Free Carried Interests in Francophone Africa Mining Legislation - Is there such a thing as a free lunch?

Partner

Toronto
+1 416 868 3448
+1 416 364 7813 (fax)
dkaba@fasken.com
www.fasken.com/daye-kaba

The concept of a "Free Carried Interest" ("**FCI**"), contained in most mining legislation in sub-Saharan Francophone Africa (the "**Region**"), refers to an equity interest granted to the State by the company holding a mining license. FCIs are typically viewed as forming part of the fiscal regime of a given jurisdiction, which usually also includes, among other things, corporate income taxes, valued added taxes, custom duties and royalties. As such, from a mining company's perspective, FCIs should be evaluated as part of the overall fiscal regime applicable in a particular jurisdiction.

FCIs in their current form raise a number of issues that will be examined in this article which will first discuss their characteristics and policy objectives, then examine some of the issues raised by FCIs, and lastly explore some of the proposals being circulated within the Region involving ways in which FCIs could be monetized.

I. Characteristics and Purpose of the FCI

While the majority of mining codes in the Region provide for a 10% FCI, the Democratic Republic of Congo provides for a 5% FCI and Guinea provides for an FCI of up to 15% depending on the type of mineral. All of the mining codes provide for the possibility for the State to acquire an additional interest in the share capital of project companies at market price. In practice however, this option is almost never exercised. FCIs are typically granted to the State by the company incorporated locally to hold a mining license at the commencement of the development stage of a mining project.

Increased Revenues

Clearly the primary purpose of FCIs is to generate revenues to the host State through the receipt of dividends declared and paid by operating companies. The payment of dividends to States is oftentimes a point of contention between mining companies and host States, as host States frequently take the view that dividend payments are not being made promptly enough. To the extent that the principal policy objective of FCIs from the State's perspective is to generate additional revenues as early as possible, a question arises as to whether FCIs are the best tool to achieve this objective, and whether the introduction of a net profits interest royalty for example might achieve this objective more effectively. In

this regard, while a net profits interest royalty is similar to a dividend inasmuch as it is a payment made on the basis of profits,[1] it has the distinct advantage of removing board discretion from the equation.

Ownership Stake

Politically, FCIs serve the purpose of giving States, and therefore by extension the people of the host country, an ownership stake in mining projects developed in-country. They help States rebut criticism that they are giving the country's resources away by allowed them to viewed as maintaining part-ownership in the project and merely "partnering" with mining companies. This is a significant consideration given both the increasing public scrutiny over the mining sector, and what in some cases may be an imperfect understanding of mineral taxation and the manner in which States receive their share of a given mineral project.

Board Representation

Another benefit of FCIs from the States' perspective is that they typically give States the ability to have a nominee appointed to the board of the operating companies of mineral projects.

Companies in the Region are governed by the *Uniform Act on Commercial companies and economic interest groups* under OHADA (the "**Act**") which does not give a shareholder holding an interest as small as 5% or 15% the right to nominate a member to the board. In fact, Article 419 of the Act states that board members of a joint stock company (société anonyme) are designated through an ordinary shareholders' meeting, namely by simple majority.

Moreover, although the Region's mining codes typically provide that the State will be entitled to a non-dilutable interest of 5% to 15%, they do not explicitly provide that the State will be entitled to a nominee to the board of directors of the project company. Hence, unless there is a shareholders' agreement at the project company level, which is typically not the case, there appears to be no legal basis for the State to require a nominee to the board of the project company.

It may be the case that companies grant a board seat to the State as a matter of customary practice and as a complimentary gesture of good will, though one wonders what would occur if a company decided not to extend such a gesture to the State.

The fact that the board of a project company includes a representative of the State raises the fundamental issue as to whose interest this representative represents. Does the State's representative represent the interest of all shareholders of the project company, as would normally be the case? Or would the State's nominee attend meetings and report back to the State, as regulator, as to what is transpiring with the project company? In other words, the State's nominee could have a dual and sometimes conflicting role which not only may put the State's nominee in a peculiar situation, but may also hinder the company's ability to have open and frank discussions during board meetings on issues that may affect the project.

