Editor's note: Reconsideration granted; reaffirmed as modified -- See 99 IBLA 313 (Oct. 29, 1987).

AMAX LEAD COMPANY OF MISSOURI

IBLA 84-194 Decided December 10, 1984

Appeal from a decision of Director, Minerals Management Service, affirming a decision of District Mining Supervisor to require higher royalty payments on the sale of zinc concentrates. MMS-82-41-MIN.

Affirmed.

1. Mineral Leasing Act: Royalties

Where the mineral lease provides for such determination, the Minerals Management Service may properly determine to value zinc concentrates sold, for royalty purposes, on the basis of the highest price which the lessee would pay or receive pursuant to a contract with an unaffiliated supplier or buyer, if the contract under which the concentrates are actually sold is not a bona fide arm's-length transaction between independent parties.

APPEARANCES: Gerald A. Malia, Esq., and Linda J. Gyrsting, Esq., Washington, D.C., for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Bruce W. Dannemeyer, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

AMAX Lead Company of Missouri (AMAX Lead) has appealed from a decision of the Director, Minerals Management Service (MMS), dated August 26, 1983, which affirmed a decision of the District Mining Supervisor, MMS, Rolla, Missouri, dated March 22, 1982, as amended on March 23, 1982, requiring appellant to make higher royalty payments on the sale of zinc concentrates to AMAX Lead & Zinc, Inc. (AMAX Lead & Zinc), under contract No. S-182, dated January 1, 1981.

Appellant holds an undivided 50-percent interest in various Federal leases 1/ under which it mines, concentrates, and sells zinc produced from

1/ The Federal leases are A-050303, A-050304, A-050698, A-050847, A-073742, A-073749, A-075369, and A-077396. These leases were initially issued to AMAX Inc. On Aug. 5, 1965, AMAX, Inc., assigned an undivided 50 percent to appellant and an undivided 50 percent to Homestake Lead Company.

the leased premises. For purposes of royalty valuation, section 2(b) of the leases, as amended on July 26, 1978, provides, in pertinent part:

> For the purposes of this lease, the gross value of the minerals mined hereunder at the point of shipment to market (hereinafter called the "Gross Value") shall, at the discretion of the Secretary of the Interior, be either of the following prices less transportation charges in effect at the time of shipment from the place of origin of the concentrates referred to below to the smelter:
>
> (i) The price paid the lessee under arm's-length contracts (bonafide transactions with independent parties) for all or any part of the concentrates produced from ore mined under this lease, or
>
> (ii) When concentrates are processed for lessee's account at its own (captive) or any other smelter, the highest price the lessee would pay or receive, whichever is greater, for concentrates or substantially similar quality, if such price were determined by contracts then in effect between the lessee and any of its suppliers or buyers of concentrates other than parties affiliated with the lessee.

In his March 1982 decision, the District Mining Supervisor concluded that because contract No. S-182 is between "affiliated entities" (AMAX Lead and AMAX Lead & Zinc), the gross value of the zinc concentrates for royalty valuation purposes should be determined on the basis of contracts between appellant and unaffiliated parties. The Supervisor selected the contract between AMAX Lead & Zinc, Inc., and St. Joe Lead Company (St. Joe), dated November 24, 1981, as representing the payment of "higher prices" for zinc concentrates of "substantially similar quality." 2/ Accordingly, the Supervisor stated:

> On the basis of this information, you are hereby directed to calculate royalty from November 24, 1981 on zinc concentrates sold under Contract No. S-182 on a gross value equivalent to prices paid under Contract No. S-194 to St. Joe Lead Company.
>
> If you are receiving or paying higher prices for concentrates of substantially similar quality from any other unaffiliated entity, you are directed to calculate royalty on that basis.

2/ Three smelter agreements for processing concentrates at the AMAX Zinc Company (AMAX, Inc.), smelter and refining at Sauget, Illinois, are discussed in this opinion. The contract for processing St. Joe Lead Company concentrates is referred to as the "St. Joe Contract," the contract for processing Homestake Lead Company of Missouri (Homestake) concentrates is referred to as the "Homestake Contract" and the contract for processing AMAX Lead concentrates is referred to as the "AMAX Contract."

On April 26, 1982, appellant filed an appeal to the Director, MMS, from the District Mining Supervisor's March 1982, decision pursuant to 30 CFR 290.3.

The Federal leases involved herein are owned jointly by appellant and Homestake, each with an undivided 50-percent interest. Appellant and Homestake entered into separate 5-year contracts, dated January 1, 1981, for the sale of zinc concentrates to AMAX Lead & Zinc (the AMAX Contract and the Homestake Contract). AMAX Lead, AMAX Zinc and AMAX Lead & Zinc are separate corporate subsidiaries of AMAX, Inc. Appellant argued that section 2(b) of the Federal leases requires that the valuation of zinc concentrates sold by appellant be based on the AMAX Contract price because "the smelter at which the zinc concentrates are processed is not owned by lessee, but is owned by a different company, AMAX Zinc" and because the concentrates are "purchased and are not processed at AMAX Zinc's smelter for the account of AMAX Lead." Appellant contended that the AMAX Contract represents an arm's-length transaction.

