A Primer for Family Offices and Institutional Investors on Art and Other Alternative Asset Investment Funds

By Lawrence M. Shindell, J.D., Chairman
ARIS Title Insurance Corporation
New York, New York, United States
August 2012

As the leading title insurer in the world for fine art and other important collectibles, we know that nearly all of the currently estimated $960 million to $2.25 billion invested in art and other alternative asset (sometimes referred to as passion) investment funds worldwide comes from multi- and single family offices and thus substantial wealth individuals. These alternative asset investment funds are also now seeking to expand and draw in capital from institutional investors.

Family offices and institutional parties that have invested in or are considering investing in art or other alternative asset investment funds should thoroughly review how the subject fund manages the art and collectibles market legal title risks.

By legal title risks, we mean the risk that an investment fund does not acquire clear legal title – or ownership – of the asset purchased. In the art and collectibles world, "possession is *not* nine-tenths of the law." The risk of defective legal title continues to pervade the global art and collectibles markets, despite the best due diligence efforts of the transacting parties, because these markets are opaque and unregulated.

For more information on the legal title risks in the art and collectibles markets, see http://www.aristitle.com/news/docs/ARIS_Article_PAM_Magazine_November2011_DistributedPAMPermission.pdf and other articles at http://www.aristitle.com/news/index.php.

There are significant consequences to investors if a fund does not manage these risks properly; and this has become a rapidly increasing issue as the alternative asset investment sector continues to mature and continues to push toward institutional investment standards.

ARIS works with several leading international art investment funds and fund associations to help this sector update their best practices and mandate the use of title insurance in every fund sales or purchase transaction as a necessary risk management and investor-protection tool.

There are two key reasons for family offices and institutional investors to mandate that the funds in which they invest follow this best practice.

The first goes to fundamental management of investor risk. The failure of an art investment fund to manage the art and collectibles market legal title risk creates Directors and Officers and Errors and Omissions liability around: (i) inadequate disclosure of investment risk factors (the best due diligence standards in the art and collectibles market cannot eliminate the title risk, and 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 general three to five year exit period); (ii) inability to secure Unqualified Audit reports (especially under the now mandatory Uniform Standards of Professional Appraisals Practice ("USPAP") (mandatory in the U.S., adopted as the *de facto* standard in the EU) for valuing art and collectibles); and (iii) inability of funds to close at the 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 rescission of art sales or from the enforcement of warranties that the fund gave of clear legal title.

The $600 million collapse and eventual delisting of the Canadian-based Sino-Forest fund in May 2012 amid questions over whether the fund had clear legal title to the fund's assets, $35 million in investigatory and curative legal expenses later and the cascading liabilities to the fund's auditors, who wrongly assumed that the fund had clear legal title to the assets, are all a loud warning sign to the art investment fund sector.

Second, 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 ROIs are conflict-free based entirely on arms-length transactions with no manipulation by any party including fund principals. Only a title insurer, by virtue of its underwriting, will have the necessary confidential information and be able to provide an independent third-party certification to the auditors that the fund's purchase and sales transactions are arms-length on which the fund's auditors can rely to provide an overall certification of the financial integrity of audited results to investors.

If an art or other alternative asset investment fund does not acquire title insurance and reap the corollary benefit of a formal auditing integrity practice, then the fund will not have an acceptable means to assure investors that stated ROIs are unbiased; the fund will be hampered from drawing investments from the institutional sector, which requires compliance with ILPA standards; and the fund will not achieve its business plan forecasts on growth of assets under management.

We encourage family offices and other investors to refer to www.ilpa.org for more information on institutional investment standards and to www.aristitle.com for more information on the title risks in the global art and collectibles markets.

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