[1] A typical NPI royalty would be calculated on the basis of a percentage of gross sales, less operating costs, transportation, handling, and freight. In some cases capitalized costs are also deducted.

From a policy perspective, a question arises, given the inherent conflict of interest of the State's nominee, as to whether it is desirable to have such a nominee on the board of the operating company, and what specific policy objective is being attained as a result thereof.

To the extent that the policy objective of the State's nominee is to police board meetings and/or report back to the State as regulator, one might argue that this is inappropriate as it hinders the proper functioning of the operating company. If the role of the representative is to facilitate the transfer of knowledge, then both the State and the companies should make an effort to ensure that the transfer of knowledge actually takes place. Accordingly, States should send the right people to represent them on boards, and companies should help put these nominees in a position to make meaningful contributions to the board, by arranging suitable training.

In addition to the issue of potential conflicts of interest of the State's nominee on the board of the project company, issues arise in respect of the very concept of a "free carried interest."

II. Issues Raised by FCIs

Is there such a thing as a free lunch in Mining Legislation?

Within the context of the term "free carried interest", a question could be raised as to what exactly the term "free" actually qualifies. Is it intended to mean that the interest itself is free (i.e., that the State does not have to make a cash payment to receive the equity interest), is it intended to qualify the term "carry" (i.e., that the State is "carried" for free), or is it perhaps intended to qualify both the interest and the carry?

Free interest?

FCI provisions in the mining codes of the Region usually provide that the State is issued an equity interest "free" or "free of charge". For example, the mining code of Senegal (2003) states that "*The State may, in addition to the ten percent (10%) free shares, negotiate on its behalf and the national private sector an interest in the mining company*", and the mining code of Mali (2012) states: "*Upon award of the mining permit, the holder of the exploration permit or prospecting license will initiate steps to create a corporation under Malian law in which the State will participate in a 10% free of all charges*."

To the extent that the phrase "free equity interest" is intended to mean that the equity interest granted to the State is "free", it may be a misnomer. As would be the case in common law jurisdictions, the notion that an entity (private or public) can be granted shares in a company for "free" is untenable from an OHADA corporate law perspective, as consideration is required in order for shares to be validly issued. Pursuant to Article 40 of the Act, the consideration for the issuance of shares may be either cash, the supply of labour or contributions in kind.

Accordingly, the provision of the Guinean mining code (2011, as amended) which states that the grant by the State of a mining license shall immediately give the State a free equity interest of up to a maximum of 15% in the capital of the company may not pass muster from a corporate law perspective.

It is therefore to be understood that the word "free" as utilized in the Guinean and other mining codes of the Region, is intended to signify that the State will not be required to pay consideration in cash for the equity interest it is granted in the operating company in connection with the issuance of the mining license.

What is happening legally is that the State is granted the FCI in consideration for a contribution in kind, i.e., the granting of the mining license and/or mining rights to the mining company. Accordingly, while terms such as "free of charge" or "free" are used, the better practice would be for mining codes to state explicitly "*in consideration for the issuance of the mining license and the mining rights granted pursuant thereto, the State shall be entitled to a [10]% non-dilutable equity interest in the project company*". This is in fact what is provided for in the mining code of Cote d'Ivoire (2014). In particular, Article 7 of the mining code of Côte d'Ivoire states: "*The award by the State of the mining permit gives the right, in consideration for the wealth distributed and the impoverishment of the subsurface, to the award to the State of shares equivalent to 10% of the share capital of company for the life of mine*."

Free Carry?

In a typical joint venture scenario (either unincorporated or incorporated) in a commercial setting, each of the parties is obligated to contribute an amount proportionate to its equity interest in the joint venture company (or , as may be the case, to its participating interest in an unincorporated joint venture) upon receiving a cash call (i.e. a call for payments made pursuant to a work program which is agreed upon pursuant to the terms of the joint venture agreement). The "penalty" for not contributing to a cash call is typically dilution of the non-contributing party's equity interest.

However, a joint venture or shareholder agreement may provide that one of the parties will be "carried", which means that such party will not have to contribute to the exploration and/or development costs of a project until the project reaches an agreed-upon milestone. Accordingly, the term "carry" refers to the fact that the non-contributing party is "carried" by the other party or parties to the agreement through exploration, development or such other time as agreed by the parties to the agreement.

