



Selling the Crown Jewels: Diamond Royalties and Marketing Agreements in Canada

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SELLING THE CROWN JEWELS: DIAMOND ROYALTIES AND MARKETING AGREEMENTS IN CANADA

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§ 13.01 Introduction

The Point Lake diamond strike in the Great Slave region of Canada's Northwest Territories triggered the largest mineral staking rush in North American history.² The discovery ultimately led to the development of two large mines, now in production, and the rush is still underway.³

Diamonds are a unique commodity. The process of diamond exploration, production and marketing is one with which many transactional attorneys are not familiar. Diamonds, unlike oil and gas, metallic minerals or coal, are non-fungible. Consequently, diamonds are marketed and sold on the basis of the distinctive

² Matthew Hart, *Diamond* 84, 95 – 103 (2001); See also Kevin Krajick, *Barren Lands* 332 (2001).

³ The Ekati Diamond Mine™ opened in 1998. BHP Billiton Diamonds Inc., Issue 6, “Ekati Diamond Mine Facts” 2 (2003). The Diavik Mine opened in 2003. Diavik Diamond Mines Inc., “History”, <http://www.diavik.ca/history.htm> (2 June 2004).

characteristics of each stone. The process of diamond sales therefore involves a degree of subjectivity absent from fungible mineral commodity sales in the international commodities market where published prices are readily available. For transactional attorneys this presents certain challenges in drafting royalty agreements, marketing agreements and joint ventures which allow taking in kind.

This paper is intended as an introduction to the subject. It will briefly discuss diamond geology, diamond production and diamond marketing practices. It will then address the use of diamond royalty agreements and diamond marketing agreements in Canada and present practical guidance for transactional attorneys regarding the specific issues which should be considered in drafting these documents.

§ 13.02 The Geology of Diamonds

[1] Diamond Formation

The word “diamond” is derived from the Greek *adamas*, meaning indomitable.⁴ A diamond is composed of pure carbon, the fourth most abundant element in the solar system after hydrogen, helium and oxygen.⁵ They are formed when carbon atoms are compressed together, in a zone in the earth’s upper mantle known as the diamond stability field, into layers upon which additional layers of carbon atoms are

⁴ Hart, *supra*, note 2 at 24.

⁵ Stephen E. Haggerty, “A Diamond Trilogy: Superplumes, Supercontinents, and Supernovae”, 285 *Science* 851 (1999).

compressed.⁶ Through this process the carbon atoms share electrons and form the strongest bond known in chemistry.⁷

Diamonds may be carried to the surface of the earth, after their formation, in high velocity magma eruptions called kimberlites, a word derived from the Kimberly, South Africa diamond mining district.⁸ The search for diamonds in Canada is the search for kimberlites and the indicator minerals which mark their presence. However, diamonds are not present in all kimberlites and, when they are, they occur in concentrations of only one to five parts per million.⁹

[2] Diamond Varieties

Diamonds vary in shape, size and color. Shapes include octahedrons and cubes.¹⁰ Smaller diamonds are more common than larger stones, as size decreases exponentially as a function of frequency.¹¹ Diamonds are typically thought of as clear, but occur in colors as diverse as green, brown, pink and yellow.¹²

Diamonds are measured by carat, a unit of metric weight equal to 0.20 grams. In the context of diamond sales, value is often expressed in the unit price per carat.

⁶ Hart, *supra*, note 2 at 24.

⁷ *Id.*

⁸ Hart, *supra*, note 4 at 24.

⁹ Haggerty, *supra*, note 5 at 851.

¹⁰ *Id.* at 852.

¹¹ *Id.*

¹² *Id.*

However, additional factors, such as color, clarity and cut impact the value of a given diamond. Diamond color is graded by determining how closely the diamond approaches colorlessness, with most stones having a trace of yellow or brown. Diamond coloration is described by reference to a scale correlated to color intensity. A diamond with a color of greater intensity that exceeds the scale is termed a “fancy” diamond. A colorless diamond is more valuable than one with a trace of coloring, but an intensely colored fancy stone is more valuable than a stone in a lighter shade of the same color.

Clarity is measured by an additional graduated scale. The clarity scale extends from “flawless”, through degrees of minor imperfection, to “imperfect” where flaws are visible to the naked eye.

The cut of a diamond refers to its shape, proportions and finish. The art of diamond cutting has been described as the art of determining how to most effectively disperse and distribute light entering the diamond.

§ 13.03 A Brief History of Diamond Mining & Sales

[1] Ancient

Diamonds were first mined in India in approximately 2000 B.C.¹³ The stones were obtained through alluvial digs, where they were recovered in rivers.¹⁴ Much

¹³ *Id.* at 851.

¹⁴ Hart, *supra* note 2 at 33.

later, in 1720 A.D., diamonds from alluvial deposits were recovered in Brazil.¹⁵ By the mid-eighteenth century Brazil had replaced India as the world's leading diamond producer.¹⁶ Diamonds continue to be mined in India and Brazil. However, the history of modern diamond mining began in South Africa.

[2] Modern

In 1867 the son of a Dutch farmer in South Africa found a 21.25 carat diamond close to his home.¹⁷ Several years later an 83.5 carat diamond, discovered by a native shepherd, was placed on exhibit in Cape Town.¹⁸ The stone was eventually shipped to London where it was cut, polished and purchased by the Earl of Dudley for £30,000.¹⁹ British newspapers reported the transaction, and the story was picked up by the European and American press. The publicity triggered the South Africa diamond rush.²⁰

In 1880 Cecil Rhodes formed De Beers Mining Company Ltd. ("De Beers"), having previously purchased the mining claims on a farm originally owned by the de

¹⁵ Haggerty, *supra* note 5 at 851.

¹⁶ Hart, *supra* note 2 at 33.

¹⁷ *Id.* at 34.

¹⁸ Stefan Kanfer, *Last Empire* 26 (1993).

¹⁹ *Id.* at 27.

²⁰ *Id.*

Beers brothers.²¹ Through a series of transactions, De Beers ultimately gained control of the assets of its chief competitors, the Compagnie Francaise des Mines de Diamant du Cap de Bon Esperance and the Kimberly Central Diamond Mining Company.²²

By 1900 De Beers controlled 90 percent of the world's rough diamonds.²³ It gained this control through a strategy of controlling the flow of production and sales to boost prices.²⁴ The strategy, which created a false scarcity in diamonds, became known as "supply management."²⁵ Initially, the strategy was implemented through the formation of a cartel of the ten largest international diamond merchants. De Beers allocated each cartel member a certain percentage of its output. In exchange, the cartel members provided De Beers with market data to enable De Beers to gauge demand and ensure a steady supply at maximum price.²⁶ Throughout the 20th Century De Beers refined this technique and, in the process, replaced the original cartel members with approximately 125 members.²⁷

De Beers' control of the diamond supply utilized its marketing entity, the Central Selling Organization ("CSO"). The CSO purchased the output of the De

²¹ Hart, *supra* note 2 at 41.

²² *Id.* at 41-43.

²³ *Id.* at 44.

²⁴ *Id.*

²⁵ Lauren Weber, "The Diamond Game", N.Y. Times, April 8, 2001, § 3 at 1.

²⁶ Nicholas Stein, "The De Beers Story", Fortune, February 19, 2001 at 186.

²⁷ *Id.*

Beers' mines, which eventually included properties throughout the world.²⁸ De Beers shipped diamonds from these properties to CSO headquarters in London where they were separated into 14,000 categories and divided into lots called "boxes." Every five weeks, De Beers conducted a diamond "sight" in which cartel members, called "sightholders," were invited to view the boxes on display at the sightholding. A given box would contain stones of higher quality mixed with stones of lesser quality, thereby ensuring a market for lesser quality stones. De Beers set a non-negotiable price for each box in advance and determined the quality and quantity of diamonds each sightholder received.²⁹

De Beers maintained control of the diamond trade throughout the 20th century by controlling the supply of diamonds from its mines and contracting for rough stones from third party mines.³⁰ However, by the end of the twentieth century De Beers control, while still significant, had diminished from 90 percent to 66 percent.³¹ In 2004, De Beers reduced the number of cartel members by approximately 20%, citing a

²⁸ *Id.*

²⁹ *Id.*

³⁰ Richard S. Teitelbaum, "Hard Times for Diamonds", *Fortune*, April 22, 1991 at 167.

³¹ William Kay, "The Jewel in the Crown", *The Independent* (London) May 2, 2001 at 1.

reduced share of the rough diamond market.³² De Beers had long been threatened with violation of antitrust laws in the United States.³³ However, its main concern remained new sources of non-cartel controlled production.

