

## Mineral Leases: Royalty Rates Only Part of the Story

*The devil is in the details, so make sure you spell them out clearly in the lease agreement*

BY MICHAEL NOWOBILSKI

**Editor's Note:** *This is the second article in a two-part series on negotiating successful mineral leases.*

### CASE STUDY A

Recently, a two-year old lease containing a 20-percent royalty rate was unilaterally terminated by the lessor. As a result, the producer (lessee) lost its capital and development investments. How did this occur? In this case, the producer's monthly royalty check (for less than \$2,000) was 10 days late. Following its receipt, the lessor cashed the check. However, the lessor then served the producer with a written termination notice citing the lease's termination clause that stated, "this agreement shall automatically terminate upon lessee's failure to pay the lessor in accordance with the provisions of this paragraph."

### CASE STUDY B

A lessor sued its lessee (mineral producer) for \$2 million. Subsequently, the lessee settled for \$1 million. Why? In this situation, the lessor's claim resulted from the fact that

the mineral producer elected to terminate mining on the lessor's property as a result of poor mining conditions that were encountered within its underground mine. In many instances, this would have been the end of the story. In this case, however, the lessor believed that the producer had made sufficient representations regarding sales forecasts (producer's forecast of sales volume that would be mined and sold from the property) that it was due royalty payments even though its property was not mined. As a matter of fact, the lease contained a written estimate.

