

Mitigating Risks in Art Related Financial Transactions

Fine Art Wealth Management in collaboration with ARIS Title Insurance Corporation examine the various risks associated with art related financial transactions and how to develop proactive, preventative strategies to help mitigate such risks.



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Foreword

The growth of art collecting and investing by a new generation of wealth is creating a more complex set of financial needs which go beyond the traditional range of services financial institutions offer, and indeed are ill-equipped to provide through their existing business models.

A survey conducted by Deloitte and ArtTactic in their 2013 Art & Finance Report among private banks, art professionals, and collectors reported that while the emotional and social value of art remain the primary reasons for buying art; financial motivations are becoming increasingly more important among sophisticated collectors. Just over half of the collectors surveyed (53%) viewed art as a financial asset. According to the Report, participants also believed that as the value of art increases so too is the need for financial services to protect, preserve and monetise this value.

While financial institutions have made advances in assessing the value and risks attached to art assets, the lack of clarity concerning ownership of a work of art and proper due diligence around authenticity are often a challenge in art transactions. For instance, confirming authenticity and whether a self-declared owner of an object has clear title to it can be difficult. The development of proactive, preventative strategies for dealing with the problems of art theft, forgery, illicit traffic of works of art and export/import violations depends largely on the willingness of financial institutions to execute due-diligence to the fullest extent possible, which still does not eliminate the risk.

This paper lays out general insights around art as an asset class and how best to mitigate risks inherent in art-related transactions to buyers and sellers, financial institutions, trust and estate practitioners, and art investment vehicles.

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The Evolution of Title and Authenticity

Ownership defects in the art world have evolved overtime fundamentally because of the lack of transactional standards and transparency in art transactions. It is not uncommon for multimillion dollar transactions to occur with little or no paperwork. The practice in the industry to transact art anonymously has always occurred and continues today. Buyers want to conceal interest in specific works and methods of accumulation to minimize purchase price. Sellers want to conceal reasons for selling (often financial distress) to maximize price. Intermediaries facilitate transactions via undisclosed principals to accommodate each principal's motives. Because participants keep transaction records discrete and incomplete, today it is nearly impossible to demonstrate, in absolute terms, an unbroken chain of title to works of art.

In the past, art accumulation was a result of centuries of colonialism, exploration, and wars including World War I and II, the Russian Revolution, and the Cuban Revolution. Historical theft in addition to contemporary looting from civil war (Syria, Afghanistan, Iraq etc.) have resulted in the theft or illegal exporting of tens of millions of works, including fine art, antiquities or cultural artifacts. Many developed and developing countries have increased their efforts to recoup allegedly-looted works of their cultural artifacts.

Today, with the escalation of the value of art and other important collectibles ownership claims continue to rise. Title claims often come in the form of traditional liens and encumbrances and questions of legal authority to sell and transfer title; indeed, only 25% of all claims emanate from historical and contemporary theft while 75% of title disputes are a result of these more liens, encumbrances and authority to sell – or non-provenance – related questions. Traditional liens and encumbrances can be characterized as bank liens, authority to sell and import/export violations. There has been an increase in claims stemming from the lack of estate disclosures when executing estate plans or filing estate taxes, dementia and family infighting. Also, the financial challenges of recent years have created liquidity needs resulting in increased use of art and collectibles as collateral for loans. However, since the seller is rarely disclosed it is often impossible for purchasers to discover these liens.

In addition to well publicized litigation over defects in title, newspapers today are replete with stories about collectors purchasing faked or forged works. While forgeries are not new, many well published cases recent cases are causing collectors to struggle more than ever with how to avoid purchasing fake or forged works. In the recent past, the estates and foundations of artists created authentication boards to help the market navigate the issue. However, the

eventual burden—financial and otherwise—of litigation on boards from claims by owners who argued that boards were economically motivated to control market inventory and, in turn, values forced many authentication boards to disband. Scholars, under fear or threat of similar litigation against them, have also become reluctant to render public or even private opinions about the authenticity of works.

Collectors must navigate the thorny landscape of fakes and forgeries through scientific testing (which can generally only disprove authenticity or prove that the physical aspects of a work are “consistent” with the attributed artist), as well as connoisseurship and provenance research which has long been a central tenet of authentication. Most art experts agree that authentic paintings tend to have a “correct” provenance, including literary references in the artist's catalogue raisonné, scholarly publications, exhibition records, or auction catalogs. On the other hand, if a work by an important artist has no documented history (such as the plethora of artworks by “Pollock”, “Rothko” and “Motherwell” sold by Knoedler and the subject of pending litigation) then it may be a fake or forgery, though that is not always the case. Moreover, a fake or forged artwork almost always has a fake or forged provenance.

