approval and registration requirements apply;

25 For a discussion of this issue, see D. A. Ipp and D. A. W. Maloney, 'Dealing with Interests in Petroleum Tenements' (1983) 57 *Australian Law Journal* 513.

— ensuring where possible that, if one is acting for the payee, the Deed is registered or otherwise contains proper protection provisions and this may involve drafting further clauses to bring one within the Ministerial approval and registration requirements;
— ensuring that there are provisions in the Deed which deal with the situation where the Deed may be found to be void.

Conceptually this would seem fairly straightforward. However, when one looks at the relevant legislation, the issues and their resolution become more complex.

Offshore Petroleum Legislation

Section 81(1) of the Petroleum (Submerged Lands) Act 1967 (Cth) provides in the relevant parts that, if an overriding royalty interest, a production payment, a net profits interest or a carried interest or any other interest that is similar to any of the foregoing interests is created or assigned by virtue of a dealing then such dealing, will have no force in relation to a particular tenement until it has been approved by the Joint Authority and an entry made in the appropriate register. The section also catches options and the creation or assignment of rights to enter into any such dealings.

It is clear from this section that all the royalty interests addressed in this paper should be approved and registered and that if they are not, then the relevant dealings have no force until such approval and registration is effected.

Offshore Areas Administered by the States or Territory

I will not deal with each State's and Territory's legislation relating to these areas as time does not permit. However, one would expect this legislation to follow the Commonwealth offshore legislation. The analytical principles outlined at the start of this section will apply.

Onshore Legislation

In this section of the paper, only the legislation in force in New South Wales, Western Australia and Queensland will be considered. In the other states, if having reviewed the relevant legislation, one is unsure whether to register a Deed the matter should be discussed with the relevant Department to determine its practice.

If there is any doubt with regard to this issue it would seem prudent to lodge the Royalty Deed with an appropriate submission at the relevant Department. One should always bear in mind that such Department may dispute your submission and refuse to approve or register the Deed.

NEW SOUTH WALES

The relevant sections are ss.37 and 38 of the Petroleum Act 1955 and s.107 of the Mining Act 1973.

Petroleum

Section 37 makes it clear that each and every interest under a licence or lease under the Act shall be deemed to be personal property.[26]

Section 38 interestingly provides that 'every instrument ... (including ... deeds of trust ... or any other instrument) affecting any licence or lease under this Act must be lodged for approval and registration within a certain specified time and in a particular manner.' Any such instrument is of no force and effect unless it is in writing and is of like effect if it is not so approved and registered.

In-kind Royalties

The Royalty Deed is clearly an instrument and the principal question is whether the terms of that instrument affect the tenement. In my view 'affecting' can be interpreted very widely, i.e. producing an effect on a tenement (being the collection of rights which comprise that tenement and not just the title). However Murray J in the *Oil Basins* case made a number of comments about the term but surmised that it 'relates to some direct *physical affect* on the thing itself *or the property in it*'[27].

It is possible, depending on the terminology used in the Deed and the particular stage of development of the project at the time of the granting or reservation of the royalty (i.e. exploration, feasibility, development and production) that such Deed could have an effect on the tenement and therefore, require approval or registration.

One of the prime rights under a production or mining tenement is the exclusive right to mine or extract and recover the relevant mineral or petroleum and presumably, impliedly to remove such product from the tenement (and in certain States expressly to dispose of such product, for example, the Tasmanian and Western Australian Mining Acts). If the payer grants the payee an interest in a share of any such right (i.e. in relation to an in-kind royalty where the payee has the right to go on to the tenement and mine or extract the product and take a share thereof) then it seems to me that the payer is granting the payee a form of interest which affects the tenements (albeit that such interest will not bite until the product is ready to be extracted or mined).