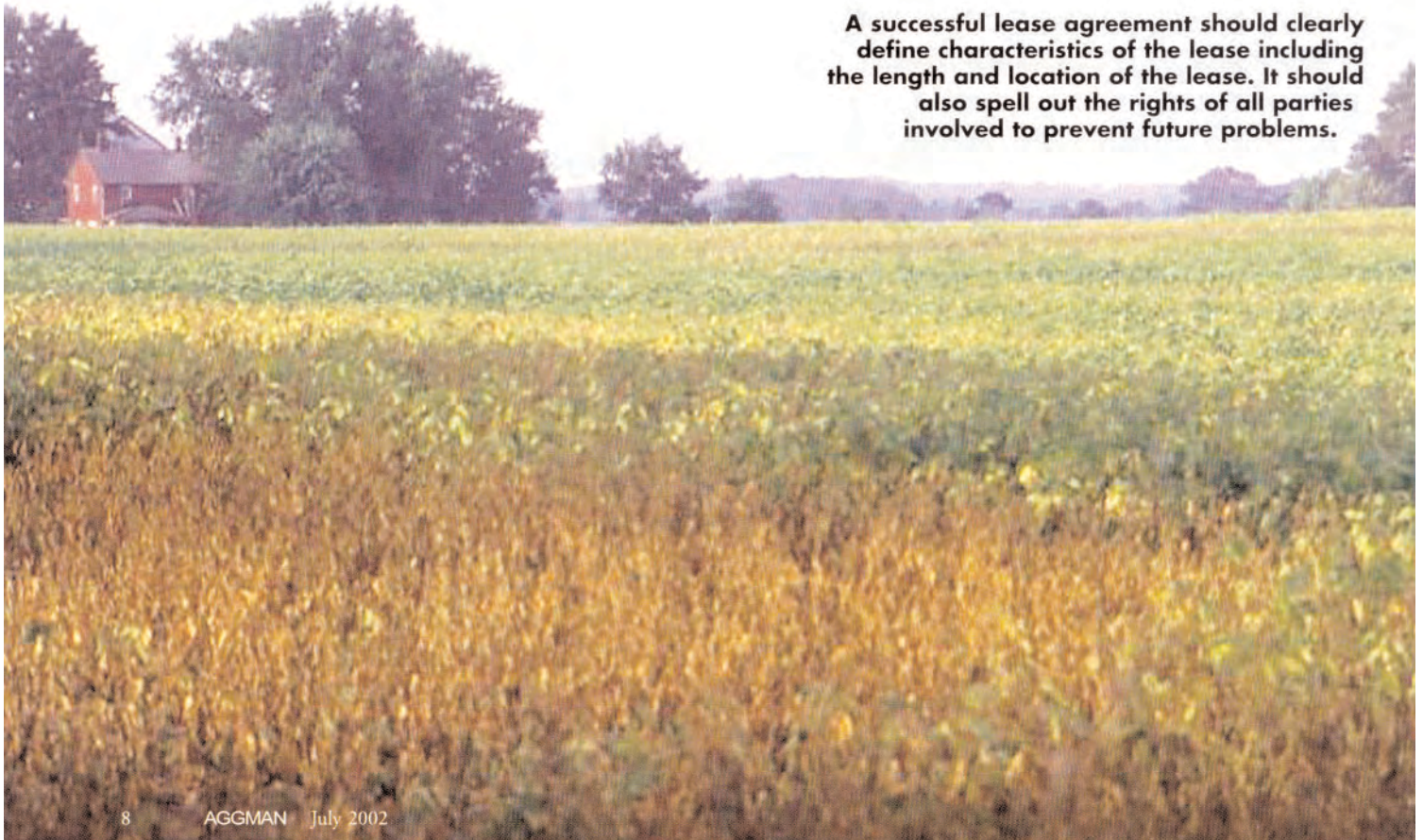
### CASE STUDY C

The continued operation of a large quarry and processing plant is in question. Why? The landowner (lessor) believes the producer is conducting activities upon its property that are not permitted under their lease. More specifically, the producer currently processes mineral — extracted from the lessor's property as well as an adjacent tract of land — through a processing plant located on the lessor's property. The lessor contends the lease restricts processing to mineral extracted from the lessor's property.

Each of these three cases — true cases — illustrate the problems that can arise when the parties to the lease (lessor and lessee) do not adequately address the myriad of details associated with negotiating a mineral lease (a long-term contract) that will adequately and fairly serve the needs of both parties over the years. Royalty rates are only part of the story. As illustrated by Case A, even a 20-percent royalty rate may not eliminate the threat of a lease cancellation.

In order to avoid problems, the lease should be fair or balanced. Case A's lease cancellation is an excellent example of what can happen when the rights of both parties are not protected. In this lease, the lessor did not have adequate provisions to provide for any opportunity to cure for its lack of performance. Such provisions are common in contracts, such as a mortgage. An analogous situation is if a mortgage gave your bank the right to foreclose on your mortgage the very first time you were late making a monthly payment. Instead, mortgages typically contain provisions to provide for late payments, including prescribed penalties.

**A successful lease agreement should clearly define characteristics of the lease including the length and location of the lease. It should also spell out the rights of all parties involved to prevent future problems.**



This article focuses on non-economic aspects of mineral leases. Its purpose is not to provide a comprehensive list of all the terms and conditions that might be included in a mineral lease, but rather to present several key components of mineral leases in sufficient detail to be of value to the reader. For financial aspects of mineral leases, refer to the first installment of this series (*AggMan*, June 2002, p. 11)

## DEFINE THE LEASE TERM

The lease term provision sets forth the number of years during which the contract will be a legal and binding contract upon the parties. For example, the lease may state that the lease has a term of 25 years. Often, a lease stipulates an initial term and a secondary term, or an optional lease extension that the lessee may exercise if it is in compliance with all the lease's other terms and conditions.