One common misconception in the art market is that a good provenance means that the legal title to or ownership of the work is clear. These two concepts are not identical. Provenance is the history of physical possession of a work from the date the artist created it to the present day, and thus it is only a subset of legal title. Legal title is the full right, interest, and ownership of the work, which may or may not overlap with physical possession of the art. Because the art market does not record and track both sides of a sale-purchase transaction, every provenance carries the inherent risk of being inaccurate or incomplete, including the provenance information stated in catalogues raisonnés and auction catalogs. Besides, when a purchase or sale is recorded, such as in an auction catalog, it is generally recorded in a generic fashion (e.g., “Private Collection”). These market challenges on clear legal title are compounded by the prevalence of transactions involving multiple layers of undisclosed consignors or dealer-agents.

Because legal title and authenticity are regarded as first cousins of each other, the process that a title insurance company undertakes to guarantee clear legal title serves as an additional lens through which to study authenticity as well as to understand valuation.

Bringing Financial Discipline to an Unregulated Industry

Financial institutions are beginning to realise that evaluation of the risks associated with art investment is quantifiable and manageable on the basis of applying the same rigorous professional discipline utilised with other financial assets. However, dealing professionally with art requires experience and extensive knowledge. Obtaining recognition as an art expert generally requires intense study, whether theoretical, academic, or practical. The right experts can help minimise the risk inherent in art transactions through expertise, experience, and market intelligence from an art historical perspective but unlike the financial markets, the art market lacks regulation and internationally accepted standards of best practice.

Disputes concerning title and authenticity can come in many forms. Art appraisers are typically the first in line of defence in combating these problems. Frequently, they are the first ones to be asked by a financial institution lending against art, “What is it worth?” A top appraiser also realises that the value of a work is determined to a great extent by whether or not it is tainted by title or authenticity risk. A work of art whose ownership has been contested or whose authenticity has been doubted is worth much less (and arguably nil) than a similar object which has been universally accepted as authentic and rightfully owned. The United States Internal Revenue Service (IRS) adoption of the Uniform Standards of Professional Appraisal Practices (USPAP), which are similar to the standards developed by International Valuation Standards (IVS) in the U.K., requires disclosure of potential assumptions such as liens and encumbrances on title that could cause diminution of value.

It is also important to note that the global art market is becoming more litigious and art lenders must take special care to mitigate art risks associated with ownership title claims, attribution and art fraud. Attorneys who specialise in art law in the U.S. and Europe are reporting greater demand for their services than ever before. Asked what sub-segment of art law is expanding most rapidly, experts are quick to point to estate law in light of the fact that collectors, who are actively buying or planning for their collection legacy, are now the most powerful part of the art world.

With the current trend of financialization of the art market, heightened attention to the lack of transactional standards and transparency of the transaction is imperative to protect all market sectors. In order for all market participants to protect themselves from financial risk, greater attention must be devoted to conducting due diligence, eliminating gaps in ownership information, such as addressing the uncertainty over who is the current

owner of the object (verses representative of the owner) and whether that party has the legal authority to sell the work as well as gaps in the overall succession documentation. Ultimately these issues impact liability of collectors, advisors, art lenders and fund managers regarding title, authenticity and valuation.

Mitigating Risks to Buyers and Sellers

Collectors want the assurance that the art they buy is purchased for a fair value, is authentic (accurately attributed, not a fake or forgery) and is free and clear of any lien, encumbrance or other issue impacting the buyer’s ability to take clear and absolute legal title.

While auction markets are subject to limited local regulations and self-imposed protocols given public nature of auctions, art dealers, advisors and galleries operate largely unregulated creating a host of exposures and conflict of interest.

Buyers need to be cognizant of the laws in the various applicable jurisdictions (where the purchase occurred, the artwork came from, the buyer lives and stores the art) because of the complex landscape of what protections are afforded to the purchasers resulting from contractual obligations, commercial transaction law (Uniform Commercial Code in the U.S. and Register of Charges in the UK and other similar laws worldwide) to criminal law, etc.

Sellers must realize that they are being asked to warrant title and authenticity to their works of art which is often unknowable and creates on-going liability to upstream collectors with no time limitation. This issue is particularly thorny for executors, trustees and other advisors with fiduciary duties and estates and trusts which need finality of the sale and funds-settlement closure.