[3] Canada

In the late 1980s, geologist Charles Fipke was exploring for diamonds on the Slave Craton, a remote area of Canada three hundred miles north of Yellowknife.³⁴ The search culminated in 1991 with the discovery of a diamond-bearing kimberlite at a lake named Point Lake by Fipke and his colleagues.³⁵ The Point Lake discovery eventually became the BHP Billiton controlled Ekati mine.³⁶ The Point Lake

³² The Professional Jeweler, “DTC’s Shorter Sightholder List for 2004”, <http://www.professionaljeweler.com/archives/news/2004/011304story.html>, 13 January 2004, (4 <http://www.lawsonlundell.com/lawyers/ChrisGBaldwin.html> June 2004). Several years earlier De Beers had changed the name of the CSO to the Diamond Trading Company (“DTC”). Encyclopedia Britannica Premium Service, “De Beers Consolidated Mines”, <http://www.britannica.com/ebc/article?eu=387686>, (18 June 2004).

³³ A 1945 Department of Justice ruling prevented De Beers from conducting business in the United States, although De Beers was able to circumvent this problem by dealing through London-based intermediaries. See Dan Atkinson, “Don’t Arrest Me, I’m Here for De Beers”, Mail on Sunday (London), April 18, 2004 § C1 at 6.

³⁴ Hart, *supra* note 2 at 76.

³⁵ *Id.* at 82. The name Point Lake was chosen to be purposefully confusing to competitors as another Point Lake already existed. *Id.*

³⁶ The Ekati Diamond Mine™ is a joint venture between BHP Billiton Diamonds Inc., Charles Fipke and Stewart Blusson. BHP Billiton Diamonds, *Diamonds* <http://ekati.bhpbilliton.com/index.asp>, (2 June 2004).

discovery was followed by a discovery at Lac de Gras which became the Rio Tinto controlled Diavik Mine.³⁷

§ 13.04 The Diamond Pipeline

The “Diamond Pipeline” is a term for the route which diamonds follow from the mine to the ultimate consumer. The stages of the Diamond Pipeline consist of production, cleaning, sorting and valuation, sightholding, cutting and polishing, jewelry manufacturing, distribution to retailers, and final sale to consumers. The initial stages of production, cleaning and sorting of rough stones takes place at the mine.

Canadian diamonds are subject to a federal royalty mandated by the Canada Mining Regulations.³⁸ The federal royalty is set as lesser of 13% of the value of the output of the mine, or an amount calculated on the basis of a sliding scale royalty from zero to 14%, applied to incremental output valuations.³⁹ Canadian law prohibits the removal of diamonds from the mine site, other than for assay or testing purposes, until they have been valued by a government mining royalty valuer.⁴⁰ The existence of the Canadian federal royalty is useful for private royalty determinations because, while

³⁷ The Diavik Mine is a joint venture between Diavik Diamond Mines Inc. and Aber Diamond Mines Ltd., Diavik Diamond Mines Inc., Corporate Profile, <http://www.diavik.ca/corp.htm> (2 June 2004).

³⁸ C.R.C., c. 1516, ss. 65 – 69.

³⁹ *Id.* at s. 65(1).

⁴⁰ *Id.* at s. 69(2).

such a royalty could theoretically be calculated at any point in the pipeline, there is logic to determining the private royalty at the time of government valuation.⁴¹

§ 13.05 Diamond Royalties

[1] The Gross Overriding Royalty

In Canada, the typical form of royalty for diamond production is the gross overriding royalty (“GOR”). A gross overriding royalty can be created on a mine which produces a product which, like rough diamonds, can be sold with little or no alteration of its basic character. However, a gross overriding royalty loses its defining character if it is created in relation to a mine whose product must undergo significant alteration before sale.

The GOR originated in the oil and gas industry, where it is known more simply as an overriding royalty. In Canada the GOR has been standardized in the Canadian Association of Petroleum Landmen (“CAPL”) Overriding Royalty Procedure (1997). In the CAPL Overriding Royalty Procedure, the royalty owner is entitled to a share of the market price of petroleum substances at the time they are available to be taken in kind less any costs incurred by the operator to bring the

⁴¹ In addition to the Canadian federal royalty, practitioners should be aware of Canada’s Export and Import of Rough Diamonds Act which establishes certification, documentation and packaging standards for the export and import of rough diamonds from and to Canada. Canada enacted this legislation in response to the Kimberly Process, an initiative by African diamond producing countries to limit the trade in “conflict”, or “blood” diamonds. Conflict diamonds are rough diamonds used by rebel movements in African nations to finance military actions. See Louis Goreux, “Conflict Diamonds”, The World Bank Africa Region Working Paper Series No. 13, (2001). In 2001 the United Nations passed a resolution expressing the need for creation and implementation of an international certification scheme for rough diamonds. G.A. Res. 56, 55th Sess., A/Res/55/56 (2001).

petroleum substances to the point of sale. These deductions include costs of making the substances merchantable and delivering them to market.

In diamond production, the GOR is calculated by multiplying the negotiated royalty percentage by the appraised value of the diamonds at the minesite. A form of GOR is attached as Appendix A.

[2] Checklist for Drafting Diamond Royalty Agreements

A diamond royalty agreement should address the following matters:

[a] The Parties

The agreement should state whether each party may assign the contract freely, or only with the other's consent. If consent is required, is it not to be unreasonably withheld? If so, it may be unreasonable for the royalty owner to withhold consent where the proposed assignee is a responsible mining company.

The operator may want a right of first refusal on any proposed assignment of the royalty, to give it an opportunity to eliminate the royalty. The royalty owner may wish a reciprocal right, but with less clear justification particularly if the royalty owner is not a mining company.

Where the royalty owner is an individual, consider whether the obligation to pay the royalty will survive the owner's death.

[b] The Property

The property to which the royalty applies must be defined with legal certainty, and it should be clear that it applies not just to mineral claims held by the operator

when the royalty is granted but also to mining leases or other forms of mineral tenure that replace the claims when the property is taken to development. The royalty owner may wish to consider requiring the operator to re-grant the royalty by a re-executed royalty agreement whenever new forms of tenure are acquired.

In jurisdictions where mineral claims expire after a set number of years unless taken to lease and the claim-holder is not permitted to restake them, it is not unknown for claim-holders to allow the claims to lapse but to arrange for a related company to restake them immediately. Such actions have given rise to litigation.⁴² Consider a provision in the agreement assuring the royalty holder his or her royalty would not be lost as a result.

It is sometimes appropriate to include an “area of interest” clause. This would typically provide for the royalty to extend to production from any claims staked or acquired in the future by the operator and/or the royalty holder within the defined area of interest. The area of interest is best defined as a quantifiable geographic area, such as the area within x kilometers of the outermost boundaries of the claims initially subject to the agreement. Without this temporal limitation, the area of interest has the potential for ambiguity or to expand infinitely. The area of interest should be defined to include internal fractions, in jurisdictions where fractional claims are possible. Less typically, the area of interest clause might apply to any claims that are staked to follow mineralization discovered on the initial claims.

⁴² Gerle Gold Ltd. v. Golden Rule Resources Ltd., [1999] 2 F.C. 630 (T.D.).

Whether an area of interest clause should be included depends on the circumstances. If the royalty holder is a prospector whose work first attracted the operator to the area, the prospector can make a case for participation in any future success that the operator has in the area. The royalty holder's case is weaker if the operator was already active in the area and acquired property from the royalty owner to build a land position around an existing discovery.

[c] Grant of Royalty

If the royalty is to be an interest in land, there should be a grant or reservation of an interest in the minerals to make it apparent that the royalty owner is entitled to more than a share of the proceeds of sale less defined deductions. It should be stated expressly that the royalty is intended to be an interest in land. The royalty owner should be given rights under the agreement consistent with his or her position as an "owner", such as the right to withhold consent to the abandonment of the property.

If the royalty is an interest in land, and particularly where the royalty owner seeks involvement in the operations or decisions of the operator to protect that interest, the royalty owner may become exposed to liability as an owner or operator, including for damage to the environment, and may also find that contractors and others dealing with the operator may require the royalty owner to become a party to such contracts. As an example, a contract for the construction of a mine may contain a provision limiting the contractor's liability to its insurance coverage; if the royalty

owner owns an interest in the land, the contractor may well require the royalty owner's agreement to this limitation.

[d] Covenant to Pay

In this section the operator will agree to pay the royalty, defined as a percentage of gross proceeds.

[e] Calculation of the Royalty: Definitions of Key Terms

Key terms used to calculate the royalty need to be defined with as much precision as possible. A typical GOR will require the operator to pay a percentage of the Appraised Value of the Diamonds. "Appraised Value" will be defined as fair market value of the diamonds after cleaning and sorting, with no deductions for cost or expenses. "Diamonds" will mean rough diamonds that are produced from the property or tailings from the property. "Royalty" will mean the percentage by which the Appraised Value is multiplied to determine royalty payments. "Valuator" will mean a qualified and accredited individual charged with sorting, grading and valuing the diamonds at the minesite. The more detail in which these terms can be defined, the less likely the operator can manipulate the calculation to its benefit with potential for dispute.

[f] Time and Manner of Payments

This section will prescribe the frequency and manner in which payments are to be made and the contents of the detailed statement that should accompany each payment showing how it was calculated. Interest should be charged on late payments.