The argument may also be extended to in-kind royalties where the payee is only entitled to collect a share of actual product from the tenement. This is because the tenement gives the payer the exclusive right to extract the petroleum and vests title to it in the payer on severance. A Royalty Deed may provide that a certain percentage of such product when severed is to be held beneficially by the payee (as opposed to the payer). Thus, one of the rights given by the tenement is not vested in the payer but in the payee and therefore the payee could argue that it has by virtue of the Deed an interest affecting the tenement. If these arguments are correct

26 This statutory provision endorses my personal opinion that real property concepts should not be paramount when considering the rights of the tenement holder under the relevant tenement.

27 [1975] VR 725, 736, (emphasis added).

then the relevant Deed should be registered. This is not to say the Deed will be accepted for registration. The need to consider these arguments may be obviated if one adopts one of the protective measures outlined below.[28]

In-Cash Royalties

It is much harder to argue that in-cash royalties which are created by Deed affect a tenement. The payer's interest is in a sum of money which is usually calculated by reference to the revenue or profit arising from a project. This interest is not an interest in the tenement itself; it is not an interest in product but an interest in-cash derived from such product. Therefore, I do not consider that such interest will normally 'affect' a tenement, and if this is the case then the relevant Deed will not be registrable. Put another way, such a royalty is certainly dependent on or affected by the existence of a producing tenement but a tenement is not dependent on or affected by such a royalty, i.e. the tenement can subsist in its own right without the royalty.

In practice, I understand that the Department does not accept Royalty Deeds for registration under s.38. However, the Department will, if a submission is made, place such documents on the file relating to the tenement, albeit that such file is not open for inspection. I understand that a White Paper relating to the petroleum and mining legislation has been prepared and that it is proposed that the legislation will be amended in approximately one to two years time so as to allow for registration of all such Royalty Deeds. The register will be open for inspection.

Mining

Section 107 of the Mining Act 1973 (NSW) provides that:

> [U]nless the Minister approves . . . an instrument by which a legal or equitable interest in, or affecting, an authority is created, assigned or dealt with, whether directly or indirectly, . . . the instrument is of no force.

In-kind Royalties

The wording of this section differs from the petroleum legislation in that it refers to 'legal and equitable interest' and 'whether directly or indirectly'. Dawe's paper on equitable interests and contractual rights in petroleum titles[29] wisely, does not attempt to define an 'equitable interest.' The term can be interpreted narrowly, in the sense of an equitable interest in real property or the title to the tenement, such as a trust, equitable mortgage etc. — a view which appears to have considerable support, or widely in the sense of an interest whether relating to personal or real property which the Courts of Equity will give effect to.[30]

The legal interest is presumably the title vested in the registered tenement holder. The equitable interest, could, if given a wide interpret-

28 See infra 421–422.

29 A.A. Dawe, 'Equitable Interests and Contractual Rights in Petroleum Titles' [1985] *AMPLA Yearbook* 309.

30 A view which I would endorse.

ation[31] catch an interest in this type of Royalty Deed. Most of my comments with regard to the New South Wales petroleum legislation apply equally here. The interest could be classified as 'equitable' in that it is a contractual right to mine or take a share of property (i.e. it is a chose in action which is personal property) and it may be given effect to by a court of equity, albeit that any action may not be brought before such court until mining commences or the product is produced and the payer commits a breach of the Deed.

In-Cash Royalties

My comments with regard to the New South Wales petroleum legislation apply.

In practice, I understand that the Department is unlikely to register stand alone Royalty Deeds under s.107 (although royalties granted to private mineral owners are registrable). However, as noted above, it is proposed to amend the legislation to allow for registration of such Royalty Deeds.

WESTERN AUSTRALIA

Petroleum

Very broadly speaking, s.75 of the Petroleum Act 1967 (WA) follows the mining legislation in New South Wales and thus my comments above apply. However, it should be noted that a Bill is before Parliament in Western Australia which will seek to bring the State legislation in line with the Commonwealth offshore legislation.

