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Abstract **-** A person who carries out mineral exploration and discovers a mineral deposit taking a certain risk is interested in entering into an agreement with an investor who has the ability to use the mineral deposit and carry out mining, with the term of "receiving a private mineral royalty". However, due to the lack of understanding, recognition and correct interpretation of this private mineral royalty agreement, disputes between foreign investors and domestic enterprises have arisen. Therefore, the origin, nature, and types of royalties used by investors and mining companies, and related law regulation of Mongolia are reflected in this article.

Key words – Contract law, Mongolian mining law, Private mineral royalty, NSR, NPI

1. INTRODUCTION

It is common practice in international mining investment to utilize "private mineral royalty" terms, enabling not only the government but also private companies holding licenses to establish joint ventures with investors and receive returns as shareholders. Whether our country uses these methods in the investment agreements concluded so far, whether the implementers of the agreements understand the means of obtaining returns, and furthermore, how commonly this issue is discussed in lawyers' discussions raises doubts. However, Mineral resources royalty, or mineral royalty tax, is set by law, and the tax is collected from mining entrepreneurs who extract and sell minerals. This state mineral royalty (mineral resources royalty, or mineral royalty tax) is equated with the contractual

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right to receive private mineral royalty, and there is still confusion among lawyers and experts that individuals cannot receive royalties.

The methods, mentioned below can be determined by the terms of the agreement, and is not specifically prohibited by law that the companies can attract investors to let them own shares and distribute dividends to them, or enter into a "private mineral royalty" agreement and give investors a certain percentage of the revenue and profit from the sale of minerals in order for companies to raise funds and sustain their activities. Clause 189.1 of Article 189 of the Civil Code of Mongolia states that "Parties to the contract shall be entitled within the legal frame-work to conclude contract freely and define its content" clearly reflects the principle of freedom of the parties which is freedom of contract [1]. There is no legal regulation that restricts or prohibits how the parties will distribute income, profits, and returns generated during cooperation or when implementing the agreement, and what methods will be used for such distribution. According to Company Law, shareholders and investors can use many other methods of receiving returns on investment in addition to dividends. In this case, there is no legal regulation that prohibits that method, except that the tax issue is discussed.

To reinforce the ability and freedom for the investment and profit distribution of mining companies freely by mutual negotiation, to specify those in the terms of the agreement detailed and to recognize its legal practice have some advantages to attract foreign and domestic investment in the mining industry in our country, introduce multifaceted means of cooperation, strengthen legal anticipation and certainty.

Our lawyers are faced with the need to fully accept the conclusion of an agreement under the terms of "receiving private mineral royalties" and learn to use many versions of the terms in accordance with international standards and practices. Therefore this article is written in order to introduce Mongolian law practices to foreign investors and analyse international common practices which useful for Mongolian lawyers interesting in mineral royalty issues.

2. LEGAL OPPORTUNITIES TO RECEIVE RETURNS FROM MINING INVESTMENT

2.1. Arrangements for shareholders to receive returns from the company in accordance with the laws of Mongolia

Any legal entity or enterprise implementing a mining project related to investment shall pay all types of taxes, payments, and fees to the state budget in accordance with tax laws and regulations. In any country, depending on the economic activity, the types of taxes and the obligation to pay taxes are determined. This pertains to the external relations for corporate tax payment. However, the distribution of income, profits, and returns between investors and shareholders which is internal relation of the enterprise is usually regulated by the investment, shareholders' agreement and the company's charter. There may be returns related to non-shareholder investments, financing or loans, which will also be contractually regulated. For this reason, contractual relationships are important, and investors are primarily interested in ensuring that contractual agreements are respected and upheld.

In the mining projects, it takes a considerable amount of time until the company is established and starts to generate profits, and during this period, there are large costs of pre-mining and during mining, such as the construction of mining facilities and infrastructure, as well as topsoil stripping. However, when the parties start making profits, the issue of distribution of profits and separation of power is raised, and if the agreements are not clearly established and implemented, there is a risk of disputes between the parties.

Regardless of the form of ownership, when the investors establish a joint venture, one party invests with a license for the exploration or mining resources, and the other party finances the project by investing capital with its own capital or loans. So that, the parties agree on how the project management activities will be carried out and what benefits they will receive.

A shareholder of any company, not only in mining, receives benefits and returns from the company's activities in the following ways. It includes:

- Receive company dividends;
- Establishing a company, investing and receiving returns in other forms specified in the shareholders' agreement;
- Receive some part of the contractual payment as a percentage of future revenue by transferring the license.