[g] Buy-out; Cap

The operator will be interested in capping the royalty at a fixed amount (which might be linked to inflation) and in having the right to buy the royalty out or at least to purchase a reduction in the rate at which it is paid.

[h] Security Interest

If the royalty is not an interest in land, then it is a contractual right only to payment of money.⁴³ As such, if it is not secured, it is vulnerable in the event of the operator's insolvency or bankruptcy or in the event the operator sells the property to a purchaser who does not assume the royalty obligation. The royalty owner may therefore wish to take security over the mine to which the royalty applies or over all of the operator's assets including that mine.

[i] Representations and Warranties

Each party will give to the other the usual warranties dealing with its corporate status and the enforceability of the agreement. One of the parties will also give to the other representations and warranties dealing with the underlying property.

Where the royalty is reserved to the prospector or other person vending mineral claims to the operator, these representations and warranties will be given by

⁴³ In some Canadian jurisdictions, such as British Columbia, recorded mineral claims are not land and so charges against them cannot be registered in the land title office; nor are they personal property under personal property security legislation (having been specifically excluded by definition) and so security granted in them cannot be perfected in the personal property registry. To complicate the situation further, in some Canadian jurisdictions, such as British Columbia, mining leases, which will ultimately replace the operator's mineral claims when the property is taken to development, are treated as personal property under personal property security legislation.

the royalty owner to the operator and will be fairly modest in scope. Their purpose will be to establish the status and validity of the claims; the royalty owner's title to them; and compliance by past operators with laws, regulations and permits including environmental protection legislation.

Where the royalty is created and sold by the operator to raise capital, the representations and warranties will be given by the operator to the royalty holder and may be quite extensive in order to assure the royalty owner that it is fully informed about the current status of the project and the requirements the operator will have to satisfy to commence production and payment of the royalty.

[j] Term

The term of the agreement will be specified. If the royalty is an interest in land, the term will be in perpetuity and a provision dealing with the rule against perpetuities will be included.

[k] Commingling

The royalty owner will be concerned that diamonds from the property to which the royalty applies may be commingled with lower-grade diamonds from the operator's neighboring properties before sale, thereby diminishing the appraised value of the diamonds from the property to which the royalty applies.

The agreement will therefore either prohibit commingling outright, or stipulate that the operator must appraise the diamonds from the property to which the royalty applies before commingling in accordance with a detailed procedure.

[l] Hedging Transactions

Some operators engage in commodity futures trading, option trading, and other hedging transactions. Others as a matter of corporate policy prefer to have unhedged exposure to rises (and falls) in the commodity markets for all of their production or at least for the portion of it not required to meet operating costs.

The operator will have to decide whether it is prepared to involve the royalty owner in the results of its hedging transactions and the royalty owner will have to decide whether it wants the involvement. The agreement should then make express provision one way or the other.

[m] Books; Records; Inspections

Even if the royalty owner's position is that of a passive recipient of money, the operator should be required to keep true and accurate books and records of its activities and the royalty owner should have the right to inspect and audit them, to the extent they contain information relevant to the calculation of the royalty.

If the royalty owner is in a more assertive position, it may be entitled to unrestricted access to the operator's books and records, the right to detailed activity reports and the right to inspect the property and operations. The royalty owner will be required to keep all information confidential, except as required to be disclosed by law or securities regulatory authorities. Press releases are sometimes made subject to prior approval.

[n] Tailings

Diamonds are mined through the extraction and processing of ore. Processing detects and removes diamonds, and produces tailings as a by product. The tailings may have future value if enhanced recovery technologies are developed and utilized to reprocess the tailings. Therefore, It should be clear in the agreement that the royalty applies to tailings.

[o] Stockpiling

The operator may wish to stockpile material from the property at other locations. The agreement should then require the operator to obtain an agreement from the owner of that location in favor of the royalty owner in which the royalty owner's rights are recognized and the minerals are protected from third-party liens.

[p] Maintenance of Property

The agreement might obligate the operator to maintain the property in good standing, pay all taxes and keep the property free from liens. The operator may be required to notify the royalty owner where it intends to abandon any part of the property. The operator might even be required to carry out at least the amount of work needed to advance the property toward specified milestones (such as preparation of a feasibility study).

On the other hand, the operator may consider that the royalty owner is entirely passive and must be content that the operator's self-interest will ensure that the best decisions for the project are made.

[q] Insurance

The agreement might obligate the operator to arrange insurance against third-party claims, property loss and business interruption to ensure that the royalty owner does not suffer direct loss and that the operator is able to continue the operation of the mine for the royalty owner's benefit.

On the other hand, the operator may consider that the royalty owner is entitled only to a share of its profits or revenues, if any, and as such does not need or warrant such protection.

In the context of diamond mining, insurance coverage in an amount and scope adequate to cover theft of rough stones is a particular concern.

[r] Conduct of Operations

If the royalty owner has the negotiating strength to obtain a royalty that is an interest in land and he or she is not averse to the risks that may entail, then there may be covenants by the operator to conduct all its activities in compliance with law; and depending on the status of the project, to develop the property only in accordance with an independently commissioned feasibility study or to adhere to its mine plan without departure, unless approved by the royalty owner. A royalty owner in a particularly strong negotiating position might even bargain for the right to approve the recommendations in the feasibility study or mine plan.

If, however, the royalty owner is in the position of a passive recipient of cash payments then it is unlikely that any provisions to this effect will be included.

[s] Implied Covenants

Craig Haase and Peter Babin, writing in the American context, state that:

[T]he royalty owner cannot assume that the operator will be burdened, as a matter of law, with any duties to develop the property, or to commence or continue mineral production, or to otherwise advance the interest of the royalty owner, or to furnish or disclose information to the mineral owner regarding the operator's exploration, development, operations, or processing activities or plans for that particular property (or any other property), or to refrain from preferring development of other properties over development of the royalty owner's property. Virtually the only generally imposed requirement that benefits a royalty owner, as a matter of law, is the duty of the operator to accurately account for production from the property that is subject to the royalty. If it is important to the royalty owner that the operator adhere to any of the other above-listed but not legally imposed duties, then it is incumbent upon the royalty owner to raise such matters, and to ensure that an acceptable statement of the agreed-upon duties is memorialized in the agreement.⁴⁴

While this prescription might be true in the Canadian context it is nonetheless fairly common in royalty agreements for operators to expressly disclaim any such implied covenants and to expressly deny the existence of any fiduciary relationship between royalty owner and operator.

In Canada, there may be a concern about where courts will go with the relatively new notion that contracts contain an implied duty of good faith. Duties of good faith appear in statutes and in contracts but the judicial consideration of good faith has not been consistently applied. In some instances, courts have found an implied duty of good faith and, while such activism has been less than frequent, it has

⁴⁴ M. Craig Haase & Peter B. Babin, "Mining Royalties from the Royalty Owner's Perspective – Forging Symbiosis with the Operator, [42] Rocky Mt. Min. L. Inst. 21-1 (1996).

been gaining momentum since the decision in *Gateway Realty Ltd. v. Arton Holdings Ltd.*⁴⁵

[t] Registration of Interest

Most Canadian jurisdictions have legislation that would permit the royalty owner to record its royalty on title to the mineral claims. If the royalty is not an interest in land, this will serve as notice to third parties of the existence of the royalty, but may not bind them legally.

[u] General Provisions

A royalty agreement is like any other contract and as such should contain provisions dealing with governing law, time being of the essence, dispute resolution, and other similar provisions.

§ 13.06 Royalties as Interests in Land

Canadian courts have historically shown reluctance in recognizing mineral royalties as an interest in land. While more recent case law has concluded that oil and gas royalties may constitute an interest in land if that is the intention of the parties, the application of this oil and gas based case law to diamond royalties remains uncertain.

[1] Historical Treatment of Royalties on Mining Properties

For many years, the leading case on mining royalties was *Saskatchewan Minerals Ltd. v. Keyes*.⁴⁶ In that case, alkali leases were granted by the Government of

⁴⁵ *Gateway Realty Ltd. v. Arton Holdings Ltd.*, 106 N.S.R. (2d) 180 (N.S.S.C.) (1991).

⁴⁶ *Saskatchewan Minerals Ltd. v. Keyes*, [1972] S.C.R. 703.

Saskatchewan to Astral. Astral, the lessee, entered into an overriding royalty agreement with Keyes. Astral later assigned its mining leases to Saskatchewan Minerals, a Crown corporation. At issue was whether Saskatchewan Minerals was obliged to recognize the royalty interest of Keyes, which it was only required to do if the royalty to Keyes was found to be an interest in land. The granting language at issue was as follows: “The consideration to be paid by Astral . . . shall be . . . a royalty of twenty-five cents (25[¢]) per ton on all anhydrous salt produced and sold from the said leasehold property.”⁴⁷

The majority found that the royalty was not an interest in land based on *St. Lawrence Petroleum v. Bailey Selburn Oil & Gas*⁴⁸ and a statutory requirement that a lessee must get government approval to transfer an interest in land (which Astral had not done). Specifically, on the question of whether the use of the word “royalty” implied an intention on the part of the lessee to create an interest in land in the third party, Martland, J. for the majority stated: “I would doubt that it does.”⁴⁹ Because the majority had decided the case on other grounds, the brief comment regarding the nature of the royalty was clearly *obiter dicta*.