In addition, appellant argued that in 1974 the Department recognized a similar AMAX Contract price as resulting from an arm's-length transaction which mirrored a then existing Homestake Contract price. Appellant stated: "Since AMAX Lead continues to sell its zinc concentrates to AMAX Lead & Zinc, Inc. upon the same terms and conditions as Homestake Lead does, the valuation for AMAX Lead of zinc concentrates sold should remain the price paid the lessee, AMAX Lead." Appellant concluded that section 2(b) of the Federal leases does not permit the valuation of zinc concentrates sold by appellant under the AMAX Contract to be "based upon the price that an affiliated company operating a smelter in a different state pays for zinc concentrates."

In his August 1983 decision affirming the District Mining Supervisor's March 1982 decision, the Director, MMS, held that, under the Federal leases, the Secretary has the "discretion" to invoke either clause "i" or clause "ii" of section 2(b), and that, under the circumstances, it was appropriate to invoke clause "ii." The Director, concluding that appellant was properly required to pay royalties on the basis of the prices paid to St. Joe under the St. Joe Contract, stated:

> Since the smelter where the concentrates are processed is owned by an affiliated company, the concentrates may be deemed to have been processed for the lessee's account within the meaning of section "ii" of the lease amendment, and the royalty value may be determined by reference to the highest price paid at such smelter. Where the corporations involved are related, the notion of separate legal entities will not be permitted to defeat the public interest in maximizing the return under mineral leases covering public lands.

In its statement of reasons (SOR) for appeal before this Board, appellant contends that MMS is required under section 2(b) of the pertinent Federal leases to use the AMAX Contract price for royalty valuation purposes, where the AMAX Contract represents an arm's-length transaction, pursuant to clause "i" and that clause "ii" is only to be invoked where there are no such transactions. Appellant argues that the AMAX Contract represents an arm's-length transaction because the contract price is the same as that under the Homestake Contract and because appellant and AMAX Lead & Zinc are distinct corporate entities.

Appellant states that its interpretation of section 2(b) of the leases is supported by a memorandum, dated May 4, 1978, from Karen A. Shaffer, Esq., Branch of Onshore Minerals, Division of Energy and Resources, Office of the Solicitor (Shaffer memorandum), which stated at page 12, that the language of clause "ii" of section 2(b) was changed to indicate that "this type of valuation would take place in a captive situation where there was no sale through an arms-length contract." The amended language of section 2(b) currently appears in appellant's lease. Appellant also cites, as support for its proposition that the contract price in an arm's-length transaction must be used for royalty valuation purposes where such a transaction is present, 30 CFR 231.61 (1982) and an August 26, 1983, decision by the Director, MMS, involving these same leases, AMAX Lead Company of Missouri, MMS-79-22-MIN, MMS-79-23-MIN, MMS-79-24-MIN, and MMS-79-26-MIN.

In addition, appellant states that a contract price derived from a contract between related parties may, nevertheless, be based on an arm's-length transaction, where the price is the same as that resulting from an unrelated arm's-length transaction between the lessee and a third party. Appellant claims that this was recognized by the Board in Getty Oil Co., 51 IBLA 47 (1980). Appellant also contends that MMS has misconstrued the meaning of clause "ii" of section 2(b) of its leases to include all situations where the smelter processing the concentrates is owned by an affiliated company. Appellant states that clause "ii" is applicable "where a price is not paid for the zinc concentrates, rather they are simply processed for lessee's account" (SOR at 18). Appellant observes that the present case involves the payment by AMAX Lead & Zinc for zinc concentrates sold by appellant.

Finally, appellant contends that even if the contract price under the St. Joe Contract were to be used, that contract does not represent a "comparable sale" for purposes of determining the "true gross value" of the zinc concentrates because it represents a "forced" or "abnormal" sale. Id. at 19. Appellant states that the sale should be considered "abnormal" because the St. Joe Contract was negotiated on an emergency basis to supply an incremental amount of zinc concentrates to the AMAX Zinc smelter in late 1981 when the smelter was faced with an unexpected shortage of zinc concentrates. Appellant contends that this contract was entered into in order to avoid shutting down or cutting back production in a time of high unemployment. Appellant also argues that MMS should not be allowed to recompute royalties based on contract entered into subsequent to the original contract under which the zinc concentrates were sold.

In an answer to appellant's SOR, MMS contends that it properly invoked clause "ii" of section 2(b) of appellant's leases because AMAX Lead, AMAX Lead & Zinc, and AMAX Zinc, are affiliated entities. For this reason MMS contends that the sale of AMAX Lead zinc concentrates cannot be regarded as an example of sales "to independent processors or purchasers" (Answer at 5). MMS states that the case involves processing by a captive smelter, within the meaning of clause "ii." MMS concludes that clause "ii" therefore requires calculation of gross value based on the highest price paid for concentrates of substantially similar quality. That price is the St. Joe Contract price.