Company dividends. According to the Company Law, certain regulations regarding the shareholder receiving dividends from the company are stated in Article 34, Clause 34.1.2 of the Company Law. The dividend distribution is regulated by Article 80, Clause 80.6 of the Company Law, to be decided by the majority vote of the members /shareholders/ participating in the meeting of the board of directors /in its absence, a shareholder's meeting/ unless otherwise specified in the company's charter. In the current situation of the legal regulation of the company, the difficulties faced by the small shareholder to exercise the right to receive dividends are common in the practice of Mongolia. A company's majority shareholders are given preferential treatment, which creates conditions where the company's minority shareholders may not benefit for years or ever.

Establishing a company, investing and receiving returns in other forms specified in the shareholders' agreement. This form arises from one of the negative aspects of investment agreements, so it is worth explaining. It is not only in Mongolia that there are many problems in practice of hiding profits by raising costs and expenses due to the popular belief that the operating expenses are high from the side of the shareholder (in most cases, the "major shareholder") managing the mining company.

Receive some part of the contractual payment as a percentage of future revenue by transferring the license. According to Article 49 of the Law on Minerals, it is allowed to transfer the license for mineral exploration or mining to another person. For example, in Clause 49.3 of Article 49 of the Law on Minerals, "A mining license holder may transfer its license after providing evidentiary proof that the mine together with its machinery, equipment and documents have been sold as set forth in the applicable laws and regulations, and that taxes have been paid accordingly" pointed out. In this way, it is possible to receive a part of the payment in cash and receive a certain percentage of the future income every year, in other words, the right to receive a "private mineral royalty" without taking the all remaining part at once. There are quite a few cases where Mongolian legal entities have agreed with foreign investors on such conditions for "receiving royalty" and transferred their licenses.

In addition to the 3 types of agreements mentioned earlier, many different types of investment are widely used in the mining industry [2]. For example, the Government of Mongolia signed an investment agreement for the Oyu Tolgoi project in 2009, and Mongolia has not been able to receive dividends until now, and there is a lot of criticism among the public. Moreover, the government has been using production sharing agreements in the oil industry since 1991, and has been using an internationally established method of reaping benefits.

One of the ways to avoid the negative consequences of not distributing company dividends, and to receive a guaranteed return in the event of profitable earnings, is to ensure the right to "receive private mineral royalty" by agreement. The fact that the method of "receiving private mineral royalty" is not specifically regulated by law does not mean that it is prohibited by law, and it can be regulated within the framework of the right to" conclude contract freely and define its content" provided for in Clause 189.1 of Article 189 of the Civil Code.

In Mongolia, there are cases where the private mineral royalties are defined by law in the field of intellectual property and technology transfer. For example, Clause 3.1.10 of the Law on Innovation states that "royalty" refers to the the percentage of the profit earned by using the intellectual property under the license agreement to the lessor of the license, etc., which is a form of private royalty.

When discussing royalty, the question of how to distinguish between private and state royalties is raised. So let's talk briefly about state royalty.

2.2. Mineral resources royalty or state royalty

Article Six of the Constitution of Mongolia, Clause 1 states that "In Mongolia the land, its subsoil, forests, water, fauna and flora and other natural resources shall be subject to people's power and State protection" and Clause 2 states that “The land, except those owned by the citizens of Mongolia, as well as the subsoil, its wealth, forests, water reserves, and wildlife shall be the state public property”. The person who uses the subsoil and its resources is obliged to pay the government in the sense that he is using the public property of the state. In our country, this payment is called Mineral Resources Royalty in Article 47 of the Law on Minerals, and it is sometimes called "royalty" in ordinary speech.

When calculating Mineral Resources Royalty, it is arranged to pay the amount specified by law from the market value determined by the government. Due to the fact that mining companies cannot pre-regulate the situation in which mining companies increase their costs, the tax department uses the method of calculating mineral resource royalty from sales revenue and setting the minimum market price of raw materials and products through an administrative normative act. In the developed countries with mining such as Canada, Australia, China, Russia, United States of America, Japan, South Korea and the European Union, Mineral Resources Royalties are paid in the form of royalty, and royalties are commonly used as payments between the private sector in addition to payments to the government [3].