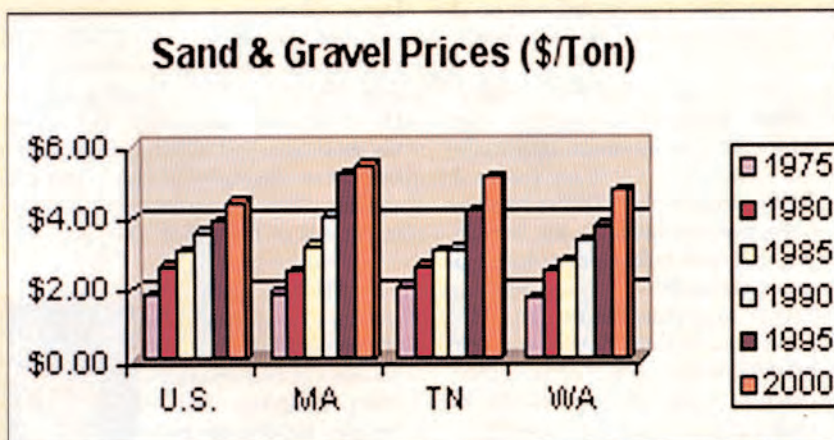
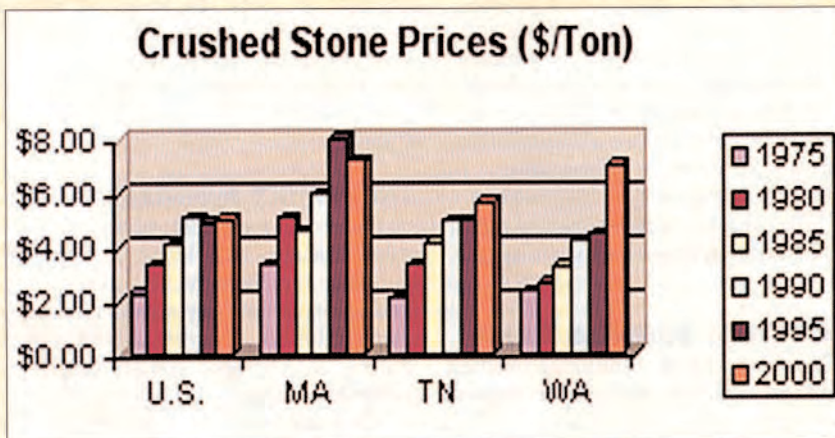
Although this seems to be a simple concept, it can create problems if not clearly drafted. For example, last month's article made reference to a \$5 million

Often, the producer does not request the right to process mineral extracted from adjacent tracts of land and, therefore, it may not be included in the lease. At some future date, they may obtain the mining rights to other tracts of land in the area. If these rights are not defined in the lease, they may have to renegotiate the original lease.

lawsuit won by the lessor (refer to Case A in that article). As described, the unhappy lessor hired an attorney to look for loopholes in the lease that could be used to effectively increase the lessor's royalty income. It may surprise you to learn that the loophole used by the lessor involved the lease term. The lease defined the lease term as: "...25 years or

so ever long as it took to mine the coal." Mining took place shortly after the twenty-fifth year, however, the mining company's legal team and its managers believed that that was OK because the lease provided that such mining might take place after the twenty-fifth year. Unfortunately, the lessor was able to successfully argue that the maximum term of the lease was 25 years. More specifically, their attorneys argued they did not sign a perpetual lease. A jury agreed. A mineral lease should have a clear and finite term.

FIGURE 1. Long-Term Price Trends



Source: USGS Mineral Industry Surveys.

## DEFINE THE LEASE PREMISES

The lease should describe the tract of land where the producer will be allowed to conduct mining and processing operations. This tract of land is commonly referred to as the lease premises. It is important and needs to be specific.

Lessors need to realize that their use of any tract of land included under a lease may be restricted for the duration of its full term. So it is important that the lessor understand and attempt to meet the needs of the producer, but it is often advisable not to lease any tract of land that is not required for the mining operations. For example, a recent client who owned a 500-acre tract of land was approached by a producer who asked to lease the property. During our negotiations, the lessee agreed to limit its operations to a 100-acre tract of land.

By contrast, producers should carefully assess their needs to ensure they include sufficient acreage within the lease premises. Failure to do so could cause long-term operational inefficiencies or result in an ability for the lessor to ask for higher royalties in exchange for adding additional acreage at a later date.

## DEFINE THE LESSEE'S (THE PRODUCER'S) RIGHTS

In this section, the two parties set forth

in writing the rights that the lessor agrees to grant to the producer during the term of the lease. It is very important that the producer develop a comprehensive list of the rights that it requires and/or desires. If these are not detailed in the lease, the producers' mining or processing activities could be limited at some point in the future. Similarly, the lessor is acknowledging what rights are granted to the producer.

Producers typically wish to include the following rights:

- To extract (mine), process, store, ship, and sell mineral extracted from the lease premises.
- To build, operate, and maintain roads, buildings, processing ponds, refuse piles, etc. as may be required to operate the quarry or mine.
- To process, store, and ship mineral that may be extracted from property other than the lessors.