The neutral third-party lens of a title insurer should be a key ingredient for any significant art purchase, sale, charitable gift or estate plan for today’s collector, whether buying or selling. The title insurance company focuses on the unique aspects of the art and collectibles market assuring the integrity of purchases, sales, estate plans, tax strategies and other transactions. This is done through examining, confirming and guaranteeing through a true financial guaranty the fair market value of the object plus defense costs, in a confidential, insurance industry/government-regulated and independent way that manages the art market risks.

Such an approach helps market parties to eliminate efficiently otherwise pervasive conflicts of interest – many times unintentionally present when multiple agents are

involved on one side or both sides of a transaction – and the effects of these conflicts.

Mitigating Risks to Art Lenders

The rapid growth of the global art market and liquidity demands is driving the need for art financing and new specialist art lenders have entered the markets primarily in the U.S. to tap into this increasing demand. These lenders are often referred to as asset-based lenders and offer “non-recourse” financing whereas few mainstream banks will accept these terms.

Art lenders can currently be identified as recourse lenders and non-recourse lenders. A recourse loan is secured by the art assets but also guaranteed by the borrower which implies the borrower’s full credit is essentially backing the loan. A non-recourse loan, on the other hand, is secured solely by the art asset underlying it. Under this scenario, lack of clarity concerning title and ownership of a work of art can significantly compromise the lender’s collateral. Detailed information on the art is normally required including photographs, bills of sale, provenance history and catalogue raisonné references. A qualified appraiser should also complete a comprehensive market-based valuation for each piece of art selected for collateral.

Generally, the financial due-diligence bankers do for the client pursuing art loans is similar to what would be carried out to structure an unsecured loan and can be summarised in a 3 Stage Process.

- Assessment and Validation
- Due-diligence and Documentation
- Transaction Structuring and Closing

Bankers need to assess the financial health of the client (to the extent that the client has income and is not an estate or trust) along with the quality and marketability of the art. Unlike auction houses (who still provide to some extent advances and direct or third-party guarantees on offered lots), wealth managers and asset-backed lenders prefer to avoid having to sell the art if the client cannot repay the loan. For that reason, the client’s cash flow and investments are also often relied upon for repayment, not only the sale of the art.

To underwrite the loan, bankers must assess the borrower’s principal assets, liabilities and contingent obligations. This includes determining unencumbered liquidity and evaluating quality of recurring cash flow. Art collections are not income producing and may be illiquid. Other financial information must therefore be assessed by wealth managers while the art collection is evaluated and values assigned for lending purposes. Unfortunately, even with this assessment not all loan defaults can have a

satisfactory loan workout and every lender should contemplate on every transaction that they may be the seller of the art assets and will have to warrant title to the upstream buyer.

Mitigating Risks to Trust & Estate Practitioners

Just as trustees and executors must undertake proper due diligence with regard to financial assets; they must do the same for art assets owned by the estate and trust. Once a collection has passed a certain threshold a wide range of estate planning considerations come into play. Trustees need to consider art as part of the overall financial and estate planning process, especially in relation to other assets, such as real estate and investments.

The ability to establish and prove ownership of artworks is essential. There is no central registry of art ownership, but there are various stolen art databases, which have varying degrees of utility. Although not a universal practice for art theft losses, failure by a trustee to register stolen art may in some circumstances be negligent.

A trustee’s role may include buying, selling, exhibiting, maintaining, moving or loaning clients’ art. In each case, different considerations arise that require detailed and separate examination. The use of carefully drafted agreements for transacting around the art is one way to limit trustee’s exposure. Such agreements cover, for example, liability for tax, compliance with import and export regulations, payment of artists’ resale rights, copyright, risk and insurance as well as much more. However, the efficacy of such agreements may be limited as the art market does not always embrace such agreements. Moreover, the U.S. the Pension Protection Act imposes fines and penalties for underpaying taxes based on appraisals.

Few collections are thoroughly vetted by trust and estate practitioners. It is unusual to find a full inventory of art appended to a trust deed or elsewhere. It is also rare to see complete documentary evidence of sale and purchase, ownership history, an accurate description of the artwork with images or up-to-date valuations. All of this information needs to be sought out and regularly updated. If art is lost or stolen, the chances of recovery or adequate compensation are greatly reduced without such organized information. A trustee could be exposed to a claim for breach of fiduciary duty and negligence for failing to obtain and maintain adequate records of the art collection.