The state mineral royalties are mandatory, while the private mineral royalties are mutually beneficial. The state mineral royalties tend to be common and similar for owners of the mining rights of the same nature, while the private mineral royalties are characterized by diversity, taking into account the advantages and goals of the parties' negotiations [4]. The private mineral royalties in the mining industry are used among private companies, joint-stock companies, landowner consortia and local groups.

In Mongolia, in addition to the legalization of state mineral royalties as Mineral Resources Royalty, according to Article 42, Clause 42.1 of the Law on Minerals "*A license holder shall work in cooperation with the local administrative bodies and conclude agreements on issues of environmental protection, mine exploitation, infrastructure development, job creation and donation and assistance in relation to the mine-site development*" and "*Agreement on environmental protection, development of infrastructure related to the use of mines, establishment of factories, and increase of employment*" which is the model of the agreement approved by the Government's Resolution No. 179 dated March 28, 2016, It is a common practice for the holder of a license to enter into an agreement with a local administrative organization and transfer the amount specified in the agreement to the local administrative budget.

2.3. Private mineral royalty

The term "*Royalty*" was originally used as a payment to the Emperor in exchange for the right to extract minerals owned by the British Empire [5]. But nowadays it is used to name the share to be paid or allocated to the "license de facto holder". An exploration company discovers a mineral deposit and transfers the right to mine the mineral deposit to a mining company, where private mineral royalty agreements are created. Moreover, if an exploration and mining company discover a mineral deposit that is not suitable for strategy /with minerals that are too small, large or different than expected/ there is also a possibility of royalty negotiations.

Depending on the scale of the mining operations, companies tend to form joint ventures (JVs) or joint operating companies (JOCs) with the aim of sharing expenses, risks, experience, and royalties.

The types of royalties arising under private sector agreements may vary. For example, unit-based, price-based, profit-based, income-based, etc., and depending on the type of precious metal and when it will be paid, types of royalties can be classified such as GVR /Gross value royalty/ which is royalty calculated based on the top-line revenue (or percentage of revenues) from mine operation before any deductions for expenses get made, GSR /gross smelter royalty/ calculated as a percentage of gross revenue less any expenses charged to the operator that gets defined in the contract and NSR /Net smelter return/ calculated from a percentage of gross revenue, less a proportionate share of transportation and processing costs.

From the types of royalties above, the contracting parties can choose the most suitable one based on their situation and risks /Table 1 shows the risks to be assumed by the parties for the three main

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types of royalties/ [6]. Commonly used internationally are NSR and NPI, which have the advantage of allowing the parties equal distribution of profits and equitable ownership of property [7].

Table 1. Exposure to Risk with Periodic Mineral Royalties

Description	**Production royalties (unit based)**	**Net smelter return royalties (value based)**	**Profit-or income-based royalties**
		Exposure to risk	
Owner of mining right	low risk	medium risk	high risk
Investor	high risk	medium risk	low risk

In Canada and South Africa, private and state mineral royalties are defined differently. Specifically, in South Africa, private royalties and government royalties are mutually exclusive, and a mining company must pay royalties to either the private sector or the government, and cannot be paid twice. In Canada, however, private and state mineral royalties are not mutually exclusive, and a mineral miner in Canada will pay both mining taxes and royalties regardless of whether a private royalty is negotiated. The private mineral royalties are treated as allowable deductions in calculating mining tax revenue. In addition, special situations of combined private and state mineral royalty payments arise when indigenous people agree with the government to collect royalties from their ancestral lands [4].

Considering Canada is a major producer of minerals, it is a country that has created favorable conditions for mineral exploration and mine development. Exploration expense in Canada accounts for 15 to 25 percent of global exploration expense. Most of this expense is spent on assets with joint-venture agreements that contain royalty terms. These private mineral royalties represent a joint ownership interest in the asset. For the country, among the types of royalty used internationally, depending on the period of payment, two types are commonly used: NSR and NPI [4].

2.3.1. NSR (Net smelter return) Royalty

NSR, or Net Smelter Return, is a royalty paid to the previous license holder or government authority. This payment is made after deducting specified costs (such as transportation and processing) from the sales revenue of minerals extracted from the mine [8]. NSR is determined solely by the sales price and the quantity of products sold. Typically, it is provided in cash, although in some cases, such as with precious metals, royalty holders may have alternative options.