MMS also contends that the AMAX Contract cannot be regarded as an arm's-length transaction, as defined in clause "i" of section 2(b) of the lease, because it is not a transaction between "independent parties." MMS also argues that Getty Oil Co., supra, is inapposite because in that case, while the Board permitted use of a contract price based on a non-arm's-length transaction, i.e., between a parent corporation, Getty Oil Company (Getty), and its wholly owned subsidiary, Getty was under certain governmental constraints to sell its natural gas at the contract prices.

MMS states that AMAX Lead is not under similar constraints. MMS further states that the St. Joe Contract indicates that the market value of zinc concentrates had increased and the public should have the benefit of that increase. MMS further argues that, even if the AMAX Contract was deemed to be arm's-length, the Secretary retains the discretion to invoke clause "ii" of section 2(b) of appellant's leases. MMS rejects the interpretation suggested by appellant that clause "i" must be invoked where the contract price is reflective of an arm's-length transaction. MMS concludes that clause "ii" can be invoked regardless of whether the AMAX Contract is reflective of the price in the Homestake arm's-length transaction. MMS contends that the discretion to apply clause "i" or clause "ii" of section 2(b) of appellant's leases distinguishes this case from Getty Oil Co., supra.

MMS further contends that the St. Joe Contract did not involve an "abnormal" sale because it was negotiated for a full 3-year term and covered "three times more than [AMAX Lead & Zinc] claims it needed if nothing more than 'emergency' conditions were involved." MMS states that the St. Joe Contract was a result of changed market conditions and not a "forced sale" (Answer at 16-17).

In a reply to MMS's answer, appellant contends that MMS has presented no evidence that the AMAX Contract was not an arm's-length transaction, and that, in such circumstances, the Secretary has no discretion under section 2(b) of appellant's lease to invoke clause "ii." Appellant also argues that Getty Oil Co., supra, cannot be distinguished on the basis of constraints on the ability of the controlling party to the non-arm's-length transaction to rescind the contract, where such constraints were merely "inconvenient" (Reply at 6). Appellant also disputes the applicability of clause "ii" of section 2(b) of appellant's leases, contending that the zinc concentrates were not "processed" by AMAX Zinc for AMAX Lead's account and that AMAX Zinc is not a "captive" smelter. Finally, appellant reiterates its position that the St. Joe Contract was based on an emergency situation and does not reflect "normal market conditions." Id. at 10.

Agreements between smelters and concentrate producers generally fall within two broad categories. These categories are concentrate sales and agreements and tolling agreements. In a concentrate sales agreement the concentrates are sold to a smelter. The sales price is customarily based on a percentage of the average metal price less treatment charges, deductions and penalties. Ownership of the concentrates passes to the smelting company prior to processing. In a tolling agreement the smelter processes the concentrates for the account of the concentrate owner and either delivers the finished product to the owner or sells the finished product for the owner. Title does not pass until sale of the finished product and the owner is charged a fee for the processing of his concentrates. The AMAX, Homestake, and St. Joe Contracts are concentrate sales agreements.

[1] The first question which arises concerns under which circumstances MMS may invoke clause "ii" of section 2(b) of appellant's leases as the basis for calculating the gross value of zinc concentrates for royalty purposes. The initial language of section 2(b) indicates that the Secretary has the discretion to invoke "either" clause. However, clause "i" is limited in its applicability to "arm's length contracts," as that term is defined in clause "i."

The term "arm's length" is defined in clause "i" as "bona fide transactions with independent parties." There is little doubt that the transaction between AMAX Lead and AMAX Lead & Zinc was bona fide. However, it is equally apparent that the parties are not "independent." Both companies are wholly owned subsidiaries of AMAX, Inc. A sale at arm's length has been held to connote "a sale between parties with adverse economic interests." Campana Corp. v. Harrison, 114 F.2d 400, 408 (7th Cir. 1940), overruled on other grounds, F. W. Fitch Co. v. United States, 323 U.S. 582 (1945). Overlapping ownership and control are indicators of the lack of adversity. Creme Manufacturing Co. v. United States, 492 F.2d 515, 520 (5th Cir. 1974). In the present case, there clearly is such overlapping ownership and control where appellant and AMAX Lead & Zinc are both wholly owned subsidiaries of the same company. 3/ Thus, the above cases support the contract definition of an "arm's length" agreement.