Mineral claims in the Northwest Territories were considered in *Isaac v. Cook*,⁵⁰ In that case net smelter return royalties of two percent (2%) were granted by the holders of a lease and mining claims. The owner of the claims went into receivership

⁴⁷ *Id.* at 708.

⁴⁸ *St. Lawrence Petroleum v. Bailey Selburn Oil & Gas*, 36 W.W.R. 167 (Alta. T.D.) (1961).

⁴⁹ *Saskatchewan Minerals*, [1972] S.C.R. 703, 709.

⁵⁰ *Isaac v. Cook*, 44 C.B.R. N.S. 39 (NWT S.C.) (1982).

and the receiver claimed the right to sell the property free of the royalty interests. The NWT Supreme Court concluded that the royalty was not an interest in the ores or minerals nor an interest in the mining lease or mining claims themselves.

The language contained in the royalty agreements considered in *Isaac v. Cook* was described by the court as follows:

21. The agreements recite that in consideration for the assignee having arranged financing for the assignor, the assignor has agreed to assign to the assignee:

an amount equal to two (2%) per cent of the net smelter returns received by the Assignor from the sale of ores and other products from the said lands, all as hereinafter provided.

22. The agreement in each instance recites the sum paid by the assignee to the assignor as a binding consideration for which:

1. The assignor hereby agrees to pay to the Assignee a royalty on net smelter returns for any ores processed in any manner other than by smelter or on the market value (FOB the said lands) subsequent to processing for any ores processed by smelter on the said lands (the net smelter returns and the market value as aforesaid herein called "Returns") as follows:

2% of all Returns (hereinafter called "royalty").⁵¹

Based on this language, the NWT Supreme Court concluded that the royalty agreements were "no more than an assignment of a percentage of sums received or receivable by the assignor as the consideration for sales or other dispositions of ore produced from mineral claims, as a simple matter of contract."⁵²

The court, in basing its conclusion on the language of the agreements, did leave open the possibility that an agreement with different language may lead to a different result.

⁵¹ *Id.* at 46.

⁵² *Id.* at 47 (emphasis added).

[2] Oil and Gas Cases.

[a] Application to Diamond Royalties.

Barton, in *Canadian Law of Mining*⁵³, observes: “Oil and gas cases will be considered by the courts in the analysis of hardrock mineral royalties, notwithstanding the differences between the industries.” Until recently, the preponderance of case law regarding oil and gas royalties had found that such a royalty did not constitute an interest in land. However, the Supreme Court of Canada has recently clarified the circumstances under which such a royalty may become an interest in land in the case of *Bank of Montreal v. Dynex Petroleum Inc.*⁵⁴. It is likely that the reasoning in *Dynex* will be applied to diamond royalties as well given that the Court’s reasoning in *Dynex* was largely based upon the dissenting opinion of Laskin, J. in *Saskatchewan Minerals*.⁵⁵

[b] Laskin, J. Dissent in *Saskatchewan Minerals v. Keyes*

Laskin, J. found that the royalty granted to Keyes was an interest in land and specifically:

[Keyes] became entitled to an overriding royalty in respect of the lessee’s interest in lease A-4010, whether that interest was a leasehold in the strict sense or a profit-à-prendre for a term and the royalty, unaccrued, was an interest in

⁵³ B.J. Barton, *Canadian Law of Mining* (Calgary: Canadian Institute of Resources Law, 1993) at 465.

⁵⁴ *Bank of Montreal v. Dynex Petroleum Inc.* [2002] 1 S.C.R. 146 (S.C.C.). *See also* *Alberta Energy Co. v. Goodwell Petroleum Corp. Ltd.*, 233 D.L.R. (4th) 341 (Alta. C.A.); *James H. Meek Trust (Trustee of) v. San Juan Resources Inc.*, 2003 ABQB 1053 (Alta. Q.B.); *Lorne H. Reed & Associates Ltd. v. ProMax Energy Inc.*, 2003 ABQB 121 (Alta. Q.B.); *Computershare Trust Co. of Canada v. Jonas*, 2003 ABQB 446 (Alta. Q.B.).

⁵⁵ *Saskatchewan Minerals*, [2002] 1 S.C.R. 146 (S.C.C.) 710.

land, analogous to a rent-charge, and, in the circumstances, binding on the appellant as subsequent assignee of lease A-4010.⁵⁶

Laskin, J. explicitly stated:

This is not to say that every reservation or grant of a royalty creates an interest in land. The words in which it is couched may show that only a contractual right to money or other benefit is prescribed. However, if the analogy is to rent, then the fact that the royalty is fixed and calculable as a money payment based on production or as a share of production, or of production and sale, cannot alone be enough to establish it as merely a contractual interest.⁵⁷

[c] *The Dynex Case*

In *Dynex* the Supreme Court of Canada relied on Laskin, J's dissent in considering whether and in what circumstances an oil and gas royalty interest can constitute an interest in land. *Dynex Petroleum Ltd.*, a lessee, granted overriding royalty and net profit interests to third parties respecting its oil and gas leases. *Dynex* was petitioned into bankruptcy and at issue was whether the third party royalty interests were interests in land so as to give the holders of those royalties higher priority in the bankruptcy proceedings.

The court expressly stated that an overriding royalty interest can be an interest in land if it was the intention of the parties to create such an interest. The court concluded, "A royalty which is an interest in land may be created from an incorporeal hereditament such as a working interest or a profit à prendre, if that is the intention of the parties."⁵⁸ Findings of fact are necessary in relation to the parties' intentions. It

⁵⁶ *Id.* at 728.

⁵⁷ *Id.* at 725.

⁵⁸ *Dynex*, [2002] 1 S.C.R. 146, 154 (S.C.C.) (emphasis added).

appears from the authorities that these findings may be made based on the language of the granting language itself and, if necessary, on parol evidence concerning the circumstances in which the agreement was made.

The Court rejected outright the longstanding but archaic common law principle that an interest in land could not be created from an incorporeal hereditament (a profit-à-prendre). The Court emphasizes that it is the intention of the parties that will determine whether the specific royalty interest at issue is an interest in land or not. The Court referred the matter back to trial for a determination on the parties' intentions in entering the agreements at issue.

The court in *Dynex* also cited with approval the analysis at the trial level in *Scurry-Rainbow Oil v. Galloway Estate*.⁵⁹ There the court held that a lessor's royalty can constitute an interest in land "given the proper construction." In particular, the head note is helpful: "The courts must search for an interpretation which would advance the intent of the parties at the time they entered into the contract. A literal approach should not be followed if it would bring about an unrealistic result not contemplated in the commercial context of the times."⁶⁰

[3] Intent of the Parties.

Regardless of the fact that a royalty may be an interest in land, the test remains one of exploring the intentions of the parties. Such intention may be reflected in the

⁵⁹ *Scurry-Rainbow Oil v. Galloway Estate* [1993] 4 W.W.R. 454 (Alta. Q.B.)

⁶⁰ *Id.* at 456

words of the document itself or by resorting to the surrounding circumstances. Thus the matters to consider in determining whether a particular royalty is an interest in land will include:

1. Whether the underlying interest is itself an interest in land (corporeal or incorporeal);
2. The intentions of the parties, as evidenced by the language of the grant and any admissible evidence of the surrounding circumstances of behavior, indicate that it was understood that an interest in land was created/conveyed; and
3. Whether the interest is capable of lasting for the duration of the underlying estate.

In determining whether the underlying interest is itself an interest in land, the legislation under which the underlying interest is created will have to be considered. By way of example, in the Northwest Territories a mineral claim recorded under the Canada Mining Regulations is an interest in land.⁶¹ Prior to development of the mine, mineral claims are replaced in the NWT by mining leases. Barton, in *Canadian Law Of Mining*, states: “Mining leases invariably convey an interest that is undoubtedly property and undoubtedly an interest in land.... The exclusive right, even against the Crown, to develop and (above all) to extract minerals, a right that is granted for a term of years with considerable security of tenure and is freely transferable, is unlikely to be

⁶¹ *Beakhurst et al. v. Williams et al.*, [1971] 1 W.W.R. 230 (N.W.T.T.C.); *Isaac v. Cook*, [1983] N.W.T.R. 11 (N.W.T.S.C.)(1982); *Smith v. Northern Geophysics Ltd.*, [1994] N.W.T.J. No. 53 (N.W.T.S.C.) (QL)

anything less than an interest in land.”⁶² By contrast, in British Columbia mineral claims recorded under the Mineral Tenure Act are not interests in land.⁶³

The question of whether the underlying interest is itself an interest in land may also arise in relation to provisions typically found in royalty agreements that the royalty will apply to any claims staked in the future within a defined area of interest. If the royalty is characterized in the agreement as an interest in land, there is thus an attempt to create a royalty that is an interest in land in which the operator does not yet have an interest.