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Deductible costs. NSR Royalties are calculated based on the revenue generated from the sale of ores, concentrates, and other mineral products produced by mining, with certain allowable deductions. The following expenses are deductible:

1) Transportation costs from the mine site to the buyer (typically smelters and refineries).
2) Security costs and cargo insurance.
3) All costs and fees associated with the refining and enrichment of mineral products.
4) Ad valorem tax related to the separation or sale of mineral products (excluding the seller's income tax).
5) Administrative expenses and sales/marketing-related expenses are usually not deductible [9].

NSR is a crucial component in mining financing and development contracts, often preferred over other types of royalties due to its prevalence. The primary advantage of an NSR royalty is its provision for the company to receive a predetermined percentage of returns on ore mined from its properties. This benefit remains consistent regardless of the company's accounting, economic, or financial performance. Consequently, NSR royalties offer a significant advantage in circumventing prolonged and unnecessary litigation.

In certain scenarios, NSR royalties can pose a significant burden on the operator. For instance, a company might face unprofitability due to elevated non-mining expenses. Despite this, the license holder is obligated to pay an NSR. Consequently, the pressure of royalties on mining operations can precipitate premature mine closures, resulting in considerable detriment to both the mining company and the license holder. Such closures not only diminish the prospect of future mining activities but also incur physical damage to the mine, alongside high operational costs, which serve as impediments to its reopening.

The decision to grant NSR royalties necessitates careful consideration of site-specific factors. This includes assessing various elements such as the nature of proven or probable reserves, anticipated production and development costs, expenses incurred in exploration and exploitation, potential asset value, competitive offers, and prevailing royalty rates in the area [10].

2.3.2. NPI (Net profits interest) Royalty

NPI (Net Profit Interest) royalties are characterized as a percentage of the profits generated from operations associated with an asset, calculated after subtracting operating expenses and reimbursing the operator for all exploration and development costs [11]. Frequently, profits are determined by deducting interest on funds borrowed for the project undertaken by the operator. Additionally, in certain contracts, provisions may be made for establishing an accounting reserve for restoration and working capital, with this sum factored into the deduction.

Unlike NSR royalties, operators have the prerogative to deduct all exploration and operating costs before generating profits, potentially deferring royalty payments until production begins. However, the complex calculations involved in NPI royalties often lead to disputes between operators and royalty owners. Critics argue that NPI royalties exploit loopholes in accounting standards, allowing companies to manipulate financial records. Consequently, some experts dub this royalty as a 'non-profit' royalty. Operators are often inclined towards NPI royalties due to their payment deferment feature, unlike NSR royalties that demand payment only upon profitability [11].

NPI royalties typically range from 10% to 20% of profits or higher, but substantial deductions are permitted until exploration and capital costs are recouped, resulting in delayed payments. Consequently, royalty holders often have the option to opt for an NSR royalty ranging between 0.5% and 3% instead of NPI royalties.

3. INVESTMENT AGREEMENTS AND THE PRINCIPLES OF PROTECTION OF EQUILIBRIUM AND LEGAL FAITH

No party desires an unfair deal, and fairness in contracts and agreements is not merely an abstract concept. A pragmatic approach involves understanding and interpreting the principle of balance, aligned with the original intent and legal framework [12].

Internationally, agreements aimed at ensuring equitable distribution of investments and returns, frequently incorporating private mineral royalties, are negotiated through investment and cooperation agreements. However, within our country, a misunderstanding persists between investors and original license owners regarding the proper understanding and application of private mineral royalties.

On one hand, when a major shareholder oversees all project investments and costs, there's a tendency to inflate expenses, potentially leading to unprofitable operations. On the other hand, for minor shareholders seeking returns, there's a risk of losing investor confidence if dividends, as stipulated in Company Law, are not received.

Interpreting personal royalties from an equilibrium perspective. Investment law underscores the principle of balance, which operates at both macro and micro levels. At the macro level, it involves ensuring the balanced development of human rights, the economy, and the environment [13]. Conversely, at the micro level, the focus shifts to balancing the interests of parties involved in specific investment contracts. Here, an analysis of economic efficiency and return is conducted from a perspective of justice. Parties engaged in a mining project, for instance, may undertake risks, create liabilities, and conduct break-even analyses to assess ultimate benefits and returns.

For example, consider the general conditions outlined in the table below, which reflect several project contracts concluded with the participation of our country's government. In these contracts, when investors agree, the major shareholder typically assumes project management responsibilities, secures commercial loans for financing, and reserves the right to engage in conflict of interest agreements as outlined in the company's charter. Additionally, they commit to operating principles

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by signing an operator contract. In such scenarios, minority shareholders may have minimal involvement in the project, resulting in agreements primarily focused on Net Smelter Return (NSR) or private royalties. Excluding NSR or private mineral royalties from such agreements may deprive minority shareholders of benefits, potentially compromising the principle of balance.