Mitigating Risks with Art Investment Vehicles

A good art fund manager must be keenly familiar with the risks associated with the purchase of individual works of art, including questions of authenticity, title, condition, and provenance. This can only be achieved through the

depth of expertise, market intelligence and experience within its management team. However, there is no guarantee -- due to the lack of transparency in the art market -- even with a team of top professionals that that an individual work thought to have been genuine at the time of purchase by the fund may not subsequently turn out to have been counterfeit or have defective title.

In advance of purchases, art fund managers should seek to establish provenance as part of the buying process and verify that works of art which it is considering for the fund are not registered on a stolen art database. Sellers may not always be the rightful or legitimate owners of art in their possession, and in certain cases may be unaware that their right of ownership is impaired. This applies to art stolen (and particular risks in respect of works of art stolen during the Holocaust) or art illegally exported from source countries such as Italy or Turkey. In effect, those art funds that are the most successful will be those that have set up adequate risk management mechanisms to afford protection to investors. To do so, they must form partnerships with dealers, curators, brokers, insurance companies, appraisals and other art sector experts supported by quantitative and qualitative research.

It is also important to understand the fund management risks associated with an alternative asset art fund. The failure of an investment fund to mitigate the art and collectibles market legal title risk creates Directors and Officers and Errors and Omissions liability for:

(i) Inadequate disclosure of investment risk factors (the best due diligence standards in the art and collectibles market cannot eliminate the legal title risk; if a fund loses one work of significant value in the portfolio due to a legal title issue, this will severely erode the fund's ROI from which the fund will not be able to recover in a three- to five-year exit period).

(ii) Inability to secure Unqualified Audit reports and the failure to disclose this fact in investor solicitation materials. The inability to secure an Unqualified Audit report is heightened by the now-mandatory in the U.S. Uniform Standards of Professional Appraisals Practice ("USPAP") valuation standards, which also have been adopted as the de facto standard for valuing art and collectibles in the EU.

(iii) Inability of funds to close at their designated exit without creating claw-back liabilities for investors and in turn professional liability for fund management and advisors if the fund does not properly reserve for contingent liabilities flowing from the rescission of sales of fund assets or from the enforcement of warranties the fund gave of clear legal title in order to effect the sale.

Art-associated risks may also impact the integrity of financial results for art funds. Title insurance is the only means by which an alternative asset investment fund can assure to the fund's auditors and in turn to the fund's investors that fund ROI's are conflict-free based entirely on arms-length transactions with no manipulation by any party including fund principals. By virtue of its underwriting, a title insurance company will have the necessary confidential information to be able to provide an independent third-party certification to the auditors that all fund purchases and sales are arms-length transactions. In addition, a title-insurance-based underlying certification enables the fund's auditors to provide an overall certification of the financial integrity of audited results in the form of an Unqualified Audit report.

Conclusions

As we look toward the future, we can expect that globalization and structural inefficiencies in the art market will continue to drive demand for financial innovation around art assets by sophisticated collectors and investors. As younger generations of wealth assume leadership of family offices, new approaches to managing important family collections will be demanded requiring long term financial planning. Equally important, higher prices reached in the global art market for works of art have made art more desirable and, therefore, unfortunately also more desirable targets for illicit practices. The development of preventative strategies for dealing with the problems of art theft, forgery, title defects and illicit traffic of works will depend in large part on the willingness of those providing financing to the art market to adopt best practices including requiring title insurance and executing due-diligence to the fullest extent possible.

About ARIS Title Insurance Corporation

ARIS Title Insurance Corporation is the recognised global authority on the subject of legal title risks impacting the global fine art market. ARIS is the only insurer that underwrites title insurance for fine art and other important collectibles. ARIS manages art market title risks utilising underwriting protocols and proprietary tools based on assuming the financial risk of defective legal title, which is in contrast to the traditional art industry practices 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. ARIS Title Insurance Corporation is a member of Argo Group International Holdings, Ltd.

About Fine Art Wealth Management

Fine Art Wealth Management (FAWM) is the first wealth management consultancy dedicated exclusively to art, collectibles and other investments of passion as an alternative asset class and the disciplines required to analyse this complex field of investment. We are wealth structuring specialists in art assets and the leading provider of intelligence on art wealth planning to sophisticated collectors, wealth managers, private banks, family offices and professional advisors.

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