Often, the producer does not request the right to process mineral extracted from adjacent tracts of land and, therefore, it may not be included in the lease. At some future date, they may obtain the mining rights to other tracts of land in the area. At that point, their attorneys analyze the lease to see if they have been granted the right or they decide to attempt to renegotiate the lease.

Often, the parties disagree on their interpretation of the lease, especially if it is an older lease. This issue created the problem described in Case C. In this instance, the majority of the remaining mineral reserves for this million-ton plus quarry were located on the adjacent tract of land. Settlement options included a relocation of the processing facilities, or a renegotiation of the financial terms of the lease in order to provide the lessor with additional compensation. Either settlement has the potential to cost \$1 million or more.

## DEFINE THE LESSEE'S OBLIGATIONS

Typically, this section of the lease seeks to limit any risks to the lessor that result from the mining operation. For example, if an employee or other person should be seriously injured or killed upon the lease premises, the lessor seeks to ensure that the lessee has taken adequate measures to prevent the accident.

It also provides sufficient insurance to prevent any financial claims against the lessor. In addition to workplace accidents, we've all heard about the drownings that occur each year in flooded abandoned pits and ponds.

Leases typically include the following lessee obligations:

## Mineral Lease Principles

The following principles should help you structure a highly effective lease.

- ✓ Lessors should understand the lessee's (producer's) general development plan and market.
- ✓ Use a percentage earned royalty rate in order to keep pace with the long term trend of increasing commodity prices. (See Figure 1)
- ✓ Set a realistic minimum annual royalty.
- ✓ Establish a clear lease term (for example, a specific number of years).
- ✓ Include a definitive list of the producer's rights being granted by the lease. At a minimum, this typically includes all the operations one associates with quarries.
- ✓ Include a list of the producer's obligations to be effective for the duration of the lease term.
- ✓ Negotiate realistic default provisions and include language that can address what should occur in the event there is a breach of the agreement.

- To indemnify the lessor against any and all claims;
- To operate its mine or quarry in compliance with all federal, state, and local rules and regulations;
- To obtain and maintain any necessary permits, licenses, and bonding (if required);
- To reclaim the quarry and processing site in accordance with all federal, state, and local guidelines and any applicable reclamation permits;
- To maintain some minimum level of general liability insurance during the term of the lease and any subsequent reclamation efforts; and
- To dispose of all hazardous wastes in accordance with applicable regulations at approved off site disposal sites.

## ADDITIONAL BUSINESS TERMS

There are several additional business terms that should be included in mineral leases.

**Default Provisions.** Default provisions should be clearly defined in the lease. Typical lessee default provisions include:

- Failure to pay earned royalties and annual minimum royalties in accordance with the financial terms of the lease.
- Failure to comply with the lessee's obligations included in the lease. For example, failing to maintain all necessary permits.
- Failure to operate the quarry and processing facilities within the rights granted by the lease. For example, processing material from adjacent property if not granted under the lease.

**Termination Provisions.** Termination provisions need to be clearly defined.

Typically, the lessor is granted the right to terminate the lease in the event of a default by the lessee.

It is important that the lessee negotiate inclusion of an adequate mechanism to allow it to remedy defaults (which inevitably occur).

Lessors need to be fair. It is common for lease provisions to provide for written notification from the lessor identifying the default and to prescribe a cure period(s) that will be applicable.

Failure to include such provisions can lead to serious circumstances. Refer to Case A.

## THE PERFECT MINERAL LEASE

There are thousands of quarries and mineral leases. New leases are being negotiated or renegotiated every day. Perfection in writing a mineral lease is comparable to achieving a perfect score during an Olympic competition — it rarely happens.

There are many reasons why the perfect lease may seem elusive. One major factor is that it is a negotiated agreement attempting to meet the needs of both parties. Also, it is difficult to accurately predict 20 or 30 years into the future. However, with preparation and by using the guidelines described in these two articles (see "Mineral Lease Principles," above), a lease that scores a 9.5 should be achievable in most cases. ▲

Mike Nowobilski is president of Mid-America Energy & Mining Services, Inc. He can be reached at (618) 624-0155, or [nowobilski@midam-inc.com](mailto:nowobilski@midam-inc.com).