In practice, I understand that the Department has been advised that such Deeds need not be registered in order to have any legal effect under the present legislation. However, the Department will as a matter of policy, if requested under s.75, process the relevant application and if ministerial approval is forthcoming will note the royalty against the relevant tenement.

Mining

The mining legislation provides for ministerial approval in relation to the transfer or assignment of exploration licences (in their first year) and mining leases[32] and also makes it clear that all instruments which create, assign, affect or deal with, whether directly or indirectly, a legal or equitable interest, in or affecting, a mining tenement must be in writing.[33] Regulation 110 provides that all dealings affecting a mining tenement must be lodged for registration. Failure to do this will render the

31 Burt CJ in *Swan Resources Ltd v. Southern Pacific Hotel Corporation Energy Pty Ltd* [1983] WAR 39 seemed to be in favour of a wide interpretation in that he held that a negative covenant that the appellants would not sell or deal with the permit otherwise than in an accordance with its terms, amounted to an equitable interest affecting the tenement.

32 Mining Act 1978 (WA), ss.64, 82 and 119, see also regs. 103 and 110.

33 Ibid s.119(2).

relevant dealing ineffective to pass an estate or interest in a mining tenement until such dealing has been registered.

In-kind Royalties

It would seem that an in-kind royalty can in certain circumstances be a dealing affecting a tenement and therefore require registration.

In-cash Royalties

There are arguments on both sides as to whether such an arrangement is a dealing affecting a tenement.

I understand that in practice the Department will register most Royalty Deeds under reg. 110.

QUEENSLAND

Petroleum

Section 41 of the Petroleum Act, 1923–1981 (Qld) provides that no tenements or any interest therein can be directly or indirectly assigned, transferred, sublet, mortgaged or made the subject of a trust except with the consent of the Minister. If such consent is not obtained the relevant dealing is void. In my opinion, certain in-kind royalties should be submitted under this legislation on the basis outlined above but it is difficult to see the need for an in-cash royalty to be registered. The emphasis is on the dealing and not on the instrument being void.

In practice, the Department has a policy of noting all such royalty arrangements against the relevant authorities and tenements if an appropriate submission is made albeit that they consider that there is no statutory provision expressly requiring this.

Mining

Section 19(b) of the Mining Act 1968 (WA) does not appear to have any application to royalties. Section 37 provides that any mining lease or any share or interest therein may be transferred, assigned, sublet or encumbered if the Minister gives approval. Failure to obtain such approval will render the transaction void. Certain in-kind royalties may be capable of registration under s.37 on the basis of my previous comments but I do not consider that in-cash royalties will be registrable.

In practice the Department is apparently reluctant to register such Deeds under s.37.

It should be borne in mind that the current legislation is soon to be replaced by the Mineral Resources Act. This Act provides that the granting of any tenement does not create an interest in land. In relation to exploration licences, mineral development licences and mining leases the legislation provides that such licences or leases or any interest therein may be assigned or mortgaged (in the case of mineral development licences and mining leases) but only with the approval of the Minister. If such approval is not forthcoming the assignment or mortgage will be ineffective. There are also provisions for recording in a register, any agreements,

dealings or interests in relation to exploration and mineral development licences but unfortunately there is no equivalent provision in relation to mining leases which is somewhat odd. The effect of such registration is to give the particular transaction priority over any other dealings. The new legislation is wide enough, it is submitted, to allow for the registration of in-kind royalties and in-cash royalties against most forms of tenement (excluding Mining Leases).

PROTECTION OF PAYEE

Having briefly examined certain of the relevant statutes, one should consider how one can protect the payee. The common approaches include:

Charges and Mortgages

The payer grants the payee a mortgage or charge over the tenement and all the payer's rights thereunder and possibly over certain other assets to secure the payment of the royalty or the obligation to deliver. This will usually be an equitable mortgage or charge and will require registration. However, this solution relies on the payer being prepared to grant such a charge and if the payer is intending to obtain non-recourse or recourse financing for the project then the presence of such a charge may create considerable practical problems (not to mention drafting problems). However, these are not insurmountable and providing that the charge or mortgage is sufficiently limited in its application it is hard logically to see why a bank should not accept it. It is after all only giving effect to what the real position is i.e. the payer cannot charge the particular share of the product to the bank and if properly drafted the payer cannot seek to charge moneys which are really the property of another to the bank. In practice and in the current economic climate, the banks may well see things differently.