Further, royalty agreements often apply not just to mineral claims or leases but also to a broad array of after-acquired rights or interests in the property, with typical language being: “any mining claim, license, lease, grant, concession, permit, patent, or other mineral property or surface rights or water rights or other rights or interests located wholly or partly within the Area of Interest.” As discussed above, some of these rights might be interests in land but others may not.

The issue of royalties being granted on after-acquired property received some inconclusive comments in Laskin J.’s dissent in *Saskatchewan Minerals*. Laskin, J. noted the decision of the Alberta Court of Appeal in *Emerald Resources Ltd. v. Sterline Oil Properties Management Ltd.*⁶⁴ where the royalty clause in the agreement provided for a

⁶² Barton, *supra* note 53 at 386.

⁶³ *British Columbia v. Tener* (1986), 27 D.L.R. (4th) 305; *Cream Silver Minerals Ltd. v. British Columbia* (1993), 75 B.C.L.R. (2d) 324.

⁶⁴ *Emerald Resources Ltd. v. Sterline Oil Properties Management Ltd.*, 3 D.L.R. (3d) 630 (Alta. C.A.) (1969); *aff’d* on other grounds (1969), 15 D.L.R. (3d) 256n (S.C.C.).

certain royalty of the lessee's share of specified substances "produced, saved and sold from each property acquired by [the lessee] after the date hereof and during the term of this agreement." Whereas the Alberta Court of Appeal doubted that an interest in land had been created, Laskin J. concluded that any interest in land created by the provision would be equitable only. He then stated:

It is convenient to say at this point that in the present case the fact that the royalty to Keyes was prescribed in an agreement which preceded Astral's acquisition of lease A-4010 would not alone affect his right to enforce it against the appellant. Astral's subsequent acquisition of the leasehold or of the profit à prendre fed the grant to Keyes so as to preclude Astral from denying legal effect in that respect to the agreement . . .⁶⁵

Royalty agreements often provide that if the operator surrenders or allows any claims to lapse and then subsequently restakes them directly or indirectly, the royalty shall apply to the restaked claims. As above, this contemplates a royalty (intended to be an interest in land) which is created and meant to apply before the grantor of the royalty has acquired any underlying interest in the land to which the royalty is to apply.

As a practical matter, if it is intended that the royalty be an interest in land, these difficulties can to some extent be dealt with by inserting in the agreement a covenant by the operator to execute any and all documents necessary to give effect to the royalty as an interest in land over any after-acquired claims in the area of interest, or in any restaked claims, such documents to be executed when the new claims are staked or acquired.

⁶⁵ *Saskatchewan Minerals*, [2002] 1 S.C.R. 146 (S.C.C.) 721 (emphasis added).

Consideration may also be given to filing a notice of the agreement or caveat in the appropriate office of public record. The effectiveness of this will vary from jurisdiction to jurisdiction and depend on local laws. For example, under the *Canada Mining Regulations*, applicable in the Northwest Territories and parts of Nunavut, the Mining Recorder is required to register any document filed in relation to a claim or lease.⁶⁶ The *Canada Mining Regulations* state that all persons shall be considered to have received notice of every document so registered as of the date of registration of the document.⁶⁷ In addition, under the regulations, a transfer of a recorded claim or lease is subject to the encumbrances registered against the claim or lease at the time of registration of the transfer.⁶⁸ The notice which is typically filed with the Mining Recorder in relation to a royalty interest is called a Notice to Third Parties. While filing a Notice to Third Parties is effective in granting others notice of the claim, the Mining Recorder will take no role in evaluating the legitimacy of the royalty claim or enforcing compliance. The Mining Recorder views its role as simply a repository for such notices and refuses to involve itself with the substance of the notice. A notice to third parties which states that a property cannot be transferred without the consent of another party will not prevent the Mining Recorder from accepting and registering a transfer for that property in the absence of any consent from the party that filed the

⁶⁶ C.R.C., c. 1516, s. 63(1).

⁶⁷ Id. at s. 63(3).

⁶⁸ Id. at s. 63(4).

notice. Accordingly, registration should not be relied on to accomplish any purpose beyond notice.

As to the intentions of the parties evidenced by the language used by them, a plethora of authority exists on how those intentions are to be found. An instructive example is *Bensette v. Reece*⁶⁹ in which the Saskatchewan Court of Appeal interpreted a grant in the following terms: “doth give, grant, bargain, sell, assign and transfer ... a six percent (6%) royalty in all the ... minerals ... which may be found in, under or upon the said lands.”⁷⁰ In concluding that the royalty did in fact constitute an interest in land, the Court reasoned as follows:

Had the word “interest” or “property” been used instead of “royalty”, it would be clear that an interest in the minerals themselves was to pass. Had the words “payment on” been used instead of “royalty in”, intention to pass an interest *in rem* would not be inferable. The question is then as to what is meant by a “royalty” in “the minerals”.

The words “royalty in” connote an interest of some kind “in” the minerals. If it were “royalty on” the minerals, some kind of a commission would be readily inferable....

Here then is a transfer and sale of a 6% royalty in minerals. Under the circumstances obtaining here, this connotes a conveyance of an interest in the minerals themselves *in situ* and hence an interest in the land⁷¹

A diamond royalty agreement should, therefore, explicitly state that the parties intend the overriding royalty on diamonds to be a recordable interest in land. The

⁶⁹ *Bensette v. Reece*, 34 D.L.R. (3d) 723 (1973).

⁷⁰ *Id.* at 726.

⁷¹ *Id.*

executed royalty agreement should then be filed for recording in the appropriate jurisdiction.

§ 13.07 Diamond Marketing Agreements

The non-fungible nature of diamonds creates inherent difficulties in distributing rough diamonds as product taken in kind among joint venture participants. However, if the participants pool diamond production for sale, the proceeds can easily be distributed among the participants in accordance with their respective participating interests. Consequently, when diamonds are produced through a joint venture it may be advantageous for one participant to be appointed as an agent to sell diamonds on behalf of the other participant or participants. This can be accomplished through a marketing agreement.

Such an agreement normally provides for pooling of diamonds for sale, appoints one participant as the sales agent, contains provisions for reimbursement of related expenses, and provides consideration for the agent on a percentage of sale basis. A form of marketing agreement is attached as Appendix B.

[1] Checklist for Drafting Diamond Marketing Agreements

A diamond marketing agreement should address the following matters:

[a] Parties

In a joint venture where the participants pool diamonds for marketing, a participant may be appointed marketing agent by virtue of its management of the joint venture or by virtue of its expertise in the diamond marketing. In either event the

potential for dilution of interests must be recognized and addressed. If the appointment is made on the basis of expertise it may be desirable for the experienced participant to remain the marketing agent regardless of dilution. Alternatively, if appointment as marketing agent is an ancillary duty of the manager, the dilution-driven potential for the removal of one party as marketing agent, and the appointment of another in its place, must be addressed.

Consideration should be given to whether assignment of the contract requires consent and, if so, whether consent must not be unreasonably withheld. It may be unreasonable for consent to be withheld by the non-agent where the proposed assignee is a reputable individual or entity experienced in diamond marketing. Conversely, it may be reasonable to withhold consent by the non-agent where the proposed assignee lacks the requisite experience. Lastly, consideration should be given to whether the participants have the right to assign sale proceeds.

[b] The Property

The property to which the marketing agreement applies, and any area of interest, will be defined in the joint venture agreement to which the marketing agreement applies.

[c] Pooling of Diamonds

The marketing agreement should expressly provide for pooling of diamonds from the joint venture property. Sales proceeds from the pooled diamonds are divided amongst the participants on a pro rata basis in accordance with participating interests.

One of the features that distinguishes a joint venture from a partnership is that the participants take product in kind rather than a share of profits. The agreement should try to preserve, at least notionally, the concept of taking in kind followed by pooling.

[d] Appointment of Agent

One participant is appointed by the others as the exclusive agent to represent the joint venture in diamond marketing. The agreement should expressly state that all diamonds from the venture property must be sold by the agent. The agreement should specify when the appointment takes effect, the circumstances in which it will terminate, and whether the agent is empowered to retain sub-agents. Consideration should be given to the potential that the agent, or other participants may produce diamonds from other non-venture properties, and whether such diamonds can be commingled with diamonds from the venture property.

[e] Terms of Sale

The marketing agreement should specify that all contracts for sale of diamonds executed by the agent shall be inherently binding on the other participants. The agreement should allow the agent sole discretion to set such sale terms and conditions, subject to an obligation by the agent to honestly market the diamonds on commercially reasonable terms on an arm's length basis.

[f] Obligations of the Agent

The agent should be required to maintain proper accounting and to allow access to such accounts for audits. In addition, the agent's obligations with respect to make payments and reports in accordance with an agreed schedule must be stated. The agreement should state whether or not the agent is responsible for non-payment by buyers.