We have studied the May 4, 1978, Shaffer memorandum cited by appellant and conclude that it supports the MMS determination and is generally in line with present Departmental regulations. The memorandum outlines the historic basis for certain changes made to the royalty clause in Federal leases for lead, zinc, and copper deposits. The prior royalty clause read, in pertinent part:

> For the purposes of this lease, the gross value of the minerals mined hereunder at the point of shipment to market (hereinafter called the "Gross Value") shall, in the discretion

---

3/ In its statement of reasons at page 17, footnote 2, appellant contends that the Department had determined in 1974 that an AMAX Lead-AMAX Lead & Zinc Contract was based on an arm's-length transaction. Appellant refers to a Nov. 20, 1974, letter from the Area Mining Supervisor, Geological Survey (the predecessor of MMS), which accepted the royalty valuation on the basis of the contract price in a January 1974 AMAX Lead-AMAX Lead & Zinc Contract (S-118). We cannot construe acceptance of the royalty valuation as a conclusion that the contract was based on an arm's-length transaction where the Shaffer memorandum indicates that the question of arm's length was not being considered by the Department until an Apr. 29, 1976, Secretarial decision and the subsequent amendment of 30 CFR 231.61 (1977).

> of the Secretary of the Interior, be either of the following prices less transportation charges in effect at time of shipment from the place of origin of the concentrates referred to below to the smelter:
>
> (i) the highest price, if any, paid or offered the lessee for all or any part of the concentrates produced from ore mined under this lease, or
>
> (ii) the highest price the lessee would pay for concentrates of substantially similar quality, if such price were determined by contracts then in effect between the lessee and any of its suppliers of concentrates, other than suppliers affiliated with the lessee.

(Shaffer Memorandum at 3). The applicable regulation in effect in conjunction with this lease provision, 30 CFR 231.61 (1977), provided that:

> The sale price basis for the determination of the rates and the amount of royalty shall not be less than the highest and best obtainable market price of the ore and mineral products, at the usual and customary place of disposing of them at the time of sale, and the right is reserved to the Secretary of the Interior to determine and declare such market price, if it is deemed necessary by him to do so for the protection of the interests of the lessor.

At page 8, the Shaffer memorandum notes the concerns of the Solicitor's Office in promulgating 30 CFR 231.61. The memorandum states in pertinent part: "The final regulation in 30 CFR § 231.61 clearly reflects the concerns of the Solicitor's Office that the United States' interest be safeguarded through reserving to the Secretary the discretion to determine whether a contract is in fact a bona fide transaction between independent parties." The meaning of the royalty clause and 30 CFR 231.61 (1977) was characterized in the Shaffer memorandum at page 11, as follows:

> In accordance with the then existing regulation in 30 CFR 231.61, the Secretary reserved the right (and through this lease language as well) to determine that the price under an ostensibly arm's-length contract was not an acceptable base value for royalty purposes and then the Secretary could determine that a higher value was in fact applicable.

In an effort to clarify the royalty clause in a way which would "minimally change the existing lease term language," the memorandum relates that Shaffer proposed the following changes to clauses "i" and "ii":

> (i) The price paid the lessee under arm's-length contracts for all or any part of the concentrates produced from ore mined under the lease, or
>
> (ii) When concentrates are processed at lessee's own smelter the highest price the lessee would pay or receive, whichever

> is greater, for concentrates of substantially similar quality if such price were determined by contracts then in effect between the lessee and any of its suppliers or buyers of concentrates other than parties affiliated with the lessee.

(Shaffer Memorandum at 11-12). The memorandum explains the meaning of these proposed changes:

> I divided (i) and (ii) into two separate and distinct situations to which separate methods for determining the value base would be applied. (i) was made applicable to the time when the lessee sold concentrates under arm's-length contracts. (ii) was then limited to situations where concentrates are processed through some sort of captive operation. [Emphasis added.]

Id. at 12. The memorandum further notes that the language of clause "ii" was subsequently amended to read,

> "when concentrates are processed for lessee's account at its own (captive) or any other smelter" as opposed to reading "when concentrates are processed at lessee's own smelter." This change was made in accordance with the idea that this type of valuation would take place in a captive situation where there was no sale through an arm's-length contract. [Emphasis added.]

Id. The above-quoted recommended language was further modified following comments by the Deputy Solicitor. Shaffer made the following comment regarding this change:

> The following day, November 30, 1977, I showed the lease terms that were agreed upon the day before to Frederick N. Ferguson, Deputy Solicitor, and he was quite pleased with the results of the meeting. He said that he would be satisfied with these lease terms provided the term "arm's-length contracts" was defined in some fashion in the lease. Accordingly, I have inserted in the proposed lease terms in Section 2(b)(i) the following language:
>
>> The price paid the lessee under arm's-length contracts (bona fide transactions with independent parties) for all or any part of the concentrates produced from ore mined under this lease, or . . . . [Emphasis in original.]

Id. at 14.

The language of clause "ii" as finally revised can be read to include those situations where there is a bona fide transaction. 4/ 30 CFR 231.61 (1977) was amended effective April 12, 1978, to provide that:

4/ Indeed, the phrase "processed for lessee's account" would not exclude situations where an independent smelter processed concentrates for the lessee's account (i.e., tolled) pursuant to an arms-length agreement.