Registration in this case will constitute actual or constructive notice (depending on the circumstances) of the royalty to third parties.

Trusts

Whilst I have not investigated this issue thoroughly it seems to me that one can have a proprietary right in personal property that is capable of assignment so long as it is a present right entitling one to future income/profit.[34] If this right is capable of assignment then why should it not be capable of being the subject of a trust? Admittedly, there are problems as to the certainty of the subject matter of the trust (which may cause the declaration to be struck down) but why should the trust not exist until the product is ascertained and appropriated or the relevant sums of money come into the hands of the trustee whereupon it will bite (as in the case of an equitable assignment of future specified income when that income comes into being)?

34 *Booth v. Federal Commissioner of Taxation* (1987) 164CLR159; *Re Trytel* (1952) 2 TLR 32; and *Shepherd's Case* (1965) 113 CLR 385.

The problem with this argument is that it relies on a number of weak links (for example certainty of subject matter, unascertained goods) and it also requires very careful drafting in the relevant Deed. For example, if the payer is not obliged to provide a specified percentage of product or a number of tonnes of product derived from the project but can provide them or the cash equivalent from elsewhere, [35] then it may be that the personal property and trust arguments will fall down. The trust will have no effect unless it is registered so as to give notice to a bona fide purchaser.

If there is no express trust then why should a constructive trust not apply? With certain in-kind royalties it may be arguable that the payer is holding part of its right to recover the product on trust for the payee. Similar arguments may be put forward in relation to the sales proceeds of certain in-cash royalties.

Caveats

The payer can seek to lodge a caveat against the relevant tenement if the legislation permits. This will involve checking the relevant legislation to see if the payee can lodge a caveat (whether in its own right or with the consent of the payer). It is understood that such caveats are accepted by the mining Departments in Queensland and Western Australia. The lodging of a caveat (where possible) will at least allow a payee to have notice of a potential assignment of an interest in the tenement. This in turn should allow the payee to notify the purchaser of its rights and may result in the purchaser agreeing to assume the relevant obligations with regard to the royalty.

Possible Carry Arrangement

The payee might seek to retain an interest in the tenement (i.e. remain as a registered holder) with a small working interest until production commences whereupon there would be a contractual obligation on the payee to transfer its interest in return for the payer granting the relevant royalty. The payee would, until the payer executes the Royalty Deed, be entitled to be fully carried and indemnified by the payer. This would seem an unduly complex means of obtaining protection for the payee and it may have adverse stamp duty implications for the payer and adverse tax implications for the payee.

It should be borne in mind that if the Royalty Deed also provides for the assignment of an interest in the title (legal or equitable) of a tenement then this will require registration. This does not necessarily mean that the royalty provisions will be noted or registered in the appropriate State or Territory.

If there is any doubt about any of the above issues, then it is clearly preferable to lodge the Deed for registration or approval with an appropriate submission (particularly if the instrument may be rendered void) or to seek to lodge a caveat.

35 *King v. Greig: Rechner, Claimant* [1931] VLR 413 and *Re Wait* [1927] 1 Ch 606.

Finally, one should try to ensure that the Deed incorporates certain provisions giving the payee or payer some comfort in the event that the approval or registration is not forthcoming within a stated period or which deal with the possibility of the Deed being rendered void. This may involve provisions seeking to return the parties to the position that they were in prior to the execution of the Deed or provisions in a separate Deed which give effect retrospectively to the royalty arrangements and which comply with the legislation. These types of saving provisions should be set out in a separate deed just in case the Royalty Deed is rendered void. Care should be taken to ensure that nothing in the separate deed falls foul of the registration and approval provisions.

