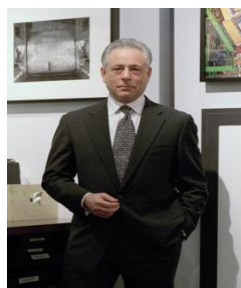


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Directors & Officers and Errors & Omissions Liability in Managing Art Investment Funds



Lawrence M. Shindell, Chairman, ARIS Title Insurance Corporation (Member Argo Group, Nasdaq: AGII), discusses the D&O and E&O exposures surrounding legal title of art in art investment funds.

The January 28, 2011, *Financial Times* article entitled, “Banks move to keep their top clients in the picture,” and its report that major industry banks are capitalizing on renewed client demand for art investments by launching art portfolio funds, is yet another signal of the return to a robust art market where “art investing” takes on new rigor.

This cyclical rush to market carries a corollary phenomenon, which is that buyers (e.g., art investment funds) tend during booming markets to deemphasize best risk management practices only later to face a variety of economic and legal exposures.

These consequences are no more acute than in the art industry, because the art industry is the largest, lawful industry in the world that is unregulated and non-transparent.

A return to a “high” market (or even considering the preceding “down” market) warrants a full understanding of the nature of ownership (legal title) risks in the art industry and how these risks can create D&O and E&O liabilities for art investment fund managers.

The truth about title risks in the art industry

Far from conventional wisdom, the art industry’s legal title risks are not limited to stolen art generally or to WWII Nazi-Era stolen art in particular. An estimated 75% of the art market title risk is due to a host of issues generally categorized as liens, encumbrances and authority to sell (e.g., the events at Art Basel Miami just over a year ago in which U.S. authorities seized paintings by Léger, Miró, Degas and Klein worth over \$7 million from the display of a dealer to enforce a \$760,000 judgment against the dealer unrelated to the seized works, see <http://www.aristitle.com/news/index.php> Dec. 3, 2009). Only 25% of the market risk is due to stolen art (contemporary or historical theft and import and export issues combined).

Adding to this equation, 20% to 30% of the \$6-billion-a-year in art stolen annually is not reported to law enforcement authorities, and only 5% of art reported as stolen is recovered. Traditional industry due diligence practices (including the use of stolen art databases) provide at best a 16% efficacy rate in managing the art market title risk overall.

The risk of defective legal title permeates the art industry (versus the low levels in the real estate industry) because of the non-transparent, non-regulated nature of the art industry. The term “art” for the current discussion broadly includes all forms of collectibles (fine art, vintage automobiles, rare books and manuscripts, rare stringed instruments and other important collectibles) in which art funds invest.

The nature of the art industry means that buyers such as art investment fund managers and their advisors cannot learn the identity of the seller when buying. The market deems this information to be confidential for various reasons including to hide pricing. If an art fund cannot know the identity of the actual owner from which it is purchasing a work (which is likely *not* the dealer selling the work as inventory), then the fund cannot possibly begin to manage the legal title risks that might be associated with that work.

Traditional due diligence practices in the art industry and the review of the provenance of a work (i.e., what art investment funds and their art advisors typically follow) were not designed to manage transactional risk. These practices initially arose to address connoisseurship and only later evolved to incorporate a sensibility about risk – and then only a limited sensibility centering on WWII Nazi-Era stolen art beginning in the mid-1980s with the Seattle Art Museum case of a WWII-stolen Matisse painting. Art industry traditional due diligence practices, although serving as a starting point in the buying process, operate under significant misnomers about what provenance does and does not identify from a risk management standpoint: the art industry never recorded both sides of each transaction, so a given provenance is not necessarily complete and accurate; and there is often a fundamental misunderstanding about the difference between provenance and legal title (provenance is only a subset of legal title).

The art industry solution of the past – to rely on private indemnity (dealers or individuals explicitly warranting clear legal title to their buyers, or merchant-dealers implicitly doing so absent disclaiming the warranty under various laws for a limited time period) – does not manage the title risks. Dealers and individuals are not in the business of assuming the legal title risk: they do not reserve funds to back the warranties.

Furthermore, private indemnity poses enforcement obstacles because most art transactions involve parties which at the time of the transaction were, or at the time of the attempted enforcement of the indemnity are, located in multiple jurisdictions or countries (presuming that the indemnifying party is even alive or in business and has attachable assets). The auction sector of the industry also does not have in its business model reserves to assume the art market legal title risk. As a non-modifiable auction industry term, auction houses contractually impose on buyers and sellers an unfettered right to rescind the auction transaction at any time based on later-discovered title concerns.