> (a) The gross value for royalty purposes shall be the sale or contract unit price times the number of units sold, Provided, however, That where the Mining Supervisor determines:
>
> (1) That a contract of sale or other business arrangement between the lessee and a purchaser of some or all of the commodities produced from the lease is not a bona fide transaction between independent parties because it is based in whole or in part upon considerations other than the value of the commodities, or (2) That no bona fide sales price is received for some or all of such commodities because the lessee is consuming them, the Mining Supervisor shall determine their gross value, taking into account: (i) All prices received by the lessee in all bona fide transactions, (ii) Prices paid for commodities of like quality produced from the same general area, and (iii) Such other relevant factors as the Mining Supervisor may deem appropriate. [Emphasis in original.]

43 FR 10341-42 (Mar. 13, 1978). The regulation is currently codified at 43 CFR 3577.2 in slightly amended form. The 1978 amendment of the regulation reflects the parties' understanding at the time the lease was amended. The contract or sale price is controlling except where there is no arm's-length transaction for the sale of the concentrates or the lessee is consuming the mineral product. Interpreting section 2(b) of appellant's leases in light of 30 CFR 231.61 (as amended in 1978) indicates that clause "i" must be invoked unless: (1) there is no arm's-length transaction (i.e., a bona fide transaction between independent parties); (2) the concentrates are processed for lessee's account (tolled); or (3) the lessee is consuming the mineral product. Thus, clause "ii" is not an alternative to clause "i" if there is an arm's-length transaction. Clause "ii" is to be invoked in the absence of such a transaction. As noted above, the AMAX Contract is not an arm's-length transaction. Therefore, the District Mining Supervisor properly invoked clause "ii" of appellant's leases.

Appellant urges this Board to find that the provisions of clause "i" should apply pursuant to the Board's findings in Getty Oil Co., supra. Appellant states that in the Getty decision "the distinct corporate status of both the parent and its wholly owned subsidiary was recognized and the price under their normal, legitimate arm's-length business transaction was accepted as the basis for a royalty determination, exactly as it should be in the instant case" (Statement of Reasons at 14-15). We find the determination in Getty is, as appellant urges, applicable to this case. However, we cannot apply that case in the manner that appellant urges.

In the Getty decision the Board found the validity of Getty's agreement for the sale of gas to Eastern Operations to be essential to Getty's appeal. Getty asserted that its agreement with Eastern Operations was a valid contract and argued that the agreement was not rendered invalid by the mere fact that the parties thereto are a parent corporation and its wholly owned subsidiary.

The Board found that a parent corporation and its wholly owned subsidiary may enter into a valid contract. No facts appeared in the record to indicate that Getty's transfer of its assets and obligations to Eastern Operations was for other than a legitimate business purpose. However, the Geological Survey's (GS's) statement that Getty could rescind its contract with Eastern Operations was found to be contrary to the actual situation. Transco and Eastern Operations had obtained certificates of public convenience and necessity from the Federal Energy Regulatory Commission (FERC). For Getty to sell the residue gas to a third party, both Transco and Eastern Operations would have had to obtain abandonment authority from FERC pursuant to section 7(b) of the Natural Gas Act, 15 U.S.C. § 717f(b) (1982).

The Board concluded that it was error for GS to disregard the validity of Getty's agreement with Eastern Operations. Getty sold its residue gas to Eastern Operations for the same price which Transco paid to Getty under the gas purchase contract of August 7, 1970. The Department's audit found that Getty had correctly valued this gas for sale to Transco in accordance with FERC Opinions 595 and 749. Getty pointed out that Getty received the highest price obtainable in the interstate market at the time it entered into the transportation agreement.

The Board noted that although contracts between a parent corporation and its subsidiary may not be arm's length, they may result in a fair market price. If a transaction is not at arm's length, some other manifestation that the price is nonetheless an accurate portrayal of the article's worth is required. It must be a price which independent buyers in arm's-length transactions would be willing to pay. The Board found that inasmuch as the auditors clearly found that the price obtained by Getty pursuant to the gas purchase contract represented fair market value, and recognizing that royalty was tendered for the gas involved in the transportation agreement at the same rate, the price provided in the transportation agreement was the fair market price.