[g] Risk of Loss and Insurance

The agreement should allow the agent to remove diamonds from the mine site for purposes of sale, and specify at what point the agent assumes responsibility for possession and risk of loss. The obligations of the agent, or other participants, to maintain insurance should be addressed. Lastly, the standard of care assumed by the agent in discharging its duties must be clearly defined.

[h] Commissions and Expenses

Generally, the agent is granted a commission in the form of a percentage of sales receipts. The amount of such commission, and the timing of its payment, must be defined. Likewise, the sale-related expenses which the agent may deduct from sales proceeds must be defined. Consideration should be given to granting the agent a security interest in the accounts, money and other proceeds from the sale of participant's diamonds to secure payment of commission and expenses.

[i] General Provisions

A marketing agreement is like any other contract and as such should contain provisions dealing with governing law, time being of the essence, dispute resolution, and other typical provisions.

§ 13.08 Taking in Kind

There may be instances where the participants of a joint venture want to retain the right to take in kind and market their respective share of the diamonds separately. While the non-fungible nature of diamonds creates some difficulty in this regard, the problem is not insurmountable.

The respective diamond shares can be determined by reference to their value after grading as determined by an independent valuator. Consideration should be given to providing a mechanism which will resolve an impasse amongst the participants regarding the choice of a valuator. One approach, analogous to common arbitration provisions, is to allow each participant the right to appoint its own valuator, with the two appointed valuers agreeing on a third. Each valuator then values the diamonds, and the final, deemed value is the average of the three. Thereafter the diamonds are distributed, based on value, among the participants in accordance with their respective participating interests.

Another solution may be to provide mechanical riffing of the diamonds by size categories. The participants are then allocated their respective shares, with special diamonds handled separately under an internal buy-sell process.

§ 13.09

APPENDIX A
Gross Overriding Royalty Agreement

THIS AGREEMENT is dated as of ●

BETWEEN:

XCO, a company incorporated under the laws of _____ having its head office in _____
(hereinafter called “XCO”)

AND:

●, a company incorporated under the laws of _____,
having its head office in _____
(hereinafter called “Owner”)

WITNESSES THAT for good and valuable consideration (the receipt and sufficiency of which is hereby acknowledged) the parties hereto agree as follows:

1. **DEFINITIONS AND INTERPRETATION**

- 1.1 “**Affiliate**” means any corporation which directly or indirectly controls, is controlled by, or is under common control with, a party. The term “control” as used in this section means the rights to the exercise of more than 50% of the voting rights attributable to the shares of the controlled corporation.
- 1.2 “**Appraised Value**” means the fair market value in Canadian dollars of the Diamonds after they have been cleaned and sorted, determined as provided in sections 2.2 and 2.3 hereof, with no deductions for costs or expenses of any nature or kind.
- 1.3 “**Claims**” means ●.
- 1.4 “**Diamonds**” means rough diamonds that are produced from the Property or tailings from the Property after the date of this Agreement.
- 1.5 “**Encumbrances**” means any mortgage, charge, pledge, lien, licence, privilege, security interest, royalty or other encumbrance.
- 1.6 “**Package of Diamonds**” has the meaning assigned to it in section 2.2.

- 1.7 “**Production Decision**” means a decision by the Owner to bring the Property or any part of it into the commercial production of diamonds.
- 1.8 “**Property**” means the area, including the surface and subsurface, which on the date of this Agreement is within the boundaries of the Claims.
- 1.9 “**Royalty**” has the meaning assigned to it in section 2.1.
- 1.10 “**Valuator**” has the meaning assigned to it in section 2.2.
- 1.11 Schedules

Attached to and forming part of this Agreement are the following Schedules:

Schedule A – Claims

2. ROYALTY

2.1 The Owner hereby grants, sells, assigns, transfers and conveys and agrees to pay, in perpetuity, to XCO a gross overriding royalty (the “**Royalty**”) in all Diamonds that are produced from the Property after the date of this Agreement equal to ●% of the Appraised Value of such Diamonds.

2.2 For the purpose of determining the Appraised Value of Diamonds, the Owner will at its expense appoint a valuator (the “**Valuator**”) who is independent of the Owner and duly qualified and accredited as such and shall have been approved in writing by XCO, such approval not to be unreasonably withheld. The Owner shall cause the Valuator to sort, grade and value the Diamonds at the minesite on the Property or other location in Yellowknife, NT not less frequently than once in each calendar quarter (all of the Diamonds which are valued by the Valuator at a particular time being hereinafter referred to as a “**Package of Diamonds**”). The Owner will give XCO not less than 15 days notice of the date, time and place at which each such valuation shall take place, and XCO shall have the right to be present at and observe the valuation with, if it so elects, a diamond valuator of its selection and the Owner shall afford XCO and its valuator with such access to the Package of Diamonds and to the Valuator as may be necessary to ensure that XCO is able to form its own view as to the value of the Package of Diamonds individually and in the aggregate. The Owner will cause the Valuator to value the Diamonds in accordance with industry pricebooks, standards and formulas and in accordance with industry standards, having regard to, but without limiting the generality of the foregoing, the commercial demand for the Diamonds and their grades, colours, sizes and clarity and to provide a report in reasonable detail to the Owner and to XCO showing his conclusions as to the Appraised Value of the Package of Diamonds individually and in the aggregate.

2.3 Upon receipt of the Valuator's report showing the Appraised Value of a Package of Diamonds, XCO shall have 15 days in which it may give notice to the Owner that it disputes such valuation. If XCO does not give notice of dispute, the Appraised Value of the Package of Diamonds referred to in the report shall be as provided in the report. If XCO gives notice of dispute, the value of the Package of Diamonds shall be decided by an arbitrator under the Arbitration Act (Northwest Territories) which shall then be the Appraised Value of those Diamonds, and the decision of the arbitrator shall be final and binding.

2.4 The Owner will calculate and pay the Royalty in respect of each Package of Diamonds to XCO in Canadian dollars within 15 days after the Appraised Value of the Package of Diamonds has been determined in accordance with section 2.3.

2.5 If from time to time the Owner files a royalty return under the Canada Mining Regulations pertaining in whole or in part to Diamonds, it will concurrently with such filing deliver a copy of the return to XCO.

2.6 The Owner will retain possession of each Package of Diamonds at the minesite on the Property or at a location in Yellowknife, NT and will not sell or otherwise dispose of any such Package of Diamonds or commingle the Diamonds therein with other diamonds unless:

2.6.1 the Appraised Value of the Package of Diamonds has been determined in accordance with section 2.3; and

2.6.2 the Owner has at the minesite or such other location Diamonds with an Appraised Value of at least two times the amount of the Royalty in respect of the Package of Diamonds or cash equal to two times the amount of the Royalty in respect of the Package of Diamonds.

3. MAINTENANCE OF CLAIMS

3.1 The Owner shall do all things and make all payments necessary or appropriate to maintain the right, title and interest of the Owner in the Claims and to maintain the Claims in good standing. The Owner may from time to time, abandon or surrender or allow to lapse or expire any part or parts of the Claims if the Owner determines, acting reasonably, that such part or parts are not economically viable or otherwise have insufficient value to warrant continued maintenance or if a qualified person (as defined in National Instrument 43-101) determines that such part or parts do not warrant the expenditure of additional funds.

3.2 Notwithstanding section 3.1, the Owner shall not abandon or surrender, or allow to lapse or expire, any of the Claims for the purpose of permitting any third

party to restake such claim and avoid the Royalty; and if the Owner or any person with which the Owner does not deal at arm's length or joint venturer, restakes any expired claims or leases relating to or comprising the Property, this Agreement shall include any such new claims.

4. BOOKS; RECORDS; INSPECTIONS

4.1 The Owner shall keep true and accurate books and records of all of its operations and activities with respect to the Property and the Diamonds, prepared in accordance with Canadian generally accepted accounting principles, consistently applied. XCO may, from time to time, perform audits or other examinations of all of the books and records of each of the Owner to confirm Royalty calculations and compliance with the terms of this Agreement. The reasonable expenses of any audit or other examination permitted hereunder shall be paid by XCO, unless the results of such audit or other examination permitted hereunder disclose a deficiency in respect of the Royalty payments paid to XCO hereunder greater than \$5,000, in which event the costs of such audit or other examination shall be paid by the Owner.

4.2 Within 60 days following the end of each calendar year, the Owner shall provide XCO with an annual report of Diamonds produced from the Property during such calendar year in reasonable detail including grade, size, colour and clarity. Such annual report shall include estimates of anticipated production from and estimated remaining mineral reserves on the Property for the succeeding calendar year and any changes to, or replacements of, the mine plan or any "life of mine plan" with respect to the Property. The Owner shall provide XCO with a copy of any "life of mine plan", if produced, within 30 days of its approval by them and any changes to, or replacements of, any such "life of mine plan" or any mine plan within 30 days after such change or replacement thereof.

4.3 After a Production Decision has been made, from time to time on not less than five business days' notice to the Owner, XCO, or its authorized agents or representatives, may, under the direction and control of the Owner, enter upon all surface and subsurface portions of the Property for the purpose of inspecting the Property, all improvements thereto and operations thereon, and all production records and data pertaining to all production activities and operations on or with respect to the Property, including without limitation, records and data that are electronically maintained.