One could argue notionally that unless otherwise agreed, as a shareholder of the project company, the State should contribute to expenditures during the development phase of the mine in proportion to its equity interest. The first issue this raises is that the remedy for non-contribution, which typically would be dilution, may not be available against the State, as its equity interest may not be diluted. More importantly, another issue this raises is whether there is in fact a legal or contractual basis for the State to be "carried" through the life of the project.

As it pertains to the mining codes of several countries in the Region, although English speakers like to use the term "free carried interest" when referring to the equity interest granted to the State, the notion of the "free carried" interest may be an error in translation, as the language actually contained in most of the mining codes of the Region says nothing about the State being carried. In the case of Burkina Faso for instance, the relevant provision in the mining code (2015) reads as follows in French:

> *L'octroi du permis d'exploitation industrielle de grande ou de petite mine donne droit à l'État à titre gratuit à une participation à dividende prioritaire de 10% au capital social de la société d'exploitation pendant toute la durée de la mine. Cette participation est libre de toutes charges et ne peut connaître aucune dilution en cas d'augmentation du capital social.*

This provision translates into:

> *The grant of a large or small scale mining license entitles the State, free of charge, to an equity interest of 10% of priority dividend shares in the share capital of the operating company for the*

duration of the mine. This interest is free of all charges and may not be diluted in case of a share capital increase.

Clearly, based on the wording of the provision set forth above, it is the intention in the mining code that the term "free" refers solely to the equity interest and not to the carry. By way of contrast, the mining code of Guinea makes it clear that both the interest and the carry are at no cost as Article 150 of the code states "*this interest is free of all charges and no financial contribution may be requested in consideration to the State*" (which suggests that it is a free carry). This also appears to be the case for Côte d'Ivoire as Article 7 of its mining code states: "*No financial contribution may be required from the State on the account of its shares, even in the case of an increase in share capital*." However, this type of wording does not seem to have yet been adopted by the majority of countries of the Region. It would appear that this is an oversight by the drafter of the legislation which should be rectified.

As stated at the beginning of this article, the State is usually granted its equity interest in the project company at the beginning of the development stage of the mining project. Given the current state of the legislation in most jurisdictions, one could argue that if the State is not actually entitled to a carry, then, as a shareholder of the project company, it should contribute a proportionate share of development expenses as at the development stage of the mining project.

To the extent that the State does not contribute its portion of development expenses, an argument could be made that such non-payment should be considered as a debt owing to the shareholder who would be deemed to have contributed to development expenditures on behalf of the State. The reasoning would be that monies that were contributed by the contributing shareholder on behalf of the State ought to be reimbursed to the contributing shareholder and offset against future dividend payments to the State.

It should be noted that in practice, in a typical joint venture scenario, a joint venture partner would be asked to contribute to the development expenses of a project pursuant to the terms of the joint venture agreement or shareholder agreement, as may be the case, governing the relationship between the parties. We note that there is typically no such agreement between the State and the mining company, and that the relationship between the parties is typically governed by the statutes of the project company as well as applicable corporate law, which do not typically require the State to contribute to development expenses. Accordingly, it could be argued that in practice, the State's interest is effectively a free carry even where the law is silent on that specific point.

Nevertheless, for clarity and greater certainty, mining codes of the Region should state explicitly that the State will benefit from a free carry, and as such will not be required to make any financial contributions in respect of development expenditures of the project company.

Is the Preferred Share the magic pill?

There appears to be an issue at least in some cases whereby States could have expected to receive payments from their interests in project companies early, (e.g., that they would be entitled to 10% of the revenues produced by a mine upon commencement of commercial production), and may not have considered the full breadth and applicability of accounting rules and corporate laws.

From an accounting perspective, mining companies are entitled to recover expenditures on the basis of applicable cost recovery rules and methods. This may delay when companies start showing a profit and have therefore the ability to declare and pay dividends.