As can be seen, the Getty determination does not stand for the principle that there can be an arm's-length contract between a corporation and it subsidiary. It stands for the proposition that there can be a bona fide contract between a parent and a subsidiary. Thus, the determination in Getty can be properly applied to make a determination that the price paid under the AMAX Contract reflects the fair market value of the concentrates, in light of the companion Homestake Contract. Therefore, during the period between the time that AMAX Lead entered into the AMAX Contract and the time that the St. Joe Contract was executed, the Homestake Contract could be used for a determination of the "highest price the lessee would pay or receive for concentrates of substantially similar quality." However, when the St. Joe Contract came into being, that contract supplanted the Homestake Contract as the contract representing the "highest price lessee would receive." 5/

5/ Our dissenting colleague has apparently overlooked the fact that the lease amendments were worded in a manner to reflect the Secretary's "discretion to determine whether transactions are in fact bona fide and reflect the true gross value of the minerals," not discretion to elect to apply either subsections (i) or (ii). See Shaffer memorandum at 8 and 15 and 43 CFR 3577.2. Once it is determined that subsection (ii) is applicable (e.g., for

As noted above, the only limitations on invocation of clause "ii" is that the concentrates are "processed for lessee's account at its own (captive) or any other smelter." In its August 1983 decision, MMS held that where the smelter is affiliated with the lessee (as in the case of AMAX Lead and AMAX Zinc) "the concentrates may be deemed to have been processed for the lessee's account within the meaning of section 'ii' of the lease amendment." However, clause "ii" states that concentrates may be processed for the lessee's account not only at a "captive" smelter but at "any other smelter." Thus, clause "ii" is applicable not only to situations where there is no arm's-length transaction because the smelter is "captive," but also to situations where there is an arm's-length transaction for the toll of concentrates through a smelter owned by another. In effect, section 2(b) provides that the Secretary must apply clause "ii" in a captive situation, but has the option of applying clause "ii" in certain noncaptive situations.

Appellant also argues that the St. Joe Contract is "abnormal," in that it does not reflect normal market conditions. Appellant bases this conclusion on the fact that at the time this agreement was negotiated, AMAX Zinc was faced with an unexpected shortage and, presumably, was at a bargaining disadvantage in relation to the terms and conditions of any purchase to meet that shortage. However, we are not persuaded that such change in bargaining position represented an abnormal situation justifying rejection of the St. Joe Contract as a basis for royalty determination. The situation apparently had changed from a buyer's market to a seller's market. A change in market conditions resulting in differing contract terms does not per se dictate the conclusion that a subsequent (or prior) contract is "abnormal." There is no question that in the minerals industries there are periodic and cyclical changes in market conditions. In order to establish that the St. Joe Contract was "abnormal," appellant must do more than characterize the circumstances under which it was negotiated as an "emergency." Indeed, noticeably absent from appellant's evidence is any indication that the purportedly "abnormal" St. Joe Contract was a stopgap measure to fill a short term concentrate shortage or at odds with other long term contracts negotiated by AMAX or other companies in the industry in late 1981. The St. Joe Contract was for the purchase and sale of St. Joe's entire annual production

---

lack of a bona fide transaction as that term is defined in subsection (i)), the language of subsection (ii) would apply. The language in subsection (ii) plainly dictates the use of the St. Joe Contract for royalty calculation because the St. Joe Contract reflects the highest price paid to an independent party. Important to this case is the fact that the AMAX parent corporation is at liberty to direct the amendment or termination of the AMAX Contract without affecting the Homestake Contract, as there is nothing in the mineral leases, the joint venture agreement or the Homestake Contract that requires that AMAX Lead and Homestake receive like amounts for the sale of their respective portion of the concentrates produced. Thus, AMAX is at all times free to amend the agreement between its subsidiaries to reflect the St. Joe Contract or to terminate the AMAX Contract and sell its portion of the concentrates to a third party, which might result in a return below that received from the captive smelter.

from its Viburnium, Fletcher, and Brushy Creek properties during a 3-year period. Absent a clear showing that AMAX Lead & Zinc actually anticipated that the "abnormal" conditions would continue for a period of 3 years we find little basis for a conclusion that the parties intended to merely deal with a short-term emergency situation.

Accordingly, we conclude that MMS properly found that the St. Joe Contract is the proper basis for determining the highest price that AMAX Lead "would pay or receive" under clause "ii" of section 2(b) of its leases for purposes of valuing zinc concentrates and that the Director, MMS, properly affirmed the District Mining Supervisor's March 1982 decision.

Pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

R. W. Mullen
Administrative Judge

I concur:

Will A. Irwin
Administrative Judge

ADMINISTRATIVE JUDGE BURSKI DISSENTING:

The majority herein affirms a decision of the Director, MMS, requiring AMAX Lead Company of Missouri (AMAX Lead) to recalculate royalty payments made subsequent to November 24, 1981, on zinc concentrates sold under a contract entered into between it and AMAX Lead & Zinc, Inc. (AMAX Lead & Zinc), on the basis of prices paid under a contract entered into on that date between St. Joe Lead Company (St. Joe) and AMAX Lead & Zinc. The net effect of this decision, as might be expected, is to increase the basis upon which royalty must be calculated.