SECURITY

To a large extent I have covered this in the previous section. The alternatives are clauses creating trusts (not without considerable difficulties), mortgages and charges (most preferable) and obligations with regard to ensuring that caveats are lodged (where applicable). With regard to the creation of trusts, mortgages and charges one should bear in mind the stamp duty issues and the registration and approval requirements under the relevant mining and petroleum legislation and also in relation to mortgages and charges, that they may require registration under the relevant Companies Code.

COVENANTS AND WARRANTIES

These would be provisions for the benefit of both the payer and the payee.

They should include:

— Warranties by the payee as to the rights it is transferring to the payer (i.e. warranties as to title, no prior interests affecting the rights being assigned, etc.);

— Covenants by each of the parties to procure (if appropriate) that the Deed is registered in accordance with the relevant legislation;[36]

— Covenants by the purchaser that it will not do anything which may adversely affect the royalty granted i.e. grant charges, mortgages, liens or other interests which may affect the royalty, or otherwise transfer the tenements without the consent of the payee which will be granted if an appropriate deed of assumption is executed, no assigning or charging of any sales proceeds arising from products without the consent of the payee (with regard to certain in-cash royalties);

— Warranties by the payer as to the accuracy of all information supplied to the payee during the term of the Deed.

These covenants will have to be carefully drafted and tailored to the particular circumstances. It should be borne in mind that it may be preferable, in those States and Territories where the legislation renders the instrument void, for these provisions to be set out in a separate deed.[37]

36 See my comments above.

37 See comments supra fn. 31.

ASSIGNMENT

This provision will usually be the subject of considerable negotiation. The payer will probably want to ensure that the payee does not fragment the royalty interest[38] while the payee, depending on its circumstances, will want to retain as much freedom as possible.

The payee will want to ensure that any transferee or assignee of the tenement will be bound by the obligations with regard to the royalty. Because of the privity of contract problems the payer should covenant not to assign its interest in any part or the whole of the tenements or in any part of the rights with regard to the royalty (whether at law or in equity) unless the payer procures that the transferee or assignee enters into an appropriate deed of assumption with the payee.

The payee will also be concerned with the financial standing of any assignee and this issue should also be addressed. The payer should reserve the right to strike whatever deal it wants with its assignee i.e. it may have a 100 per cent. interest and may only be assigning 40 per cent. but it may wish to have not just 40 per cent. of the royalty obligations assumed by the assignee but the whole 100 per cent.

The payer should also attempt to obtain a full release in relation to the obligations that have been assumed by the assignee. If the payee is concerned as to the financial standing of any assignee then it may not view such a release as appropriate.

The payer will probably try to procure that the payee only has a limited right of assignment i.e. it can only assign the whole of the royalty interest and not part. This attempt to prevent fragmentation will usually be resisted by the payee. Any such assignment should be effected by a deed to which all parties are present.

The payer should seek to have an option to buy-out the royalty at certain milestone dates in accordance with an agreed valuation method. The payer should also seek a pre-emptive right if the payee wishes to sell the whole or part of its interest.

The question as to whether there are any registration requirements in relation to the deeds of assignment or assumption should also be addressed.

If possible, and to avoid later arguments, the parties should annex drafts of the relevant deeds of assumption or assignment to the Royalty Deed as schedules which the parties will execute (in substantially that form) at the appropriate time.

The question as to the costs (legal, stamping, etc.) in relation to the negotiation and execution of such supplemental deeds and the Royalty Deed itself should also be addressed.

The above list of draft clauses and my comments in relation thereto are not to be seen as exhaustive but should rather be viewed as a guide only with each case being carefully examined in relation to its particular facts. Much of the discussion above may be viewed as applying in an 'ideal' world, but nonetheless the principles and issues are set out as a reminder for practitioners.