As well, from a corporate law perspective, Article 146 of the Act states that the modalities of the payment of dividends are set by the general assembly of shareholders, which may delegate this power to the manager or the chairman and managing director, the general manager or the managing director as may be the case. As discussed above, in the event a company were to take the view that it is not appropriate to declare and pay dividends at any particular time, as a 10% shareholder there is very little that the State could do about it. A company may indeed in its discretion choose to retain earnings or invest in another project in the same jurisdiction as opposed to declaring and paying dividends.

One recent development in mining legislation, which is intended to deal with the timing of the payment of dividends is the introduction in the mining codes of Burkina Faso (2015) and Mali (2012) of the concept of preference shares to be granted to the State. Whereas the previous iteration of the mining code of Burkina Faso (2003) simply stated that the grant of a mining licence entitles the state to a 10% equity interest in the project company, the recently-adopted mining code of Burkina Faso (2015) states:

> *The grant of a large or small scale mining license entitles the State, free of charge, to an equity interest of 10% of* ***priority dividend shares*** *in the share capital of the operating company for the duration of the mine. [underline added]*

As it pertains to joint stock companies, the concept of a priority dividend is contained in Article 755 of the Act, which states that during the formation of the company, priority shares which have advantages not conferred on other shares, including a superior share of the profits, a priority rights on profits, or cumulative dividends, may be created. The articles of the project company may also provide for a "first dividend" which is to be paid to shareholders as soon as a distributable profit is realized.

The introduction of the concept of preferred shares makes sense: on the one hand, as a 10% shareholder, the vote of the State has little impact on decisions of the company and as such the voting right could be forfeited with little consequence; on the other hand, the State is interested in generating revenues as quickly as possible and as such a preferred dividend class of shares seems logical. It remains to be seen however whether the introduction of preferred shares will in practice address the concerns that it was intended to remedy.

While the mining code of Burkina Faso does not contain provisions setting out how and when the priority dividend must be paid, the Malian code attempts to set out the parameters pursuant to which the priority dividend payment must be made, as it states:

> *"When a profit is recognized by the operating company, it will take from such distributable profit, i.e. the profit for the year less prior losses and withdrawals for constitution of legal reserves, payment of corporate income tax and increased by retained earnings, a preferred dividend to be paid to the state. This preferred dividend, whose rate is equal to the free interest of the State in the capital of the mining company(10%) shall be paid to the State prior to any other allocation of the distributable profit"*[2]

[2] See Article 65 of the Mali Mining Code (2012)

Only two of the mining codes of the Region reviewed for purposes of this article (namely Burkina Faso and Mali) provide for preferred shares. We can however expect that the inclusion of preferred shares is going to become more prevalent in the Region's mining legislation. If this is the case, mining companies will need to seek clarity as to the exact scope of their dividend payment obligations.

III. Monetization Proposals Regarding FCIs

A number of proposals are being discussed which attempt to find ways in which States could derive maximum benefits from their FCIs.

With the most recent downturn of the mineral industry and the unavailability of funds on the stock exchanges, a number of mining companies have turned to private equity funds that specialize in purchasing royalties from companies and building portfolios comprised of such royalties.

In a similar vein it is being suggested that a State might create a vehicle that would hold all of the State's carried interests in mining projects in which third party purchasers such as private equity groups could potentially invest, and the State could use some of the money generated from the monetization of FCIs to invest in infrastructure, heath care, education etc. Alternatively, it may be desirable to hold the FCI in either a sovereign wealth fund or in a vehicle to be listed on a local stock exchange in which the local population could invest.

Monetization proposals raise questions on whether monetizing FCIs would be contrary to their basic policy objectives, which presumably is to ensure that the State is given and maintains an ownership stake in the project for its life.

Second, there is the issue of whether monetization of FCIs is feasible from a legal standpoint, considering that some of the mining codes in the Region contain restrictions on disposals. The mining code of Guinea for example states that the "*interest which is at no charge to the State, can neither be sold nor become the subject to a pledge or encumbrance*".

For those countries which do not place transfer restrictions on FCIs or amend their legislation to remove such restrictions, it will be interesting to see whether proposals to monetize FCIs gain traction and come to fruition.