The Board bases its decision on an interpretation of amendatory language added to section 2(b) of AMAX Lead's lease by mutual agreement of AMAX Lead and the Department on July 26, 1978. This language provided, in pertinent part, that the gross value of the minerals mined under the lease:

> [S]hall, at the discretion of the Secretary of the Interior, be either of the following prices * * *:
>
> (i) The price paid the lessee under arm's-length contracts (bonafide transactions with independent parties) for all or any part of the concentrates produced from ore mined under this lease, or
>
> (ii) When concentrates are processed for lessee's account at its own (captive) or any other smelter, the highest price the lessee would pay or receive, whichever is greater, for concentrates of substantially similar quality, if such price were determined by contracts then in effect between the lessee and any of its suppliers or buyers of concentrates other than parties affiliated with the lessee.

MMS had justified its action on two independent theories. First, it noted that the contract between AMAX Lead and AMAX Lead & Zinc was not an arm's-length contract since both AMAX Lead and AMAX Lead & Zinc are subsidiaries of AMAX, Inc. Thus, since subsection "i" could not, by its own terms, apply, recourse was properly made to subsection "ii." As an alternative theory, MMS contended that, even were it conceded that the contract between AMAX Lead and AMAX Lead & Zinc was an arm's-length contract, the language in section 2(b) clearly establishes that the Secretary may, <u>in his discretion</u>, use either of the two approaches. Thus, he would not be required to utilize the price established in a bona fide transaction, but, rather, has an absolute right to select the basis on which royalty payments will be computed.

The Board, in essence, accepts MMS' first theory and rejects its second basis. While I agree with the majority's conclusion that the contract between AMAX Lead and AMAX Lead & Zinc cannot be considered to be arm's-length because the two corporations are not "independent," I also believe that MMS is correct in its contention that the Secretary has discretion, regardless of whether or not an arm's-length contract exists for the sale of the concentrates produced from mined ore, to determine to elect the assessment of royalty on the basis of clause "i" or "ii."

It is noted, of course, that inasmuch as both I and the majority are in agreement that the contract entered into between AMAX Lead and AMAX Lead & Zinc were not "arm's-length contracts" within the meaning of section 2(b) of the lease, it could be argued that the holding on this point is dictum, and it would not be necessary for me to discuss this matter to any great extent. However, for reasons which shall subsequently be made clear, the authority of the Secretary to elect either to follow the results derived from an arm's-length transaction or from the highest price which a lessee receives from any of its other buyers is, to my mind, critical in determining the outcome of this appeal.

Initially, I think it is useful to explore the reasons why the Department has taken particular care to safeguard its royalty interests where the contract between the lessee and the smelter are not truly "independent" contracts. The essential concern arises from recognition that, to the extent that a lessee is a subsidiary or an affiliate of the company purchasing the concentrates, it is possible that for reasons totally independent of market considerations (not least of which might be a desire to minimize royalty payments on production) an agreement could be entered into which results in payment of a price below that which could be obtained were the parties to the agreement in a truly competitive relationship. Thus, while the Department would normally expect that a lessee would, in an agreement with a smelter, attempt to maximize its own return (and, thereby, maximize the return to the Government based on its royalty interest), this expectation may not be a well-founded one in those situations where components of the same company are dealing with each other. Accordingly, the Department eschewed granting such contracts the presumption normally ascribed to contracts entered into between truly independent companies that the fair market value has been established in arriving at the mutually agreed upon price.

I do not, however, think that the Department has ever taken the position that contracts between affiliates or subsidiaries are irrelevant per se. As I understand the rationale implicit in our decision in Getty Oil Co., 51 IBLA 47 (1980), while a contract between affiliates may be a valid contract, the Department will not assume that the negotiated price represents fair market value unless there is independent indicia establishing that the contract price is one fairly derived from the marketplace.

The present case involves an unusual fact situation. AMAX Lead owns a 50 percent undivided interest in the subject Federal mineral leases. The other 50 percent interest is owned by Homestake Lead Company (Homestake). Both AMAX Lead and Homestake sell their concentrates to AMAX Lead & Zinc. The contract of sale between Homestake and AMAX Lead & Zinc is, insofar as the royalty provisions are concerned, 1/ a verbatim replication of the contract between AMAX Lead and AMAX Lead & Zinc. They are also for the

1/ It should be noted that the AMAX Contract requires shipment of a greater amount of concentrates than does the Homestake Contract. It is not inconceivable that this differential might make the two contracts less compatible than same duration, a point which I believe to be of some relevance. What I find difficult in the instant case is that MMS is, in effect, admitting that the Homestake Contract with AMAX Lead & Zinc validly establishes fair market value for Homestake's concentrates while denying that the same payment based on a similar contract between AMAX Lead and AMAX Lead & Zinc constitutes fair market value for AMAX Lead under the same Federal leases. This disparate result is justified solely on the ground that AMAX Lead and AMAX Lead & Zinc are affiliated companies. While granting the latter proposition, I scarcely see how this justifies forcing AMAX Lead to pay royalty on the basis of a higher valuation than Homestake for mining the same deposit.