38 As happened in the *Oil Basins* cases.

REMEDIES

The normal remedy is for the payee to sue the payer for damages for breach of contract. It may in addition be possible to sue any purchaser of the payer's interest in the tenement for breach of contract (if my suggestions in the Assignment section above are followed).

Depending on the circumstances (for example if a trust is established) it may be possible to pursue a range of equitable remedies against the payer and his assignee (if such assignee has notice of the equitable interest which should be the case if registration of the Royalty Deed has been effected). Such remedies could include declarations, specific performance, tracing, account etc.

If possible the payee should try to procure that the payer waives any rights to claim that equitable remedies such as specific performance and injunction are inapplicable. The payer should also acknowledge that such remedies are appropriate in the circumstances.

If one has a mortgage or charge as security for the obligation to pay or deliver the royalty and this has been registered then any purchaser of the payer's interest must take such interest subject to the relevant charge or mortgage.

Other remedies in tort may be pursued with in-kind royalties if the circumstances permit, for example conversion.

Consideration should also be given to whether the payee's position can be enhanced in any manner in the event of a default. For example, obtaining guarantees from a third party of substance or, from a bank albeit that this may be strongly opposed by a payer.

TAX ISSUES

This is an unduly complex area of the law which I, as a non-tax practitioner, find somewhat confusing. I will only briefly address the issues. As a general rule it is essential for any payee or payer to seek advice at the earliest opportunity from its tax advisers as to the consequences of the relevant transaction and this may involve making an appropriate submission to the tax authorities so as to obtain a clearance in advance.

General Principles

FNWIs can, for tax purposes, either be 'royalties' within the definition set out in s.6(1) of the Income Tax Assessment Act 1936 (Cth) (the Tax Act) or they can be royalties at general law (i.e. under the common law) or they may not be royalties at all but rather capital payments given in consideration for the transfer of an asset. It should be noted that the s.6(1) definition is inclusive so that royalties under the general law are caught by the section. Thus it is necessary to examine each transaction, the surrounding circumstances and the accompanying documentation to see what type of arrangement one has for tax purposes and what can be done to assist one's client (whether the payer or the payee) in the circumstances.

The significance of the various classifications outlined above is as follows:

— if the transaction is a royalty under the general law then the royalty payments will be assessable as income in the hands of the payee under s.26(f) and/or 25(1) of the Tax Act;
— if the transaction is a royalty within the statutory definition and is not a royalty under the general law then one has to clarify whether the payments are of an income or capital nature for the purposes of s. 26(f) of the Tax Act. If they are of a capital nature the capital gains tax provisions will apply and if they are of an income nature, they will be assessable to income tax. Thus s.26(f) is intended to catch royalties under the general law and s.6(1) royalties that are of an income nature; and
— the transaction may be structured to look like a royalty (either statutory or general) but in reality it may be tantamount to a capital payment for a particular asset and thus will involve capital gains tax considerations for both the payee and the payer.

Determining whether the arrangement is a royalty, a statutory royalty or a capital payment is not necessarily an easy task.

The starting point is to determine whether one has a statutory royalty, within s.6(1) of the Tax Act. This involves checking whether or not the arrangement falls within the section which provides:

> 'Royalty' or 'royalties' includes any amount paid or credited, however described or computed, whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for:
> (a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark, or other like property or right;
> (b) the use of, or the right to use, any industrial, commercial or scientific equipment;
> (c) the supply of scientific, technical, industrial or commercial knowledge or information;
> (d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c);
> (e) ... or
> (f) a total or partial forbearance in respect of:
> (i) the use of, or the granting or the right to use, any such property or right as is mentioned in paragraph (a) or any such equipment as is mentioned in paragraph (b);
> (ii) the supply of any such knowledge or information as is mentioned in paragraph (c) or of any such assistance as is mentioned in paragraph (d).