5. COMPLIANCE WITH LAWS; ENVIRONMENTAL OBLIGATIONS

5.1 The Owner agrees to indemnify and save XCO and its Affiliates harmless from any loss, cost or liability including, without limitation, reasonable legal fees arising

from a claim against XCO or its Affiliates in respect of any failure by the Owner to at all times comply with all applicable present or future federal, provincial, territorial and local laws, statutes, rules, regulations, permits, ordinances, certificates, licences and other regulatory requirements, policies and guidelines relating to the Owner or the Property; provided, however, the Owner shall have the right to contest any of the same if such contest does not jeopardize the Property or XCO's rights thereto or under this Agreement.

5.2 The Owner agrees to indemnify and save XCO and its Affiliates harmless from any loss, cost or liability (including, without limitation, reasonably legal fees) arising from a claim against XCO or its Affiliates in respect of:

5.2.1 any failure by the Owner to timely and fully perform all abandonment, restoration, remediation and reclamation required by all governmental authorities pertaining or related to the operations or activities of by the Owner on or with respect to the Property or required under this agreement; or

5.2.2 the Owner causing, suffering, or permitting any condition or activity at, on or in the vicinity of the Property which constitutes a nuisance.

6. CONDUCT OF OPERATIONS

6.1 All decisions concerning the extent, times, procedures and techniques of exploration, development, mining and processing Diamonds shall be made by the Owner, acting reasonably and in accordance with good mining and engineering practice in the circumstances.

7. INSURANCE

7.1 The Owner shall purchase or otherwise arrange at its own expense and shall keep in force at all times insurance (including, without limitation, comprehensive general public liability insurance) against claims for bodily injury or death or property damage arising out of or resulting from activities or operations on or with respect to the Property and in respect of loss, theft or destruction of Diamonds, in such amounts as will adequately protect the Owner, XCO, the Royalty, and the Property from any and all claims, liabilities and damages which may arise with respect to the Property and as will adequately protect the Owner and XCO from loss, theft and destruction of Diamonds. XCO shall be named as a loss payee on all property, liability and other insurance policies held by the Owner relating to the Property, the Diamonds or the Royalty.

8. TERM

8.1 This Agreement shall continue in perpetuity, it being the intent of the parties hereto that if and to the extent permitted by applicable law the Royalty shall constitute a covenant and an interest in land running with the Claims and all successions thereof or leases or other tenures which may replace same, whether created privately or through governmental action, and including, without limitation, any leasehold interest. If any right, power or interest of any party under this Agreement would violate the rule against perpetuities, then such right, power or interest shall terminate at the expiration of 20 years after the death of the last survivor of all the lineal descendants of Her Majesty, Queen Elizabeth II of England, living on the date of this Agreement.

9. REPRESENTATIONS AND WARRANTIES

The Owner represents and warrants to XCO as follows:

9.1.1 It is a corporation duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation;

9.1.2 It has all necessary corporate power and authority to enter into and perform its obligations under this Agreement and to own the Claims or an undivided interest in it and to carry on its business as now conducted;

9.1.3 Neither the execution nor delivery of this Agreement nor the consummation of the transactions contemplated herein nor compliance with the terms, conditions and provisions of this Agreement will conflict with or result in a breach of any terms, conditions or provisions of its charter documents or by-laws, any law, rule or regulation having the force of law, any contractual restrictions that are binding upon it or the Claims, or any writ, judgment, injunction, determination or award that is binding upon it;

9.1.4 The execution and delivery of this Agreement and the consummation by it of the transactions contemplated herein have been duly authorized by all necessary corporate action, and all necessary third party consents have been obtained;

9.1.5 This Agreement has been duly executed and delivered by it and constitutes a legal, valid and binding obligation, enforceable against it by XCO in accordance with its terms;

9.1.6 There are no actions, suits or proceedings pending or, to the best of its knowledge, threatened against or affecting it, the Claims or the Diamonds, before any court, arbitrator or governmental administrative body or agency, that might materially

adversely affect the Claims or its respective interest therein or challenge the validity or propriety of the transactions contemplated herein. It is not in default in any material respect under any applicable statute, rule, order, decree or regulation of any court, arbitrator or governmental body or agency having jurisdiction;

9.1.7 Except for the Royalty, there is no Encumbrance upon or with respect to the Claims, the Diamonds or receivables derived from the sale or other disposition of the Diamonds; and

9.1.8 The Owner has good and marketable title to and is in exclusive possession of a 100% right, title and interest in and to the Claims free of any Encumbrance.

9.2 XCO represents and warrants to the Owner that:

9.2.1 XCO is a corporation duly incorporated, organized, validly existing and in good standing under the laws of Canada;

9.2.2 The execution and delivery of this Agreement and the consummation by XCO of the transactions contemplated herein have been duly authorized by all necessary corporate action on the part of XCO; and

9.2.3 This Agreement has been duly executed and delivered by XCO and constitutes a legal, valid, binding and enforceable obligation of XCO.

10. TRANSFER OF INTERESTS

10.1 The Owner shall not sell, assign, transfer, convey or otherwise dispose of or deal with or agree to sell, assign, transfer, convey or otherwise dispose of or deal with its rights and interests in or with respect to the Claims or under or by virtue of this Agreement in whole or in part or permit any Encumbrance to exist thereon unless the proposed transferee shall have first entered into an agreement in writing with XCO in form and content to XCO's satisfaction in which it assumes all the obligations of the transferor hereunder and agrees to be bound by the terms hereof in the same manner and to the same extent as though a party hereto in the first instance.

10.2 In the event of an assignment, conveyance, transfer or other disposition by a party in compliance with section 10.1, such party shall not be relieved or discharged of any of its obligations or liabilities hereunder, and XCO may continue to look to it for the performance thereof.

10.3 The consent of XCO to the proposed transaction in section 10.1 shall not relieve or discharge Owner from any of its obligations or liabilities hereunder, and XCO may continue to look to it for the performance thereof.

10.4 XCO may freely assign this Agreement and all its rights and interests hereunder.

11. GENERAL PROVISIONS

11.1 Further Assurances; Registration of Interest

Each party shall execute all such further instruments and documents and do all such further actions as may be necessary to effectuate the documents and transactions contemplated in this agreement, in each case at the sole cost and expense of the party requesting such further investment, document or action. XCO shall have the right from time to time to register or record notice of this agreement, any other instruments relating to this agreement, a notice of the Royalty, and a caution or other title document against the title to the Property and the Owner shall cooperate with such registration or recording and provide its written consent or signature to any documents or things necessary to accomplish such registration or recording.

11.2 Time

Time is of the essence of this Agreement.

11.3 Notices

Any notices to be given to one party by the other may be sent by telecopy or may be personally delivered addressed as follows:

11.4 Enurement

This Agreement shall enure to the benefit of and be binding upon the parties hereto and their respective successors and assigns.

11.5 Public Announcements

The parties hereto shall consult with each other before issuing any press release or making any public announcement with respect to the transactions contemplated by

this Agreement and, except to the extent required by any applicable law or regulatory requirement, neither party will issue any such press release or make any such public announcement without the prior written consent of the other party, which consent will not be unreasonably withheld or delayed. Each party will review and may provide comments on any such press release or other public announcement mentioning another party hereto proposed to be made by another party within 48 hours after receipt.

11.6 Governing Law

This Agreement shall be construed and enforced in accordance with, and the rights of the parties shall be governed by, the laws of ●.

11.7 Execution in Counterparts

This Agreement may be executed in counterparts and, upon the execution of one such counterpart by each party hereto, such counterparts shall together constitute one agreement and shall be construed as if all parties hereto had executed one copy of this Agreement.

IN WITNESS WHEREOF this Agreement has been executed as of the day and year first above written.

XCO. c/s

Authorized Signatory

Authorized Signatory

[OWNER] c/s

Authorized Signatory

Authorized Signatory

§ 13.10

APPENDIX B
DIAMOND MARKETING AGREEMENT

THIS AGREEMENT is dated ●,

BETWEEN:

YCO, a company incorporated under the laws of ●
(hereinafter called "YCO")

OF THE FIRST PART,

AND:

XCO,
a company incorporated under the laws of Canada,
(hereinafter called the "**Agent**")

OF THE SECOND PART.

THIS AGREEMENT WITNESSES that in consideration of the covenants and agreements hereinafter contained the parties hereto agree as follows:

1. **DEFINITIONS**

1.1. In this Agreement the following terms shall have the meanings assigned to them respectively:

1.1.1. "**Affiliate**" has the meaning assigned to it in the Joint Venture Agreement.

1.1.2. "**Agent's share of Diamonds**" means the Diamonds to which the Agent may from time to time be entitled in accordance with the Joint Venture Agreement.

1.1.3. "**Diamonds**" means all gem and industrial diamonds and other precious and semi-precious stones mined from the Properties.