The critical flaw in MMS' approach has been its failure to recognize that "fair market value" is not merely a question of the price that may be obtained at any finite moment of time, but involves, particularly insofar as long-term contracts are concerned, consideration of the other contract terms, especially the duration of the agreement, which have a direct effect on the purchase price offered.

It is no secret that smelter prices have had a long history of price volatility. Thus, prices can be expected to vary dramatically depending upon the actual date at which a new supply becomes available. 2/ The fact that MMS recognizes the validity of AMAX Lead's royalty computations from the period between January 1 to November 24, 1981 (the date of the St. Joe Contract with AMAX Lead & Zinc), represents an explicit finding that the price agreed upon in the AMAX Contract was fair market value. The fact that MMS has not challenged continued royalty payments by Homestake based on its contract with AMAX Lead & Zinc shows that MMS considers the price received by Homestake is still fair market value considering the fact that the contract was entered into for a period of years. What MMS has attempted to do with respect to AMAX Lead, however, is to divorce contract price from contract duration. Such action, I would suggest, cannot be justified on any valid economic theory.

The fallacy of MMS's position can be seen in the following example. Assume an individual has $100,000 to invest and is offered an 11-percent rate of return for a 5-year investment. Recognizing that this is a fair rate of return the investor commits himself. A year later, due to inflation or a shortage of investment capital, the rate of return for a 5-year note is now 12 percent. In the marketplace, an investor would be allowed to withdraw his investment from the original commitment only at the cost of a sizable interest penalty. The investor could make money in such a maneuver only if

---

they would appear to be by merely comparing the contract price (Article 4). However, MMS has made no such allegation and, in the absence of such a contention, I believe we are forced to assume that the contracts are, as AMAX Lead asserts, similar in all relevant aspects.

2/ A new supply could become available either through the development of a new source of supply or upon the running of the terms of a prior contract which enables the supplier to shop around for the best available deal with a smelter.

the interest differential over the ensuing 4 years, on a presently adjusted basis, would be greater than the interest lost as a penalty for prematurely withdrawing his original investment capital. In no circumstances, however, would that real rate of return be 12 percent, since such penalty as would be assessed would necessarily diminish the ultimate return.

In the instant case, the situation is different only in that rather than involving the assessment of a penalty for the early withdrawal of funds, the real constraint against early termination of a contract is a suit for breach. Thus, should Homestake decide that it, too, would like to achieve the return paid to St. Joe, it could theoretically abrogate its contract and sell its concentrates elsewhere. What prevents Homestake from resorting to such action, however, is the realization that it would be liable for damages (or even specific performance) on the contract that it entered into with AMAX Lead & Zinc. This liability to suit is the "penalty" factor which serves to limit Homestake's freedom of action to the same extent that the interest "penalty" constrains an investor.

MMS argues, in essence, that since AMAX Lead and AMAX Lead & Zinc are affiliated companies, AMAX Lead could breach the contract without running any realistic risk of suit and, therefore, there is no "penalty" factor inhibiting AMAX Lead from obtaining the price subsequently offered to St. Joe. 3/ What this ignores, however, is that the price which both AMAX Lead and Homestake originally obtained is, in real part, the result of the duration of the agreement which MMS seeks to simply ignore. In other words, the determination of the values to be paid to Homestake included consideration of the length of the supply commitment. Absent such a commitment, it cannot be maintained that the same price would be received by Homestake. Thus, when MMS chose to accept the Homestake Contract as validly representing fair market value it accepted not merely the contract price but the duration of the contract as well.

I have no difficulty with the view that we should carefully review contracts between subsidiaries and affiliates to determine whether the Government's royalty interest is being adequately protected. I do not think, however, that this gives us a license to actually penalize such entities. There seems to be no gainsaying that had AMAX Lead made its contract with someone other than an affiliate the Government would not be seeking increased royalties. I do not see how the fact that it chose to deal with an affiliate should change the result of this equation. If the Homestake Contract with AMAX Lead & Zinc fairly establishes market value, I do not see how it can be contended that the AMAX Contract, executed the same day, for the same duration and return, is open to attack.

3/ MMS, however, has not fully explored the logic of its position. If AMAX Lead can break its contract with impunity, so, too, can AMAX Lead & Zinc. If, rather than represent an increase in price, the St. Joe Contract had involved a lowering in payments, I doubt that MMS would stand idly by while AMAX Lead & Zinc unilaterally terminated its contract with AMAX Lead and permit AMAX Lead to tender royalty payments on the newly lowered valuations. In reality, MMS' valuation approach works like a ratchet; the price can go up but not down.

It is no answer to point to the Secretary's discretion. Such discretion must always be exercised in a fair and rational manner. In the instant case, I fail to see how the decision of MMS can be reconciled with fair treatment of our lessees. So long as MMS concedes that the Homestake Contract is a valid basis upon which to compute its royalty payments, I think AMAX Lead has the right to make its payments on the same basis. I would reverse the decision below.

James L. Burski
Administrative Judge