The definition is very broad and significantly expands the general notion of a royalty at common law. The characteristics of common law royalties are:

— they are usually paid for the right to exercise a beneficial privilege;
— they are usually payable as and when the privilege is exercised; and
— they are measured by the quantum of the benefit derived from time to time[39].

39 R. H. Woellner, T. J. Vella and R. S. Chippendale, *Australian Taxation Law* (2nd edn 1990) 381.

If the arrangement does not fall within s.6(1) then it is likely to be a royalty under the general law unless it is a payment for an asset and therefore a capital payment.

The distinction between common law royalties and capital payments was highlighted in the cases of *McCauley v. Federal Commissioner of Taxation*[40] and *Stanton v. Federal Commissioner of Taxation*[41]. In the *McCauley* case, the rights granted to the payer were the rights to cut timber from a certain area of land owned by the payee and in consideration of these rights the payer agreed to make certain payments to the payee which were calculated by reference to the amount of timber cut from time to time. It should be noted that the payments to be made by the payer were conditional on the payer actually carrying out timber cutting activities on the land.

In the *Stanton* case, a purchaser was given the right to cut a stated amount of timber in return for paying a stated sum of money by instalments to the vendor. The payments were not conditional on the payer actually carrying out any timber cutting operations. Thus the consideration in this case was a fixed amount and was not conditional on any activities to be carried out on the land which might result in a benefit to the payer.

It was held in the *McCauley* case that the payer derived a royalty at general law, which in effect meant that the moneys received by the payee were assessable income in its hands, whereas in the *Stanton* case it was held that the payments were really of a capital nature and as such were not a royalty under the general law.

As a general rule, it would seem that the majority of FNWIs will usually be royalties under the general law (assuming that the documentation has been properly structured and that the payments are not capital payments made in connection with the acquisition of an asset). Thus if the payment is nothing to do with know-how, equipment, confidential or processing information, etc. (i.e. it does not fall within s.6(1)); is not a fixed sum payable by instalments over a period of time in respect of an asset; and is a payment which is conditional on the payer finding a mineral or petroleum and exploiting the same, then it is likely to be a royalty under the general law.

If one has a s.6(1) royalty then one has to determine whether it is of an income or capital nature. This to a large extent will depend on the facts relating to the particular transaction and the documentation evidencing the same.

The Payee

Most FNWIs will constitute assessable income in the hands of the payee unless either they are s.6(1) royalties that can be shown to be of a capital nature, or they are not really royalties at all but rather fixed capital payments in respect of the acquisition of an asset.

This means that, unless the payee falls within an income tax exemption such as, for example s. 23 (pa) or has available losses or deduc-

40 (1944) 69 CLR 235.
41 (1955) 92 CLR 630.

tions to offset against the income stream, the payee may have a tax problem.

Thus if a payee is in the situation outlined above and has a pre-Capital Gains Tax asset it may be advisable for the payee, if possible, to structure the transaction as an outright sale of a capital asset, i.e. so that the consideration is classified as capital and the payee will not have to pay any capital gains tax. Alternatively, the payee may consider, if the option is available, to try to procure that a s.6(1) royalty is created and the relevant payments are classified as capital rather than income. This may not be easy to achieve particularly bearing in mind that confidential information is not an asset for capital gains tax purposes.

It should be borne in mind that if the payee carries on a business which consists of earning most of its income from FNWIs then it is likely that the FNWIs paid to such payee will be assessed as income in its hands.

The Payer

It is important to note that the tax authorities are not obliged to examine the payer's tax position having regard to their assessment of the payee's position (although I understand that in practice the tax authorities are seeking to create a symmetry in treatment as between the payee and payer).

The payer will usually, unless it intends selling the asset in the near future (in which case capital gains tax will be an issue), want to ensure that the payments of FNWIs are deductible expenses. To do this the payer will have to establish through the drafting of the documentation and by reference to the surrounding circumstances that the payments are not of a capital nature (i.e. payments in connection with the acquisition of an asset) and are necessary expenditures in the course of earning income from a business carried out on or in connection with a particular tenement (i.e. they are day-to-day business expenses).