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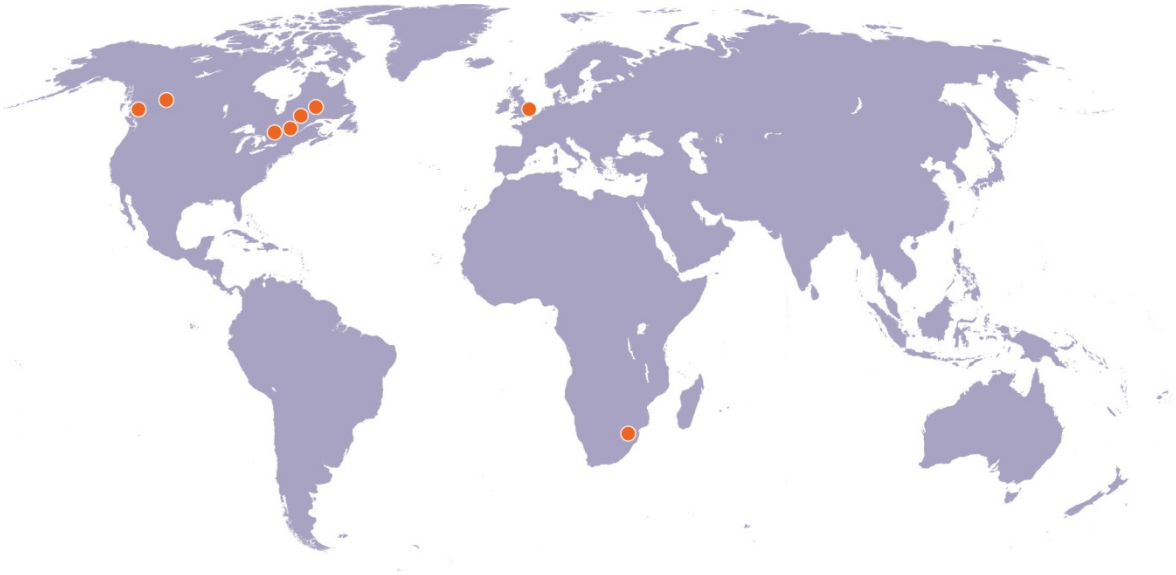
I act both for companies and governments in the mining sector throughout Francophone Africa. Please contact me if you wish to discuss further any matters raised in this article.

Locations



Vancouver

2900-550 Burrard Street
Vancouver, British Columbia
Canada V6C 0A3
Tel: +1 604 631 3131
Fax: +1 604 631 3232
Toll-Free: 1 866 635 3131
vancouver@fasken.com

Ottawa

55 Metcalfe Street
Suite 1300
Ottawa, Ontario
Canada K1P 6L5
Tel: +1 613 236 3882
Fax: +1 613 230 6423
Toll-Free: 1 877 609 5685
ottawa@fasken.com

London

15th Floor
125 Old Broad Street
London, England
EC2N 1AR
Tel: +44 20 7917 8500
Fax: +44 20 7917 8555
london@fasken.com

Calgary

3400 First Canadian Centre
350-7th Avenue SW
Calgary, Alberta
Canada T2P 3N9
Tel: +1 403 261 5350
Fax: +1 403 261 5351
Toll-Free: 1 877 336 5350
calgary@fasken.com

Montréal

Stock Exchange Tower
P.O. Box 242, Suite 3700
800 Victoria Square
Montréal, Québec
Canada H4Z 1E9
Tel: +1 514 397 7400
Fax: +1 514 397 7600
Toll-Free: 1 800 361 6266
montreal@fasken.com

Johannesburg

Inanda Greens, Building 2
54 Wierda Road West
Sandton
Johannesburg 2196
South Africa
Tel: +27 11 586 6000
Fax: +27 11 586 6104/5
johannesburg@fasken.com

Toronto

333 Bay Street, Suite 2400
Bay Adelaide Centre, Box 20
Toronto, Ontario
Canada M5H 2T6
Tel: +1 416 366 8381
Fax: +1 416 364 7813
Toll-Free: 1 800 268 8424
toronto@fasken.com

Québec City

140, Grande Allée Est
Suite 800
Québec City, Québec
Canada G1R 5M8
Tel: +1 418 640 2000
Fax: +1 418 647 2455
Toll-Free: 1 800 463 2827
quebec@fasken.com

FASKEN MARTINEAU