Table 2. Comparison of Balance Principles

Reasons for applying NSR terms to contracts based on the principle of balance:

<table>
<tr><th>Parties to the Agreement</th><th>Participation in project management</th><th>Loan/debt/percentage when financing with a commercial loan</th><th>Form of receiving a return</th></tr>
<tr><td>Major shareholder</td><td>all operations, including cost management</td><td rowspan="2">loans and debts will be allocated to shareholders in proportion to their shares</td><td>the right to enter into contracts with conflicts of interest, such as parent company management services agreements and operator services</td></tr>
<tr><td>Minor shareholder</td><td>none</td><td>net smelter royalty only</td></tr>
</table>

Form of inclusion of NSR terms in contracts and agreements. In the contract signed by the parties, the NSR terms are referred to as percentages or distributable percentages, rather than liabilities, to prevent confusion in accounting. For example:

Example 1: The Australian mining investment agreement states "Any mineral production on the project is subject to a 3% Net Smelter Return Royalty (the “NSR”) to the property owner, subject to the Company’s right to reduce the Royalty from 3% to 2% for $2,000,000 USD” [14].

Example 2: Australian mining investment agreement states: On October 18, 2006, the Company and the property vendor entered into a termination and sale agreement whereby the option agreement was cancelled and the Company purchased an undivided 100% interest in the property for a one-time payment of $5,000 subject only to an underlying 2.0% Net Smelter Return Royalty, of which the Company may buy back one half for $500,000 [14].

Example 3: The Canadian Mining Investment Agreement states: Upon receipt of the company's shares, the license holder shall provide the company with 20% of any expenses incurred by the investor in connection with the license area exceeding a minimum of US$800,000, and 20% of the costs associated with exploration, development, and exploitation activities, accepting this obligation.

Consequently, it is acknowledged that the license holder's responsibility entails paying only 80% of the net cash flow generated by mineral exploitation activities on the licensed area.

Consideration in the context of the principle of protection of legitimate faith. In the interpretation of agreements defining investment and initial participation, courts and arbitrators prioritize the initial agreement made by the shareholder or investor with their explicit consent, rather than solely relying on legislative provisions. This principle safeguards the legal confidence of involved parties. Attention must be given to the potential benefits and how the parties either adhered to or breached the opportunities outlined in the agreement. Upholding the principle of protecting legal trust necessitates honoring the signed agreement, its terms, the interests of the investment enterprise, and considering the customary practices of mining entrepreneurs.

4. CONCLUSION

One of the adverse outcomes stemming from the surge in foreign investment in mining and mineral extraction, along with the proliferation of foreign-owned mining companies, is the scenario wherein Mongolia's mineral profits are flowing abroad. In response, the state, as the mineral owner, and Mongolia's legal entities, as the initial license holders, are compelled to explore avenues within legal frameworks to enable local benefits from mining activities. This entails expanding contractual mechanisms to secure returns domestically.

The state royalty is meticulously regulated within the legislative framework, and the management of the company has fostered conditions where evading mineral resources royalties is unfeasible. However, the legislation aimed at safeguarding the rights of shareholders and license holders to receive benefits from mining in Mongolia lacks clarity, and the implementation of existing laws remains unestablished.

In international practice, shareholders and licens holders often incorporate personal mineral royalties into their contracts, a subject worthy of further study. Interpreting private mineral royalties from an equity perspective involves understanding that if the major shareholder finances a project with a commercial loan as agreed in the contract, the loan liability extends to all shareholders, regardless of size. According to Company law, when a large shareholder appoints a management team, implements corporate cost management, and engages in conflict-of-interest arrangements, minority shareholders may not receive dividends until the project concludes. In such instances, applying private mineral royalties can be justified based on principles of justice.

To ensure the participation of license holders, investors, and shareholders of mining companies, their rights and conditions to receive profits and returns must be outlined within the framework of the Civil code, such as license sale-purchase agreements, shareholder agreements, and cooperation agreements. Recognizing and implementing the principle of freedom of contract through these agreements will be a crucial factor in fostering increased investment in the mining sector and ensuring balance among stakeholders.

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AUTHOR'S INTRODUCTION

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