When one asks “Is there a title risk in the art industry?,” an art fund official need only to consider the media coverage on the increasing prevalence and complexity of art market title risks, see www.aristitle.com/news/index.php, or to ask, “If not, then why is private indemnification (which does not work) a standard required practice?” and “If not, then why the auction house’s insistence on a right to rescind (which means that an art fund does not have

finality of the transaction)?”. The title risk traverses the entire art market across all periods and genres and from the secondary market to the primary market. For example, see Takashi Murakami’s *Flower Blood Ball (3-D)*, 2007, pulled from auction at Christie’s London in June 2008 due to a breach of a resale right-of-first refusal contract, with litigation between the artist and buyer ensuing in Hong Kong courts.

The real impact of legal title risks on art investment funds

“Buy low, expose, sell high”

Eventually an art investment fund *buyer* becomes an art investment fund *seller*. Then the fund, absent transferring the risk to a third-party title insurer, must explicitly warrant to *its* buyer or consignee that the fund has clear legal title to its art asset and assume open-ended legal and financial liability for legal title risks that the fund has no meaningful basis to assess.

Between buying and selling a work in the fund, the art investment fund faces another transaction-related title risk. Each time the fund publicly exhibits or publishes in literature a work held in the fund in order to expose the work and increase its market value, particularly if the work is fresh to the market, the fund unwittingly increases its exposure to a title claim to that work.

Disclosure obligations

When raising money, an art investment fund faces disclosure obligations around the legal title risks. If an art investment fund loses a work held in the fund to a title dispute, then the fund must absorb the loss and in all likelihood will be unable to yield anything near the returns it forecasted when it solicited investors.

Once the fund discloses this risk of substantial loss, the fund must decide what else to say about it – tell the investor that the fund is sticking with traditional due diligence practices despite the risk of loss or that the fund has transferred the risk to a third-party title insurer in order to avoid loss on this basis and has included this cost in its return-on-investment model. (Depending on the legal domicile of the fund, the cost might be a tax deductible operating expense or might go (e.g., in the U.S.) to the cost-basis for capital gains tax purposes.)

Failure to solve this paradigm correctly can create dead-center D&O and E&O liabilities.

✚ Contingent liability reserves

If an art investment fund does self-insure against the legal title risks, the problems compound.

In order to close the fund, the art fund must reserve money to cover the contingent liability for an auction sale unwinding and having to disgorge auction proceeds or indemnify under a private sale warranty of title. Because the art investment fund is not in the business of insuring legal title risks, it will not have an actuarially sound basis to decide how much money to reserve and for how long. Either form of loss, and the failure to reserve adequately or at all (leaving the fund's investors exposed to claw-back liabilities), will put fund management in the crosshairs of several D&O and E&O liabilities.

✚ Audit requirements

Auditors are becoming more familiar with the art market and the implications to art funds of defective legal title of fund assets. Art investment funds can expect auditors to require art funds to disclose unmitigated title risks in the fund's financial statements, to report reserves against these risks, and to demonstrate an actuarially sound basis for these determinations.

Absent showing adequate compliance in these areas, it will become increasingly difficult for art investment funds to secure unqualified audits. The situation will exacerbate as art investment funds increasingly accept money from institutional investors.

Conclusion

The nature and extent of legal title risks in the art industry and their resulting impact on art investment fund fiduciaries are at their genesis. Investors should inquire about and know whether an art investment fund under consideration takes proper steps to protect against defective legal title when the fund buys and whether the fund warrants clear legal title when it sells the fund's assets.

The failure of an art investment fund and its directors and officers to manage these risks properly can create legal and financial exposure – from contingent liabilities that can affect whether the fund can close and distribute profits to a legal finding that forward-looking statements in solicitation materials are inherently misleading.

These risks, however, if understood, can be avoided through implementing current best practices in art asset risk management.

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Lawrence M. Shindell, J.D., is Chairman of ARIS Title Insurance Corporation, a U.S. (New York) title insurance company. ARIS is the recognized authority on the legal title risks in the fine art and collectibles industry and is a member of Argo Group, a global, publicly-traded, multi-billion dollar, A.M. Best-rated 'A' specialty insurance and reinsurer (Nasdaq: AGII). (www.argolimited.com.)

ARIS is able to manage the art market title risks by a combination of unique access to transaction and ownership information that transacting parties will not share with each other (as the only market-neutral party in the industry and having government-regulated confidentiality obligations) and underwriting protocols and proprietary tools that are based on assuming the financial risk of defective legal title in contrast to the traditional art industry practices discussed where the risk is not assumed. ARIS's tools include the only art title plant in the industry, ownership of or access to which is required by law in the U.S. in order to be a licensed title insurance company.