It should be borne in mind that the stage at which the asset is acquired (i.e. greenfields exploration, acceptable feasibility study, development and production) may be very relevant from the tax authority's viewpoint. Thus if an asset such as, for example an interest in a tenement, is acquired at an early greenfields stage, it is much easier for the payer to argue, assuming that the transaction has been properly structured, that the capital cost of the asset was negligible and therefore most of the royalty payments are not in respect of capital but are deductible as being a necessary cost of allowing the business to produce income.

However if the payer acquires a tenement at the acceptable feasibility or development stage then it is easier to value the capital asset and if the tax authorities can establish that the payer's base cost of the asset was less than its market value at the time, they may be inclined to treat part of the royalty payments as part of the original capital cost of the asset and only allow the remaining part of the payments to be treated as a deduction for income tax purposes.

In this regard, it is interesting to note the decision of *Cliffs International Inc. v. Federal Commissioner of Taxation*[42] which examined the

42 (1979) 142 CLR 140; 85 ATL 4374.

deductibility of deferred payments made pursuant to an agreement specifying that the purchase price of a particular asset was composed of an initial cash payment plus a number of deferred payments. The High Court, in a split decision, determined that the deferred payments constituted revenue expenditures as opposed to forming part of the purchase price of the asset, and were deductible. However, there is some doubt as to whether the decision in *Cliffs International* would be upheld by the High Court today.

Non-residents

Where the payments are made to a non-resident the payer must also determine whether there is a legal requirement to withhold taxes from the payments. In particular, the provisions in the tax legislation regarding natural resource payments should be closely examined as they can operate to deem natural resource payments to have an Australian source, thereby creating an Australian tax liability.

Miscellaneous

Taxation Ruling IT 2506 treats production payments as loans, that is, as if they are a transaction on capital account. The effect of the ruling is that payments, in-cash or in-kind, made to the holder of the production payment (the financier) are deductible to the payer, and assessable income to the payee, as if such amounts were interest.

STAMP DUTY

This topic could be the subject of a paper in its own right and I will only make a few general observations:

— Each transaction should be carefully examined in the context of the governing stamp duty legislation to see if it comes within an applicable head of duty (for example is the consideration payable for the transfer of property? does loan security duty apply? etc.);

— Whether property is being conveyed will depend on what is being conveyed (i.e. the nature of the tenement and its location) and how the transaction has been structured;

— One should be careful in the drafting and execution of the document to ensure that liability to duty will not arise in more than one State due to the potentially broad operation of the 'territorial nexus' provisions; and

— One should always check what the stamp duty authority's administrative practice is in the relevant jurisdiction(s) with regard to the particular transaction in hand for example confidential information is treated as property in some States but not in others.

CONCLUDING OBSERVATIONS

Most tenements are a collection of statutory rights and obligations granted to the holder. These rights are choses in action and are a form of personal property. It is, in my view, a misleading analogy to try to classify tenements by references to real property concepts under the general law as they are 'sui generis' and creatures of statute.

There appears to be considerable uncertainty as to the interpretation of some of the registration or approval provisions set out in the onshore statutes. It would be a welcome step if such legislation were amended to provide for registration of all royalty agreements (this process appears to be under way in certain jurisdictions) as this would provide an element of certainty for all parties (and their advisers) and additional protection for the payee. It could also allow for a uniform approach to the problem to be adopted by all the States and Territories. I am not advocating that stand alone Royalty Deeds should be made the subject of ministerial approval as I do not think this necessary.

If such a suggestion were followed, it might also be a convenient time to review those sections which render instruments void if they are not approved and/or registered. It must be preferable and far more equitable to refer to 'transactions' or 'dealings' rather than 'instruments' so that the parties to the relevant documents would be left with rights 'inter parties' in the event of non-approval or failure to register

This paper is dedicated to Minkie and Louis.