1.1.4. "**Expenses**" means all costs paid and expenses incurred by the Agent in respect of the Diamonds after they have been made available to be taken by it pursuant to the Joint Venture Agreement including without limitation all costs of insuring, transporting, marketing and selling the Diamonds including taxes (other than income

taxes) and governmental duties, levies and similar costs for which the Agent may be responsible and payments to sub-agents of fees and expenses.

1.1.5. "**Joint Venture Agreement**" means the joint venture agreement entered into by the parties on ●, and "**Joint Venture**" means the joint venture formed thereunder.

1.1.6. "**Participating Interest**" has the meaning assigned to it in the Joint Venture Agreement.

1.1.11. "**Properties**" has the meaning assigned to it in the Joint Venture Agreement.

1.1.12. "**Receipts**" means all amounts actually received by the Agent as payment for Diamonds sold by it for the account of YCO and itself.

1.1.13. "**YCO's share of Diamonds**" means the Diamonds to which YCO may from time to time be entitled in accordance with the Joint Venture Agreement.

2. **POOLING OF DIAMONDS**

2.1. YCO's share of Diamonds and the Agent's share of Diamonds shall be at all times pooled for the purposes of sale by the Agent hereunder.

2.2. All sales of Diamonds by the Agent and all Expenses incurred shall be deemed to be for the account of YCO and the Agent pro rata in accordance with their respective Participating Interests from time to time.

3. **APPOINTMENT OF AGENT**

3.1. YCO hereby appoints the Agent as exclusive agent throughout the world for the sale of YCO's share of Diamonds upon the terms and conditions hereinafter set forth and the Agent hereby accepts such appointments.

3.2. YCO shall not appoint any other agent for the sale of Diamonds.

3.3. YCO shall not sell Diamonds directly and all of the Diamonds to which it is from time to time entitled under the Joint Venture Agreement shall be available to the Agent to be sold hereunder.

3.4. The Agent and YCO acknowledge that the other party, its Affiliates and other companies with which it is related now own and may acquire further interests in diamond-bearing properties in addition to the Properties and that, subject to the limitations in subsection 6.1.5, it shall be free to market and sell for itself and as agent for others diamonds which may be produced from such properties in competition

with the Diamonds and on terms which may be different from or more favorable than the terms on which the Diamonds are sold hereunder.

3.5. The Agent may appoint persons with whom it deals at arm's length as sub-agents, on commercially reasonable terms. The fees and expenses of any such sub-agents will be included in Expenses.

4. TERM

4.1. This Agreement shall commence as of the date of this Agreement and shall continue until the earliest of the following to occur:

4.1.1. the date on which the Joint Venture Agreement is terminated;

4.1.2. the date on which the Agent or its Affiliate ceases to be the party acting as Manager under the Joint Venture Agreement;

4.1.3. ninety days after the Agent has given notice to YCO to terminate this Agreement;

4.2. The termination of this Agreement shall be without prejudice to any rights, obligations or liabilities of the parties then accrued.

5. TERMS OF SALE

5.1. All contracts for the sale of Diamonds will be entered into by the Agent on behalf of itself and YCO and shall be binding upon YCO without the requirement for further action by it.

5.2. All sales shall require payment in full concurrent with delivery of the Diamonds to the customer and the currency of all sales shall be U.S. dollars. Subject to the foregoing and to the provisions of section 6.1, the Agent may sell the Diamonds on such terms and conditions including as to price and to such persons as it in its sole discretion may from time to time determine. All payments by customers for Diamonds shall be to the Agent.

6. OBLIGATIONS OF THE AGENT

6.1. The Agent shall:

6.1.1. maintain proper and adequate accounts and records reflecting its activities hereunder;

6.1.2. afford YCO reasonable access to such accounts and records and allow it at its expense to audit the same on reasonable notice;

6.1.3. provide monthly statements to YCO in respect of sales hereunder by it for such month, on or before the fifteenth day of the next month, which statements shall include the calculation of Receipts and Expenses for the month and accounts receivable, collections and remittance data and a statement of commissions charged and deducted;

6.1.4. pay to YCO in U.S. dollars on or before the fifteenth day of each month the portion of the Receipts for the previous month which corresponds to its Participating Interest as at the last day of such previous month, provided that the Agent shall have the right to set off against any payment to YCO hereunder any amounts then due and owing by YCO to the Agent hereunder or under the Joint Venture Agreement;

6.1.5. act in good faith and ensure that all sales of Diamonds hereunder are to persons dealing at arm's length with the Agent and on commercially reasonable terms in a manner that will provide maximum long-term return to the parties; and

6.1.6. comply with all laws of each jurisdiction in which it carries out its activities pursuant to this Agreement.

7. RISK OF LOSS

7.1. The Agent may remove YCO's share of Diamonds from the minesite and deliver them to another location or to an intermediary if necessary or desirable to effect the sale of them. While YCO's share of Diamonds remain at the minesite they shall be deemed to be in the possession of YCO. Risk of loss of YCO's share of Diamonds shall remain with YCO until risk of loss passes to the purchaser of them and risk of loss of the Agent's share of Diamonds shall remain with the Agent until risk of loss passes to the purchaser of them. If the Agent takes possession of YCO's share of Diamonds it shall exercise the same degree of care in protecting them as it does with its own Diamonds. The Agent shall procure for YCO the same insurance as the Agent has against loss, theft or destruction of diamonds and is prudent and reasonable in the circumstances. The Agent shall not be required to meet any standard of care which is higher than or in addition to the standard of care provided in this Section 7.1.

8. PAYMENT OF COMMISSION AND EXPENSES

8.1. YCO will pay to the Agent in on or before the fifteenth day of each month that portion of the Expenses incurred by the Agent for the previous month which corresponds to its Participating Interest as at the last day of such previous month.

8.2. Goods or services obtained by the Agent from its Affiliates and charged hereunder as Expenses shall be on commercially reasonable terms and at competitive rates.

8.3. YCO will pay to the Agent in U.S. dollars on or before the fifteenth day of each month a commission on all sales of Diamonds hereunder equal to ● % of the Receipts for the previous month multiplied by its Participating Interest as at the last day of such previous month.

9. GENERAL PROVISIONS

9.1. **Force Majeure.** Except for the obligation to make payments when due hereunder, in the event of an inability or failure by the Agent to perform its obligations hereunder by reason of any war, riot, strike, walk out, labor controversy, transportation facilities or default or failure of carrier, act of God or public enemy, any law, act or order of any court, board, government of other authority of competent jurisdiction, or any other direct cause (whether or not of the same character as the foregoing) beyond the reasonable control of the Agent, then the Agent shall be excused from the performance of its obligations hereunder during the period and to the extent of such inability or failure. The Agent shall promptly give notice to YCO of the suspension of performance and it shall resume performance as soon as reasonably possible.

9.2. **Governing Law.** This Agreement shall be made and construed in accordance with the laws of ●.

9.3. **Arbitration.** All disputes which may arise hereunder shall be submitted to and finally settled by arbitration, which shall be subject to the provisions of the ● in effect from time to time and be conducted in ● by a single arbitrator.

9.4. **Currency of Payments:** The Agent shall be reimbursed for Expenses in the same currency or currencies in which they were incurred. The Agent shall be paid its commission and YCO shall receive payment of its share of receipts in U.S. dollars.

9.5. **Time.** Time shall be of the essence of this Agreement.

9.6. **Entire Agreement and Amendments.** This Agreement together with the Joint Venture Agreement constitute the entire agreement between YCO and the Agent with respect to the sale of Diamonds. This Agreement shall survive the execution and delivery of the Joint Venture Agreement and will not merge therein but will continue in full force and effect. YCO acknowledges that its execution of this Agreement has not been induced by, nor does it rely upon or regard as material, any representations or writing whatsoever not incorporated herein. This Agreement shall

not be amended, altered or qualified except by memorandum in writing signed by the parties.

9.7. **Notices.** All notices, payments, and other required communications ("**Notices**") by one party to the other shall be in writing and shall be addressed as follows:

9.8. **Waiver.** The failure of a party to insist on the strict performance of any provision of this Agreement or to exercise any right, power or remedy upon a breach hereof shall not constitute a waiver of any provision of this Agreement or limit that party's right thereafter to enforce any provision or exercise any right.

9.9. **Severability.** In the event that any condition, covenant or other provision of this Agreement is held to be invalid or void by any court of competent jurisdiction, the same shall be deemed severable from the remainder of this Agreement and shall in no way affect any other condition, covenant or other provision of this Agreement. If such condition, covenant or other provision shall be deemed invalid due to its scope or breadth, such condition, covenant or other provision shall be deemed valid to the extent of the scope or breadth permitted by law.

9.10. **Assignment.** None of the parties may assign this Agreement without the consent of the others, not to be unreasonably withheld, provided that each party may assign this Agreement to an Affiliate.

9.11. **Enurement.** This Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and permitted assigns.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date first above written.

YCO

By: _____
Title: c/s

By: _____
Title:

XCO

By: _____
Title: c/s

By: _____
Title:

Vancouver

1600 Cathedral Place
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